BOFIT Weekly – Russia headlines 2007

5.1.2007 BOFIT Weekly – Russia 1/2007
• Russian GDP up nearly 7% in 2006.
• Russian inflation 9% in 2006.
• Gazprom doles out hefty hikes in export prices to CIS countries; Belarus and Georgia not happy.

• Russian current account surplus at 11% of GDP.
• Stabilisation fund at 10% of GDP as of end-2006.
• Central Federal District records lowest fixed investment growth.
• Heavy subsidies of consumer gas and electricity prices continue.

• Sharp rouble appreciation during 2006.
• State continues to pay off foreign debt; private sector increases borrowing.
• Russian RTS index hit record high at the end of 2006.
• Growing role for small and medium-sized enterprises.

• Modest growth in oil and gas production in 2006, decline in exports.
• Industrial output, retail sales and construction growth continues in Russian Federal Districts.
• New year, new regulations.

2.2.2007 BOFIT Weekly – Russia 5/2007
• Russian wages rise rapidly.
• Brisk economic growth expected to continue.
• CBR lowers rates.
• India and Russia put new touches on cooperation during Putin visit

• Russian inflation continues to decline.
• Russian economy grew 6.7% in 2006.
• Putin urges oligarchs to internationalise.
• The lofty ambitions of Russian aerospace.

• BOFIT forecasts 6.4% GDP growth for Russia this year.
• CBR increases euro weight in currency basket.
• Challenges facing Russia’s banking sector.
• Russia raises export tariffs on raw wood.

• Brisk foreign trade growth in 2006.
• Russia ramps up cooperation on natural gas development.
• Finnish industry cuts back on investment in Russia.
• New faces in the cabinet and CBR board.
- Structural problems in Russia’s labour markets.
- Russia invests in defence industry and modernisation of weapons systems.
- Local administration reforms stumble.

- Russian 12-month inflation slows to 7.6% in February.
- CBR reveals composition of foreign currency reserves.
- Decline in mobile phone exports to Russia depresses Finnish export growth to Russia.

- President Putin sends annual budget message to parliament.
- Further hike in deposit guarantee.
- 14 regions elect new regional parliaments.

- Growth in foreign investments in Russia slowed in 2006.
- Russia’s 2006 consolidated budget strongly in surplus.

30.3.2007 BOFIT Weekly – Russia 13/2007
- Russia’s WTO talks continue.
- Prime minister Mikhail Fradkov visits Africa to study business cooperation opportunities.
- Possible changes ahead for electricity sector privatisation plan.
- Finns increase portfolio investment in Russia.

5.4.2007 BOFIT Weekly – Russia 14/2007
- Russian 2006 current account surplus shrank slightly as share of GDP.
- Regional budget surplus up in 2006.
- Russian oligarchs get wealthier.

- Russian inflation continues to decline.
- Rouble appreciation slows.
- Gas exporters establish committee to study formation of gas prices.
- Yukos bankruptcy assets on the auction block.

- National programs of Russia in 2006.
- Housing prices grew rapidly in 2006.
- Stock market rise continues.

27.4.2007 BOFIT Weekly – Russia 17/2007
- Russian economic growth accelerated in the first quarter.
- Significant changes in Russia’s budget process.

4.5.2007 BOFIT Weekly – Russia 18/2007
- President Putin’s state-of-the-nation address to the parliament stresses higher spending on economic and social development.
- Government approves main principles of 2008 monetary policy programme together with the budget.
11.5.2007  BOFIT Weekly – Russia  19/2007
• Inflation picked up slightly in April.
• Rise in producer prices slows.
• Government approves 2008 privatisation programme.

• CBR hikes reserve requirements for commercial banks.
• First-quarter trade surplus down from previous quarters.
• Russia and Central Asian countries intensify cooperation on development of natural gas resources.
• Vyugin resigns as head of federal financial watchdog agency.

25.5.2007  BOFIT Weekly – Russia  21/2007
• EU–Russia summit in Samara delivers little in way of concrete solutions.
• Russia gradually increases its share of EU trade.
• Consensus forecast of Russian growth boosted after strong economic performance in 1Q.
• Low growth in agriculture despite reforms.

• Russian state increases its role in the energy sector.
• Law establishing new development bank approved.
• Russian prime minister visits Finland.

• Russian inflation remains within target range.
• Rapid investment growth continues.
• Russian share prices seesaw in first half of the year.

• Optimism prevails at St. Petersburg international economic forum.
• Incremental deregulation of gas prices for industrial users gets underway.
• Demand for passenger cars continues to rise sharply; foreign makes increasingly take over the market.

• Economic output continues to soar.
• IMF urges budgetary restraint and inflation-fighting measures.
• Russia a major energy producer and consumer.

• Gazprom strengthens its position.
• Russian courts increasingly afflicted with corruption.
• Russia confronts large regional disparities.

• Société Générale strengthens its position in Russia.
• Italians purchase a stake in Russian aircraft company Sukhoi.
• Global warming effect hits Russia’s arctic areas hard.
• Huge investment needed for Sochi 2014 Winter Olympics.

• Russia to establish new state companies.
• Russia invests in nanotechnology.
• Population decline poses new challenges for Russia.

27.7.2007  BOFIT Weekly – Russia  30/2007
• Strong economic growth continues in Russia.
• Liquidity levels rise on higher oil prices and increased capital inflows.
• Wages up, unemployment down.

• Government submits strategic sector draft legislation to Duma.
• Russia’s WTO talks continue.
• New legislation on small and medium-sized companies.

• More funds for development of Russia’s Far East.
• Rapid banking sector growth continues.

• Capital inflows into Russia continue.
• The increasing prominence of Russia’s metals sector.
• No major changes in Russian military spending as a share of GDP.

• Global stock market jitters reach Russia; increased volatility in rouble exchange rate.
• Business climate shows signs of modest improvement.
• SCO leaders meet in the Kyrgyzstan capital of Bishkek.

• Strong first-half federal budget performance.
• Regional budgets also post surpluses in first half.
• Russia’s electricity exchange sees sharp increase in electricity prices.

• Russia prepares for elections.
• Economic growth spreads increasingly to regions.

• BOFIT sees Russia’s strong economic growth continuing.
• Tight liquidity situation also evident in Russia.
• Russian banks and companies kept piling on foreign debt.
• Russian government disbands.
• Russian inflation still rapid.
• Economic growth accelerated in 1H07.
• Domestic natural gas prices still well below export prices.

• President Putin blesses new cabinet of prime minister Viktor Zubkov.
• Rise in housing prices rapid, but slowing.
• Growth in Finland’s exports to Russia slowed in 1H07.

5.10.2007  BOFIT Weekly – Russia  40/2007
• Russia’s current account surplus shrinks.
• Liquidity remains tight on Russia’s financial markets.
• President Putin’s candidacy strengthens United Russia’s position in upcoming Duma elections.

• Food prices on the rise.
• State’s role in the economy increases.
• Criticism at CIS summit in Dushanbe.

• Central bank moves to prop up banking sector.
• Russia lures foreign investment.

• Brisk economic growth continues.
• Food producers and sellers agree to price ceilings for basic food items.
• State companies account for increased oil production.

2.11.2007  BOFIT Weekly – Russia  44/2007
• Public spending soars ahead of the elections.
• Little achieved at last week’s EU-Russia summit in Portugal.

• Russian banking sector continues to grow rapidly despite jitters on international finance markets.
• Finnish companies’ operations in Russia increased significantly in 2006.

• Law on strategic branches postponed.
• State fosters revival of Russia’s shipbuilding industry.
• RAO Unified Energy System set to wind down at the beginning of July 2008.
• Russian’s actively invest abroad.

• Russia makes almost no headway in international competitiveness.
• Russia increases special economic zones.
• Lower-house Duma adjourns final session of term.
• Russia readies for elections.
• Gazprom world’s eighth largest company in terms of market value.

• United Russia again dominates Duma elections.
• German Gref to head Sberbank.
• Russia begins talks on OECD membership.
• Russia’s WTO talks plod ahead.

• Russian real exchange rate continues to appreciate; inflation picks up.
• Natural gas prices on the rise.
• Medvedev candidacy announced.

• Russian economic growth accelerated slightly during this year.
• Resolution of Russia-Poland meat dispute paves way for talks on renewing EU-Russia cooperation pact.
• Russian students score poorly in latest PISA study.
BOFIT Weekly – China headlines 2007

5.1.2007  BOFIT Weekly – China  1/2007
• Chinese stock markets boom in 2006.
• Fewer benefits for foreign companies operating

• China promotes the development of interbank markets by introducing SHIBOR; PBoC tightens monetary stance.
• China’s 2006 foreign trade surplus hits $177 billion.
• ICBC acquisition of Indonesia’s Bank Halim – a milestone for Chinese banking.

• China’s foreign currency reserves shattered trillion-dollar mark in 2006.
• Foreign direct investment flows into China remained strong in 2006.
• Yuan continues to appreciate.
• Asia considers vast free-trade area; China and Japan mend fences.

• China’s GDP growth accelerated to nearly 11 % in 2006.
• Finance conference sets main directions for finance sector.
• China drops in economic freedom rankings.

2.2.2007  BOFIT Weekly – China  5/2007
• Robust economic growth to continue in China.
• Money supply growth slightly exceeded last year’s 16 % target.
• Income and labour productivity increase rapidly.

• President Hu makes second Africa tour in a year.
• Warnings of overheating cause stock market jitters.
• US files protest with WTO over China’s subsidy practices.

• China posts massive trade surplus in January.
• China climbs into global top ten for international patent applications.
• Bountiful grain harvest in 2006; major agriculture census underway.

23.2.2007  BOFIT Weekly – China  8/2007
• Chinese consumer price inflation remains low; central bank tightens its stance.
• Energy and raw material issues dominate China-Russia economic discussion.
• Both China and Russia fare poorly in global assessment of corporate tax burdens

2.3.2007  BOFIT Weekly – China  9/2007
• China’s stock market meltdown felt around the world.
• Chinese steel production continues to rise.
• China eases foreign currency regulations for private individuals.
• China’s National People’s Congress convenes.
• Paulson makes quick visit to China; yuan’s rise continues.
• China restricts capital imports to ease appreciation pressure on yuan.

• China posts massive trade surplus in February; exports of higher value-added products increasing.
• China strengthens its position as a major trade partner of Finland.
• China creates new investment company to manage part of its foreign currency reserves.

23.3.2007 BOFIT Weekly – China 12/2007
• People’s Congress ends by approving laws on corporate income tax and protecting property.
• State spending and income increase rapidly.
• PBoC hikes rates again.

30.3.2007 BOFIT Weekly – China 13/2007
• Chinese growth driving Asian economic development.
• Banking sector still burdened by non-performing loans.
• China launches new Postal Savings Bank.
• Chinese and Russian leaders pledge to increase economic cooperation.

5.4.2007 BOFIT Weekly – China 14/2007
• US escalates measures on Chinese imports.
• Rapid economic growth in Hong Kong and Macao continued in 2006.

• China’s foreign trade surplus doubled in 1Q07; US increases pressure on China.
• Yuan appreciation against the dollar slows; China lifts bank reserve requirements again.
• Huge gains on Chinese stock markets.

• Strong rise in China’s foreign currency reserves continued in first quarter.
• Tax havens provide increasing share of foreign direct investment in China.
• Wen Jiabao pays official visit to Japan.

27.4.2007 BOFIT Weekly – China 17/2007
• Economic growth of China accelerates slightly in first quarter.
• Inflation accelerated in March; money supply growth nearly on target.
• Higher income growth.

4.5.2007 BOFIT Weekly – China 18/2007
• PBoC monetary tightening measures avoid foreign exchange policy.
• China’s foreign debt small by international standards.
• Move to cities continues.

11.5.2007 BOFIT Weekly – China 19/2007
• Chinese share prices reach dizzying levels.
• China strives to become the world’s largest shipbuilder.
16.5.2007  BOFIT Weekly – China  20/2007
• Rising food prices feed inflation in China.
• China releases 2006 balance-of-payments data.
• CBRC eases rules on Chinese foreign investment abroad.

25.5.2007  BOFIT Weekly – China  21/2007
• Central bank tightens monetary policy further, widens yuan exchange rate fluctuation band.
• China-US strategic economic dialogue continues.
• State investment company made its first investment.

1.6.2007  BOFIT Weekly – China  22/2007
• Tripling of stamp duty on stock trades causes jitters.
• Imports now meet over half of China’s oil needs.
• Changes in fuel pricing regime.

• Stock market jitters, higher quotas for foreign institutional funds.
• Robust growth for China’s car industry even as competition intensifies.
• Rapid growth in Hong Kong and Macao continues.

• China’s trade surplus swells along with US dissatisfaction.
• Most Chinese FDI still goes to Asia.

• Slight pick-up in inflation; money supply growth nearly on target.
• Insurance sector grows rapidly; increased investment opportunities for insurance companies.
• Eight banks fined for lending to stock market speculators.

• Chinese securities brokers and fund managers gain limited possibilities to invest client funds abroad.
• 10th anniversary of Hong Kong handover to China.
• Listed firms to gain better possibilities to issue corporate bonds.

• US$200 billion in foreign currency reserves will be shifted to state asset management company.
• New labour contract law set to enter into force in January 2008.
• Study finds evidence that unreported income and income differences in China are greater than reported.

• No signs of moderation on growth of China’s foreign trade surplus.
• China expands its interbank markets.
• India increasingly attractive to investors, but still lags China substantially.

• China’s foreign currency reserves now exceed $1.3 trillion.
• China’s soaring stock markets take a breather; IPO boom on Mainland exchanges continues.
27.7.2007 BOFIT Weekly – China 30/2007
• China’s economic expansion accelerated further; 2006 GDP growth figures revised upwards.
• Consumer price inflation accelerates; monetary stance tightened.

• Incomes continue to rise; middle class keeps growing.
• Chinese export prices on the rise.
• Increased investment opportunities for insurers.
• Bank reserve requirements hiked.

• Chinese banks thrive in first half.
• Good summer harvests; higher food prices fatten farmer incomes.

17.8.2007 BOFIT Weekly – China 33/2007
• China's consumer price inflation picked up in July.
• Trade surplus, rising inflation and US disaffection increase pressure on China’s foreign exchange policy.
• Increases in electrical power generation capacity fail to keep up with rising demand; power shortages continue throughout China.

• China hikes benchmark rates.
• Opening up of financial markets continues; limited trial lets private individuals purchase foreign stocks.
• Easier rules on bond issues for exchange-listed companies.
• Income inequality in China continues to widen.

• China’s finance ministry issues 600-billion-yuan ($79bn) in special treasury bonds to fund state investment company.
• Growth in Chinese oil production lags rising demand; China and Russia compete for Central Asian energy resources.
• China-India trade expands rapidly.
• 17th People’s Congress set for mid-October.

7.9.2007 BOFIT Weekly – China 36/2007
• New competition law set for next August.
• Government postpones roll-out of trial scheme to let Chinese investors trade in foreign shares.
• Energy and raw materials dominate first phase of president Hu’s Australia visit.

• BOFIT foresees continued strong economic growth for China.
• Consumer price inflation picks up; monetary tightening continues.

• China hikes interest rates yet again.
• Slow appreciation of the yuan’s exchange rate continues.
• China’s trade surplus grows; growth in exports to the United States slows.
- Increased direct state support for Chinese banks.
- China improves and Russia slips in corporate business climate surveys.
- Rapid growth in Finland-China trade continues.

5.10.2007 BOFIT Weekly – China 40/2007
- State investment company officially begins operations.
- Minor changes in China’s foreign debt status.
- Chinese share prices keep climbing.

12.10.2007 BOFIT Weekly – China 41/2007
- China’s fiscal policies stress rural development and defence.
- Rapid growth in Chinese exports to Russia increasing demand for protectionist measures in Russia.

- China's Communist Party Congress gets underway.
- Further tightening from PBoC.
- EU removes quotas on Chinese textiles; monitoring of imports to continue.

- Europe joins in demands for faster yuan appreciation.
- Party congress consolidated China's leading figures for the next five-year period.
- Chinese bank operations abroad on the increase.
- Direct investment from China on the rise.

2.11.2007 BOFIT Weekly – China 44/2007
- Rapid economic growth continues.
- Rural incomes show record gains.

- China’s current account surplus rises to nearly 12% of GDP.
- China, India and Russia now account for half of global economic growth.

- Rising food prices the main factor behind inflation spike in China.
- China’s central bank tightens further in response to inflation pressures.
- PetroChina becomes the world’s largest corporation by market cap – in a falling market.

23.11.2007 BOFIT Weekly – China 47/2007
- Growth of fixed capital investment in urban areas remains brisk.
- China’s thirst for energy continues to grow.
- China-Russia gas pipeline projects move ahead.

- High level EU-China summit held in Beijing.
- Yuan showing slightly faster appreciation against US dollar.
- EU trade commissioner Mandelson weighs in on China’s failure to enforce intellectual property rights.
• Chinese financial institutions keep on investing abroad.
• East China Sea oil and gas field tops agenda at China-Japan summit.
• China still only making little efforts to deal with mammoth environmental problems.

• China’s inflation picks up; tighter monetary policy measures expected.
• China promises to open access to its financial markets and improve safety inspections of export goods at third round of US-China strategic dialogue.
• China’s foreign trade surplus continues to swell.

• Banks operating in China gain permission to invest Chinese assets in London financial markets.
• State companies begin to pay dividends to the state.
• Economic growth in Hong Kong and Macao remains robust.
Russia

Russian GDP up nearly 7% in 2006. President Vladimir Putin predicted at a year-end cabinet meeting that overall economic growth reached 6.9% in 2006, up from 6.4% in 2005. The president’s figure matched the economy ministry’s estimate published in December. Rosstat will release its official GDP estimate for 2006 in about four weeks. Rosstat’s most recent indicators for production cover the first eleven months of 2006. They show industrial output increased 4.1%, agricultural output 2.2%, transportation 2.1%, retail sales 12.8% and construction 14.2%.

Rosstat also released third-quarter GDP demand-side data at the end of December. The data suggest consumption and investment continue to drive economic growth. Consumption rose 9% in January-September and investment 13%. At the same time, exports grew just 6% in volume terms. Imports, on the other hand, soared 21%.

Contribution of core demand components to GDP, 2004–2006, on-year change, %

Source: Rosstat

Russian inflation 9% in 2006. Although full-year inflation exceeded the government’s original target range of 7–8.5%, it met the government’s later-adjusted 9% target. In any case, 2006 inflation was lower than the 10.9% rate of 2005. In recent years, inflation has been fuelled by high growth in export earnings from oil and other natural resources. Despite a modest decline in oil prices over the past six months, growth in foreign capital inflows continues to keep Russia awash with liquidity. The economy ministry estimates inflation will decline to 7% in 2008 and 6.5% by the end of 2010.

In 2006, prices for services led inflation, rising 13.9% y-o-y. Prices for foodstuffs increased 8.7% and other goods 6.0%. Within services, prices for water, public transport and education rose fastest. Within foodstuffs, highest price increases were registered for bread, grain and sugar. Gasoline and construction materials led price development in the other goods category.

Gazprom doles out hefty hikes in export prices to CIS countries; Belarus and Georgia not happy. Russian gas giant Gazprom continues to raise rates for CIS customers in its quest to raise prices towards world market levels. Belarus, which annually consumes more than 20 billion cubic metres of Russian natural gas, was forced to accept a doubling of its gas rates. After years of talks, Belarus also had to accept Gazprom’s acquisition of a 50% stake in the Belarusian gas pipeline grid operator Beltransgaz. About a fifth of Russian gas exports to Europe pass through Belarus, so the purchase will give Gazprom improved oversight of gas transmission via Belarus to western Europe. The deal carried a cash price of $2.5 billion. Belarus responded last week with the announcement that it was implementing a surcharge of $45-per-ton on Russian oil passing through its territory. It also declared its intention to stop buying Russian crude oil after Russia imposed an export fee of $180.70 per ton of oil exported to Belarus.

Georgia, which also has political differences with Russia, found its more than two-fold hike in Russian gas prices too much to swallow. Prime minister Zurab Nogaideli said Georgia will seek to purchase most of its annual 1.8 billion m³ gas needs from Azerbaijan at a price of $120/1,000 m³.

Gazprom contract prices for select countries, 2005–2007, US$/1,000 m³

<table>
<thead>
<tr>
<th>Country</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
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<tr>
<td>Western Europe</td>
<td>174*</td>
<td>250*</td>
<td>260**</td>
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<tr>
<td>Germany</td>
<td>200</td>
<td>250</td>
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<tr>
<td>Azerbaijan</td>
<td>60</td>
<td>110</td>
<td>235**</td>
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<td>Georgia</td>
<td>68</td>
<td>110</td>
<td>235</td>
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<td>n.a.</td>
<td>n.a.</td>
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<tr>
<td>Slovenia</td>
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<td>n.a.</td>
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<tr>
<td>Poland</td>
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<td>n.a.</td>
<td>n.a.</td>
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<tr>
<td>Latvia, Lithuania, Estonia</td>
<td>90*</td>
<td>123*</td>
<td>240*</td>
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<td>Moldova</td>
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<tr>
<td>Belarus</td>
<td>47</td>
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* Average; ** Preliminary information

Figures compiled from several news sources.
China

Chinese stock markets boom in 2006. Chinese stock markets have boomed faster than other exchanges since the long slump in share prices ended in 2005. Last year, shares rose 130% on the Shanghai bourse and 95% on the Shenzhen bourse. The market capitalisation of the Shanghai stock exchange is about $800 billion and the Shenzhen stock exchange $230 billion. The market capitalisation of the Hong Kong stock exchange was $1,700 billion at the end of last year. Emerging market equity funds globally had net inflows of over $22 billion last year. About half of that net increase went to Chinese stocks.

China’s stock exchanges, buoyed by the general rise of stock markets internationally and China’s robust economic growth, got an extra boost from the country’s advances in market reforms. The process of converting non-tradable state shares of listed firms to tradable shares commenced in 2005 is now nearly complete. At the start of 2007 only 40 companies were still in the process of converting shares, and Chinese bourses have imposed limits on the daily price changes of these companies’ shares to spur them to complete the share conversion process. The state rewarded the generally good progress in conversion in May by lifting a one-year ban on IPOs. Since then there have been several impressive IPOs, including the world’s largest IPO ever with Industrial & Commercial Bank of China (ICBC) staging a $22 billion IPO on the Hong Kong and Shanghai bourses at the end of October.

Despite market liberalisation, share trading is still strictly regulated. Trading of new marketable shares has been strictly limited for the next three years, and foreign possibilities to participate in A-share trading are only allowed for a select group of international investors. The number of tradable shares available is still rather limited, which may increase volatility in the Chinese stock markets. On the other hand, limits on foreign capital reduce the sensitivity of Chinese stock prices to international shocks.

A new feature in the Chinese stock markets is a fast increasing enthusiasm of households to invest in equity funds. Last year, people opened nearly three times the number of accounts with investment funds than in 2005. The shift can be seen in the shift of savings away from standard savings accounts. The People’s Bank of China reports that 10% of depositors have invested in mutual funds. Households, nevertheless, are naturally poorly informed about stock market risks and also fund management companies have shown themselves to be vulnerable.

Fewer benefits for foreign companies operating in China. The long drafted bill on unification of income tax rules for foreign and domestic enterprises is finally ready. As presented, the prevailing corporate income tax would be 25% and 15% for high technology fields. Foreign companies operating in China now nominally pay an income tax rate of 15%. While domestic firms pay a higher rate of 33%, they also enjoy numerous tax breaks. As a result, their effective tax rate is 24%. The proposed law would strip foreign firms of e.g. the tax breaks they get during their five first years of operations. Current tax breaks will continue, however, five years from the time the law enters into force. Assuming the final bill on tax harmonisation get formal approval at the People’s Congress in March, it would enter into force at the beginning of 2008 at the earliest.

Sources: Bloomberg and RTS

The tax harmonisation measures are expected to reduce the state’s tax take by 90 billion yuan (€9bn). Chinese officials say unification of tax rules should have little impact on foreign firms as most foreign firms are engaged in high-tech industries.

A law reducing land use benefits for foreign-owned firms entered into force this week. Foreign companies must now pay the same tax for land use as domestic firms. The amount of the annual land use tax varies widely depending on location and land quality, but the tax rate is very low (0.6–30 yuan/m²).

Chinese officials hope unification of taxation on foreign and domestic enterprises will simplify tax practices and create a level playing field for domestic and foreign enterprises. By plugging a number of tax loopholes, Chinese companies will no longer have an incentive evade taxes by circulating domestic capital via third countries.
Russia

Russian current account surplus at 11 % of GDP. The latest balance-of-payments figures from the Central Bank of Russia show a current account surplus of nearly $78 billion for the first nine months of 2006. The trade surplus in goods rose to more than 16 % of GDP. The services trade deficit corresponded to 2 % of GDP. The investment income and compensation of employees account deficit grew to nearly 3 % of GDP, reflecting higher spending on dividends and debt servicing.

Within the financial account, foreign direct investment in Russia rose in January-September to $25 billion, or more than 3.5 % of GDP. Foreign portfolio investment in Russia amounted to $12 billion. Direct investment outflows from Russia increased to $14 billion, while Russian portfolio investment abroad shrank to $0.5 billion. The capital outflow from Russia in the form of non-repatriation of exports proceeds, non-supply of goods and services against import contracts and remittance against fictitious import contracts in securities diminished a bit last year, but still amounted to nearly $15 billion. Russian firms and banks also substantially increased their borrowing from abroad.

The CBR’s the foreign currency reserve climbed by $76 billion in the first nine months of 2006, and stood at $289 billion at the beginning of December. Russia currently has the world’s third-largest goods trade surplus, third-largest foreign currency reserves and fourth-largest current account surplus.

Stabilisation fund at 10 % of GDP as of end-2006. The finance ministry reports that as of end-2006, the stabilisation fund totalled 2,350 billion roubles ($89bn). The purpose of the stabilisation at its inception in 2004 was to collect part of revenues from export taxes and mineral extraction fees from the oil sector in a fund in order to insulate the Russian economy from the effects of fluctuating oil prices. The fund has grown faster than expected, allowing Russia to release fund assets to e.g. pay down its foreign debt. Last August, Russia paid off all of its Soviet-era debt to Paris Club ahead of schedule. Despite the spending of fund assets, the fund doubled in size last year, and stood at $289 billion at the beginning of December. Russia currently has the world’s third-largest goods trade surplus, third-largest foreign currency reserves and fourth-largest current account surplus.

Central Federal District records lowest fixed investment growth. The Central Federal District accounted for nearly a quarter of fixed capital investment nationwide in January-September 2006. Growth was, however, dragged down by investment growth of less than 4 % in the City of Moscow, even as the Moscow Region enjoyed growth above 10 %. Growth in the Volga Federal District was hampered by a 1 % drop in fixed investment in the Republic of Tatarstan.

The fastest growth was seen in the Far East Federal District, where it climbed 22 % thanks to strong investment growth in the Sakhalin Region. The 19 % growth in the North West Federal District was driven by booming fixed investment in the Leningrad Region and the Arkhangelsk Region, which includes the resource-rich Nenets Autonomous District. Investment growth in the City of St. Petersburg was below 4 %.

12-month change in fixed investment and federal district shares for January-September 2006, %

<table>
<thead>
<tr>
<th>Federal District</th>
<th>Fixed investment Growth</th>
<th>Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Central</td>
<td>5.4</td>
<td>23.7</td>
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<tr>
<td>North West</td>
<td>19.4</td>
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<tr>
<td>South</td>
<td>13.8</td>
<td>8.4</td>
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<tr>
<td>Volga</td>
<td>12.0</td>
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<tr>
<td>Ural</td>
<td>16.2</td>
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<td>Siberian</td>
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<tr>
<td>Far East</td>
<td>22.4</td>
<td>7.9</td>
</tr>
</tbody>
</table>

Source: Rosstat

Heavy subsidies of consumer gas and electricity prices continue. The IEA reports that the Russian state in 2005 subsidised 57 % of the price paid by consumers for gas and 34 % for electricity. The figures refer only to end-user prices; cross-subsidies from industry to households are not taken into consideration. Energy subsidies overall exceeded $40 billion last year, of which $25 billion went to holding companies. The cap on energy subsidies is currently set at 3.5 % of GDP. Foreign portfolio investment in Russia rose in January-September to $25 billion, or more than 3.5 % of GDP. The purposes of the stabilisation fund are to collect part of revenues from export taxes and mineral extraction fees from the oil sector in a fund in order to insulate the Russian economy from the effects of fluctuating oil prices. The fund has grown faster than expected, allowing Russia to release fund assets to e.g. pay down its foreign debt. Last August, Russia paid off all of its Soviet-era debt to Paris Club ahead of schedule. Despite the spending of fund assets, the fund doubled in size last year, and stood at $289 billion at the beginning of December. Russia currently has the world’s third-largest goods trade surplus, third-largest foreign currency reserves and fourth-largest current account surplus.

Stabilisation fund and federal government external debt, US$ billion

Source: CBR and Ministry of Finance

Heavy subsidies of consumer gas and electricity prices continue. The IEA reports that the Russian state in 2005 subsidised 57 % of the price paid by consumers for gas and 34 % for electricity. The figures refer only to end-user prices; cross-subsidies from industry to households are not taken into consideration. Energy subsidies overall exceeded $40 billion last year, of which $25 billion went to holding down gas prices and $15 billion to electricity prices. As low consumer prices do not promote higher energy efficiency, society economist German Gref would like to see Russia gradually bring wholesale prices for electricity and gas into line with world-market prices by 2011, even if household subsidies continue after that. Households represent 34 % of gas consumption and 22 % of electricity consumption.
China

China promotes the development of interbank markets by introducing SHIBOR; PBoC tightens monetary stance. After a month-long start-up period, China’s monetary authorities started to publish the new Shanghai Interbank Offered Rate (SHIBOR) from the beginning of January. SHIBOR rates now are quoted for overnight, one-week, two-week, 1-, 3-, 6-, 9- and 12-month borrowing. Rates are based on daily quotes for the various maturities received from 16 commercial banks, including three foreign banks.

The SHIBOR is not a true reference rate yet as commercial banks still are not compelled to lend to each other at SHIBOR rates (i.e. these banks are not yet market makers). Other bank lending is also strictly bound to rates set by the central bank. Currently, the reference rate ceiling on interest paid on consumer deposits with commercial banks is just 2.52%. The reference rate on bank lending is 6.12% and banks are forbidden to lend at rates of less than nine-tenths of the reference rate. The 12-month SHIBOR rate on Friday (Jan. 12) was 3.00%.

China’s first interbank lending rate, the CHIBOR, introduced in 1996, was never suitable as a true reference rate. It was based on implemented bank lending contracts among banks. The CHIBOR’s practical value has remained minor, a reflection of the underdevelopment of China’s interbank lending market. For years, interbank lending has suffered from the thinness of the market, the dominance of a few large actors, and a lack of transparency and trust among banks. The People’s Bank of China would like to see the SHIBOR promote the evolution of a robust interbank lending market and new derivative products such as interest rate swaps. The PBoC also hopes the SHIBOR will help in judging the liquidity situation of financial markets. This latest rate-setting reform is an extension of central bank efforts at controlling US Senate.

The PBoC has also been struggling to put the brakes on lending growth. The reserve requirement will rise to 9.5% next week – the fourth half-percentage-point hike in the last seven months. The reserve requirement had previously not been touched for over two years.

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China’s 2006 foreign trade surplus hits $177 billion. China Customs reports the country’s foreign trade surplus for December was $21 billion, raising the overall trade surplus for last year to a record-shattering $177 billion. The trade surplus swelled as export growth clearly outpaced import growth for a second year in a row. Growth in exports in 2007 is expected to remain brisk and the trade surplus is expected to at least match the 2006 performance.

Export growth remained vigorous throughout 2006 (27% y-o-y). Machinery and equipment accounted for 57% of all exports. Clothing and textiles increased 25% y-o-y and represented 15% of China’s total exports. Growth in clothing and textile exports has been restricted, however, after the EU, the US and several other countries imposed import quotas on Chinese products. Certain Chinese goods have also become subject to anti-dumping tariffs.

Imports climbed 20% y-o-y in 2006. Machinery and equipment accounted for over 50% of imports. China also imported 145 million tons of crude oil last year, an increase of 15% from 2005.

The EU (15% of total trade), US (15%) and Japan (12%) remained China’s top trading partners last year. Japan’s share of overall trade, however, dwindled for the third year in a row. Chinese Customs figures show the foreign trade surplus with the US increased last year to $144 billion. Calls for the Chinese government to allow faster appreciation of the yuan to help balance US-China trade have become louder with the seating of a new Democrat-controlled US Senate.

China’s foreign trade balance since 2000

ICBC acquisition of Indonesia’s Bank Halim – a milestone for Chinese banking. Industrial and Commercial Bank of China (ICBC), China’s largest bank, is set to take a 90% stake in the small Indonesian Bank Halim. The purchase represents to the first-ever acquisition of a foreign bank abroad by a Chinese bank. Bank Halim has twelve branch offices and total assets of about $50 million. The deal still requires approval from Chinese and Indonesian officials. The final decision on the sale will be voted on at Bank Halim’s meeting of shareholders at the beginning of February. Indonesia’s financial markets have expanded rapidly; in recent years, several international banks have begun to operate in the country.

ICBC, which reportedly is considering several international acquisitions this year, is not the only Chinese bank buying foreign assets. In December, Bank of China paid nearly a billion dollars for a Singapore-based aircraft leasing company. Newspapers have also mentioned China Construction Bank’s plans to buy a bank in the United States.
Russia

Sharp rouble appreciation during 2006. The rouble’s real effective (i.e. the CBR’s trade-weighted currency basket) exchange rate strengthened 7.6 % from December 2005 to December 2006 (10.5 % a year earlier). Massive earnings from raw-material exports and increased capital flows into Russia have been the main factors driving rouble appreciation. The rouble’s real exchange rate last year climbed 5.8 % against the euro and 17 % against the dollar. The CBR has so far strived to prevent further nominal appreciation of the rouble, which has been reflected in higher inflation. The nominal effective exchange rate strengthened 2.2 % (compared to 3.2 % a year earlier), the euro exchange rate weakened 1.7 %, and the dollar strengthened 9.6 %. Nominal exchange rates for the rouble at year’s end were 26.3 to the dollar and 34.7 to the euro. In its December forecast, the economy ministry said it expected the rouble’s effective real exchange rate to strengthen 4.6 % this year and 2.6 % next year.

Nominal and real rouble exchange rates, (Dec. 2001 = 100)

Source: Central Bank of Russia

State continues to pay off foreign debt; private sector increases borrowing. Russia used stabilisation fund assets last year to rapidly pay off foreign debt. At the beginning of October 2006, the Russian general government owed $46 billion in foreign debt, which was only about a third of what was owed in 2000. Since Russia paid off its remaining Paris Club debt, only $12 billion in Soviet-era liabilities remain on the government’s balance sheets. In 2000, Soviet legacy debt represented about 4/5 of the state’s external debt stock. The state’s improved financial position is reflected in higher credit ratings on sovereign debt and increased capital flows into Russia. Russia’s private sector, however, has increased its borrowing from abroad. As of end-October 2006, debt owed by Russian banks to foreign lenders was up 80 % y-o-y to $79 billion. External debt for the rest of the private sector increased 32 % to $136 billion. Despite the rapid growth in private sector indebtedness, Russia’s overall foreign debt relative to GDP remains quite low by international standards, about 29 % of GDP.

Russia’s external debt 2000–2006, US$ billion

Source: Central Bank of Russia

Russian RTS index hit record high at the end of 2006. The RTS index finished December with an all-time high of 1,921, a gain of over 70 % from December 2005. The index has since shed 6%. Interest in the Russian stock market has been fuelled largely by high world energy prices. Over half of the RTS index is weighted to oil and gas companies, with gas giant Gazprom and Lukoil each accounting for about 15 % of the RTS index’s total value. Investors now appear to be discovering shares of non-energy businesses in fields such as telecommunications, banking and retail sales. State-owned Sberbank and Vneshtorgbank are expected to hold IPOs this year. Russian firms raised about $18 billion from IPOs in 2006, a 3.4-fold increase from 2005.

Growing role for small and medium-sized enterprises. Although Russia’s small and medium-sized enterprise (SME) sector remains tiny by international standards, growth within the sector has begun to take off. A survey by MDM Bank found that SME output has grown nominally at a rate of 34 % a year throughout the 2000s, surpassing the nominal average of 26 % GDP growth during the same period. SMEs generated about 12 % of GDP last year, and employed about 12 % of Russia’s labour force. Official figures omit the self-employed and certain types of agricultural workers. When these are included, the SME share of the workforce rises to above 20 %. Under Rosstat’s definition, the SME sector consists of firms employing fewer than 100 people. Approximately 46 % of SMEs are involved with retail or food services, 12 % with industry and 11 % in construction. These three segments account for 80 % of SME-sector output. About half of SMEs operate in the Central or Northwest Federal Districts. Strong growth in SMEs is also occurring in the South and Volga Federal Districts. Policy measures such as simplification of rules for setting up a company have contributed to growth of the SME sector.
China

China’s foreign currency reserves shattered trillion-dollar mark in 2006. China’s foreign currency reserves increased last year by $247 billion to $1,066 billion at year’s end. Some $177 billion of the rise resulted from China’s booming trade surplus. The second largest factor contributing to the increase was foreign direct investment (see below). China surpassed Japan as holder of the world’s largest currency and gold reserves last February.

While the People’s Bank of China does not reveal the structure of its foreign currency holdings, it is widely believed that the yuan’s dollar peg of earlier years resulted in the PBoC holding about 80% of its foreign currency reserves in dollar-denominated instruments. An active discussion in China has arisen recently as to whether it may be prudent to diversify reserve holdings into other currencies to spread risk. According to some estimates, the central bank has been increasing euro and yen purchases so that at the moment only about 65–70% of new incremental reserves are invested in dollar assets.

China’s foreign currency reserves, US$ billion

Yuan continues to appreciate. Since mid-2006, the PBoC has permitted the yuan to strengthen relative to the dollar at a slightly higher pace. Last week, the yuan-dollar rate fell below the 7.8 mark. Early this week, the yuan hit another milestone with the rate for the Hong Kong dollar, which is pegged to the US dollar, slipping below 1. The event, however, had no impact on Hong Kong’s foreign exchange policy. A vast majority of market observers expect Hong Kong to keep its US-dollar peg in place during the coming year. On Friday (Jan. 19), one US dollar bought 7.775 yuan and a Hong Kong dollar 0.996 yuan.

Yuan-dollar, yuan-euro rates, 2005–2007

Source: Reuters, Bank of Finland

Asia considers vast free-trade area; China and Japan mend fences. Last week’s meeting of Asian foreign ministers in the Philippines included representatives from ASEAN countries (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam), Australia, China, India, Japan, Korea and New Zealand. Although the theme was foreign trade, discussions also touched on energy issues. The 16 countries attending supported a Japanese initiative on creation of a huge free-trade area that would encompass about half of the world’s population. China has presented a more modest initiative covering 13 of the countries present. India, Australia and New Zealand were omitted because China is currently engaged in separate bilateral free-trade talks with them.

The meeting also saw China and ASEAN members agree on extending their current free-trade agreement (which was launched in summer 2005) to include services. The gradual liberalisation of trade in services will begin in July. ASEAN members and China hope to achieve near-complete free trade in goods by 2015.

Long-inflamed China-Japan relations have improved significantly since Japan’s new prime minister Shinzo Abe took office. Unlike Japan’s previous prime minister, who avoided travel to China for five years, one of Abe’s first acts was to pay a visit. Chinese prime minister Wen Jiabao will visit Japan this spring and Abe will again visit China this summer. Official Chinese media seem ready to declare 2007 the year of Chinese-Japanese friendship.

Foreign direct investment flows into China remained strong in 2006. Foreign direct investment in China last year totalled $69 billion, of which $6 billion went to the finance sector. During the past three years, the inflow of direct investment into China has remained remarkably stable.

China’s latest investment program, published at the end of last month, emphasises the need for China to encourage large international technology firms to move manufacture and assembly of their most advanced products in China, as well as conduct more of their R&D activities in China. FDI outflows from China remain small ($12bn in 2005), but continue to grow rapidly.

The United Nations Conference on Trade and Development preliminarily estimates that last year 6% of foreign direct investment worldwide went to China, a decline of two percentage points from 2005. UNCTAD said that slightly less than a third of all Asian FDI went to China.
Russia

Modest growth in oil and gas production in 2006, decline in exports. Russia produced 480 million tons (9.6 million bpd) of crude oil last year, making it the world’s second largest oil producer after Saudi Arabia. Russian oil production, however, grew just 2.1% on year – a considerable slowing from the pace of growth in the early 2000s. Production climbed fastest at state-owned Rosneft and the privately owned oil companies LUKoil, Russneft and Surgutneftegaz. The economy ministry estimates that Russia exported 252 million tons of crude oil in 2006, a 0.4% drop from 2005. Exports of oil products rose to 104 million tons (a 6.5% increase from 2005). Many oil companies have reduced crude oil exports and increased their refining capacity to take advantage of lower taxation on exports of refined oil products relative to crude oil.

Russia last year was the world’s largest gas producer, generating a total of 656 billion cubic metres of natural gas. Gas giant Gazprom, by far Russia’s largest gas producer, accounted for over 80% of total production. Number-two gas producer, the privately held Novatek, accounted for just 4% of production. According to the economy ministry, Russia exported 203 billion cubic metres of gas (2.3% less than in 2005). Half of gas exports went to Western Europe, a fifth to Central and Eastern Europe and a third to the Baltics and CIS countries.

On-year change in Russian crude oil and gas production and exports 2001–2010, %

In January-November, the growth in retail sales was slowest in the Central Federal District, which accounted for about 36% of retail sales nationally. Even though the City of Moscow alone accounted for 21% of all retail sales nationally, growth in retail sales in Moscow was up less than 7%. Retail sales growth in the surrounding Moscow Region was up 26%. The highest growth in retail sales was measured in the Ural and Volga Federal Districts.

Construction activity was again highest in the Central Federal District, which accounted for 30% of all construction activity in Russia in the January-November period. The City of Moscow represented for about half of the Central Federal District’s share. Construction activity increased fastest in the North West Federal District. In St. Petersburg, construction grew 31% and the city’s share of the entire country construction was 6%.

On-year change in retail sales, industrial output and construction by federal district, January–November 2006, %

New year, new regulations. Following last summer’s disputes with immigrants, president Vladimir Putin has initiated new measures to limit the working possibilities of immigrants. Under a government decision in November, foreigners will no longer be allowed to work in sales of alcohol or pharmaceuticals, and after March, also at outdoor markets and sales booths. The new rules are intended to regulate the millions of workers from CIS countries, the bulk of which are said to work without work permits.

Under a tax amnesty approved in December, citizens who failed to pay their income taxes before 2006 can pay their tax arrears without retribution. The arrears should be paid off during this year and settled at the standard tax rate of 13%.

The Duma last week approved a proposal, whereby a state-owned holding company will manage Russia’s entire nuclear power sector. The 31 nuclear reactors operating at Russia’s ten nuclear power plant sites produce about 16% of Russia’s electricity.

After months of back-and-forth, the Duma and the Federation Council approved the transfer of the Constitutional Court from Moscow to St. Petersburg. The move is scheduled for autumn 2008 and will require extensive construction and renovation works.
China

China’s GDP growth accelerated to nearly 11% in 2006. Preliminary figures from the National Bureau of Statistics show that GDP grew 10.7% last year in real terms. The total value of GDP was 20,940 billion yuan (about €2.1 trillion). After peaking in the second quarter, the pace of economic growth slowed to 10.4% y-o-y in the fourth quarter. The largest contributions to GDP came from industry and construction (49% share of GDP) and the service sector (39%). The relative contribution of agriculture to GDP continued to decline, falling below 12% of GDP. At the same time, the NBS released a revised 2005 GDP growth figure of 10.4%.

The acceleration in GDP growth last year was driven by booming exports that swelled the foreign trade surplus to nearly $180 billion. Even if fixed capital investment growth slowed from 2005 by two percentage points, it was still up 24% y-o-y. China targeted specific industries of the economy (mainly the raw material sector) last year with administrative controls to limit investment growth. Retail sales grew by nearly 14%, the highest growth seen in ten years.

Consumer price inflation accelerated slightly towards the end of the year, reaching 2.8% y-o-y in December. The rise in prices was largely driven by higher food prices.


This latest conference dealt with three familiar issues. On the first of what to do with central bank foreign currency reserves, it appears China’s leaders have decided that a part of the reserves will be entrusted to an investment firm for management in order to secure a higher return on currency reserve assets. A likely candidate for the task is the central bank’s own investment firm, Huijin Investment. Another possibility is to use part of the currency reserves to build up the country’s strategic raw material reserves.

A second theme dealt with development of state-owned banks. The largest challenge is saving the sickly Agricultural Bank of China (ABC). Of China’s four large state banks, only ABC has yet to be put into shape so that its shares can be listed on the stock market. Non-performing loans represented about 24% of ABC’s loan stock at the end of 2006. Several sources reported that the conference members decided to spend about $100 billion to recapitalize ABC. ABC’s revitalization is tied extensively to general reforms in the countryside and increasing the efficiency of rural finance. In addition, reforms and efficiency improvements at China’s three state-owned policy banks (China Development Bank, Export-Import Bank of China and Agricultural Development Bank of China) will continue.

The conference’s third theme was setting policy on liberalisation of the corporate bond market. Currently, enterprises must endure a convoluted bureaucratic nightmare to get permission from the National Development and Reform Commission (NDRC) to issue short-term paper. The reform would apparently abolish the permitting process and transfer oversight completely to the China Securities Regulatory Commission (CSRC). The reform would increase competition on the market and force commercial banks to operate more efficiently.

The conference agenda likely included discussion on setting up a deposit insurance scheme in China. China currently lacks any formal depositor protection, although in practice the state or provincial administrations would step up and insure bank deposits in their own banks in the event of a crisis. Rather than a de facto state guarantee of deposits, the shift to a bank-financed deposit insurance scheme is seen as a necessary evolutionary step in market development.

The policy directions taken at the finance conference for the most part bolster increased openness of China’s markets, greater competition and consistency with earlier policy directions. Some of the recommendations and decisions of the conference may be put forward already at the upcoming National People’s Conference in March. The latest decisions are generally seen as framing development of China’s finance sector for the remainder of this decade.

China drops in economic freedom rankings. Last week saw the publication of the Heritage Foundation’s annual Index of Economic Freedom. The 2007 survey ranked 161 countries, four more than in 2006. China ranked 119th, dropping from 111th place last year. China received low marks for highly controlled and regulated foreign direct investment and financial freedom. In addition, China’s evaluation was also hurt by widespread corruption and poor protection of property rights. On the other hand, China’s foreign trade policies were seen as more liberal than average. Hong Kong scored the highest ranking for economic freedom for the 13th year in a row. Russia placed 120th, right behind China.
Russia

Russian wages rise rapidly. The average monthly wage in Russia last year was 10,700 roubles (310 euro), a 14 % increase in real terms from 2005. Wage differences vary substantially across sectors and regions. Western firms often pay top wages for highly educated, linguistically skilled Russian workers. The average wage in Moscow was over 70 % higher than the national average; wages in St. Petersburg were about 20 % above average. Wages were lowest in the South Federal District (two-thirds the national average). Wages in the Ural and Far East Federal Districts were a third higher than the national average. In the oil-rich Tyumen and Chukotka Regions, wages were 2.3 times the national average. Finance and mineral extraction industries are the best-paying sectors in Russia. Industries paying the lowest wages include agriculture, forestry, as well as hotel, restaurant and catering services. The rapid rise in wages, real estate prices and prices generally has also driven up production costs in Russia.

Average monthly wage (€) by sector in November 2006

<table>
<thead>
<tr>
<th>Sector</th>
<th>Average wage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finance</td>
<td>6.6</td>
</tr>
<tr>
<td>Mineral extraction industries</td>
<td>5.7</td>
</tr>
<tr>
<td>Public admin and defence</td>
<td>5.0</td>
</tr>
<tr>
<td>Transport</td>
<td>5.9</td>
</tr>
<tr>
<td>Construction</td>
<td>5.6</td>
</tr>
<tr>
<td>Average wage</td>
<td>5.9</td>
</tr>
<tr>
<td>Manufacturing industries</td>
<td>5.0</td>
</tr>
<tr>
<td>Social and healthcare</td>
<td>4.0</td>
</tr>
<tr>
<td>Retail sales</td>
<td>3.7</td>
</tr>
<tr>
<td>Agriculture and forestry</td>
<td>2.3</td>
</tr>
</tbody>
</table>

Source: Rosstat

Brisk economic growth expected to continue. Economic forecasters generally agree that Russian economic growth looks set this year to repeat its above-6 % performance of 2006. Rosstat has initially put 2006 GDP growth at 6.7 %. Nearly all major forecasts assume the price for Urals-grade crude oil will this year remain at its current level – a bit above $50 a barrel. A rapid decline in oil prices would be a risk for strong economic growth. At the moment, brisk growth is driven by accelerated investment and consumption growth, which forecasts also expect to continue this year.

Russian GDP estimates for 2007

<table>
<thead>
<tr>
<th>Source</th>
<th>2007e</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economy Ministry (12/06)</td>
<td>6.2</td>
</tr>
<tr>
<td>CBR (11/06)</td>
<td>5.0–6.6</td>
</tr>
<tr>
<td>OECD (12/06)</td>
<td>6.0</td>
</tr>
<tr>
<td>MDM (12/06)</td>
<td>6.7</td>
</tr>
<tr>
<td>Fitch Ratings (1/07)</td>
<td>6.5</td>
</tr>
<tr>
<td>IMF WEO (08/06)</td>
<td>6.5</td>
</tr>
<tr>
<td>Consensus forecast (11/06)</td>
<td>6.0</td>
</tr>
</tbody>
</table>

CBR lowers rates. The Central Bank of Russia lowered its refinancing rate on Monday (Jan. 29) by a half percentage point to 10.5 %. The CBR last lowered the refinancing rate three months ago by a similar increment. The reduction reflects the on-going deceleration in Russian inflation. The refinancing rate has little effect as a means of monetary policy. The CBR also lowered its rate on overnight lending charged to banks to 10.5 %. Since February 2003, the overnight lending rate has been the same as the refinancing rate. Although the volume of overnight lending increased last year to meet bank liquidity needs, the amounts involved were still relatively small (less than €1.5 billion).

The central bank’s monetary policy program for 2007 seeks to give teeth to interest-rate policy instruments with the development of the refinancing system for banks. The program estimates 19–29 % growth in the M2 aggregate and puts inflation target in the range of 6.5–7 %.

Indian inflation and interest rates 2004–2007, %

<table>
<thead>
<tr>
<th>Year</th>
<th>Inflation</th>
<th>Refinancing rate</th>
<th>One-day interbank lending rate (rouble)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>9.0</td>
<td>8.0</td>
<td>12.0</td>
</tr>
<tr>
<td>2005</td>
<td>10.0</td>
<td>8.2</td>
<td>11.5</td>
</tr>
<tr>
<td>2006</td>
<td>11.0</td>
<td>7.5</td>
<td>11.0</td>
</tr>
<tr>
<td>2007</td>
<td>12.0</td>
<td>7.0</td>
<td>11.0</td>
</tr>
</tbody>
</table>

Sources: Rosstat and CBR

India and Russia put new touches on cooperation during Putin visit. The Russian leader’s two-day visit last week saw signing of deals on weaponry and joint development of new military technology. Russia is currently building two nuclear reactors in India and initial agreement was reached on the sale of four more. In a speech to business leaders, president Putin underscored the need to base trade on market conditions. He also raised the issue of restrictions related to India’s rupee debt owed to Russia and difficulties that the restrictions have caused certain companies. The countries agreed to work out the $126 million debt in part through investments in aircraft and titanium, and the establishment of joint ventures in India. Ways of developing traditional cooperation in the areas of energy, transport, trade and investment as well as trilateral cooperation with China were also discussed.
China

Robust economic growth to continue in China. Mainstream 2007 GDP projections for China generally expect growth in the range of 9.5 % to 10 %. The high growth reflects continued growth in fixed capital investment driven by urbanisation and massive infrastructure projects. Steady growth in domestic consumer demand should also continue as wages rise. However, a major collapse in share prices would hurt household consumption, as households have recently invested a larger share of their savings in stocks. The foreign trade surplus this year is expected to at least match last year’s spectacular performance, although growth in trade could suffer if US demand weakens. Trade disputes could also cut into Chinese foreign trade. Consumer price inflation is expected to remain low this year. Pricing pressures have been suppressed by stiff domestic competition and overcapacity in certain industries.

2007 GDP and inflation estimates for China, %

<table>
<thead>
<tr>
<th></th>
<th>GDP growth</th>
<th>Consumer price inflation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asian Development Bank</td>
<td>9.5</td>
<td>1.8</td>
</tr>
<tr>
<td>IMF</td>
<td>10.0</td>
<td>2.2</td>
</tr>
<tr>
<td>World Bank</td>
<td>9.6</td>
<td>2.1</td>
</tr>
<tr>
<td>National Development and Reform Commission</td>
<td>10.0</td>
<td>1.5–2.0</td>
</tr>
</tbody>
</table>

Money supply growth slightly exceeded last year’s 16 % target. As of end-December, China’s broad money supply (M2) was up 16.9 % y-o-y. In efforts to rein in money supply growth, the People’s Bank of China hiked key reference rates twice last year. The 12-month lending rate is currently 6.12 %. The PBoC also last year increased reserve requirements for commercial banks by a total of 1.5 percentage points to 9 %, and gave commercial banks direct orders to restrict lending and issued central bank bonds. Despite the central bank’s measures, money supply growth last year overshot its 16 % target for the year. High M2 growth did not translate, however, into higher consumer prices, which were up just 2.8 % y-o-y in December. The slight acceleration in inflation in the last quarter of 2006 was driven almost entirely by higher food prices. Producer prices in December were up 3.1 % y-o-y.

The central bank left its M2 growth target for this year unchanged at 16 %. PBoC assumptions underlying the money supply target this year include 8 % GDP growth and inflation below 3 %. Unlike in previous years, the central bank has announced no targets for credit or deposit growth. It continues, however, to tighten its monetary policy stance – most recently by issuing bonds and increasing bank reserve requirements to 9.5 %.

Income and labour productivity increase rapidly. China’s near 11 % GDP growth last year was reflected in a strong increase in household incomes. The National Bureau of Statistics reports that city-dwellers saw their per capita disposable incomes increase 10 % in real terms last year. Real incomes were up 7 % in the countryside. As of end-September, the average disposable monthly income of an urban resident was 978 yuan (about €100), while rural inhabitants had about 307 yuan (€30) to spend.

While precise determination of overall Chinese wages is complicated by the general lack of statistical data and variations in development across sectors and provinces, there are clues as to the present trend. The NBS reports that in January-September 2006 the average monthly salary for a Chinese worker was 1,560 yuan (€156), an approximately 12 % increase in real terms from the same period a year earlier. A just-released sampling study of 1,800 companies in 13 cities by Mercer Human Resources Consulting found that Chinese salary costs in 2006 increased an average of 8 % y-o-y. There have also been adjustments of minimum wage levels around the country to reflect higher wages and living costs. The highest minimum wage level is in Shenzhen city in the pricey Pearl River Delta, where the minimum monthly wage standard is 810 yuan (€81). The Jiangxi province has the lowest monthly minimum wage standard, just 270 yuan (€27).

Chinese productivity gains have kept up with rising wages for years. Productivity growth has been sustained by the unabated influx of underemployed labour from the countryside to major growth centres. Not surprisingly then, a fresh study by business researchers at the Conference Board notes that China’s 9–10 % labour productivity gains over the past two years may be due almost entirely to structural changes in China’s transforming economy. The Conference Board currently found labour productivity growth in the European Union at less than 2 % a year.

Average monthly salaries in China, (€, US$)

Sources: NBS and BOFIT
Russia

Russian inflation continues to decline. Rosstat reports Russian consumer prices rose in January at a pace of 8.2 % y-o-y, compared to 10.7 % y-o-y in January 2006. Inflation was led by hikes in regulated prices for housing and municipal services at the start of this year. Goods inflation last month was led by higher prices for bread and other grain products, building materials and gasoline.

Producer price inflation for industrial products has slowed in recent years. Producer prices for industrial products rose 10.4 % last year, a three-percentage-point decline from 2005.

12-month change in consumer and industrial producer prices, 2005–2007, %

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.

Growth and GDP contributions of key sectors in 2006, %

<table>
<thead>
<tr>
<th>Sector</th>
<th>Growth, y-o-y</th>
<th>Share of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mineral extraction industries</td>
<td>2.1</td>
<td>10.2</td>
</tr>
<tr>
<td>Manufacturing industries</td>
<td>4.9</td>
<td>18.8</td>
</tr>
<tr>
<td>Other production</td>
<td>7.0</td>
<td>14.0</td>
</tr>
<tr>
<td>Retail sales</td>
<td>8.7</td>
<td>19.3</td>
</tr>
<tr>
<td>Other services</td>
<td>7.0</td>
<td>37.7</td>
</tr>
<tr>
<td>Total GDP</td>
<td>6.7</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Rosstat

Putin urges oligarchs to internationalise. In a talk to Russia’s most powerful business leaders (oligarchs), at a meeting of the Union of Russian Industrialists and Entrepreneurs (RSPP) held this week at the Kremlin, president Vladimir Putin said that the national economy had become overly dependent on natural resources and that this dependence has increased in recent years. The president recommended that industry make greater efforts to diversify and enter the international sphere. He said the state is ready to back large internationalisation of large industry as long as the Russian economy and the general welfare of the public benefit. He acknowledged that earlier attempts of Russian companies to break into international markets have sometimes been thwarted, citing Vneshtorgbank’s failure to win a seat on the board of the European defence consortium EADS. The oligarchs requested relaxation of Russian export and import tariffs, and improvements in the investment climate.

The lofty ambitions of Russian aerospace. The industry ministry reports strong export demand helped boost production of Russian aircraft about 25 % last year as foreign buyers purchased especially military aircraft, which account for the lion’s share of aircraft built in Russia. As the situation highlighted the second-fiddle status of Russia’s civil aircraft industry, Russia now has plans of reviving its civil aircraft industry, with the help of military aircraft manufacturing. The aircraft industry development strategy through 2015 calls over a billion dollars a year in investment in the civil aircraft sector. About half of the money would come out of the federal budget. The sector currently is under consolidation as was seen last November with the registration of a new giant venture United Aircraft Building Corporation (UABC), which brings together large state and private aircraft manufacturers. Sergei Ivanov, who serves as deputy prime minister, defence minister and chairman of the new company’s board, has targeted a 10–12 % share of global civil aircraft sales by 2015. UABC has had cooperation talks with major international players, including Boeing and EADS. Russia’s first producer of foreign-designed civil planes, however, could be Samara-based Aviakor, owned by tycoon Oleg Deripaska. His company has negotiated with Bombardier to begin in Russia production of one of its models.
China

President Hu makes second Africa tour in a year. Since China committed in 2005 to a high-profile policy of reaching out to African countries to secure energy and raw material supplies, it has moved ahead aggressively to implement the policy. President Hu Jintao visited three African states last April, and in June prime minister Wen Jiabao toured seven African countries. China then hosted an Africa conference in November, featuring the participation of nearly all leaders of the 48 African states with which China has diplomatic relations (there are 54 countries in Africa). Hu’s latest 12-day tour of eight African nations concluded this week. During the visit, he talked up economic relations and signed a number of agreements on investment and trade. China can also back up its words with actions by promoting economic cooperation through large loan packages and other forms of financial and technical assistance.

China’s decision-makers have also found that the new, outstandingly state-led, policy has attracted considerable scrutiny, with a backlash of stinging criticism and questions about China’s motives. China has been accused of indirectly supporting failed governments, degrading working conditions and environmental standards, as well engaging encouraging bad or corrupt behaviour. There is also a fear that the Chinese invasion of Africa will only lock the continent into its traditional role as a commodity producer rather than promote economic diversification. In Sudan, which sells 60% of its oil output to China, Hu faced strong demands for help in resolving the Darfur conflict. In Zambia, where China has its largest foreign copper-mining operation, he cancelled visit to the mine when workers staged a protest over low pay.

China is involved in a number of raw material projects in Africa, but its role in Africa has grown rapidly in other economic areas. Also Chinese exports to the continent are booming. China’s exports to African countries increased about 40% in 2006 to around $27 billion. Imports from Africa also grew 40% to about $28 billion. African countries account for about 3% of China’s goods exports and 4% of China’s good imports.

Warnings of overheating cause stock market jitters. The rapid rise in Chinese shares in recent months has moved Chinese officials to warn that a price bubble may be forming. The markets reacted by interpreting the warnings as a sign the government may be considering measures to restrain price development. So far, at least, officials have concentrated on making sure that banks do not grant credit to fund stock market speculation.

Daily price fluctuations have been huge since the start of the year, but the rise in prices seems to have abated for the time being. At mid-week, yuan-denominated A-shares on the Shanghai bourse had returned to end-December levels. Trading in A-shares is only allowed for Chinese citizens and a handful of approved international institutional investors. According to some observers, dollar-denominated B-shares, which also are available to foreign investors, have benefited from the uncertainty surrounding A-share values and expectations that the share series may be combined already this year. Presently, there are only about 50 companies with B-shares listed on the Shanghai bourse. Over 800 companies list A-shares.

Shanghai A- and B-share price indices

US files protest with WTO over China’s subsidy practices. Last week the United States filed a complaint with the WTO on subsidies paid to Chinese companies. The complaint charges that China subsidises exports and Chinese practices constitute de facto discrimination against foreign-made products in favour of domestic products. The US sees Chinese practices as denial of a level playing field for foreign products. Moreover, WTO commitments explicitly forbid export subsidies to industry, yet China uses tax breaks to effectively subsidise to certain types of business, particularly companies involved in steel, paper and IT industries. China denies violating any rules, but has announced it is considering abolishing VAT rebates for exported steel. Resolution of the dispute could take up to 18 months. Observers admit that it is difficult to determine the actual extent of China’s use of export subsidies, because Chinese firms receive support and tax breaks from multiple sources in many forms. The Japanese seem to be agreeing with the US view, and may even join as a party in the complaint. The EU earlier protested China’s export subsidy policies.

Chinese statistics on trade with the US last year show a trade surplus of $150 billion. US trade representative Susan Schwab says 60% of China’s exports to the US are state supported. The US has long suggested that a revaluation of the yuan would go far in reducing the trade imbalance and tensions between the two countries.

Sources: Bloomberg, Bank of Finland

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

BOFIT forecasts 6.4 % GDP growth for Russia this year. In our latest BOFIT Russia Forecast (1/2007), we predict Russian economic growth to continue near the 6 % level through 2008 and 2009. Russia’s economic growth will be underpinned by rapid growth in consumption and investment, high world oil prices and stable fiscal policies. Robust economic growth and real appreciation of the rouble should be reflected in booming import growth. Imports should rise three times faster than GDP in coming years.

Russia remains heavily dependent on its energy sector, and thus exposed to shocks from lower world oil prices. Cheaper oil could crimp growth and quickly erode Russia’s sizable current account surplus. On the other hand, Russia’s strong state finances provide it with a buffer to deal with oil price shocks and create opportunities by boosting public consumption and investment. However, an abrupt change in direction of the fiscal policy could admittedly disrupt current stability and growth. The upcoming parliamentary and presidential elections are not expected to have a strong impact on economic policy. The full BOFIT Russia forecast is posted on our website.

12-month change in Russian GDP, 1996–2009, %

<table>
<thead>
<tr>
<th>Year</th>
<th>ROSSSTAT</th>
<th>BOFIT Russia forecast</th>
</tr>
</thead>
<tbody>
<tr>
<td>96</td>
<td>-10</td>
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<tr>
<td>97</td>
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<tr>
<td>09</td>
<td>15</td>
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</tbody>
</table>

Sources: Rosstat and BOFIT

CBR increases euro weight in currency basket. The Central Bank of Russia announced last week that effective February 8 it was increasing the weight of the euro in the dual currency basket used to steer the rouble’s exchange rate. The euro’s share has been increased to 0.45 and the dollar’s share reduced to 0.55. The earlier dollar-euro weights effective since December 2005 were 0.6/0.4. CBR deputy chairman Konstantin Korishchenko noted that the composition of the basket had been adjusted to better represent the structure of Russian trade. CBR chairman Sergei Ignatyev reports that Russia’s currency reserves are roughly allocated as follows: 50 % in US dollars, 40 % in euro, 10 % in British sterling and 1 % in Japanese yen.

Challenges facing Russia’s banking sector. Last November, president Vladimir Putin ordered his cabinet to consider a range of measures on remodelling the banking sector. His to-do list included getting banks to offer long-term credit to clients outside the financial sector, making bank mergers easier, development of regional and small-town banking services and evaluating the possibilities for using pension fund assets to finance e.g. housing loans.

The CBR last week announced credit institution managers and owners would have to demonstrate unblemished records and expressed concern over the upsurge in non-performing consumer loans, money laundering and corruption. The CBR suggested supervision of commercial banks could be improved through placement of central bank curators in commercial banks to monitor bank activities.

The increased borrowing of Russian banks on international markets has forced banks to gradually become more transparent. Several banks are planning international share offerings. State-owned Sberbank leads the pack with its offering plans.

Last year saw the CBR’s pulling of a number of banking licenses, rapid growth in housing and car loans, widespread issuance of credit cards and a somewhat bumpy launch of credit reporting services.

Russia raises export tariffs on raw wood. A recent decree calls for export tariffs on raw softwood and birch to be increased in four steps. From July 1, 2007, the tariff will be 20 % of the value, or at least €10/m³; from April 1, 2008, 25 %, or at least €15/m³; and from January 1, 2009, 80 %, or at least €50/m³. Starting January 1, 2011 the prevailing tariff would extend also to birch pulp. The softwood export tariff is presently 6.5 % of declared value or at least €4/m³.

The higher tariffs are designed to encourage Russian forest industries to increase the value-added production and attract especially foreign investment. Russia has the world’s largest forest reserves and is the largest exporter of raw wood (one-third of all raw wood exports globally). In contrast, in value-added products such as paper and cardboard Russia only accounts for about 2 % of global production and exports. In 2006, Russia produced a total of 7.4 million tons of paper and cardboard (growth of 4 % y-o-y). Under the industry ministry’s development plan, their production would double by 2015. Investment incentives also include the lifting of import duties on forestry technologies not made in Russia and export tariffs on all value-added forest products. Investment may still be hard to attract given Russia’s crumbling infrastructure and logistical challenges.

The new tariffs will cause serious problems for Finland’s forest industry, which gets about a fifth of its wood feed from Russia. Finns say they will have to stop importing Russian wood altogether before the highest tariff rate enters into force. Finns now import considerable amounts of birch pulp, which is not used in Russian industry. The tariff increases violate prevailing agreements between the EU and Russia and could hamper Russia’s progress in its WTO membership talks.
China

China posts massive trade surplus in January. China Customs reports that the overall January foreign trade surplus reached $16 billion, up from $9 billion in January 2006. The surplus was driven by continued higher export growth (up 33 % y-o-y) relative to import growth (up 28 % y-o-y). The January figure was dominated by large trade surpluses with the US ($13bn) and the EU ($10bn). China ran trade deficits with several of its main Asian trading partners. The impressive January trade-figure gains may to some extent reflect the timing of Chinese New Year, which falls in February this year.

China’s burgeoning trade surpluses have provoked rising criticism of its trade and foreign exchange policies. At the beginning of February, the US filed a complaint with the WTO over China’s various subsidies to exporters. The US claims that 60 % of Chinese goods imported into the US receive some form of state aid, which in turn distorts competition. China’s top trading partners, the US and the EU, have both requested that China allow the yuan to appreciate faster. This hope was reiterated at last week’s G7 meeting.

China climbs into global top ten for international patent applications. Preliminary data from the World Intellectual Property Organization (WIPO) show that the number of patent applications from China under Patent Cooperation Treaty (PCT) increased 57 % in 2006 from the previous year, while patent applications overall rose 6 %. The number of patent applications from China rose to nearly 4,000 or 3 % of all patent application filings globally. China surpassed both Switzerland and Sweden in the number of PCT patent filings. Just two years ago China trailed Finland in 14th place with 1,700 patent filings for the year. Moreover, the rise of South Korea to the number-four position (surpassing both the UK and France) suggests an Asian ascendancy in the intellectual property realm. Topping the list were the United States (34 % of all applications), Japan (19 %) and Germany (6 %).

China’s science and technology minister Xu Guanhua said Chinese R&D spending rose 22 % last year to an amount equal to 1.4 % of GDP. While the OECD average for R&D is still about one percentage point higher, China’s spending level essentially matches that of Russia and well exceeds R&D spending in India and Brazil. China resembles OECD countries, where the government typically funds less than a third of R&D spending and companies contribute the rest. In Russia, in contrast, the state funds most R&D costs.

International patent applications from BRIC countries, 2000–2006

Source: WIPO (www.wipo.int)

Bountiful grain harvest in 2006; major agriculture census underway. The National Bureau of Statistics reports that last year’s harvest of grains (maize, beans, potatoes, rice and wheat) reached 490 million tons, up from 484 million tons in 2005. Meat production grew nearly 5 % to 80 million tons. Last year agricultural production was sufficient to support higher exports, with the result that China’s agricultural trade deficit was nearly halved to 670 million dollars. In recent years, China has managed to increase the area of land under cultivation and make grain production more efficient through increased mechanisation of farming, development of better grain varieties and better fertiliser use. Further increases in grain production are limited by several factors, including availability of irrigation water and small plot size. A state rural strategy report released in January urged further mechanisation of agriculture.

China is currently conducting a massive census of rural agriculture that encompasses over 200 million households throughout the country. Farming families are asked about e.g. the size of their grain harvests, the plants they cultivate, the degree of mechanisation of their operation, fertiliser use and irrigation systems. The census is considered especially important in evaluating the true situation of farmers. In earlier years, China extrapolated from small surveys to estimate the overall situation of agriculture. A similar census of the service sector in 2005 resulted in a 17 % upward revision of China’s official GDP figures.

Grain harvest and land under cultivation, 1997–2006

Source: National Bureau of Statistics
Russia

Brisk foreign trade growth in 2006. The Central Bank of Russia reports the value of goods exports last year increased 25 % and goods imports 31 %. Even with the rapid growth in imports, Russia posted a record trade surplus of $141 billion (14 % of GDP). Russian exports are largely commodities – crude oil, oil products and natural gas together represent over 60 % of Russian exports. Metals constitute about 14 %. Unsurprisingly, the decline in oil prices at the end of last year cut into Russia’s export growth.

Nearly half of imports last year were machinery and equipment, with car imports alone accounting for 10 % of all imports. Over half of the roughly one million passenger cars imported to Russia were brought in via Finland. Other important import items included food products and chemical products (both with import shares nearly 16 %).

The European Union continued as Russia’s most important trade partner, representing 53 % of Russian foreign trade. Asian and Pacific nations constituted 17 % of Russia’s foreign trade and CIS countries 15 %. Russia’s most significant trade partner nations were Germany and the Netherlands, with each holding for near-10 % shares of Russian trade. Finland, with a 3 % share, was Russia’s twelfth largest trade partner.

Russian goods trade and Urals oil price, 2003–2006

Source: CBR and economy ministry

Russia ramps up cooperation on natural gas development. President Vladimir Putin and an entourage of high-powered business leaders visited Saudi Arabia, Qatar and Jordan last week (Feb. 11–13) to discuss energy cooperation. Although Putin earlier suggested an OPEC-like organisation of gas producers might be worth consideration, the Russian president has recently been more cautious in his statements, saying only that he would like to see closer, more coordinated cooperation among gas-exporting countries. The current international body of gas producers, the Gas Exporting Countries Forum (GECF) has been faulted for its ineffectiveness, and many observers believe that a gas cartel will never work: gas exports must typically pass through a pipeline and most gas contracts are long range, often exceeding 20 years.

Russian gas giant Gazprom agreed a month ago with the Algeria’s state gas company Sonatrach on closer cooperation in natural gas production and developing gas liquefaction technology. Transporting liquefied natural gas (LNG) with tankers is technically challenging and expensive. Russia has the world’s largest gas reserves with a share of 27%, and Russia, Iran and Qatar together control over half of the world’s natural gas resources.

Finnish industry cuts back on investment in Russia. An annual survey by the Confederation of Finnish Industries (EK) finds that Finnish industrial firms invested €118 million in Russia last year, a 32 % drop from a year earlier. Russia’s share of Finnish industrial investment spending abroad fell to 3.5 %. Russia was a particularly important investment destination last year for the Finnish food industry and Finnish clothing and textile manufacturers.

The EK survey does not include the service sector (e.g. retail trade), and it is conceivable that some industrial investments were not included in the survey, which depends on respondent activity.

Capital investment spending of Finnish industrial firms in Russia, 2001–2006

Source: Confederation of Finnish Industries, EK

New faces in the cabinet and CBR board. On February 15, president Putin named Sergei Ivanov (54) as first deputy prime minister responsible for defence, industrial policy, a portion of private-sector industry, transportation and telecommunications sectors. Tax service chief Anatoli Serdyukov (45) was named to succeed Ivanov as defence minister. Government chief of staff Sergei Naryshkin (52) was named deputy prime minister responsible for foreign trade (particularly CIS relations) and state property management. Dmitri Medvedev (41) will stay on as first deputy prime minister responsible for national priority projects. Ivanov and Medvedev have been mentioned in recent months as possible successors to president Putin.

At the start of February, Gennadiy Seleznev (55) was appointed the CBR’s first deputy chairman in charge of banking supervision. Alexei Simonovskii, head of the banking supervision department, and Mikhail Sukhov, head of the credit institutions licensing department, each began four-year terms on the central bank board in January. The CBR board has twelve members.
China

Chinese consumer price inflation remains low; central bank tightens its stance. The National Bureau of Statistics reports that consumer prices were up 2.2% y-o-y in January, compared to 2.8% in December. Higher food prices accelerated rise in consumer prices generally towards the end of last year. Food prices were also up 5% y-o-y in January, when prices for other products increased less than 1% on average. Food prices currently make up a third of China’s consumer price index, so any changes have a substantial impact. The NBS calculates the index weights on the basis of household consumption survey. China’s leaders, worried about the impact of higher food prices, have ordered the release of additional grain from the national reserves to balance the situation. Producer prices were 3.3% higher in January than a year earlier.

The broad money supply (M2) was up 15.9% y-o-y as of end-January, a decline of one percentage point from the previous month. The People’s Bank of China has announced a money supply growth target of 16% for this year. China imposed a number of monetary measures last year to constrain money supply growth, including bond issues, interest rate hikes and higher reserve requirements for commercial banks. The PBoC has continued to tighten its monetary stance this year. The central bank has announced it will increase bank reserve requirements by a half percentage point to 10%, effective this Sunday (Feb. 25). A similar increase was made in January. The central bank expects inflationary pressures to build this year.

12-month change in consumer prices and food prices, %

![Chart showing 12-month change in consumer prices and food prices from 2005 to 2007.](image)

Source: NBS

Energy and raw material issues dominate China-Russia economic discussion. Cooperation between China and Russia has long been guided by China’s appetite for Russia’s energy and raw material resources, and there is little indication that Russia has made headway in diversifying its exports to China.

Russia just this month announced plans to increase electricity exports to northeast China significantly. Chinese and Russian oil companies are also in talks over ways to boost oil imports from Russia. A Chinese forest products company is planning construction of $2 billion facility in the Irkutsk Region. The Chinese and Russian partners would own equal shares in the project.

Chinese figures show China’s exports to Russia in 2006 rose 20% to nearly $16 billion. China’s imports from Russia last year amounted to $18 billion, an 11% increase from 2005. Russia presently accounts for just under 2% of China’s total goods exports and just over 2% of imports. Russian trade figures show Russian imports from China of $13 billion and exports to China of $16 billion. China provided 9% of Russia’s total imports and 5% of exports. Unlike in earlier years, the discrepancies between Chinese and Russian bilateral trade figures for 2006 were significantly smaller.

Both China and Russia fare poorly in global assessment of corporate tax burdens. The Doing Business report Paying Taxes: The Global Picture from the World Bank Group and PricewaterhouseCoopers compares corporate tax burdens worldwide. Released last December, the study evaluates average corporate tax burdens in 175 countries, and includes assessments of how often companies must make various tax payments, the “total tax rate” and how much time companies must spend complying with tax requirements. The lowest overall corporate tax burdens were found in the Maldives, Ireland, several Middle East oil-producing nations, Switzerland, Singapore and New Zealand. Hong Kong also ranked in the top ten, while Mainland China came in at 168th, just eight places from the bottom. The survey found that a mid-sized firm in China spent nearly 900 hours a year dealing with tax matters, when a comparable Hong Kong firm got by with just 80 hours a year. The study found that Mainland China has a total tax rate of 77%, while Hong Kong has a mere 29%.

The Russian tax system also compared poorly, rating just 148th. A Russian company diligently complying with the law must spend 256 hours a year dealing with tax matters and pay a total tax rate of 54%.

The worst countries from the standpoint of corporate taxation were Ukraine and Belarus. A fascinating aspect of the study was that countries famed for their high tax rates – Iceland, Denmark and Norway – all made it into the top twenty business-friendly countries. Finland had the highest total tax rate of any Nordic country (overall ranking 72).

The report’s makers noted that corporations confronted with complex tax systems are more inclined to engage in tax evasion and the grey economy. As the grey economy grows, the tax burden is shifted onto the backs of fewer and fewer firms. Instead of raising taxes, the authors recommend that policy-makers in emerging countries should focus on simplifying tax systems and broadening the tax base.
Russia

Structural problems in Russia’s labour markets. Rosstat reports that Russian unemployment, measured by ILO methodology, stood at 5.1 million unemployed at the end of last year. The share of unemployed relative to the labour force fell below 7 %, a near percentage-point drop from end-2005. The health and social development ministry’s latest program for labour markets targets 6–7 % unemployment by 2010. The plan primarily tackles structural problems in the labour market, such as labour mobility within the country, Russia’s Central and North West Federal Districts already have a problem finding workers, while unemployed persons actively seeking work in the South and Far East Federal Districts vastly exceed the number of jobs available. The ministry wants to encourage greater labour mobility within the country though such measures as improving housing possibilities for workers from elsewhere.

Russia’s labour force is expected to shed over 700,000 workers a year in coming years as the overall population shrinks and ages. To compensate this, the government would prefer to attract highly educated labour from abroad. The poorly educated foreign labourers are seen to compete with local low-skilled workers for low paying jobs. For example, the government will next month tighten the current 40 % limit on foreign workers allowed to work in market squares and totally forbid their activities there. So far the only effect has been to empty outdoor markets from elsewhere.

Russia invests in defence industry and modernisation of weapons systems. At the beginning of February, defence minister Sergei Ivanov presented a $190 billion program extending through 2015 designed to modernise Russian weapons and replace 45 % of Russia’s current military hardware. Russia also wants to significantly expand its arms exports, which traditionally have focused on China and India. Russian arms exports have grown about $1 billion a year since 2001, reaching $6.4 billion in 2006. Russian arms exports are expected to hit $7.5 billion this year.

Three weeks ago, president Vladimir Putin told representatives from over 40 countries at the 43rd Munich Conference on Security Policy that the US’s de facto achievement in creating a world of unipolar military might has several drawbacks. Overwhelming US military superiority has promoted an unreasonable emphasis on solving global political problems militarily. He was particularly concerned about plans to extend the proposed missile defence system to Europe and the threat to Russian security posed by new NATO bases in Europe.

Comparison of national defence budgets in 2007

<table>
<thead>
<tr>
<th></th>
<th>Budget allocation, US$ billion</th>
<th>Share of global defence spending, %</th>
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<td>421</td>
<td>43</td>
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<tr>
<td>China</td>
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</table>

Source: Opednews

Local administration reforms stumble. The act on reform of local administrations passed in 2003 intends to create a comprehensive and consistent system of local governments nationwide. The idea is to give newly created local administrative units clear spheres of responsibility and assure their funding. Another goal of the reform is to increase citizen participation in local decision-making. Despite the lofty goals, there have been many practical problems in reforming local administrations. These difficulties have meant that implementation of the law originally set to enter into force in 2006, has had to be postponed to 2009.

The first phase of the reform, calling for creation of new local administrative bodies, has in principle been completed, but there still are some disagreements related with border lines. The reform doubled the number of local administrative units to over 24,000. Local administration has two levels. The upper level represents cities and municipalities, the latter of which are further divided into urban and rural suburbs. There are about 20,000 rural suburb units. The increase in the number of local administrative units has meant in practise more bureaucracy and created urgent need for competent personnel. In the new law the duties of each type of local administrative units partially overlap, which means they have to be divided among them. At present, the division of assets among the administration levels also requires a lot of work.

The new law still leaves local administrators highly dependent on transfers from higher administrative levels. The finance ministry estimates that 60 % of local budget revenues in January-September 2006 consisted of budget transfers from federal and regional budgets. Tax revenues accounted for 30 % of revenues. Most of them came from income tax, the revenues of which are divided between regional and local budgets. Local administrations only have two tax revenue sources entering solely to their own budgets: the property tax on private individuals and the land tax.
China

China’s stock market meltdown felt around the world. Tuesday’s (Feb. 27) 9 % drop on the Shanghai stock exchange was the largest single-day decline in a decade. On the previous day, the Shanghai A-share index peaked at an all-time high. The decline generated over 1,000 billion yuan (€100bn) in paper losses on China’s stock markets. On Wednesday (Feb. 28), Chinese share prices recovered slightly, only to fall back again on Thursday along with declines on other Asian bourses.

Given the absence of large clouds on China’s economic horizon, it was difficult to identify any specific cause of drop in share prices. Some observers speculated that the drop may have been caused by profit taking in the wake of Chinese New Year or rumours that Chinese officials were planning increase capital gains taxes and crack down on purchasing stocks on loan in order to curb the rise in share prices. The warning from former US Federal Reserve chairman Alan Greenspan on Monday (Feb. 26) that the US could slip into recession by the end of this year certainly provided little comfort to nervous investors.

Actually, the most significant factor in the stock price swings may be the concern over the tremendous run-up in share prices in the latter part of last year. The spectacular performance in stocks had begun to resemble a classic asset bubble. Following Tuesday’s drop, the average P/E ratio for stocks listed on the Shanghai exchange was 38 (compared to 18 a year ago). The corresponding figure for the Hong Kong stock market is currently 18.

Stock market unrest spread from China to other major exchanges. It was the first time Chinese stock market jitters had a significant impact on international markets. On Thursday (Mar. 1), Russian shares (RTS) were off almost 9 % from Monday levels.

Chinese steel production continues to rise. Last year China’s steel output increased nearly 20 % y-o-y to a total of 420 million tons. China also secured its position as the world’s largest steel producer last year, producing a third of all steel in the world. China mainly exports low-grade carbon steels, but constant technology improvements have helped increase production of higher-grade steels as well. China surpassed Japan as the world’s largest producer of stainless steels last year. Steel production has grown substantially faster than domestic demand so China’s steel exports have grown dramatically. China exported slightly over 40 million tons of steel last year, a 100 % increase from 2005. While the boom in Chinese steel exports is still only a modest concern for most countries, several steel-producing countries have imposed anti-dumping tariffs to protect domestic steelmakers. China says it expects steel exports to rise only slightly this year.

Even with Chinese steel production suffering from serious overcapacity problems, profits after taxes in the industry soared over 30 % y-o-y in 2006. The explosion in profitability could drive further investment in production capacity, even as officials try to calm these pressures. Last year, investments in steel production facilities did not grow. China’s National Development and Reform Commission (NDRC) estimates production will rise 10 % this year to 460 million tons.

In December, China sealed major deals with leading international iron ore suppliers. The delivery contracts allow for a 9.5 % increase in iron ore prices this year. Iron ore prices are typically set in April on a year-to-year basis. This year was the first time China negotiated the world reference price of iron ore contracts. China must import about 45 % of its iron ore needs, even with a strong increase in domestic iron ore production.

China eases foreign currency regulations for private individuals. The People’s Bank of China issued new rules at the beginning of February that raise to $50,000 the annual amount of foreign currency a private individual can acquire to handle transactions with foreign suppliers or purchase directly from banks without needing a special permit. The annual quota replaces earlier payment-specific limits and the $20,000 annual ceiling set in May 2006 on the amount of foreign currency a private person could purchase. The change is part of China’s efforts to gradually liberalise its foreign exchange system and achieve full convertibility of the yuan in the long run. The new regulations should make it easier for private individuals e.g. to invest in foreign securities. New rules help reduce appreciation pressures on the yuan also by tightening regulations concerning residents’ possibilities to exchange currencies into the Chinese yuan.

Shanghai A-share index and Moscow RTS index

Sources: Bloomberg and Bank of Finland
Russia

Russian 12-month inflation slows to 7.6 % in February.
Inflation continued to cool in February, falling well within the central bank’s target range of 6.5–8 % for this year. The rise in food prices has slowed in recent months, while inflation for services has accelerated. Russian monetary policy has traditionally focused on keeping the nominal exchange rate stable, which to date has made it hard to restrain inflation in the face of massive capital inflows into Russia, mostly in the form of huge export revenues and investment. However, the CBR has recently signalled plans to shift monetary policy-setting from exchange-rate targeting to inflation targeting. Deputy chairman Alexei Ulyukayev announced that the CBR is in talks with the government on necessary amendments to the law and that the shift to inflation targeting probably take place in three or four years.

CBR reveals composition of foreign currency reserves.
Russia’s central bank last week issued a report specifying for the first time how its international reserves are administered. The report was a response to criticism from the Duma audit committee that the CBR has administrated growing reserves inefficiently. At the end of June 2006, the holdings in currency terms broke down as follows: 51.5 % in US dollars, 38.6 % in euro, 9.8 % in British pounds and 0.2 % in Japanese yen and Swiss francs. The CBR’s international reserves also included $8 billion in gold, as well as other assets worth several hundred million dollars. Russia’s foreign currency reserves last year increased 68 % to $296 billion, making Russia’s foreign currency holding the world’s third largest after China and Japan. At the beginning of this year, Russia was estimated to hold about 6 % of the world’s foreign currency reserves. Russia’s foreign currency reserves include assets in the state stabilisation fund, which is managed by the finance ministry. Stabilisation fund assets as of January 1, 2007, amounted to $89 billion (about 30 % of Russia’s total foreign currency reserves).

International reserves and stabilisation fund 2002–2007, US$ billion

Decline in mobile phone exports to Russia depresses Finnish export growth to Russia. Customs Finland figures show Russia remained Finland’s largest source of imports in 2006, but only the third-largest destination for Finnish exports. The value of Russian imports to Finland was €7.8 billion (14 % of total Finnish imports), up 18 % from a year earlier. The value of exports was €6.2 billion (10 % of total exports), an 8 % increase from 2005.

Russia was the leading destination for Finnish exports the year before. In 2005, Finnish exports to Russia grew by 30 % y-o-y, with mobile phones alone counting for a fifth of total exports. Nearly all major mobile phone manufacturers earlier used Finland as the main mobile phone re-export route to Russia (i.e. phones made in third countries were initially registered as imports to Finland and then as exports to Russia). This distorted Finland’s true export figures for Russia. Last year, many manufacturers found alternative routes into Russia, causing the share of mobile phones in Finnish exports to Russia to decline from 20 % in 2005 to just 9 % last year. On the other hand, re-exports of cars and other home electronics manufactured in third countries continued to increase last year. Re-exported passenger cars alone accounted for 13 % of total Finnish exports to Russia last year. It is estimated that re-exports accounted for 21–28 % of all Finnish exports to Russia in 2005. Exports to Russia of products made in Finland consisted largely of consumer and investment goods. Imports from Russia were largely energy products and raw materials for industry.

Russian trade figures (in euro) show total imports rose 30 % last year. Finland was Russia’s twelfth largest trading partner accounting for 3 % of Russia’s total foreign trade. The value of road freight transit via Finland to Russia in 2006 was estimated at €25 billion, an 8 % increase from the previous year. Transit freight is not subject to Finnish customs nor is it recorded as part of Finland’s foreign trade. The 530,000 passenger cars hauled by lorry through Finland in 2006 constituted 29 % of all road transit freight. The radio, TV and computer category, as well as machinery and equipment, also represented substantial shares of transit freight. The value of transit freight in the radio, TV and computer category, however, declined with a fall-off in mobile phone transit shipments.

Finland’s exports to Russia, Germany and Sweden, 1998–2006, (as a percentage of total exports)
China

China’s National People’s Congress convenes. Monday (Mar. 5) was the first day of the annual National People’s Congress. The two-week meeting brings together almost 3,000 representatives. Although the NPC is nominally China’s highest legislative body, it typically does little more than rubber-stamp legislative proposals from the government.

In his opening address, prime minister Wen Jiabao summarised the government’s achievements last year and laid out the program for the current five-year plan. Wen’s central themes again were improving rural conditions and reducing inequality in Chinese society. As expected, the prime minister also mentioned the importance of developing healthcare, education and environmentally responsible approaches to economic growth. Wen said China’s central government will put greater pressure on local administrations to reduce pollution and increase energy efficiency. China failed badly last year in reaching its energy efficiency targets. Wen said China plans to close down many of its inefficient steel mills during the current five-year plan, jettisoning excess steelmaking capacity of about 100 million tons per year. China’s steel production last year was about 420 million tons. A number of older coal-fired power plants are also slated for closing.

The NPC’s two-week agenda includes consideration and approval of e.g. last year’s realised budget and this year’s proposed budget. The methods for selecting national legislators as well as their number will be decided in the coming days. The five-year term of current representatives ends this year.

The 10th NPC is expected to approve a bundle of new laws. Items under consideration include a new enterprise income tax law that would unify income taxes for domestic and foreign firms, a new property law that would better protect private property and allow e.g. purchase and sale of land use rights. All matters will be voted on next Friday (Mar. 16) when the congress wraps up business.

Paulson makes quick visit to China; yuan’s rise continues. US treasury secretary Henry Paulson took time to visit China this week as part of his Asia tour this week. Paulson repeated his earlier suggestions that Chinese leaders should continue with financial market reforms and support market-based solutions over administrative regulation. He also noted that China’s economy is already so developed and integrated into the global economy that administrative measures have become less effective. To make Chinese monetary policy more effective, Paulson suggested permitting the yuan to fluctuate more widely to help absorb excess liquidity in the markets and thereby reduce risks related to booming credit markets. Paulson was careful not to demand overtly an immediate revaluation of the yuan. This well reflects his new approach of trying to influence Chinese policies through dialogue rather than tough demands.

Over the past two months, the yuan has nominally strengthened 0.9 % against the dollar without noticeable changes in the pace of appreciation recently. When China abandoned its dollar peg in July 2005, one dollar bought 8.28 yuan. To date, the yuan has appreciated 7.0 % against the dollar. In contrast, the yuan’s exchange rate against the euro has tracked shifts in relative values of the euro and the dollar. The yuan has appreciated about 1 % against the euro since end-2006. On Friday (Mar. 9), one dollar bought 7.74 yuan and one euro 10.18 yuan.

Yuan exchange rates for the dollar and euro, 2005–2007

Sources: Reuters, Bank of Finland

China restricts capital imports to ease appreciation pressure on yuan. China’s State Agency for Foreign Exchange (SAFE) is restricting banks’ borrowing from abroad to diminish speculative capital flows into the country. Under the new rules, Chinese banks’ quotas for short-term offshore borrowings will be gradually reduced. By end-June 2007, the foreign borrowing of banks may not exceed 45 % of last year’s quota. Next March, the limit will fall to just a third of the 2006 level. The foreign debt quotas for foreign-owned banks operating in China will be reduced to 85 % by the first of June and just 60 % of the 2006 level by next March.

The Chinese economy has relatively little foreign debt for its size and the degree of foreign indebtedness has risen quite slowly – even if debt in dollar terms climbed 14 % last year. About 57 % of China’s foreign debt consists of short-term liabilities.
Russia

President Putin sends annual budget message to parliament. In last week’s budget message, president Vladimir Putin notes the achievements of budget policy in recent years as well as the fiscal challenges facing the nation and budget guidelines for 2008–2010. The message states that the strategic goals for the budget sector laid out in 2001 have generally been met: the federal budget has been in surplus since 2000, foreign debt has been paid down, the budgeting process has become more efficient, transparency has increased and the tax burden has generally been reduced.

According to Putin, budget policy should be made an effective tool for regulating the macro economy and e.g. in helping bring annual inflation down to a level of 3–4 % (9 % in 2006). The Russian economy’s heavy dependence on raw materials need to be reduced and the operating principles of the stabilisation fund changed so that the fund not only captures an increasing share of crude oil earnings but also substantial shares of earnings from the sale of gas and refined oil products. Putin suggests dividing the stabilisation fund into two parts: a reserve fund and a fund for future generations. The reserve fund would be used to balance the federal budget. The amount of assets transferred to the reserve fund and the federal budget need to be defined relative to GDP. Any money left after transfers to the reserve fund and the budget would be set aside in the future generations fund.

The president also wants to increase longer-term budget planning. In addition to the annual budgeting process and the current shift to three-year budgeting, he would also like to see 10–15-year budget outlines. In addition to the current budget spending emphasis on “national projects” (housing, health care, education and agriculture), he requested a strong focus on road construction, shipbuilding and development of the aerospace industry. The president is particularly concerned about finding immediate answers to financing the pension fund. Agencies administering budget spending need greater independence and responsibility if they are to increase efficiency and improve productivity. Russia’s regional and local levels need to develop ways to boost their own revenue collections and wean themselves from overdependence on federal transfers to fund their budgets. The message also includes a call to study possibilities to reduce the tax burden.

Further hike in deposit guarantee. President Putin this week signed legislation raising the ceiling on insured deposits of private individuals from 190,000 roubles to 400,000 roubles (about 12,000 euros). Russia’s original deposit insurance scheme, introduced in 2004, set a ceiling of 100,000 roubles (about 12,000 euros). At the beginning of 2007, Russia had 921 banks licensed to take deposits from private individuals. To qualify for a license, the bank must show that it has been approved to join the deposit insurance scheme. Over a hundred banks had their licenses revoked in 2006. Nearly all of the €100 billion of deposits of private individuals held by banks at the start of this year were covered by the deposit insurance scheme. Russians deposited a total of €30 billion in 2006, about a third more than in 2005. The rapid increase in deposits has been driven by rising real incomes. Last summer’s hike in the guarantee ceiling apparently also increased trust in banks as deposits increased strongly in the second half of 2006.

14 regions elect new regional parliaments. The United Russia (UR) party was the clear winner in last Sunday’s (Mar. 11) regional elections. Candidates on UR party lists took an average of 45 % of the vote, allowing it to hold on to top-party status in 13 of the 14 regions holding elections. The Communist Party, which gathered 16 % of the vote, was nearly matched by the newly established Just Russia party (JR) which took over 15 % of the vote. Just Russia was even the overall winner in the southern Stavropol Region. Zhirinovski’s nationalist Liberal Democratic Party gathered just over 9 % of the vote. Observers were also surprised that the centre-right Union of Rightist Forces (URF) managed to exceed the 7 % threshold in five regions. The URF, however, failed to win a seat on the St. Petersburg city council, even if the city is the party’s stronghold. Voter turnout was up slightly to 39 % from just over 37 % in 2003.

Three older parties – Motherland, the Pensioners’ Party and the Life Party – combined to create the new Just Russia party, which is led by Federation Council chairman Sergei Mironov. In his view, Just Russia must become Russia’s leading leftist party and displace the Communist Party in heading the opposition to United Russia, which is led by Duma speaker Boris Gryzlov. To the surprise of many, newcomer JR raked in nearly 38 % of the vote in the Stavropol Region, while the ruling UR party had to settle for less than 24 % of the vote.

All parties consider last Sunday’s regional elections a dress rehearsal for the Duma election next December. The current Duma parties (UR, Communists, JR and the Liberal Democrats) are all expected to win re-election with little difficulty. The chances of the URF to become the fifth Duma party are seen slim even with the successes in regional elections. There have been major changes to Russian elections law since the 2003 Duma elections. All 450 representatives are now elected from party lists in accordance with a proportional representation system, the threshold for a party to enter the Duma has been raised to 7 % of the vote from 5 %, election alliances are no longer permitted, voters may no longer vote for “none of the above” and the minimum requirement of 25 % voter turnout has been abolished.
China posts massive trade surplus in February; exports of higher value-added products increasing. China Customs reports a foreign trade surplus of $24 billion for February. The increase reflected an over 50 % y-o-y increase in exports, while imports rose just 13 %. The $40-billion surplus amassed in the first two months of 2007 was three times larger than in the same period a year earlier, suggesting that this year’s surplus could far exceed last year’s record. While China says it remains committed to balancing its foreign trade, efforts to date have been modest.

The structure of China’s foreign trade has changed substantially in the 2000s. Exports are increasingly directed towards higher value-added products. The share of food and raw materials has fallen from 10 % to 5 %, while the share of machinery and equipment in exports has risen slightly to 57 % in 2006. Exports of high-tech products have also increased. High-tech products accounted for 29 % of China’s total exports in 2006, up from 25 % in 2003. In recent years, car exports have also been on the upswing, even if export volumes remain modest. One reason for the shift in the structure of exports is the increased emphasis on processing trade by foreign companies operating in China. The share of processed export goods has continued to increase at the same pace as exports generally. Processed goods account for over half of China’s total exports. With support of major international manufacturers’ processing operations, China has become the world’s largest exporter of mobile phones and laptops.

China’s imports still consist mainly of machinery and equipment, which has remained at a slightly more than 50 % share for the past seven years. At the same time, the share of raw materials has risen steadily. In 2006, raw materials accounted for 24 % of total imports. The higher raw material import figures partly reflect higher prices and volumes of crude oil imports as well as increased raw material demand from processing industries. About 40 % of imports are intermediate products for further processing.

China strengthens its position as a major trade partner of Finland. Finland’s imports from China grew by 46 % last year to €4.1 billion. The value of Finnish exports to China rose 27 % to €2.0 billion. China accounted for 7.5 % of Finland’s total imports, making China Finland’s fourth largest source of imports. Some 3.2 % of Finland’s total exports went to China, which boosted China into a tie with Italy as Finland’s eighth largest trading partner. Hong Kong, which was not included in the above figures, represented 0.2 % of Finland’s imports and 0.5 % of exports.

Figures from mid-2006 show electrical machinery and equipment accounted for 35 % of exports. Within this category, mobile telephones were the largest product group. The machinery and equipment category accounted for a quarter of exports. The value of Finnish machinery and equipment exports to China has varied wildly in recent years due mainly to paper machine deliveries. The impact of paper machines is even visible in the overall export trend (see chart). The remaining shares of exports are fairly evenly divided among Finland’s traditional export products of forest and metal industries.

Mid-2006 figures show Finland’s imports of phones, radios and televisions from China soared to 35 % of Finland’s total imports from China. China became the main source of mobile phone imports. However, most imported mobile phones are re-exported from Finland to third countries. When office equipment, computers and other electrical equipment are included, electrical equipment accounted for nearly 70 % of Finland’s imports from China. Textiles, clothing, leather goods and footwear accounted for just over 10 % of Finland’s imports from China. China was by far Finland’s largest source of imports of textiles, clothing, leather goods and footwear, accounting for more than a fifth of all such imports.

China’s significance to Finland as a trading partner is considerably larger than to the average EU country. In 2005, China represented 4.9 % of total imports to EU countries (external and internal trade) and 1.6 % of exports.

China creates new investment company to manage part of its foreign currency reserves. China’s state-owned news agency Xinhua reports that China will establish a new investment firm to manage part of its over $1 trillion in foreign currency reserves. It is widely expected that $200–300 billion would be shifted to the new fund. The aim of the new arrangement is to improve yields on foreign currency reserve assets which up to now have been mainly invested in low-risk, low-yield instruments such as US treasuries. Former deputy finance minister Lou Jiwei has been tapped to lead the group that will set up the new fund and, supposedly, he will be the new company’s CEO.
Russia

**Russia’s 2006 consolidated budget strongly in surplus.**

Rosstat’s latest consolidated budget figures include the federal budget, regional budgets and also state off-budget funds. Consolidated budget revenues and expenditures grew by nearly a quarter in nominal terms, with consumer inflation running at 9%. The shares of revenues and expenditures relative to GDP remained nearly unchanged from 2005, leaving the surplus high (8.5% of GDP).

The largest single revenue stream in the consolidated budget was still export and import tariffs, which accounted for over a fifth of total revenues in 2006. The share of profit tax remained unchanged at 16%. Revenues from the value-added tax (VAT) fell sharply both relative to GDP and as a share of budget revenues. The decline in VAT revenues reflects sharp increases in VAT refunds and exemptions as a result of changes in the law. Other significant income streams included social taxes and mandatory payments and natural resource use fees.

Over half of 2006 consolidated budget expenditures went to the social and cultural sector. Although such spending increased 15% in real terms, the share of social spending remained essentially the same as in 2005. Spending on the social and culture sector includes spending on e.g. social policy, health care and education. The “production, transport, etc.” and the general administration categories each accounted for about 10% of spending. General administration was the only spending category where expenditures remained at the 2005 level in real terms. Real growth in housing spending was the highest of all spending categories.

Russia’s consolidated budget 2006

<table>
<thead>
<tr>
<th>2006</th>
<th>% of GDP</th>
<th>% share</th>
</tr>
</thead>
<tbody>
<tr>
<td>RUB bn</td>
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<td>2006</td>
</tr>
<tr>
<td>Revenues</td>
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<tr>
<td>Export and import tariffs</td>
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<td>Profit tax</td>
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<td>Revenues from public property</td>
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<tr>
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<td>Expenditures</td>
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<tr>
<td>Expenditures</td>
<td>8,384</td>
<td>31.5</td>
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<td>Social and cultural sector</td>
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<td>30.8</td>
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<tr>
<td>Production, transport, etc.</td>
<td>4,555</td>
<td>17.1</td>
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<tr>
<td>General administration</td>
<td>950</td>
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<tr>
<td>National security and law enforcement</td>
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<tr>
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<tr>
<td>Housing</td>
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<tr>
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<td>631</td>
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<tr>
<td>Surplus</td>
<td>2,259</td>
<td>8.5</td>
</tr>
</tbody>
</table>

Source: Rosstat

1 includes state off-budget funds

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**Growth in foreign investments in Russia slowed in 2006.**

Investments are classified as direct investments, portfolio investments or “other investments,” which include loans and deposits, trade credits, accounts receivable and other debts. These investments in the Russian private sector last year amounted to $57 billion according to the CBR and $55 billion according to Rosstat. According to CBR figures, investments grew 5% y-o-y, while Rosstat figures showed 3%. The pace of growth has slowed substantially: just a year ago investments according to both authorities were growing at over 30%. The CBR and Rosstat figures differ mainly in the distribution of investments. The CBR says that 54% of total investments last year were direct investments, 28% portfolio investments and 18% other investments. Rosstat states 25% of investments were direct investments, 6% portfolio investments and 69% other investments. The CBR and Rosstat figures have traditionally differed slightly from each other due to differences in statistical methodologies. Unlike Rosstat, the CBR includes reinvested profits of foreign subsidiaries in its direct investment figures. This alone, however, does not explain the differences in categorisation. Apparently, Rosstat records as long-term loans from abroad components that the CBR considers as direct investments and portfolio investments.

Rosstat also reports the breakdown of foreign investments by sector. In 2006, nearly a third of investments went to manufacturing industries, a fifth to mineral extraction industries and a fifth to retail sales. The real estate and construction fields together accounted for about a tenth, the same as the transportation sector. The leading countries investing in Russia last year were Cyprus, the UK and the Netherlands.

Rosstat said Russian investments abroad in 2006 reached $52 billion (up 67% y-o-y), with the US and Austria topping the lists of investment destinations.

**Foreign investment inflows to Russia 1998–2006, US$ billion**

Source: Rosstat
### China

**People’s Congress ends by approving laws on corporate income tax and protecting property.** Under the new corporate income tax law implemented at the start of 2008, corporate income tax rates charged to domestic and foreign firms will, within a five-year transition period, be unified at 25%. Foreign firms have paid a 15% tax rate and domestic firms 33%. Domestic firms, however, enjoy a range of tax breaks making their effective tax rate considerably lower. Under the new law, foreign hi-tech technology firms will continue to be subject to a 15% income tax. According to official estimates, the new law will cause a net reduction in state income of 100 billion yuan (€10bn). Observers say the new law will especially benefit commercial banks.

After years of preparation, China got its first property law setting forth the property rights of the state, collectives and private individuals. The state will continue to own most of the national infrastructure and all land. The state can appropriate land for new uses as long as the current possessor is fairly compensated for any losses. The taking of farmland for construction is strictly limited under the law, but the law is unclear on how this is to be enforced. The transfer of land use rights is allowed with official permission and the law provides an opportunity for the use of real property as collateral (excluding farmland use rights). The law has received mixed reviews. While the need for such laws is generally acknowledged, most people would like to see further clarification.

**State spending and income increase rapidly.** China released information about the realised 2006 budget and the 2007 budget. State spending last year amounted to 4,000 billion yuan (€400 billion) or 19% of GDP. Although the realised budget was 150 billion yuan (0.7% of GDP) in the red, the deficit was smaller than projected due to higher-than-expected growth in revenues (up 24% y-o-y). The central administration budget showed a deficit, while regional administrations posted surpluses. Regional administrations cannot draft deficit budgets without special permission from the central administration.

China expects budget spending of the central administration to rise 16% this year, and the budget is planned to be slightly in deficit. There are practically no changes in spending structures. Although number of programs focus specifically on improving rural conditions, budget spending on rural areas will increase only 15% (less than overall spending), a. The spending on rural areas amounts to 8% of the budget, about the same as defence spending. Some 4% of rural spending is earmarked for poverty reduction. Spending on education will rise 42% this year, although the actual amount is still quite modest (2% of expenditures).

Health care spending nearly doubles, but is still below 1% of total spending. Social security spending will go up 14% this year and science and research spending 20%.

**State spending, revenues and overall deficit, % of GDP**

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue (left)</th>
<th>Expenditure (left)</th>
<th>Balance (right)</th>
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</thead>
<tbody>
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<td>2000</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2007*</td>
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</tbody>
</table>

* estimate

Source: National Statistics Bureau, Budget Draft 2007

**PBoC hikes rates again.** Last weekend the People’s Bank of China lifted lending and deposit rates by 0.27%. Following the hike, the one-year reference rate was 2.79% for deposits and 6.39% for loans.

Several factors underlie the decision to tighten. Despite earlier measures, economic growth continues to boom. On-year growth in industrial output accelerated in the first two months of the year to nearly 19%, while fixed investment rose 23% y-o-y. The foreign trade surplus in January-February hit a new record, further increasing liquidity in the economy. Credit growth continued to sizzle in the first two months of the year. Finally, 12-month inflation accelerated in February to 2.7%. While much of the recent inflation spurt reflects higher food prices, the central bank wants to nip any inflation expectations at the bud. Without the rate hikes, real interest paid on household deposits would have turned negative, further fuelling the desire of average people to transfer their bank saving to the stock market, where prices have soared.

Implementing monetary policy in China is difficult under current circumstances. Higher yuan interest rates reduce the interest differential between China and the United States and increase speculative capital flows into China, which, in turn, adds to appreciation pressures on the yuan. In the opinion of many, China should tolerate faster appreciation of the yuan to ease its current monetary imbalances.

**Chinese inflation and reference interest rates on one-year loans and deposits, %**

<table>
<thead>
<tr>
<th>Year</th>
<th>Inflation</th>
<th>Deposits</th>
<th>Lending</th>
</tr>
</thead>
<tbody>
<tr>
<td>1996</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td></td>
<td></td>
<td></td>
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<td>1998</td>
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<td>2004</td>
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<td></td>
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<tr>
<td>2005</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: NBSC, PBC, CEIC

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*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

Russia’s WTO talks continue. Multilateral negotiations on Russia’s WTO accession continued at the start of this month in Geneva. The list of unresolved issues continues to be topped by phytosanitary measures, intellectual property rights and agricultural subsidies. However, new problems between the EU and Russia are also brewing. The EU criticised Russia for failing to uphold its end of the bilateral trade agreement signed in 2004. The most pressing issues have to do with Russia’s recent hikes in raw wood export tariffs, the banning of meat imports from Poland and discriminatory rail tariffs. These subjects continued to come up also in informal three-way talks involving the US, EU and Russia, and during this week’s visit of EU trade commissioner Peter Mandelson to Moscow. Mandelson commented that slight progress had been made in the talks.

Prime minister Mikhail Fradkov visits Africa to study business cooperation opportunities. Mr. Fradkov took the opportunity of the first Russian premier visit ever to the southern part of the African continent – Angola, Namibia and South Africa – to promote a new stage of cooperation in energy and natural resource industries. In recent years, Russia has been involved in development work in Africa and granted debt forgiveness to a number of countries, but its trade cooperation has remained modest. Fradkov said Russia now has the economic possibilities to participate in oil, gas, diamond and metal projects in Africa. Perhaps the most concrete results were achieved in Angola. Russian diamond producer Alrosa is currently developing two diamond deposits in Angola and plans to expand its operations in the oil and gas sector. Russia also is involved in early discussions with Namibia, which currently imports all its electricity from South Africa, on developing a uranium mine and construction of a nuclear power plant. South Africa is the only country visited with which Russia has an investment protection agreement. Alrosa last year signed a diamond mining cooperation agreement with the South African De Beers, but many other Russian companies also would like to get involved in South Africa’s oil, gas and metal businesses.

Possible changes ahead for electricity sector privatisation plan. The board of state electricity monopoly RAO UES has approved the company’s revised privatisation plan. Under the plan, the state would not sell off production companies slated for privatisation directly to investors, but would create two intermediate holding companies with the state holding a majority position. The purpose of the change is to resolve legislative inconsistencies on privatisation of state production facilities and encourage investment in an electricity sector starved for investment. Some complain that the new privatisation plan is unnecessarily complicated and will delay privatisation of the electricity sector.

UES has also agreed with Gazprom on gas deliveries for 2007–2011. Under the deal, Gazprom will provide about 60 % of UES’ annual gas requirements at a government-set price. The rest of UES gas needs will be satisfied with gas purchased at prevailing market prices (from 2011 onwards the gas price will be determined by the market price charged to all industrial consumers). Russia now generates over 60 % of its electricity with gas, but it strives to increase coal’s share. Gazprom has signed a memorandum of understanding deal with SUEK, Russia’s largest coal producer, on merger of the companies’ electricity production and coal resource holdings. The companies are estimated to control about a quarter of Russia’s electricity production. The project still needs the blessing of the Russian competition authority. UES head Anatoli Chubais and economy minister German Gref have criticised Gazprom’s plans, claiming they conflict with the overall goals of electricity sector reform.

Finns increase portfolio investment in Russia. According to Bank of Finland balance-of-payments figures, the stock of Finnish direct investment in Russia rose to €1.3 billion at the end of 2006. Portfolio investment amounted to €1.8 billion. The figures do not include investments in Russia made by Finnish investors via a third country. Direct investment is defined as investment to establish a subsidiary or production facility as well as corporate acquisitions when the Finnish investor acquires at least a 10 % voting share in the Russian firm. The stock of direct investment grew last year by €220 million, mainly as a result of rising asset valuations. The net investment inflow remained modest due to Nordea’s €400-million divestment last year of its stake in International Moscow Bank. Portfolio investment includes financial investment where the Finnish investor takes a less than 10 % voting share in a company, and some debt securities. Such investments are seen as purely focused on generating investment income, e.g. investment in Russia-themed mutual funds. The stock of portfolio investment in Russia rose over 50 % last year and is now substantially larger than direct investment stock.

Stocks of Finnish portfolio and direct investment in Russia 2004–2006, € billion

![Graph showing the stocks of Finnish portfolio and direct investment in Russia from 2004 to 2006.](image-url)
China

Chinese growth driving Asian economic development. The Asian Development Bank (ADB) expects approximately 8% growth this year and next for Asia (excluding Japan). Asian economic growth will continue to be led by high growth in the Chinese and Indian economies. The two giant nations accounted for about 70% of all growth in the region in 2006.

ADB forecasts China’s economy will grow about 10% annually in 2007 and 2008. Rising investment, exports and domestic consumption underlie the robust growth. The ADB would like to see domestic consumption assume a larger share of China’s economic growth so that the country would be less susceptible to shocks from the global economy. The forecast also expressed worries that investment is growing too rapidly (over 20%), which could lead to over-capacity and deflation. ADB noted the rising disparity in Chinese incomes, unemployment and environmental problems, and said China needs to focus on service sector to increase job creation. ADB considers reforms in the finance sector exceptionally important for China. Households need access to consumer credit for the purchase of durable goods, education and covering social costs.

Banking sector still burdened by non-performing loans. At the end of 2006, the stock of non-performing loans held by Chinese banks was nearly 1.3 trillion yuan (€130bn), a slight decline from a year earlier. Non-performing loans represented about 7% of the entire loan stock at the end of 2006. The share has been slightly declining, as the loan stock has been growing. Officials hope to improve the health of state-owned Agricultural Bank of China this year. By some estimates, the bank needs a capital infusion from the state of 1 trillion yuan (€100bn) to clear its books of non-performing loans. China is working hard to prevent new non-performing loans through a variety of measures that include setting a deadline for banks to adopt the Basel II framework for capital adequacy and risk assessment. The new system should be in place at all large Chinese banks by the end of decade. Li Jinhui, head of China’s National Audit Office, said it could take Chinese banks as long as 20 years to internalise risk assessment practices that meet current western standards.

China launches new Postal Savings Bank. China has long planned to break up postal operations. The new Postal Savings Bank began operating on March 20, and oversees deposits of 1.660 billion yuan, making it the country’s fifth largest bank. It has 36,000 branches throughout China. Officials have limited the new bank’s range of operations initially. The bank will continue to provide deposit-taking services and will be allowed to grant small loans and consumer credits. Officials hope that the bank can help alleviate problems of access to credit of firms and private individuals in the rural areas.

Chinese and Russian leaders pledge to increase economic cooperation. On Monday (Mar. 26), Chinese president Hu Jintao arrived in Moscow for a three-day official visit to Russia. Hu and Russian president Vladimir Putin emphasised the potential of economic relations between China and Russia.

During the visit nearly two dozen company-level economic agreements with a total value of over $4 billion were signed. The deals cover a range of topics, including exports of Chinese cars, home appliances and foodstuffs to Russia, and exports of Russian machine-building equipment and steel products to China. The parties also agreed on four major joint projects involving wood processing, shipbuilding and mining. Originally, it was planned that the leaders would also sign an agreement boosting Russian oil deliveries to China by rail from last year’s 10 million tons to 15 million tons. The deal collapsed, at least temporarily, due to high freight charges demanded by Russian railways.

Previously, joint Russia-China investment projects have often been marred by a tendency to not be completed. China’s National Bureau of Statistics figures show Chinese exports to Russia climbed 20% in 2006 to about $16 billion, while imports from Russia increased 11% to about $18 billion. (Russian figures show imports last year from China amounted to $13bn and exports to China $16bn.)

Russia plays a relatively minor role in China’s foreign trade, accounting for just 2% of Chinese imports and exports. However, Russia is a big provider of raw wood (30–40% of Chinese imports), oil products (over 10%) and military arms and weapons systems.

From Russia’s standpoint, the trade development between the two countries is somewhat disconcerting. While China’s share of Russian exports has in recent years fallen to about 5%, China’s presence on Russian markets has exploded (see graph).

China’s share of Russian foreign trade, %
Russia

Russian 2006 current account surplus shrank slightly as share of GDP. According to revised Central Bank of Russia balance-of-payments figures, last year’s current account surplus was $94 billion, which corresponded to just under 10% of GDP (11% in 2005). The share shrank due to the dip in world oil prices in mid-2006 that cut into export second-half earnings. Import growth remained brisk. Crude oil and oil products represented 48% of goods exports last year. The goods trade surplus shrank to 14% of GDP, and the services trade deficit persisted at 2% of GDP. The investment income and compensation of employees account deficit rose to nearly 3% of GDP, due in part to higher stock dividend payments and debt servicing costs.

On the financial account, growth in foreign direct investment into Russia slowed sharply in 4Q06. Russia received a total of $29 billion for the year, which corresponded to 3% of GDP. The inflow of foreign portfolio investment was concentrated mainly in the third quarter of the year. For all of 2006, they totalled $12 billion. Direct investment outflows from Russia increased to $18 billion. The account for portfolio investment out from Russia was negative as Russians repatriated $0.5 billion more portfolio investments than they invested abroad. Capital flight from Russia, under the account of non-repatriation of exports proceeds, non-supply of goods and services against import contracts, remittances against fictitious transactions in securities fell slightly from 2005 to a bit more than $19 billion. The international borrowing of Russian firms and banks increased sharply. Russia’s gold and foreign currency reserves soared by $107 billion in 2006 and stood at $332 billion as of mid-March 2007. Russia currently has the world’s third largest foreign currency reserves and the fourth largest current account surplus.

Russian current account surplus, 2002–2006

Regional budget surplus up in 2006. The combined 2006 revenues and expenditures of consolidated regional budget and off-budget regional funds increased by over a quarter in nominal terms. Both regional revenues and spending rose slightly as shares of GDP, and the consolidated surplus corresponded to 0.5% of GDP (0.3% of GDP in 2005). The structure of revenues and expenditures remained largely unchanged from 2005. The biggest revenue streams for regions were the profit tax, income tax and transfers from the federal budget. These together constituted over two-thirds of regional revenues. Rising budget transfers from the federal budget increased regional dependence on the central administration. Regional spending focused on the social and cultural sector, where about 35% went to education, a third to social policy and over a quarter to health care. The production and transport sector and the housing sector each accounted for 15% of expenditures.

Consolidated 2006 regional budget ¹

<table>
<thead>
<tr>
<th></th>
<th>2006 RUBbn</th>
<th>2006% of GDP</th>
<th>2006%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>4,135</td>
<td>15.5</td>
<td>100</td>
</tr>
<tr>
<td>Profit tax</td>
<td>1,161</td>
<td>4.4</td>
<td>28</td>
</tr>
<tr>
<td>Income tax</td>
<td>930</td>
<td>3.5</td>
<td>23</td>
</tr>
<tr>
<td>Transfers from the federal budget</td>
<td>716</td>
<td>2.7</td>
<td>17</td>
</tr>
<tr>
<td>Property taxes</td>
<td>311</td>
<td>1.2</td>
<td>8</td>
</tr>
<tr>
<td>Social contributions</td>
<td>209</td>
<td>0.8</td>
<td>5</td>
</tr>
<tr>
<td>Income from public property</td>
<td>197</td>
<td>0.7</td>
<td>5</td>
</tr>
<tr>
<td>Excise taxes</td>
<td>160</td>
<td>0.6</td>
<td>4</td>
</tr>
<tr>
<td>Other revenues</td>
<td>451</td>
<td>1.7</td>
<td>10</td>
</tr>
<tr>
<td>Expenditures</td>
<td>3,996</td>
<td>15.0</td>
<td>100</td>
</tr>
<tr>
<td>Social and cultural sector ¹</td>
<td>2,300</td>
<td>8.6</td>
<td>58</td>
</tr>
<tr>
<td>Production, transport, etc.</td>
<td>605</td>
<td>2.3</td>
<td>15</td>
</tr>
<tr>
<td>Housing</td>
<td>579</td>
<td>2.2</td>
<td>15</td>
</tr>
<tr>
<td>Administration</td>
<td>295</td>
<td>1.1</td>
<td>7</td>
</tr>
<tr>
<td>Other expenditures</td>
<td>217</td>
<td>0.8</td>
<td>5</td>
</tr>
<tr>
<td>Surplus</td>
<td>139</td>
<td>0.5</td>
<td></td>
</tr>
</tbody>
</table>

Source: Rosstat

¹ Includes off-budget regional funds
* Consisting mainly of spending on health care and social services

Russian oligarchs get wealthier. In its annual rating on the richest people in the world, Forbes magazine lists 53 Russian billionaires with a combined worth of $282 billion. The 2006 Forbes list included only 33 Russians. The wealth of those listed in 2006 increased by about a third. The fortune of Russia’s oligarchs was boosted largely by the rapid appreciation in the value of their companies and increased transparency of ownership structures. Stable economic growth, Russia’s improved credit ratings and increased international investor interest in Russian companies has improved the opportunities for Russian firms to stage IPOs on international stock markets, which, in turn, has boosted market capitalisations both at home and abroad.

Russian five richest persons in 2007

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>R. Abramovich</td>
<td>18.7</td>
<td>10th</td>
<td>10th</td>
</tr>
<tr>
<td>S. Kerimov</td>
<td>14.4</td>
<td>35th</td>
<td>41st</td>
</tr>
<tr>
<td>V. Lisin</td>
<td>14.3</td>
<td>36th</td>
<td>50th</td>
</tr>
<tr>
<td>V. Potanin</td>
<td>13.5</td>
<td>38th</td>
<td>46th</td>
</tr>
<tr>
<td>M. Prokhorov</td>
<td>13.5</td>
<td>38th</td>
<td>41st</td>
</tr>
</tbody>
</table>

Source: Forbes

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China

US escalates measures on Chinese imports. The United States last week imposed 10–20 % countervailing duties on Chinese high-gloss paper. US trade officials justified the imposition of the duties, noting that Chinese producers are given state aid in violation of international agreements. The decision was seen as a major reversal of US policy as the US has not imposed a countervailing duty on any country classed as a non-market economy in over twenty years. The move was announced by US commerce secretary Carlos Gutierrez, who noted China is no longer a traditional command economy, but corporations in China take advantage of state subsidies to gain a competitive edge. The US says the evolution justified its decision to expand its trade policy toolbox to include countervailing duties.

The US has long accused China of unfair competition practices and demanded that China speed up revaluation of the yuan. The Americans also complain about the inadequacy of Chinese efforts at protecting intellectual property rights and removing barriers to access to Chinese markets. The new US congress has also sharpened its stance on Chinese trade. Many observers feel the Democrats and Republicans are united on passing protectionist legislation against China. Two months ago, the US filed a complaint with the WTO charging that Chinese subsidies of domestic firms had an illegal discriminatory effect against foreign firms operating in China. The EU and Japan also accuse China of competition-distorting state subsidies and unfair competition practices. Last autumn, the EU filed a complaint with the WTO concerning Chinese tariffs on imported car parts. The parties have also accused each other of rocking the boat in the latest Doha Round of WTO talks. China has criticised heavily the use of agricultural tariffs and subsidies by the EU and US.

What is undisputed is that China’s subsidy arrangements are complex. Firms often collect supports from several agencies in a variety of forms. The subsidies vary in size from the billions of euros paid out in direct subsidies to state banks and oil companies to modest benefits or exemptions granted by local authorities. One of most controversial practices is China’s use of state export subsidies to develop specific industrial fields. Whatever the case, China is gradually weaning firms off export subsidies. At the end of March, China announced it would reduce the amount of tax refunds going to companies involved in metal exports. At the same time, China said over 300 articles would no longer require import licensing. Import liberalisation affects such goods as steel products, electronics, plastics and machinery. By reducing export subsidies and freeing up imports, China hopes to slow the growth in its swelling foreign trade surplus, thereby reducing imbalances in the domestic economy and appreciation pressures on the yuan.

Some fear the US decision to impose punitive duty on high-gloss paper is a harbinger of further protectionist measures in other fields and reprisal measures from the Chinese. The increased willingness of governments to resort to protectionist measures is widely seen as a serious threat to global economic growth.

Rapid economic growth in Hong Kong and Macao continued in 2006. Preliminary figures show GDP of the 7-million-resident Hong Kong Special Administrative Region rose nearly 7 % in real terms in 2006. The SAR’s annual economic growth exceeded 6 % for the third year in a row, after a period of subdued economic growth during 2000–2003. High economic growth drove down the unemployment rate to just over 4 %, which helped fuel growth in domestic consumption stimulated also by fast investment growth (8 % in 2006). The SAR’s allimportant service sector grew nearly 9 %. Hong Kong’s economic growth has accelerated as Mainland China’s economic growth has remained brisk. Mainland China and Hong Kong continued to liberalise bilateral trade and e.g. increased opportunities to make transactions in yuan in Hong Kong. The latest version of the Closer Economic Partnership Arrangement, CEPA IV, entered into force at the start of this year. One of the main thrusts of CEPA IV is to reduce restrictions on trade in services and the transportation sector. The new agreement also makes it easier for Hong Kongers to establish companies in Mainland China. Hong Kong officials estimated that the local economy will grow 5 % this year.

The Macao SAR, with its half-million population, saw GDP climb last year 17 % y-o-y. The economic growth figures for the region have been impressive, albeit uneven, in recent years (GDP grew 28 % in 2004 and 7 % in 2005). Macao’s main industry, gambling, saw profits soar 22 % last year to nearly 50 % of GDP. Macao overtook Las Vegas as the world’s top gambling market. Gambling is forbidden elsewhere in China, so last year Macao was visited by 19 million Mainland Chinese and Hong Kongers. Increased numbers of casino-goers and higher profits have increased investments substantially (up 40 % in real terms in 2006). In recent years, many large international casino operators have invested in Macao. Macao, like Hong Kong, has also signed CEPA agreements with Mainland China.
Russia

Russian inflation continues to decline. 12-month inflation fell in March to 7.4%. For the second month in a row, inflation ran at a level below the government’s 8% target ceiling for this year. The Central Bank of Russia appears to be departing slightly from its policy of recent years as it has cautiously allowed the rouble’s nominal exchange rate to strengthen. This, in turn, has helped in the inflation battle.

Food items make up about 40% of Russia’s consumer price index. The rise in food prices has slowed to a half from a year earlier, and was 5% y-o-y in March. Prices for services, which account for a fourth of the consumer price index, rose at 14% y-o-y. Prices for non-food goods increased 6% y-o-y.

12-month inflation and inflation targets, 2001–2007, %

<table>
<thead>
<tr>
<th>Year</th>
<th>Realised 12-month inflation</th>
<th>Government inflation target for year</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>25</td>
<td>30</td>
</tr>
<tr>
<td>2002</td>
<td>20</td>
<td>25</td>
</tr>
<tr>
<td>2003</td>
<td>15</td>
<td>20</td>
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<tr>
<td>2004</td>
<td>10</td>
<td>15</td>
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<tr>
<td>2005</td>
<td>5</td>
<td>10</td>
</tr>
<tr>
<td>2006</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>2007</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

Sources: Rosstat, RenCap

Rouble appreciation slows. The rouble’s nominal exchange rate against a trade-weighted currency basket increased 0.4% in the first quarter of 2007 (2.2% in 1Q06). Appreciation pressures on the rouble have slightly abated with growth in export earnings falling from a year ago. The rouble has strengthened 0.7% against the dollar and 0.5% against the euro since the start of this year.

The rouble’s real exchange rate against a trade-weighted currency basket appreciated in January-March 2.6% (compared to 6.2% in 1Q06). Slower inflation has also eased the appreciation of the rouble’s real exchange rate. The economy ministry’s December forecast projected a 4.6% rise in the real exchange rate this year (actual increase of 7.4% in 2006). In the first quarter, the rouble strengthened in real terms 2.7% against the dollar and 3.2% against the euro.

Gas exporters establish committee to study formation of gas prices. At this week’s meeting of the Gas Exporting Countries Forum (GECF) in Doha, members discussed ways to increase cooperation. While some members support the establishment of an OPEC-style natural gas cartel, others favour looser forms of cooperation. In the end, GECF members voted to establish a technical committee of high-level bureaucrats to study the mechanisms of gas price formation on international markets. Russian industry and energy minister Viktor Khristenko said Russia was prepared to act as committee coordinator as well as host the next GECF meeting. The GECF’s 15 member states control over 70% of the world’s natural gas reserves and account for over 40% of current gas production.

GECF member state shares of the world’s proven natural gas reserves and production in 2005

<table>
<thead>
<tr>
<th>Country</th>
<th>Share of proven gas resources, %</th>
<th>Share of world production, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>27.1</td>
<td>21.6</td>
</tr>
<tr>
<td>Iran</td>
<td>15.5</td>
<td>3.1</td>
</tr>
<tr>
<td>Qatar</td>
<td>14.6</td>
<td>1.6</td>
</tr>
<tr>
<td>United Arab Emirates</td>
<td>3.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Nigeria</td>
<td>2.9</td>
<td>0.8</td>
</tr>
<tr>
<td>Algeria</td>
<td>2.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Venezuela</td>
<td>2.4</td>
<td>1.0</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1.5</td>
<td>2.8</td>
</tr>
<tr>
<td>Egypt</td>
<td>1.1</td>
<td>1.3</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.9</td>
<td>2.2</td>
</tr>
<tr>
<td>Libya</td>
<td>0.8</td>
<td>0.4</td>
</tr>
<tr>
<td>Oman</td>
<td>0.4</td>
<td>0.6</td>
</tr>
<tr>
<td>Bolivia</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>0.3</td>
<td>1.0</td>
</tr>
<tr>
<td>Brunei</td>
<td>0.2</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Sources: IEA, BP Statistical Review

Yukos bankruptcy assets on the auction block. The process of auctioning off the remaining assets of the bankrupt Yukos oil company began at the end of March when a subsidiary of state oil company Rosneft bought back a 9% stake of its own shares from the Yukos estate for a price of $7.6 billion. At the beginning of April, a consortium of the Italian energy companies Eni and Enel submitted a winning bid of $6.8 billion for Yukos’ 20% stake in Gazprom Neft (formerly Sibneft). Following the auction, the Italian bidders announced that they had also agreed with Gazprom on a call option that gives Gazprom the right to purchase the stake in Gazprom Neft within the next 24 months. Among the most significant assets remaining in the Yukos bankruptcy estate are the Yukos subsidiaries Samaraneftegaz and Tomskneft. Starting bids around $6 billion have been set for each subsidiary in an early May auction. The Yukos estate still owes about $27 billion to creditors, mainly the tax authorities and Rosneft. Most Yukos assets are expected to wind up in the hands of state-owned entities, particularly Rosneft. Rosneft geared up for the March auction by borrowing $22 billion in cash from international lenders.
China

China’s foreign trade surplus doubled in 1Q07; US increases pressure on China. China Customs reports a $46 billion trade surplus for the first three months of this year. The surplus was approximately double that of 1Q06. The March trade surplus of $7 billion, however, was the smallest monthly surplus since February 2006, and sharply lower than the surpluses posted in January and February. Lower export growth of 7 % y-o-y against import growth of 15 % helped reduce growth in the surplus. Compared to the January-February period, sharp on-year declines in export growth were registered in March by makers of textiles, clothing, leather goods and footwear, as well as manufacturers of machinery and equipment. A number of authorities suggest that the reduction in the March trade surplus was the result of official efforts to rebalance China’s international trade position. However, monthly trade figures this year may simply reflect recent changes in China’s export subsidy policies. Nevertheless, strong export growth is still generally expected to continue throughout the year, so the trade surplus is likely to exceed last year’s record $71.79 billion.

This week the US filed two new complaints against China with the WTO. The first claim is that the thresholds for bringing suit in China for industrial patent infringements and other intellectual property violations are too high, making the country a safe harbour for piracy. The second claim argues Chinese sales restrictions on foreign-made books and films should be abolished. China slammed the US charges, responding such actions could seriously harm trade relations between the two countries. US firms estimate that they lost over $2 billion in sales of music, DVDs and software in China last year due to piracy and counterfeiting. While industrialised countries have long been justified in complaining about the laxity of Chinese efforts to protect copyrights and trademarks, they also generally acknowledge that monitoring has improved in recent years. The United States, nevertheless, feels compelled to push the issue in the WTO. Earlier this year, the US filed a complaint with the WTO on the competition-distorting subsidies China grants to export companies and then imposed countervailing duties on high-gloss paper from China. The WTO is still wrangling over the case of import duties China imposes on car parts. China Customs figures show the country’s surplus with the United States reached $35 billion in the first quarter ($23 billion in 1Q06).

Yuan appreciation against the dollar slows; China lifts bank reserve requirements again. Despite the soaring trade surplus, Chinese officials have staunchly resisted rapid yuan appreciation. In fact, yuan strengthening has slowed in the recent weeks compared to earlier months. In the first quarter of this year, the yuan strengthened just 1 % against the dollar. Since the mini-revaluation of July 2005, the yuan has gained about 7 %. Thus, the yuan has tracked the dollar’s decline and the euro has gained a lot against the yuan in the last two months. Today (April 13), the dollar was priced at 7.72 yuan, while the euro was 10.43 yuan.

Persistent massive trade surpluses have become a major headache for China’s central bankers, who must find ways to mop up the flood of excess liquidity under a relatively tight exchange rate regime. A week ago, the People’s Bank of China hiked reserve requirements for commercial banks by 0.5 percentage points to 10.5 %. The increase, which enters into force at the beginning of next week, is the third this year. In March, the central bank increased commercial bank lending and deposit rates by 0.27 percentage points. The 12-month reference rates are currently 2.79 % for deposits and 6.39 % for loans. Chinese inflation accelerated to 2.7 % y-o-y in February.

Huge gains on Chinese stock markets. After the wild gyrations in January-February, Chinese bourses were up over 10 % for March – and the gains have continued in April. In addition to markets flush with liquidity, stock prices seem set for a skyward trajectory by a government plan to give foreign institutional investors greater opportunities to invest in yuan-denominated A-shares. Foreign investors are currently limited to an A-share quota of $10 billion, but news reports suggest the quota ceiling will be lifted to $16 billion. A sudden dive in Chinese stocks at the end of February dragged down share prices around the world.

The increasing global importance of Chinese firms was illustrated by the Nasdaq CEO Robert Greifeld’s visit to Beijing early this month. The aim of the visit was to encourage more Chinese firms to list on the Nasdaq, where some 40 Chinese companies are already listed. The exchange plans to launch a new index of about 30 of its most actively traded Chinese firms on its lists.

Shanghai A-share index; Moscow RTS index

Sources: Bloomberg, Bank of Finland
Russia

National programs of Russia in 2006. The highly publicised national projects were launched at president Putin’s behest in 2006 to improve the state of health care, housing, education and agriculture. The first year of the program, however, has so far produced mixed results.

The 2006 federal budget set aside 135 billion roubles (€3.9 billion) for national projects, increasing total budget spending by over 3%. When off-budget funds and state guarantees are also included, the total spending for national projects in 2006 was 180 billion roubles. This year’s budget designates 206 billion roubles for national projects.

Among the national programs, the largest chunk of budget spending last year, 63 billion roubles, went to the health care program, increasing budget spending on health care by nearly 70%. Most of the funds went to augment salaries in the poor-paying sector and acquisition of high-end medical equipment.

The national program gave 31 billion roubles to improving education, and boosted overall spending on education by about a quarter. The extra resources were spent e.g. on higher salaries and equipment acquisitions. One goal is to get all Russian schools connected to the Internet.

Some 22 billion roubles were set aside for the housing program. The program’s goal is to increase housing production and availability of home loans. Banks eagerly began to make housing loans, but because housing construction has not increased correspondingly, the main consequence has been a rise in apartment prices.

Last year the 19 billion roubles boost to agriculture under the national project increased total spending on agriculture by about 20%. The financing was provided in the form of interest supports, especially for reform of animal husbandry and support to small farms and housing construction.

The national projects have been criticised for throwing money at specific problems, which has tended to obscure widespread reform needs. For example, the health care sector needs fundamental structural reforms in order to provide it with a stable financial base. Without deep structural changes, individual measures and increased financing cannot deliver permanent results.

Housing prices grew rapidly in 2006. Rosstat reports that nationally prices for new apartments shot up an average of 40% last year. In the secondary market, prices were up over 60%. In Moscow, the price of older apartments nearly doubled. The rise in housing prices has moderated slightly over 60%. In Moscow, the price of older apartments nearly 40% last year. In the secondary market, prices were up

Quarterly average price of apartments in the secondary market, €/m²

Stock market rise continues. Following last month’s correction, the RTS index of major Russian shares bounced back to all-time highs breaking through the 2,000-point level. The gains have been fuelled by the high commodity prices of recent years. Increased investor interest in emerging markets generally has also helped make Russian shares more attractive. The RTS index was launched at 100 points in September 1995 and broke the 1,000-point barrier in September 2005.

Russian stock market gains since the start of the year have been driven, e.g. by majority state-owned oil company Rosneft and Sberbank, the largest bank in Russia. After gas giant Gazprom, they have the highest market capitalisations of companies listed in RTS. Last summer’s Rosneft IPO raised a record $10 billion and Sberbank’s share offer at the start of this year brought in nearly $9 billion. Number-two Vneshtorgbank, which is almost entirely state-owned, has also launched its own IPO.
China

Strong rise in China’s foreign currency reserves continued in first quarter. China’s foreign currency reserves, now the world’s largest, stood at $1.2 trillion at the end of March – with an astonishing $140 billion added in the first three months of this year. About $50 billion of the gain came from the foreign trade surplus and foreign direct investments. The People’s Bank of China explained that the remaining $90 billion represented currency purchased through swap contracts with domestic commercial banks and repatriation of IPO earnings by Chinese companies, which recently have listed on exchanges outside Mainland China. Expectations of further yuan appreciation continued to sustain a steady inflow of foreign currency into the country, although speculative foreign currency flows are not believed to have increased during the first quarter.

Most of China’s foreign currency reserves are invested in dollar assets, but efforts are afoot to diversify reserves gradually into other assets. China has decided to establish an investment firm to oversee investment of an estimated $200–300 billion to improve the returns it gets on the reserves. Details on how the investment firm will operate and its governance rules are presently under discussion. No date has been announced for when the firm will commence operations.

The large influx of foreign currency into China has forced the central bank to further tighten its monetary stance. The PBoC has hiked interest rates once and reserve requirements on commercial banks already three times this year, as well as issued large amounts of bonds to mop up liquidity. Further monetary tightening is expected to continue.

Largest foreign currency reserves, US$ billion

![Graph showing foreign currency reserves for China, Japan, Russia, Taiwan, and Korea.](image)

Sources: IFS, *Taiwan central bank

Tax havens provide increasing share of foreign direct investment in China. Some $16 billion in foreign direct investment (excluding the financial sector) flowed into China in the first quarter of 2007. For the period, FDI was up about 10 % y-o-y. About a third of investment came from both Hong Kong and tax havens. The contribution of tax havens has risen strongly in recent years, while the relative contributions of FDI from traditional sources (e.g. Japan and Korea) have declined.

A number of major international high-technology firms have announced plans to increase investment in China. US chipmaker Intel will build a $2.5 billion factory in northeast China. US-based General Motors, the largest foreign carmaker operating in China, expects to double its production in China by 2010. At the end of last year, Airbus announced plans to site its first aircraft assembly plant outside Europe in China.

Beginning in 2008, China will begin the process of unifying the profit tax rules for domestic and foreign-owned firms over a five-year transition period. However, foreign high-tech firms have been exempted from the change and will continue to enjoy a range of tax breaks.

Wen Jiabao pays official visit to Japan. The Chinese premier’s visit to Japan last week was the first official visit to Japan by a top Chinese leader since 2000. Just a month after his election last September, Japan’s new prime minister Shinzo Abe made a point of travelling to China to begin the process of fence-mending in the wake of stormy relations during the five-year term of Japan’s previous prime minister Junichiro Koizumi. In addition to differences over interpretation of historical events of World War II, political relations have been chilled by China’s refusal to accept Japan’s petition for a permanent seat on the UN security council. Political differences came to head two years ago with violent protests in China against the Japanese embassy, consulates and Japanese firms operating in China. The countries remain at odds also over energy issues that include a Siberian oil pipeline and development of hydrocarbon resources in the East China Sea.

While the focus of the visit was to improve political relations, the parties talked up the importance of good economic relations. The visit produced no tangible accomplishments.

China and Japan are important trading partners for each other. In 2006, a tenth of Chinese exports went to Japan, while the US and EU each took about a fifth of China’s exports. Some 15 % of China’s total imports last year came from Japan, and Japan’s market share in China is clearly larger than that of the EU or the US. Chinese figures show Japan’s share of direct investment in China fell to 7 % in 2006.

The US remained overwhelmingly to top destination for Japanese exports (over 20 %) last year, but at a 14 % share, China is now tied with the EU as Japan’s second largest export market. China provided about a fifth of Japan’s total imports, outpacing both the US and EU, each with approximately 10 % shares. Some 16 % of Japan’s direct investment went to China and Hong Kong in 2006.
Russia

Russian economic growth accelerated in the first quarter. Growth accelerated considerably in all five core production sectors in 1Q07 compared to 1Q06. Industrial output growth was 8%, supported largely by manufacturing industries (up 15% y-o-y). Mining and quarrying growth accelerated to 4%, as also the growth in long-stagnated oil production. In manufacturing, production of, e.g., machinery and equipment, electronics and optics, as well as of rubber and plastic goods, climbed over 20%.

Among core economic sectors, strongest growth was observed in construction (up 23% y-o-y). Retail sales increased 14%, transportation 3% and agricultural output 2%. The economy ministry preliminarily estimates that GDP rose 7.9% in 1Q07. Economy minister German Gref said that economic growth was likely boosted by the mild winter and a strong increase in consumer spending during the first quarter. Also investment growth accelerated and was about 20% y-o-y. The strong growth figures to some extent reflect the relatively low point of reference a year earlier, when Russia suffered a harsh winter.

Export growth slowed primarily in response to a dip in world oil prices. Preliminary estimates show the value of exports increased only a few per cent over the last 12 months, while imports grew by nearly a third. Neverthe-
less, Russia’s goods trade surplus was still $28 billion (11% of GDP) in the first quarter—a decline of $9 billion from 1Q06. The current account surplus was 8% of GDP. The diminished growth in export earnings decreased inflation and appreciation pressures on the rouble. On-year inflation was 7.4% in March and the rouble’s real effective exchange rate strengthened 2.6% in January-March.

The average wage in March was $452 a month, up by over 30% y-o-y in dollar terms. The economically active population was 74 million people in March (52% of the population), and unemployment was 7.2% measured by ILO methodology.

Quarterly growth of main economic indicators 2005–2007*, %

<table>
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Source: Rosstat

*GDP preliminary estimate

Significant changes in Russia’s budget process. The Duma and Federation Council passed in mid-April legislation to reform the budget process introduced in 1998. The law passed quickly in essentially the same form as submitted by finance ministry. The smooth passage reflects Kremlin support for the tight fiscal stance of recent years. The new law seeks to assure long-term stability of state finances and limit growth in budget spending in years when world energy prices are high and tax revenues exceptionally large.

The bill redefines the operating principles for the stabilisation fund, an off-budget entity long a point of contention. The stabilisation fund presently holds oil extraction taxes and income from export tariffs when the world market price for oil exceeds a long-term nominal level (currently $27 a barrel). The new rules would add to current fund sources from the start of next year by including tax revenues from natural gas and export tariffs when the gas price rises above a yet-to-be-defined price level. The law specifies that the stabilisation fund will be split into two parts: a reserve fund with a ceiling of 10% of GDP and a fund for future generations that will accumulate any surplus funds when the upper limit on the reserve fund is reached.

The major reform in the bill is the exclusion of oil and gas revenues that are transferred to the funds from the budget draft. Thus the budget draft will be cleaned from additional revenues during favourable business conditions. The federal budget deficit under the new law may amount to no more than 4.7% of GDP. Reserve fund assets can, however, be used to fund the deficit.

The central government will shift at the start of next year to three-year budgeting. Due to the upcoming elections, next year’s budget planning has been started earlier than before and the government hopes to submit its proposed 2008–2010 budget to the Duma before month’s end.

Economy ministry forecasts 6% economic growth in 2008–2010. The government last week approved the economy ministry’s draft three-year forecast on which it will base its first three-year budget proposal. Under the submitted forecast, Russia’s economic growth will average about 6% a year during 2008–2010. The price of Urals-grade crude oil is assumed to be $53 a barrel in 2008, $52 in 2009 and $50 a barrel in 2010. Inflation should decline into the 5–6% range by 2010. The value of exports is predicted to hold nearly at last year’s level through 2010, while the value of imports is expected to almost double and thus drive the current account balance into deficit. Economy minister Gref stressed the forecast assumes the Russian economy will advance in the transition from a commodity-based economy to an innovation economy. If this change fails to materialise, growth will remain lower.
China

Economic growth of China accelerates slightly in first quarter. GDP growth reached 11.1 % y-o-y in real terms in 1Q07, beating out the overall growth rate for 2006 (10.7 %). As usual, robust economic growth was sustained by high growth in investment and exports. Growth in retail sales, a good indicator of domestic consumption, also accelerated slightly. The strong first-quarter growth figures increased expectations of interest rate hikes and made several international institutions raise 2007 growth forecasts for China.

Industrial output growth picked up to more than 18 % y-o-y in the first quarter. High first-quarter growth was registered in production of metals, cars, phones and computers. On-year industrial output growth was slightly higher than the overall growth rate last year. China’s National Development and Reform Commission (NDRC) is concerned that sizzling growth is making it harder to achieve efficiency targets for energy use. The current five-year plan (2006–2010) calls for reducing energy use by 20 % per GDP unit, but China is quite far from the target. Retail sales were up 15 % y-o-y in the first quarter, a slight acceleration from previous years.

Fixed capital investment in urban areas was up 25 % y-o-y in the first quarter. Highest growth was recorded in real estate investment (up 27 % y-o-y) and industry (32 %). Although officials have sought to quell investment growth in certain fields, the dip in investment growth towards the end of last year appears to have been temporary.

Foreign trade continued to steamroll ahead. Exports rose 28 % y-o-y in the first quarter, while imports grew 18 %. The first-quarter surplus totalled $46 billion. China’s trade partners continued to step up pressure on China to play fair by instituting further retaliatory trade measures. Over the past four months, the US has filed complaints with the WTO on supports China grants to its exporters, the failure of Chinese efforts to monitor and punish copyright and other intellectual property rights violations and the maintaining of specific barriers to market access (see BOFIT Weekly 15/2007). The WTO is currently reviewing an earlier complaint about Chinese import practices for car parts.

Inflation accelerated in March; money supply growth nearly on target. Consumer prices in March were up 3.3 % y-o-y. The rise in prices accelerated in late 2006 with higher food prices. March food prices were nearly 8 % higher than a year ago, while prices of other products were up an average of 1 %. Food prices account for about a third of the consumer price index, so swings in food prices are readily apparent in the CPI. The long-running decline in clothing prices appears to have ceased; clothing prices in March were unchanged from a year earlier. Car prices declined 2 % y-o-y, reflecting stiff competition in China’s emerging car industry. Producer prices continued their lazy rise in March (up 2.7 % y-o-y).

The broad money supply (M2) as of end-March was up 17.3 % y-o-y, while the People’s Bank of China’s target for all of 2007 is 16 %. China’s burgeoning foreign trade surplus and expectations of further yuan strengthening have increased inflows of foreign currency into the country. Lending by commercial banks soared in the first quarter. At the start of the year, the central bank tightened its monetary stance with new measures that included an interest rate hike, three successive increases in the reserve requirements for commercial banks and additional bond issues to soak up liquidity in the market. Further monetary tightening is expected.

Consumer and producer prices, M2 growth, % y-o-y

Higher income growth. The average monthly disposable income of a city-dweller rose to 1,310 yuan (€130) in the first quarter and incomes climbed nearly 17 % y-o-y in real terms. Income growth clearly outpaced 2006 income growth. The National Bureau of Statistics did not release data on the income structure and wage figures have yet to be published. The rapid rise in incomes might reflect increases in the minimum wage in nearly all provinces last year. Rural incomes also rose rapidly in the first quarter (up 12 % in real terms). The widening income disparity between rural and urban China continues and the jump in incomes at the start of the year may increase inflation pressures.

Average monthly wage, in yuan

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

President Putin’s state-of-the-nation address to the parliament stresses higher spending on economic and social development. In the final annual address of his second term in office, Vladimir Putin talked at length on active state support in modernisation of the economy and improving the living standards of average Russians.

Rather than basing economic growth solely on exploiting natural resources, the president said he would like to see Russia build on its technological expertise and innovation skills. The president specified several industries for R&D focus, including aerospace, shipbuilding and nanotechnology. He wants the state to establish a world-class company, a national champion, in each field. These companies would be the best in Russia, globally competitive, highly innovative and possibly include foreign partners.

Putin laid out specific development projects in the areas of electricity production, transport infrastructure and natural resource use. Increasing electrical power generation capacity two-thirds by 2020 will require the construction of 26 new nuclear power plants as well as numerous hydro, power and coal-burning plants. The president noted private investment’s role in helping to fund this huge increase in generation capacity.

Putin stressed the importance of road and rail connections, canals and sea ports in his speech. He chastised his own cabinet for not heeding his repeated requests for measures to build ports. This inaction, he said, has meant that a large share of Russia’s foreign trade currently moves through foreign ports, which is “simply unacceptable.” The president requested that a port construction investment programme be prepared, that the land for the new ports and infrastructure be set aside and that new free port zones be designated during the current year.

Putin defended the government’s recent decision to increase tariffs on raw wood exports, noting that Russia should focus on development of value-added industries in ways that “do not harm the interests of our foreign business partners.” The president also mentioned his commitment to Russia’s commercial fishing industry, which has been getting a lot of attention lately. He demanded that fishing quotas no longer be granted to foreign companies and that priority be given to domestic fish processors.

When speaking about the pension system, the president rejected any increase in the retirement age from the current 55 years for women and 60 for men. He promised that average pension will increase by 65 % by 2009.

Government approves first three-year budget for 2008–2010. The goal of three-year budgeting is to make the budget process more efficient through better long range-planning of the state economy. The main parameters of the budget are planned to hold for the entire three-year period so that the annual budget process can focus on balancing specific revenue and spending items. The three-year budget reserves some funds for discretionary spending that can be designated yearly as needs dictate.

Revenues from taxes and export tariffs on oil and gas nowadays represent a substantial part of budget revenues. One of the basic assumptions underlying the three-year budget is that the role of the oil and gas sector in the economy will diminish due to lower oil and gas prices and slower growth in oil and gas production and exports. Modest surpluses are planned for the 2008 and 2009 budgets; the 2010 budget should be in balance. While budget revenue estimates are always drawn up cautiously, it appears that Russian public finances will face major changes in coming years. Last year’s budget surplus was over 7 % of GDP, and the budget surplus for the first half of 2007 is on track to match that performance.

2008–2010 budget spending will climb each year in real terms, but growth is expected to fall from over 9 % in 2008 to below 3 % in 2010. Spending will be boosted for pensions, the budget sector and military pay, social spending and the national priority projects (healthcare, housing, education and agriculture). Other important spending items include improvements in rail and road infrastructure, financing of major aerospace and shipbuilding projects and modernisation of the coal industry.

The budget now goes to the Duma, where it is expected to be approved by the end of July. President Putin has requested an accelerated budget approval schedule so that the budget gets finalised well before Duma elections late this year.

Government approves main principles of 2008 monetary policy programme together with the budget. In order to match the budget, the monetary policy programme includes for the first time a forecast for three years. Central Bank of Russia chairman Sergei Ignatyev stated the CBR will continue its policy of exchange rate steering, but, he predicted, Russia should be ready to drop exchange rate steering in favour of inflation targeting within 4-5 years. The rouble’s real effective exchange rate will depend on economic developments at home and abroad, particularly oil prices. The CBR predicts the rouble could appreciate up to 10 % in real terms next year. If the average crude oil price next year is $53 a barrel, the rouble would strengthen 3 % in real terms.

Towards the end of the forecast period, monetary policy will face diminishing foreign currency inflows as imports exceed exports. The CBR predicts this could make central bank crediting the main channel for money supply, and thus puts development of bank crediting system at the top of CBR priorities.
China

PBoC monetary tightening measures avoid foreign exchange policy. The People’s Bank of China decided last weekend to hike the reserve requirement for commercial banks by a half percentage point to 11 % effective May 15. It was the fourth such increase this year and part of ongoing central bank efforts to curb bank lending and reduce liquidity in the economy. The fast investment growth and the pick-up in inflation at the start of the year and, in particular, soaring share prices on Chinese stock markets still indicate a relatively lax monetary stance.

Foreign currency inflows into China gathered strength in the first quarter of this year, due both to the foreign trade surplus and capital movements that have increased liquidity on Chinese markets. Even in the face of massive capital inflows, China’s top leaders continue to insist on very slow yuan appreciation that forces the PBoC to buy foreign currency in order to hold the yuan’s appreciation trajectory at the desired level. The central bank tries to manage the concomitant liquidity growth by selling bonds, hiking reserve requirements and interest rates and by ordering banks to curb lending.

Despite international pressures and China’s big problems with managing the domestic liquidity situation, there appears to be little evidence that China will modify its foreign exchange policy any time soon. The yuan’s rate of appreciation against the US dollar in March and April was actually lower in than in January or the latter part of last year. On Friday (May 4), one dollar bought 7.69 yuan and a euro 10.43 yuan. The yuan has strengthened over 1 % against the dollar since the start of the year, and lost nearly 2 % of its value against the euro in the same period.

Yuan-dollar, yuan-euro rates, 2005–2007

Sources: Reuters, Bank of Finland

China’s foreign debt small by international standards. The State Administration of Foreign Exchange (SAFE) reports that as of end-2006 China’s foreign debt totalled $320 billion. The relative size of the debt is tiny by international standards – just 12 % of GDP or 30 % of the country’s foreign currency reserves. Short-term debt (less than 12 months) rose to 57 % of foreign debt at the end of last year. The rapid growth of short-term debt has been fuelled by growth in trade credits. As of end-2006, some 32 % of foreign debt was trade credits, up from just 13 % in 2001. Traders can benefit from yuan appreciation with trade credits. SAFE has long given special scrutiny to such borrowing.

Foreign debt (% of GDP) and share of short-term debt (%)

Sources: CEIC

Move to cities continues. China’s National Statistics Bureau reports some 580 million people lived in urban areas (44 % of the population) at the end of last year, up from 460 million (36 % of the population) in 2000. Official figures show that the urban population has been increasing on average about 17 million persons a year in this decade, but the actual number is likely considerably higher as not all migrant labour goes registered (or is even eligible for registration) as urban residents. High-end estimates put the migrant worker population in China at around 200 million.

The move to the cities has helped drive investment as millions need new apartments each year. The NBS reports investment in apartment construction reached nearly 1,400 billion yuan (€140bn) in 2006. Some 430 million square metres of living space were completed during the year, while 1,500 million m² was under construction at year’s end. Urbanisation also adds pressures to improve e.g. infrastructure and the social safety net. The investment needed to deal with the move from the countryside will not subside soon as the move to cities is expected to continue. Officials estimate that half of the Chinese population, or about 670 million people, will live in cities by 2010.

Urban populations in 2005, % of population

Sources: UN, China’s National Bureau of Statistics
Russia

Inflation picked up slightly in April. Russian consumer prices in April rose 7.6 % y-o-y, slightly faster than in March. Russian inflation has, however, clearly slowed from the double-digit rates a few years ago, when export earnings climbed rapidly as oil prices soared.

Oil prices have declined somewhat since last summer, but inflationary pressure is kept up by the increasing capital inflows into Russia. Foreign firms are investing more in Russia and the private sector is borrowing increasingly from abroad. In the first quarter of this year, the private sector imported $13 billion more than it sent out of the country. A year earlier, the private sector exported $6 billion more than it brought into Russia in Q1. Last full year the balance-of-payments figures in the capital account showed a large surplus ($42 billion). This year the Central Bank of Russia expects the surplus to reach at least $35 billion, suggesting a significant shift in the structure of Russia’s capital account. Due to the CBR’s limited set of monetary instruments for dealing with excess market liquidity, the growing export earnings and increasing capital inflows are reflected in money supply growth. The money supply increased 34 % y-o-y in the first quarter, which was still slightly lower than the rate of growth posted for 2006 overall.

Rise in producer prices slows. March industrial producer prices were up 6 % y-o-y, a substantial decline from 15 % y-o-y in March 2006. The costs for companies involved in mineral extraction, particularly energy production, have long driven the rise in producer prices. In March, however, producer prices in mineral extraction industries fell 5 % from the previous year. The decline partly reflects the point of comparison: last year Russia experienced a cold winter and world oil prices have declined since then.

Industrial producer prices 2004–2006 (1M04=100)

Since January 2004, producer prices for extraction and processing of hydrocarbon energy products have nearly doubled. In the same period, producer prices for manufacturing have risen less dramatically – about 50 %. Producer prices for oil and coke refining have increased the fastest, whereas the growth was slowest in the textile, leather goods and food industries. March producer prices for manufacturers increased 11 % y-o-y. Producer prices for production and distribution of electricity, water and gas have risen about 50 % from the start of 2004. In March, prices in the category were up 15 % y-o-y.

Government approves 2008 privatisation programme. The programme’s scope is similar to previous years and in number terms mostly involves small companies of minor significance to the government. The programme’s publicly declared aim is to continue the government’s earlier established policy of transferring to the private sector those state businesses not absolutely necessary to its mission.

In January, the federal government reports it had ownership in about 4,000 joint-stock companies, of which the state owned 1,700 outright. The number of fully state-owned companies has actually increased in recent years as the state has turned state-owned enterprises into joint-stock companies. Nearly half of state-owned joint-stock companies operate in industry, 13 % in agriculture, about 10 % in the transportation field and 10 % in the construction field. The state also owns nearly 38,000 other business entities, most of which are quite small.

The list of companies slated for privatisation next year prepared by the economic development ministry includes about 560 joint-stock companies. The state will focus on selling off its stakes in firms where it only holds a minority stake. Other assets destined for the auction block include, among others, fishing boats and real estate properties. Among the more important entities set for divestment are Tekhnopromeksport, a federal unitary enterprise involved in foreign trade, and the Lenfilm motion picture studios located in St. Petersburg.

Investors have been left to wonder about when certain state jewels will be divested. Despite years of talk about privatisation of teleoperator Svyazinvest, in which the state owns 75 % plus one share, and Aeroflot, in which the state holds 51.2 % stake, neither has yet made the list. Both companies must fund huge investments in the future. Economy minister German Gref is certain that the companies will eventually be privatised, but their sale is on hold for the moment.

Privatisation sales have been a major subject for cabinet debate in recent months. In particular, prime minister Mikhail Fradkov has questioned the wisdom of continuing to sell off state property along current lines. Privatisation sales are expected to bring in 12 billion roubles (€340 million), or about 0.2 % of projected budget revenues.
China

Chinese share prices reach dizzying levels. After a week’s hiatus, China’s stock markets opened again on Tuesday (May 8) with an explosive performance. The Shanghai A-share index has risen nearly 3% since the end of April. Yuan-priced A-shares, which are mostly intended for domestic investors, have increased in value 45% since the beginning of the year. Dollar-priced B-shares, which foreigners can purchase without restriction, are still cheaper than A-shares even if their prices have lately been rising faster than A-shares. The accelerated increase in B-share prices may be partly due to a belief that Chinese share series will be unified.

Profits of large Chinese enterprises increased last year over 50%. Profitability growth of listed companies even increased during 1Q07. The rise in share prices, however, has been considerably faster than corporate profits. Price-to-earnings ratios (P/E) on Mainland China’s bourses now average 41. Share prices on the Hong Kong bourse have an average P/E value of 17.

The combined market capitalisation of companies listed on the Shanghai and Shenzhen stock exchanges ($1,650 billion and $470 billion, respectively) now tops the value of companies traded on the Hong Kong bourse ($1,860 billion). However, only a third of the shares that make up the market capitalisation figure for Mainland China bourses are actively traded. The rest are held by the government. The role of foreigners on the market is relatively modest at the moment and B-shares only account for slightly over 1% of total market capitalisation. In practice, the amount of foreign funds used to purchase A-shares exceeds the official quota.

Shanghai A-share index and Moscow RTS index

The current fever to own shares in China defies rationality. Bloomberg reports Mainland China’s two bourses daily trading volume hit a record level of nearly $50 billion on Wednesday (May 9), a level equal to the combined daily volumes of all other Asian bourses. In the last week of April, one-and-a-half million new mutual fund investment accounts were opened in China. Fund managers report they are swamped in their efforts to keep track of assets as small investors keep rearranging their portfolios. Few expect the current exuberance to last much longer without structural problems ahead.

China strives to become the world’s largest shipbuilder. East Asia is the leading global region for shipbuilding. The sector is dominated by Korea, which last year took in 40% of the world’s new ship orders. With 25% of world orders, China continues to chip away at the competition, surpassing Japan (23%) for the first time. China’s production capacity and order books are growing rapidly. China’s two largest shipbuilders announced plans this spring to double production capacity from the 2006 level by 2010. Officials say China can reach a 30% world market share within ten years and overtake Korea as the world’s largest shipbuilder. China has designated shipbuilding as a sector to emphasise in the current five-year plan.

While Japan and Korea have concentrated on specialised ships such as LNG tankers, China mainly produces simpler offerings such as bulk carriers and oil tankers. In order to achieve its professed intention to raise its technological capabilities, China restricts foreign direct investment in China’s shipbuilding sector. Foreign companies can enter to the Chinese market only as minority partners (49% or less) in joint ventures. Officials hope this situation will stimulate domestic shipbuilders to learn more advanced technologies and increase the domestic component of Chinese-built ships (which is low compared to Japan and Korea).

Last year China exported 80% of the ships it built and the value of ship exports rose over 70% from 2005. Even so, ship exports only accounted for about 1% of China’s total exports. The number of domestic ship orders continue to rise. The China Ocean Shipping Company (COSCO) recently announced it had ordered 66 new ships from domestic shipbuilders.

Shanghai A-share index and Moscow RTS index

The rapid growth in global trade has fuelled growth in shipbuilding worldwide. The volumes of international sea freight shipping and capacity usage of ships in service have risen rapidly. Sea freight shipping rates reached record levels last year, which helped shipyards win a record number of new orders. China’s rapid ascendance as a major global shipbuilder is expected to depress international shipbuilding prices once pressure to lower sea freight rates begins to bite. Some observers say sea freight shipping rates could fall as much as 40% by 2010.
Russia

CBR hikes reserve requirements for commercial banks. The Central Bank of Russia announced it will raise the reserve requirement for household rouble deposits on July 1 by a half percentage point to 4 % and other rouble and foreign currency deposits by one percentage point to 4.5 %. The central bank said that it raises reserve requirements on commercial banks in response to the liquidity growth caused by heavy capital inflows into the country.

Reserve requirements were lowered during the brief banking crisis of August 2004. At that time, the reserve requirement was 7 %, but it was lowered in order to improve bank solvency.

First-quarter trade surplus down from previous quarters. The CBR reports that the value of exports grew 6 % y-o-y and imports 39 % in the first quarter of 2007. The trade surplus contracted by a fifth from a year earlier to $28 billion. Mineral extraction industries accounted for nearly 60 % of exports. The export volume of Russia’s most important export product, crude oil, climbed 6 %, while the value of crude oil exports increased just 2 % due to the recent decline in world oil prices. Metals rose to a 13 % share of exports, while their export volume increased by nearly a third and their value by 60 %. Machinery and equipment continued to account for nearly half of imports. Passenger cars alone accounted for 10 % of all Russian imports. In the first quarter, Russia imported 290,000 passenger cars, or over 60 % more than in 1Q06.

Russia and Central Asian countries intensify cooperation on development of natural gas resources. Russian president Vladimir Putin last week visited Turkmenbash to meet with the leaders of Turkmenistan, Kazakhstan and Uzbekistan to discuss increased energy cooperation in the region. The leaders agreed on the construction of a new natural gas pipeline running from Turkmenistan around the Caspian Sea through Kazakhstan to Russia where it would link up with Russia’s existing pipeline grid. The decision on the pipeline project was a slap in the face for the US and EU, which have been encouraging Central Asian governments to choose alternative pipeline routes that circumvent Russia.

Russia considers energy cooperation with Turkmenistan a top priority as Russia meets part of its gas export commitments to Europe with Turkmenistani gas. Last year Russia imported 42 billion cubic metres of gas from Turkmenistan at a price of $100 per 1,000 m³. At the same time Russia sold gas to Europe at an average price of $250 per 1,000 m³. In 2003, Russia agreed with Turkmenistan on a 25-year delivery contract, under which Turkmenistani supplies would reach 80 billion m³ a year by the end of the contract period. At the meeting, however, the countries’ leaders estimated that the new project will allow them to increase their exports to Russia to 90 billion m³ already in 2009. Russia produces about 600 billion m³ of gas annually. It exports about 150 billion m³ of gas to Europe each year.

Russia provides a substantial share of the natural gas supply for many EU countries, and delivers over a quarter of the natural gas consumed in the EU as a whole. Finland and some countries in Central and Eastern Europe get all their natural gas from Russia. Russia accounts for over 40 % of gas consumption in Germany, whereas France and Italy get over a quarter of their gas from Russia. Italy and several other countries in Southern Europe import most of their natural gas from Algeria.

Vyugin resigns as head of federal financial watchdog agency. Oleg Vyugin has headed the Federal Financial Markets Service (FFMS) since its inception three years ago. Before moving to the federal financial watchdog agency, Vyugin, known as a liberal macroeconomist, was the CBR’s deputy chairman in charge of monetary policy. He is now moving to a yet-to-be-specified position in the private sector.

On May 9, 2007, the prime minister appointed his adviser Vladimir Milovidov to lead FFMS on the advice of Vyugin. During 2000–2003, Milovidov served as deputy head of the federal securities commission, the FSFM’s predecessor.

Milovidov is expected to maintain the same policies as Vyugin, whose term was characterised by active efforts to build up securities markets and create a legal environment that promotes the listing of Russian companies on domestic bourses. Russia’s securities markets legislation is still inadequate in many respects. A glaring defect is the lack of insider trading rules, given that abuses of insider information and share price manipulation are not rare on Russian bourses. Other barriers to market development include the lack of a central securities depository and the absence of legislation governing derivatives trading. While officials concede the shortcomings of Russian markets, reaching agreement on the solutions has been hampered by interagency squabbles and meddling of outside interest groups.

Vyugin long pushed for an integrated supervision agency to oversee all aspects of financial market activities, but nothing ever came of it. Nevertheless, early this year the Duma opened a discussion on combining Russia’s insurance supervision agency, which operates under the finance ministry, with banking supervision, which is under the central bank.
China

Rising food prices feed inflation in China. April consumer prices were up 3% from a year earlier, a slight decline from the 3.3% rate posted in the previous month. The pick-up in inflation in recent months largely reflects higher food prices. Food items make up about a third of the consumer shopping basket that forms the basis of the consumer price index. Food prices climbed 7.1% in April. Prices of non-food items were up just 1%.

The People’s Bank of China wants to keep inflation under 3% this year. As part of its efforts, the PBoC has set a money supply (M2) growth target of 16%. Even with China’s financial markets awash with liquidity from massive foreign trade surpluses and heavy investment inflows, the PBoC has at least temporarily managed to hold money supply growth to reasonable levels. M2, the monetary aggregate of cash and bank deposits, rose 17.1% y-o-y in April, a slight decline from February-March.

Although the central bank has tightened its monetary stance in order to reduce inflationary pressures, deposit rates have recently been negative. This combined with wild increases in stock prices have lowered the traditional Chinese enthusiasm for keeping money in bank savings accounts. Household deposits fell in April by 167 billion yuan (€16bn), which, the central bank says indicates a shift from savings accounts to investment in domestic shares. Consequently, the markets now expect the central bank to continue its tightening measures by raising interest rates this summer. Rates were last boosted 0.27 percentage points in March. Also the new reserve requirement for commercial banks (11%) became effective this week.

Chinese inflation rate and reference interest rates on one-year loans and deposits, %

China releases 2006 balance-of-payments data. The State Administration of Foreign Exchange (SAFE) reports that China last year posted a current account surplus of $250 billion (nearly 10% of GDP), a sharp increase from earlier years. The current account surplus consisted of $210 billion from foreign trade and $30 billion from current transfers. The remaining $10 billion came from wages and capital income. The capital account was in balance. Somewhat surprisingly, the large financial account surplus of recent years all but vanished. Capital imports were offset by an unusual outflow of over $100 billion to offshore securities markets – a quadrupling in such outflows from 2005. It seems likely that some of the money came from Chinese banks’ IPOs abroad and the sale of equity stakes to strategic investors prior to the IPOs. Some of the figure could also represent currency swap deals by the central bank with commercial banks that have invested the currency abroad. Balance of payments figures show $78 billion in foreign direct investment in China, while direct investment from China abroad rose to $18 billion.


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Source: SAFE

CBRC eases rules on Chinese foreign investment abroad. Last Friday (May 11), the China Banking Regulatory Commission (CBRC) issued new rules that allow qualified domestic institutional investors (QDIIs) to offer their customers opportunities to invest in foreign shares through mutual fund products. The rules enter into force immediately. To be eligible, customers must invest at least 300,000 yuan (about 30,000 euro) in a particular fund. Investment can only involve investment markets approved by the CBRC (currently only the Hong Kong bourse) and the shares must be investment grade (a rating of at least BBB from international credit rating agencies). In addition, no mutual fund can invest more than half of its portfolio in foreign-listed shares and no more than 5% in the shares of the same company. Announcement of the new rules boosted share prices on the Hong Kong stock exchange and prices of shares of Mainland Chinese companies listed on the Hong Kong bourse rose to record levels.

The new rules are part of China’s efforts to increase the flow of capital out of China to reduce appreciation pressure on the yuan. While the Chinese are eager savers, they have few options on where to put their money. A large share of deposits is still stashed in low-yield savings accounts, despite the recent trend of taking money out of savings and investing in domestic stock markets.
Russia

EU–Russia summit in Samara delivers little in way of concrete solutions. A top economic issue at last week’s (May 18) informal summit was Russia’s ban on Polish meat imports. On Monday (May 21), however, president Putin followed up with instructions to his cabinet to get to work fixing the dispute at the expert level. The meat embargo has led Poland to hold up the start of talks on the new EU–Russia Partnership and Cooperation Agreement (PCA).

The EU expressed concern over hikes in Russian tariffs on raw wood exports. On several occasions, Russia has stated that its current economic policy aims at diversification of the country’s production structure away from its current role as a raw material exporter. Exporting unprocessed wood contradicts this aim.

Despite differences on trade policies, delegation leader Jose Manuel Barroso reaffirmed EU support for Russia’s WTO membership.

Russia gradually increases its share of EU trade. Although Russia’s share of EU-area foreign trade nearly doubled from 2000 to 2006, it was still just 3 % at the end of the period. Russia accounts for 9 % of the EU’s external trade. Russian trade is most active with the neighbouring Baltic states and Finland, accounting for a fifth of Lithuania’s foreign trade, and about a tenth of the trade for Finland, Estonia and Latvia. Re-exporting activity (sale of products from third countries) explains part of the large Russia trade shares for these countries. The Russia trade shares for countries in Central and Eastern Europe are also higher than the EU average.

Consensus forecast of Russian growth boosted after strong economic performance in 1Q. The latest GDP consensus forecast compiled by Russian Tsentr Razvitiya has been raised to 6.6 % for 2007. The consensus forecast comprises the outlooks of 26 major domestic and foreign investment banks and research institutes. The GDP growth outlook for 2008 was also lifted to 6.2 %.

The outlook assumes real incomes and investment growth this year will remain at last year’s level, while growth in retail sales and industrial output will accelerate. Growth in imports is expected to pick up further and thus reduce the trade surplus slightly faster than anticipated in earlier forecasts. Oil prices are assumed to average $57 a barrel this year and $55 next year. Russia’s economic ministry last month forecast GDP growth of 6.5 % this year and 6.1 % in 2008.

Low growth in agriculture despite reforms. Agricultural output contracted strongly through much of 1990s, but returned eventually to low growth after the 1998 financial crisis. Much of the recovery should be credited to increased crop cultivation; livestock production remains far below the 1990 level. Agricultural production in 2006 was up 2.8 %, quite in line with the growth pace of 2004 and 2005. Agricultural crops were up 2.1 % and livestock 3.7 %. The 2006 grain harvest was 78.6 million tons (78.2 million tons in 2005).

Russian experts say the most productive animal husbandry businesses are currently broiler chicken operations and industrial-scale pig farms, which are experiencing strong growth in investments compared to recent years. The amount of cattle, pigs, and poultry slaughtered last year increased by nearly 5 % from 2005. Private farms registered the largest meat production gains (13 %). Milk production ceased its long decline last year.

Agriculture now receives special budget funding as one of the four national priority projects announced in 2005. In agriculture, the extra financing is concentrated on animal husbandry, supporting small farms and constructing houses for young families in the countryside. Small farm creation is supported through inexpensive loans, mainly from state-owned Rosselkhoznak and Sherbank. Unofficial data suggest that in 2006 over 2,000 agricultural cooperatives were established and housing for over 12,000 families was built.

Russian agricultural enterprises can be roughly divided into two groups: large farms that invest heavily and are typically part of vertically integrated production entities, and smaller highly-indebted, poorly mechanised farms. Every third farm in Russia operates in the red. Access to new farm equipment is improved through federal and regional subsidies for equipment leasing. A government decree exempting from import tariffs farming equipment not produced domestically will remain in force until the end of June. Regional use of subsidies varies widely; in some areas they are unheard of and elsewhere they are actively granted.

Russian agricultural output, 1990 = 100

![Graph of Russian agricultural output, 1990 = 100](image)

Source: Rosstat
China

Central bank tightens monetary policy further, widens yuan exchange rate fluctuation band. First-quarter economic growth of 11.1 % y-o-y, a near doubling of the trade surplus in January-April, a pick-up in inflation and an unprecedented run-up in share prices have motivated China’s monetary authorities to tighten their stance with an exceptionally broad range of measures.

First, the latest round of interest-rate hikes last weekend raised the reference rate for 12-month commercial loans by 18 basis points to 6.57 % and the reference deposit rate by 27 basis points to 3.06 %. The larger increase in deposit rates is an acknowledgement of the need to bring yields on savings deposits back into positive territory and dampen the current craze among Chinese savers to use their bank savings to invest in shares. Still, the minor increase in deposit yields is a time drop against the wave of share-owning exuberance sweeping the nation. Thus, authorities have also issued warnings and intensified oversight in order to quell the rise in stock markets. Second, commercial bank reserve requirements will also go up another half percentage point to 11.5 % at the beginning of June.

Third, new forex trading rules widening the allowed daily fluctuation range of the yuan came into force early this week. Under the new rules, the yuan can gain or lose 0.5 % of its value against the US dollar on any trading day; the earlier fluctuation range was ± 0.3 %. The purpose of widening the currency fluctuation band is to increase the sensitivity of market participants to exchange rate risks. The timing of the measure coincides with this week’s meeting of China’s vice premier Wu Yi and US treasury secretary Henry Paulson in Washington DC. The move was seen as a gesture that China is willing to give sight in order to quell the rise in stock markets. Second, commercial bank reserve requirements will also go up another half percentage point to 11.5 % at the beginning of June.

Yuan-dollar exchange rate and daily fluctuations in 2007 (20-day moving average)

The widening of the yuan fluctuation bank has little practical significance, given that the Chinese currency had plenty of room to appreciate even within the narrower appreciation band. During 2007, the yuan has gained about 2 % against the dollar, which averages out to a 0.02 % gain every day. Ahead of Wu’s Washington visit, yuan appreciation picked up again after a long period of languishing growth. On Friday (May 25), one dollar bought 7.65 yuan and one euro 10.28 yuan.

China-US strategic economic dialogue continues. US treasury secretary Henry Paulson hosted the second economic dialogue session in Washington DC this week. The Chinese delegation was led by vice premier Wu Yi. Despite US dissatisfaction over the trade imbalance, there was little progress in getting China to let the yuan appreciate faster. The US in turn was not willing to ease curbs on exports of high-tech products to China. However, China did promise to continue opening its finance sector this year by increasing opportunities for foreign securities trading firms and raising the quotas of yuan-priced shares that can be held by foreign institutional investors. The parties agreed on a substantial increase in air traffic between the two countries over the next five years. There was also discussion of improved oversight and enforcement of intellectual property rights in China.

Little concrete action resulted from the meeting. The US congress, which claims current treaties are inadequate, is considering new measures against China. Congress demanded China accelerate yuan appreciation against the dollar to reduce the trade imbalance. Earlier in May, Paulson commented that while he would like to see the yuan appreciate faster, a more expensive yuan would do little to correct the trade imbalance. In his opinion, China should concentrate on development of its financial sector to give Chinese savers a better yield on deposits and increase domestic consumption. China customs reports China’s trade surplus with the US grew in January-April by nearly $10 billion from the same period a year earlier to $47 billion.

State investment company made its first investment. Even before completing the set-up, China’s new state investment company moved to acquire a 10 % stake in US-based private-equity investor Blackstone Group for a price of $3 billion. The deal should be completed during this year when Blackstone is listed on the stock market. The Chinese owners will have no voting rights nor will they get even a single seat on Blackstone’s board. Moreover, the Chinese committed to retain their share for at least four years. Media reports suggest China will invest about $200 billion of its foreign currency reserves in the state investment company.
Russia

Russian state increases its role in the energy sector. The government has designated companies operating in the oil and gas sector as strategic enterprises and state ownership in the oil and gas sector has increased considerably since state-owned Rosneft purchased at auction nearly all of the Yukos production facilities in the bankruptcy process. Rosneft acquired all core production units for just over $30 billion with most of the money borrowed from foreign lenders. State gas giant Gazprom and companies under its control picked up the remaining fragments of Yukos. Back in 2004 Yukos was still Russia’s largest oil company, but the recent deals have made Rosneft the largest producer. Rosneft was approved last month as a “strategic enterprise,” meaning that at least 75 % of its shares are now held by the state. The government added the company to the list, given its importance to national research and defence.

Many foreign oil companies have found themselves in hot water with officials in recent years. The British-Dutch Shell as well as the Japanese Mitsui and Mitsubishi were forced in April to surrender to Gazprom their majority stake in the Sakhalin-2 oil and gas fields. More recently, officials brought a court suit against the British-Russian TNK-BP over disputes on the production volumes in the Kovykta gas field. There have been speculations that TNK-BP will be forced to transfer its majority stake of the field to Gazprom.

Insecurity about the energy sector has dampened production growth and investment by private investors. Oil production increased in January-April just 4 % y-o-y, a number that was largely driven by Rosneft’s 13 % growth. Gas production increased just 1 %. State-owned companies account for about a third of Russian oil production at the moment. In the gas sector, the state is involved in nearly 90 % of output.

Crude oil production and exports, January–February 2006, million of barrels a day

Law establishing new development bank approved. The Bank for Development and Foreign Economic Activity will be established on the basis of Vneshekonombank, which manages Russia’s foreign debt payments and investment of certain pension funds. The new institution will absorb two smaller state financial institutions, but retain the name Vneshekonombank. The development bank is set to open its doors before the end of this year.

The establishment of a development bank is part of Russia’s latest economic policy measures to promote diversification of the national production structure and improve global competitiveness. The bank will finance and provide expert services that promote innovation and exports, develop infrastructure as well as encourage the activities of small and medium-sized enterprises. It will also grant leasing financing and export guarantees. The bank will participate in most state investment projects. While the bank is state institution, it hopes to attract private participation, including foreign investors.

The development bank is a special financial organization exempt from central bank licensing requirements and not subject to central bank supervision. Prime minister Mikhail Fradkov will chair the supervisory board and Vneshekonombank’s current boss Vladimir Dmitriyev will become the new bank’s CEO.

The bank’s initial capital is set at 250 billion roubles (just over €7bn). The money will come from combining the capital of existing banks and assets transferred from the state stabilisation fund.

Russian prime minister visits Finland. On his Tuesday (May 29) visit, prime minister Mikhail Fradkov raised the possibility of Finnish-Russian cooperation on technological innovation. The two countries currently are at odds over Russia’s planned hikes in raw wood export tariffs. Fradkov stated that rate hike would go ahead, but said the details such as the types of wood affected and a transition period were still negotiable. Fradkov encouraged Finns to invest in Russia’s forest industry and mentioned planned investment incentives such as the elimination of import duties on wood-working equipment.

At a cabinet meeting discussion of forest policy last week, also some other Russian ministers anticipated increased foreign investment in the sector. Natural resources minister Yuri Trutnev said that every year nearly 30 % of Russia's usable raw wood stocks is left unused. In 2006, he said about 60 million cubic metres of raw wood were unused, more than the entire volume of raw wood exports (50 million m³). Hikes in export tariffs could also hurt Russian wood producers, if large foreign investors cannot be persuaded to the sector. Trutnev further warned that tariff hikes could increase the grey wood exports.
China

Tripling of stamp duty on stock trades causes jitters. China’s decision to raise the stamp tax on stock trades from 0.1% to 0.3% sent Chinese stock exchanges into a brief tailspin on Wednesday (May 30), with the Shanghai stock exchange’s A-share index dropping nearly 7%. The notion that a tiny regulatory change could cause such a precipitous drop in share prices reflected market jitters. On Thursday, however, share prices resumed their upward trend. Stock investors fear officials will introduce more measures to stem what they see as an overly exuberant rise in share prices.

The Chinese desire to own shares only gets stronger as share prices climb. This year over 20 million new share trading accounts have been opened, bringing the number of such accounts to over 100 million. The popularity of dumping one’s savings into stocks has not only been pulled by the rise in share prices but also pushed by the lack and the low yield of other savings alternatives.

Shanghai A-share index and Moscow RTS index

Imports now meet over half of China’s oil needs. The International Energy Agency (IEA) reports that China last year was the world’s sixth largest oil producer. Even so, oil production has been unable to keep up with China’s booming consumption growth. China was last year the world’s second largest oil consumer. The IEA estimates that China’s domestic oil production this year for the first time will be less than half of what it takes to meet the country’s needs and projects that two-thirds of China’s oil needs will be satisfied by imported oil in 2015. In 1992, China was still a net exporter of oil.

Oil imports to China grew nearly 11% y-o-y in January-April to 54 million tons. China has sought to diversify its import sources by making supplies deals with producers in Africa, South America, the Near East, Kazakhstan and Russia. Increases in oil deliveries have been agreed this year with e.g. Kazakhstan, Venezuela and Russia.

Companies in China’s oil sector estimated this spring that China has some 2 billion tons of unexploited oil reserves, which at current production levels will last eleven years. However, China has discovered numerous oil deposits in recent years. At the beginning of May, China’s largest oil producer CNPC announced it had found a new deposit preliminarily estimated at about 900 million tons of oil in the Bohai Bay basin. The find was the largest in decades. Chinese experts say it is possible even larger deposits may be discovered in the same area. China’s largest oil refiner Sinopec announced this week that it had found a new oil deposit in Western China.

To secure oil supplies, China is planning a number of oil pipeline projects. Chinese sources report that construction will begin already this year on a pipeline from the western Myanmar’s port city of Sittwe through the country to China. The project will help China eliminate about 4,000 km in sea shipping of oil from Africa and the Near East and avoid the pirate-plagued Malaccan Strait. In contrast, implementation of a proposed Russian oil pipeline is expected to drag on for years. Russian oil exports to China (about 10 million tons) must currently be shipped by rail. Pipeline deliveries from Kazakhstan to China commenced last year.

To balance oil consumption and price spikes, China began construction in 2003 of its strategic oil reserves. Filling of the first reserve began last year and the second this month. At least two more stores are presently under construction and four more on the drawing boards. China will initially build up supplies sufficient to cover two weeks of national oil use. Despite requests from the IEA and other bodies, Chinese officials have yet to disclose information on their strategic reserves.

Changes in fuel pricing regime. China has modified how it prices domestic fuel. Officials earlier based reference prices solely on world market prices. The new regime will take into consideration production costs of oil refiners. While the change has no immediate effect, reference prices are still tightly regulated and revised just once a month. As before, gasoline stations can sell fuel at prices that vary no more than ±8% from the reference price. The reference price in recent years has been too low to cover production costs. The lag in hikes in domestic fuel prices relative to rising crude oil prices has hit many oil refiners hard. For example, China’s largest oil refiner, Sinopec, last year declared losses of 25 billion yuan (about €2.5bn) on its oil refining operations. On the other hand, the state has often come to Sinopce’s aid with billions of yuan in direct supports. The low price of state-subsidised fuels confers a substantial competitive advantage on Chinese firms.

Sources: Bloomberg, Bank of Finland
Russia

Russian inflation remains within target range. Despite the inflation pressures caused by huge capital inflows into the country, on-year inflation remained below 8% in May. As the pressures are unlikely to abate, the Central Bank of Russia will attempt to mop up excess liquidity by raising minimum reserve requirements on commercial banks on July 1. CBR deputy chairman Alexei Ulyukayev also suggested state companies could restrict their foreign borrowing in order to reduce capital inflows. With regard to foreign exchange policy, the CBR has announced to be very cautious, as besides inflation target it also tries to keep the nominal exchange rate of the rouble stable.

Discussion of monetary policy has been lively recently, with administration representatives holding conflicting positions. The office of the president continues to stress the importance of staving off rouble appreciation in order to protect the competitiveness of Russian producers. In addition, restricting foreign borrowing by state companies is opposed. Putin’s chief economic adviser, Arkady Dvorkovich, proposes that increased domestic borrowing by the state to soak up excess liquidity would be a viable alternative to rouble strengthening. Meanwhile, the finance ministry opposes increasing state debt. It continues to defend prioritising the inflation target and is willing to achieve it even at the cost of rouble appreciation. The IMF and the World Bank are encouraging Russia to adopt greater flexibility in its foreign exchange policy in order to restrain inflation.

Rapid investment growth continues. Fixed capital investment grew nearly 20% y-o-y in the first four months of 2007. The pickup has been driven by investment in energy production rather than diversification of the economy, as investment in mineral extraction industries outpaced investment in manufacturing industries. Investments in mineral extraction industries grew by nearly a third, while investment in manufacturing industries was up just 4%. Investment was down in such industries as metalworking and machine-building. The roles of budget expenditures and share offerings in financing investments increased from a year earlier. Some 5% of fixed capital investment came from abroad.

A record amount of foreign capital has flowed into Russia this year already exceeds $60 billion, an amount greater than all of last year.

Fixed investment finance sources, %

![Fixed investment finance sources](chart)

Source: Rosstat

Russian share prices seesaw in first half of the year.
The RTS index of leading shares traded on the Moscow stock exchange rebounded to all-time highs in April only to fall again. Share prices are currently up about 2% from the start of the year. Growth in the RTS index this year has lagged indices in other emerging markets. One reason is the particularly tepid price development of energy company stocks caused by stagnating world crude oil prices. Energy companies represent over half of the capitalisation of the RTS index. Capitalisation of the finance sector accounts for about 15% of the RTS overall value and base metal production 13%.

The rise in share prices driven by recent share offerings has been offset to some extent by investors dumping their old shares. Russia’s second largest bank, state-owned VTB (formerly state foreign trade bank Vneshtorgbank) raised $8 billion in May from its IPO, including $1.45 billion in investment from Russia. Even after the IPO, the state retains a 75% stake in VTB. In Russia, about 130,000 investors bought shares. In last year’s first-ever “national IPO” about 115,000 Russian investors purchased shares of the state oil company Rosneft. About 30,000 Russian investors participated in the IPO of state savings bank Sberbank at the start of this year.

Russia’s RTS index performance over the last 18 months

![Russia’s RTS index performance over the last 18 months](chart)

Sources: Bloomberg, RTS
China

Stock market jitters, higher quotas for foreign institutional funds. Chinese stock markets have yet to recover fully from the tailspin set off by a minor hike in the stamp tax last week. Nevertheless, recent days have seen the return of optimism as feared official measures to restrain the rise in share prices have failed to materialise. Unlike last February, when a drop on China’s exchanges coincided with a warning from ex-Fed chairman Alan Greenspan, global stock markets have generally shrugged off the recent declines on Chinese exchanges.

The Shanghai A-share index has gained about 40 % since the start of the year as a result of Chinese eagerness to own shares. The situation has been fed by the fact that interest rates on deposits are low and a general lack of available investment opportunities. Several officials have tried to warn share investors of the risks associated with publicly traded shares.

Chinese officials decided at end-May to again increase the investment quota to $30 billion for qualified foreign institutional investors (QFIIs). The current quota of $10 billion is nearly maxed out. China’s state administration of foreign exchange (SAFE) divvies out quotas to QFIIs. Foreign institutional investors still occupy a relatively minor presence in Chinese stock markets which have a current capitalisation of nearly $500 billion.

Shanghai A-share index during first six months of 2007

Sources: Bloomberg, Bank of Finland

Robust growth for China’s car industry even as competition intensifies. China’s car industry produced slightly over 2 million vehicles in January-April, an increase of 21 % from the same period a year earlier. Growth in demand remained strong. Last year, car sales rose 25 % to make China the world’s second largest car market after the United States.

Fierce competition on the Chinese market has forced manufacturers to lower prices. China’s domestic carmakers now control 27 % of the Chinese market, but they are seeking to increase market share through improvements in quality and development of new inexpensive models. Despite the stiff competition, the carmakers have not cut back on investment programs to create new plants and capacity in anticipation of rising demand.

China’s car exports have begun to take off. China exported nearly 140,000 passenger cars in 2006. There is healthy demand for cheap Chinese cars. In Russia, for example, Chery sales have grown rapidly even if they still represent only a tiny slice of Russia’s booming car market. Chinese carmakers have traditionally exported to Africa, East Asia and the Middle East, but increasingly Chinese cars are finding buyers in Europe and the US. Chinese carmakers are also using a direct investment strategy to establish footholds in foreign markets. For example, Nanjing Auto has purchased plants in England and Chery is launching assembly operations in Russia.

Production and exports of passenger cars (thousands)

Source: CEIC

Rapid growth in Hong Kong and Macao continues. Preliminary data suggest that the GDP of Hong Kong (population 7 million) grew 6 % y-o-y in real terms in the first quarter. Services trade increased over 8 % y-o-y, while consumer spending rose to nearly 6 % y-o-y. In contrast, investment growth slowed to 4 % and 12-month inflation fell below 2 %. Mainland China’s rapid economic expansion and ongoing integration with the world economy have helped sustain Hong Kong’s GDP growth above 5 % for the past three years. Trade between the Hong Kong and the mainland has eased under a succession of CEPA (Closer Economic Partnership Arrangement) agreements. The latest CEPA, which entered into force in January, has helped increase trade in services. Officials expect the Hong Kong economy to expand about 5 % this year.

Preliminary figures first quarter figures show GDP in Macao (population 500,000) rose 26 % y-o-y in real terms. Huge growth in the gambling sector has propelled Macao economic success. The sector’s earnings were up 44 % y-o-y in the first quarter and the number of tourist visits climbed to 6.4 million. Nearly 90 % of tourists came from Mainland China and Hong Kong, where casinos are banned. A large share of large international casinos have begun or are about to begin operations in Macao.
Russia

Optimism prevails at St. Petersburg international economic forum. Major figures in international business gathered last week in St. Petersburg with Russia’s top political leaders and entrepreneurial elite at the premier annual event on the economy.

In his address to the forum, president Vladimir Putin focused on international issues and Russia’s role in the global economy. His discussion of energy matters touched on the impact of emerging producer countries Kazakhstan, Turkmenistan, Azerbaijan and Uzbekistan on the oil market and emphasised the need for strategic cooperation among nations that are net consumers and producers of energy as well as countries important to energy transit. In the transport sector, Russia is planning projects to connect Central Europe, Central Asia and countries in the Far East, and would help e.g. landlocked Caspian Sea countries gain access to the Mediterranean and the Indian Ocean. In his discussion of international financial institutions, the president noted the need to reform organisations and the financial markets and commented that a system based on one or two currencies and a few financial centres was inadequate to meet the needs of the world economy. Russia will continue to work to make its finance and banking sector more attractive to investors and encourage greater use of the rouble as a payment currency for its exports. Putin further claimed that developed countries have largely moved towards limiting foreign investment in their infrastructure, telecommunications and energy sectors. Russia, in contrast, seeks to create the best possible conditions for foreign investors through continuous improvement in e.g. enforcement and protection of property rights.

First deputy prime minister Sergei Ivanov laid out Russia’s ambitious development goals. By 2020, he said, Russia would have the world’s fifth largest economy (currently Russia ranks about tenth) and would become the most important global provider in 4-6 fields of high technology. The high-tech fields with potential for Russia include nuclear power, shipbuilding, aerospace, space technology, computer programming and nanotechnology. At a panel of Russia’s top economists arranged in connection with the economic forum, one of the main conclusions was the need for continuing structural reforms in order to reach sustainable economic growth. Another condition for sustainable growth is integration of the Russian economy with the global economy.

Russia used the forum as an opportunity to lobby the US and EU for support of its WTO membership. In the current trade negotiations with the EU the raw wood export tariffs still remain one of the issues under dispute.

Incremental deregulation of gas prices for industrial users gets underway. The government has decided that state-owned Gazprom can charge prices above the state-regulated price on gas delivery contracts made on or after July 1. The ceiling price this year is 60 % above the regulated price. The price difference will be reduced gradually and eliminated entirely in 2011, when the gas price will be set entirely by the market.

The price hikes are intended to assure that Gazprom provides adequate gas supplies to domestic consumers. In addition, higher gas prices are expected to encourage greater efficiency in gas use. The reform has been criticised for the fact that Gazprom is not bound to invest its new profits from the price change in its core business.

The new pricing system is expected to increase trading and prices on Russia’s natural gas exchange where independent producers sell their gas. The price increase has special significance for electrical power companies, as much of Russia’s electricity is presently generated by gas-fired plants. The higher prices are expected to lead to substitution by coal in electrical power generation.

Demand for passenger cars continues to rise sharply; foreign makes increasingly take over the market. During January-April, sales of foreign cars climbed over 70 % y-o-y. Sales of Chinese models made particularly impressive gains. In contrast, leading Russian makes Lada and Volga continued to experience severe sales declines. The indirectly state-owned AvtoVaz car plant, which makes the Lada, announced plans to cut production and reduce staff. Although still Russia’s largest carmaker, AvtoVaz’ market share has contracted substantially in recent years.

Russia already imported more cars than it built in January-April. Car imports rose by two-thirds, while production grew 13 % y-o-y. The production growth has, however, accelerated as international carmakers now build and assemble cars locally. St. Petersburg has become a major carmaking centre, and new plants are under construction in the Kaluga district near Moscow. Ford, Toyota and Renault all have plants in Russia, and Ford and Toyota have even established their own banks. Volkswagen, Nissan, Suzuki and General Motors are building plants in Russia. Russian plants also assemble models for several international carmakers. Foreign carmakers establishing plants in Russia are motivated both the exploding demand and the high tariffs imposed on imported cars. As part of its WTO accession commitments, however, Russia is expected to drop its tariff on cars from 25 % to 15 % after a seven-year transition period. One problem for companies operating in the Russian market is the requirement that carmakers use a set percentage of Russian-made components, even though competent local subcontractors to make such parts are still hard to come by.
China

**China’s trade surplus swells along with US dissatisfaction.** China’s foreign trade surplus hit $22 billion in May, bringing the surplus for the first five months of this year to $86 billion (an increase of over 80% from the same period a year earlier). The surplus was boosted by a wide disparity in export and import growth. China posted January-May trade surpluses of $60 billion with the US and $47 billion with the EU. The surplus is expected to easily exceed last year’s record $177 billion. Chinese officials have publicly expressed concern over the trade imbalances. To date, however, official measures to balance trade have been fairly modest. For example, export tariffs on certain products were raised slightly in May.

A US treasury department report on international exchange rates released this week finds that the yuan is undervalued. However, the report gives no indication, as had been hoped by some senators, as to whether China intentionally keeps the yuan’s exchange rate undervalued to secure economic competitiveness or to support its trade imbalance. If the treasury department had come out with a clear statement that China is deliberately using its exchange rate policy to gain trade advantages, it would be easier for the US to take new counter-measures against China such as increasing import duties on Chinese products. After publication of the report, several senators proposed new anti-China legislation to be considered along with currently pending proposals.

The US has filed several cases against Chinese trade practices with the WTO this year. US officials have also warned consumers about Chinese products, including Chinese toothpaste and pet food additives and poor quality Chinese toys. EU trade commissioner Peter Mandelson this week expressed his concerns about the growth in China’s surpluses and said that pressures have grown for Western countries to put protectionist measures in place. On Friday (June 15), one dollar bought 7.62 yuan and one euro 10.16 yuan.

**Most Chinese FDI still goes to Asia.** China’s foreign direct investment abroad has grown rapidly in recent years and topped $18 billion in 2006. According to some estimates, Chinese companies made about 100 cross-border deals last year. Even so, China’s FDI outflows are modest in comparison to its FDI inflows.

The goal of Chinese investment traditionally has been to secure access to raw materials and energy. Investment has concentrated on Asia, which has familiar business practices and low wage levels. Chinese FDI targeting Europe or North America remains fairly unusual. The highest profile acquisitions have been Lenovo’s purchase of IBM’s personal computer production business and Nanjing Auto’s acquisition of the British MG Rover car company. The Chinese are still newcomers to international mergers and acquisitions, and have already made some unsuccessful investments. For example, Chinese television maker TCL had to abandon last autumn European operations they had purchased from Thomson. Also the US Congress intervened to deny Chinese oil company CNOC the opportunity to buy the American Unocal’s Asian operations. China’s appetite for international corporate acquisitions is growing, as they are supported by officials. China needs to increase its capital outflows in order to balance at least some of the massive capital inflows coming from huge trade surplus and large FDI inflows.

China’s activities in Africa have drawn considerable attention. Although China’s direct investment in Africa has risen in recent years ($400 million in 2005), they have consistently remained below 2% of Africa’s total yearly FDI inflows. Chinese investment in Africa has concentrated on resource-rich countries (e.g. Angola, Nigeria, Sudan and Zambia). China mainly imports raw materials from Africa, and nearly at third of China’s oil imports now come from Africa. To offset local worries about Chinese investment, the Chinese often engage in public projects such as infrastructure development. Chinese companies are often accused of violating local labour laws and environmental regulations, as well as preferring Chinese workers over the local talent.

**Direct investment outflows from China, US$ billion**

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*Source: SAFE*
**Russia**

**Economic output continues to soar.** Rosstat’s latest preliminary figures suggest Russian GDP grew 7.9 % y-o-y in the first quarter of the year – well above levels anticipated by most observers. A 23 % y-o-y jump in construction activity can be partly explained by the low reference point caused by last year’s harsh winter and exceptionally mild weather at the start of this year. The on-year decline in electrical power generation also reflects the anomalous weather. Domestic demand remained the engine of growth and heavy capital investment helped boost manufacturing output growth to 12 %. The climb of 9 % in retail sales and 14 % in restaurant and hotel services evidence rapid gains in real wages. The average real wage was up 18 % y-o-y in the first quarter this year.

**IMF urges budgetary restraint and inflation-fighting measures.** Based on its annual evaluation of the economic development of its member countries, the Article IV consultation, the IMF expects that Russia’s twin current account and budgetary surpluses will evaporate rapidly in the face of rising domestic demand. The Fund’s preliminary conclusions also suggest Russian economic growth for 2007 may reach 7 %.

The IMF emphasised the need for Russia to coordinate its fiscal and monetary policies. Russia’s foreign exchange inflows are increasingly dominated by capital investment rather than export earnings. Such currency inflows cannot be sterilised simply by diverting revenues to the stabilisation fund. Moreover, inflation pressures will be increased by the gradual deregulation of energy prices. For this reason, the IMF advised that relaxation of budget policy should be reconsidered with a view to keeping inflation subdued and allowing only gradual appreciation of ruble’s real exchange rate. The IMF praised Russia’s new budget arrangement that separates oil and gas revenues from other income, but was still concerned about whether decision-makers will comply with tight fiscal policy.

The Fund said it was pleased with the rapid evolution of Russia’s financial sector, but noted that further development is still needed. The IMF is not presently overly concerned with systemic risk in the Russian banking sector, but cautioned that problems could still emerge from e.g. an increase in risky consumer lending and foreign borrowing to finance rouble loans.

The IMF credited Russia’s output gains of recent years to improvements in productivity rather than growth in employment and capital investment. In this respect, Russia still has considerable potential for economic development. Structural reforms could bring efficiency improvements to sectors such as housing and municipal services. Over the long term, however, the investment climate needs to be improved to encourage new investment, as the growth cannot be based on increasing the productivity of existing resources anymore. Growth in the energy sector is expected to lag the rest of the economy in coming years. The slowdown in part reflects the growing state ownership in the sector.

**Russia a major energy producer and consumer.** British Petroleum’s survey of global non-renewable energy reserves and production in 2006 ranks Russia seventh with 7 % of the world’s total oil reserves. Russia also accounted for 12 % of global oil production last year, making it the world’s second largest oil producer after Saudi Arabia. At the current rate of production, Russia will exhaust its known oil reserves in about 22 years, i.e. much faster than other major oil-producing countries. Russia has not made any major oil discoveries in the last ten years, due to a lack of geological exploration activity, partly because of a poor investment climate. Despite uncertainty in the oil sector, Russian oil production grew faster than production in any of the other major oil producing countries. Russian oil production was up 2.2 % in 2006, while globally production was up just 0.4 %. Oil refining capacity has remained steady for the past seven years and accounted last year for 6 % of the world’s refining capacity. Most of Russia’s refined oil products are consumed domestically, while crude oil dominates exports. About four-fifths of crude oil exports go to Europe.

Russia has the world’s largest natural gas deposits (26 % of world reserves) and accounted for 21 % of global production in 2006. At current production, Russia’s known gas reserves are sufficient to last 78 years. Russian gas production increased 2.4 % last year, lagging somewhat the 3% increase in global gas production. Most of the gas went to domestic consumption; only 25 % was exported.

Although Russia ranks fourth globally in terms of coal reserves, it accounted for only 4 % of world coal production in 2006. Most Russian coal is used domestically. Russia accounts for 6 % of the world’s electricity generated by nuclear power and hydropower. Russia’s share of the world’s primary energy consumption (excluding renewable resources such as peat, wood, solar and wind power) was 7 %, while China’s share was 16 %, the EU 16 % and the US 21 %.

**Breakdown of primary energy generation in Russia and China, %**

![Diagram showing the breakdown of primary energy generation in Russia and China, %](image)

Source: BP

**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.**
China

Slight pick-up in inflation; money supply growth nearly on target. China’s National Bureau of Statistics reports that May consumer prices were 3.4 % higher than a year earlier. An over 8 % y-o-y rise in food prices drove the increase as prices for other goods were up on average just 1 %. Meat prices led the food price charge, rising 27 % y-o-y in May. Changes in food prices have a large impact on China’s consumer price index as they make up about a third of the index. Officials are concerned about soaring food prices. The 2007 target ceiling for consumer price growth announced by the People’s Bank of China is 3 %. The pick-up in inflation has put pressure on the PBoC to hike its key lending and deposit rates. Indeed, the 1-year reference deposit rate (3.06 %) is currently insufficient even to keep up with current inflation.

The broad money supply (M2) was up 16.7 % y-o-y at end-May, just above the central bank’s target of 16 % growth for this year. The PBoC has tightened its monetary stance this year by raising reserve requirements for commercial banks, hiking reference rates on deposits and loans, and issuing bonds. Money supply growth has been fuelled by massive trade surpluses and PBoC efforts to control appreciation of the yuan’s external value.

**Consumer prices and key 1-year reference rates, %**

Sources: National Bureau of Statistics and PBoC

Insurance sector grows rapidly; increased investment opportunities for insurance companies. The assets of Chinese insurers have increased at about 30 % a year in recent years. Their assets reached nearly 2 trillion yuan (approx. €200bn) in 2006. The growth of insurance company assets reflects a growing demand for insurance and better asset allocation by insurers (especially investment in shares, which have generally performed well lately). Insurance premia were up 14 % y-o-y in 2006 and amounted to 564 billion yuan (about €55bn).

China’s weak social security system, its aging population, growth in the ownership of automobiles and the general lack of investment opportunities have helped push demand of insurances. China’s insurance sector is still underdeveloped, but strong demand has drawn more companies into the field. For example, China’s largest bank Industrial and Commercial Bank of China has applied for permission to begin insurance activities. Although China has opened its insurance sector to foreign companies in line with its WTO commitments, foreign insurers still represent a tiny share of the market (just 7 % at the end of 2005). Chinese rules require foreign insurers to take on a Chinese partner and their ownership of the joint venture cannot exceed 50 %. Foreign companies are also excluded from the lucrative car insurance business. The EU and the US want China to further open its insurance sector to foreign participants.

The scope of investment allowed in the insurance sector has gradually broadened. In 2004 insurers gained the right to hold up to 5 % of their stated assets in shares. The two largest insurers, China Life and Ping An have acquired stakes in i.a. Chinese banks. Limited permission to purchase foreign bonds was granted in spring 2006. China’s Insurance Regulatory Commission announced insurers will soon get additional opportunities to invest abroad.

**Insurance company assets and premia income, billion yuan**

Eight banks fined for lending to stock market speculators. The China Banking Regulatory Commission (CBRC) has handed out small fines to eight banks for granting loans to two large state-run Chinese enterprises that used the money for buying stocks. The CBRC further demanded that banks identify and punish the employees involved in the leveraging schemes. The CBRC believes the borrowed money was used to fund 2.5 billion yuan (€250m) in share purchases over the past five years. The fined banks include two of China’s large state-owned banks, the Bank of China and Industrial and Commercial Bank of China. The use of borrowed money to fund share purchases is banned in China. The sanctions are apparently the first ever handed out by the CBRC to banks for involvement in lending money for share purchase. Such infractions are believed to be fairly widespread. Officials hope the measures will dampen the current craze to own shares that has driven Chinese stock prices high.
Russia

**Gazprom strengthens its position.** State gas giant Gazprom is set to acquire TNK-BP’s majority stake in the massive Kovykta gas field and the East Siberian Gas Company. TNK-BP has long been threatened with the loss of its Kovykta license, as officials have continued to harass the company for non-compliance with licensing standards. With the license now in the hands of Gazprom, it is seen unlikely that the license will be pulled. Gazprom acquired the majority stake in the Sakhalin-2 gas field in April. That project was previously plagued with environmental violations. Sakhalin-1, operated by Exxon, is now the only significant gas field not controlled by Gazprom. But Gazprom wants to block Exxon’s plans to export Sakhalin-1 gas to China, claiming that the gas is needed to supply the domestic market in eastern Russia and in any case Gazprom is already in separate negotiations with China on gas contracts. Gazprom has offered to purchase all gas produced by the Sakhalin-1 field and has stated it is willing to buy out the entire project.

Gazprom exported over a quarter of its output in 2006. To make direct export deliveries possible, Gazprom recently agreed with Italian gas distributor Eni on construction of a gas pipeline from Russia to Bulgaria. To further supply Europe, Gazprom has also signed a memorandum on a gas pipeline that will run along the bottom of the Baltic Sea to Germany. Export shipments of liquefied natural gas from the Sakhalin-2 field are slated to begin next year, and the Ust-Luga gas terminal on the Baltic Sea should be in use by 2010. Plans to increase exports together with the growth in domestic consumption have raised doubts about Gazprom’s ability to meet all its commitments. Although boosting gas production will require huge investment, the company has recently been spending its money on diversification into other businesses, particularly the electricity sector. Under Gazprom’s optimistic scenario, gas production will rise 2.5% from 2006 to 2010. An industry ministry forecast expects domestic consumption to rise at 8.5–10% in the same period.

**Russian courts increasingly afflicted with corruption.** Transparency International’s latest Corruption Perception Index ranks Russia 121 out of the 163 countries surveyed, putting Russia just behind Kazakhstan and Zambia. Russia has made only marginal gains in fighting corruption since 2005.

It is estimated that Russians annually spend about $210 million bribing members of the judiciary and political organisations are exerting an increasing influence over court rulings. Both trends have contributed to an erosion of the citizenry’s trust in the fairness of the court system. On the other hand, courts are only seen as the fifth most corrupt sector in Russia. Health care institutions, for example, are even more susceptible to bribes.

Although in recent surveys has been found that companies are increasingly active in bribing public administrators, they have become more willing to record transactions in their bookkeeping, such that last year only about 16% of sales were made off the books. However, over two-thirds of Russian firms still pay wages under the table. The Prosecutor General’s office estimates about $270 million in illegal income was laundered last year in Russia, and it is now establishing a new anti-corruption unit.

**Russia confronts large regional disparities.** Recently published estimates from the World Bank and the UN both find that large differences in economic conditions continue to persist among Russia’s regions. The World Bank sees a clearly identifiable trend towards agglomeration of production in the economic growth centres in the Central, Northwest and Southern Federal Districts. In particular, areas on the outskirts of Moscow and St. Petersburg have gained in attractiveness as the populations of these cities continue to grow and cost levels rise. Although the differences among regions are still huge, above-average economic growth in poorer regions and a lower growth in resource-producing regions had decreased the rate of disparity growth. The World Bank believes that regional differences will again diverge in the medium and long term due e.g. to increased agglomeration effects.

According to the UN human development report economic growth has reduced the number of people living below the poverty line in Russia. On the other hand, the higher the income levels in a particular region, the greater the income disparities within that region. Russian economic growth has also supported reduction in infant mortality. Expected lifespan has not, however, increased and regional disparity in lifespan has risen. HIV infection rates seem to depend inversely on region’s income, as infection rates are higher in richer regions. The UN human development index (HDI), which is based on expected lifespan, standard of living, education and literacy, has risen in nearly all Russian regions. However, the differences among regions have also increased.

Regional development minister Vladimir Yakovlev stated recently that the federal government should abandon its program, originally scheduled to run through 2015, to reduce socio-economic differences among regions as it has failed to meet its goals. On the contrary, income disparities have grown since 2002. Part of the reason for the program’s failure was a lack of financing in the off-budgetary funds of which only about 10% realised. Yakovlev said more funds should be channelled to regions through the budgetary funds instead of federal programs.
China

Chinese securities brokers and fund managers gain limited possibilities to invest client funds abroad. The China Securities Regulatory Commission (CSRC) announced plans to expand its qualified domestic institutional investor (QDII) scheme to allow mainland securities brokers and fund managers to invest client funds abroad. Starting July 5, domestic securities brokers and fund managers can petition the CSRC for a share of the foreign investment quota. The QDII arrangement allows investment in bonds and stocks traded on approved foreign exchanges. The Hong Kong stock exchange is currently the only officially approved exchange.

Currently officials have granted investment quotas totalling around $15 billion to banks since the QDII scheme was launched last year. So far only a fraction of the quotas have been used, however. Officials plan to incorporate insurers into the QDII program in the coming months. By broadening QDII program officials hope to increase investment outflows from China in order to relieve appreciation pressures on the yuan. Chinese interest in foreign investment has recently been depressed by the spectacular gains on local stock markets and the yuan’s slow-but-sure appreciation. However, share prices for a number of major Chinese firms are considerably cheaper on the Hong Kong stock exchange than on the Shanghai or Shenzhen bourses, which may encourage some investment outflow.

10th anniversary of Hong Kong handover to China. Since the handover of Hong Kong from Great Britain to China took place on July 1, 1997, China has, as promised, kept in place its “one country, two systems” policy that preserves Hong Kong’s status as a special administrative region until 2047. Hong Kong has stayed as one of the world’s most open economies, benefiting also from the strong growth and world-economy integration occurring in mainland China. Hong Kong’s economic growth has bounced back after the Asian financial crisis in 1998 and the SARS epidemic in 2003.

Economic cooperation and trade relations between Hong Kong and the mainland have intensified since the inauguration of the Closer Economic Partnership Arrangement (CEPA) in early 2004. The original agreement has been expanded every year to eliminate or lower barriers to trade and promote investment between Mainland China and Hong Kong. Mainland China is by far Hong Kong’s most important trading partner, but re-exports represented 96 % of Hong Kong’s goods exports to China last year. More importantly to Hong Kong, Mainland China represented about a quarter of Hong Kong’s service exports. Hong Kong’s leading service industries include logistics and transportation, as well as finance and consulting services.

A considerable amount of investment from Hong Kong flows into mainland China. During 2001–2005, the stock of direct investment made from or through Hong Kong in China grew over 75 %, standing at nearly $200 billion at the end of 2005. In addition, the Hong Kong stock exchange now is an important provider of financing for the large Chinese companies that list there. Some fear Hong Kong’s status as a financial centre will weaken as the Shanghai and Shenzhen stock exchanges continue to grow. The combined capitalisation of the two bourses surpassed the Hong Kong exchange in April.

Hong Kong’s real GDP 1990–2006, percentage change y-o-y

Source: Hong Kong Census & Statistics Office

Listed firms to gain better possibilities to issue corporate bonds. Chinese officials recently released a draft of new rules governing bond issues by listed firms. Under the new arrangement, the regulation of bond issues will be transferred from the National Development and Reform Commission (NDRC) to the China Securities Regulatory Commission (CSRC). According to officials, quotas on bond issues will be abolished and bond pricing and yields will be set by the market. Rules on bond issues will also be clarified. In the future, listed firms will not be required to obtain special permission for each issue, but rather the firm will only have to meet CSRC criteria.

China’s corporate bond market is still incredibly thin; only a few large state enterprises have been allowed to issue their own bonds. Only about 100 billion yuan (€10bn) in corporate bonds were issued last year, as of year’s end the entire stock of corporate bonds outstanding was less than 300 billion yuan (€30bn, about 1 % of GDP). The rules governing bond issues remain vague and the current regulator, the NDRC, has in practice done little more than designate initial bond prices and dates of issuance. The forthcoming rules should encourage a rapid expansion of the corporate bond market. At the moment, most Chinese firms finance investment from retained earnings. When they do resort to external financing, 90 % is obtained in the form of bank loans and only 10 % is raised from issuing shares and bonds.
Russia

Société Générale strengthens its position in Russia. The French bank Société Générale (SG) announced last week that it would exercise its option to purchase 30 % of Rosbank, Russia’s tenth-largest bank. The option was exercised well before its expiry at the end of 2008. The bank’s largest shareholder is Interros, a conglomerate owned by Vladimir Potanin. When the sale is completed, SG will own a 50 %-and-one-share stake in Rosbank for a total cost of $2.33 billion. The sale still requires the blessing of the federal anti-monopoly service and the central bank. SG has announced it could eventually increase its stake to as much as 90 %.

The Rosbank acquisition gives SG control of a broad network of bank branches. Rosbank’s 600 nationwide branch offices is Russia’s second largest after Sberbank’s branch network. SG also has its own Russian subsidiary, Société Générale Vostok, which began operations in 1993. With the completion of the Rosbank sale, SG becomes Russia’s largest foreign-owned banking group.

Italians purchase a stake in Russian aircraft company Sukhoi. Alenia Aeronautica, a subsidiary of Italian aerospace giant Finmeccanica, will purchase a 25 %-plus-one-share stake in the civil aircraft division of Russian aircraft builder Sukhoi. The deal is expected to be completed by the end of this year. The companies made a tentative agreement on the deal in 2005, but the deal was slowed until exceptional arrangements could be made. That is because Russian legislation restricts foreign ownership in strategic industries to under 25 %. Sukhoi is part of the state-owned Unified Aircraft Corporation established last year.

Sukhoi is currently planning a new line of civilian jets that will carry up to 100 passengers. The Superjet-100 is hoped to revive Russia’s moribund civil aircraft industry. The plane is expected to be a hit on the international market and many hope that the majority of sales will be exports. The first planes should be in service next year.

A large group of international firms are involved in the design and construction of the Superjet-100. In 2001, US-based Boeing and Sukhoi jointly launched an initial feasibility study for the Superjet project. Sukhoi and the Russian government are spending $1.6 billion on development of the Superjet. The European Bank for Reconstruction and Development (EBRD) is providing €100 million in finance.

The small Italian airline ItAli announced in June that it was purchasing ten Superjet-100 planes at a price of $283 million. The deal includes an option to purchase an additional ten planes. ItAli is the first non-Russian company to order Superjets. Observers note the ItAli deal could track back to Finmeccanica, i.e. it may be little more than a marketing gimmick to spike international interest in Superjets. Sukhoi also has contracts to provide more than 70 Superjets to Russian airlines, mainly Aeroflot, Russia’s biggest carrier.

Global warming effect hits Russia’s arctic areas hard. The fourth report from the UN’s Intergovernmental Panel on Climate Change (IPCC) estimates that Russia’s average temperature has risen 2–3°C over the last 90 years. Winters and springs have become milder and the permafrost areas in Siberia are shrinking. Rainfall seems to be heavier, particularly in western Russia, while conditions seem to be getting drier in eastern Russia. River flows have in average increased about 5 % a year in recent years due to permafrost melting. On the other hand, runoff varies considerably from region to region. In southern Russia, a decline in runoff has been detected. Tree-line in the Ural Mountains has moved to higher elevations as temperatures have risen. The melting of the permafrost in large marsh areas in northern Russia may also cause the release of considerable amounts of ice-trapped methane gas, which will accelerate global warming. A 3–4 % increase in average temperatures by 2050 translates to a reduction of 12–15 % in permafrost areas.

Some believe Russia could also gain from rising temperatures. The number of days annually requiring heating should fall 3–4 days a year until 2015, which, with current time energy efficiency, would decrease energy needs by 5–10 %. While the area of arable land is expected to increase and growing seasons are expected to lengthen, droughts in southern Russia are also expected to increase. There are still no specific assessments of the macroeconomic impacts of greenhouse gases on Russia.

Russia accounted for 6 % of global carbon dioxide emissions in 2006, when the world’s largest greenhouse gas producers were the US (23 %) and China (17 %). The Kyoto Treaty on climate change calls for the signatories to cut their emissions by 2012 to an average of 95 % of their 1990 emissions. Russia is easily on track to meet its target as industrial output declined after the collapse of the Soviet Union and modernisation has brought in considerably more efficient technology. As a result, Russia today is a major seller of carbon credits.

Many still estimate that Russia has possibilities to further reduce its carbon dioxide emissions with improved energy efficiency. Russians are rather wasteful consumers of energy compared to OECD countries. This is due in part to the availability of cheap energy, creaky energy distribution networks and inefficient energy use. The World Bank estimates that Russia loses about 10 % of its annual natural gas production to leaky pipelines and distribution grids.

Editor-in-Chief Seija Lainela
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.
China

US$200 billion in foreign currency reserves will be shifted to state asset management company. The National People’s Congress last week approved the transfer of $200 billion from China’s foreign currency reserves to the newly created state investment company. The new company operationally will be funded by the finance ministry, which will issue bonds for the new company worth 1.500 billion yuan to the central bank. The timing of the sale has yet to be announced and the transfer of assets is not expected to have any affect on bond markets as the bonds will be sold directly to the central bank and no sizable lots will ever make their way to market.

China’s foreign currency and gold reserves stood at $1.200 billion as of end-March. Most of the assets are invested in US treasuries or similar low-yield, low-risk instruments. Officials decided establish state investment company last spring to broaden the state’s portfolio and increase returns. So far the company has already committed to investing $3 billion for a nearly 10 % stake in the recently listed Blackstone private equity group. It has been suggested that the investment company should consider investments in strategic natural resources.

The rapid rise of state controlled international investment in recent years has begun to raise concerns. Germany announced last month it was considering new rules to allow limiting investment by foreign countries in Germany’s strategic sectors. The US invoked similar measures in 2005 when it blocked the purchase of US oil producer Unocal by the Chinese state oil company CNOOC.

New labour contract law set to enter into force in January 2008. After a year and a half of drafting and unusually open public comment round, the final draft of labour contract legislation was approved last week by the National People’s Congress. The new law would enter into force at the beginning of 2008, and would entitle every worker in China to a written work contract that spells out the terms of the working relationship and pay. It will be harder to terminate workers contracts and dismissed workers will be entitled to severance payments. Limits will also be imposed on the use of temporary or transient labourers.

The new law grants temporary workers nearly the same rights as other labourers. They will be considered permanent workers if their working relationship with the same employer lasts longer than a year. The move is planned to eliminate a current practice of employers to circumvent paying less than the prevailing minimum by hiring workers from temporary employment agencies in other provinces. These temporary workers are often brought in from provinces with lower minimum wage levels than in the employer’s province. Chinese provinces set their own minimum wage. The lowest minimum wage levels are under 300 yuan (30 euro) a month, while the highest exceed 800 yuan (80 euro).

China currently has no law governing labour contracts. Most workers have no contract with their employer and are in a weak position in the event of a dispute. Moreover, China’s labour laws are inadequately enforced. It is common for employers to withhold wages or not pay for overtime. Firing workers is relatively easy.

The new law has generally been positively received. Several observers have noted that even with the new law, supervision and enforcement will remain weak. Moreover, labour contracts will be only be negotiated at the factory or workplace level by China’s sole labour union, so individual workers will have almost no possibility to influence the contract terms. Some employers, on the other hand, have showed unhappiness with the new restrictions on the use of temporary labourers.

Study finds evidence that unreported income and income differences in China are greater than reported. A just-published report from China’s National Economic Research Institute reveals that China’s urban grey incomes were worth about 4,400 billion yuan ($440bn or 24 % of GDP) in 2005. In the study, the grey income includes income from illegal activities, morally questionable income, as well as unknown or unreported income sources. Part of the grey income is illegal (e.g. bribery), while part is legal income where taxes have been evaded. Chinese tax collection is inefficient and tax laws have loopholes. Officials are not immune to taking bribes e.g. to speed up the granting of permits, licenses or land for construction projects.

Income disparity between rich and poor is also likely larger than officially reported. Official figures show the households in the top decile (10 %) of the population make 21 times as much as those in the bottom decile. The study suggests the differential is more like 55 times as much, making income disparity in China worse than in Brazil or Argentina.

The study suggests that the difference between officially reported earnings and actual household incomes increases with household wealth. The Chinese Worker’s Daily commented this shows grey income issues largely affect the upper class and administrative elite, i.e. the people who have the greatest opportunities to earn unreported income.

The survey was based on a relatively small sample of 2,100 respondents, so one should be cautious in extrapolating the results nationally. Nevertheless, the findings support the general perception that official figures fail to capture a considerable amount of economic activity.
**Russia**

**Duma approves three-year federal budget for 2008–2010.** The budget process was conducted early this year at the request of president Putin, who wanted the budget ready well ahead of the Duma elections. Under a law approved last spring, Russia will shift next year to a three-year budgeting regime, designed to assure consistency of fiscal policy and effective use of state resources.

In recent years, taxes and tariffs on oil and gas have provided about half of federal budget revenues. As a result, assumptions about future oil prices have a profound effect on budget calculations. As often in earlier years, the budget is based on fairly cautious oil price projections. The price of Urals-grade crude oil is expected to fall from an average price of $61/bbl in 2006 to $53 next year, $52 in 2009 and $50 in 2010. If realized, Russia would suffer a substantial drop in energy revenues to fund budget spending. The budget calculations estimate Russian inflation will slow from 9 % in 2006 to 6–7 % next year, 5.5–6.5 % in 2009 and 5–6 % in 2010. GDP is expected to grow at about 6–6.2 % a year during the 2008–2010 period.

Budget revenues are expected to fall 6 % in real terms next year, mainly due to lower oil and gas prices. Revenues will contract from 23 % in 2006 to 19 % of GDP. Revenues begin to rise again in 2009, but the rate lower than in recent years. No big changes in taxation are expected. The top reforms include lowering taxes on dividends paid to strategic investors.

After maintaining a tight fiscal stance throughout the first half of this decade, fiscal policy gradually began to tolerate higher budget spending. The urge to spend is partly driven by the upcoming elections and pressure to use the country’s prodigious oil earnings on improving the quality of life for average citizens and economic development. 2008 budget spending will rise 20 % nominally and 12 % in real terms. Expenditures as a share of GDP will rise to 18.8 %, up from 16 % last year. In 2009 and 2010 the spending share would decline slightly. The 2010 budget would show a deficit for the first time since 1999.

The fastest growing spending category in the 2008 budget is “national economy” with a nominal growth of 44 %. The category includes, among others, the energy sector, transportation and telecommunications, agriculture, the water and forest sectors as well as space research. Strong spending increases are also set for social needs and culture (27 % and 22 %) and transfers to off-budget funds (28 %), which include the national pension, social and health insurance funds. Spending on both defence and national security will continue to rise less than the average, up 17 % and 16 % in nominal terms.

**Breakdown of 2008 federal budget**

<table>
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<tr>
<th>Revenues</th>
<th>billion roubles</th>
<th>% share of revenue</th>
<th>% share of GDP</th>
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<tr>
<td>Oil and gas, of which:</td>
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<tr>
<td>Mineral extraction tax</td>
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<td>Export tariffs</td>
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<tr>
<td>Profit tax</td>
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<td>8</td>
<td>1.5</td>
</tr>
<tr>
<td>VAT</td>
<td>2,168</td>
<td>33</td>
<td>6.2</td>
</tr>
<tr>
<td>Excise taxes</td>
<td>150</td>
<td>2</td>
<td>0.4</td>
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<tr>
<td>Other</td>
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<td>3.1</td>
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<tr>
<td>Total</td>
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</table>

<table>
<thead>
<tr>
<th>Expenditures</th>
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<td>General state spending</td>
<td>712</td>
<td>11</td>
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<tr>
<td>Debt-servicing costs</td>
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<td>Defence</td>
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<td>National security</td>
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<tr>
<td>National economy</td>
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<td>Health care</td>
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<tr>
<td>Transfers to funds</td>
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<td>21</td>
</tr>
<tr>
<td>Other</td>
<td>66</td>
<td>1</td>
</tr>
<tr>
<td>Total</td>
<td>6,570</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Finance ministry

**Huge investment needed for Sochi 2014 Winter Olympics.** Sochi, located in the Krasnodar region of the Southern Federal District, will become a focal point for Russian infrastructure investment in coming years. At least $12 billion will be spent for putting Sochi and its surroundings in shape to host the 2014 Winter Olympics. Most of the over $7 billion in state investment will be spent on improving infrastructure in the Sochi region, including better connections and transport capacity, as well as construction of sport facilities. Some of Russia’s biggest companies have promised to provide private investment for e.g. the Olympic village, hotels, shopping malls and construction of many of the event sites.

The Southern Federal District is among the poorest in Russia; GDP per inhabitant is about half the national average. Although the Krasnodar region’s role as a tourism centre has made it a major recipient of investment, economic growth in recent years has clearly lagged the national average. The region’s contribution to Russian GDP has shrunk from 2.6 % in 1999 to 2 % last year. The economy ministry reports that the Olympics will annually add more than one percentage point growth to the region’s economic output over the next seven years.

Russia’s steel and cement industries are expected to benefit extensively from the boom in investment. Other businesses are also expected to benefit from the Winter Olympics.
China

No signs of moderation on growth of China’s foreign trade surplus. China Customs reports the June foreign trade surplus hit a record $27 billion and that China amassed a trade surplus of $113 billion in the first six months of the year. The 28 % y-o-y rise in exports in the first half of 2007 compared to 18 % growth in imports has widened the trade surplus. Growth in the trade surplus is expected to accelerate further as monthly surpluses tend to increase in the second half of the year. The surplus this year is estimated to reach $250 billion.

Although Chinese officials often profess plans to balance foreign trade, the current measures, which focus on reducing tax advantages for exporters have had little if any impact. The latest move at the beginning of July involves the reduction or elimination of VAT refunds on nearly 3,000 products. In anticipation of the measure, exporters boosted their June shipments. While this slightly increased the June trade surplus, the measure is not expected to affect export growth for the year overall.

While China runs huge trade surpluses with the EU and US, it typically has trade deficits with most of its Asian trading partners. China Customs figures show the surplus with the EU in the first half of this year climbed to $58 billion. In order to rebalance trade, the EU has asked China to eliminate or lower its import barriers, which, according to EU trade commissioner Peter Mandelson costs the EU €20 billion a year in unrealised exports.

China Customs says China’s trade surplus with the US in the first six months of this year amounted to $74 billion, which most likely will increase US pressure on China to allow faster revaluation of the yuan. The US is clearly hardening its China policy. The US last spring filed a claim with the World Trade Organisation protesting China’s trade-distorting export subsidies paid to domestic companies. In June, the US announced it would restrict China to eliminate or lower its import barriers, which, according to EU trade commissioner Peter Mandelson costs the EU €20 billion a year in unrealised exports.

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China expands its interbank markets. The People’s Bank of China announced that as of August 6, it would allow trusts, financial leasing firms, insurance and auto financing companies and brokerages to operate in the interbank markets. Companies use the interbank markets to cover their short-term finance needs. While the trading volume in China has grown rapidly, the overall depth of interbank markets is still modest (just over 2 trillion yuan in 2006). Under the new rules, banks can lengthen the allowed lending period from four months to one year. Finance leasing firms, insurance companies and car financing companies can lend or borrow for up to three months and trusts, brokerages and insurance asset management companies can loan or borrow for no longer than seven days. Allowed borrowing amounts vary according to the type of firm. Banks, for example, can borrow up to 8 % of their overall liabilities.

India increasingly attractive to investors, but still lags China substantially. Foreign direct investment in China in the first half of 2007 was up 12 % y-o-y to $32 billion. FDI inflows into China ($70 billion in 2006) continue to outpace those to India (about $11 billion in 2006). However, in recent years the FDI growth rate has been outpacing Chinese FDI inflows and India’s FDI inflows have doubled annually.

According to a just-released Ernst & Young study, China is now the second-most attractive investment destination after Western Europe, while India ranked fifth. Of the nearly one thousand international decision-makers interviewed for the survey, 48 % put China in the top three highest-potential areas for business investment, while India was mentioned by 26 % of the respondents.

The 2006 World Economic Forum global competitiveness index ranked India (43rd) ahead of China (54th). A country’s appeal to investors was evaluated in terms of the opinions of international business leaders and key macroeconomic indicators. China received high marks for stable economic growth and sustainable public economic policies, but was critcised for the underdevelopment of its institutional and financial markets as well as failure to integrate more advanced technologies. India again was credited with its innovation talents and high-tech applications, while noting that the country’s lack of infrastructure and poverty could lead to uneven economic growth.

India’s cities appear more attractive than Chinese cities as destinations for outsourcing. This month, the market research firm IDC published its index of Asia’s most attractive cities for foreign investors. The top ten included the Indian cities of Bangalore (1st), New Delhi (3rd) and Mumbai (4th) ahead of the Chinese cities of Dalian (5th), Shanghai (6th) and Beijing (7th). The IDC, however, forecast Chinese cities will exceed Indian attractiveness by 2011, mainly due to the heavy investment in infrastructure underway in Chinese cities. In both countries, competition for workers has become tighter. Wages for professional managers have risen dramatically.
Russia

Russia to establish new state companies. Establishment of the new state controlled companies that President Putin brought up in his annual policy address is now in its finishing stages. The purpose of these enterprises is to diversify the structure of the economy and improve the competitiveness of Russian companies globally. Those new companies that enjoy a special status of a state corporation will also get budget funding. The first state corporation, a development bank to support innovation ventures, was created last month. At the beginning of July, the Duma also approved bills on setting up state corporations to coordinate development of Russia’s nanotechnology industry and operations in the housing and municipal services sector.

In addition, state-owned firms in Russia’s nuclear and shipbuilding industries will be consolidated under umbrella companies. A total of 89 companies with state participation will be organised under the umbrella of a nuclear energy specialist Atomenergoprom. After a long planning stage, the merger of Novoship to Sovkomflot will be completed to form one of the world’s largest shipbuilders. Both Atomenergoprom and Sovkomflot will be added to the state’s list of strategic companies that cannot be privatised. Some major Russian aircraft manufacturers were organised under a state-majority parent company already last year.

Russia invests in nanotechnology. Nanotechnology has been targeted as an important sector in diversification of the Russian economy to decrease the current dependence on exporting raw materials. Nanotechnology is technology that is built and operated at the atomic or molecular scale. Nanotech is used, e.g., in microelectronics and biotech for purposes like enhancing the properties of materials. Russia is planning to use it in the fields of energy, metals, electronics, arms, aircraft, shipbuilding and space. President Putin has named nanotechnology a major engine of national scientific and technological development. Russian officials have projected that by 2020 the contribution of nanotech industry, e.g., by modern technological equipment, and to advance commercialisation of new ideas.

Population decline poses new challenges for Russia. According to a new report from the United Nations Population Fund (UNFPA), Russia’s population is expected to fall at an average rate of 0.4 % a year during the period 2005-2010. The number of urban dwellers should fall even faster, an average of 0.6 % a year. UNFPA forecasts the population will contract from the current 142 million to 112 million by 2050.

While Russia’s birth rate is 1.4, holding the current population without immigration would require a birth rate of 2.1. The loss of Russian population mainly is the result of changes in living standards and a drop in the birth rate. Infant mortality in Russia is only slightly higher than the EU average, but life expectancy is substantially lower. The current average life expectancy in Russia is 59 years for men and 72 years for women.

To modify this demographic trend, a new programme based on a Putin policy speech last year has been formulated. The programme extends to 2025 and introduces measures to increase birth rates, lower mortality and implement an effective immigration policy. Measures for the programme, some already implemented last year, include rewarding mothers giving birth to their second or subsequent child, increases in assistance paid to families with young children, subsidised daycare, increased spending on healthcare and campaigns to promote healthier lifestyles.

If the programme succeeds, the natural population decline (deaths exceed births) is anticipated to slow in the coming three to four years. The population is expected to stabilise in 2011, and population growth should thereafter return so that by 2025 the Russian population will reach 143–145 million. At that point, the average Russian lifespan should be extended to around 70 years. Russia plans to take in 160,000-300,000 immigrants yearly by 2025. Observers point out that that number is quite small relative to the size of the Russian population. In 2006, the net inflow of immigrants into Russia compensated for about a fifth of the overall population decline.

Russian population trends, millions of people

Source: Rosstat.
China

China’s foreign currency reserves now exceed $1.3 trillion. China’s central bank announced its foreign currency and gold reserves stood at $1,330 billion at end-June. The second quarter increase of $130 billion closely matched growth in the first quarter. The growth in reserves in the first half of the year was driven largely by China’s ballooning foreign trade surplus ($113bn) and consistently strong foreign direct investment inflows ($32bn). Other capital inflows into China also continued to strengthen.

China’s foreign currency reserves are rising because the People’s Bank of China makes currency interventions (buys foreign currency) in the domestic markets in order to restrain yuan appreciation. The flip side of this approach is that the interventions increase the amount of yuan in the market. To control money growth, the PBoC sells bonds to the market and this way the PBoC has sterilised about a third of its interventions this year.

China does not publish a breakdown of the composition of its reserves. The US Treasury Department, however, estimates that China held just over $400 billion in US treasuries at the end of May 2007. The figure is based on Treasury Department records of bond sales and an annual survey. Observers note that China also holds substantial amounts of other US government agency securities (estimated at $250bn as of end-June 2006), but only limited holdings of other kind of debt securities and shares. Chinese officials have announced plans to reduce the share of dollar-denominated assets in the reserve portfolio gradually. The Chinese weekly *Beijing Review* estimates that currently 70 % of the China’s reserves are invested in dollar assets, 20 % in euro assets and 10 % in instruments in other currencies. At the end of last month, China decided to shift $200 billion of the reserves to a newly created state asset management company that will pursue to diversify investments and hopefully increase the returns China is getting on its assets.

China’s soaring stock markets take a breather; IPO boom on Mainland exchanges continues. Market jitters are reflected in recent bumminess in share prices and a drop in trading volumes on Mainland China stock markets. Share prices have been on rollercoaster ride for the past eight weeks. During the boom in share prices this spring, daily trading volumes on the Shanghai and Shenzhen exchanges exceeded even 200 billion yuan (€20 billion). Investing in shares gained popularity for the average household as a savings alternative to bank deposits, and stock trading accounts for small investors were opened in record numbers – sometimes as many as 300,000 accounts a day. Since the beginning of July, however, small investors appear to have lost some of their enthusiasm as the number of stock accounts opened has fallen to about 100,000 a day and trading volume has dropped to below 100 billion yuan (€10 billion). Some observers suggest China’s high stock prices could be supported by what are basically pyramid schemes; companies invest more of their spare cash to the stock market, which in turn increases the profits of those companies.

The end of the bull market and the decline in trading volumes is accompanied by a series of IPOs that also help drain off liquidity from Chinese stock markets. Encouraging the IPO activity helps the government’s efforts to curb stock market exuberance. A-share listings on the Shanghai and Shenzhen stock exchanges raised altogether capital for about 170 billion yuan (€17bn) in 1H07. For this year, listings could reach 400 billion yuan (€40bn) if several large firms go through with their announced IPO plans. It would make Mainland China’s two bourses the world centre of listing activity, outpacing the London, New York and Hong Kong stock exchanges.

The Chinese government’s latest measures point out its commitment to healthy securities markets. Relatively modest measures (and expectations of measures) have had a surprisingly large effect on share prices. Share prices went into brief tailspins at the end of May after the announcement of a modest hike in the stamp tax on share trades and at the end of last month when the law was amended to allow for a lower or elimination of taxes on bank deposit interest. Also at the end of June, a total of 29 banks (including ten foreign-owned banks) were sanctioned for funnelling foreign capital into domestic stocks.

Expectations that the government is about to announce further measures to rein in China’s booming economic growth have increased share price volatility. First-half economic figures released this week show GDP accelerated to 11.5 % y-o-y, while 12-month inflation hit 4.4 % in June. This news has increased expectation that the PBoC will raise rates soon. On the other hand, the China Insurance Regulatory Commission (CIRC) is expected to double the limit on domestic shareholdings of insurance companies to 10 % of total assets, which might support the stock prices.

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**Trends for Shanghai A and Moscow RTS indices, 2006–2007**
Russia

Strong economic growth continues in Russia. Deputy prime minister Alexander Zhukov said this week that according to a preliminary estimate the Russian economy grew 7.8% y-o-y in the first half of this year. Increasing private consumption continued to feed economic growth. Retail sales rose 14% y-o-y in the first half. Recently, also rapid acceleration in investment growth has helped support overall economic growth. Fixed investment was up 22% y-o-y in the first half. Especially state enterprises are implementing big investment plans. For example, gas giant Gazprom has increased its investment programme for this year to nearly $30 billion and electrical power company UES to $20 billion.

Investment growth was also reflected in increasing industrial output and construction. Industrial output in January-June was up nearly 8% y-o-y. Mineral extraction industries saw production rise 3%, while manufacturing industries enjoyed 12% growth. Within manufacturing, highest growth was seen in machine building, manufacture of electrical devices, and the rubber and plastics industries (each with growth above 20%). The spike in machine building, however, was affected by a large turbine delivery. Construction growth accelerated in the first half of the year to 25%. Housing construction rose nearly 35%, due in part to more favorable weather conditions than in 2006. The state also supports housing construction as part of its national priority programme. Agricultural output grew 2.5% in January-June, while transportation rose 3.4%.

Growth of main economic indicators, % y-o-y

Liquidity levels rise on higher oil prices and increased capital inflows. Preliminary balance-of-payments figures show goods exports in the first half rose 8% y-o-y and imports 39%. Higher imports reduced the trade surplus by about a fifth in the first half. Capital continues to deluge Russia, however, as foreign borrowing has increased substantially. Bank sector borrowing from abroad more than doubled from a year earlier, while private sector borrowing increased over seven-fold. A substantial share of foreign borrowing was taken by a few state firms, including Rosneft and Vneshtorgbank, pursuing strategic acquisitions.

Huge export earnings and capital inflows have increased liquidity in the economy, which the central bank strives to neutralise in order to control inflation. The rise in nominal exchange rate and inflation strengthens the rouble’s real exchange rate, which hurts the competitiveness of Russia’s value-added industries and fuels higher imports. On-year inflation picked up to 8.5% in June. Money supply (M2) at the beginning of July was over 50% larger than a year ago. The rouble’s real appreciation, however, has slowed from a year ago. The real effective exchange rate of the rouble strengthened 3.3% from January to June. The nominal effective exchange rate has weakened slightly since the start of the year. Foreign currency reserves have added about 25% since January. Reserves stood at $406 billion at the beginning of July, of which $121 billion consisted of oil income diverted to the state stabilisation fund.

Wages up, unemployment down. Rosstat’s preliminary figures for the first half show the average monthly wage in Russia reached 12,500 roubles (€360) in the first half of the year, up 27% from a year earlier. In real terms, the average wage increased 18%. The wage growth was highest in retail trade and agriculture and forestry, although in the latter the wage still remained only about half of the national average. Wages in the energy and finance sectors, in contrast, continued to be more than double the national average. Growth in pensions and social benefits has been lower than wage growth and thus the per capita income growth has failed to keep up with wage growth. Income per capita in June reached 12,200 roubles (up 18%).

The number of unemployed persons fell in the first half by over 7% y-o-y. As of end-June, the number of unemployed in Russia was 5 million. The unemployment rate stood at 6.7% and the workforce corresponded to 52% of the population.
China

China’s economic expansion accelerated further; 2006 GDP growth figures revised upwards. China’s real GDP growth reached 11.9 % y-o-y in the second quarter, a slight pick-up from the first quarter (11.1 %). 1H07 real growth was up 11.5 % from a year earlier. The National Bureau of Statistics (NBS) also recently revised its assessment of 2006 real GDP growth from 10.7 % to 11.1 % – the highest economic growth figure in over a decade. The NBS said the adjustment was made to reflect higher growth in the industrial sector than previously estimated. China’s real GDP growth has exceeded 10 % a year for four years in a row, and China is expected to soon surpass (if it has not done so already) Germany as the world’s third largest economy.

Industrial output growth accelerated to 18.5 % y-o-y in the first half. Industrial production of private companies soared 26 % y-o-y, while state-owned enterprises experienced 14 % growth. Machinery and light industry experienced particularly strong growth, while growth tapered off in energy-intensive industries. China’s industrial output figures include all state enterprises as well as companies with annual sales in excess of 5 million yuan (€500,000).

Nominal growth in retail sales picked up to 15.4 % y-o-y in the first half. Retail sales nationally amounted to 4,200 billion yuan (€420bn), and the retail sector is still relatively small. However, foreign retail chains continue to expand their operations in the Chinese market.

Fixed investments in urban areas were up 26.7 % y-o-y in the first six months of this year. The pace of investment growth has slightly slowed in recent years. While investment in the western and central provinces was altogether lower compared to the eastern provinces, investment rose faster in the urban areas. Machinery and light industry experienced particularly strong growth, while growth tapered off in energy-intensive industries. China’s industrial output figures include all state enterprises as well as companies with annual sales in excess of 5 million yuan (€500,000).

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Several parties have voiced concern over China’s sizzling growth. The National Development and Regulatory Commission (NDRC) recently stated that curbing economic overheating needs to be the government’s top priority in the second half of this year. The NBS noted that first-half growth, despite its high rate, has been quite balanced overall. China has strived in recent years to dampen investment growth and stimulate growth in private consumption.

Consumer price inflation accelerates; monetary stance tightened. The National Bureau of Statistics reports June consumer prices were up 4.4 % y-o-y. The on-year rise in prices was the highest in nearly three years and a percentage point higher than in May. The pick-up in inflation has been largely driven by higher food prices (up 11 % y-o-y in June), but in addition to that long term decline in prices of several products (such as clothing) has ended. Food accounts for a third of China’s consumer price index, and because of the large share the food price changes have a significant impact on the index. Officials are concerned about the rising food prices, and have extended subsidies to e.g. meat consumption where prices are skyrocketing.

The price of pork was up over 60 % y-o-y last month. The People’s Bank of China estimated at the start of this year that the rise in consumer prices would remain under 3 % this year. The rise in producer prices in June was just 2.9 % y-o-y. At end-June, the broad money supply (M2) was up 17.1 % y-o-y, which exceeded the 16 % target set by the central bank for the entire year.

With the release of the first-half figures, the PBoC decided to hike rates. The reference rate for 12-month deposits was raised from 3.06 % to 3.33 %, which is the maximum deposit rate that commercial banks can pay depositors. The reference rate for 12-month loans was increased from 6.57 % to 6.84 %. The actual lending rate must be at least nine-tenths of the reference rate. The rate hike was anticipated since deposit rates have clearly failed to keep up with inflation and growth in bank lending has exceeded targets. The June rate hike was central bank’s third hike this year. The PBoC has also tightened its monetary stance over the past seven months by increasing bank reserve requirements by 2.5 percentage points to 11.5 % and issuing bonds. In conjunction with the rate hike, officials also announced a reduction in the tax on deposit interest income from 20 % to 5 %. The change enters into force in mid-August and is expected to put at least a small crimp in the current investor craze in buying stocks.
**Russia**

**Government submits strategic sector draft legislation to Duma.** Two years ago at the initiative of president Vladimir Putin, the cabinet began its struggle with a law designating strategic fields where foreign ownership would be restricted. Last week, after lengthy disputes, the cabinet finally submitted its proposal. Early comments from observers view the proposal as a relatively liberal compromise. The draft lists 39 strategic fields in six sectors of the economy and gives criteria on where foreign ownership can be restricted. The sectors important to national security include space technology, defence, special technologies, aerospace, nuclear power and natural monopolies. Foreign investors hoping to acquire a controlling stake in a company operating in a strategic field must get permission from a government commission led by the prime minister. Permission can be denied in cases listed by the law, e.g. where companies use secret state information or are involved in the import or export of weapons systems. Commission decisions will take into consideration an opinion from the Federal Security Service. Companies owned by foreign governments are banned from holding majority stakes in firms operating in strategic fields.

The new law is not retroactive, so it has no impact on deals made before it enters into force. Foreign investors are generally glad the bill has finally been submitted to the Duma; they expect the law to clarify the scope of investment opportunities and eliminate uncertainty. The law does not, however, cover the energy sector. Foreign investment in the energy sector will likely be restricted. Last week, after lengthy disputes, the cabinet finally submitted its proposal. Early comments from observers view the proposal as a relatively liberal compromise. The draft lists 39 strategic fields in six sectors of the economy and gives criteria on where foreign ownership can be restricted. The sectors important to national security include space technology, defence, special technologies, aerospace, nuclear power and natural monopolies. Foreign investors hoping to acquire a controlling stake in a company operating in a strategic field must get permission from a government commission led by the prime minister. Permission can be denied in cases listed by the law, e.g. where companies use secret state information or are involved in the import or export of weapons systems. Commission decisions will take into consideration an opinion from the Federal Security Service. Companies owned by foreign governments are banned from holding majority stakes in firms operating in strategic fields.

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**Russia’s WTO talks continue.** At an unofficial meeting last week in Geneva, Russia moved ahead with multilateral talks on WTO membership. Russia needs to clear 46 items on the multilateral agenda. About half of these were still unresolved going into the meeting. The economy ministry said a dozen or so points were discussed and agreed on in Geneva, and Russia’s chief negotiator Maxim Medvedkov estimated that the talks could be wrapped up by the end of this year.

Medvedkov noted this week that agricultural subsidies remain one of the most difficult hurdles in WTO talks. Russia has announced as its starting point in the negotiations a sum of $9 billion in annual farm subsidies (compared e.g. to $40 billion in the US and $130 billion in the EU). According to the recently approved development programme for agriculture the sector’s federal budget funding is planned to rise from $6 billion next year to over $10 billion in 2012. The agriculture ministry says, however, that subsidies subject to WTO rules constitute only about a half of that sum.

On raw wood export tariff issue remaining to be cleared with the EU, Medvedkov commented that from the legal point of view Russia is entitled to raise tariffs before its membership, but in the view of the EU-Russia bilateral deal penned three years ago a mutually satisfactory resolution should be sought.

In bilateral talks between Russia and Georgia, trade with the regions of Abkhasia and Southern Ossetia remains a disputed issue. Russia also has yet to sign bilateral deals with Cambodia and Saudi Arabia, which have only this year wanted to open negotiations.

**New legislation on small and medium-sized companies.** The new law to promote development of small and medium-sized enterprises (SMEs) approved in July replaces a previous law on small enterprises from 1995. The law enters into force at the start of next year. It introduces a new classification system for SMEs that corresponds to the system used by the EU, which should help in comparison of the Russian enterprise sector internationally. Under the new system, SMEs are defined as companies that employ 250 or fewer persons. SMEs are further divided into small companies which have 100 or fewer employees and medium-sized enterprises which have 101–250 workers. The classification also considers corporate balance sheets and net sales.

The new law introduces the concept of the medium-sized enterprise and extends certain forms of assistance to medium-sized firms. For example, medium-sized firms will be eligible for interest supports and assistance in export promotion. SMEs will be supported with a special national programme that includes regional centres to nurture embryonic firms, guarantee funds and export promotion. One of the main jobs of the recently established Russian Development Bank is to fund SMEs. Although small firms enjoy simplified taxation and bookkeeping requirements, such benefits will not apply to medium-sized firms.

At the end of last year, Russia had over a million small businesses employing nearly 10 million workers. The number of small firms has grown at about 5% annually, but the distribution of them remains uneven geographically. In and around Moscow and St. Petersburg, small firms employ nearly a quarter of all workers, while in the poorest regions they provide just 5% of total jobs. Half of small businesses currently are involved in retail sales and 15% in other service businesses. The government wants to promote diversification of the small business and increase their role in business other than retail sales, particularly science, information technology, health care and social services.
Incomes continue to rise; middle class keeps growing. The National Bureau of Statistics reports Chinese incomes grew strongly in the first half of this year. Urban dwellers saw their real disposable monthly incomes climb 14% in real terms to 1,175 yuan (115 euro). In the countryside, real cash incomes were up 13% to 350 yuan (35 euro) a month. Incomes have soared along with the rapid increase in wages. Official figures show wages up nearly 20% y-o-y in urban areas, which is partly an effect from minimum wage hikes in the provinces. Wage growth is nearly double recent assessments of productivity gains, so wage hikes are expected to be increasingly reflected in the general price level.

Worker turnover in China (14% in 2006) is among the highest in Asia. This situation has forced firms to compete aggressively with higher salaries for skilled workers. Wages in China’s four largest cities (Beijing, Shanghai, Guangzhou and Shenzhen) are all about the same level. Wages in other cities are about 75–85% of that.

China’s expanding middle class is expected to become a rising power for consumption. A recent study by international consultant firm McKinsey found that China’s “middle class” (people with annual incomes of 25,000–100,000 yuan or 2,500–10,000 euro) constituted 22% of the population in 2005, while the “poor class” (annual incomes below 25,000 yuan or 2,500 euro) was 77%. Under these criteria, McKinsey estimates that the share of middle class will rise to 70% of the Chinese population by 2015. As incomes rise, the share of consumption devoted to food will fall, while spending on housing, health care and education will take increasingly large bites out of the consumer’s pocketbook.

Widening income disparity and weak labour laws have received negative publicity in China. Officials admit labour disputes and workplace demonstrations are on the increase. A new law to improve the legal protection of workers will enter into force at the start of next year, but its impact will be determined by the extent to which it is enforced. Despite continued disparities in wage levels, the McKinsey study finds China will succeed in avoiding worker turnover pressures on the yuan. Higher capital flows abroad should reduce excessive liquidity in domestic market and thereby diminish appreciation pressures on the yuan.

Increased investment opportunities for insurers. China’s Insurance Regulatory Commission announced it was immediately increasing foreign investment opportunities for Chinese insurance companies. Under the new rules, insurers are now permitted to invest 15% of their assets abroad, up from 5% earlier. The assets of Chinese insurance companies have increased nearly 30% a year since 2002. The assets of insurance companies are now 2,500 billion yuan (€250bn). Under the new rules, insurers are now permitted to invest 15% of their assets abroad, up from 5% earlier. The assets of Chinese insurance companies have increased nearly 30% a year since 2002. The assets of insurance companies are now 2,500 billion yuan (€250bn). The gradual relaxation on capital movements is part of China’s strategy to increase Chinese investment abroad. Higher capital flows abroad should reduce excessive liquidity in domestic market and thereby diminish appreciation pressures on the yuan.

Bank reserve requirements hiked. The PBoC continued its fight to restrain bank lending by lifting commercial bank reserve requirements to 12% of deposits. The latest hike, the sixth this year, enters into force on August 15. China’s Banking Regulatory Commission reports that its top priority is to get annual growth in new bank loans below 15% by the end of this year. The PBoC noted the volume of new loans in January-May exceeded 2,500 billion yuan (£250bn), an increase of nearly 17% y-o-y.
Russia

More funds for development of Russia’s Far East. The rise of Asia’s significance in the global economy has highlighted in Russia the problems of its Far Eastern regions. While the regions represent for about 40 % the nation’s land area, they collectively account for less than 10 % of the population and GDP. Currently, the Far East suffers from steeper population declines than elsewhere in Russia and a higher-than-average share of people living below the poverty line. Despite great natural resource endowments, the potential of the Far East’s riches has not been fully exploited due to severe climatic and geographic conditions and poor infrastructure.

A development programme for the Far East and Baikal area (which includes the Far East Federal District, the Buryat Republic and the Chita region) was first compiled over a decade ago. Until 2002, however, the programme’s funding was modest due to the low priority given to regional policy. During 2002–2006, the federal budget provided €170 million for the Far East development programme. This year’s budget sets aside as much as €120 million for the programme. Altogether, the Far East will receive this year a total of €1.2 billion in budget support.

At the beginning of August, the government approved a revised development programme for the Far East and Baikal extending out to 2013 that would massively increase federal budget spending on the region. The Far East is set to receive €12 billion during 2008–2013. The emphasis will also shift from improving housing, municipal services and the social sector to development of transport infrastructure. Transport systems will go from receiving a current 2 % share of funding to nearly 60 %. The focus on development of the energy sector will remain, however. The shift reflects the importance of the now-under-construction oil pipeline running from Eastern Siberia to the Pacific Ocean and other major energy projects in the area. About a quarter of the development programme’s funds will go to a sub-programme on making the city of Vladivostok a focal point of international cooperation in the Pacific Rim.

Goals of the development programme include increasing regional GDP by 2.6 times and expanding the labour force by 10 % by 2013. The programme has been criticised for failing to specify measures to attract workers to Far East regions.

Rapid banking sector growth continues. The stock of loans granted to businesses was up in May 47 % y-o-y. Lending to households skyrocketed 71 % y-o-y. Corporate lending amounted to 6,700 billion roubles (€190 billion), while the stock of domestic loans rose to 2,400 billion roubles (€69 billion). Even so, Russia’s credit industry is still small relative to the size of the economy.

Total assets of Russia’s banking sector as of end-May stood at 17,000 billion roubles (€487 billion) – an amount equal to about 50 % of GDP (again, fairly low by international standards). Nevertheless, balance sheet growth has been nothing short of remarkable – up 52 % y-o-y. Growth has in part been driven by massive IPOs to enhance the position of Russia’s two largest banks. The efforts follow the national economic development strategy. Sberbank’s IPO at the start of this year raised nearly $6 billion in fresh capital. Vneshtorgbank’s listing in May brought in over $8 billion, making it one of the largest share offerings anywhere in the world this year. Even with the IPOs, the state is to retain its majority position in both banks.

Russia’s four largest banks based on total assets are savings giant Sberbank, in which the central bank holds a 58 % stake; Vneshtorgbank (VTB), in which the state owns 77.5 %; Gazprombank, the banking arm of natural gas provider Gazprom; and the City of Moscow’s Bank Moskvy. Next come Russia’s leading private banks, Alfa-Bank and Uralsib. The biggest foreign bank, International Moscow Bank, which is owned by the Italian UniCredit, occupies eighth place. Tenth place goes to the Austrian Raiffeisen Bank. Sberbank continues to dominate Russian banking, accounting for 53 % of all deposits, 37 % of household loans and 32 % of corporate loans.

Foreign ownership of banks, measured in terms of charter capital, climbed from 16 % in January to 21 % at end-June – partly a reflection of the Sberbank and VTB share offerings. Foreign ownership in VTB now exceeds 20 %. As part of its WTO agreement currently under negotiations, Russia can limit foreign ownership of the national banking sector to 50 %.

The Banker last month ranked Sberbank 66th among the world’s top 1,000 banks. Some 27 Russian banks made the list.

Ten largest Russian and Chinese banks on The Banker list

<table>
<thead>
<tr>
<th>Rank</th>
<th>Bank</th>
<th>Tier 1 capital, US$ million</th>
<th>Total assets, US$ million</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bank of America, USA</td>
<td>91,065</td>
<td>1,459,7</td>
</tr>
<tr>
<td>7</td>
<td>ICBC, China</td>
<td>59,166</td>
<td>961,57</td>
</tr>
<tr>
<td>9</td>
<td>Bank of China</td>
<td>52,518</td>
<td>682,26</td>
</tr>
<tr>
<td>14</td>
<td>China Construction Bank</td>
<td>42,286</td>
<td>697,74</td>
</tr>
<tr>
<td>65</td>
<td>Agricultural Bank of China</td>
<td>11,425</td>
<td>684,34</td>
</tr>
<tr>
<td>66</td>
<td>Sberbank, Russia</td>
<td>11,134</td>
<td>131,65</td>
</tr>
<tr>
<td>68</td>
<td>Bank of Communications, China</td>
<td>10,647</td>
<td>220,19</td>
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<tr>
<td>101</td>
<td>China Merchants Bank</td>
<td>6,800</td>
<td>119,62</td>
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<tr>
<td>116</td>
<td>VTB Bank, Russia</td>
<td>6,200</td>
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<td>137</td>
<td>Gazprombank, Russia</td>
<td>4,67</td>
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<tr>
<td>160</td>
<td>China CITIC Bank</td>
<td>3,98</td>
<td>90,5</td>
</tr>
</tbody>
</table>

Source: The Banker 7/2007

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.
**China**

**Chinese banks thrive in first half.** Commercial banks operating in China saw their profits rise substantially in the first half of this year. The Industrial and Commercial Bank of China (ICBC), China’s largest bank, announced its profits increased more than 50% y-o-y in the first half. Several mid-sized commercial banks announced doublings in their earnings. Bank profits have been boosted by substantial increase in gained fees and the rapid growth in lending. Last year the central bank widened the spread between lending and deposit interest rates, which increased profitability of lending. Banking regulators report incidents of embezzlement and bank fraud in the first half declined 60% from a year earlier.

The rapid growth of Chinese banks has lifted them in the rankings among the world’s largest. The Banker magazine’s latest list of the world’s top 1,000 banks ranked by total assets puts ICBC in seventh place. Chinese banks have benefited strongly from the run-up in Chinese share prices. Measured in terms of market capitalisation, ICBC overtook US-based Citibank last month to become the world’s largest bank.

Chinese commercial banks have been busy lending this year. As of end-June, the loan stock was up 16% nominally from a year earlier and deposit growth decelerated to 15%. China’s central bankers consider the expansion in lending excessive, so they have this year implemented a number of measures to dampen borrowing demand (and inflation). For example, the PBoC’s monetary stance has been steadily tightened this year through measures that include interest rate hikes, higher deposit requirements for commercial banks and government bond issues.

Among China’s four large state banks, government efforts have currently focused on bringing Agricultural Bank of China back to financial health. Officials plan to pump $40 billion into the bank this year to help it cleanse non-performing loans from its balance sheet. The bank’s non-performing loans amount to more than 20% of the bank’s loan stock. Bank regulators want commercial banks to keep their non-performing loan ratios below 8% of loans. The government has provided similar bail-out packages in recent years to the other three major state banks (ICBC, Bank of China, and China Construction Bank). Presently, all three have non-performing loan ratios below 8%.

Under China’s WTO commitments, the country committed to opening up opportunities for foreign commercial banks in China. The CBRC is set to approve another dozen banks. Founding a subsidiary is mandatory for foreign banks that want to offer Chinese clientele local banking services under the same rules applied to Chinese banks. Bank operations, however, continue to be subject to huge capital demands when establishing new branch offices.

In addition to legitimate banks, dozens of illegal banks also operate in China. Last year, government investigators exposed over 70 illegal banks and foreign exchange centers. The largest illegal bank was found to have account activity over an 18-month period in excess of 4 billion yuan (€400 million). Illegal banking operations are encouraged by Chinese restrictions on capital movements. In addition, small and medium-sized businesses turn to the illegal operators as they still face difficulties in getting loans from legitimate banks.

**Good summer harvests: higher food prices fatten farmer incomes.** Figures from the National Bureau of Statistics show China’s summer grain harvest was up 1% from 2006 to 115 million tons. Officials base their grain harvest estimate on crops of maize, beans, potatoes, rice and wheat. The size of the summer grain harvest has grown for four years in a row, and accounts for about 20% of China’s yearly grain harvest. Production of meat, eggs and milk products also rose in the first half. The agriculture ministry warned, however, that annual flooding in Eastern and Southern China and a drought in Northern China might reduce the total annual harvest. Pork supplies have been affected by outbreaks of blue ear disease, a syndrome that affects the respiratory and reproductive systems in pigs. Pork prices increased 60% y-o-y in June. Although the area of land under cultivation has increased slightly in recent years, China relies more and more on food imports. For example, soybean imports from Brazil have more than doubled since 2004.

China’s National Bureau of Statistics reports that the real monthly disposable incomes of farmers rose on average 13% y-o-y to 350 yuan (35 euro). The breakdown of typical farm incomes consisted of 35% wages, 42% income from sales of farm produce and animal products, and the remainder from household participation in industrial production, real estate-related businesses and income transfers. The growth of farmer incomes has been supported by higher prices for meat and farm produce. Earnings from cultivated plants climbed 16.5% y-o-y and animal products 21%. In May, China’s finance ministry granted 42 billion yuan (€4.2bn) in direct subsidies paid to farmers, a 63% hike from the 2006 level. The purpose of the subsidies is to bolster farmer incomes and encourage higher production.
Russia

Capital inflows into Russia continue. In the first half of this year, Russia received about $100 billion in foreign capital, i.e. more than it received for all of 2006. Most foreign capital was borrowed. Rosstat reports about 70% of capital inflows (excluding the banking sector) were in the form of various credits. Many large Russian firms have borrowed considerably this year to finance major corporate acquisitions. Foreign capital flows into the banking sector were boosted by both foreign borrowing and the Vneshekonombank IPO.

FDI inflows into Russia also rose clearly in first half. Most FDI originated in the Netherlands and focused on the energy sector. Nearly half of investment in manufacturing went to food processing. Other direct investment came also largely from the Netherlands, as well as Cyprus.

Russian investment abroad also grew notably in the first half, exceeding $30 billion. Nearly a third of investment went to the US, followed by Cyprus and the Netherlands with shares of a fifth each.

Shares of FDI inflows by economic sectors, %

![Chart showing shares of FDI inflows by economic sectors for 1H06 and 1H07.]

Source: Rosstat

The increasing prominence of Russia’s metals sector.

Russia’s large metals producers are seeking to consolidate their international positions through domestic and international acquisitions. At the start of the year, the Russian aluminium firms RusAl and SUAL merged with the aluminium operations of the Swiss Glencore to create the new RusAl, one of the world’s largest aluminium producers. Norilsk Nickel is also just finalising its purchase of the Canadian LionOre for over $6 billion.

Many metals producers are considering large investments also in production capacity. The sector badly needs the investment due to the age of equipment and infrastructure constraints in general. Several metals producers are also looking to participate in higher value-added manufacturing activities like the automobile and construction industries.

Due to the energy intensity of metals production, many producers are increasingly involved in the energy sector. For example, Norilsk Nickel has acquired a majority stake in the OGK-3 power facility and RusAl is planning to develop hydropower sources. Russia’s metals producers have benefited from the high global demand for metals and strong metal prices, so they have good possibilities to fund their corporate acquisitions and investments. In addition, metals producers are not taxed nearly as heavily as the oil sector in Russia.

The metals industry has traditionally been one of Russia’s most important industrial branches. Metals production accounts for around 5% of Russian GDP and it represents over 10% of the country’s exports. Russia is a major metal producer also globally; it produces more nickel than any other country and is a major supplier of steel and aluminium. The main share of production of several metals (e.g. nickel and aluminium) is currently exported. Russia hopes to increase domestic use and processing of metals by developing branches such as machine building.

No major changes in Russian military spending as a share of GDP. The Stockholm International Peace Research Institute (SIPRI) estimates Russian military spending amounted to $40 billion in 2006, or about 4% of GDP. In real dollar terms the annual growth of military spending has averaged 10% throughout the 2000s, but its share of GDP has been rather stable.

SIPRI reports that Russia was the world’s second largest arms exporter after the US in 2006. In terms of volume, Russia provided about a quarter of global arms exports. Most of Russian arms production is geared to exports. Russian arms exports increased only a few per cent last year, even as arms exports rose globally by about a fifth. Russia’s top customers for its weapons are China and India. Russian arms exports are administered entirely by the state-owned enterprise Rosoboronexport.

Per capita military spending in 2006 and change from 2005

<table>
<thead>
<tr>
<th>Country</th>
<th>Per capita 2006 spending, US$</th>
<th>Real on-year change, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>1,756</td>
<td>4.8</td>
</tr>
<tr>
<td>Great Britain</td>
<td>990</td>
<td>– 1.4</td>
</tr>
<tr>
<td>France</td>
<td>875</td>
<td>0.3</td>
</tr>
<tr>
<td>Germany</td>
<td>447</td>
<td>– 2.8</td>
</tr>
<tr>
<td>Japan</td>
<td>341</td>
<td>– 1.1</td>
</tr>
<tr>
<td>Russia</td>
<td>244 *</td>
<td>11.6 *</td>
</tr>
<tr>
<td>China</td>
<td>37 *</td>
<td>11.7</td>
</tr>
</tbody>
</table>

Source: SIPRI * SIPRI estimate
China

China’s consumer price inflation picked up in July. The National Bureau of Statistics reports consumer prices in July were up 5.6% y-o-y, the largest spike in monthly inflation in a decade. The NBS said July food prices climbed 15% y-o-y and other prices were up on average less than 1%. Rising food prices have boosted farmers’ incomes, which partly explain why the government so far has not been more concerned about rising prices.

On-year rise in consumer prices and money supply (M2), %

![Graph showing consumer prices and money supply (M2) from 2003 to 2007.](image)

Sources: National Bureau of Statistics, PBoC

Trade surplus, rising inflation and US disaffection increase pressure on China’s foreign exchange policy. Even with on-year growth in imports accelerating to 27% in July, China still posted a near-record monthly trade surplus of $24.4 billion as export growth boomed (34% y-o-y in July compared to 27% in June). The large trade surplus hampers official efforts to manage the domestic liquidity situation and money supply growth continues to exceed official targets (see chart above). Moreover, officials must also grapple with the disconcerting possibility of higher inflation. While inflation is largely driven by rising food prices at present, the easy availability of money from the markets could readily push up wages and prices of other goods. Quelling inflation with rate hikes may be difficult in the face of revaluation expectations, as rate hikes would likely add liquidity by increasing capital imports. Nevertheless, there is a need for a rate hike as deposit rates are currently negative in real terms – a situation that has pushed investors in droves into the stock market. On the monetary policy side, arguments for faster yuan revaluation have also increased.

Moreover, the US continues to harden its trade stance with China. At the end of July, the US Senate’s finance committee approved a bill imposing higher tariffs on Chinese imports if China does not allow the yuan to appreciate faster. Chinese officials, however, are reluctant to let the yuan strengthen quickly due to potential damage to the competitiveness of the agricultural sector and exports. In addition to tightening monetary policy, authorities have also lowered import duties and tax rebates related to exports, as well as increased opportunities for Chinese institutional investors to invest abroad in order to deal with liquidity in the economy. State Agency of Foreign Exchange this week abolished foreign currency limits for firms. Although such measures are steps towards reform, they have proven insufficient for reducing pressure from yuan revaluation.

The yuan appreciated against the dollar in the second quarter, but since mid-July the yuan-dollar exchange rate has been fairly steady. Indeed, this month the yuan actually lost a bit of its value.

Increases in electrical power generation capacity fail to keep up with rising demand; power shortages continue throughout China. In the first half of the year, power outages were experienced in 12 of China’s 31 administrative regions. Summer blackouts have become commonplace as power companies fail to keep up with tens of millions of air-conditioning units set to full blast. Power shortages have been worst in the south, where they hit for the fifth year in a row. Ongoing blackouts have forced many companies to set up their own back-up power generation facilities.

The China Electricity Council reports electricity consumption rose 16% y-o-y. Industrial consumption of electricity accounts for 76% of total electrical power consumption. Electricity consumption increased sharply in western and central provinces, where economic growth, particularly growth of heavy industry, has been strong. Although China has invested heavily in more electrical power generation capacity, supply continues to lag the booming demand created by high economic growth. Production rose an estimated 14% in 1H07. Electricity production has been limited regionally by droughts and problems with coal supplies. In some regions, production of hydroelectric power has been boosted by summer flooding. China is building several new nuclear power plants, but their overall contribution will be minor. Coal-fired plants generate about four-fifths of electricity in China and the most of the remainder is generated by hydroelectric plants.

The national power grid lacks capacity to transfer electricity from surplus regions to those in deficit. China’s large power distributors are investing in improving the power grid. For 2006–2010, some 1,000 billion yuan (€100bn) has been set aside to upgrade the grid.

State-owned electricity producers have demanded hikes in electricity rates to compensate for higher coal prices. The National Development and Reform Commission (NDRC), which sets the price of electricity, announced it has no plans to raise rates in the near future. The government is paralyzed over raising rates as it will not be politically popular and is likely fuel inflation.
Russia

Global stock market jitters reach Russia: increased volatility in rouble exchange rate. The RTS index, which includes some of Russia’s most actively traded shares, has fallen about 10% from its historical high in July. Even with the decline, the RTS index is still up about 4% from the start of the current year. Foreign investors led the market decline as they converted their investments in Russia and other emerging markets into less volatile investments, particularly government bonds of developed countries. Thus, the sharpest declines were registered for shares of Russian companies more widely held by foreign investors.

Capital outflows from Russia have increased demand for foreign currencies and somewhat weakened the rouble’s external value. At the beginning of the week, the Central Bank of Russia moved to prop up the rouble by selling dollars from its currency reserves – the first such action in a couple of years. Generally, the central bank has been a buyer of dollars as it has sought to quell appreciation pressures on the rouble caused by large foreign trade surpluses and extensive capital imports.

Higher interbank lending rates indicate a tighter liquidity situation on the financial markets in recent days. Liquidity typically diminishes at the end of the month as companies pay their taxes, but the increase this month has been unusually substantial. Overnight lending rates have increased from slightly over 4% at the end of July to 7% this week.

Rouble-dollar, rouble-euro exchange rates (monthly average)

![Chart of rouble-dollar and rouble-euro exchange rates]

Source: Central Bank of Russia

Business climate shows signs of modest improvement. According to surveys conducted by the World Bank and Russia’s centre for economic and financial research CE-FIR the country’s business climate has improved, even if the positive progress has been slowing somewhat recently. Legislative and regulatory changes at the start of this decade have helped reduce the bureaucratic red tape encountered by entrepreneurs (although it has not been reduced to levels targeted by law due to implementation problems). For example, only slightly more than half of small firms managed to get their registration within the timeframe set by law and the average licence fee paid was about double the amount specified at law. Large and small firms alike continue to be troubled by uncertainties of the operating environment caused by e.g. sudden legislative shifts and economic instability. Taxation and the behaviour of tax officials also caused problems. Companies clearly spent more time dealing with tax officials than with any other regulatory authority. The lack of access to financing and difficulties in acquiring land caused problems especially for small enterprises. Nevertheless, problems overall have diminished in recent years. However, a recent upswing in corruption was generally noted by the companies interviewed.

The World Bank indicator for the regulatory quality in the Russian economy is about the same as for India and China. As to rule of law and control of corruption, World Bank indicators suggest these areas are less problematic for China, and particularly India, than for Russia. On the other hand, it is simpler and cheaper to set up a new company in Russia than in either China or India.

SCO leaders meet in the Kyrgyzstanz capital of Bishkek. Last week’s meeting of the Shanghai Cooperation Organization (SCO) was the organisation's seventh annual summit. In addition to leaders of SCO member states Russia, China, Kazakhstan, Kyrgyzstanz, Tadzhikistan and Uzbekistan, the summit was attended by representatives of the organisation's observer states, India, Iran, Mongolia and Pakistan.

The SCO was created in 2001 from the Shanghai-5 organization. In recent years it has gained status as a forum for member states in the spheres of political, security and economic cooperation.

Energy questions were among the leading topics of discussion at this year’s summit. The idea of creating a regional Energy Club within SCO received positive response, although no concrete decisions on the issue were made. The Club would act as an advisory organ, consisting of representatives of governments, business circles and research institutes of SCO's member and observer countries.

The summit approved a statement, according to which the security of the region can best be guaranteed by the countries of the region themselves and their organisations. In connection with the summit, joint antiterrorism exercises were staged in the Chelyabinsk district in Southern Siberia.
China

China hikes benchmark rates. The People’s Bank of China continued to tighten its monetary stance this week, raising deposit rates by 0.27 % and lending rates 0.18 %. The reference rate for one-year deposits is now 3.60 % and one-year loans 7.02 %. The increases went into effect on Wednesday (Aug. 22). Although there is no upper limit on lending rates, commercial banks must lend at rates no less than 90 % of the reference rate. Deposit rates offered by commercial banks may not exceed the reference rate.

Given that real rates on deposits are still negative, the rate hike was expected. China’s consumer price inflation has accelerated this year, with July prices up 5.6 % y-o-y. Growth in the broad money supply (M2) has also picked up. By the end of July, M2 growth for the year already exceeded the central bank’s 2007 target of 16 % by 2.5 percentage points. The larger increase in deposit rates compared to lending rates also erodes bank profit margins. The central bank’s widening of the spread between deposit and lending rates last year helped fuel a large jump in commercial bank profits in the first half of this year.

Opening up of financial markets continues; limited trial lets private individuals purchase foreign stocks. China’s State Administration of Foreign Exchange (SAFE) recently let customers at the Tianjin branch of the Bank of China near Beijing invest directly and without limit in foreign shares. In practice, investor choices were limited to shares listed on the Hong Kong exchange since it is the only foreign exchange currently approved by Chinese authorities. The trial will be extended to other banks and stock exchanges in the near future. Before the announcement, the same shares of Chinese companies listed on bourses in both Mainland China and Hong Kong were considerably cheaper in Hong Kong than in Mainland China. After the announcement of the trial, the Hong Kong bourse’s Hang Seng index rose nearly 6 % and registered the largest daily gain in almost a decade. Officials hope the reform will help to relieve appreciation pressure on the yuan.

Chinese share prices have continued to strengthen. Although many companies reported better-than-expected profits in the first half, some observers attribute the improvements to corporate investments in stock markets rather than fundamental gains.

Easier rules on bond issues for exchange-listed companies. The China Securities Regulatory Commission (CSRC) significantly eased its rules on the issuance of debt securities by listed companies. Bond issuers will still need official approval under the new rules. Earlier, complicated regulations made corporate bond issues so difficult in practice that they were quite rare. To this day, government-issued bonds effectively constitute almost the entire bond market in China. Enterprises have welcomed the new rules and several firms are already reported to be planning bond issues. Companies last year relied on borrowing from banks for 80 % of their external financing. Most investments, however, were financed directly out of corporate profits.

Income inequality in China continues to widen. Newly released report from the Asian Development Bank (ADB) suggests income inequality has risen in China and elsewhere in Asia. The study uses the Gini coefficient, which shows increased income disparity as its value approaches 1. China’s Gini coefficient was 0.41 in 1993, 0.45 in 2001 and 0.47 in 2004. While China has a high Gini coefficient by Asian standards, it has yet to match the income inequality found in most of South America.

Underlying the widening of income disparity in China is the unevenness of economic growth among regions and sectors. The difference in incomes between rural and urban areas is particularly pronounced. However, also the incomes of poor people in China have risen, just not as fast as their wealthy counterparts. ADB reports that the opening of China’s markets and globalisation have also contributed to higher income disparity as wage gains from foreign investment have mainly gone to the wealthiest and most developed provinces on the coast.

The Gini coefficient is a simplistic measure of income distribution in that it fails to take into account many factors behind income inequality such as education and land ownership. According to ADB, the share of China’s population living on less than a dollar a day has fallen from over 30 % in 1990 to 11 % in 2004. ADB estimates that without an increase in income disparity, the share of people still living in absolute poverty in China would have fallen to 5 % in the same period.

2004 income disparities measured by Gini coefficient

<table>
<thead>
<tr>
<th>Country</th>
<th>Gini Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>0.6</td>
</tr>
<tr>
<td>China</td>
<td>0.5</td>
</tr>
<tr>
<td>Thailand</td>
<td>0.4</td>
</tr>
<tr>
<td>Russia</td>
<td>0.3</td>
</tr>
<tr>
<td>India</td>
<td>0.2</td>
</tr>
<tr>
<td>Korea</td>
<td>0.1</td>
</tr>
<tr>
<td>Finland</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Sources: World Bank and Asian Development Bank
Russia

Strong first-half federal budget performance. The federal budget surplus for the first six months of 2007 corresponded to nearly 8 % of estimated GDP for the period. Federal budget revenues reached €93 billion (3,246 billion roubles), which was slightly below the original budget target. Revenues showed 11 % y-o-y nominal growth. Taxes and fees on fuel production and exports contributed a substantial share of revenue to federal coffers. Export and import tariffs provided the largest single revenue stream – 31 % of total revenues. The value-added tax brought in another 30 %, natural resource use fees 16 % and corporate profit taxes 8 %. Revenues were spiked by €4 billion from the forced sale of assets in the Yukos oil company bankruptcy estate to recover back taxes.

Federal budget expenditures in January-June amounted to €62 billion (2,170 billion roubles), a nominal increase of 17 % y-o-y. Expenditures were 20 % below target due mainly to the fact that several ministries and government agencies have been slow in using their allotted funding. That delay, in turn, reflected the lack of administrative rules in connection with the new budget act as well as new state procurement rules. Once the rules are clarified, budget spending is expected to take off and the budget surplus will decline. At year’s end, the budget surplus is expected to amount to less than 5 % of GDP. The 2006 federal budget surplus equalled 7.4 % of GDP.

The supplemental budget approved by the Duma in June grants additional money to regions for the remainder of the year for such purposes as road construction and basic improvements in the housing stock. The supplemental budget was funded out of proceeds from the sale of assets in the Yukos bankruptcy estate.

Some €19 billion in customs and tax revenues from crude oil were transferred from the first half budget to the stabilisation fund. At the end of June, the stabilisation fund contained assets worth €90 billion ($122 billion), which corresponds to about 11 % of GDP.

Regional budgets also post surpluses in first half. Measured in nominal terms, regional budget revenues in 1H07 climbed 25 % y-o-y and expenditures 27 %. Revenues were boosted largely by higher collections of personal income tax and corporate profit tax. Growth in income tax collection follows a rapid rise in wages – in part the major increase in public sector wages of the past couple of years, which has been largely funded out from the federal budget. Tax revenues grew most in the major growth centres (e.g. realised tax revenues increased 39 % in the Leningrad region and 36 % in the Moscow region).

Personal income tax, the major revenue stream for regions, is shared between the region and local governments in a ratio of 60/40. Regions also retain 73 % of corporate profit tax collections (27 % goes to the federal budget) and 5 % of natural resource use fees. Regions also retain all regional taxes, which include the corporate property tax, gambling tax and transport tax. Regions still receive a significant share of their incomes from federal budget transfers. Last year, only about 20 of Russia’s 88 regions generated sufficient revenues to cover their spending.

Russia’s electricity exchange sees sharp increase in electricity prices. Spot prices for electricity this month broke through 1,000-rouble-per-megawatt-hour level (about €30/MWh) for regions in European Russia. Prices last year in the same regions averaged less than €20/MWh. While electricity continues to be cheaper in Siberia, prices there are also on the rise. The trading price of electricity in Russia includes an added capacity charge that is estimated presently at over €10. Thus, Russian electricity prices are effectively on par with Europe (e.g. the average spot price for electricity on Nord Pool, the Nordic power exchange, averaged below €20/MWh this month). The rise in Russian electricity prices reflects maintenance work, an unusually warm summer and higher prices for gas and coal.

Russia’s electricity exchange was launched a year ago. While industrial consumers still satisfy most of their power needs from the monopoly RAO UES at regulated prices, the use of electricity traded at market prices has increased to about 10 % since the beginning of July. The government’s plan is to continue increasing this share gradually so that by 2011 all pricing is set by the market. The reform applies solely to industrial consumers, however. Private consumers will continue to enjoy regulated rates. A long-range economy strategy paper by the economy ministry predicts electricity rates for private consumers will double by 2015.

Structural reforms in the electrical power sector proceed. RAO UES plans to spin off the first two of its 20 production companies in September. In the share offerings of production companies this year Norilsk Nickel has purchased a majority stake in the OGK-3 power facility and gas giant Gazprom nearly half of the shares in Mosenergo, a generator serving the Moscow area. The Italian energy company Enel is set to become the first foreign majority owner in the electricity sector. Enel earlier bought nearly 30 % of OGK-5 shares and has recently received permission from the Russian anti-monopoly office for acquisition of the majority stake. Finland’s Fortum has announced plans to participate in the upcoming offering of St. Petersburg-based production company TGK-1 to retain its 25 % stake in it. Fortum recently divested its approximately one-third stake in St. Petersburg power distributor Lenenergo for a price of nearly €300 million.
China

China's finance ministry issues 600-billion-yuan ($79bn) in special treasury bonds to fund state investment company. The special 10-year treasury bonds issued Wednesday (Aug. 29) carry a 4.3 % coupon, in line with the current rate for long-term government bonds. The bonds were sold to the central bank, which can use them to adjust liquidity in the system as part of its market operations. The issue had no direct impact on financial markets.

The bond issue is part of state efforts to get the state investment company (SIC) up and running. The finance ministry will direct money from the bond sale to the SIC, which will then purchase foreign currency from the central bank to invest in better-yielding instruments abroad. At the end of June, the parliament granted the finance ministry permission to issue 1.550 billion yuan worth of treasury bonds to fund the SIC’s purchase of $200 billion from the central bank’s reserves. At end-June, the value of China’s currency reserves stood at $1,330 billion.

Growth in Chinese oil production lags rising demand; China and Russia compete for Central Asian energy resources. In the first half of this year, crude oil consumption in China was up 7 % y-o-y to 173 million tons. Domestic oil production increased in the same period nearly 2 % to 93 million tons and oil imports rose 11 % to 82 million tons. In contrast to international practices, oil consumption in China is measured as the sum of domestic production and net imports without including information about changes in oil inventories.

Although Chinese oil companies recently announced the discovery of several large oil deposits in the Bohai Sea and in Western China, they are insufficient to offset the rising demand for energy imports. As a result, Chinese companies have been actively making energy deals internationally. This month, natural gas and oil pipeline deals were penned with Turkmenistan and Kazakhstan. China and Russia compete for Central Asian energy resources. In late spring, Russia agreed tentatively on new natural gas supplies to China; the present leadership.

China-India trade expands rapidly. Chinese exports to India grew 30 % a year during 2004–2006. China’s imports from India have also grown at over 50 % a year throughout the 2000s. Trade between the countries has increased from less than $3 billion in 2000 to $24 billion in 2006. China ran a near $6 billion surplus in bilateral trade. China is India’s third largest trade partner, accounting for 6 % of India’s trade. India represents less than 2 % of China’s trade.

Chinese exports to India largely consist of electronics, machinery, refined metals, chemicals and textiles. China’s main imports from India are raw materials, particularly iron ore, cotton, plastics and industrial minerals. Metals trade has grown fastest in recent years. China imports raw metals from India, such as iron ore and scrap metal, while it exports to India refined metals such as aluminium, zinc and lead as feedstock for e.g. the car industry.

China and India have traditionally had little to do with each other. Even today, there are few direct banking and airline connections. In the last three years, however, the leaders of both countries have sought to improve relations and resolved part of the border disputes. China supports Indian membership on the UN Security Council. A bilateral free trade agreement is also under consideration, but unlikely to be agreed on soon.

Foreign direct investment flows between the countries remain modest, although Indian investors have found more reasons to invest in China than vice versa. Indian companies seek to take advantage of the low production costs in China, China’s attractive investment policies and large markets. Chinese firms, on the other hand, have found few reasons to invest in India, as their own markets are larger and much easier to access. The technology and service sectors offer potential synergy advantages for bilateral investment. For example, the Chinese telecommunications network provider Huawei funds R&D operations in India. Indian software-maker Tata Consultancy Services has also enjoyed a degree of success in China.

17th People’s Congress set for mid-October. This week it was announced that the Communist Party Congress, held every five years, will convene on October 15. The congress, which is closed to the public, will be attended by about 2,000 representatives. President Hu Jintao, the current party head, is expected to bolster his position inside the party by adding more of his own people to the party’s eight-member Central Committee. The formulation of party policies will face such challenges as preserving the party’s unitary power. Increased wage disparity, corruption, environmental destruction, rising inflation and stock market volatility have all fostered criticism of the present leadership.

Recent surveys found that, thanks mainly to continued strong economic growth, party support remains fairly stable generally, especially among the emerging middle class. People tend to be more critical of their local administrations.

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

Russia prepares for elections. This Duma’s final session convened on Monday (Sept. 3). Elections for the next Duma, which begins its work in January, are set for December 2.

The upcoming Duma elections will be the first arranged according to 2005 legislation on elections and political parties. Under the new rules, all 450 Duma deputies will be elected according to a proportional representation system from party lists that only registered parties can submit. Earlier half of Duma representatives were elected from individual lists that allowed e.g. popular opposition candidates to win a seat even if their party had a poor showing in the election. The threshold for a party to get into the Duma has been increased from 5 % to 7 % and electoral blocs are forbidden. Every party has been required to re-register and the registration criteria have been tightened so a party must show it has at least 50,000 members and activities in at least 45 of Russia’s 85 regions.

Duma composition 2004–2007

<table>
<thead>
<tr>
<th>Party</th>
<th>Representatives</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Russia</td>
<td>303</td>
<td>67</td>
</tr>
<tr>
<td>Communists</td>
<td>47</td>
<td>11</td>
</tr>
<tr>
<td>Just Russia</td>
<td>33</td>
<td>8</td>
</tr>
<tr>
<td>Liberal Democrats</td>
<td>31</td>
<td>7</td>
</tr>
<tr>
<td>National-Patriotic Union</td>
<td>8</td>
<td>2</td>
</tr>
<tr>
<td>Non-affiliated representatives</td>
<td>23</td>
<td>5</td>
</tr>
</tbody>
</table>

Russia has currently 17 registered parties, but according to observers not all of them will take part in the elections. Only four parties are expected to win seats. Polls show voters overwhelmingly support Putin’s party, United Russia. Other parties likely to do well are the Communists, Just Russia and Vladimir Zhirinovski’s Liberal Democrats. Two liberal right-wing parties – The Union of Right Forces and Yabloko – are not expected to exceed the 7 % threshold.

United Russia is well covered in the media as most top political figures belong to their ranks. In June, the party released its platform, entitled “Putin’s Program,” a compendium of development goals for Russia mentioned by the president in recent policy speeches. Just Russia was created with Kremlin support through the merger of three smaller parties last year. The party is led by Federation Council speaker Sergei Mironov. Just Russia supports president Putin, but focuses more on social issues than United Russia.

Campaigning officially starts at the beginning of November, when the Central Elections Committee approves the final candidate lists.

Economic growth spreads increasingly to regions.

Growth in the first half accelerated in all core sectors in Russia, although notable regional differences persisted. Although the Central Federal District (FD) and especially Moscow remains the most significant area by far, in 1H07 fastest growth was seen mainly in other districts.

In the Central FD, the rise in investment and industrial output was slightly above average, while construction growth was significantly below average. In the Moscow region investment increased over 50 %. Real wage growth in the Central FD was highest nationally. During January-June, the average monthly wage was €410 and €600 in Moscow.

Construction and investment growth in the Northwest FD was clearly the lowest nationally. Even so, industrial output and investment growth was 50 % in Kaliningrad. In the Nenets region, investment doubled mainly due to development of northern gas deposits. The average monthly wage was €400 for the district and €440 in St. Petersburg.

Growth was slightly faster than average in all sectors except construction in the South FD. In the Volga FD growth was overall average, but in the Samara region concentrated on manufacturing investments climbed 60 %.

The Urals FD registered the highest national growth in construction and retail sales. Industrial output in the district was below average, as output declined slightly in the Yamalo-Nenets region, an important energy production area. Construction rose 60 % and investment 40 % in Yamalo-Nenets.

Investment in the Siberian FD grew by nearly a third, well above the national average. Investment in the Irkutsk and Tomsk regions doubled, due e.g. to the oil and gas pipeline projects. Other Siberian growth was lower than elsewhere and industrial output increased just 2 %.

In the Far East FD, where growth is usually below average, industrial output soared in 1H07. Growth of nearly 30 % was driven by a tripling in mineral extraction activity in the Sakhalin region. The region still accounts for only a minor share of Russia’s total mineral extraction activity.

Growth in other sectors in the Far East FD was substantially below average. The exception was the Saha republic, where investment doubled.

Annual growth by federal district in 1H07, %

<table>
<thead>
<tr>
<th>Federal Districts</th>
<th>Industrial output</th>
<th>Investment</th>
<th>Retail sales</th>
<th>Real wages</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Russia</td>
<td>7.7</td>
<td>22.3</td>
<td>14.2</td>
<td>17.4</td>
</tr>
<tr>
<td>Central FD</td>
<td>9.5</td>
<td>25.9</td>
<td>12.4</td>
<td>20.2</td>
</tr>
<tr>
<td>Northwest FD</td>
<td>11.1</td>
<td>6.3</td>
<td>14.9</td>
<td>14.2</td>
</tr>
<tr>
<td>South FD</td>
<td>11.2</td>
<td>26.5</td>
<td>16.5</td>
<td>18.0</td>
</tr>
<tr>
<td>Volga FD</td>
<td>7.9</td>
<td>22.9</td>
<td>16.7</td>
<td>15.4</td>
</tr>
<tr>
<td>Urals FD</td>
<td>4.2</td>
<td>19.8</td>
<td>18.0</td>
<td>17.9</td>
</tr>
<tr>
<td>Siberian FD</td>
<td>2.4</td>
<td>31.6</td>
<td>12.1</td>
<td>15.4</td>
</tr>
<tr>
<td>Far East FD</td>
<td>27.8</td>
<td>7.1</td>
<td>8.5</td>
<td>12.3</td>
</tr>
</tbody>
</table>

Source: Rosstat
China

New competition law set for next August. After 13 years in preparation, legislators cobbled together a new anti-monopoly law (AML) from existing regulations. The law forbids restrictive agreements that promote cartels, price-fixing or abuse of dominant market position, but permits monopolies encouraging innovation and technology development. The full text of the law has yet to be released. An anti-monopoly commission will be set up under the State Council which will deal with anti-monopoly issues.

The US and EU Chambers of Commerce in China welcome the law and hope that it promotes transparent competition rules. They are worried, however, about how the law will be applied to foreign acquisitions of Chinese companies when they are considered important to national security. Such deals will be subject to clearing a national security examination. The AML does not define which sectors will require security checks nor does it state the bases for such checks. EU competition commissioner Neelie Kroes warned China not to use the new law to provide cover for protectionist measures. China last year received over $70 billion in foreign direct investment, but it is still rare for foreign firms to attempt takeovers of Chinese firms.

The AML introduces the concept of administrative monopolies. State-owned companies in China presently exercise considerable powers in many parts of the economy. The AML will also permit the phasing out of state monopolies. China last December published a list of the strategic branches where state monopolies would continue. These include the manufacture of military equipment, electrical power companies, oil and fuel companies, companies operating in the telecommunications field, the coal industry, ground and sea freight transport and airlines.

Government postpones roll-out of trial scheme to let Chinese investors trade in foreign shares. China’s government reportedly put the brakes on a trial scheme by the State Administration for Foreign Exchange (SAFE) until new rules regulating capital flows out of the country are in place. The government’s fear is that Chinese investors could become overly enthusiastic about foreign investment. In practice, SAFE’s trial scheme is restricted to trading in shares listed on the Hong Kong stock exchange. The trial scheme also requires participants to open a foreign exchange investment account with a branch of the Bank of China located in the Tianjin Binhai New Area. In principle, anybody anywhere in the country can open an investment account with the Bank of China branch in Tianjin.

Hong Kong’s Hang Seng index has risen 18 % since SAFE announced the trial scheme. Chinese investors are expected to pile into the Hong Kong market as soon as trading is permitted as share prices for many Chinese firms are substantially cheaper on the Hong Kong stock exchange than on Mainland exchanges. Limits on capital exports prevent private individuals from investing abroad. Rules on foreign investment by insurance companies and banks have gradually been liberalised. The Qualified Domestic Institutional Investor (QDII) program launched last year was expanded this summer to include securities brokers and mutual funds. QDII investors can apply to the securities regulator to invest part of their assets abroad in foreign securities. Insurance companies presently can invest up to 15 % of their assets abroad.

China’s government sees gradual liberalisation of capital outflows as a way to deal with yuan appreciation pressures. Foreign investment also reduces the risk of overheating on domestic stock exchanges. Share prices in Mainland China have more than doubled over the past eight months.

Energy and raw materials dominate first phase of president Hu’s Australia visit. President Hu Jintao flew to the Western Australian city of Perth on Monday (Sept. 4) to begin an Australia tour culminating in his attendance of the APEC summit currently underway in Sydney.

Talks between China and Australia focused on new agreements on energy and raw materials. The state visit kicked off with China’s state oil company PetroChina and Shell signing a 20-year agreement on supplying liquefied natural gas (LNG) from Western Australia to China. Just five years ago, China signed its first long-term LNG-contract ever with Australia.

Economic expansion and the accompanying demand for raw materials and higher commodity prices have fuelled explosive growth in Australia-China trade. Over two-thirds of Australia’s exports to China now consist of industrial raw materials or semis. Australian trade figures show China’s share of Australian exports doubled over the past decade to 12 % of total exports at the end of 2006.

Australian imports from China consist largely of consumer goods and investment goods such as machinery and equipment. Australian statistics show the country’s China imports have expanded much more rapidly than other imports. As of end-2006, Chinese imports accounted for 14 % of Australia’s total imports.

In the first seven months of this year, Australian exports rose by a fifth and imports from China 15 % y-o-y. Australia currently runs a trade deficit with China.

China is Australia’s third largest trading partner after the EU and Japan. Australia, with a population of just 20 million, is Asia’s fifth largest economy and China’s ninth largest trading partner.
Russia

BOFIT sees Russia’s strong economic growth continuing. BOFIT’s latest forecast anticipates Russia will post 7 % GDP growth this year. In 2008-2009 economy is expected to grow at around 6 %. BOFIT revised its forecast upwards from the beginning of the year on positive economic data. Russian economy grew nearly 8 % in the first half of this year. The growth has been supported by persistent high oil prices. In addition, economic growth was still boosted by rapidly growing consumption, and most recently, rising investment. Import growth should sustain fast in view of robust growth in consumer and investment demand and continuing real appreciation of the rouble. Imports are still expected to increase at three times the pace of exports and thereby erode the current account surplus in a few years. As Russia’s economy remains dependent on oil revenues, a decline in oil prices remains the largest risk to economic growth. However, the government could mitigate the effects of a decline with the stabilisation fund.

BOFIT Russia forecast 2007–2009, annual GDP growth, %

![Graph of BOFIT Russia forecast 2007–2009, annual GDP growth, %]

Sources: Rosstat, BOFIT

Tight liquidity situation also evident in Russia. The global drying up of liquidity caused by the problems in the US housing loan market has also affected Russian markets with some foreign investors squeezing their securities portfolios. The Central Bank of Russia responded to the liquidity squeeze by increasing liquidity available to the banking sector and by selling foreign currency to support the rouble. Russia’s currency reserve declined nearly $7 billion during two weeks in August and stood at $416 billion at the end of August.

Rising interbank rates contributed further to bank liquidity problems, particularly those of small and financially fragile banks. Banks in Russia are divided into tiers according to size and creditworthiness. The largest top-tier banks can get cheaper financing from the interbank market. Recently, banks have also increased their reliance on the use of capital borrowed from abroad to finance their domestic lending activities. Banks have turned to foreign borrowing as it has become cheaper thanks to the country’s improved credit ratings and, until recently, an abundance of liquidity on world markets.

In statements from the central bank and the economy ministry the liquidity is expected to squeeze slightly further during the autumn, but the tightening is not anticipated to have much impact on Russian economic growth overall. Russia still has a huge current account surplus and a massive foreign currency reserve. If necessary, the CBR can intervene by injecting liquidity into the market. The situation is challenging for the central bank as tight liquidity tends to force up interest rates and market insecurity. On a more positive note, tight money may encourage consolidation within the banking sector.

Russian banks and companies kept piling on foreign debt. The CBR reports that at the beginning of April foreign borrowing by Russian companies and banks was up almost 60 % y-o-y. Bank and corporate borrowing corresponded to 28 % of GDP at that time. By comparison, Russia’s total public sector debt was a mere 4 % of GDP. The willingness of banks and companies to take on indebtedness has led a number of observers to warn on risks of this development if interest rates go up. CBR deputy chairman Gennady Melikyan said that currently about 15 % of liabilities of Russian banking sector consists of foreign borrowing. He stated that this share should not exceed the 20 % mark and encouraged bankers to consider raising money instead from domestic markets. Companies (notably certain state-owned enterprises) have also developed profound appetites for international borrowing in recent years.

Russia’s foreign debt 2000–2007, US$ billion

![Graph of Russia’s foreign debt 2000–2007, US$ billion]

Source: CBR *latest available figure

Russian government disbands. On Wednesday (Sept. 12), president Putin accepted the resignation of Mikhail Fradkov’s government. Fradkov explained the move was necessary in view of the upcoming elections. Putin then tapped Viktor Zubkov, head of the Federal Financial Monitoring Service, as acting prime minister. The Duma is expected to approve Zubkov’s appointment today.
China

BOFIT foresees continued strong economic growth for China. With China posting higher-than-expected economic growth in the first half of this year, BOFIT has revised its outlook for on-year GDP growth in 2007 upwards to nearly 12%. Economic growth should slow gradually to about 10% by 2009. The bullish outlook stems from evidence that China’s potential for growth has increased as a result of successful structural reforms and elimination of production bottlenecks.

Realised and forecast GDP growth 2000–2009, % y-o-y

Economic growth this year has been driven largely by rapid investment growth, but also private consumption growth has boosted the trade surplus. Moreover, robust export growth is expected to continue as industrial investment remains strong and foreign firms continue to move their operations to China.

Nevertheless, signs of economic overheating have also begun to show up in cost levels and a disconcerting spike in the inflation rate. The acceleration in inflation that began at the end of 2006 originates in the agricultural sector and food prices. The inflation spike presents a more difficult situation for regulators than the last inflation flare-up in 2004 (see chart opposite), because prices of durable goods are no longer declining, wages continue to increase relatively fast and strong growth in both the credit markets and the money supply have now gone on for an extended period. The rise in prices of assets such as housing and shares in particular has been worrisome to officials.

Further fiscal and monetary tightening measures to rein in inflation are needed and consequently, there is a risk that rate hikes have a depressing effect on investment. As investment presently represents about 45% of total demand, a drop in investment growth would have a profound impact on GDP growth overall.

BOFIT’s forecast assumes growth of the global economy will remain strong in coming years and that Chinese exports will not be significantly hurt by protectionist measures.

Consumer price inflation picks up; monetary tightening continues. China’s National Bureau of Statistics reports August consumer prices were 6.5% higher than a year earlier – the highest on-year inflation figure registered in over a decade. Food prices soared 18% y-o-y, while prices of non-food goods rose just 1%. Pork prices have risen sharply (nearly 50% y-o-y) due to domestic supply problems arising from outbreaks of blue-ear disease, but also poultry and fish prices have climbed over 20%. An overall trend in rising food prices globally has also affected Chinese food prices. Higher food prices are expected to increase farm incomes, which is a welcome development for politicians. However, it might become difficult for officials to keep inflation low, if consumer price and wage increases will become more closely linked.

The PBoC continued to tighten its monetary stance by raising the reserve requirement for commercial banks for the seventh time this year. The requirement was increased a half percentage point to 12.5% of deposits, and enters into force on September 25.

As of end-August, the broad money supply (M2) had increased 18.1% y-o-y, exceeding the central bank’s (PBoC) target for this year of 16% M2 growth. The PBoC has gradually tightened its monetary stance over the course of this year as M2 growth has overshot the target and the rise in consumer prices has accelerated. The PBoC is expected to continue to tighten its monetary stance as inflation well exceeds the current one-year reference rate for deposits of 3.6%.

12-month change in consumer prices, commercial bank reserve requirements and reference rate for one-year deposits, %

Sources: National Bureau of Statistics, People’s Bank of China
Russia

Russian inflation still rapid. On-year inflation in August was 8.6 %, slightly ahead of the government’s 8 % target for the end of the year. While 12-month inflation was on track to meet the official 2007 target in the spring, a surge in food prices in early summer pushed up the overall inflation rate. A global increase in grain prices was reflected in higher prices for grain products in Russia. Furthermore, last spring, Russia banned foreign sellers (typically citizens from former Soviet Union countries such as Georgia and Azerbaijan) from market squares, which has reduced the offerings at market squares and pushed up prices for fruits and vegetables.

To deal with the flood of foreign-currency export earnings flowing into the country, the Central Bank of Russia has used a two-pronged monetary policy approach in recent years that tries to restrain inflation while preventing the rouble’s nominal external value from appreciating too rapidly. Until recent months, the CBR has placed its main efforts on holding down rouble nominal appreciation by purchasing foreign currency with its reserves. This strategy, however, has increased liquidity in money markets and for its part sustained inflation. The money supply has expanded rapidly; at the beginning of August, M2 (cash and deposits) was up 53 % y-o-y.

The recent turbulence in global financial markets has somewhat reduced growth of capital inflows into Russia, which in turn has diminished both appreciation pressure on the rouble as well as inflationary forces.

Financial services grew about 10 %, about the same pace as a year earlier. Agricultural output increased 3 % and mineral extraction activity (including oil production) was up 2 %.

Domestic natural gas prices still well below export prices. The Federal Tariff Service (FTS) has calculated what domestic gas prices would be if the market-based price-setting scheme planned to be implemented in 2011 would be already in use. Under the new price-setting mechanism, the wholesale price of gas would be the same for domestic users and export buyers, excluding transport and other related costs. The FTS calculates that the gas price in this quarter (3Q07) would be about three times above the current regulated price. This year, the regulated wholesale price for gas to Russian industrial users varies between $30 and $65 per 1,000 cubic metres depending on the price zone. Currently, the average export price to Europe is estimated as slightly under $300 per 1,000 m³.

Almost a third of Russian gas production is exported at present. State-owned Gazprom essentially handles all gas exports from Russia, and Gazprom’s monopoly status in gas exports was officially recognised by law last year. Gazprom also sells gas produced in Central Asia to world markets. Russia’s industry ministry reports that Russia exported about 200 billion m³ of gas last year and about 60 billion m³ gas produced in Turkmenistan, Uzbekistan and Kazakhstan. Currently, Gazprom sells gas mainly to Europe and CIS countries. The largest purchaser is Ukraine, which accounts for nearly a quarter of Gazprom’s gas sales abroad. The leading EU buyer is Germany.

Finland accounts for about 2 % of Gazprom’s international sales.

Plans to expand gas exports focus strongly on Asia. Under the freshly greenlighted Far East and East Siberia gas plan, pipeline gas and LNG deliveries to Asian markets could reach 50–70 billion m³ annually by 2020. Since the domestic consumption in Russia’s eastern federal districts is also expected to rise to nearly 30 billion m³ in the same period, gas production will have to be increased strongly to keep up with demand. Presently, annual production in the area is still below 10 billion m³. Gazprom wants the joint venture partners (a consortium of international energy companies and Rosneft) developing the Sakhalin 1 gas field to dedicate all their output to Russian domestic markets rather than selling the gas to China as initially planned. Gazprom says most of the gas in the Sakhalin 2 field under its control has already been sold to foreign buyers under long-term supply contracts, so it cannot be supplied to domestic markets. Gazprom’s view is backed by the industry ministry and the latest economic plan defines one of the state’s tasks as assuring the realisation of the “single export channel” principle.

Economic growth accelerated in 1H07. Rosstat reports real GDP growth in the first half of this year climbed to 7.9 % y-o-y, up from 6.0 % in 1H06. High investment growth helped fuel a record 23 % growth in construction activity. Growth in construction was three times higher than in the same period a year earlier. The pace of industrial output growth doubled to 9 %. Both retail trade and

Sources: Rosstat and CBR

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China

China hikes interest rates yet again. The People’s Bank of China further tightened its monetary stance last Saturday (Sept. 15) by boosting the reference rates for deposits and lending by 0.27 percentage points. The reference rate for one-year deposits is now 3.87 % and loans 7.29 %. The rate hike was expected as growth in the broad money supply continues to exceed central bank's target. Consumer price inflation has also accelerated, reaching 6.5 % y-o-y in August, and driving real interest rates on deposits into negative territory. The low yields on bank deposits have probably pushed investors into buying of shares and other investment assets with higher expected returns.

In addition to monetary measures, officials have also increased administrative efforts to restrain inflation. Officials announced that there will be no further hikes in state-regulated prices this year (e.g. rates for municipal services, fuels and transport tariffs).

Slow appreciation of the yuan’s exchange rate continues. Following a momentary drop in the yuan’s value in mid-August, the Chinese currency has continued its long-term slow appreciation against the US dollar. The yuan has recently lost ground, however, against the soaring euro. On Thursday (Sept. 20), 7.51 yuan bought one dollar and 10.54 yuan bought one euro.

Both the EU and the US would like to see faster yuan appreciation. The US Congress continues to draft legislation to make it easier to impose punitive tariffs on Chinese products unless yuan appreciation accelerates. However, faster yuan appreciation could well increase speculative capital flows into China. China has sought to reduce yuan appreciation pressures by e.g. broadening the possibilities for operators in its financial sector to invest abroad. There is also a trial project under discussion that would allow private Chinese citizens to invest in shares traded on the Hong Kong stock exchange.

Yuan-dollar, yuan-euro exchange rates

China’s trade surplus grows; growth in exports to the United States slows. China’s overall trade surplus in August was $25 billion. The cumulative surplus for the first eight months of the year was $162 billion, up 70 % from a year earlier. Even as growth rates fell relative to July for both exports and imports, exports increased 23 % y-o-y to $111 billion and imports 20 % y-o-y to $86 billion. Export growth remains strong, despite efforts to restrain growth by such measures as reducing tax breaks for exporters.

China Customs reports China’s exports to the European Union, China’s largest trading partner, grew 38 % y-o-y in the first eight months of this year to more than $153 billion. Imports from the EU were valued at $70 billion, a 22 % increase from a year earlier. As of August, the trade surplus for the year had grown to $82 billion, compared to $54 billion a year earlier.

China Customs valued exports to the US in January-August at $149 billion and imports from the US at $45 billion. The growth in exports to the US slowed to 17 % y-o-y in the period, compared to 23 % growth for all of last year. The slowdown likely reflects faltering US demand. Widespread discussion of problems with the safety and quality of Chinese products may have also depressed the US appetite for Chinese products.

China’s exports to Russia soared 80 % y-o-y in January-August, while imports from Russia increased just 10 %. Chinese exports to Russia consist largely of textiles, clothing and, machinery and equipment. Russia has also become the most important export market for Chinese cars. China’s imports from Russia consist largely of oil and other commodities. Import growth has been slowed in the first half due to delays in oil deliveries caused by transportation problems. Rapid export growth turned China’s bilateral trade with Russia to surplus for the first time.

According to figures from EU and US customs agencies China’s surplus is larger than China Customs reports. The customs figures reported by the Russian and Chinese customs, however, are surprisingly similar.

Quarterly development of Chinese foreign trade
Russia

President Putin blesses new cabinet of prime minister Viktor Zubkov. Several ministers from the previous cabinet held over in their post in the new 16-member Zubkov government announced Monday (Sept. 24). Notably, German Gref, who served as economy minister since 2000, was relieved from his duties, along with health and social minister Mikhail Zurabov and regional development minister Vladimir Yakovlev. Gref’s successor will be Elvira Sakhipzadovna Nabiullina (43), who served in 2000–2003 as deputy economy minister. Nabiullina is known as a reform-minded economist who has worked in close cooperation with Mr. Gref. In 2000, she participated in the preparation of the so-called Gref program mapping out government economic reform policies. Former deputy finance minister, Tatyana Alexeyevna Golikova (41), who has been in charge of federal budget drafting since 1999, was named health and social minister. Dmitri Niko- layevich Kozak (49) was named regional development minister. Kozak served as chief of staff and deputy head of the presidential administration in 2000–2004, and more recently as the president’s envoy to the Southern Federal District.

The minister changes are not expected to have a significant impact on Russian economic policy. Observers generally agree that pro-reform voices are in ascendance in the government due in part to the promotion of former finance minister Alexei Kudrin to deputy prime minister. The new government also has four other deputy prime ministers – all holdovers from the previous cabinet with Dimitri Medvedev and Sergei Ivanov as first deputy prime ministers.

Rise in housing prices rapid, but slowing. The average price of new apartments in Russia, measured by square metre of floorspace, rose in nominal terms 50 % y-o-y in the first half. Prices soared in the first quarter and stabilised in the second quarter. The slowdown reflected partly an increased supply as housing construction rose 35 % y-o-y in the first half. Borrowing for housing has expanded rapidly. At the beginning of July, the stock of housing loans reached 360 billion roubles ($20 billion), up 160 % from a year earlier. The housing loan stock is small by international standards. The share of foreign-currency loans in housing loans was nearly 30 %, but it has decreased. Interest rates on housing loans have fallen and loan times have lengthened. The average annual interest rate at the beginning of July was 13.3 % on rouble housing loans and 11.3 % on forex housing loans. The average loan time for rouble loans was 16 years and 15 years for forex loans. The share of defaulted or non-performing loans among loans to private persons has grown slightly; such problem loans represented 3 % of the loan stock at the beginning of July.

Growth in Finland’s exports to Russia slowed in 1H07. Customs Finland figures for the first half of this year show that Russia remained Finland’s third largest export destination after Germany and Sweden. Some 9 % of Finnish exports went to Russia. Finland’s imports that came from Russia (13.6 % share) were almost on par with Germany (14 % share), Finland’s leading source of imports. The value of Finland’s exports to Russia in January-June was €3 billion and the value of imports was €4 billion. Customs Finland figures for Finnish exports to Russia include certain goods produced elsewhere. Hence, the actual value of Finnish exports to Russia is somewhat smaller.

The value of Finnish exports to Russia increased 6 % y-o-y in the first half, while imports were essentially unchanged from a year earlier. Finland’s trade with Russia increased more slowly than its foreign trade generally, as Finland’s total exports rose 10 % and imports 9 %. Central Bank of Russia figures show that 1H07 the dollar value of Russia’s total imports increased 37 % and exports 9 %. The EU continues to be Russia’s largest trading partner. China has recently become one of Russia’s main trading partners.

Customs Finland reports road transit freight moving through Finland to Russia increased 26 % y-o-y in terms of tonnage. Customs Finland estimates the value of transit freight grew about 30 %. Autos (302,000 vehicles) accounted for 30 % of the total value of transit freight.

Selected trading partners of Russia in 1H07

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<th>Share of imports</th>
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<td>USA</td>
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Source: Rosstat
China

Increased direct state support for Chinese banks. China continued with efforts to strengthen the balance sheets of the state banks. About a third of the $200 billion in foreign currency reserves used to fund the new state investment company will go to propping up three banks. The biggest recipient is the ailing state-owned Agricultural Bank of China, which gets $40 billion. The policy bank, China Development Bank, which acquired a minor stake in Barclays Bank this summer, will get $20 billion. Mid-sized Everbright Bank will receive $3 billion. Similar bail-outs were arranged in 2003 and 2005, when a total of $60 billion was spent on helping the three largest state banks.

China also supports the banking sector indirectly. Last year, for example, the central bank widened the spread in its reference deposit and lending rates, which helped boost bank profits in the first half of this year significantly. The interest rate margin was then reduced to previous levels this summer.

Officials support for Chinese banks is intended to make the banks competitive with international players.

China improves and Russia slips in corporate business climate surveys. Two major international business surveys were released this week. Doing Business 2008, compiled by the World Bank and the International Finance Corporation, ranked 178 countries on the basis of how much time and money companies expend complying with official regulatory demands. The survey, which has been made every year since 2003, uses ten indicators that describe e.g. the cost and regulatory burden of compliance required for establishing and winding down a business, taxation, licensing processes and foreign trade rules.

Doing Business noted China was one of the best-improved countries in the survey. New laws on private ownership and bankruptcy processes improved company access to financing by giving better possibilities to use fixed capital as loan collateral. In addition, construction permitting in major cities has been simplified with a shift to online permit handling. China rose from 93rd place last year to 83rd place – and still has an abundant range of opportunities for reducing bureaucratic red tape further.

Official reform of Russia’s regulatory environment has had a mixed record during the last 12 months. On one hand, companies have better access to financing since the introduction of credit information registers has made it easier for banks to ascertain a potential client’s creditworthiness. On the other hand, corporate operating costs have increased significantly, as officials in the Moscow region have introduced an expensive licensing method for firms to connect to the grid in order to limit electricity consump-
tion. Russia’s overall ranking dropped from 96th place to 106th place. The survey found the easiest places in the world to do business were Singapore, New Zealand and the US.

In its annual corruption perception survey, Transparency International estimates that the situation regarding corruption in China has improved a bit although China’s ranking slightly dropped to 72nd place out of 179 countries surveyed. Perceived corruption in Russia increased somewhat, lowering Russia’s position in the rankings 20 notches to 143rd place. The least corrupt countries were Finland, Denmark and New Zealand.

Rapid growth in Finland-China trade continues. Customs Finland reports that Finnish exports to China grew 16 % y-o-y in the first half of this year and had a value of €1.1 billion. Growth in exports was slightly lower than in previous years. Exports consisted mainly of machinery, equipment and transport vehicles, which together accounted for over 60 % of exports in 2006. Communications devices accounted for 24 % of total exports, while paper machines represented 9 % of Finnish exports to China. Other important export goods included metals and paper products. China takes about 3 % of Finland’s total exports. On average, China accounts for slightly less than a 2 % share of exports among the 27 EU members.

Chinese imports to Finland rose 13 % y-o-y in the first half to €2.1 billion. Import growth slowed from last year. Nearly half of Finland’s imports from China are communications devices. The remainder is mainly other electrical machinery and equipment, clothing and other manufactured goods (e.g. toys). Finland also imports a certain amount of non-ferrous metals from China. China accounts for about 7 % of Finland’s total imports, while EU countries on average get about 5 % of their imports from China.

China is by far Finland’s most important Asian trading partner. Finland long ran trade surpluses with China until a couple of years ago, when Chinese imports pushed the trade balance into deficit. In the first half of this year, Finland ran an approximately €1 billion trade deficit with China.
Russia

Russia’s current account surplus shrinks. The latest balance-of-payments figures from the central bank show Russia’s current account surplus shrank to $40 billion in the first half of 2007, down 30 % from the same period a year earlier. The decrease was largely due to import growth outpacing export growth. The value of goods exports climbed 9 % y-o-y against a 37 % increase in goods imports. The value of oil exports was up 3 %, while the value of natural gas exports fell 9 %. The deficit in services trade continued to widen, with services comprising 14 % of Russia’s total foreign trade.

Public sector debt-servicing costs fell by a third following last summer’s early payment of outstanding Paris Club debt. Russia’s ballooning foreign currency reserves have increased the capital income received from abroad by the public sector. Due to the recent rapid expansion in foreign borrowing by the banking sector, bank debt-servicing costs for their foreign borrowing have more than doubled from a year earlier. Other private sector debt-servicing costs also increased nearly a third.

Net capital inflows into Russia in the first half of 2007 slightly exceeded $60 billion. Foreign capital inflows into Russia nearly tripled from a year earlier. Highest growth was seen in foreign borrowing by banks and companies, but there was also a sharp increase in direct investment into Russia. Direct and portfolio investment abroad by Russian firms also increased significantly.

Russia’s exports and imports; current account surplus

![Graph showing Russian exports and imports and current account surplus over time]

Source: Central Bank of Russia

Liquidity remains tight on Russia’s financial markets. Mid-August instability in international financial markets precipitated some tightening of liquidity in Russia’s banking sector, which caused interbank lending rates to rise. Overnight lending rates that before the crisis at the start of each month were typically running in the range of 3–5 %, increased to 5–8 % after mid-August. Nevertheless, real interest rates are still negative as 12-month inflation is currently about 8 %.

Higher interest rates have increased banks’ refinancing costs. Long-term housing loans tend to be particularly sensitive to higher refinancing costs. As a result, some private banks active in the housing loan market have temporarily stopped granting housing loans. Finance minister Kudrin announced in September that the State Development Bank could support liquidity by purchasing securities from the investment portfolios of commercial banks.

Overall, the situation appears to have calmed and the central bank has not had to buy roubles to support the currency since August. After a minor August dip, Russia’s foreign currency reserves began to increase again last month, with the central bank’s gold and foreign currency reserves reaching a record $425 billion at the end of September (partly a reflection of the declining dollar). Like most major currencies, the rouble has experienced large gains against the dollar in recent weeks. At the beginning of October, the official exchange rate was 24.9 roubles to the US dollar.

Since the August hiccup in share prices development globally, international investors have gradually returned to emerging markets. At the end of September, the RTS index surpassed its early August level; on Tuesday (Oct. 2), it hit a record level of 2,108 – a rise of about 16 % from the start of the year.

President Putin’s candidacy strengthens United Russia’s position in upcoming Duma elections. On Tuesday (Oct. 2), the United Russia party confirmed president Putin’s candidacy in the Duma elections to be held in early December. President Putin did not deny the possibility of serving as prime minister when his second presidential term ends next year. Observers think the president’s candidacy in the election could boost United Russia’s support to a level of 60–70 %, and possibly give the party a constitutionally unassailable two-thirds majority in the Duma. Prior to the announcement of Putin’s candidacy for a Duma seat, opinion polls were putting United Russia support at around 50 %. In the 2004 presidential election, 71 % of voters supported Putin.

While a president can run for a Duma seat, he cannot hold both offices concurrently. United Russia has put many well-known faces at the top of its candidate lists, including several governors, to attract support for the party. However, many of them will not actually serve as Duma deputies, but rather surrender their seats to alternates.

Russian share prices reached record levels following the revelation of the possibility of Putin serving as prime minister. Market-watchers are treating the information as an indication that Russia’s current economic policies will continue after the elections. The longer term impact on the business climate is too early to judge, however.
China

State investment company officially begins operations. The new China Investment Corporation (CIC) launched operations officially on Saturday (Sept. 29.). A CIC press release declared that the company will operate independently and according to market conditions. The company emphasised the importance of transparency in its operations. The ministry of finance is in the process of transferring about $200 billion from the central bank's foreign currency reserves as ($1,330bn as of end June) to capitalise CIC and make it one of the world’s largest sovereign funds. Technically, the finance ministry generates CIC assets through bond sales, mainly to the central bank. A small amount of these bonds have also been sold directly on the market. The CIC has so far received about half of its planned funding.

The CIC’s mission is to improve the return on China’s massive foreign currency reserves. Although the company has just begun its operations officially, it already purchased a 10 % stake in the US-based private equity firm, the Blackstone Group, at the end of June. Central Huijin Investment Corporation was also merged into the new company. In recent years, Huijin has served as a channel for state assets to the banking sector, and CIC will continue Huijin’s role of distributing direct support to the banking sector (see BOFIT Weekly 39/2007). Officials stress, however, that CIC is mainly focused on a long-term investment strategy. The investment company is not expected to be very active in direct acquisition of large stakes in individual private firms listed on foreign exchanges.

Five of world’s ten largest sovereign funds were established within the past seven years. The total value of their investments currently total about $2 trillion. Several actors worry openly about the rapid expansion of sovereign funds. The biggest fear is that assets will be used for political leverage. In reaction to this potential threat, Germany, for example, has drafted a law that gives its officials authority to investigate, and, if necessary, block foreign investment in Germany’s strategically important industries. A similar mechanism is already in place in the US.

Minor changes in China’s foreign debt status. The State Administration of Foreign Exchange (SAFE) reports that China’s foreign debt position at end-June was $330 billion, just $5 billion more than at the end of 2006. The amount of the debt is small by international standards – a mere 11 % of GDP. Given the rapid growth of China’s foreign currency reserves, China’s foreign debt now compares to less than 25 % of its foreign currency reserves. While SAFE did not specify details about the structure of China’s foreign debt, officials have been concerned about the growth of speculative short-term commercial borrowing from international markets to take advantage of potential yuan appreciation as such capital movements complicate implementation of monetary policy. At the end of 2006, short-term loans represented 57 % of China’s foreign debt. China’s foreign debt is essentially commercial debt; public sector borrowing abroad represents only some 0.5 % of GDP.

Chinese share prices keep climbing. On the eve of the week-long National Day holiday (Sept. 28.), the Shanghai bourse’s A-share index finished up 107 % for this year. The rise in share prices on the Shenzhen stock exchange matched the pace of its sister bourse. Soaring share prices in mainland China have been driven by better-than-expected corporate earnings in the first half of this year and the recycling of profits by companies back into share purchases. The rapid rise in share prices also reflects a trend on the part of private investors to put more of their money into securities. A quarterly study by China’s central bank found that for the first time the majority of private investors consider direct investment in shares and participation in mutual funds preferable to keeping savings in a bank account.

The rise in stock prices has shown no signs of abating, despite efforts by the government to absorb market liquidity. Officials want more listings of state-owned firms on mainland China bourses as increasing the number of shares on the market is expected to dampen the rise in share prices. Some of the amounts raised from recent IPOs have been eye-popping. In September, IPOs on the Shanghai and Shenzhen stock exchanges raised 150 billion yuan (€15 billion). The largest newcomers to the stock exchange were the mainly state-owned China Construction Bank (CCB), one of China’s four large state-dominated commercial banks, and China Shenhua, the country’s largest coal producer. This year, the new share offerings have already raised a total of 430 billion yuan (€43 billion), which exceeds the total amount of money raised in China’s stock exchanges during 2002–2006. Officials imposed a temporary ban on IPOs from summer 2005 to summer 2006.

Shanghai A-share index and Moscow RTS index

Sources: Bloomberg

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Russia

Food prices on the rise. 12-month inflation accelerated in September to 9.5 %, reflecting higher food prices. Strong capital flows into Russia during the first half of 2007 added impetus to the inflation spike.

Over the past twelve months, bread prices have increased 24 %, butter 20 % and vegetable oil and milk 17 %. In September alone, the price of vegetable oil climbed 14 %, butter 9 % and milk 7 %. The agricultural ministry’s original estimate this year that annual grain harvest would be relatively small, 74–75 million tonnes, coupled with rising grain prices globally added to price pressures during the summer. In fact, the ministry recently revised its grain harvest estimate upwards to a respectable 79.5 million tonnes.

Food prices represent about 40 % of the consumer price index in Russia, which is substantially higher than the average in developed countries.

Economy minister Nabiullina said that the exceptionally high September inflation made it unlikely that the government’s 8 % target rate for 2007 consumer price inflation would be met. The ministry has submitted a proposal to the cabinet on implementation of grain export tariffs to secure domestic supply and an export tariff is under consideration for powdered milk. Furthermore, import tariffs on milk products could be lowered.

State’s role in the economy increases. Russia’s industrial policy has recently picked up the so-called “national champion” enterprises in encouraging development of industrial sectors. Several new state corporations and state conglomerates are being established or under planning.

Nanotech specialist Rosnanotekh was the first in this new industrial wave of state corporations. The assets of state arms export monopoly Rosoboronexport are to be merged into a new state corporation, Russian technologies, dedicated to machine-building and technology industry development. In recent years, Rosoboronexport has expanded into several branches through acquisition of stakes in, e.g. helicopter builders, Russia’s largest carmaker Avtovaz, titanium giant VSMPO-Avisma and steelmaker Russpetsstal. Rosoboronexport also plans new acquisitions in the metal, machine-building and technology industries. The state-controlled assets in nuclear power sector will be consolidated under the state corporation Rosatom. Construction work for the Sochi Olympics will be organised under the state corporation Olimpstroy.

Russia’s large aerospace and shipbuilding companies have also been consolidated under the United Aircraft Building Corporation and the United Shipbuilding Corporation. Both companies are majority state-owned and listed as nationally strategic companies.

The creation of new state corporations has aroused criticism in some circles. Arkady Dvorkovich, presidential staff head of expert administration, has criticised ministry proposals to establish new state firms for road construction, pharmaceutical production and commercial fishing. Dvorkovich argues that excessive creation of state enterprises poses a threat to economic growth and sees two possible development paths for Russia: one where privileged state enterprises dominate the market and another where private firms compete on a level playing field with the state concentrating on ensuring a robust business environment. Dvorkovich stated the administration favours the latter path.

Increased state ownership in the energy sector has also provoked public discussion. Recently, the heads of private oil companies Lukoil and Surgutneftegaz expressed their concerns over dwindling competition on the market as state-owned energy companies have increased their ownership significantly this year. For example, gas giant Gazprom has acquired control over the massive Sakhalin 2 and Kovyktinskaya gas fields and Rosneft picked up control of also the remaining Yukos’ production units at a state-ordered bankruptcy auction to become Russia’s largest oil company.

Criticism at CIS summit in Dushanbe. The summit of heads of the twelve CIS member states (minus Ukrainian president Yushchenko), held in the Tajik capital on October 5–6, criticised the ineffectiveness of the CIS, due to the organisation’s lack of legal basis for its decision-making. CIS resolutions are rarely implemented.

Kazakhstan president Nazarbaev and Georgian president Saakashvili hammered at Russia’s dominance of the organisation. Nazarbaev wants Central Asia’s economic significance to be properly acknowledged and proposed the creation of a separate economic cooperation area for Central Asia.

The summit approved agreements on fighting crime, drugs and terrorism, among others. The presidents of Russia, Belarus and Kazakhstan agreed to speed up implementation of their previously agreed customs union. The customs union should be operational within three years and will operate as part of the Eurasian Economic Community, whose members include the three above-mentioned countries as well as Kyrgyzstan, Tajikistan and Uzbekistan. The purpose of the Eurasian Economic Community, established in 2000, is to create an integrated economic area. So far, there has been little progress towards this end.

Sergei Lebedev, head of Russia’s foreign intelligence service was named secretary general of the CIS organisation at the summit. President Putin named former prime minister Mikhail Fradkov the new head of Russia’s foreign intelligence service.
China

China’s fiscal policies stress rural development and defence. Since 2004, rural development has topped the government agenda and become a popular theme in official speeches. In reality, however, resources dedicated to rural development have failed to keep up with growth of the overall central government expenditures. Defence spending, on the other hand, has grown faster than central government budget spending on average over the past two years. Last year, some 15% of central government funds went to rural development and 13% to defence. China’s spending on research and technology, and education is paltry by international standards. Despite significant increases the amounts of money allotted to both budget areas in recent years, neither accounts for even 3% of central government spending. While education, for example, is mainly on lower administration's responsibility, estimation of China’s public spending is complicated by the fact that officials do not publish information about the structure of spending of local administrations.

The combined expenditures of state central administration and local administrations last year was about 4 trillion yuan (€400 billion), the equivalent of 19% of GDP. Using official figures, China’s public sector appears fairly small by international standards; national spending by the public sector as a share of GDP is less than half of the OECD average. Off-budget revenues and spending, especially at the local level, are quite significant in China. If this money is included, the total budget is estimated to be nearly 30% of GDP.

China has struggled to rework its complicated budgeting process since 2003. Despite efforts, however, the budget figures published by the government still fail to capture a satisfactory picture of how much actual resources are deployed. The system is complicated by the fact that the total budget is dispersed over five levels, of which the central government’s share is a mere 30%. Some 55% of resources are consumed by entities administered at the city or lower level. The comparable average is 14% for developed countries and 32% for developing countries.

State spending in China began to increase in 1998, when the government moved to mitigate the economic repercussion of the Asian financial crisis. Even though government tax revenues have tripled during the 2000s, the consequence of policy reorientation has been an increase in the state budget deficit. The deficit peaked in 2002 at 2.6% of GDP, and thereafter declined gradually to 0.7% of GDP in 2006.

Rapid growth in Chinese exports to Russia increasing demand for protectionist measures in Russia. As relations between China and Russia improved in recent years, officials openly expressed satisfaction with the situation in their public statements. This year, however, matters have become problematic from the Russian standpoint with the tidal wave of Chinese exports and investment into the Russian market. The situation has many Russians calling for protectionist measures. In fact, some Chinese argue that Russia has already implemented measures to restrict Chinese car companies’ investments in Russia due to the fact that their cheap models will compete directly with Russian cars. So far, at least six carmakers have submitted permit applications to Russian officials, but only China’s number-two carmaker, Chery Automobile, has received permission to build cars in Russia.

Chinese figures show that Chinese exports to Russia climbed over 80% in the first eight months of this year, while the value of imports from Russia increased just 10%. At the same time, China has gone from running a trade deficit with Russia to running a trade surplus. The increase in imports from Russia to China was slowed by a contraction in oil import volumes in January-June by 9% y-o-y due to transportation problems. Russia accounts for just a couple of per cent of China’s exports and imports, with imports of raw wood and energy playing significant roles.

Figures from Russian Customs give somewhat lower figures for Russia-China trade than Chinese figures. However, also Russia’s figures show imports from China have nearly doubled this year relative to a year ago, while growth in Russian exports to China has grown less than 10%. China’s market share of Russian imports has risen exceptionally fast from about 9% at the end of last year to nearly 11%. China’s share of Russia’s total exports remains around 5%.

China’s exports and imports to Russia, US$ million, 12-month moving sum

Sources: CEIC, China Customs
Russia

Central bank moves to prop up banking sector. The Central Bank of Russia has undertaken measures to increase liquidity to stabilise the banking sector ahead of the traditional liquidity crunch at the end of the year when companies face multiple tax payments.

On October 11, the CBR lowered the reserve requirement for deposits by private individuals from 4 % to 3 % and for other deposits from 4.5 % to 3.5 %. The lower requirement will be effective for three months. In August, the central bank also broadened its list of securities that banks can use as collateral when borrowing from the central bank. The move was particularly helpful to smaller banks in improving their access to short-term financing.

The CBR appears to have reprioritised banking sector stability ahead of fighting inflation. Inflation has further accelerated in October and measures to add liquidity increase the pressure on prices. Experts expect the higher liquidity to sustain higher inflation into the coming year.

Russia’s finance sector had long been awash in liquidity, which is a big reason real money market interest rates have been negative. Due to the finance sector’s underdevelopment, however, liquidity is distributed unevenly with some banks facing difficulties in getting financing from the market and the central bank. Thus, tight liquidity situations can be particularly harmful to certain banks.

12-month inflation and the overnight interbank rate

Sources: Rosstat, CBR

Russia lures foreign investment. Preliminary balance-of-payment figures show that $37 billion in direct foreign investment flowed into Russia during the first nine months of 2007 – a more than 40 % growth y-o-y.

The upbeat theme of last Monday’s (Oct. 15) annual meeting of the Federal Investment Advisory Council, where business leaders and government representatives meet annually, was that foreign firms have been attracted by Russia’s strong economic growth and soaring consumer demand. Unfortunately, investors also perceive corruption, bureaucracy, capricious application of the law and inadequate protection of intellectual property as hurdles to operating in Russia. Business leaders also express their disappointment that the subsoil investment law is still delayed. A bill regulating limits on foreign company ownership in non-resource strategic areas was approved in the first reading of the Duma in September.

The council’s head, prime minister Viktor Zubkov, discussed the role of foreign investment in the acquisition of new technology and encouraged foreign firms to invest actively in infrastructure and regional development. The economy ministry’s concerns about the country’s investment image internationally came out during the meeting. A study commissioned by the council found that potential investors consider Russia’s business environment much tougher than the companies already operating in Russia. The economy ministry wants to establish a new state corporation to promote Russia’s image among foreign investors.

UNCTAD’s latest World Investment Report notes that Russia’s FDI stock has increased six-fold since 2000 to $198 billion as of end-2006. Last year, Russia received $29 billion in direct investment, which corresponds to two-thirds of all investment made in CIS countries last year. After China, Russia was the second-most favoured investment destination among the four developing giants, the so-called BRIC countries (Brazil, Russia, India and China). However, the lion’s share of FDI flows has traditionally gone to developed markets. Russia accounted for just 2 % of global FDI flows last year, while China accounted for 5 %. For example, Sweden and Switzerland took in about the same amount of FDI last year as Russia.

About a third of direct investment in Russia went to mineral extraction industries, a quarter to real estate and a fifth to industrial production.

FDI stock in 2006, US$ billion

Sources: UNCTAD

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China

China’s Communist Party Congress gets underway. President Hu Jintao opened China’s 17th National Congress of the Communist Party of China on Monday (Oct. 15) in Beijing. During the week-long congress, the party will select the make-up of the governing bodies behind closed doors and define with a broad brush the major policy themes for the next five years. Over 2,200 party delegates are participating in the congress.

Hu is expected to remain the party chief during the next five-year period. He is expected to consolidate his power base in the party with the replacement of persons allied with his predecessor Jiang Zemin with his own people on the Politburo Standing Committee. The new member selection is expected to affect the choice Hu's successor in 2012 presuming that Hu will hold onto his leadership post throughout the coming five years. The new Politburo Standing Committee members will be announced at the end of the congress.

In his opening address, Hu stated that rapid economic growth is China’s most important goal in the coming five-year period. He also delivered the familiar liturgy on the importance of environmental protection and rural development. The party leaders hope to increase the role of democratic processes within the party and some remarks of China’s relations with Taiwan.

Despite numerous rural development programs over the past seven years, China has accomplished little towards assuring that the benefits of China’s growth would be more equally distributed. Although official figures report that about 60% of China’s 1.3 billion people still live in the countryside, farming only contributes about 12% of GDP. China’s pollution problems have also worsened dramatically in recent years.

Further tightening from PBoC. The People’s Bank of China announced the reserve requirement for commercial banks would be raised another half percentage point to 13%, effective October 25. It was the eighth hike in the reserve requirement this year. The central bank’s tightening monetary policy measures this year have included interest rate hikes and the selling of bonds on the market. The PBoC currently seeks to reduce bank lending and put the brakes on soaring consumer prices. Consumer prices were up 6.5% y-o-y in August. Comments coming out of the National Congress this week suggest that inflation may have slackened slightly in September. The official inflation figure for September will be published next week.

EU removes quotas on Chinese textiles; monitoring of imports to continue. At the end of 2007, EU restrictions on imports of China-made clothing and textiles will be abolished. The EU and China have agreed at the beginning of this month, however, that Chinese imports into the EU covered under eight product groups where EU producers are particularly sensitive (e.g. T-shirts, trousers, sweaters and bed sheets) would continue to be monitored throughout 2008, after which trade will be fully deregulated. Monitoring will be based on export licenses in China and import monitoring by member states within the EU. According to the EU, the purpose of monitoring is to increase the reliability of clothing import forecasts to help European producers and retailers anticipate the Chinese impact.

The EU and China agreed during summer 2005 on the current quota regime, which would be phased out at the end of this year. The call for quotas arose in response to an explosion of imports from China that occurred after the international quota system that protected textile producers in industrialised countries for 40 years was dropped in 2004. While Italian, Portuguese and French producers have been particularly shrill in their demands for limiting imports from China, most EU countries and retailers oppose import limits.

China Customs reports that the total value of China’s textile and clothing exports in January-August increased 21% y-o-y. Exports to EU countries were up 31% y-o-y. The EU currently accounts for 17% of China’s textile and clothing exports, up from 11% in 2004. The total value of China’s textile and clothing trade has increased rapidly since 2002 and the EU quotas of 2005–2007 appear to have little impact on the overall growth of China’s clothing exports. There is also other evidence suggesting that Chinese exporters and/or EU-importers circumvented the rules by bringing clothing into the EU via third countries.

Other countries have also continued to protect their domestic textile and clothing industries. The United States applies the quotas system until the end of next year. In addition, protectionist measures are in place in e.g. Turkey, South Africa and Brazil.

Yearly values of China’s textile and clothing exports, US$ billion

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Sources: CEIC, Customs China
Russia

Brisk economic growth continues. Industrial output grew at 6.6 % y-o-y in the first three quarters of 2007, but signs of slowing appeared in August and September. Natural gas production declined slightly from last year due to full storage facilities from last year’s exceptionally warm winter. Production rose 6 % y-o-y in the food industry and 9 % in the paper industry.

Russia’s grain harvest is looking good. As of early October, 81.8 million tons of grain had been harvested, a 6 % increase over the harvest at same time last year. On the other hand, the potato crop was 9 % smaller than a year ago and other vegetable crops were down 5 %. Overall agricultural output was up just 2 %.

Investment growth soared 21 % and retail sales climbed 15 %. The growth in consumption has been sustained by rapidly rising real incomes. The average monthly wage in September was up 14 % in real terms from a year earlier. The nominal monthly wage was 13,800 roubles (about €390).

Food producers and sellers agree to price ceilings for basic food items. On Wednesday (Oct. 24), representatives of food producers and retailers agreed to limit the rise of prices in socially essential foods items. According to media reports, the deal will remain in force until the end of January and covers essentials such as milk products, bread, cooking oils and eggs. The price ceilings are a response to the recent pick-up in inflation. Finance minister Alexei Kudrin explained the measures were meant to offset a surge of prices in socially essential food items. According to media reports, the deal will remain in force until the end of January and covers essentials such as milk products, bread, cooking oils and eggs. The price ceilings are a response to the recent pick-up in inflation. Finance minister Alexei Kudrin explained the measures were meant to offset a surge of prices in socially essential food items.

State companies account for increased oil production. Russian oil output averaged around 9.5 million barrels a day during the first nine months of this year, making Russia the world’s second-largest oil producer after Saudi Arabia. Oil production growth was 2.5 % y-o-y. The world price for Urals-grade crude averaged $77 a barrel in September. Despite the high world market price, growth in Russian oil output has been cautious in recent years. The growth is moderate due a lack of investment on the oil sector, stemming from uncertainty in the sector and the tight taxation of oil production and oil exports. The marginal tax rate on crude oil exports is currently about 90 %. In addition, officials have tightened rules for private domestic oil companies and foreign energy companies operating in Russia (e.g. stricter oversight of environmental permits as well as limiting foreigners’ access to geological data).

Oil production growth has been led by state-owned Rosneft, which became Russia’s largest oil producer after it scooped up Yukos’ core production unit in a bankruptcy sale. Indeed, Rosneft’s production growth of over 3 % y-o-y in January-August was led by the former Yukos production units. Rosneft now accounts for nearly a quarter of Russia’s total oil production. While firms owned by the state or regional authorities accounted for just 15 % of total production in 2003, their share of oil production has risen to 36 % today. This share is expected to climb some more percentage points if the official investigation of mid-sized Bashneft leads to a state takeover. The Federal Tax Service is also pursuing mid-sized Russneft for back taxes and a shakeup in its ownership structure is also widely expected. Russia’s largest private oil company at present, Lukoil, saw its production in January-August increase less than 1 %. The company accounts for almost a fifth of oil output. Production of other private oil companies is down slightly from a year ago.

Russian crude oil exports grew 3 % y-o-y in January-August. Nearly half of crude oil production was exported. Russia’s top exporters were Rosneft, Lukoil and Surgutneftegaz. Over half of Russia oil shipped by sea passed through the Baltic port of Primorsk on the Gulf of Finland, a third exited Russia via the port of Novorossisky on the Black Sea, and the rest went through smaller oil terminals. Some crude oil is also shipped by rail and pipeline to CIS countries and Europe.

The economy ministry reports that about 90 % of exported crude oil from Russia goes to Europe. The government, however, would like to diversify into other export markets so that by 2015 about two-thirds would go to Europe and Asia would take about a quarter of exports. Russia also exports some refined oil products. Preliminary balance-of-payment figures from the central bank show earnings from exports of crude oil and oil products increased 7 % y-o-y in January-September. Some 49 % of Russia’s total earnings on goods exports were oil related.

Russian oil production growth and price of Urals oil

Sources: Rosstat, MinEcon
China

Europe joins in demands for faster yuan appreciation. 
Until recently, EU officials have been cautious when publicly discussing the yuan’s exchange rate. At the beginning of this month, however, euro-zone finance ministers suggested undervaluation of the yuan relative to the euro is a bigger problem for Europe than the euro’s current strength against the dollar or the yen. As a result, EU countries have joined the US in demanding faster yuan appreciation. The yuan’s exchange rate also came up at the G7 meeting in Washington DC at the weekend. The G7 joint communiqué unambiguously called on China to let its currency appreciate faster.

China’s burgeoning trade surplus, which at the end of September hit $186 billion, continues to fuel European and US demands. The surplus for the first nine months of 2007 exceeded all of 2006. In January-September, China’s exports overall increased 22 % y-o-y and imports 19 % y-o-y. Exports to the EU-area increased 37 % (imports 22 %) and to the US 16 % (imports 15 %).

While China’s exchange rate in practice remains loosely pegged to the US dollar, monetary authorities have allowed the yuan to appreciate 4 % against the dollar this year. With the dollar depreciating against major currencies, the yuan has lost nearly 4 % against the euro for the year. Although the yuan’s exchange rate has held fairly steady against the dollar in recent weeks, this week it dipped below the level of 7.5 yuan to the dollar.

Yuan-dollar, yuan-euro exchange rates

![Yuan-dollar, yuan-euro exchange rates graph](image)

Source: Reuters

Party congress consolidated China's leading figures for the next five-year period. As expected, president Hu Jintao was voted to continue as China’s leader until 2012. Hu, who originally took office in 2002, strengthened his power base in the congress and managed to get his signature policy of “scientific development” written into the party constitution. The doctrine frames China’s efforts to attain a better balance in its economic and social development. Hu consolidated his position as party leader with the removal of Zeng Qinghong, a key ally of Hu’s predecessor Jiang Zemin, from his seat on the politburo’s permanent committee.

The most significant promotions to the nine-member permanent committee were party leader Xi Jinping of Shanghai and party leader Li Keqiang of Liaoning. Xi is widely expected to assume vice president Zeng’s tasks and to succeed Hu when he steps down in 2012. Li, a Hu supporter, is expected to become chief vice premier, which will give him a considerable voice in economic policy. The composition of the new government will be officially ratified at the People’s Congress next year.

Chinese bank operations abroad on the increase. In August, Russian officials granted China’s largest and largely state-owned Industrial and Commercial Bank of China (ICBC) permission to establish a subsidiary in Russia. ICBC will operate mainly in the corporate sector as it has not a license to deal with private depositors. Operations launch in November. Another major state bank, Bank of China, has held a Russian banking permit since 1993.

Several Chinese banks have long experience in operations abroad, especially within Asia. For example, ICBC operates nearly a hundred foreign offices internationally (including Hong Kong and Macao). Many Chinese bank foreign offices are representative offices and are not engaged in day-to-day banking operations. However, the number of branches providing routine banking services is on the increase. For example ICBC has petitioned officials in Dubai, Doha and Sydney for operating permits.

In recent years, Chinese banks have also begun to acquire shares in foreign banks. ICBC announced this week of its intentions to acquire a stake of 20 per cent in Standard Bank, the largest bank in Africa by assets. At the end of 2006, it acquired a 90-% stake in a small Indonesian bank. China’s leading policy bank, China Development Bank, acquired a 3-% stake in the British Barclays Bank. In October, mid-sized Minsheng Bank made an offer for a 10-% stake in the American United Community Bank. The deal is under review by US authorities.

Direct investment from China on the rise. Chinese direct investment abroad reached $21 billion in 2006. Of that, about $8 billion went to purchase of shares in existing companies. Chinese acquisitions have aroused concern in international circles. In summer 2005, an attempt by China’s number-three oil company CNOOC to purchase the Asian assets of the American Unocal was blocked by the US Congress. US officials are currently reviewing an offer from Chinese telecommunications company Huawei for a 20-% stake in US-based 3Com. In addition, several recent deals in the Philippines pushed by Chinese firms have failed under clouds of corruption charges.
Russia

Public spending soars ahead of the elections. The government submitted to the Duma a supplemental budget that increases federal budget spending this year by 20 % from the original budget. The additional spending will go to improving social services (e.g. an across-the-board increase in pensions at the end of this year) and the financing of new state development organisations such as the Russian Development Bank, the state investment fund and the establishment of a state nanotechnology corporation that is hoped to increase economic growth potential over the long run. It appears the new funds will not be entirely used this year, so the supplemental budget allows for a carry-over of unspent funds to next year.

Including the supplemental budget, total budget spending for 2007 will rise to 6,531 billion roubles (€183bn), an amount equivalent to 20 % of this year’s projected GDP. Budget expenditures last year constituted 16 % of GDP.

The supplemental budget also takes into account the improved income record: federal budget revenues for the year as a whole will be 7 % higher than originally anticipated. Revenues are particularly strong from the corporate profit tax, import tariffs and revenues from value-added and excise taxes on imported goods. Revenues this year should reach 7,444 billion roubles (€209bn), which corresponds to 23 % of GDP. The budget surplus should come in at around 3 % of GDP, down from an original forecast of approximately 5 % of GDP.

The spending frenzy led the IMF to voice its concern about Russian fiscal policy. Fund experts note that in the current phase of the business cycle, increased public spending will add to inflationary pressures.

In the first three quarters, the federal budget surplus was 7 % of estimated GDP. The stabilisation fund, which is used to set aside budget surpluses, grew by €31 billion from the start of the year. As of end-September, fund assets were €99 billion.

Deputy finance minister Sergei Storchak announced last week in Washington DC at the World Bank Group meeting that Russia was prepared to pay back early most of its World Bank loans and that it might cease borrowing altogether from the World Bank. Russia’s World Bank borrowings currently amount to €3.1 billion from the start of the year. As of end-September, fund assets were €99 billion.

Public administration and social services.

The share of Russia in selected EU countries' foreign trade in 2006, %

Source: Eurostat
China

Rapid economic growth continues. China’s National Bureau of Statistics (NBS) reports GDP grew 11.5 % y-o-y in the first nine months of 2007. Growth has decelerated only a 0.4 percentage-point from end-June. Highest growth was registered in the industry and construction sectors (14 % y-o-y in both) and the service sector (11 %). Growth in primary production was just 4 %. The industry and construction sectors now account for about half of GDP, the service sector 39 % and primary production 11 %.

China does not release a quarterly breakdown of demand-side factors in GDP. It may be inferred from other published data that all demand-side factors currently support rapid growth.

Investment continues to play a central role in development of the Chinese economy. For the first nine months of the year the nominal value for fixed capital investment was about 25 % higher than in the same period in 2006. Thus, the pace of investment growth seems to be declining slightly. NBS figures for the third quarter show investment equalled 42 % and domestic consumption 37 % of GDP. The investment ratio has declined slightly from the end of last year. At end-September, direct foreign investment in China this year had already reached $47 billion, up 11 % from a year earlier.

Considering other demand-side items, the 16 % growth in retail sales together with strong income growth indicate also private consumption supporting economic growth. The foreign trade surplus has continued to mount during this year. For January-September, the value of China’s exports increased 27 %, while imports rose 19 %. The foreign trade surplus climbed to $186 billion, or about $76 billion more than at end-September 2006.

Rapid economic growth also has its drawbacks. China is experiencing severe environmental degradation and inflation has begun to pick up. In September, consumer prices were 6.2 % higher than a year earlier, but down from the 6.5 % rate in August. Even though the inflation has largely been driven by rising food production problems in China and worldwide trend to higher food prices, there now seems to be a real danger that inflationary contagion will spread via wages to the entire economy. Higher inflation could also be fuelled by soaring real estate and share prices. In the beginning of November China had to increase petrol and diesel prices by 10 % in order to alleviate fuel shortages. This illustrates well, how international price developments put pressure on China, which still maintains a system of regulated fuel prices.

Rural incomes show record gains. The growth of incomes of rural dwellers has accelerated considerably in recent years. In the first nine months of this year, growth in rural incomes surpassed growth of urban incomes for the first time in a decade. Real incomes in the countryside were up nearly 15 % y-o-y, while urban incomes climbed 13 %.

More detailed information about the income gains is only available for the first half of this year. The data suggests rural nominal incomes have been boosted this year the most by increased earnings in the agricultural sector. In addition to increased production, farmers’ incomes have also benefited from higher food prices. A quarter of rural incomes are derived from farming and over 15 % from animal husbandry.

Wage income grew fastest of all in the first half. It now accounts for 35 % of total rural incomes. Wage income was about a fifth higher in the first half of this year than a year earlier. Part of the rapid rising in rural income story, however, is the increased migration of rural workers to urban jobs. Migrant worker incomes are still classified as rural incomes. Nevertheless, also average wages per worker have increased.

According to several company surveys, the increase in wage levels has spread recently from educated labour to less skilled labour. Only a few years ago it was commonly held that wage levels of less skilled workers were essentially fixed for over a decade due to the massive pool of unskilled labour. Last year, it appears less skilled workers saw nominal wage gains around 10 %. The wage increase suggests that the pool of underemployed workers in China is shrinking. Companies in some of China’s coastal provinces report difficulties in recruiting cheap labour suggesting that years of strong economic growth have finally begun to translate into higher wage levels in China.

Comprehensive wage data that would provide a proper base for comparison and monitoring are currently not available for China.
Russia

Russian banking sector continues to grow rapidly despite jitters on international finance markets. The stock of outstanding credits of banks at end-September was up 54% y-o-y. During the third quarter, the credit stock grew 15%.

Market insecurity was reflected in the sector’s development in September, when growth in lending to both households and firms slowed somewhat. Even so, the stock of loans to households has increased a breathtaking 62% over the past 12 months, while the stock of corporate loans has grown 50%.

On the other hand, banks’ claims on other banks continued to increase rapidly this autumn. Claims on foreign banks, in particular, rose dramatically. They consist mostly of Russian bank deposits and other investments. At the end of September, claims were double the amount a year earlier. However, the share of claims on foreign banks in the entire credit stock of banks is still only about 8%.

Although there was no evidence of increased distrust in banks on the part of depositors, growth in household deposits slowed a bit in the third quarter. Over the past twelve months the stock of deposits has increased 39%.

Total assets of the banking sector rose 6% y-o-y in the third quarter, down from 11% in the first quarter and 10% in the second quarter. Total assets were up 46% y-o-y at the end of September.

Some 1,149 banks operated in Russia at the end of September, down from 1,205 a year earlier. The number of loss-making banks was 27 – two fewer than a year earlier. Bank operations in Russia are highly profitable; the sector’s combined profits grew 35% y-o-y.

Monthly growth in banking sector balance sheet items, July-September 2007, in billions of roubles

![Chart showing monthly growth in banking sector balance sheet items](chart.png)

Source: Central Bank of Russia

Finnish companies’ operations in Russia increased significantly in 2006. Investment figures from the Bank of Finland show that subsidiaries of Finnish companies operating in Russia employed over 20,000 people in 2006, an increase of nearly a third from 2005. The combined net sales of subsidiaries operating in Russia climbed 25% to €2 billion.

Finnish subsidiaries largely focus on processing industries and trade. Even though two-thirds of personnel employed by Finnish subsidiaries in Russia work in processing industries, the combined net sales of these industries account for about half of the total turnover of Finnish subsidiaries in Russia. The main processing industry sectors include the foodstuffs and electronics industries.

While the trade sector employs fewer people, 40% of the combined net sales of Finnish subsidiary companies come from the trade sector.

Persons employed in Russia by subsidiaries of Finland-based companies in 2006, %

<table>
<thead>
<tr>
<th>Industry</th>
<th>Personnel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foodstuffs</td>
<td>15.8</td>
</tr>
<tr>
<td>Electronics</td>
<td>22.3</td>
</tr>
<tr>
<td>Other value-added</td>
<td>19.0</td>
</tr>
<tr>
<td>Construction</td>
<td>11.3</td>
</tr>
<tr>
<td>Trade</td>
<td>22.0</td>
</tr>
<tr>
<td>Other branches</td>
<td>9.5</td>
</tr>
</tbody>
</table>

Source: Bank of Finland

The stock of direct investment from Finland to Russia was €1.7 billion at the end of 2006 – an increase of more than 50% from a year earlier. A third of the increase came from changes in exchange rates and other valuations.

Personnel and net sales of subsidiaries of Finland-based companies in select countries in 2006

<table>
<thead>
<tr>
<th>Country</th>
<th>Personnel</th>
<th>Net sales, € billion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sweden</td>
<td>63,217</td>
<td>31.1</td>
</tr>
<tr>
<td>United States</td>
<td>36,565</td>
<td>19.1</td>
</tr>
<tr>
<td>Germany</td>
<td>33,374</td>
<td>17.2</td>
</tr>
<tr>
<td>Russia</td>
<td>20,453</td>
<td>2.0</td>
</tr>
<tr>
<td>China</td>
<td>19,918</td>
<td>14.6</td>
</tr>
<tr>
<td>Estonia</td>
<td>16,817</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: Bank of Finland
China

China’s current account surplus rises to nearly 12 % of GDP. China’s state administration for foreign exchange (SAFE) early last month released balance-of-payments figures for the first half of 2007. The data show a current account surplus of $163 billion for the period, an increase of $70 billion from 1H06. Some $136 billion of the current account surplus was generated by goods trade, while imports of services exceeded services exports by a couple billion dollars. With its foreign currency reserves ballooning China has gained higher interest earnings, which also contributed to the current account surplus increase in the first half of the year.

An idea of net currency flows can be gleaned from the financial account surplus, which rose to $89 billion in the first half (up considerably from 1H06). Direct investment made the largest contribution to the financial account. China’s balance-of-payments figures show direct foreign investment inflows of $58 billion, an increase of over 50 % from 1H06. Direct investment abroad by Chinese companies rose by about a fifth to just over $7 billion. Securities investment in China remained modest ($10 billion), and Chinese investment in foreign securities nose-dived from $45 billion in 1H06 to just $15 billion in 1H07. Net imports of capital related to trade credits and foreign borrowing increased by a fifth to $43 billion. The pull-back in securities investment abroad and the increase in capital investment inflows suggest expectations of yuan appreciation on the part of investors.

As a result of the burgeoning current account surplus and strong capital imports, China’s currency reserves swelled to more than $1.3 trillion at the end of June. Growth of the foreign trade surplus and currency reserves has remained brisk since. The goods trade surplus in January-September was $186 billion, and the foreign currency reserves stood at $1,434 billion as of end-September.

China’s balance of payments and foreign currency reserves in 1H06 and 1H07, US$ billion

<table>
<thead>
<tr>
<th></th>
<th>1H06</th>
<th>1H07</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current account</td>
<td>92</td>
<td>163</td>
</tr>
<tr>
<td>Capital account</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Financial account</td>
<td>37</td>
<td>89</td>
</tr>
<tr>
<td>Net errors and omissions</td>
<td>-8</td>
<td>13</td>
</tr>
<tr>
<td>Growth in currency reserves</td>
<td>122</td>
<td>266</td>
</tr>
<tr>
<td>Currency reserves as of June 30 (stock)</td>
<td>941</td>
<td>1,333</td>
</tr>
</tbody>
</table>

Source: SAFE, CEIC

China, India and Russia now account for half of global economic growth. In a new report, the International Monetary Fund (IMF) expects world economic growth to slow overall next year, even as high economic growth in emerging economies should keep the situation fairly stable. The IMF lowered its original 2008 economic growth forecast by ½ percentage point to 4.8 % in its World Economic Outlook Update released last month. The downward revision reflects the impact of recent bumpy trends in world financial markets, particularly on the US economy.

Taken as a group, China (11 % GDP growth), India (9 %) and Russia (7 %) accounted for half of all the economic growth in the world last year, indicating that global economic development is driven more than ever by emerging economies. The WEO Update notes that China for the first time this year became the largest driver of global economic growth measured both adjusted for purchasing power parity (PPP) and in terms of nominal exchange rates.

The WEO Update predicted that China next year will surpass Germany in GDP, making it the world’s third largest economy measured in terms of nominal exchange rate. Using the same yardstick, Russia and India are the world’s tenth and twelfth largest economies. In terms of PPP, China has long been the world’s second largest economy after the United States.

The IMF expects the current financial market turbulence to have only a limited affect on emerging markets, but warned that slowing global economic growth could create a risk of over-investment in China. Measures recommended by the IMF for China include a substantial tightening of the monetary stance and letting the yuan strengthen further against the dollar. A stronger domestic currency would make imports cheaper relative to exports, which would help ease international trade pressures. The IMF expects China’s GDP to grow 10 % next year. Russian GDP is expected to grow 6.5 % and India 8.4 %.

Comparison of GDP adjusted for PPP in 2000 and 2007, US$ billion

Source: IMF (WEO)
Russia

**Law on strategic branches postponed.** Industry minister Viktor Khristenko announced last week that consideration of a bill regulating foreign ownership of companies in designated strategic branches would be put off until after the new Duma has been seated next year. After more than two years of drafting, the Duma approved the first reading of the bill in September. The bill gives rules for limiting foreign investment in 39 branches, mainly connected to the defence industry. Khristenko said that the delay in dealing with the law was due to postponing the separate bill on limiting foreign ownership in the natural resources sector and to differing views on which branches should be classed as strategic.

**State fosters revival of Russia’s shipbuilding industry.** Russia’s cabinet ministers, concerned of the domestic civil shipbuilding production, especially in relation to the needs of current hydrocarbon resource development projects, last week approved €2.5 billion in federal funds for a development program extending through 2016. The program is part of the government’s overall development strategy for the shipbuilding sector. One goal is to increase the share of civil shipbuilding from about a quarter to over 30%.

The new state-owned United Shipbuilding Corp. is expected to play a large role in development of the shipbuilding sector. The umbrella corporation brings together state-owned shipbuilders and will have regional subsidiaries in western, northern and far eastern Russia. State-owned firms in the shipbuilding sector account for over half of the sector’s production. While shipbuilding is a priority branch of the newly created State Development Bank, prime minister Viktor Zubkov would like to see financing for the sector also come from the private sector.

**RAO Unified Energy System set to wind down at the beginning of July 2008.** At the general meeting of shareholders of RAO UES at the end of October, shareholders approved the final plan for winding down the company. Under the plan initially approved already in 2001, UES will be broken up into 21 electrical power companies: six cogeneration companies (WGCs), 14 local power producers (TGCs) and a hydropower company (TGKHydro). The state and UES will divest their ownership in these companies by spring 2008.

As of end-September, nearly all new production unit shares were stock-exchange listed and the state and UES have already divested some of their holdings in the new companies. Notably, Gazprom, SUAL and the Italian Eni and Germany-based E.ON have actively boosted their holdings in the production companies. The UES distribution grid will be shifted to the newly created state-owned Federal Grid Company. A holding company, IDC-Holding, will oversee four other new distribution companies and remain in state ownership. A separate system operator will also be established.

The goal of the reforms is to open electricity markets to competition and attract capital for refurbishing old infrastructure and existing production capacity. Ambitious investment plans have been set for the production companies. By 2011, at least 41 GW of new production capacity should be on stream. By comparison, only 23 GW of new production capacity was added between 1991 and 2006. The purchasers of the production companies are committed to their investment plans and industry minister Khristenko said the Federal Energy Agency will see to it that companies do not slip from the timetable.

UES generates about 70% of Russia’s electricity and a third of its district heating. Consumer prices for electricity and heating are largely regulated and only about 10% of electricity is sold under contracts traded on the deregulated electricity exchange. Under current plans, consumer prices for electricity would be fully deregulated by 2011.

**Russian’s actively invest abroad.** Fuelled by oil money, Russian firms have increased their investment abroad. During the 2000s, the stock of direct investment outflows has grown an average of 50% a year. Russia has also become the leading BRIC (Brazil, Russia, India and China) country in terms of international investment abroad. UNCTAD reports that as of end-2006 the stock of Russian investment abroad was $157 billion. By comparison, the stock of international FDI from mainland China amounted to $73 billion. (The Chinese figure, however, is nearly ten times larger if Hong Kong and Macao are included.) The stock of Finnish FDI abroad amounted to $91 billion at the end of 2006.

Russian firms have continued to be fairly active in broadening their operations abroad and the pace of investment growth has remained brisk this year. The Central Bank of Russia reports that total Russian investment flows abroad nearly doubled between January and September 2007. Rosstat figures show the largest shares of FDI in January-Sept. went to the Netherlands and Cyprus. Ukraine was the leading destination for portfolio investment.

**Outward FDI stocks of BRIC countries, US$ billion**

Source: UNCTAD
China

Rising food prices the main factor behind inflation spike in China. Consumer prices surged to a 12-month rate of 6.5% in October (6.1% in urban areas and 7.2% in the countryside). Inflation matched its August high, picking up after a slight drop to 6.2% in September. Food price climbed 18% from a year earlier, while prices of other goods were up just 1%. Pork prices led the rise, soaring 55%, followed by prices for poultry (38%) and fruit (30%). The People’s Bank of China forecasts inflation will come in at 4.5% for the year, up from 1.5% in 2006. The central bank’s original informal inflation target of 3% for this year will very likely be exceeded.

Supply-side problems drove most of the rise in food prices. Higher producer prices and a drop in available arable land pushed up fruit prices. Pork prices were hit by lower production levels due to outbreak of porcine disease and higher feed costs. The central government’s greatest fear is that higher prices for food will incite rioting unless soaring food prices are constrained. The average Chinese household now spends about a third of its disposable income on food. On November 10 in the city of Chongqing, three people died and 31 were injured in a stampede to get on-sale cooking oil.

The central government’s decision last week to increase prices of gasoline and diesel fuel 10% is expected to add to inflationary pressure in the last months of this year. The government raised prices in an attempt to reduce the impact of a nationwide fuel crisis that has been created by record global crude oil prices. High oil prices have hit production at China’s smaller oil refineries particularly hard. Gasoline and diesel fuel prices are administered by the central government, so changes in the world crude oil price have a limited impact on price setting. The central government last raised gasoline and diesel prices in May 2006, when Brent-grade crude oil was trading at a price of about $70 a barrel. The government has reacted to the fuel shortages by boosting production at state-owned refineries. Incurred expenses will be covered from the state budget.

China’s central bank tightens further in response to inflation pressures. Last Saturday (Nov. 13), the PBoC announced it was raising the reserve requirement of commercial banks by ½ percentage point to 13.5%. The new reserve requirement, which enters into force on November 26, is the ninth such hike this year and reflects central bank efforts to quell commercial bank lending and restrain rising consumer prices. In October, broad money (M2) was up 18.5% y-o-y, which is 2.5 percentage points more than the central bank’s target for the entire year.

The central bank is expected to continue to tighten its monetary stance in coming months with further measures. On November 8, the central bank admitted its credit control measures and higher reserve requirements for banks were insufficient by themselves to rein in galloping money supply growth and other structural problems. The central bank has hiked interest rates five times so far this year. According to unofficial data, Chinese officials have told commercial banks that they should not grant any more loans this year for real estate or for financing heavily polluting industrial investments. The decision would also apply to some foreign firms operating in China.

PetroChina becomes the world’s largest corporation by market cap – in a falling market. The Shanghai and Shenzhen bourses have both lost nearly 10% of their value since the end of October. Expectations of further monetary tightening over the next two months are believed to be driving the decline. The market decline was hampered surprisingly little by the IPO of the mainly state-owned oil company PetroChina on the Shanghai stock exchange at the beginning of the month. The company sold 13% of its shares for nearly $9 billion in the largest IPO in the history of the Shanghai stock exchange. As PetroChina’s share price rose in the days after the listing, the company surpassed Exxon Mobil to become the world’s largest company in terms of market capitalisation.

At the beginning of this month, China’s prime minister Wen Jiabao announced the suspension of a trial program begun in August that allowed private individuals to make investments in companies listed on the Hong Kong stock exchange. The results of the trial will now be reviewed and the trial will likely resume next year. During the three-month trial period, shares on the Hong Kong exchange rose 40%. Hong Kong share prices then plunged on the news that the program had been put on ice.

**Shanghai A-share index and Moscow RTS index**

Sources: Bloomberg, Bank of Finland
Russia

Russia makes almost no headway in international competitiveness. The latest Global Competitiveness Report 2007–2008 from the Switzerland-based World Economic Forum ranks Russia 58th out of 131 countries in terms of overall competitiveness. Among the largest problematic factors facing Russia are structural weaknesses that cannot be corrected overnight. These include inefficient public administration, the absence of judicial independence, inadequate protection of property rights and low business ethics. Russia ranked among the 25 worst countries in terms of these criteria. On the other hand, Russia won relatively high praise for flexibility of wage formation (rank 31), ease of hiring and firing workers (15) and the ratio of pay to productivity (14).

Overall competitiveness rankings for 2007

<table>
<thead>
<tr>
<th>Country</th>
<th>Rank</th>
<th>Country</th>
<th>Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>1</td>
<td>Latvia</td>
<td>45</td>
</tr>
<tr>
<td>Korea</td>
<td>11</td>
<td>India</td>
<td>48</td>
</tr>
<tr>
<td>Estonia</td>
<td>27</td>
<td>Poland</td>
<td>51</td>
</tr>
<tr>
<td>China</td>
<td>34</td>
<td>Russia</td>
<td>58</td>
</tr>
<tr>
<td>Lithuania</td>
<td>38</td>
<td>Brazil</td>
<td>72</td>
</tr>
</tbody>
</table>

Source: World Economic Forum

The Country Risk Poll in the September issue of Euromoney ranked Russia 57th out of 185 countries, a rise of one place from its previous ranking. China ranked 54 and India 58. The overall country risk to investors is compiled from ratings of countries in terms of factors that include political risk, economic performance, indebtedness and access to finance.

The European Bank for Reconstruction and Development’s latest report on transition economies (Transition Report 2007) found little progress in structural reform of the Russian economy in the last twelve months except for the areas of railways and electrical power generation. Furthermore, the bank is concerned over the lack of investment in Russia. Investment is needed in particular to repairing and upgrading the aging infrastructure base.

Last month’s IMF’s annual Russian Federation: Article IV Consultation – Staff Report and last Monday’s World Bank’s semiannual Russian Economic Report both stress the importance of creating a favourable business climate in order to increase private investment. During 2007, reforms of public administration that would help improve the operating environment of companies have not progressed significantly. Investment has been increased in the 2007 and 2008 federal budgets, and the inefficiencies of public administration and lack of expertise on the part of public officials may hurt the opportunities for investment to be effectively targeted and managed.

Russia increases special economic zones. The Russian government sees special economic zones as a way to diversify the country’s production structure, which today is still largely based on raw material extraction. The first six special economic zones, established in 2005, focus on industrial production and technological development. Later on special economic zones with a focus on promoting tourism were established. The Duma last October approved a law on creation of special economic zones for port activities, but the affected ports have yet to be named.

Economy minister Elvira Nabiullina says that firms that locate in special economic zones will enjoy the advantages of ready-built infrastructure, easy access to commercial real estate and lower administrative burdens. One key to lower bureaucracy is the shift to a one-stop paperwork principle, whereby all administrative transactions can be taken care of in the same government office. Companies that locate in special economic zones also enjoy tax and customs breaks.

The economy ministry wants to increase by 2010 the number of companies operating in special economic zones five fold to 250 firms. Some 40 billion roubles (over €1 billion) have been budgeted for development of special economic zones in coming years. The goal is to attract an equal amount of private investment and create 20,000 jobs.

The enthusiasm for creating special economic zones has aroused criticism among specialists. For example, the OECD has warned that such zones can distort competition and unnecessarily subsidise companies that would succeed anyway. It is necessary to monitor the transparency of the existing zones’ administration and the effectiveness of the functioning of the zones before establishing new zones. One of the fears is that special economic zones could become pockets of grey economy activity.

Russian special economic zones

<table>
<thead>
<tr>
<th>Special economic zones</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td>Moscow Region</td>
<td>Technology</td>
</tr>
<tr>
<td>Moscow</td>
<td>Technology</td>
</tr>
<tr>
<td>St. Petersburg</td>
<td>Technology</td>
</tr>
<tr>
<td>Tomsk Region</td>
<td>Technology</td>
</tr>
<tr>
<td>Tatarstan Republic</td>
<td>Industry</td>
</tr>
<tr>
<td>Lipetsk Region</td>
<td>Industry</td>
</tr>
<tr>
<td>Altai Region</td>
<td>Tourism</td>
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<tr>
<td>Altai Republic</td>
<td>Tourism</td>
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<tr>
<td>Buryat Republic</td>
<td>Tourism</td>
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<tr>
<td>Irkutsk Region</td>
<td>Tourism</td>
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<td>Kaliningrad</td>
<td>Tourism</td>
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<tr>
<td>Krasnodar</td>
<td>Tourism</td>
</tr>
<tr>
<td>Stavropol</td>
<td>Tourism</td>
</tr>
</tbody>
</table>

Source: RosOEZ
China

Growth of fixed capital investment in urban areas remains brisk. China’s National Bureau of Statistics reports that fixed capital investment in cities during the January-October period was up 27 % y-o-y in nominal terms. Growth matched fairly well the rates of earlier years. The rise in the price of investment goods, however, has accelerated slightly this year. Investments in urban areas during the first ten months of the year amounted to 8,900 billion yuan (over €800 billion). Of that, 44 % went to the industry and construction sectors (up 30 % y-o-y) and 55 % to the services sector (up 25 % y-o-y). Growth in fixed capital investment in real estate construction accelerated in January-October by 6 percentage points to 31 % y-o-y. Real estate construction investment represented just over a fifth of all investment.

In the provinces, the growth in fixed capital investment varies substantially from the national average. For example, in Anhui province fixed capital investment in January-September soared 50 % y-o-y in nominal terms, while in Zhejiang province investment was up only about 10 %. China’s statistics officials only report fixed capital investment in urban areas in their monthly reporting. For this reason, only a small part of agricultural investment shows up in published figures.

About 60 % of fixed capital investment in urban areas last year was financed by self-raised funds (e.g. profits and funds provided by local administrations). The share of domestic borrowing in financing fixed capital investments was considerably less (18 %), and that figure is expected to diminish further this year with the central bank’s recent imposition of restrictions on bank lending. The shares of central administration budget and foreign investment in urban fixed capital investment last year each constituted about 4 % of overall fixed investment. Other financial channels such as corporate bonds and funds provided by private individuals represented about 18 % of total fixed capital investment financing.

China’s thirst for energy continues to grow. The International Energy Agency’s annual World Energy Outlook forecasts China’s energy demand will increase more than 60 % between 2005 and 2015. Energy demand is being driven largely by the rapid growth in the industry and transport sectors. China has reacted to the rise in demand mainly with the construction of coal-fired power plants, so coal will continue to provide over 60 % of the country’s energy. Oil consumption, which is expected to climb 50 % between 2005 and 2015, will nevertheless continue to meet only about 20 % of China’s energy needs. While the use of gas, nuclear, hydro and wind power are expected to double by 2015, their overall contribution to energy production will still be less than 10 %.

China’s bedrock holds sufficient coal reserves to meet most of the country’s rapidly expanding energy needs. The IEA forecasts that China, which was still a net exporter of coal in 2005, will have to import about 100 million tons of coal a year (about 5 % of consumption) in 2015. As China’s oil production is expected to grow much slower than its domestic production, it will become increasingly dependent on foreign-produced oil. In 2005, China still produced domestically half of the oil needed to satisfy national consumption, while domestic production will only contribute 35 % by 2015. Thus, net oil imports are expected to reach 350 million tons in 2015. Domestic gas production should double from 2005 and gas imports will rise from zero to 28 billion cubic metres (about 20 % of consumption) in 2015.

Assumptions about economic growth considerably affect IEA figures. The estimates assume China’s GDP growth will average 7.7 % annually in coming years. If annual GDP growth is assumed to be 9 %, energy consumption will increase 80 % by 2015. Even if China succeeds in implementing its proposed energy savings programs, the main effects would only be felt after 2015. The IEA is also concerned that China’s rapid increase in energy consumption will add to the environmental woes nationally and globally.

China-Russia gas pipeline projects move ahead. For years, negotiations to bring natural gas from Russia to China have proceeded haltingly. Last week, however, saw a major breakthrough in talks between China’s state oil company CNPC and Russia’s Gazprom with an agreement on pricing principles. While the details of the pricing scheme were not released, Russia has apparently demanded at least the same price as it gets for gas for deliveries to European customers, while China has wanted to pay much less.

With the pricing scheme set, Gazprom is free in principle to commence construction. According to earlier information, Gazprom wants to complete the first gas pipeline by 2011. That pipeline would run from the West Siberian gas fields to China through the most western part of China-Russia border (west of Mongolia). The plan also calls for two more pipelines. One would bring gas from the Sakhalin Peninsula; the other would run east of Mongolia and bring gas from the East Siberia fields.

Natural gas exports from far eastern Russia to China will require massive investment and sharp increases in output. The situation is challenging: Russia’s recently approved gas plan for Far East Russia and East Siberia states that Russia will provide Asia markets with a total of 50–70 billion cubic metres of natural gas annually by 2020. At the same time, domestic demand in the region is expected to rise to nearly 30 billion cubic metres. The region currently produces less than 10 billion cubic metres a year.
Russia

Lower-house Duma adjourns final session of term. During the four-year term of the current Duma, several major pieces of economic legislation were implemented, including a law that fundamentally changed the federal budget-drafting process, a law on use and ownership of forest resources and a law on waterways. In addition, the Duma abolished foreign currency controls and approved a competition law that limits cartels.

Unlike its predecessor, the 2000–2003 Duma, the current Duma, dominated by United Russia, operated throughout its term in seamless cooperation with the government and rarely made changes to bill proposals submitted by the government or the presidential administration. When called upon, the Duma could handle all three readings of an important bill in a single day.

Several important bills on the economy were not finished by the current Duma and will be transferred to the incoming Duma when it convenes next February. Among them are a law promoting voluntary pension savings, amendments to the bankruptcy law that ease debt restructuring, as well as a law tightening registration rules for corporate shareholders. Another unfinished law seeks to keep company property from disappearing when confiscated by officials in cases where firms are suspected of engaging in illegal activities.

Russia reads for elections. Candidates in this Sunday’s upcoming Duma elections represent eleven parties. Most votes are expected to go to United Russia, the Communist Party of Russia, Just Russia and the Liberal Democratic Party of Russia.

The United Russia Party, led by vote-magnet Vladimir Putin, is expected to retain at least its two-thirds majority of the Duma seats as the election has been made a vote of confidence on Putin’s leadership. Polls show the president enjoying widespread favourability with Russians, and some favourability polls put Putin’s approval above 80%. Approval of the Duma’s activities, in contrast, are seen favourably only by a quarter of the population.

The starting position of United Russia in the elections is good. The party has, among other things, received greater media coverage than other parties as it has people in leadership posts in all areas of Russia society. The party could be hurt, nevertheless, by the flare-up in the inflation rate this autumn, particularly a spike in food prices that has had a significant impact on the poorest members of Russian society.

On Monday (Nov. 26), the upper-house Federation Council set the first round of the presidential election for March 2, 2008. Candidates must declare their candidacy to the central election board by the end of December.

Gazprom world’s eighth largest company in terms of market value. According to the latest ranking by the American Forbes business magazine, the top six companies in the world last spring in terms of market value were all American. Number seven was the Japanese Toyota Motors and eighth was Russian gas giant Gazprom. The Chinese PetroChina ranked ninth.

Measured by net sales, Gazprom was the 112th largest company, putting it on par with Finnish telecom giant Nokia.

The annual company survey by Russia’s leading business magazine, Expert, ranked Gazprom as Russia’s largest company in terms of net sales. Gazprom is Russia’s most significant traded firm; as of October its weighting constituted about a quarter of the entire RTS index. Gazprom’s market value has risen rapidly since 2004, when restrictions on foreign ownership were lifted and the company’s shares were listed on the London stock exchange. The Russian government currently holds 50.01% of Gazprom’s shares.

According to Expert, the privately held oil giant Lukoil was Russia’s second largest company in terms of net sales. In terms of market value, Lukoil was the world’s 108th largest company. In terms of net sales, electricity monopoly RAO UES is Russia’s third largest company, but the company is about to be broken up in the 21 regional production companies and wound down next spring.

The next largest foreign-listed firm was the state-owned oil company Rosneft, which in terms of market value is the world’s 85th largest company. Rosneft rose in the rankings last year after it acquired most of the assets of the Yukos oil company bankruptcy estate. As recently as 2003, Yukos was still Russia’s fourth largest company.

State-owned savings bank Sberbank had the world’s 105th largest market value.

Russia’s ten largest companies

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<tbody>
<tr>
<td>1</td>
<td>Gazprom</td>
<td>Oil and gas</td>
<td>79,151</td>
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<td>Tatneft</td>
<td>Oil and gas</td>
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Sources: Expert, Forbes
China

High level EU-China summit held in Beijing. Participants at the tenth EU-China leaders meeting this week in Beijing included Chinese president Hu Jintao, Portugal’s prime minister and holder of the rotating EU presidency Jose Socrates and EU Commission president José Manuel Barroso. Although public discussions among the leaders remained at a fairly general level and highlighted the importance of increased cooperation, Europe’s leaders expressed their hopes for faster appreciation of yuan and reached agreement with their Chinese counterparts on increasing bilateral trade and finance meetings. The parties also sought to speed up revision of the framework agreement guiding bilateral relations. The current agreement was made in 1985 and concentrates on trade issues.

Other high-level meetings arranged in parallel with the leader meetings included discussions among business elites on increased cooperation, sustainable development and environmentally innovative technologies.

Yuan showing slightly faster appreciation against US dollar. During the last month, the yuan has strengthened nearly 1.5 % against the dollar. Since the dollar peg was abandoned in conjunction with the July 2005 revaluation, the yuan has gained 12 % against the dollar. In the past two years, the largest single-day drops and rises in the yuan’s value have taken place in November. Even so, the yuan-euro exchange rate tightly tracks fluctuations in the euro-dollar exchange rate, which means the yuan has lost value against the euro. On Thursday (Nov. 29) one dollar bought 7.38 yuan and one euro 10.88 yuan.

Also visiting Beijing this week, EU economic and monetary affairs commissioner Joaquin Almunia, EU trade commissioner Peter Mandelson and European Central Bank chairman Jean-Claude Trichet all noted that a stronger yuan is an advantage for China, as it would help stimulate domestic consumption and reduce the country’s dependence on exports. Before the EU delegation arrived in China, French president Nicolas Sarkozy said that a stronger yuan would bring greater harmony to the international exchange rates. As expected, Chinese premier Wen Jiabao repeated China’s position that the yuan appreciation will continue to be gradual. China’s leaders, however, have expressed concerns over the precipitous decline in the dollar’s value.

The faster appreciation demands of the yuan have been boosted by China’s exploding trade surpluses. In the January-October period, China Customs figures show China’s trade surplus amounted to $110 billion with the EU area and slightly over $130 billion with the US. China ran a trade deficit with Japan in the period.

Yuan-dollar, yuan-euro exchange rates

EU trade commissioner Mandelson weighs in on China’s failure to enforce intellectual property rights. In Beijing this week, EU trade commissioner Peter Mandelson criticised China on its failure to monitor and enforce intellectual property rights (IPR), secure a semblance of product safety in export goods, and the tacit condoning of product piracy, knock-offs and counterfeit goods. Even if the number of IPR prosecutions increased 50% a year between 2002 and 2006, a mere 350 IPR cases were heard last year in Chinese courts.

Western countries have long criticised the inadequacies of China’s efforts at protecting intellectual property rights. A recent study commissioned by the US Chamber of Commerce found that 53% of US firms operating in China felt that there had been no progress in implementing legislation to protect intellectual property rights in the current year. Over 60% of firms said that the lack of regulatory enforcement detracted from their willingness to introduce new products in the Chinese market or invest in research and development in China. In addition, an EU Chamber of Commerce study found that 66% of European companies operating in China reported inadequate IPR protections and enforcement directly affected their ability to do business in China. European manufacturers operating in China estimate that they lose one euro in profit to IPR violations for every five euros earned.

China-EU relations have long been strained by the questionable product safety of some goods produced in China, as well as the spread of pirated copies and counterfeits. Last year, 80% of goods confiscated at European Union borders were products originating in China. According to estimates from the World Intellectual Property Organization (WIPO), the cost to society from counterfeits and illegal copies (including lost profits of legitimate companies) exceed over €70 billion a year.
Russia

United Russia again dominates Duma elections. According to preliminary returns, United Russia won slightly over 64 % of the vote, with only three other parties managing to break the 7 % threshold needed to win seats in the 450-member Duma. The right-wing parties Yabloko and the Union of Right Forces not only fell far short of the 7 % threshold, but failed to break even the 3 % mark required for return of their 60-million-rouble election deposits. Voter turnout was 63 %, seven percentage points higher than in the 2003 Duma elections.

The Communists will constitute the sole opposition party in the new Duma, as both the Liberal Democrats and Just Russia representatives have traditionally supported United Russia policies. The new Duma expects to start its work before the end of this month.


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<tr>
<td></td>
<td>Deputies</td>
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<tr>
<td>United Russia</td>
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<tr>
<td>Communists</td>
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<td>Liberal Democrats</td>
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<tr>
<td>Just Russia</td>
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<td>8</td>
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<tr>
<td>Nationalist-patriotic bloc</td>
<td>–</td>
<td>–</td>
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<td>Independent representatives</td>
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Sources: Duma, www.rbc.ru

German Gref to head Sberbank. The shareholders’ meeting of the majority state-owned savings bank Sberbank last week elected former economy minister German Gref as the bank’s new director. Known as a proponent of liberal economic policies, Gref (born 1964) has been a familiar face in Russian governments, serving as economy minister from 2000 to September of this year.

Andrei Kazmin, Sberbank’s former head from 1996, will now lead the Russian post office, which is the subject of a modernisation programme approved last year by the government. During his tenure, Kazmin reformed Sberbank’s Soviet-era structure and streamlined operations (for example, by closing down 16,000 branch offices).

Sberbank is Russia’s largest bank, but its share of the market in the 2000s has somewhat contracted as other banks have grown. The liquidity crisis that has afflicted Russian financial markets since August has, however, benefited large banks and allowed Sberbank to retain some of its market share. Currently he bank accounts for nearly a third of corporate loans, nearly 40 % of loans to households and holds over half of all Russian deposits. Sberbank’s largest competitive weapon is still its nationwide network of 20,000 branch offices. Some 56 % of the bank is held by the CBR and 36 % is owned by domestic and foreign institutional investors.

Russia begins talks on OECD membership. The OECD Council, the highest-level decision making body of the Organisation for Economic Cooperation and Development, said Monday (Dec. 3) that it had given the green light to beginning accession talks with Russia. Russia submitted its OECD application in 1996.

According to OECD principles, members must be committed to democracy and the market economy. A “road map” is prepared for every country as the basis for deciding on their membership. The road map includes areas that are of particular importance in a given country, such as the country’s investment climate and its competition policies. The investment environment has a particularly important role, as under OECD principles member states must treat each other equally in terms of investment, capital movements and trade in services. Since the road map is mainly a technical document, the OECD Council reserves the right to place additional demands on applicants as needed. Unanimous agreement among OECD Council members is required for admission.

In addition to Russia, the OECD also launched membership talks with Chile, Estonia, Slovenia and Israel. Currently, the OECD has 30 members, including its newest member Slovakia, which joined in 2000. The OECD has also announced plans to engage more closely with other countries, notably Brazil, China, India, Indonesia and South Africa.

Russia’s WTO talks plod ahead. In September, Russia completed its bilateral WTO negotiations with Cambodia. Russia still has unsigned bilateral agreements with Saudi Arabia and Georgia. The Georgia talks are stuck on customs points in Abkhasia and South Ossetia. Bilateral talks are expected to continue in December and January.

In multilateral talks, Russia’s open topics include agricultural subsidies, copyright protection, phytosanitary measures and issues related to export tariffs. Russia’s economy ministry hopes the multilateral talks can be wrapped up by the first half of 2008, which would mean that Russia could become a WTO member in July.

A study commissioned by the economy ministry found that WTO membership will not cause large changes in Russian markets. Membership opponents fear that lower import tariffs will seriously weaken the competitiveness of domestic industries, but the study sees lower tariffs having little, if any, impact on markets in most Russian regions. However, larger negative impacts are expected for 22 regions, including Perm, Tatarstan and Irkutsk. Some of the products most sensitive to lower import tariffs are tea, coffee, cosmetics, passenger cars, car tires and clothing.
China

Chinese financial institutions keep on investing abroad.

One of the China's largest insurers, mainly state-owned Ping An Life Insurance, purchased a 4.2% stake in the Belgian-Dutch Fortis banking and insurance group for just under €2 billion. The stake makes Ping An the largest single shareholder in Fortis. Under the deal, Ping An gets to name one member to the Fortis board.

The deal is only one of several large investments by Chinese financial institutions in foreign enterprises this year. This week also saw the final acceptance of a €3.7 billion offer from China’s largest bank, Industrial and Commercial Bank, for a 20% stake in the South-African Standard Bank. Including this acquisition, mainly state-owned Chinese companies have already spent some €12 billion this year on stakes in foreign financial institutions. In 2006, all foreign direct investment from China totalled €14 billion. Several other large Chinese firms (including China Life and Bank of China) have announced plans to buy shares in foreign companies.

East China Sea oil and gas field tops agenda at China-Japan summit.

The high-level meeting in Beijing last weekend included six ministers from Japan and eight from China, including premier Wen Jiabao. The meeting was the most comprehensive since 1972, when the countries established diplomatic relations. Topics discussed at the meeting included trade and commerce, economic policy and environmental protection. Wen said that another step forward was taken especially in trade and commerce.

At the heart of the discussion was the right to develop and exploit offshore oil and gas resources in Chunxiao field (Shirakaba in Japanese) in the East China Sea. China and Japan have disputed over the issue for several years. Chinese drilling activity is being conducted just a few kilometres west of disputed sea area. Japan is worried that the Chinese could be also pumping their resources. Last weekend was the eleventh in a series of talks on dividing up the area’s oil and gas resources. According to Japan’s foreign ministry, the parties made no progress towards a solution. Japan hopes that the matter will be handled before the country’s new prime minister Yasuo Fukuda makes his first visit to China, which is likely to take place in couple of months.

During the summit, Chinese president Hu Jintao announced his interest to visit Japan early next year. The last time a Chinese president visited Japan was ten years ago. China-Japan relations grew tense during the five-year term of prime minister Yunichiro Koizumi (2001–2006). Koizumi inflamed the Chinese with his annual visits to the Yasukuni shrine, which is dedicated for some 2.5 million men and women killed in wartime, including more than a dozen major war criminals. Relations between the two countries have improved significantly over the past 12 months following the election of prime minister Shinzo Abe in autumn 2006. One of Abe’s first acts was to visit China.

China is Japan’s most important trading partner and Japan is China’s third most important trading partner after the European Union and the United States. In the first ten months of this year China imported from Japan goods worth $109 billion (€74 billion), and exported goods to Japan with a value of $83 billion (€56 billion).

China still only making little efforts to deal with mammoth environmental problems.

China’s rapid economic development has long overlooked the accompanying environmental degradation. By next year, China will surpass the US as the world’s largest greenhouse gas emitter. According to the Blacksmith Institute, six of the world’s 30 most polluted cities are located in China. By some estimates, 750,000 Chinese annually die prematurely due to pollution-related causes. The OECD estimates Chinese pollution will annually cause the loss of nine million man-years of work in 2020.

China’s water situation is particularly disconcerting, given that the country’s water supplies are already small in relation to its size. According to Chinese officials, all of the country's nine largest lakes are completely polluted and about a quarter of the water in the country’s large rivers is completely unusable. International estimates say the situation is much worse – at least half of China’s river water is wholly polluted. In addition, about 700 million Chinese rely on water supplies with levels of pollution above internationally approved limits.

Although China’s environmental awareness has improved, its measures to make better the environmental situation remain insufficient. Current regulation needs to be developed and particularly monitoring needs to be improved. In recent years, China’s state environmental protection administration (SEPA) has gained a bit of muscle. Newspaper reports suggest SEPA succeeded this year in shutting down some of the country’s worst polluting enterprises. Officials have also moved to deny loans to the heaviest polluting enterprises. Earlier, trees were planted in fields as part of an effort to stop desertification, but currently that project is on hold.

Despite constant international calls for China to take action on its environmental issues, China has declined to become a signatory to the Kyoto treaty on climate change. China takes the view that developed countries must bear most of the responsibility for slowing global climate change. Last summer, China drafted its own program for reducing greenhouse gases.
Russia

Russian real exchange rate continues to appreciate; inflation picks up. Persisting high oil prices and massive inflows of foreign currency into the country continue to put appreciation pressure on the rouble’s real exchange rate. The real effective exchange rate in November was up 4.7% from the start of the year. Faced with the flow of liquidity from energy export earnings and capital income, the Central Bank of Russia has sought to keep the nominal exchange rate stable so the liquidity flow is reflected in higher prices. The nominal effective exchange rate has fallen 1% since the start of the year, while the rouble has strengthened 7% in nominal terms against the US dollar and declined 3% against the euro.

Russian 12-month inflation in November exceeded 11%, well above the original target range of 7.5-8% for this year. Although the inflation rate dropped to around 7% in the summer, a fast increase in food prices in the autumn revived higher inflation. Food prices, particularly grain prices, have risen rapidly in line with world market prices. In October, the government agreed on the freezing of various basic food items until the end of January. Higher natural gas prices from next month will add to inflation pressures. The government has announced plans for a new inflation-fighting package.

After a slight dip last winter, growth in producer prices has also accelerated. In October, producer prices were up 14% y-o-y. Producer prices rose 15% in mineral extraction industries and 13% in manufacturing industries.

Russian consumer and producer prices, 12-month change, %

**Natural gas prices on the rise.** The Federal Tariff Service confirmed the planned 25% hike in natural gas prices for the domestic market, effective from January 2008.

The non-taxed gas price for industrial users will be 1,690 roubles (36 euro) per thousand cubic metres and 1,290 roubles (26 euro) for households. In practice industrial gas users may pay significantly higher prices for gas than the regulated wholesale rate. Regulated wholesale prices are gradually being increased so that by 2011 they would match market prices. Higher inflation has neutralised part of the effect from the rate hike and boosted producer prices in mineral extraction industries.

Gas giant Gazprom, which produces about 85% of Russia’s natural gas, also operates the gas transmission and distribution grids. Gazprom holds the exclusive right to export and import gas. Gas exports are typically based largely on long-term supply contracts with the gas price tied with a small lag to price trends for other energy products, particularly crude oil. Gazprom deputy chairman Alexander Medvedev said the price of gas exported to Western Europe would likely increase from around $300 per thousand cubic metres to about $350 next year.

CIS countries make an exception to this practise, as they negotiate their own gas delivery prices and quantities annually. Ukraine has already agreed to purchase its gas from Gazprom at a rate of $180 per thousand cubic metres next year ($130 in 2007). Gazprom will likely increase also other CIS prices as it hopes to reach Western European levels in all gas export prices.

Russian natural gas production last year was about 650 billion m³. In addition, Russia imported around 60 billion m³ of gas from Central Asia, mainly Turkmenistan and Uzbekistan. Domestic consumption in 2006 reached about 450 billion m³ and exports about 250 billion m³.

**Medvedev candidacy announced.** On Monday (Dec. 10), president Vladimir Putin gave his support to the plan of four parties to put first deputy prime minister Dmitri Medvedev as their common candidate in the upcoming presidential election in March. On Tuesday, Medvedev asked Putin to serve as his prime minister if he is elected. Putin’s support is expected to give Medvedev a good starting point in his run for the presidency.

Medvedev has been in charge of e.g. the national priorities program and demographic policy. He announced plans to concentrate on social issues and increasing living standards for Russians if elected president. Medvedev is also Gazprom’s board chairman.

Observers consider Medvedev more liberal than other potential presidential candidates such as deputy prime minister Ivanov and prime minister Zubkov. Medvedev is also expected to toe Putin’s economic policy line.

In a speech this week, Putin stated that the state does not aim to directly interfere in the economy but rather support development of infrastructure. He said earnings from commodity sales will still be needed to be set aside in the state stabilisation fund to provide a buffer for the economy in the event of a large decline in oil prices.

The markets appeared to take the news of Medvedev’s candidacy positively and Russian bourses continued to rise this week.
China

China’s inflation picks up; tighter monetary policy measures expected. China’s National Bureau of Statistics reports consumer prices increased 6.9 % y-o-y in November, up from 6.5 % in October. The November acceleration in inflation was the sharpest in over a decade. The rapid rise in prices has been sustained by climbing food prices (up 18 % y-o-y in November). Non-food prices in November also accelerated slightly.

Broad money supply (M2) was up 18.5 % y-o-y as of end-November – overshooting the People’s Bank of China’s growth target of 16 % for 2007. The PBoC has hiked interest rates five times this year to quell money supply growth (the 1-year lending rate is currently 7.29 %). Reserve requirements for commercial banks have also risen from 9 % at the start of the year to 14.5 % as of December 25. PBoC have issued more bonds than in earlier years, although the amount of central bank bonds on the market has actually declined slightly since the end of March. Raising reserve requirements is cheaper for the PBoC than selling bonds, as the minimum interest rate paid on mandatory reserves is a mere 1.89 %, while central bank treasuries carry pricier yields (e.g. the one-year yield is currently 3.99 %).

Last week, the PBoC announced it would shift from its current approach of mild tightening to harsher monetary measures in order to rein in soaring prices. In addition to tighter monetary policy, the PBoC also announced it would use additional measures to dampen money supply growth, which supposedly will mean greater restraints on commercial bank lending.

China promises to open access to its financial markets and improve safety inspections of export goods at third round of US-China strategic dialogue. Participants in the latest round of dialogue between the two countries included ministers and high-level officials. The US delegation was led by treasury secretary Henry Paulson and China’s team was headed by deputy premier Wu Yi. Paulson proposed the strategic dialogue format last year as a means to promoting common understanding and resolving bilateral and global economic issues. An outcome of the two-day negotiations was that China committed to open the financial markets (e.g. permitting the listing of foreign companies on Chinese bourses) and promised to allow American inspectors into the country to evaluate the quality control systems of exporting pharmaceutical manufacturers and food processors. China and the United States have made headway recently in resolving a number of sensitive economic conflicts. Two weeks ago, China agreed to reduce tax subsidies that distort trade and make it more difficult for foreign companies to sell their products in China. The case represents one of five complaints the US has filed with the WTO.

The yuan’s exchange rate, which has been a theme of discussions between China and western countries this autumn, was not primary topic this time. Paulson merely suggested that a more flexible exchange rate regime would be advantageous for China, which faces rising inflationary pressures and a risk of economic overheating.

China’s foreign trade surplus continues to swell. China’s foreign trade boomed in the first eleven months of this year. The value of China’s exports climbed to nearly $1.1 trillion, up 26 % from the same period a year earlier. The value of imports also rose 21 % to $865 billion. With export growth continuing to outstrip import growth, China’s foreign trade surplus in January-November ballooned to $238 billion, up 50 % from a year earlier.

The European Union and the United States are overwhelmingly China’s largest trade partners. Next come Japan, Korea and Taiwan. China’s foreign trade statistics practices are difficult to interpret, because they incorporate pressures and a risk of economic overheating.

The yuan’s exchange rate, which has been a theme of discussions between China and western countries this autumn, was not primary topic this time. Paulson merely suggested that a more flexible exchange rate regime would be advantageous for China, which faces rising inflationary pressures and a risk of economic overheating.

China’s foreign trade surplus with the United States ($130 billion) continues to grow rapidly, while the trade surplus with the United States ($160 billion) appears to be stabilising. In the Asia-Pacific region, China’s trade deficits are still increasing with Taiwan (12-month deficit $80 billion), Korea ($50 billion) and Japan ($30 billion). China’s trade deficit with Australia ($7 billion) has also grown slightly, but China’s aggregate trade deficit ($15 billion) with the ten ASEAN countries has been gradually evaporating for some time now. China recently began to post trade surpluses with India (12-month surplus currently $10 billion) and Russia (nearly $9 billion).
Russia

Russian economic growth accelerated slightly during this year. Rosstat reports that Russian GDP rose 7.8 % y-o-y in the first nine months of this year. Growth was driven by construction, which grew 22 % y-o-y, and manufacturing, which rose 8 %, Growth in mineral extraction industries slowed to 2 %. Agricultural production was also up 2 %.

Primary and value-added production continues to account for a relatively large share of GDP, 44 %. Manufacturing accounted for about a fifth of GDP, while mineral extraction industries represented 9 % and construction 6 %. The largest component of the service sector is retail sales, which generated nearly a fifth of GDP. Retail sales growth slowed to 11 % in January-September. Growth in the transport sector slowed to 7 %, its share of GDP was just over 10 %.

The latest consensus GDP growth forecast compiled by the economic research institute Tsentr Razvitiya predicts GDP growth for 2007 to come in at 7.4 % and then slow to 6.7 % next year. Deputy economy minister Andrei Belousov said the ministry is updating their GDP forecast at 6.6 % in 2008 and 6.3 % in 2009.

Growth of fixed capital investment accelerated this year, and was up 21 % y-o-y in January-October. Investment was directed mainly at the transportation sector, mineral extraction industries and manufacturing. The consensus forecast estimates a slight slowing in investment growth next year.

The government became concerned as inflation picked up during this autumn. At the start of the week, the economy ministry published a package of inflation-fighting measures designed especially to deal with rising food prices by improving production possibilities in the agriculture sector. The economy ministry forecasts 11 % inflation this year. The consensus forecast for next year predicts 8.5 % inflation.

On-year change in GDP and select components, %, 4-quarter moving average

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<th>Component</th>
<th>2005</th>
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<td>GDP</td>
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<td>547</td>
<td>548</td>
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<tr>
<td>Mineral extraction</td>
<td>236</td>
<td>255</td>
<td>257</td>
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<tr>
<td>Manufacturing</td>
<td>248</td>
<td>272</td>
<td>274</td>
</tr>
<tr>
<td>Construction</td>
<td>174</td>
<td>189</td>
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<tr>
<td>Retail sales</td>
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Source: Rosstat

Resolution of Russia-Poland meat dispute paves way for talks on renewing EU-Russia cooperation pact. On Wednesday (Dec. 19), Russian and Polish officials signed an agreement lifting the ban on Polish meat imports to Russia. Russia had suspended meat imports from Poland in 2005 purportedly for health and safety reasons. Poland retaliated by exercising its veto right to prevent the commencement of EU-Russia talks on a new partnership and cooperation agreement (PCA). EU-Russia cooperation is currently governed by the 1997 PCA. Both the EU and Russia want a new PCA as the current agreement is outdated in many respects. In particular, the new PCA should clarify EU-Russia energy cooperation.

Russian students score poorly in latest PISA study. The OECD-coordinated Programme for International Student Assessment (PISA) has examined various aspects of the scholastic performance of 15-year-olds in OECD member countries and selected other countries. To date, three rounds of PISA studies have been completed (2000, 2003 and 2006). 57 countries participated in the latest round. Scholastic performance is measured based on standardised testing in reading, mathematics and science, with emphasis on the student’s mastery of skills needed to participate in society. The theme of the 2006 round was science.

Finland ranked highest in the 2006 science testing, followed by Hong Kong, Canada, Taiwan and Estonia. The lowest rankings went to Qatar and Kyrgyzstan. Generally, there is a correlation between national living standards and testing results, although exceptions in both directions can be found. In countries where the average result is good, performance is typically fairly consistent across schools.

As in earlier PISA studies, Russian students failed to distinguish themselves. In all three areas of competence, Russia students scored below the OECD average. Russian students showed a clear decline from their 2000 performance in reading, while there were negligible changes in their math performances.

Summary of scores of 2006 PISA testing for select countries (rank out of 57)

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Source: OECD
China

Banks operating in China gain permission to invest Chinese assets in London financial markets. The China Banking Regulatory Commission (CBRC) announced this week plans to extend its qualified domestic institutional investor (QDII) program launched last year. Currently approved financial institutions in China can only offer to their customers foreign investment in Hong Kong, but now officials have agreed with the UK financial regulator that, Chinese investors can also invest in listed shares and mutual funds in UK within the QDII framework. No exact information on the implementation schedule of the new agreement was released. The Chinese are currently discussing a similar agreement with US authorities. By expanding the QDII program, China hopes, among other things, to improve the risk management possibilities for investors.

One purpose of Chinese officials in establishing a program for domestic institutional investors is to relieve yuan appreciation pressures by allowing liquidity built up in the economy to be channelled abroad. The program applies to CBRC-approved banks, insurance companies and fund operators. It was extended previously last summer from low-risk bonds to include stock-exchange-listed shares and mutual fund units. Under the rules, financial institutions exchange yuan from Chinese investors for foreign currency under a quota system and then invest those assets in foreign shares, public and private debt securities, or fixed-yield instruments. The investment quota granted to commercial banks is about $15 billion, of which only about $1 billion had been used by the end of October. The interest in international investment has fallen substantially as the domestic investment opportunities, mainly shares, continue to offer higher returns.

State companies begin to pay dividends to the state. Of the more than 100,000 public-sector-owned enterprises in China, 150 are directly under the central administration and they are controlled by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC). Following a brief pilot program, SASAC announced that payment of dividends will be mandatory from the start of next year for about 120 of the state-owned enterprises under the central administration. Of remaining 30 enterprises, there are about a dozen companies in the defence sector that would begin to pay out dividends within three years. The remaining companies will be exempt from the dividend requirement altogether. The energy sector, cigarette makers and telecom operators will be required to pay 10 % of their profits to the state, while other firms only pay 5 %. Subsidiaries of state-owned enterprises listed on stock exchanges would also be exempt from the requirement.

China stopped collecting dividends from state companies in 1994 to allow them to use the money on their own development. Many international entities subsequently urged Chinese officials to reinstate dividend collection.

SASAC reports profits of state companies under the central administration in 2006 totalled about 750 billion yuan (about $75 billion). First half results for state-owned enterprises suggest profits will rise to record levels this year. The SASAC estimates that about a quarter of firms account for about 80 % of profits. Officials hope that collecting dividends will help slow the rapid rise in fixed capital investment as firms still finance a lot of their capital investments out of pocket using company profits.

Most state-owned enterprises are relatively small and either lose money or only generate small profits. Officials have sought to reduce the number of state-owned enterprises by providing merger incentives. The government’s objective is to reduce the number of state-owned enterprises controlled by SASAC to less than a hundred by 2010 and turn 30–50 of them into large, internationally competitive companies.

Economic growth in Hong Kong and Macao remains robust. Hong Kong’s GDP in the third quarter was up 6.2 % y-o-y in real terms, on par with the pace of growth in recent years. Hong Kong’s Census and Statistics Department expects growth for 2007 overall to come in above 6 %. The Asian Development Bank forecasts that economic growth in the special administrative region will slow next year to 5.4 %, due mainly to a weakening outlook for growth in Mainland China and the United States.

Hong Kong’s economic growth has been driven by robust domestic demand. In the third quarter of this year, growth in household consumption in particular was spiked by increasing real wages and a favourable employment situation. Investment growth, on the other hand, slowed a bit. Hong Kong’s service sector export growth accelerated in the third quarter of this year to its highest level in three years. Among the factors driving growth were increased tourism and financial market activity. In recent years, services have accounted for over 90 % of Hong Kong’s GDP, a huge share by international standards. Consumer prices were up 1.6 % y-o-y as of end-September.

Macao’s economic growth accelerated in the third quarter of this year to a real rate of 31 % y-o-y. Gambling remains the central service-sector business in the special administrative region, accounting for about half of Macao’s GDP. In 3Q07, casino profits were up 45 % y-o-y in nominal terms. At the end of September, Macao consumer prices were up 6 % from a year earlier.
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