The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.
Ruble weakened slightly in 2011.
Changes planned for state companies.
Russian parliament approves expansion of Moscow city limits.

Foreign strategic investment law continues to evolve.
Turkey grants Gazprom permission for construction of South Stream gas pipeline in its territorial waters.

Inflation rate in 2011 drops to post-Soviet low.
Federal budget produced unexpected surplus last year.
Widening investigation of firms registered in tax havens.

Russia posts big current account surplus for 2011.
Capital exports up in 2011.
No change in Russia's creditworthiness rating.

Agriculture sector buoyed 2011 good GDP growth.
Credit growth soared last year.
Prime minister Putin stresses the importance of private enterprise and role of state firms in policy comments.

CBR reorganises banking supervision to improve effectiveness.
Financial sector's tight liquidity situation persists.
Last week's CBR board meeting finds no reasons to adjust rates.

Wholesale and retail trade sector attracts most foreign direct investment.
Recovery of domestic demand continued at regional level in 2011.
State-owned VTB Bank to reimburse shareholders for lost value.

Government prepares for major tax reform without clear direction.
Cabinet ministers at odds over divesting state-owned enterprises.

Tax revenues up sharply in 2011; budget ends year with big surplus.
Tighter competition rules.

Post-election economic policies take shape.
Rise in export prices pushed Russian foreign trade to record levels in 2011.
Spotty recovery in Finnish exports to Russia.

New BOFIT forecast sees Russian economic growth averaging around 3.5 % p.a. in 2012–2014.
Putin's election promises could have significant budget impacts.
BOFIT Weekly – Russia 2012

23.3.2012 BOFIT Weekly 12/2012
Strategy 2020 programme released.

30.3.2012 BOFIT Weekly 13/2012
Russian domestic demand weak in January and February.
Strategy 2020 emphasises economic cooperation with CIS countries and the EU.
Russia needs highly skilled immigrants.

5.4.2012 BOFIT Weekly 14/2012
Russian women earn only 65 kopeks for every ruble earned by men.
Finance ministry places a massive Eurobond issue.

13.4.2012 BOFIT Weekly 15/2012
Inflation rate hits record low in March.
Capital outflows from Russia remain strong.

20.4.2012 BOFIT Weekly 16/2012
CBR expands its monetary toolkit.
Government eyes return to tighter fiscal policies.

27.4.2012 BOFIT Weekly 17/2012
Weak first-quarter growth in demand.
Russian consumer demand also visible in Finland.

4.5.2012 BOFIT Weekly 18/2012
Russia seeks to attract Chinese investment in Far Eastern Russia and Eastern Siberia.
Cabinet members at odds over how to develop Siberia and the Russian Far East.

11.5.2012 BOFIT Weekly 19/2012
Government finances may be close to balance this year.
Putin’s promise about tax breaks spurs wave of joint oil development projects with international firms.

18.5.2012 BOFIT Weekly 20/2012
President Putin declares targeted measures with dead-lines to promote a “new economy.”
Bright lights, big city – Russian style.

25.5.2012 BOFIT Weekly 21/2012
Slower economic growth.
New cabinet likely to stick with current economic policy framework.
First road maps for improving Russia’s investment climate approved.

1.6.2012 BOFIT Weekly 22/2012
Russians show increased willingness to take a loan to buy an apartment.
Plans to move most federal administrative offices to newly created Moscow expansion zone take shape.
The wealthy Moscow suffers from unequal income distribution.
8.6.2012 BOFIT Weekly 23/2012
Ruble drops along with crude oil prices.
Cabinet braces for possible shocks from euro-area crisis.
Skolkovo innovation centre takes shape, state-owned companies grudgingly contribute to funding.

15.6.2012 BOFIT Weekly 24/2012
Thanks to everybody who responded to our February reader survey!
Cabinet approves latest programme to privatise state-owned enterprises; exact schedule and scope remain unclear.
European Commission expresses concern over protectionism as Russia’s WTO accession approaches.

IMF sees brisk economic growth ahead for Russia, but warns of loose fiscal policy.
FAS head concerned about government’s lack of commitment to increasing competition.
Growth in corporate lending of Russian banks has levelled off.

29.6.2012 BOFIT Weekly 26/2012

6.7.2012 BOFIT Weekly 27/2012
Cabinet confronts realities of tighter budget discipline.
Special agency to handle state loans and investments.
Rates for municipal services hiked on July 1.
Prices of alcoholic beverages hiked on July 1.

13.7.2012 BOFIT Weekly 28/2012
Duma approves Russia’s WTO accession agreement by a narrow majority. Putin names ombudsman to represent business interests.

20.7.2012 BOFIT Weekly 29/2012
Russia revises its farm subsidy formats as WTO membership looms. Russian railways suffering effects of long-term under-investment.

27.7.2012 BOFIT Weekly 30/2012
CBR widens fluctuation band for ruble exchange rate.
Russian economic growth slows slightly.
Russia’s current account surplus and capital outflows remain substantial.

3.8.2012 BOFIT Weekly 31/2012
Ukraine and Russia remain deadlocked over the price of natural gas. Russia actively planning new gas projects and pipeline routes. Gazprom cuts natural gas export prices. Ukraine approves CIS free-trade zone agreement.

10.8.2012 BOFIT Weekly 32/2012
Inflation accelerates in July as expected. Cabinet considers less exclusive rules on development of offshore hydrocarbon deposits. Russia ratifies agreement with US on bilateral easing of visa rules.
17.8.2012 BOFIT Weekly 33/2012
Banking sector growth remains robust.
Russia's foreign trade showed modest growth in the first half of 2012.

24.8.2012 BOFIT Weekly 34/2012
Russia became a WTO member on Wednesday.
Russia's WTO membership brings some tariff relief important for Finland.
Strong protection of Russia's car industry will continue even with WTO membership.

31.8.2012 BOFIT Weekly 35/2012
Strong state spending in first half.
New laws diminish Moscow's tax revenues.
Moscow region seeks ways to boost tax revenues.

7.9.2012 BOFIT Weekly 36/2012
Russia moves to increase port capacity, especially in the Baltic Sea and Pacific coast.
Development of Russian Far East.

14.9.2012 BOFIT Weekly 37/2012
BOFIT forecast sees Russian economic growth slowing but still relatively high.
Fixed investment remained focused on the energy sector in the first half.
Modest first-half growth in Finnish exports to Russia.

21.9.2012 BOFIT Weekly 38/2012
CBR hikes key rates as inflation accelerates.
CBR sells some of its shares in Sberbank.
President Putin signs decree to protect Gazprom.

Big plans for Russia's forest industries.
Russian adults rank among the best educated in the world, but learning results are below the average of developed nations.

5.10.2012 BOFIT Weekly 40/2012
CBR looks to phase out ruble exchange-rate steering in 2015.
Russia sees record-high grain prices; possible import restrictions a hot topic for the government.
Government decides on allocation of Sberbank sale proceeds.

12.10.2012 BOFIT Weekly 41/2012
Despite high volatility, Russian stock prices post steady gains over past three months.
Insider trading remains a problem in Russian securities markets.
Although the current account surplus contracted, it remains substantial.

19.10.2012 BOFIT Weekly 42/2012
Capital outflow from Russia's non-banking corporate sector increased.
Large part of direct investment into Russia still channelled via Cyprus.

26.10.2012 BOFIT Weekly 43/2012
Russian economic growth slows.
Gazprom brings northwestern Siberia gas field on stream.
State hospitals and clinics to charge for certain procedures.
Russia and Belarus stay on daylight saving time.
Government decides on next year’s big share sales of state enterprises.

Russia's large consumer markets.
Russian tourists spending more and more in Finland.
Russian cabinet approves environmental programme until 2020.

Slight hike in inflation forecast for this year.
Russia wants to quintuple its shipbuilding output by 2030.
Russian's shifting position in global energy markets.

Government restricts possibilities for SOEs to acquire other companies.
SOEs now generate half of Russian GDP.
Central securities depository established.

Duma approves federal budget for next year with a slight deficit.
Duma approves changes to the pension system introduced in 2002.

Russia works to limit negative effects from joining WTO.
Russia-Belarus-Kazakhstan customs union assesses trade barriers.
Russia assumes G20 presidency.

CBR makes first small rate adjustments since September.
Gazprom breaks ground on construction of South Stream gas pipeline in Russia.
Gazprom caves on gas prices in reaction to global market trends.
No new commitments from Russia on carbon emissions at Doha climate summit.

United States normalises trade relations with Russia.
Government approves a programme to boost stock of affordable housing.
Russia rolls out new anticorruption laws.


FDI outflows from China unchanged in 2011. FDI inflows to China hit new record last year. Rails move bulk of Chinese New Year celebrants.


Productivity gains key to Chinese economic growth. China grants licence to first foreign credit card issuer. Taiwan's China-friendly president keeps his job.

Pension issues worry the Chinese. New Year's celebrations stoke inflation. EU leaders in China, Xi Jinping in the United States.

China loosens monetary policy. Improved NBS data collection should be seen already in March. Shanghai has big plans to develop its financial sector.

Big changes needed for China's economy to sustain high growth. Changes in the hukou system. Yuan appreciation against the dollar stalls.

National People's Congress convenes to discuss economic plans for the year ahead. Chinese international patent activity on robust rise.

BOFIT sees lower economic growth ahead for China. NPC discussed a wide range of reforms.
23.3.2012 BOFIT Weekly 12/2012
Sacking of Chongqing party leader Bo Xilai stirs debate on China’s development options.
Over a quarter of public sector activities off-budget in 2011.

30.3.2012 BOFIT Weekly 13/2012
European Commission competitiveness report notes pluses and minuses of China's competition policies.
China invests in military technology.
Finland's trade deficit with China increases in 2011.

5.4.2012 BOFIT Weekly 14/2012
Slow growth in domestic crude oil output forces China to rely increasingly on imports.
Chinese banks again enjoyed rising profitability last year.

13.4.2012 BOFIT Weekly 15/2012
Inflation picked up in March; cautious easing of monetary stance.
United States now tied with EU as China’s top export destination.

20.4.2012 BOFIT Weekly 16/2012
China’s economic growth slows as expected.
People’s Bank of China widens yuan-dollar fluctuation band from 0.5 % to 1 %.

27.4.2012 BOFIT Weekly 17/2012
China set to be a global leader in economic growth in 2012 and 2013.
Incomes continued to rise sharply in the first quarter.

4.5.2012 BOFIT Weekly 18/2012
Foreign direct investment inflows to China continue to decline.
China’s air traffic on the rise.
Shake-out ahead for China’s shipbuilding industry.

11.5.2012 BOFIT Weekly 19/2012
Trade surplus swells on slowing import growth.
Mobile phone subscriptions surpass one billion.
Chinese hoard gold.

18.5.2012 BOFIT Weekly 20/2012
China’s economic growth continued to slow in April.
Inflation slows in April; PBoC relaxes monetary stance.
Growth in Chinese car production slows.

25.5.2012 BOFIT Weekly 21/2012
Pilot efforts to improve financing for small and medium-sized firms.
Lending trends suggest weaker outlook for corporations and households.
Trilateral free-trade talks for China, Japan and South Korea planned this year.

1.6.2012 BOFIT Weekly 22/2012
Direct yuan-yen trade lifts yuan's profile as an international currency.
Slowing economic growth not reflected in share prices.
Hong Kong still China’s most competitive city; Inner Mongolia coming on strong.
8.6.2012 BOFIT Weekly 23/2012
China implements battery of stimulus measures; reference rates cut today.
President Putin’s China visit does little to move gas pipeline project forward.
Increasing number of European firms contemplate pulling investments out of China.

15.6.2012 BOFIT Weekly 24/2012
Price pressures moderate; central bank relaxes monetary stance.
China’s foreign trade bounced back in May; US exports surged.
Slowdown in China's industrial output growth continued in May.

Liberalisation of money markets continues; interest rate competition among banks increasing gradually.
Yuan weakens against dollar but strengthens in real terms.
China hit by another food safety scandal; demand for foreign-produced dairy products increases.

29.6.2012 BOFIT Weekly 26/2012
Chinese firms increase investment in Europe.
15th anniversary of Hong Kong handover to China.

6.7.2012 BOFIT Weekly 27/2012
China experiments with further liberalisation of capital movements.
Economic cooperation between Hong Kong and Mainland China deepens further.
Developers still waiting for official actions to stimulate construction activity.

13.7.2012 BOFIT Weekly 28/2012
Inflation slowest since January 2010 – PBoC lowers reference rates for the second time in a month.
Larger-than-expected foreign trade surplus for first half of 2012.
China revises household electricity pricing scheme.

20.7.2012 BOFIT Weekly 29/2012
China returns to investment-driven stimulus measures to support growth.
Income disparity on the increase in China, even as average incomes keep rising.

27.7.2012 BOFIT Weekly 30/2012
Good summer grain harvest.
Direct investments in China contract – China’s investments abroad grow rapidly.

3.8.2012 BOFIT Weekly 31/2012
IMF concerned about China’s investment trends.
Opening of China’s bond markets to foreign investors proceeds in small steps.

10.8.2012 BOFIT Weekly 32/2012
China’s service and construction sectors post stable growth.
China experiences balance-of-payments deficit for the first time in 14 years.
China promises African countries $20 billion in low-interest loans.

17.8.2012 BOFIT Weekly 33/2012
China’s July economic numbers unnerve global financial markets.
China’s highest value brands are almost unknown outside the country.
24.8.2012 BOFIT Weekly 34/2012
Prices on Shanghai stock exchange tumble.
China to continue active development of North Korean special economic zones.
Japan is one of the most important trade partners for China.

31.8.2012 BOFIT Weekly 35/2012
Despite economic slowdown, banking sector profits rose in the first half.
China expands service-sector VAT experiment.
Asian Development Bank pushes China to reform environmental policy.

7.9.2012 BOFIT Weekly 36/2012
Mongolian pressure cuts Chinese investment in development of major ore and mineral deposits.
Yuan loans coming soon to Taiwan.
Xinjiang profiled as centre of Eurasian cooperation.

14.9.2012 BOFIT Weekly 37/2012
BOFIT China forecast sees lower economic growth ahead.
Oil and lower commodity prices lead to a contraction in the value of imports in August.

21.9.2012 BOFIT Weekly 38/2012
China-Japan island dispute a remainder of region's political risks.
More trade disputes filed with WTO.
Chinese now buy a quarter of the world's luxury goods.

China commits to further deregulation of financial markets.
Evidence points to flat growth in fixed capital investment.

5.10.2012 BOFIT Weekly 40/2012
Important Communist Party meeting scheduled for November.
Despite recent yuan appreciation, exchange rate changes against the dollar have been quite small.
China's global competitiveness declines.

12.10.2012 BOFIT Weekly 41/2012
IMF cuts again its economic growth forecast for China.
Rapid growth in Chinese tourism abroad.
Share prices in the doldrums.

19.10.2012 BOFIT Weekly 42/2012
Quarterly data show surprising signs of pickup in GDP growth.
Consumer prices up 1.9 % y-o-y in September.
Foreign trade surplus remained large in September.

26.10.2012 BOFIT Weekly 43/2012
HSBC flash PMI for October finds firms more optimistic about outlook for Chinese economy.
China's foreign currency reserves up slightly.
Rapid rise in incomes continues.
Chinese focus turns to corruption ahead of leadership change.

Unresolved issues likely to try US-China relations in Obama’s second term. Euro crisis drags down growth in Chinese exports; exports to Finland remain robust.

Xi Jinping takes the helm; leadership change holds few surprises. China’s economic growth beat official targets throughout the Hu Jintao era.

No significant shifts in China’s economic policies expected. China’s economy perks up. Little change in China’s current account surplus from 2011, but net capital flows are now outbound.

US stand on China’s exchange rate policy softens. China’s health care costs rising rapidly.

Profitability of industrial firms up 20 % in October from last year. IEA predicts rapid growth in Chinese energy use ahead.

Capital investment and private consumption doing more to support Chinese economic growth, export industries struggle. China and South Korea build on yuan-won swap arrangement to boost bilateral trade. China drops in corruption perception index.

No surprises at Economic Work Conference. Chinese university puts national unemployment rate at 8 %. Record number of patent applications submitted to China’s patent office in 2011.
Russia

Ruble weakened slightly in 2011. At the end of 2011, the value of the ruble against its euro-dollar currency basket was down nearly 4% from the start of the year. Much of the ruble’s depreciation reflected increased uncertainty about the global economy.

The value of the ruble against the currency basket hit its low point last year in early October, when it was 14% below the year’s peak in July. In last months of the year, the ruble regained its value, but was rather volatile.

The Central Bank of Russia continued its policy of increasing exchange rate flexibility by widening the ruble’s fluctuation band against the currency basket, and making it easier to adjust the band. At the end of 2011, one US dollar bought 32.1 rubles and one euro 41.7 rubles.

Ruble exchange rate against currency basket and the CBR’s exchange rate fluctuation band during 2011

Changes planned for state companies. According to an analysis of the federal budget submitted by a group of specialists to the government at the end of December, a total of 1.8 trillion rubles (€43 billion) in subsidies was paid out of the federal budget during 2010 to state-owned enterprises. The amount corresponds to 4% of 2010 GDP. The analysts criticise the scale of subsidies and the fact that much of the money is being used as life-support for otherwise non-viable firms. Furthermore, subsidies reduce the need for state companies to modernise and enhance their efficiency. The analysts proposed lowering the level of support to around 1.5% of GDP.

As recently as 2006, the value of such subsidies was only about 1.7% of GDP. The explosive growth in subsidies coincided with the creation of seven massive state corporations in 2007. State subsidies peaked in the recession year of 2009, when stimulus money was used to boost support to state firms to 5.4% of GDP.

The state corporations created out of Vladimir Putin’s National Champions Initiative include the conglomerate Rostekhnologii with origins in the arms industry, development bank VEB, and Olimpstroi, which is responsible for construction related to the 2014 Sochi Olympics. The new state corporations have been allowed to act quite independently; their activities are not monitored as closely as other state-owned enterprises. Also other state-owned large companies have been established during the past few years, such as OSK (United Shipbuilding Corporation) and OAK (United Aviation Corporation). They merged firms functioning in the same branch in the hope of creating large companies that are both innovative and capable of competing in the international arena.

The economy ministry and the Federal Accounts Chamber have long been critical of state corporations as they lack transparency. An obvious example is the steadily rising costs of Olimpstroi in construction of the Sochi Olympics facilities.

State corporations have expanded by acquisitions on new fields, bringing with it reduced competition and crowding out private firms in the affected branches. Particular criticism has been directed towards Rostekhnologii. In December, president Dmitri Medvedev asked the cabinet to prepare a proposal on how state companies can be made give up firms not related to their core business and how new acquisitions could be restricted.

The finance ministry is preparing a bill that would limit foreign borrowing of state companies. During the 2008 financial crisis, state companies were heavily burdened by their foreign liabilities.

Russian parliament approves expansion of Moscow city limits. The local Dumas of Moscow city and oblast approved already a few weeks earlier the amendments required for the expansion that would integrate some 144,000 hectares of land currently part of the Moscow oblast with the city of Moscow. President Medvedev initially proposed the idea of expanding the Moscow’s city limits last summer. When the change takes effect next July, the City of Moscow will expand to the southwest as far as the border with the Kaluga oblast. The expansion increases the area of Moscow 2.4 times and adds over 200,000 persons to the population. The expansion is expected to ease Moscow’s massive traffic snarls and permit greater housing density. Moscow’s current 11.5 million population is nearly double from the last expansion of the city limits in 1961.

The ambitions of Moscow’s administrators for the expansion area include construction of a world-class financial centre and a science and innovation cluster around the Skolkovo innovation centre. Federal and city administration functions could also be moved to the new area. The area should promote creation of as many as a million new jobs and bring house for two million Moscow residents. The plans would require construction of over 100 million m² of floorspace and significant improvements in transport infrastructure. No specific plans or timetables for the development have yet been released.
China

China prepares for selection of new leadership duo.
China’s president Hu Jintao and premier Wen Jiabao are expected to announce their retirements this autumn. Both the president and premier posts are limited to two consecutive five-year terms and both leaders are reaching the end of their second term. Although the successors to China’s presidency and premiership will in practice be chosen at next autumn’s National Party Congress, the new leaders will not be formally named to their posts until China’s National People’s Congress in spring 2013.

The two most likely successors have long been in the public spotlight; it is generally expected that China’s current vice president Xi Jinping will ascend to the office of president and first vice premier Li Keqiang will become the new premier. Also in China power transitions create internal tensions until the new leadership is finalised. Much of the current tension has to do with the fact that other names than Li are being circulated as alternative candidates for the premiership.

Yuan appreciation pressures abated in late 2011. Over the course of 2011, the yuan appreciated 4.7% against the US dollar and over 8.1% against the euro. Since the dollar peg was abandoned in July 2005, the yuan has appreciated over 31% against the dollar, even though the yuan was repegged to the dollar for almost two years in 2008–2010. The yuan has gained just over 21% against the euro in the past six years.

As of end-November, the nominal effective (trade-weighted) exchange rate had risen nearly 4% from January. The real effective exchange rate was up nearly 5%.

In the second half of 2011, appreciation pressures on the yuan eased. In September and October, the yuan was comparatively cheaper in Hong Kong for buyers with dollars than in mainland China. The price of the yuan also weakened later on in the latter markets. Although the yuan in mainland China again appreciated in late December to a level below 6.3 yuan to the dollar, Hong Kong’s Non-Deliverable Forward Market (NDF) still expects the yuan to weaken slightly over the next 12 months. Notably, last year’s NDF rates failed to predict the recent yuan appreciation, so it is probably premature to state that the current episode of yuan appreciation is over, especially in light of the fact that China’s economic growth continues to outstrip other major economic blocs. However, swings in the yuan exchange rate could widen if the People’s Bank of China increases exchange rate flexibility and expands the yuan’s 0.5% daily fluctuation range.

Increased uncertainty around yuan’s exchange rate can be seen in changes in forex flows. Smaller trade surpluses and euro depreciation reduced China’s foreign currency reserves as measured in US dollars in September. The trend and forecast for the yuan exchange rate suggest net capital inflows to China were small in the fourth quarter with little change expected. In September, China’s gold and foreign currency reserves stood at $3.217 trillion.

Dollar-yuan exchange rate in mainland China and Hong Kong

Chinese stock markets hammered in 2011. Trading volumes on the Shanghai Stock Exchange, China’s largest exchange, were down in 2011 by about 20% from 2010. The Shanghai A-share index lost over 20% of its value last year, while the A-share index of China’s number-two Shenzhen Stock Exchange fell over 30%. Share prices declined in most emerging markets last year, but the drops on Chinese bourses were particularly steep.

The biggest drops affected companies involved in construction, IT and manufacturing. Although non-performing loans in the banking sector are expected to grow in the years ahead and bank shares were in freefall several times last year, only the Bank of China of the four major state banks saw its share price decline (down 10% last year). The share prices of China’s three other major state banks finished the year unchanged.

Performance of MSCI Emerging Markets Index vs. China’s Shanghai A Index and Russia’s RTS Index

Source: Bloomberg
Russia

Foreign strategic investment law continues to evolve. Amendments approved in November to a 2008 law should ease some restrictions on foreign investment in Russia. The “Law on Foreign Investments in Legal Entities of Strategic Importance to the National Defence and State Security of the Russian Federation” identifies “strategic sectors” where foreign investors need approval of a special commission headed by the prime minister if the foreign investor’s holdings in the strategic Russian firm would exceed 50%. The amendments entered into force on December 18, 2011.

The original law required foreign investors seek permission to invest in companies in fields involving e.g. radiation sources or data encryption. With the changes, companies involved in civilian applications of radiation sources (e.g. medical and food processing industries) are no longer considered strategic. Privately owned banks have also been dropped from the list, even if they use encryption technology as a regular part of their operations. Notably, insurance companies using encryption technology are still considered strategic.

Investment in strategic sectors involving natural resources has also been eased. Now foreign private investors only need to petition the Commission on Strategic Investment if the foreign shareholder’s stake would reach at least 25% of the firm. Earlier, the threshold was 10%.

The law imposes greater limits on participation of foreign state-owned firms than private investors. The amendments now ease the regulations in the case of “high-level international financial institutions.” The government will release a list of organisations that is expected to include e.g. the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC).

The status of Russian investors has also improved as commission approval is no longer required if the “foreign” investor is a Russian-owned firm registered abroad. About a third of all the investment applications submitted to the commission have been foreign-registered Russian firms.

In its three years of operation, the commission overseeing investment in strategic sectors by foreign investors has processed a total of 136 applications. Eight applications were rejected.

Turkey grants Gazprom permission for construction of South Stream gas pipeline in its territorial waters. Gazprom chairman Alexei Miller reports that Turkey has granted the necessary permits for construction of the South Stream undersea pipeline. Construction should begin within the next 12 months. The pipeline, which is jointly owned by Gazprom, Italy’s Eni, France’s EDF and Germany’s Wintershall, will run from the Russian Black Sea coast across the seabed, emerging in the Bulgarian town of Varna. From there it will continue further to various European countries. Gas transmission is expected to begin in late 2015 and full transmission capacity of 63 billion m³ a year will be reached in 2018.

Gazprom says the purpose of South Stream (like North Stream, which opened last November) is to increase the number of routes for Russian gas supplies to Europe. At the moment, about 80% of Gazprom’s shipments to Europe transit Ukraine and most of the rest through Belarus. In recent years, Gazprom has encountered problems with transit shipping through Ukraine and Belarus due to pricing disputes. The problem was settled with Belarus last year as Gazprom acquired the Belarus national pipeline operator Beltransgaz as part of a deal guaranteeing Belarus could purchase gas at discount for the next three years. Gazprom has sought for years to buy itself also into the Ukraine’s gas pipeline monopoly Naftogaz e.g. by offering in exchange to supply Ukraine with gas at a lower price, but there has yet to be an agreement.

In a conversation with prime minister Vladimir Putin late last year, Miller noted construction of the South Stream pipeline was cheaper for Gazprom than continuing to transport gas through Ukraine given the price Ukraine requires from Naftogaz ownership, the existing gas network’s need for repair and Ukraine’s demands for gas discounts. Putin, nevertheless, encouraged Gazprom to keep negotiating with Ukraine as it is a strategic partner of Russia. Putin said Ukraine’s pipeline transmission capacity will be needed as European demand for gas continues to rise, especially as some countries are currently phasing out nuclear energy.

Operation of the South Stream pipeline could be problematic for Gazprom in light of the EU’s “Third Energy Package.” The new legislation calls for an open gas distribution grid, which may require that Gazprom make available some of its transmission capacity to other gas producers. Gazprom has sought (so far unsuccessfully) to get a special exemption status for South Stream and above-ground sections of the North Stream pipeline.

The EU is planning its own Nabucco pipeline to compete with the South Stream pipeline. It would bring gas from Central Asia and the Middle East to Europe.

Gazprom’s planned gas supplies for Europe and pipeline transmission capacity, billion m³

| Gazprom’s agreed supply contracts for 2020–2025 | 158 |
| Transmission capacity via Ukraine | 143 |
| Transmission capacity via Belarus | 35 |
| Transmission capacity to Finland | 7 |
| Blue Stream (to Turkey), transmission capacity | 16 |
| North Stream (operational), full capacity by 2015 | 55 |
| South Stream (planned), full capacity by 2018 | 63 |
| Total transmission capacity | 319 |

Source: East European Gas Analysis
China

China’s leadership contemplates financial sector reforms. An official press release from the two-day National Financial Work Conference this week in Beijing reveals that reform of the financial sector is both important and a source of great tension. China’s monetary policy will be shifted to support growth as global demand weakens. Liberalisation of capital movements, promotion of international acceptance of the yuan and reforms in the financial sector will be continued to secure long run economic growth. However, any changes will be made in cautious steps so as to maintain stability. Competition in the banking sector will be increased by allowing greater private and foreign ownership. Supervision of the financial sector will be tightened and prudent bank risk monitoring strengthened. The vision laid out by China’s leaders incorporates specific proposals included last autumn in the IMF’s assessment for China under its Financial Sector Assessment Programme (FSAP).

Some details of the reforms were included in the plan of the China Securities Regulatory Commission (CSRC). The near-term objective of the CSRC is development of China’s relatively small bond markets to improve corporate access to financing by e.g. the elimination of some bureaucracy related to arranging bond issues. Opportunities for foreign investors to participate in Chinese stock markets will be increased by raising investment quotas under the Qualified Foreign Institutional Investor (QFII) programme. The CSRC also approved a plan by Citigroup and Chinese investors to establish a jointly owned investment bank in China.

China seeks to attract more high-tech foreign production. At the end of 2011, China’s National Development and Reform Commission (NDRC) and the Ministry of Commerce released a new list of foreign investment targets in China. The list serves as a tool for guiding foreign investment flows. Production branches on the list are divided into forbidden, limited and promoted branches.

The new list supports investment in high-tech and high value-added branches such as the advanced textile and chemicals industries, machinery & equipment, as well as services, biotechnology and recycling. Certain branches that were earlier limited are now opened up to foreign investors. In addition, there is an effort to reduce investment in fields with high labour intensity, high raw-material intensity or business based on traditional technologies. For example, investment in the traditional car industry producing combustion-engine vehicles will no longer be promoted, but investment in production of electric or hybrid vehicles will continue be promoted. The changes go into effect on January 30. The list was last overhauled in 2007, but is fine-tuned every year.

Inflation unchanged in December. The National Bureau of Statistics reports that consumer prices rose 4.1 % y-o-y in December, down slightly from 4.2 % in November. Although inflation was essentially unchanged from November, upward pressure on prices has eased. The inflation rate is expected to fall in the first half of 2012.

China’s foreign trade surplus shrank in 2011. China exported goods worth nearly $1.9 trillion last year, an increase of 20 % from 2010. The value of imports increased by 25 % to $1.74 trillion, reducing the goods trade surplus to $155 billion from $185 billion in 2010. China’s goods trade surplus peaked in 2008 at nearly $300 billion.

The trade volume figures confirm the general view of slowing growth in foreign trade. In 2010, the volume of Chinese exports rose 30 % and imports 24 %. Figures for the first eleven months of 2011 show export and import volumes each grew about 10 %. The fade in export growth in the second half of last year largely reflects problems in China’s export markets. It is also evident that growth in China’s productivity is no longer as sufficient as before to offset rapidly rising costs. The lack of adequate productivity gains compared to cost increases is also moderating export growth. Although growth in imports has slowed somewhat after a strong stimulus-fuelled episode, the current pace of economic growth continues to be sustained by robust growth in domestic demand and increased purchasing power. The yuan’s real effective exchange rate appreciated nearly 5 % last year.

Growth in China’s exports to Europe, its largest export market, has slowed sharply. As a result, the EU’s share of China’s total exports fell below 18 % in December. While growth in exports to the US has also decelerated, it did not face similar problems as exports to the EU last year. The US’s share of exports is now almost on par with the EU, and Japan’s share of China’s exports is 8 %.

In 2011, the EU accounted for about 12 % of China’s imports, Japan 11 % and the United States 7 %.

China’s foreign trade

Source: Bloomberg
Russia

Inflation rate in 2011 drops to post-Soviet low. Consumer price inflation eased to 6.1% in 2011, the lowest inflation level in recent history. Russia struggled with high inflation after the breakup of the Soviet Union. It was only in 2009 that inflation was wrestled to levels below 10% p.a. on a more sustained basis.

Last year’s low inflation trend was produced by a combination of factors, including a slowdown in growth of the money supply due in part to increased capital exports and a federal budget surplus that meant the government did not have to dip into its reserves. A third factor was the slowdown in the rise of food prices, which spiked sharply in the wake of the 2010 drought and small grain harvest. Hikes in regulated rates for municipal housing services such as gas, water, electricity and heating sustain inflation year after year. Prices for municipal housing services rose rapidly again last year, with overall hikes reaching 12%.

The economy ministry forecasts that inflation will remain subdued this year in the range of 5–6%.

Federal budget produced unexpected surplus last year.
Preliminary finance ministry figures show a federal budget surplus of 414 billion rubles (€10 billion), or about 1% of GDP. The original 2011 budget plan anticipated a deficit of nearly 4% of GDP, but high oil prices boosted tax revenues to levels well above the budget forecast. The price of Urals-grade crude averaged $109.50 a barrel last year, well above the budget assumption of $75 a barrel.

At the end of last year, assets in the off-budget Reserve Fund amounted to 812 billion rubles (€20 billion) and the National Welfare Fund 2.8 trillion rubles (about €70 billion). Both funds have largely built up from fees and taxes on production and exports of oil in times of high crude prices. Money from the Reserve Fund was used to cover federal budget deficits in 2009 and 2010. The Reserve Fund reached its peak of 4.9 trillion rubles (about €120 billion) in spring 2009. The National Welfare Fund is a sovereign wealth fund intended to be held in trust to cover future pensions commitments under the reformed pension system. This year’s federal budget assumes an average Urals oil price of $100 a barrel. Even at this oil price, however, the budget is in the red. The projected deficit for 2012 is 876 billion rubles (€22 billion), or 1.5% of GDP.

Widening investigation of firms registered in tax havens. Russian officials have shown increasing interest recently in Russian firms registered abroad. The problem was highlighted in the aftermath of last January’s terror attack at Moscow’s Domodedovo International Airport. When the Prosecutor General’s Office began its investigation, it found it difficult to identify the airport’s owners as it is operated through shell companies registered in tax havens. The Prosecutor General’s Office is now demanding critical transportation infrastructure be held by identifiable owners domiciled in Russia.

The practice of Russian firms operating through front companies registered in an off-shore tax haven is widespread. It affects nearly all branches and some of Russia’s biggest companies such as steelmaker Severstal, Evraz Group and aluminium giant Rusal. Ownership arrangements have typically been arranged via Cyprus-registered firms, but Russian firms are also often registered in the Bahamas, the Cayman Islands, the Virgin Islands, Jersey, the Isle of Man, Luxembourg and the Netherlands. A major reason for off-shoring firms is to minimise tax obligations.

In December, prime minister Vladimir Putin chastised electrical power distributors for operating their businesses through non-Russian companies that are often used to transfer assets out of Russia. Putin gave particular attention to the most important retail sellers of electricity, i.e. the so-called guaranteeing suppliers. A working group under the government has been charged with investigating the possibility of compelling such utilities to move their domiciles to Russia.

Putin also declared that examination of similar arrangements is needed for the whole infrastructure sector and for firms with state ownership such as Gazprom, oil pipeline operator Transneft, Russian Railways, the Sovkomflot shipping company and state banks. Ministries have two months to make their report. Putin said the ownership arrangements of Russian firms speak to the lack of development of Russia’s business environment and that international firms complain that their business with Russian firms is hampered by uncertainty over who they are actually dealing with.

In November, a Russian arbitration court vacated a lower court ruling, finding that the interest paid on a loan from a foreign shareholder should be treated as taxable dividends. The ruling sets a remarkable precedent as borrowing from an affiliate based in tax havens is a common practice.
China

Chinese economic growth dropped below 9 % p.a. in the fourth quarter of 2011. China’s real GDP growth for all of 2011 was 9.2 %, down from 10.4 % in 2010. The value of economic output rose to nearly 47.2 trillion yuan (€5.2 trillion or $7.3 trillion). In 2010, China surpassed Japan as the world’s second largest economy. In nominal terms, however, US GDP last year was still more than double that of China.

China’s growth slowed in the second half. In the last quarter of 2011, growth dipped below 9 % y-o-y. Seasonally adjusted quarterly growth fell from 2.3 % q-o-q in the third quarter to 2.0 % in the fourth quarter. China’s growth is still robust by international standards even with the modest slowdown. Growth this year is generally expected to be slightly lower than in 2011.

The overall production structure of the economy has not changed in recent years. Industry, manufacturing and construction account for about 47 % of GDP, services 43 %, and agriculture and other primary production 10 %. Macro demand-side data have yet to be released, but China’s brisk investment pace appears to be slowing somewhat.

On-year growth of Chinese GDP, %

Chinese incomes continue to rise rapidly. The National Bureau of Statistics reports monthly disposable incomes of urban households averaged 1,800 yuan (€200) last year. Incomes rose in real terms more than 8 % y-o-y, essentially matching GDP growth. While household incomes in the countryside (580 yuan a month) remained only about a third of disposable incomes of city-dwellers, the pace of growth in rural incomes (up over 11 % in real terms) was substantially higher than in cities. Income disparity between the countryside and cities has encouraged migration to cities. Official figures last year showed that for first time ever, the population of Chinese cities outnumbered the rural popula-

China’s foreign currency reserves fell in the fourth quarter of 2011. For all of 2011, China’s gold and foreign currency reserves rose by $330 billion to $3.18 trillion. In the fourth quarter of 2011, however, the value of its reserves declined by about $20 billion. The last time China’s foreign currency reserves showed a quarterly drop was during the Asian financial crisis in 1998.

The immediate cause of the decline in the foreign currency reserves appears to be the drop in the value of the euro towards the end of the year. The shift appears in the dollar valuations of euro-denominated assets. Contraction of reserves also reflected a rebalancing in actual flows of goods, services and money between China and the rest of the world. This view is bolstered by evidence of China’s shrinking trade surplus and lower pressure for yuan appreciation in recent months. Looking ahead, analysts will pay special attention to how the increased use of the yuan in international trade affects the size of China’s currency reserves.

China’s gold and foreign currency reserves, USD billion

Source: Bloomberg
Russia

Russia posts big current account surplus for 2011. Preliminary Central Bank of Russia figures show a 2011 current account surplus of $101 billion, which corresponds to about 5.5% of GDP. The trade surplus for goods climbed to $198 billion (11% of GDP). The last time such a large surplus was seen was before the crisis in 2008. The services trade deficit was similar to 2010, around 2% of GDP.

Other entries on the current account showed a deficit of nearly 3.5% of GDP (same as 2009–2010) as interest on loans and dividends to foreign investors continued to rise.

Income from exports of goods and services continued to soar as in 2010, up nearly 30% to $576 billion. Earnings from exports of crude oil, petroleum products and natural gas were up about a third from 2010 and other export earnings by nearly 25%. The growth in export earnings largely reflects higher oil and gas prices; oil export volumes fell last year.

Exports of goods and services rose to nearly 32% of GDP, while the share of oil & gas in goods and services exports revenues climbed to 59%. The dependence of the Russian economy on energy export income was back to the pre-crisis level of 2008.

Exports, imports, current account balance and net capital flows to private sector (% of GDP, 4-quarter moving average)

The value of imports of goods and services rose 29% to $415 billion. The value of imports equaled nearly 23% of GDP, its highest level since 2003. The share of services in spending on imports remained around 20% (spending on services includes tourism, which largely consists of spending of Russian travellers on goods and services abroad).

Capital exports up in 2011. Preliminary CBR information indicates net capital outflows last year amounted to $88 billion, or over 4.5% of GDP. The outflow was driven almost entirely by the private sector, and nearly $60 billion was exported in the second half of 2011. Non-bank companies had capital exports of over $100 billion. Of that, some $70 billion went to direct investment (up from just over $50 billion in 2010). The CBR estimates grey capital exports reached over $40 billion. Grey capital exports include tax evasion schemes.

Almost $60 billion in capital came from abroad to the corporate sector. Foreign direct investment in the non-bank corporate sector amounted to $49 billion, up from $38 billion in 2010 but well below the 2008 record of $65 billion. A large share of direct investment comes from foreign-registered Russian firms channelling capital back home.

After two slow years, borrowing of Russian firms recovered to $15 billion. The amount was still far below pre-crisis levels of 2007–2008, however.

No change in Russia’s creditworthiness rating. Fitch conducted its latest creditworthiness assessment of the Russian Federation a couple of weeks ago. It left unchanged Russia’s long-term sovereign debt at BBB (mid-investment grade), but lowered its outlook for the country from positive to stable. The change in outlook was based on rising political uncertainty in the country and a gloomy outlook for the world economy. Fitch has held its sovereign rating for Russia at BBB since February 2009. Standard & Poor’s and Moody’s have held their ratings for Russia at BBB and Baa1, respectively, since the second half of 2008.

According to Fitch Russia’s credit rating is supported by its relatively strong public finances. The Russian state is one of the world’s least indebted; Russia’s public debt is just slightly over 10% of GDP. Russia’s public finances showed a slight surplus last year and the state has an additional buffer from savings in off-budget reserve funds. The trend in Russia’s public finances, however, is subject to large swings as budget revenues are dependent on oil prices.

Public debt of select countries in 2010 (% of GDP) with current long-term sovereign credit ratings
China

FDI outflows from China unchanged in 2011. The Ministry of Trade reports that foreign direct investment outflows from China last year remained virtually unchanged from the 2010 level of $60 billion. The numbers do not include financial sector capital investment, which shrank in the first nine months of 2011 to $4 billion, down about $1 billion from in the same period in 2010.

In addition to the traditional focus of China’s foreign investments on the raw material sector and investment in its Asian neighbours, investment in Europe appears to be taking off. China’s state-owned Three Gorges Corporation has agreed to purchase in April a stake of just over 20% in Energias de Portugal from the Portuguese state for €2.7 billion. This month, the Chinese spent nearly €400 million to acquire a 75% stake in Italian luxury yacht-maker Ferretti. This week, Chinese telecoms giant Huawei penned a deal with the British state to purchase British Telecom’s former lab facilities, the Centre for Integrated Photonics (CIP).

FDI inflows to China hit new record last year. Even with global uncertainty and China’s soaring production costs, foreign direct investment inflows into the country surged to record levels. The Ministry of Commerce reports that FDI inflows to China totalled $116 billion, about $10 billion more than in 2010. China last year reinforced its position as the world’s second largest recipient of FDI after the United States. According to UN estimates, global FDI flows last year were about $1.5 trillion.

The lion’s share of investment inflow to China came from countries in Asia. For years, Hong Kong has been the top source of FDI inflows and its significance continues to grow. Just five years ago, Hong Kong accounted for about 30% of China’s FDI inflows. Last year, that share had climbed to more than 60%. 15% of investments came from elsewhere in Asia, 6% from Europe and 3% from the United States. The share of investment inflows from tax havens has fallen in recent years, but was still well above 10%. Hong Kong’s dominant role as an FDI provider is explained by the region’s special status and the fact that keeping FDI statistics has become ever more challenging in globalised world.

The share of direct investment to joint enterprises has fallen steadily in recent years, with FDI instead increasingly going to firms that are 100% foreign owned. Manufacturing remains the investment emphasis for China, where the share of FDI inflows has remained at nearly 50% for several years. Investment in China’s real estate sector has accounted for about a fifth of FDI inflows in recent years.

Investments in the service sector, as well as wholesale and retail sales have grown quite rapidly in recent years; their shares of FDI last year was in the range of 7–8%.

Direct investment flows to and from China, US$ billion.

Rails move bulk of Chinese New Year celebrants. The estimated number of rail travellers for a single day hit six million last Friday as the Chinese travelled to celebrate Lunar New Year. China’s 91,000-kilometre railway network now carries about two billion passengers a year and one-and-a-half billion metric tons of freight (about 5% of passenger traffic and 10% of freight traffic). Compared to European rail use, Chinese typically take longer rail journeys and their trains are usually packed. A number of international assessments have found Chinese rail to be relatively efficient and safe. The high-speed bullet train system has become a major symbol of China’s rapid technological development.

Year 2011 was exceptionally difficult for Chinese rail. At the start of the year, the railways minister was sacked for corruption and bullet train speeds were lowered to improve safety. Upgrading China’s railways, which have traditionally been funded through ticket sales and freight fees, has become so expensive that a large part of new investment is now funded through bond issues and other borrowing. The indebtedness of the railways ministry last summer topped 2 trillion yuan, an amount equivalent to 5% of GDP.

In its December assessment, the World Bank noted that many of the problems with the Chinese rail system stem from its outdated administrative structure. Unlike in most countries, the planning, operation and oversight of the rail system is concentrated entirely under a single authority – the railways ministry. The World Bank report suggested that separating planning and supervision from operations would help China meet its growing challenges. The government this week announced it was transferring its special-jurisdiction railway transport courts from the railways ministry to provincial administrations by end-June.

The information is compiled and edited from a variety of sources.
The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.
Russia


Private consumption climbed 6.5 %, a higher pace of growth than a year ago. Real disposable household incomes grew only slightly, although the trend improved with inflation falling towards the end of the year. Consumption growth was encouraged by household borrowing from banks.

Fixed capital investment rose 6 %, which corresponds to the 2010 pace. The share of investment in GDP was about a fifth, with is little taking into consideration the country’s huge investment needs.

The recovery of agriculture from the 2010 drought and crop failures exceeded expectations; farm production was up about 20 % due to this year’s bumper harvest.

Output of value-added industries continued to rebound from the recession at a 6.5 % y-o-y rate. Growth in extractive industries (including gas & oil) decelerated to less than 1 %, with crude oil production up less than 1 %. Natural gas production increased 3 % and electricity production 1.5 %. Construction and trade rose 5 %.

GDP, demand-side factors and import volume, % change

Source: Rosstat

Export volume growth slowed to about 1 % last year as exports of oil and petroleum products contracted. Import volume increased over 20 % y-o-y, returning to near 2008 pre-crisis levels at the end of the year.

Credit growth soared last year. The total assets of the banking sector at the end of 2011 were up nearly 25 % from a year earlier, to about 42 trillion rubles (€1 trillion). Growth was highest for the big banks.

The rate of credit growth was particularly high, 28 % y-o-y. The stock of loans to households increased 36 % y-o-y, a growth rate seen already as too high by the Central Bank of Russia. The stock of corporate loans increased 26 %. The stock of non-performing loans remained basically unchanged throughout 2011.

Although the growth of household deposits slowed last year from the previous year, growth was still brisk and supported banking sector expansion. Deposits were up 21 % due largely to increasing deposit rates.

The total profits of the banking sector climbed to a record 48 % last year, or to about 850 billion rubles (€21 billion). Sberbank, Russia’s largest bank, accounted for 38 % of the sector’s profits, even if it accounted for 26 % of total assets. The profits were largely the result of the release of money tied up as reserves created in 2008 and 2009 to deal with credit losses.

At the end of 2011, 978 banks operated in Russia, a decline of 34 from end-2010. Due to the hike in capital requirements at the beginning of this year, the CBR withdrew the licences of seven banks with own capital below the 180-million-ruble minimum (4.5 million euro). In January 2011, there were 185 banks that could not meet this minimum.

Prime minister Putin stresses the importance of private enterprise and role of state firms in policy comments. In an article published in the leading Russian daily Vedomosti on Monday (Jan. 30), prime minister Vladimir Putin said Russia needs a new economic model with diversified economy and advanced technologies. In his comments, the prime minister mainly covered familiar themes on the goals and methods for achieving change, but gave slightly more emphasis to the importance of competition and international openness.

Putin said diversification of the economy would require private capital and that the main way to attract investment was to improve Russia’s business environment. Putin focused on deficiencies of the court system and the systematic corruption of Russian society. Growing internal markets through the customs union and the Eurasian economic space should also bring in investors. As a means to increase domestic financing, Putin recommended improving the transmission of household savings to long-term financing through pension funds.

Putin called stabilisation of macroeconomic conditions the biggest achievement for the Russian economy in recent years. He emphasised fiscal balance by e.g. cutting costs and improving state efficiency (e.g. increasing transparency of state procurements) and balancing the pension system. He said no cuts were planned for social services, education, health care, or military spending.

Putin stated that the role of state-owned enterprises in the economy should be reduced, but reminded on their important role in modernisation according to, say, Chinese or South Korean examples. He suggested stakes in state companies would be divested gradually as market conditions improve. Putin named non-core activities of state companies as a good starting point to trim away.
China

Global economic conditions hurting outlook for Chinese growth. According to the official purchasing managers index (PMI) compiled by the China Federation of Logistics and Purchasing, the outlook is fairly flat for Chinese manufacturing in coming months. The official January PMI was 50.5, while the competing PMI published by Hong-Kong-based HSBC stood at 48.8. Neither reading showed much change from December. Readings above the 50-point mark indicate that purchasing managers expect improved business conditions ahead, while readings below 50 indicate a deteriorating outlook.

The current backlog on manufacturing order books suggests export demand continued to fall in January, but an increase in domestic orders in part offset that drop in demand. Imports also appeared to decline, reflecting a reduced need for components in value-added industries caused by the lower demand for exports of finished goods. The data does not warrant strong conclusions about changes in the Chinese economic situation since the two PMIs gave slightly conflicting pictures of sentiment and did not indicate any significant changes.

The week-long Chinese New Year holiday fell in January this year, so estimating the economic trends for the start of the year is difficult. However, worker behaviour following the New Year’s vacation and return to the daily grind provides valuable insight into the Chinese economy and labour market conditions. The South China Morning Post reports that, in many Shenzhen textile firms this year, the number of workers who failed to show up for work after the holidays was much higher than last year. This was despite the fact that the city’s minimum wage was increased at the beginning of February by nearly 14 % to around 1,500 yuan (€180).

Wider evidence of the phenomenon could signal a tightening in the labour market and would mean that businesses using a cheap-labour model would have to move production elsewhere in China or to neighbouring low-cost-labour countries in Asia.

Chinese authorities announce new stimulus packages. The People’s Bank of China last week increased bank liquidity through exceptionally heavy financial market interventions. This week, the government announced it is supporting operation of small and medium-sized businesses through the creation of a 15 billion yuan (US$ 2.4 billion) fund. The SMEs were also promised tax breaks. In addition, the government will instruct banks to be lenient towards small firms struggling temporarily with debt servicing problems.

China’s restrictions on exports of rare earth metals found to violate WTO rules. While the matter of Chinese quotas on rare earth elements (REEs) had been decided by a panel last summer, the ruling of WTO’s highest tribunal this week simply reiterated the lower tribunal’s earlier findings. China’s Ministry of Trade argued that the imposition of quotas was needed to protect the environment as rare earth extraction and refining requires massive amounts of energy and generate radioactive byproducts that are quite damaging to the environment. China also wanted to use the quotas to influence metal prices and encourage foreign companies to move their production to China. Most of China’s REE production is based in Inner Mongolia.

China’s Ministry of Trade announced in December new export quotas for the coming year. The basic goal is to keep quotas for individual metals roughly at the same level as in 2011. Officials have also intervened with a heavy hand in operations of companies producing REEs and consolidation of the industry is expected. Following the WTO ruling, China must adjust its policies. It is now seeking ways to maintain restrictions within the constraints of its WTO commitments.

The concern in other countries about China’s export quotas reflects the fact that REEs are crucial to many 21st century technologies, from consumer electronics, x-ray and magnetic resonance scanning to wind turbines, advanced batteries, and production of special glass and lasers. Several REEs are mined solely in China at the moment, so export quotas are quite problematic for high-tech companies outside China. World market prices for many REEs have skyrocketed due to China’s actions.

The rise in prices has accelerated REE mining projects around the world, but progress is slow due to environmental problems. The most advanced and largest REE mining operation project is currently led by the Australian Lynas, which hopes to site its concentration plant in Malaysian coastal wetlands. The Lynas project is now nearing the final stages of official approval, but still needs a go-ahead from legislators. The project has raised opposition from indigenous populations due to the environmental impacts.

Price trends for select rare earth metals

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Source: Bloomberg
Russia

CBR reorganises banking supervision to improve effectiveness. The Central Bank of Russia’s Banking Regulation and Supervision Department, which is responsible for drafting bank regulations and bank inspections, is divided into two separate departments; one for regulation and the other for inspection and supervision. Russian banking regulation is planned to be brought closer to international practice which should lead to relaxation of regulations in some cases. For example, the risk ratings for certain types of bank loans are currently stricter than in other countries, weakening the competitiveness of Russian banks.

Banking supervision will be strengthened and it will focus especially on Russia’s larger banks in response to banking abuses that came to light over the past two years. Supervision of big banks will be centralized to CBR headquarters in Moscow. Previously, banks have been supervised by the CBR’s regional offices. Some observers note the concentration of supervisory functions could reduce the impact of close relations of regional offices and banks on supervision.

In the wake of the federal government’s nearly 300 billion ruble (€7.5 billion) bailout of Bank Moskvy last year, the CBR has increased supervision of banks partly owned by local governments, placing particular scrutiny on bank lending to owners. The problems of Bank Moskvy, which was partly owned by the City of Moscow, came to light after a shakeup in Moscow city leadership in late 2010.

The CBR has also decided to ease rules for foreign-owned banks seeking to establish Russian branch offices. Foreign banks currently need CBR permission to establish a branch. After the change, it will be sufficient for a foreign bank to declare its plans to the CBR. The change conforms to Russia’s WTO commitments on giving equal treatment to foreign entities and domestic enterprises (with certain exceptions). Foreign-owned banks have opened only a few branches in Russia in recent years.

Financial sector’s tight liquidity situation persists. In the first half of 2011, Russia’s financial sector enjoyed a good liquidity situation. Since autumn, however, liquidity has tightened and according to CBR renewed loosening is not in sight.

Part of the reason for the situation has been a gradual shift in Russian foreign exchange policy that has been underway since the 2009 financial crisis. The CBR is today more willing to let supply and demand establish the ruble’s exchange rate, and no longer intervenes as extensively to curb ruble appreciation. Hence the excess ruble liquidity in domestic market has diminished. A second factor is the underdevelopment of Russia’s financial sector which leads to Russian banks being relatively more dependent on foreign borrowing in their funding. Tighter credit on international financial markets has reduced the supply of funding flowing to emerging markets like Russia, which in turn has made access to borrowing on international markets harder for Russian banks.

Banks have recently sharply boosted their deposit rates in order to compete for deposit funding. The big state banks VTB and Sberbank started to offer higher interest rates last autumn and they were followed by mid-sized banks offering even better deals. The CBR is concerned about rate increases and considers deposit interests exceeding 10 % p.a. too high.

The CBR is also worried about last year’s exceptionally rapid growth in borrowing by households. The CBR has warned banks against excessive lending and the current aggressive marketing approaches used by some banks to push credit. The CBR emphasized that banks have social responsibilities and are obliged to determine the real ability of borrowers to repay loans.

Last week’s CBR board meeting finds no reasons to adjust rates. The February 3 decision is based on risk assessment of inflation pressures and slowing economic growth, as well as the development of international economic conditions.

Consumer prices were up just 4.1 % y-o-y in January. The CBR expects price growth to accelerate during this year, bringing the inflation rate up to the range of 5–6 % by year’s end. At the end of 2011, inflation was 6.1 %. Inflation was exceptionally low for January as this year’s scheduled hikes in regulated rates of municipal services were postponed until summer. Typically, rates for municipal services are raised at the start of the year and have a substantial impact on the inflation rate.

The CBR’s one-day repo credit rate remains at 6.25 % and the one-day deposit rate at 4 %. The CBR said that the liquidity situation of the financial sector is not alarmingly tight, and gave assurances that it would continue to conduct market operations and provide commercial banks with adequate access to funds. While interbank rates fluctuated sharply in January, they remain relatively high.

One-day MosPrime rate, %

Source: CBR
China

Productivity gains key to Chinese economic growth. The American research institution, The Conference Board, in January published its annual brief on productivity trends across countries. This year’s report finds that growth in labour productivity slowed globally last year, with the global average in output per worker employed up just 2.5%. Employment growth was up a mere 1.4% in 2011, so productivity growth accounted for nearly two-thirds of the global GDP growth of 3.9% in 2011. Regional differences, however, were huge. Employment growth was the main driver of productivity gains in Africa, the Middle East and Latin America, while the lion’s share of GDP growth elsewhere mainly came from productivity gains.

China, which posted the highest productivity growth of any major country, 8.8% last year, nevertheless saw a slowdown of over one percentage point from 2010. The Conference Board this year expects China’s productivity growth to slow to 7.6%. Even if China’s employment growth is a mere 0.3%, the Conference Board expects China’s GDP growth to reach about 8% this year. In India, where the growth in the size of the labour force increased over 2% last year, most of last year’s approximately 7.5% GDP growth came from productivity gains.

The breakdown in the main sources of Chinese growth show that the growth driven by labour productivity has been founded on massive investment in traditional production. According to Conference Board estimates, about six percentage points of China’s 10% GDP growth in 2010 came from increased capital investment, under one percentage point from IT investment, and about two percentage points from the increase labour force growth and improvements in quality. The remaining three percentage points came from increased total factor productivity, which measures how effectively inputs such as labour and machinery are utilised. Good overall productivity is seen as the result of economic structural reforms and an ability to innovate. The Conference Board offered sobering evidence that total factor productivity in the Euro Area has been close to zero for most of the past decade.

Although productivity growth is soaring in Asia, several countries still lag far behind the global productivity leaders. If productivity is measured in terms of a purchasing power parity adjusted GDP per worker, and the United States is assigned a value of 100, China’s productivity level is just 16 at the moment. A decade ago, the productivity of a Chinese worker was only 7% of an American worker’s productivity. Labour productivity in India is still below 9% of the US level. On the other hand, labour productivity is 79% of US productivity in Taiwan and 89% in Hong Kong.

Both countries currently match productivity of the best performers in Western Europe.

The low overall productivity of China stems from its labour-intensive, low-tech agricultural sector. Farming employs a huge share of the labour force, yet agriculture on makes a small contribution to GDP. China also is plagued with problems in collecting and reporting output and labour statistics. Any productivity comparisons should only be taken as rough indicators. In advanced countries, estimates of labour productivity are generally based on hours worked per unit of output. In other countries, statisticians have to use a rougher output-per-worker measure.

China grants licence to first foreign credit card issuer. Citibank announced this week that Chinese officials have given the green light to its credit card project. Progress in rolling out credit cards has been closely followed internationally as the WTO is currently considering a complaint filed by the US on China’s restrictions on foreign credit cards. The US complaint concerns a demand by Chinese officials whereby credit card issuers have to execute payments through the China UnionPay Co. (UniPay). According to media reports, transactions on Citibank credit cards would also have to go through UniPay.

Over two billion bank cards had been issued in China as of last September. Most of those cards are debit cards; just over 200 million were credit cards. The number of issued credit cards grew about 20% last year.

Taiwan’s China-friendly president keeps his job. Taiwan’s presidential elections held in mid-January were won by incumbent Ma Ying-jou, who leads the pro-normalisation Kuomintang Party. The president’s margin of victory was clearly smaller than in the previous election, suggesting the pro-China approach is losing favour in the island nation. Despite lower support, Ma announced that he remained committed to promoting economic cooperation with the mainland. Both China and the United States said they were satisfied with the election outcome. Since Ma took office in early 2008, relations between mainland China and Taiwan have warmed substantially. Changes in recent years include an easing of direct flights and ferry trips to and from the mainland, the reduction or elimination of certain duties and increased investment opportunities.

Taiwan’s economy grew 4% last year. The country’s strongly export-driven growth, however, began to slow towards the end of the year as the global economic conditions deteriorated. The value of Taiwan’s exports fell three months in a row after October. However, Mainland China’s strong growth gives Taiwan a cushion against weakness in the rest of the global economy, and Taiwan’s growth is expected to remain this year slightly lower than last year. Nearly 30% of Taiwan’s exports go to mainland China.
Russia

Wholesale and retail trade sector attracts most foreign direct investment. Central Bank of Russia figures show foreign direct investment inflows to Russia during the first nine months of 2011 amounted to $38 billion. In the same period in 2010, FDI inflows were $27 billion. The 1-3Q inflow peaked in 2008 at $62 billion.

Wholesale and retail sales accounted for an impressive 36 % of total FDI. The next biggest receiver was the financial and insurance sector with 17 % of FDI. Some 13 % went to manufacturing, especially the food industry.

The latest available figures for total accumulated FDI are from 2010, when the stock of FDI received by Russia amounted to $493 billion. Nearly 80 % of investment came from countries considered tax havens or other providers of favourable tax treatment. In other words, most of this FDI is of Russian origin. The stock of Russian FDI abroad stood at $369 billion. Nearly 80 % of investment flowing out of Russia was also destined for tax haven countries.

Recovery of domestic demand continued at regional level in 2011. Retail sales, which represent about 70 % of private consumption, were up in Russia’s regions by some 6–8 % last year, a level of growth roughly on par with 2010. Slower growth only occurred in the Far East Federal District. For Russia’s largest urban centres, retail sales in Moscow rose nearly 7 %, while in St. Petersburg they were up just 4 %. In nearly all regions and major cities, retail sales now well exceed pre-crisis 2008 levels. The Central Federal District, the most populous of all Russia’s federal districts, accounted for an impressive 36 % of total retail sales, while the Urals Federal District, where recovery has been slow, in- ...

Industrial output was up on average 5–7 % in regions in the European part of Russia (with the exception of North Caucasus). Regions east of the Urals experienced lower growth in industrial output. With the exceptions of Moscow and the Urals Federal District, where recovery has been slow, industrial output nationally exceeded 2008 pre-crisis levels substantially.

State-owned VTB Bank to reimburse shareholders for lost value. At an investor forum in Moscow at the start of the month, prime minister Vladimir Putin told VTB Bank to buy back shares it sold in its notorious 2007 IPO. Small investors, in particular, were hurt by severe losses after VTB’s share price tanked. The prime minister’s instruction came as a surprise to VTB’s management, although there had been discussions at the bank on possible ways of compensating small investors for their losses.

VTB shares premiered in their 2007 IPO at a price of 13.6 kopeks per share, only to be battered down to levels of some 2 kopeks in the wake of the 2008 financial collapse. Recently VTB shares have traded at around 7 kopeks.

After the listing, the Russian state’s ownership stake in VTB dropped to 75.5 %. The VTB IPO was the world’s largest stock market float in 2007, raising about $8 billion. In order to make the IPO really “national,” the state dropped the minimum investment required to 30,000 rubles (about €800). As a result, the IPO brought in about 120,000 Russia investors.

The shares will be purchased back at their original issue price. Each shareholder is entitled to a maximum buy-back of shares worth 500,000 rubles. This cut-off point allows the lion’s share of small investors (105,000) get back the full price of their investment. The share buy-back should shave less than 1 % off of VTB’s market capital and is expected to take place this spring.
China

Pension issues worry the Chinese. The number-one concern in a recent People’s Daily reader survey was that the government should focus more attention on social security reform. For the past two years, social security – and especially reform of the current pension scheme – has emerged as a major concern for Chinese. Financial security in old age is a pressing issue for the greying population. It is estimated that the share of the population over 65 will rise from 10 % today to nearly 20 % by 2040.

A recent OECD study found that the main problem with China’s old-age pension scheme is its poor coverage. Less than a fifth of China’s working-age population participates in the mandatory pension scheme. Among Asia’s emerging economies, China’s pension coverage is somewhere between Vietnam (10 % coverage) and Thailand (20 %), but well below Malaysia (36 %). In developed economies, it is typical that two-thirds of the working-age population are covered by a national mandatory pension scheme.

The current retirement age for participants in China’s mandatory pension scheme is generally 60 years for men and 55 for women. For those with jobs that involved stressful manual labour or have some special dispensation, the pension age can be five years lower. A retirement age between 50 and 60 is quite common in emerging Asian economies. In China, the pension for participants in the mandatory scheme is generous – nearly 80 % of their working wage. The OECD estimates that extending coverage of such a scheme to the full population is unsustainable.

The Chinese government has launched trials on ways to increase pension coverage. Official statistics show that 364 million Chinese participated in the pension scheme at the end of 2011. China’s leaders not only want to expand coverage, but have promised higher pensions. To quell concerns, increases in retirement ages are also under consideration.

New Year’s celebrations stoke inflation. Consumer price inflation climbed to an on-year rate of 4.5 % in January (4.1 % in December). The pick-up in inflation partly reflects the fact that Chinese New Year fell this year in January. The holiday typically boosts demand and prices of food, and food currently makes up about a third of the consumer price index. Producer prices, in contrast, were up less than 1 % y-o-y in January and have been virtually unchanged since December.

Two weeks ago, China’s National Development and Reform Commission raised the guaranteed price paid to rice producers by more than 10 % and hiked the price of vehicle fuels by over 3 %. These prices have minor index weightings, and even with the increases the inflation rate is expected to slow this spring as the rise in food prices stalls.

Further evidence of reduced inflation pressure can be seen in recent data on 12-month growth of the broad money supply (M2). M2 growth fell in January by over one percentage point to around 12 %. Moreover, the volume of new loans issued was much less than anticipated. February figures should reveal how much the Chinese New Year holidays affected the economic numbers and give a clearer picture of the extent of economic slowing. The monetary policy report published this week by the PBoC announced that the M2 growth target this year is 14 %.

Consumer price inflation in China, 12-month change, %

![Graph showing consumer price inflation in China, 12-month change](image)

Source: Macrobond

EU leaders in China, Xi Jinping in the United States. EU president Herman Van Rompuy and EU Commission chairman José Manuel Barroso travelled this week to Beijing. Discussion topics included Europe’s economic troubles, as well as topical situations such as Syria, Iran and Tibet. The discussion covered the same ground as in German Chancellor Angela Merkel’s visit to China at the beginning of the month. While no concrete breakthroughs were announced this week, China’s top leaders said that they would participate in international measures to help Europe overcome its difficulties.

In recent years, China has strived to diversify its currency reserves. By some estimates, 25–30 % (€610–735 billion) is now invested in euro-denominated assets (mostly in the form of government treasuries). In recent months, Chinese firms have eagerly acquired stakes in companies in southern Europe. These include investments in two Portuguese power companies and two Italian makers of luxury goods.

China’s prospective president Xi Jinping toured the United States this week, meeting president Barack Obama and Congressional leaders. Even though some difficult topics were touched, it was more or less a getting-acquainted visit. Current president Hu Jintao made a similar visit to the US before he took office.
Russia

Government prepares for major tax reform without clear direction. At a meeting with representatives of the national business association Delovaya Rossiya in late December, prime minister Vladimir Putin announced Russian tax policy needs to be reformed to better encourage investment in production and development of new high-tech industries. The economy and finance ministries were given until mid-February to submit ideas on reform of the tax system. While the final proposals are not yet ready, it is clear that experts have significant differences over what changes are need. At the moment, there are no clear indications on whether the reform will cut or raise taxes.

Tax revenues will need to increase if the budget is to cover already agreed hikes in defence spending and keep Putin’s recent promises to increase social sector spending (including large wage hikes for teachers and doctors). On the other hand, the finance ministry argues that there is no need to raise taxes as long as growth in spending is restrained and budget money is used wisely.

The tax reform debate has included discussion on reduction of the corporate property tax, the size of the employer’s social security contribution, functioning of the VAT system and the VAT tax rate as well as taxation of luxury goods.

The size of social security contributions are related to changes in the pension scheme that should be decided this year. The pension scheme was completely overhauled in 2002, but financing of the system has never been on a sustainable basis. The social security contribution paid in by employers has been adjusted several times over the past few years. The contribution was increased 8 percentage points to 34 % in 2011 and then lowered to 30 % this year. The latest plan is to again raise the contribution, even if many experts oppose the hike. The 2011 hike led to an increase in wages paid under the table and lower than expected tax revenues. One alternative discussed this time around has been to return the social security contribution to 34 %, but make workers pay for the increase. Employers currently shoulder the full burden of social costs.

Russia’s general value-added tax rate is 18 %. The problem with the VAT system is that in a corrupt business environment evading the tax is fairly simple and it is even possible to receive reimbursement for nonexistent VAT payments by using false documents. VAT scams have brought increased scrutiny by tax inspectors on how VAT is determined and tightened the acceptance of tax refunds. This has made VAT administration more burdensome for companies. In many cases, VAT refunds are today only effected with a court judgement. As to the VAT rate, the new proposals call for boosting it 2–4 percentage points.

A tax on luxury goods has been proposed in the name of social equality. The latest proposal would tax pricey vehicles at a higher rate than the standard vehicle tax, and high-end apartments would also be subject to a new property tax. From the social justice standpoint, such taxation hardly touches the assets of the super-rich, as such assets are typically sheltered off-shore.

The task of the new government installed after the March presidential election will be to decide on reform to the tax system using the government’s recommendations as basis.

Cabinet ministers at odds over divesting state-owned enterprises. Igor Sechin, the deputy prime minister with the energy portfolio, has proposed holding off on government efforts to sell stakes in state-owned companies, particularly energy companies and banks. Sechin has advised postponing sales in the face of uncertain market conditions and demanded that shares in companies should not be sold at a price below the original listing price. After the 2006 and 2007 IPOs of Sberbank, VTB Bank and Rosneft, shares in these companies tanked. The proposal of Mr. Sechin would mean postponement of important divestitures into unknown future. Economy minister Elvira Nabiullina dismissed Sechin’s argument, countering that shares in the big state firms need to remain on the privatisation block and preparations for their divestiture must continue. She says consistency is needed to assure markets that Russia is committed to its privatisation plans. Sales should be allowed as soon as market conditions permit.

The dispute reflects a more general differences of opinion in the government. One group of ministers favours state ownership, while liberal ministers stress the need for privatising state assets to achieve efficiency.

At the end of last year, the government responded to president Medvedev’s request by providing a new extended list of major state companies considered for sale. The ownership share remaining with the state was also reduced as compared with the previous privatisation list. In many cases, the state would significantly reduce its holdings, retaining only a “golden share” that allows the state to veto any major company decision. The golden share list includes oil company Rosneft, hydropower company Rusgidro, Russia’s international oil company Zarubezhneft, Yakut diamond producer Alrosa, state grain cooperative OZK, Sheremetyevo airport and Aeroflot.

The state would retain its majority position (50 % plus one share) in Sberbank, shipping company Sovkomflot and aircraft manufacturer OAK. It would retain a 75 % stake in Russian Railways, oil pipeline operator Transneft and electrical grid operator FSK.

The divestitures are expected to take place in increments through 2017. Last year, only one sale of stake in a large state-owned company took place: in February a 10 % stake in VTB Bank was sold. A planned issue of Sberbank shares was cancelled due to poor market conditions.
China

China loosens monetary policy. Effective today (Feb. 24), the People’s Bank of China is lowering the minimum reserve requirement for commercial banks 0.5 percentage points. In practice, this means large commercial banks must hold 20.5 % of deposits as cash in their own vaults or deposits with the central bank. Smaller banks have a 17.0 % requirement.

The PBoC started relaxing its stance in early December with a half-percentage-point cut in the reserve requirement.

Key reference rates, inflation and reserve requirement, %

The easing of monetary policy reflects the slowdown in economic growth and lower inflationary pressure. While consumer price inflation picked up in January to 4.5 %, it was due largely to the impact of Chinese New Year on food prices. Inflation is expected to cool in coming months. Credit expansion and money supply growth were both lower than expected in January.

Housing prices appear to be falling. The National Bureau of Statistics January survey of apartment prices in 70 major cities found apartment prices in about two-thirds of cities surveyed were lower than in December. Not one city showed a rise in prices. In four of the largest cities, prices are down at the most 3 % from last summer. Official figures for housing price trends are notoriously unreliable; in recent years they most probably understated actual price increases in the market and now likely tend to underestimate the price drop. Many observers expect apartment prices to decline a further 10–20 %.

Chinese monetary policy is to a great extent based on reserve requirements and “window guidance” from the central bank. Interest rate policy, in contrast, still plays a minor role. As China’s currency and money markets develop and the variety of financial instruments grows, monetary authorities should find it increasingly difficult to control the economy without active interest-rate adjustment. A year ago, related to discussions concerning the Twelfth Five-Year Plan, the PBoC laid out an initiative to give interest-rate policy a higher profile. The threshold for introducing interest-rate-based monetary policy is high, however, as officials worry such policy could lead to reckless risk-taking as banks compete for deposits. There is also concern of the distortionary effects of state-owned banks from their dominant market position.

Improved NBS data collection should be seen already in March. China’s National Bureau of Statistics (NBS) has adopted a new system that streamlines data collection and improves the quality and reliability of statistical data. Under the new regime, a total of 700,000 companies in the industrial, manufacturing, retail and wholesale trade, real estate and service sectors will submit their data directly to NBS officials. Thousands of NBS employees have fanned out across the country helping firms on site and assure a smooth roll-out of the new statistics system.

Information previously went through as many as four layers of aggregation before it was submitted to the NBS. This messy approach let local officials tamper with their figures; a tempting opportunity as the career prospects of regional leaders have long been tied to meeting economic targets. The NBS has been monitoring statistical data from local administrations through e.g. spot checking and independent surveys, and adjusting national figures accordingly. For example, last year’s reported figures for provincial GDP when added together gave a figure for China’s GDP that was over 4.6 trillion yuan (€520 billion) higher than the NBS figure for national GDP. The error corresponds roughly to Turkey’s entire GDP.

The first figures collected and compiled under the new system will be published in March.

Shanghai has big plans to develop its financial sector. At the end of January, Shanghai and China’s National Development and Reform Commission (NDRC) released a plan to increase access of foreign entities to Shanghai’s financial markets and make the city the global centre for yuan-based trading by 2015. During the changeover, trading volumes should triple and more headquarters of major financial sector businesses move to Shanghai. Beijing-based Bank of China, one of the China’s largest banks, will open a sister head office in Shanghai in March.

Shanghai’s plans assume China will continue efforts to internationalize yuan through such measures as phasing out currency controls and liberalising interest-rate regulation. Prices on the Shanghai exchange and the number-two Shenzhen exchange have risen since the start of the year. The A-share indexes of both exchanges are up about 8 % from the turn of the year. The rise in Chinese share prices, however, has lagged relative to other emerging markets. For example, Russian share prices are up 20 % this year, India 17 % and Brazil 16 %.
Russia

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Tax revenues up sharply in 2011; budget ends year with big surplus. Revenues to the consolidated federal and regional budgets increased an astounding 30 % in nominal terms and over 20 % in real terms, while budget expenditures increased a much slower 14 % in nominal terms. Realised consolidated revenues amounted 20,854 billion rubles (€510 billion) and expenditures 20,005 billion rubles (€487 billion).

The strong revenue growth boosted the budget surplus to over 2 % of GDP. Revenues corresponded to over 38 % of GDP, which was nearly as high as in the pre-crisis boom years of the mid-2000s. Expenditures, in contrast, shrank to 37 % of GDP from the high level of 2009–2010 when stimulus policies were in effect.

The surge in oil prices helped boost growth in revenues far above budget assumptions. Revenues from increased export tariffs and production fees in the oil and gas sector increased almost 50 %. The dependency of the public economy on oil and gas earnings has returned to pre-crisis levels, with the share of tax revenues from oil and gas rising to 27 % of consolidated budget revenues. These revenues go mainly to the federal budget whose surplus was up 37 %.

Tax revenues from oil and gas accounted for about 50 % of federal budget revenues last year.

Other budget revenues rose nearly 30 %. For example, the mandatory social security contribution required of employers saw revenues climb over 40 % (accounting for 17 % of total consolidated revenues). Mandatory social security contributions were hiked substantially at the beginning of 2011 (and again lowered at the start of this year). Income tax revenues increased just over 10 %, and their share of consolidated budget revenues fell below 10 %.

Among the biggest expenditure categories, spending on health care, various sectors of the economy, defence and education soared by about 20 %. These categories were forced to go without significant increases in 2010 (with spending on health care and education growing slowly already in 2009).

Unlike in 2008, 2009 and 2010, when spending on pensions soared, spending on social programmes overall increased just 5 % in 2011, with pension spending showing virtually no growth. Other social spending, in contrast, increased by over a fifth last year, even on the back of big increases in 2010. The share of social spending in total public sector expenditures fell slightly, but was still about a third. The next largest spending categories were defence, and national security and law enforcement (total 15 %), the economy (14 %), and education and health care (just over 10 % each).

Tighter competition rules. The third “ antimonopoly” package of law amendments, which substantial reforms the competition law, entered into force in January. The reforms ease the work of competition authorities by e.g. defining more clearly the characteristics of cartels and behaviour that restricts competition, as well as criteria for monopoly pricing. The new legislation is prepared according to WTO standards and is consistent with international practice.

The lack of competition and the dominant market position of monopolies in many markets have become major obstacles to development of the Russian economy. Large firms with dominant market positions are typically state- or region-owned, or have close relationship with them.

The Federal Antitrust Service FAS (Federalnaya antimonopolnaya sluzhba) works actively to increase competition. Among other things, FAS chief Igor Artemyev suggested in February that Gazprom be divided into two companies using the same reform approach as applied to the electrical power industry and the national railways. The division would create a state-owned company that would operate the pipeline grid and let commercial firms take over natural gas production. At the moment, Gazprom produces about 80 % of Russian natural gas and owns the gas pipeline grid. This gives Gazprom the power to decide on transmission of gas from other producers or even refuse to ship their gas.

The fight against cartels is one of the biggest tasks facing the FAS. Artemyev says that this year he hopes to deal with chemical industry, in particular, as well as the petroleum products and pharmaceutical industries. In 2008 and 2009, FAS took oil giants Rosneft, LUKOIL, Gazpromneft and TNK-BP to court for unjustified hikes in prices of oil products and artificial manipulation of supply. After lengthy litigation, the FAS won its cases and the oil companies paid significant fines to the state.

A new feature of Russian antitrust law is the possibility for the FAS to put companies on notice for their abuses of dominant market position. If a firm fails to correct the problem within 30 days, the FAS will take the matter to court. Earlier such abuses went straight to court and involved a long legal process. Putting companies on notice can be done in cases when the matter involves a monopoly’s refusal to provide a good or service under normal conditions. This phenomenon is most common in the energy market. A favourite scam involves requiring bribes or e.g. expensive construction work when firms want to hook up to the district heating or electrical power grid. Such instances account for half of all the abuse of dominant market position cases dealt by the FAS. The FAS hopes the new approach will improve the ability of regular firms to buy services from monopolies and free up FAS resources for other matters.
China

Big changes needed for China’s economy to sustain high growth. A new report from the World Bank and the Development Research Centre of the State Council of China (DRC) lays out development scenarios for the Chinese economy out to 2030. The basic message it that successful economic policies will be harder to implement as China evolves into an advanced economy. However, with right policies China is well positioned to move up to the group of high-income countries and assume a leading role in the global economy.

China’s biggest challenge is how to reduce the state’s over-involvement in the economy. The government has its fingers in the day-to-day decision-making of enterprises and the financial sector. The current model of centralised decision-making interferes with efforts to transit to an innovation-driven economy, where growth is based on creativity and experimentation by trial and error. To increase competition, the state must reduce its presence in business, end restrictions on foreign firms and deregulate the financial sector. It should put more effort into structural economic reforms such as functioning and fair legislation, and make improvements in the education system.

The report criticises China’s current attempt to create an innovation strategy entirely based on domestic resources. It needs to participate more in international research networks where much of the innovation occurs. China needs a functioning innovation strategy not just to sustain economic growth but also deal with the country’s serious environmental problems. In recent years, China has moved to the forefront of environmental technology, and its green tech sector is promising as it can develop with the forefront of environmental technology, and its green tech sector is promising as it can develop with the support and scale advantages of a vast domestic market.

To maintain domestic stability, China needs to improve the social safety net and give all a chance at economic advancement. Even as China’s population faces the very real danger of becoming grey before it becomes wealthy, its pension system is not on a sustainable basis. The hukou system (see next item) effectively divides the Chinese population into rural-dwellers and urbanites, preventing the rural population from sharing equally in the benefits of China’s economic growth. The report notes the need to develop the political system and asks how long China’s middle class will be satisfied with a passive role in politics.

China’s growth has increased the importance of its role in setting international economic policy. In place of passive policy role geared to its own short-term interests, China needs to take active and constructive role in institutions that promote international trade and work to clean up the environment.

Changes in the hukou system. The State Council has just released a report calling for changes in China’s domicile system (hukou). Under the plan, cities will be classed into three groups. In smaller cities, permanent residency will be granted to people who demonstrate they hold a steady job and live in owned or rented apartment. In mid-sized cities, individuals seeking permanent residency must show they have lived in the city for at least for three years. China’s megalopolises are excluded from the changes. Moreover, the report states that rural officials cannot seize the land and real property of residents who move to the city for work.

Officials have yet to comment on the report released last week. It raised eyebrows for the fact that the report is dated February 2011. According to some estimates the report reflects the need to harmonise practices in small and mid-sized cities that have been experimenting with alternative changes to the hukou system. The decision of officials to omit the big cities has been criticised. However, getting permanent residency in some big cities like Shanghai is possible after complying with strict criteria.

The number of China’s internal migrants continues to grow, and reached 253 million in 2011. In principle, migrant workers are free to move within the country, but where one can declare one’s domicile is hard to change. Social entitlements such as free day care, education and health services are provided only by domicile. Reform of the hukou system has long been an important project for the government but progress has been painfully slow.

Yuan appreciation against the dollar stalls. The yuan-dollar exchange is essentially unchanged from its level at the end of last year. In January, the yuan temporarily lost value against the dollar, only to recover. What is still unclear is whether the movement in currency rate was driven more by central bank actions or by events in the markets. In some months of the end of 2011, China experienced an unusual situation of net forex outflows, which may have been repeated in the first two months of this year. Observers expect the yuan to appreciate about 2–4 % this year.

Yuan-dollar exchange rates

Sources: Bloomberg and Reuters
Russia

Post-election economic policies take shape. Vladimir Putin walked away with Sunday’s (Mar. 4) presidential election, garnering 64% of the vote. Putin officially returns to the president’s job on May 7, when he will begin to assemble his new cabinet. Observers see many ministerial changes ahead. The prime minister’s job is expected to go to incumbent president Dmitri Medvedev. As in his two earlier terms as president, Putin is expected to be personally engaged in economic matters.

The new government’s policy has been under preparation for a while. A cornerstone in the “Strategy 2020” programme, which outlines policy choices over the coming decade. About a year ago, prime minister Putin commissioned a group of Russia’s leading liberal economists to come up with a strategy for the next presidential term.

The strategy outlines preconditions for a new type of economic growth to replace Russia’s resource-based economy. The proposals are quite radical, calling across-the-board liberalisation to allow markets to function normally. Another important area of emphasis is retaining and developing human capital, an area where experts say Russia significantly lags most advanced countries. For example, the healthcare system, as well as social, housing and environmental policy must be reformed to meet the needs of modern society. The emergence of an in-the-know middle class is adding to the pressure on the leadership to act.

The concrete proposals of the Strategy 2020 may not be implemented as such, but they can have an impact on policy formation.

Putin’s earlier two terms were characterised by high economic growth, which is not likely to repeat. In his third term, oil production should remain almost flat and the huge increases in oil prices of the 2000s are unlikely to be repeated.

The next term will also see tighter state finances. The explosion in budget spending of recent years has driven the break-even price for crude oil up to a level of $110–115 a barrel. In other words, the soaring increased in real incomes seen during the 2000s, especially in public sector wages and through social entitlement programmes (e.g. pensions) is over, which could hurt the popularity of the president.

Rise in export prices pushed Russian foreign trade to record levels in 2011. The value of goods exports last year was $520 billion and goods imports $320 billion. Both imports and exports of goods were up 30% y-o-y, and Russia posted a record trade surplus of $200 billion (14% of GDP). Russia’s main export markets were the Netherlands, China and Italy. The biggest suppliers of imports were China, Germany and Japan.

The growth in the value of exports was lifted by rising commodity prices; export volumes actually fell slightly.

Russian exports mainly consisted of oil, gas, metals and other raw materials. The only volume increase of these main product groups was in natural gas. Exports of crude oil, petroleum products and metals contracted, even if production levels were up. The increase in output went to a growing domestic market.

Most of Russia’s imports were in the form of consumer goods or investment goods. Machinery, equipment and transport vehicles accounted for nearly half of all imports, and witnessed on-year growth of about a third. The largest single product group was passenger cars. Despite 50% growth, the volume of car imports was just over half of the peak year 2008.

Spotty recovery in Finnish exports to Russia. Although Finnish exports to Russia climbed 13% last year and amounted to €5.3 billion, they were still far below pre-crisis levels. The trend partly reflects a slow recovery in Finnish re-export activity (i.e. goods that are first imported into Finland and then exported on to Russia). Customs Finland reports that re-exports continue to represent a decreasing share of exports overall (only about 13–14% of Finnish exports to Russian measured by value).

A third of exports consisted of machinery & equipment. Russia accounts for about 9% of Finnish exports, making it Finland’s third largest export market after Sweden and Germany. As much as 20–25% of Finnish exports of foodstuffs, textiles and chemical products went to Russia last year.

The value of road freight transported through Finland to Russia reached €21 billion last year. The share of Russian imports coming in via Finland has shrunk considerably. For example, passenger cars are down significantly as cargo handling at the Russian port of Ust-Luga has ramped up. Last year the amount of cargo handled at Ust-Luga doubled to over 23 million tons. In comparison, about 16 million tons of cargo passed through Finland’s busiest port Kotka-Hamina last year.

The value of Finland’s imports from Russia reached a record €11 billion due to high commodity prices. Russia was Finland’s largest source of imports, accounting for nearly 19% of Finland’s total imports.

Russian car imports by entry route (in thousands)

Sources: Customs Finland, Rosstat, Port of Ust-Luga

The information is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.
China

China’s leadership is pursuing a number of new environmental initiatives in the wake of Japan’s Fukushima disaster, renewed nuclear ambitions indicate China’s policymakers see few alternatives.

**Chinese international patent activity on robust rise.**

WIPO (The World Intellectual Property Organization) this week released preliminary figures for patent applications filed globally last year under the Patent Cooperation Treaty (PCT). Despite a weak economy, the number of PCT patent filing globally rose by 10% to nearly 182,000 applications. With a 27% share of all PCT patent applications, the United States is the leading international patent-seeker. Japan’s share of total PCT applications was 21% and Germany’s 10%. The number of Japanese filings, however, grew much faster than from any other top-three country.

China’s performance enhances the role of Asia in technological innovation. In 2010, China surpassed Korea as the world’s fourth most active seeker of PCT patents, and last year applications of Chinese firms rose by a third to 16,400 applications. At the current pace, China should exceed Germany in patent activity by next year.

The dynamism of Chinese firms can be seen in telecom giants ZTE and Huawei. Globally, they ranked #1 and #3, respectively, in PCT applications (with the #2 spot going to the Japanese Panasonic). Only one other Chinese firm, however, made it into the top 100 PCT firms in 2011. While these three Chinese companies together accounted for nearly a third of China’s PCT activity, there is a large number of other Chinese companies active in the field of innovation. The growth of China’s PCT filings is due mainly to companies not in the top 100.

China is far more active in patent-seeking than India or Russia, although PCT filings increased also in the latter countries. India last year submitted slightly over 1,400 applications, while the number of applications from Russia was still fewer than 1,000. In comparison, tiny Finland submitted about 2,000 international patent applications, conferring a ranking of 13th on the PCT list. Nokia accounted for about a third of Finnish PCT filings.

**International patent applications (PCT) by top 5 countries**

![Graph showing international patent applications (PCT) by top 5 countries](source: wipo.int)

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Russia

New BOFIT forecast sees Russian economic growth averaging around 3.5% p.a. in 2012–2014. Both the Russian GDP and imports continued their steady recovery from deep recession, with growth in 2011 essentially matching that of 2010. GDP rose 4.3% and imports increased over 20%. By late 2011, levels of Russian GDP and imports had recovered to their pre-crisis 2008 peaks.

The latest BOFIT forecast sees the economy remaining on a rather good growth path, with the increase in GDP amounting to around 3.5% p.a. throughout the period 2012–2014. Import growth should hit about 7% p.a. GDP growth is predicted to slow slightly towards the end of the period as oil prices are expected to slide about 10% from current levels by 2014.

Growth in private consumption and investment should dip this year in reaction to uncertainty on international and domestic markets before recovering somewhat next year. Russia’s export volumes are expected to grow more slowly than the export volumes of oil and petroleum products seem to have peaked for the time being.

Risks to the forecast are largely downside. For example, the current upbeat mood of Russian consumers could sour even if the global economy develops as assumed in our forecast. Russian export volumes could also grow more slowly than we currently forecast if the assessments of several international organisations that Russian oil production is set to go into modest decline prove correct. Russia would be quick to feel any shock to the world economy if it causes a drop in oil prices or increases uncertainty on financial markets. Russia’s leadership would likely take active measures as needed to alleviate adverse impacts to the economy.

Annual GDP growth and BOFIT forecast 2012–2014, %

Sources: Rosstat and BOFIT

Putin’s election promises could have significant budget impacts. During the recent presidential campaign, prime minister Vladimir Putin made an unprecedented string of promises to improve the lots of average citizens. For example, wages of public sector doctors, university professors and researchers would be raised gradually to double the national or regional average wage. Wages would also go up in the cultural sphere. Stipends for low-income students would be increased, new housing built for veterans and an additional child benefit provided to families that have a third child in regions suffering from depopulation. In January, military pay was doubled and police wages boosted substantially. The last time major wage increases were made for low-wage public sector jobs was in 2007.

Many observers have reacted critically to the election promises. Investment bank Fitch Ratings, for example, warned Russia over any increased spending as long-term budget balance is already challenging to achieve.

In his post-election comments, Putin said all of his election promises are doable. The third-term president remarked that increases in spending need to be accompanied with better allocation and greater efficiency on the part of organisations receiving federal money. As an example, Putin mentioned Russia’s university system. As a Soviet heritage, Russia today has too many institutions and among them some so inefficient ones that they deserve to simply be closed. Many schools have an overabundance of teaching staff; e.g. Moscow State University (MGU) boasts a teacher-student ratio of one-to-four. Moreover, on average only 50% of university employees are engaged in teaching; the rest provide support services or work in administration.

Putin stressed the fact that the planned hikes in child benefits and stipends would be focused on low-income citizens. This conforms to the recommendations of many international agencies that social support be better targeted and provided to the weakest members of society.

Yaroslav Kuzminov, rector of the national research university, The Higher School of Economics (Vyshaya shkola ekonomiki), reports that nearly all of Putin’s promised measures are in line with proposals included in the “Strategy 2020” national economic and social programme (see BOFIT Weekly 10/2012) submitted to the cabinet in December.

Calculations by the Higher School of Economics show that higher social spending would add the equivalent of 1.2–1.3% of GDP to annual budget expenditures. (Public sector spending last year was about 37% of GDP.) The proposed wage hikes alone would equal a spending increase of about 1% of GDP. The hike in the child benefit would equal about 0.2% of GDP and increases in stipends some 0.06%. Kuzminov said about half of the spending increases could be covered by making organisations more efficient. A large slice of the spending increases would be covered by the regional budgets, out of which teachers’ and doctors’ salaries are paid.
China

BOFIT sees lower economic growth ahead for China. China’s economic growth slowed last year to 9.2%, and under the latest BOFIT forecast growth will continue to slow. GDP growth in 2012 and 2013 should be around 8% y-o-y, with further slowing to 7% in 2014. Even at these lower levels, China’s economic growth rate remains quite high.

Figures for realised foreign trade, industrial output and retail sales in January and February suggest that the slowdown in growth is well underway. Inflation slowed in February to 3.2%. The slowdown in economic growth reflects the impact of the euro zone debt crisis, as well as tighter domestic fiscal policy. Although the focal point of economic policy in China has already shifted from inflation fighting to supporting economic growth, the stimulus a couple years back created a credit bubble, increased credit risk generally and uncertainty over price trends which make loosening economic policies difficult to implement.

Over the longer term, the limitations on raw material supplies, the decline in the number of working-age people and the need for structural adjustments to reduce the excessive role of investment in the economy will inherently decelerate Chinese growth. Improvement in the performance of the global economy doesn’t change the picture in this respect. A managed slowing of economic growth would benefit both China and the global economy in the long run.

The role of investment will remain important, but private consumption is expected to increase faster than investment in the forecast period. The ratio of investment to GDP (investment rate) will fall from its current level of over 45%, while the consumption rate will begin to climb from its current 35% level. The trend is for higher real incomes, which can be seen in both this year’s agreed minimum wage hikes of 9–23% and the onset of the decline in the working-age population.

The volume of Chinese exports will grow only slightly faster than world trade during the 2012–2014 forecast period. Because import growth outpaces export growth, China’s trade and current account surpluses should continue to shrink. Last year’s current account surplus was less than 3% of GDP, a far cry from 2007’s record of 11%.

Even without Europe’s debt crisis, China has plenty of economic challenges on its plate. The list of chronic problems is fairly constant. The real estate market is still bubbly and there is the threat of a cooling in construction activity that would hurt growth and the ability of local administrations to deal with their debt burdens that have increased in recent years. Under the worst case scenario, these problems would spill over into the banking sector. Managing economic reforms is another area of concern. While most agree that opening up the economy, promoting competition and structural reforms are unavoidable, such liberalisation is notoriously hard to manage. The recent wave of strikes demanding higher wages and open opposition to local government decisions highlight the existing political risks.

NPC discussed a wide range of reforms. The National People’s Congress (NPC) wound up on Wednesday (Mar. 14), discussed a number of pressing issues. Assurances were given that the operating environment for private firms would improve by providing access to sectors currently monopolised by the state. Private investment will be encouraged in state-dominated branches such as railways, municipal services, energy production, education and health care. Finance minister Xie Xuren proposed that local administrations establish special funds to secure repayment of debts. Improvements in the social safety net will include a reduction in healthcare costs through competitive bidding on pharmaceuticals and medical supplies. The idea of moving the NPC to the turn of the year was also floated. Prime minister Wen Jiabao emphasised the need to change China’s political system gradually to move towards a social democracy model that allows the country to avoid widespread unrest.

The NPC agenda included talks on lowering import duties on consumer goods and luxury items. China’s high customs duties make foreign brands expensive for domestic consumers, which, in turn, encourages vast production of copycat and knock-off goods, and forces Chinese to acquire branded items on trips abroad. Demand for branded foreign goods appears to have risen rapidly; UnionPay, China’s sole credit card company, reports that the use of debit cards by Chinese travelling abroad increased nearly 70% last year. Lower import duties would provide welcome access to the Chinese market for Western producers of luxury goods.

Despite the many reforms discussed at the meeting, only minor adjustments are expected this year. The larger reforms will wait until China has new president and prime minister.
Russia

Strategy 2020 programme released. A year ago, prime minister Vladimir Putin ordered the drafting of a medium-term programme to guide Russia’s economic and social development policies. “Strategy 2020” comprises contributions from over a thousand experts serving in two dozen working groups. It presents a range of development scenarios and gives concrete policy recommendations to the new president and cabinet. President Dmitri Medvedev has already begun to hold meetings with working group representatives to consider proposed measures.

The need for a revised economic policy become evident during the 2008–2009 recession, from which the Russian economy failed to bounce back to the pre-recession pace of high growth. This forced government circles to revisit measures to reduce the economy’s heavy dependence on energy exports and identify new sources of economic growth.

The basic policy framework of Strategy 2020 has already been in place at least in practice. Pursuit of low inflation and a conservative budget policy are cornerstones of the Strategy 2020. It sets a fairly rapid pace for slowing inflation: the 12-month inflation should be below 5% by the end of 2013. The conundrum for policymakers is that efforts to subdue inflation require tight monetary policy, hence foregoing higher economic growth over the next two years. The drafters of the strategy assure that the initial low growth will be made up in the out years as investment rises in a environment of stable prices. The strategy’s medium-term goal is to achieve sustained GDP growth averaging 5% a year, which would put Russian growth higher than in advanced economies and on a path to catching up with the advanced world.

Once inflation is under 5% p.a., the Central Bank of Russia would shift its monetary policy focus away from exchange-rate targeting to inflation targeting. Russia’s inflation target would be the average EU inflation rate plus 1.5–2.0 percentage points. Russia has already begun to abandon exchange-rate targeting in practice as the central bank has allowed the rouble to move in an ever widening fluctuation band since 2009.

Strategy 2020 seeks to go beyond the policy paralysis engendered by Russia’s “resource curse.” Many critical economic and social reforms have been postponed as prices of crude oil and other commodities have always been quick to recover and boost budget revenues after a couple of years. The strategy suggests improving Russia’s business environment through e.g. significant reductions in business taxes, state monopoly’s remuneration, and regulatory framework. The strategy’s medium-term goal is to achieve sustainable economic growth. Such reforms will require money, yet it is increasingly difficult to boost budget expenditures given Russia’s burgeoning budget in recent years and the need for fiscal restraint.

The strategy concedes that Russian budget policy lost its way during the 2008–2009 recession when the budget rules adopted in 2002–2004 were neglected. Under the rules, public spending could not be increased as fast as tax revenues, and any revenue surplus had to be transferred to reserve funds. Other significant revenue increases in recent years include growth in spending on pensions, defence and national security, as well as political stunts such as hosting expensive events that involve massive public investment such as the 2012 APEC summit in Vladivostok, the 2014 Olympics in Sochi and the World Soccer Championships in 2018.

Strategy 2020 emphasises a return to spending discipline to allow Russia to achieve a sustainable fiscal balance. It is proposed that new budget rules to limit spending be established, so that annual expenditures would be limited to an amount that balances the budget at a “base level” world oil price. Base level is defined as the average price of Urals-grade crude oil over the previous ten years. The strategy also presents a more lenient budget option, whereby annual budget deficits of up to 1% of GDP would be permitted. Under this rule, Russia’s public sector debt could rise from around 10% at present to 25% of GDP by 2020 (still low by international standards).

The drafters of the strategy note that it is up to policymakers to choose between these two policy lines. The first is to seek a rapid balancing of state finances, an approach that limits the possibilities of implementing structural reforms. Alternatively, policymakers can opt for a gradual increase in public debt that would allow better funding for needed reforms. Both options, however, call for significant repurposing of spending in order to leave resources for reforms. For example, Russia spends 1.5–2 percentage points of GDP less on education than the OECD average, and 2–4 percentage points less on health care.

As a third cornerstone of economic policy, the strategy tackles elimination of institutional barriers to economic growth. The importance of this subject has been repeatedly stressed at the highest government levels over the past couple of years. The strategy suggests improving Russia’s business environment through e.g. significant reductions in public regulation and restrictions, reforming incentives to motivate civil servants and cutting their oversized number.

The strategy emphasises a new approach to social policy. Social policy will continue to focus on providing the poorest and weakest members of society with a safety net, but with an emerging middle class it today also needs to align with their expectations, e.g. environmental and housing policy, as well as professional advancement. Russia’s new middle class will have a special role in economic transformation as it provides the drivers of creativity and innovation, the basis of new forms of economic growth.
China

Sacking of Chongqing party leader Bo Xilai stirs debate on China’s development options. Although the Secretary of the Chongqing Municipal Committee of the Chinese Communist Party Bo Xilai recently suffered a loss of reputation due to offences and revelations of his former subordinate, his removal from office at the end of the National People’s Congress last week came as a surprise. The events, however, have precipitated an interesting and diverse discussion on how decisions are made in China, alternative reform strategies and the growing role of the media.

The firing of Bo, who had at one time been seen as a possible pick for the premiership, was seen as exposing rifts in policy within the party. The dust-up takes place ahead of the next autumn’s power transition – typically a difficult process for China’s one-party political system. Indeed, the selection and instatement of current president Hu Jintao and premier Wen Jiabao in 2002 stands as the only instance in modern Chinese history of a leadership change implemented without drama. The sacking of Bo has also reminded the public of the closed nature and capriciousness of China’s political decision-making process.

Bo built his reputation on the “Chongqing Model,” which is founded on the elements of rapid economic growth supported by massive public investment, reducing income disparities between the countryside and cities, fighting corruption and other criminal activity…all blended with Maoist nostalgia. In the view of many, the model is best characterized by populism and notorious political campaign approach. Moreover, it lacks transparency and encourages questionable bending of the law in fighting crime. Premier Wen went so far as to compare the Bo’s policy with the pro-reform talk and the disparaging of the much-despised Cultural Revolution when discussing Chongqing’s failures.

Although Bo’s sacking is in many respects a remainder of old features of the Chinese policy making, a new element is the increased role of social media. Bo himself has a reputation for media savvy, but it has been no match for the debate concerning recent events ignited in social media. The growing role of social media is evident and is likely to have an ever increasing impact on policy formation.

The pro-reform talk and the disparaging of the Chongqing Model at the National People’s Congress, as well as the growing role of social media seem to suggest that there is a rising demand and willingness on the part of the public and leadership to adopt market reforms.

Over a quarter of public sector activities off-budget in 2011. China’s public sector can be divided into two parts: the central administration and local administrations. The finance ministry’s 2011 budget report notes that revenues of central and local administrations were roughly equal and together amounted to 10.4 trillion yuan (€1.15 trillion, 22 % of GDP). Public spending amounted to 10.9 trillion yuan (€1.21 trillion, 23 % of GDP). The bulk of tax revenues collected by the central administration is transferred to local administrations, and they accounted for 85 % of the total public spending last year. Due to higher-than-expected growth in revenues, the public sector deficit was smaller than budgeted, about 500 billion yuan (1.1 % of GDP).

The budget report found that off-budget revenues last year reached 4.2 trillion yuan. Most of that came from sales of land-use rights by local administrations. A small share of off-budget revenue is derived from management of state property (including corporate profits, income from sales of state assets and dividends). Most off-budget revenues are spent on construction projects.

Public sector revenues in the 2012 budget are expected to increase 10 % and expenditures 14 %, thereby increasing the deficit slightly. Spending on education, health care and social security should increase far more than average. Off-budget revenues are expected to decline to 3.6 trillion yuan, mostly due to reduced revenues from sales of land-use rights. Off-budget revenues this year will again mainly be used to fund construction.

Although China has improved its budget reporting substantially in recent years, many public sector activities are still poorly tracked. For example, about 30 % of public spending in 2012 has not a designated application in the report and it is unclear how much funds are allocated for domestic security. Another example is the implementation of the 2008–2009 economic stimulus programme, which was left largely to local administrations. Under the law, local administration budgets need to be in balance, which means they cannot run into debt. To implement the stimulus policies, local administrations took massive amounts of debt off budget, which is currently estimated to be 30–60 % of GDP. A few local administrations were granted the right to issue bonds last year. If the trial is expanded, local administrations will have to subject to greater market scrutiny, which will require increased transparency on their part.

Main budget spending categories in 2012, % of spending

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<td>Education</td>
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Source: Ministry of Finance
Russia

Russian domestic demand weak in January and February. The pick-up in domestic demand in February failed to compensate for January’s drop. The seasonally adjusted volume of retail sales in February was roughly on par with December, and preliminary figures show fixed investment was down from the final months of 2011. After spiking in December, real household incomes declined despite falling inflation.

In contrast, robust growth in industrial output continued throughout January and February in both manufacturing and energy production. Industrial output has recovered in several industrial branches, supported by e.g. revived exports of crude oil and higher government spending. Confidence indices for industrial firms were still fairly good in March.

Strategy 2020 emphasises economic cooperation with CIS countries and the EU. Among the biggest challenges facing Russia’s economic relations are its dependence on oil and the rapidly increasing role of emerging economies (particularly China) in the global economy. In response to these challenges, Strategy 2020 calls for deeper and wider external trade relations, liberalisation of foreign trade and increased support to foreign investment.

Unlike many international assessments, Strategy 2020 sees a substantial risk that world prices could decline sharply due to a glut of energy products on the markets. Nevertheless, the oil price is expected to average above $70 a barrel throughout the current decade. But high oil prices could also be problematic for Russia as they could put appreciation pressure on the ruble and diminish the competitiveness of Russia’s other exporting branches.

China’s strengthening position could hamper Russia’s plans to increase international use of the ruble and integration within CIS countries in Central Asia. The rising competitiveness of Chinese firms and their rapid technological advancement is also eroding the position of Russian firms on the domestic market and could threaten their possibilities to adopt high-tech manufacturing.

A regional priority of Strategy 2020 is development of the Russia-Belarus-Kazakhstan customs union into a Eurasian Union that shares a common economic space and currency. It also envisions development of other forms of cooperation with CIS members. CIS cooperation is seen as important both for political reasons and from the standpoint of expanding markets for Russian products. In technology cooperation, the EU is seen as a desirable partner.

Tighter cooperation with the EU is also recommended in other areas with an expanded free-trade agreement as a goal, including e.g. some further liberalisation of trade in services and implementation of better investor protection. EU technical standards should also be adopted by the customs union and mutual visa practices substantially relaxed. Despite deeper economic relations, Russian dependence on the EU should be reduced and export markets diversified, especially to Asia. China is seen as the most promising Asian export market, while Japan and South Korea are seen as offering the best possibilities for technology cooperation. They latter two are also seen as promising sources of investment.

Strategy 2020 proposes also measures to promote foreign trade and foreign investment, such as lowering customs duties, increasing export subsidies, reducing restrictions on foreign investment and increasing the number of special economic zones.

Russia needs highly skilled immigrants. Strategy 2020 declares that Russia needs immigrants to meet the needs of its labour markets. To date, Russia has not been an attractive destination for skilled migrant workers. Russia’s Strategy 2020 working group on immigration policy concluded that current policies are limiting and geared to immigrants’ temporary stay in Russia. It does not include measures to help immigrants adjust to society or, for example, take into account the implications of entire families immigrating.

Over 7 million people moved to Russia after the breakup of the Soviet Union. The lion’s share of immigrants were Russians living in former Soviet republics, who moved back to Russia during the 1990s. Russia is still willing to take back its ethnic Russians, but their motivations for moving to Russia have diminished.

A large share of immigrants currently come from countries south of the Russian border in Central Asia and the Caucasus region. Most take low-skilled jobs. Such workers are likely to be found in menial jobs in big cities or doing farm work in the countryside.

The actual number of immigrants in Russia is unclear. According to the Federal Immigration Service, about 1.7 million migrants legally worked in the country in 2009. The immigration service estimates that 3–5 million immigrants work illegally in Russia. The official quota for migrant labour last year was 1.7 million people. Legal migrants make up about 2.5% of the Russian workforce. Under Strategy 2020, the goal is to attract annually some 250,000–300,000 immigrants.

Strategy 2020 proposes replacement of the current general immigration quota system with special categories according to skills. Most-favoured immigrants would be highly educated experts and their families, entrepreneurs and investors and their families, as well as workers in branches suffering from manpower shortages. These groups’ immigration should be eased by improving immigrants’ legal protection, access to social security and the possibility of multi-year work permits. Several changes were made in the system in 2010 to encourage immigration of highly skilled experts, but the results so far have been fairly disappointing.
China

European Commission competitiveness report notes pluses and minuses of China’s competition policies. The report released in February shows a positive trend in the second half of 2011 in the opening up of public procurement to foreign competition. However, the EU said China had made little progress in lifting restrictions on foreign investment and issues related to standardisation, noting China had even added new restrictions on foreign investment under the guise of national security.

Friction in China-EU trade relations has also been generated by export subsidies given by China to high-tech firms. Green technologies, for example, have become an area where China seeks to dominate the world market using what critics see as unfair practices. Companies in the US and India that produce conventional solar panels have complained that the Chinese are engaging in price dumping to gain market share. The US Commerce Department last week announced it was imposing a countervailing duty on Chinese solar panels to offset unfair subsidies.

Trade policy disputes have also arisen in many other contexts. The 2012 Business Climate Survey of exporting firms released by the American Chamber of Commerce in China last week found that China gives preferential treatment to domestic firms over foreign firms in the granting of business licences. The US, EU and Japan also filed complaints with the WTO over China’s restrictions on exports of rare earth metals. The complaint follows on the heels of a January ruling by the WTO that China’s restrictions on exports of several other critical metals violated China’s WTO commitments. The US, EU and Japan in the latest filing seek a similar ruling on restrictions of rare earth metals, which were not covered in the January ruling. China produces over 90% of the world’s rare earth metals, and recently has imposed quotas on their export. China claims the restrictions reflect environmental needs.

China has brought out the heavy artillery in its dispute with EU airlines over CO2 emissions. The dispute arose when EU incorporated airlines into its emissions trading scheme at the start of this year. The ruling requires airlines using European airports to purchase carbon emission offsets from an emission trading exchange. Chinese officials have responded by declaring that Chinese airlines will not participate in the EU emissions trading scheme. China has also threatened to cancel its aircraft purchase contracts with Airbus Industries. India has followed China’s example by calling for its airlines to boycott the EU carbon tax.

China invests in military technology. During the People’s National Congress this month, China announced that defence spending would increase 11% this year to about 670 billion yuan ($106 billion), and that defence spending would account for about 6% of the national budget. Defence spending covers the upkeep of the over 2.3 million members of the People’s Liberation Army, the world’s biggest standing army.

Observers note that China’s actual defence spending is substantially higher than official figures; spending on research and development is partly outside the defence budget. The Stockholm International Peace Research Institute (SIPRI) estimates that China’s actual 2010 defence spending exceeded over 2% of Chinese GDP and in dollars terms was more than double the defence spending of Japan or Russia.

China is investing heavily in raising the technology level of arms production that includes e.g. an aircraft carrier project, development of a stealth fighter and military space applications. Although the rise in the sophistication of Chinese arms technology has been faster than many believed possible, China remains dependent on Russia for fighter aircraft engines and some key components made in Europe.

With the rise in its technological capabilities, China’s dependence of others for arms imports has fallen and its export potential has grown. SIPRI’s just-released 2011 report on international arms trade finds that over the last five years China has slipped from the top of the list as the world’s biggest arms buyer to fourth place. During the period, Russia accounted for 78% of China’s traditional arms imports. China, in turn, accounted for a 16% share of Russia’s arms exports, making it the second-most important arms buyer after India (33% share). Nevertheless, prior to last year, the volume of Russian arms going to China has been declining.

About 73% of China’s arms exports over the past five years went to countries elsewhere in Asia, 12% to the Middle East, 9% to Africa and 6% to Latin America. Pakistan alone bought nearly 64% of all Chinese arms exports. SIPRI actually noted that China so far has had trouble breaking into other markets.

Finland’s trade deficit with China increases in 2011. Customs Finland reports that the value of goods exported to China in 2011 was €2.7 billion, a slight contraction from 2010. At the same time, the value of goods imported from China increased 16% to €4.4 billion, raising Finland’s trade deficit from about €1 billion in 2010 to €1.7 billion last year. However, the 2011 deficit was not particularly large; in the pre-crisis years 2006–2008, the annual deficit exceeded €2 billion. Finland’s service trade balance with China in contrast has typically been in surplus.

China is Finland’s seventh most important destination for its goods exports and the fourth largest source of goods imports. In terms of services exports, China ranked fourth in 2010 and was Finland’s sixth largest provider of services.
Russia

Russian women earn only 65 kopeks for every ruble earned by men. The latest World Economic Forum (WEF) Global Gender Gap 2011 survey ranks Russia 43 out of the 135 countries surveyed. As usual, the Nordic countries topped the list as most egalitarian, while the most gender-discriminating countries were found in Africa and the Middle East. China ranked 61.

The WEF arrived at its overall gender gap assessment by compiling results of a country’s performance in four gender gap subindexes. Russia’s highest ranking (29) was under the “Economic Participation and Opportunity” subindex. The ranking reflected the high degree of participation of Russian women in the workforce, a common situation throughout most of the former Soviet Union. Russian women ranked top in the world (1) in participation of professional and technical workers. Overall, however, women’s earned incomes were just 65% those of men. The earnings gap has, however, diminished in recent years.

The WEF estimated that women in Russia made up 37% of legislators, senior officials and managers. However, the higher the position, the less likely it was to be held by a woman – not just in Russia, but everywhere. Even at the senior management level, Russian women are usually found in traditional fields that offered a path to advancement. For example, a recent PwC study found women in senior management were most likely to hold the post of chief accountant, head of personnel or chief financial officer.

Another survey by Grant Thornton International found that women constitute 46% of senior management in Russia and that 15% of CEOs in Russian firms are women. Both these shares were higher than in the 39 countries covered by the survey, including Finland, Sweden, the US and the UK. Business consultants at McKinsey note, however, that only 8% of Russian board members are women – far fewer women than are found on corporate boards in most of Western Europe. Interestingly, the EU’s proposed “women’s quota” for corporate boards could increase the presence of women on boards of Russian corporations. This is because a significant share of Russia’s large firms are registered within the EU (e.g. the Netherlands and the UK).

Russia’s WEF rankings were also higher than its overall ranking in the subindexes for “Health and Survival” (33) and “Educational Attainment” (41). The gap between the average lifespan of men and women (ranking 1!) reflected the sad fact of the low average life expectancy for Russian men. In terms of educational opportunity, the lot of women was enhanced by the proportionally larger number of Russian women than men who engage in graduate studies.

Russia’s lowest ranking came in the “Political Empowerment” subindex (84); less than a fifth of Duma deputies and ministers were women.

Finance ministry places a massive Eurobond issue. The three-tranche $7-billion-bond represents one of the largest sovereign bond issues of an emerging economy since 2000. The issue arrangers are BNP Paribas, Citigroup and Deutsche Bank, as well as the Russian Troika Dialog and VT Bank. Russia’s last major dollar-denominated bond issue ($5.5 billion) on international markets was in 2010. In 2011, Russia issued two ruble-denominated Eurobonds with a total value of 90 billion rubles ($2.3 billion).

Last week’s Eurobond breaks down into a 5-year tranche of $2 billion, a 10-year tranche of $2 billion and a 30-year tranche of $3 billion. Yields are 3.325% (about 230 basis points over US Treasuries) on the 5-year bond, 4.591% (240 basis-point premium) on the 10-year bond, and 5.798% (250 basis-point premium) on the 30-year bond. The bonds were vastly oversubscribed. Demand was especially strong for the 30-year long bond.

The yields on Russian Eurobonds are currently a bit higher than bonds issued by other BRIC countries, due in part to the Russian economy’s over-reliance on its natural resource sector and hence greater sensitivity to trends in the global economy. Russia, however, is considered a solid bond issuer in international capital markets. Its state finances are in relatively good shape and GDP growth is expected to hold around 4% a year in coming years.

Under the 2012–2014 budget act, the finance ministry can borrow $7 billion from international markets during 2012. Thus, no new international bond issues are expected this year. The Russian government is also limited to international borrowing of $7 billion a year in 2013 and 2014.

The 2012 federal budget will balance if the world price of Urals-crude oil averages $117 a barrel this year and provided that none of the many campaign promises of prime minister Vladimir Putin are implemented at additional cost. The average price of Urals crude this year has been around $117 a barrel and currently is just over $120 a barrel. Deputy finance minister Tatiana Nesterenko said that this year’s budget could even show a slight surplus.

Russia has no pressing need to borrow from international markets to cover the federal deficit. Instead, the purpose of the bond issue is to maintain Russia’s profile on international capital markets and provide guidance to lenders in private Russian bond issues. Finance minister Anton Siluanov said the huge demand for the 30-year bond was an impressive sign of market interest in Russia. The bond also attracted new investor groups that have not earlier invested in Russian bonds. The timing of the bond issue took advantage of prevailing positive sentiment in the markets.
China

Slow growth in domestic crude oil output forces China to rely increasingly on imports. China’s oil imports rose around 5% last year to about 253 million metric tons, while the country’s own crude oil production remained at its 2010 level of 204 million tons. In January and February this year, crude oil output was up just over 1% from a year earlier, while crude oil imports were up nearly 13%. China’s oil imports have been rising faster than domestic production for years, outstripping domestic production already in 2009. Chinese demand is widely seen as a major factor for high world oil prices.

During 2011, about 20% of China’s oil imports came from Saudi Arabia, 12% from Angola and 11% from Iran. In the first two months of this year, the share of imports from Saudi Arabia increased, while the share of imports from Iran declined some four percentage points. Iraq has also become an important oil source, currently accounting for about 7% of China’s oil imports.

Since the inauguration of a new pipeline at the beginning of last year and the later progress in resolving pricing disputes, oil imports from Russia to China have increased sharply. Russia last year supplied about 7% of China’s total oil imports. In the first two months of this year, that share had increased to 10%.

To secure adequate oil supplies, Chinese firms are actively engaged in oil resource development projects around the globe. At the end of March, China’s state oil company Sinopec finalised its acquisition of a 30% stake in the Brazilian oil driller Petrogal Brasil for a price of about $5 billion (as initially agreed last November). Sinopec is China’s largest oil refiner and is involved in dozens of production projects in over 20 countries.

Domestic crude oil output and imports (Mt/month)

Chinese banks again enjoyed rising profitability last year. China’s largest banks released their 2011 financial statements over the past two weeks. The banking sector remains dominated by the four large state banks: Industrial and Commercial Bank of China, Bank of China, China Construction Bank and Agricultural Bank of China. All four big banks managed to again raise their profitability, which jumped between 19–28%. The combined profits of the four big banks amounted to 623 billion yuan (€69 billion). Growth in profitability at some mid-sized banks, however, was even faster than at the biggest banks.

The lion’s share of bank profits came from basic banking activities, i.e. taking deposits and giving loans. The state assures banks of a minimum profit margin by setting a ceiling on deposit rates and a floor on credit rates. Banks last year managed to widen their net interest margins and increase efficiency in their banking operations. Highest profit growth, however, was seen in various fees and commissions collected by banks.

Non-performing loans of big banks fell during the first three quarters of 2011, but then began to climb in the fourth quarter. At the end of the year, the stock of non-performing loans of the big banks represented about 1% of their total loan stock. The amount of non-performing loans is expected to increase in coming years as borrowers start to default on loans given during the economic stimulus in 2009–2010. The stimulus allowed the green-lighting of many capital investment, construction and infrastructure projects that are expected to prove unprofitable or unnecessary.

Officials want to encourage banks to prepare themselves for the fallout from these failed projects, so they are raising minimum capital requirements for banks from the start of July 2012. In order to raise solidity ratios, big banks are distributing smaller share of their last year profits as dividends. Despite the expected wave of non-performing loans, share prices of banks – indeed the entire financial sector – have held up well in the bearish Shanghai stock exchange.

Shanghai A-share index and financial sector index

Source: CEIC

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Russia

Inflation rate hits record low in March. March 12-month inflation was a mere 3.7%, sharply below the 6.1% rate registered in December 2011 and 9.5% in March 2011. After periods of extremely high inflation in the 1990s, Russia’s inflation rate has subsided steadily as the economy stabilised, macroeconomic conditions improved and officials got a handle on fiscal and monetary policy tools.

The current lull in inflation is likely to be short-lived, however, as it is largely the result of a political decision to postpone this year’s scheduled hikes in regulated rates for municipal services until July (such rate hikes typically enter into force in January). In addition, annual increases in some excise taxes were divided into two steps: e.g. the excise tax on alcohol was increased 10% in January, while a further 20% hike takes place at the beginning of July.

Unofficial means for price regulation of certain products have been applied as well. For example, oil refineries agreed with the government to refrain from hiking wholesale prices of gasoline until March. Electrical power producers also agreed to hold back temporarily on hikes in wholesale prices of electricity. The price freeze meant that March retail prices for gasoline were unchanged from December. Since the presidential election in early March, producers have begun to gradually increase wholesale prices for gasoline and retail prices are expected to follow soon.

The government’s official inflation target this year is 5–6% at year’s end. Central Bank of Russia chairman Sergei Ignatyev said hitting this target will be quite difficult with the upcoming hikes in regulated rates this summer. Many observers expect Russian inflation rate will exceed 6% at year’s end.

Capital outflows from Russia remain strong. Preliminary CBR balance-of-payments figures show the net value of private-sector capital outflows in the first quarter amounted to $35 billion, about as high as in the fourth quarter of 2011. Officials seemed caught off guard by the persistence of capital gushing from the country in the first quarter.

Capital outflows during the past six months equalled about 8% of GDP for the period. For the past four quarters, capital exports amounted to about $96 billion or around 5% of GDP. Russia has only seen capital exports at considerably higher levels twice in recent history: during the 1998 Russian financial crisis and during the 2009 global recession.

A substantial share of capital exports show up in the balance-of-payments reporting as “doubtful transactions” and as “net errors and omissions.” The transactions consist of phone export or import deals that allow the export of earnings and evasion of tax liabilities. These “grey” capital exports continue to be significant. In the past four quarters, they exceeded $45 billion, i.e. 45% of net capital exports were categorised as grey.

First-quarter foreign direct investment into Russia’s enterprise sector was down from 1Q2011, while DI inflows from Russia abroad were essentially unchanged (excluding the banking sector for which the CBR releases separate figures). Over the past couple of years, DI outflows from Russia have been much bigger than FDI inflows into the country. In the past four quarters, Russian DI outflows amounted to roughly $70 billion and FDI inflows into Russia were $44 billion. In addition, repatriation of portfolio investment in Russia picked up. Borrowing of Russian firms on international markets continued ($27 billion in the past four quarters).

Banks exported about $33 billion in net terms during the past four quarters. This notable outflow of capital from the banking sector increased in the first quarter. However capital export statistics include also domestic transactions involving loans from Russian banks to large Russian firms that are registered abroad.

Current account balance and balance-of-payment figures for private sector net capital inflows, % of GDP, average of last four quarters

Russia has been a net capital exporter for most of the past 10 years. Some observers explain this as a reflection of the fact that the domestic economy lacks sufficient investment opportunities to absorb the flood of export earnings. In other words, Russia’s capital exports indicate structural issues in the economy, the lack of adequate infrastructure and a weak investment climate. Russian firms prefer to ship capital abroad where they enjoy better property protection and lower investment risk. Russian firms and households have recently been particularly active in real estate deals abroad.
China

Inflation picked up in March; cautious easing of monetary stance. China’s National Bureau of Statistics reports consumer prices rose 3.6% y-o-y in March. Although inflation accelerated slightly from February, the pace of inflation was well below 2011 levels (as recently as last September inflation was running above 6% y-o-y). The lion’s share of inflation was driven by rising food prices, while non-food prices increased only modestly. China has an official 4% inflation target this year—a target generally considered realistic. Producer prices were lower in March compared to a year earlier, so they exert no inflationary pressure on consumer prices.

Falling inflation and weakening growth prospects gave the national People’s Congress this March sufficient latitude to declare a shift in the emphasis of economic policy this year from inflation-fighting to bolstering economic growth. To stimulate economic growth, the People’s Bank of China has eased lending guidelines for commercial banks and lowered reserve requirements for all commercial banks by a half-percentage-point in both December and February. The PBoC announced last month it was lowering the reserve requirement for over 500 bank branches that deal with providing finance for the agricultural sector.

Although the PBoC has not adjusted reference rates since last July, in public there has been discussion about lowering reference rates and even phasing out interest-rate regulation altogether. By setting a ceiling on deposit rates and a floor on credit rates, the PBoC currently guarantees commercial banks a minimum profit margin. Such rate regulation reduces the possibilities of banks to compete. This practice is rare elsewhere in the world, as is the Chinese practice of setting branch-specific reserve requirements. China is finding that such micromanaging of monetary policy is increasingly difficult as it proceeds with market reforms.
Russia

CBR expands its monetary toolkit. The Central Bank of Russia this month introduced a new one-week deposit instrument and modified certain market operation practices. The CBR said the purpose of the moves was to improve the effectiveness of interest-rate policy, as well as to reduce the gap between deposit and credit rates to limit volatility in market rates. Compared to advanced economies, CBR interest-rate policy is still ineffective and needs to be improved in order to gradually shift from ruble exchange rate steering to inflation targeting as planned by the CBR and the government.

The CBR’s current view is that the days of large excesses in money market liquidity as seen in the mid-2000s are gone forever. To help banks meet their financing needs, the central bank has extended the maturities of certain credit instruments and increased their availability by e.g. easing collateral requirements.

At its April 9 meeting, the CBR board decided to leave rates unchanged. The one-day repo credit rate, the CBR’s key open market operations rate, was kept at 5.25%. Central bank chairman Sergei Ignatyev said he expects interest rates to decline a bit in the near future.

In February, the average interest rate on ruble-denominated bank loans of under a year granted to firms was 8.9%, while the average rate of household deposits of under a year was 5.3%. In the interbank market, the one-day Moscow Interbank Actual Credit Rate (MIACR) has fluctuated around the 5% level in the first three months of this year.

One-day Moscow Interbank Actual Credit Rate, % p.a.

Government eyes return to tighter fiscal policies. Presidential economic policy advisor Arkady Dvorkovich said a decision in principle had been reached at the start of this year to limit federal budget spending so that tax revenues from oil and gas are not devoted entirely to spending, but part of revenues will again be set aside in reserve funds, reinstating similar practice as used prior to the 2008–2009 financial crisis. Starting in 2003, Russia began to collect a share of oil and gas revenues in off-budget reserve funds instead of using all of them for budget expenditure. In 2008, the build-up of the reserve funds was halted due to the collapse of global oil prices and economic recession in Russia. Money from the Reserve Fund was used to finance the federal budget deficits in 2009 and 2010.

Many oil producing countries collect part of their oil revenue in off-budget funds. Also Russia’s leaders view that it is necessary to return to systematic building of the reserves. At the request of president Dmitri Medvedev, the finance ministry submitted in April a proposal on new principles for collecting funds to the reserves. Under the proposal, the part of revenues from taxes and fees on production and export of oil, petroleum products and gas that is due to oil price exceeding its previous ten-year average in the global market, would be set aside. If the price is lower than this average, then no money would be allocated to the reserve funds. This approach would mean that fiscal policy be tighter than at present, albeit still looser than before the recession when a considerably larger share of revenue from oil earnings was channelled to the reserve funds.

Over the past ten years, the price of Urals-grade crude oil has averaged $61 a barrel. If the suggested allocation principle were applied directly to the budget starting next year, it would require slashing current budget spending by nearly half. For this reason, the finance ministry has proposed that over the next three years a smaller share of revenue be shifted to the reserve funds (e.g. next year to reserve funds would be transferred the share of tax revenues originating from the oil price exceeding $102 a barrel). Starting 2016, the government would use the ten-year average.

The cabinet is still not in full agreement on the proposed spending arrangement; discussions on this topic could go on for a long time.

As of end-March, Russia’s reserve funds held assets totalling $152 billion. Of that, $62 billion was in the Reserve Fund to cover budget deficits in coming years. The remaining $90 billion was in the National Welfare Fund, which is meant to be used e.g. for the pension system reform.

Price of Urals crude (left scale) and reserve funds (right scale)

Sources: Russian Ministry of Finance, Bloomberg
China

China’s economic growth slows as expected. China’s National Bureau of Statistics reports real GDP growth in the first quarter climbed 8.1 % y-o-y and 1.8 % q-o-q. Both measures were lower than in the fourth quarter of 2011, when real growth was 8.9 % y-o-y and 1.9 % q-o-q. Realised growth was in line with consensus forecasts in the range of 8–9 % for this year, including BOFIT’s own projection of 8 %. Despite consensus projections, markets expected China to release slightly bigger numbers.

Quarterly change in China’s GDP growth (percentage change from previous quarter, seasonally adjusted)

Sources: BOFIT estimates for 2006–2010 and official NBS quarterly figures for 2011 and 2012

Other economic figures released in conjunction with the GDP numbers also were in line with expectations. Notably, there were still no indications that the Chinese economy has begun its much-touted shift from an investment-driven regime to consumption-driven growth. Retail sales growth, an indicator of domestic consumption, has been fairly stable in recent months. Although the rate of investment growth has slowed, the increase in fixed capital investment continued to outstrip growth in retail sales in the first quarter.

The slowdown in construction activity continued in the first quarter as measures implemented over the past two years to calm overheating in the sector take effect. In the first quarter, prices of new and existing apartments fell in almost every major city in China, there were fewer housing project starts compared to a year earlier and sales of residential and commercial properties, as well as land-use rights, were down on-year. In addition, stocks of existing commercial space and apartments for sale were up. Confidence in the real estate sector today stands at near-historical lows, and builders expect prices to decline much further.

The first wave of small construction company bankruptcies has already occurred. Despite the weak situation, the mood in the sector seems surprisingly calm.

People’s Bank of China widens yuan-dollar fluctuation band from 0.5 % to 1 %. The change that entered into force on Monday (Apr. 16) concerns the maximum allowed fluctuation in the yuan’s interbank spot foreign exchange rate during a given business day. While the move has little impact for the general public, it is considered to be an important step towards freer yuan convertibility. Currently, it is expected that People’s Bank of China will move to free convertibility of the yuan by 2015.

After a one-and-a-half-year episode of yuan appreciation against the dollar, the yuan-dollar rate has held quite steady over the past four months. Both the official Shanghai yuan-dollar rate and the Hong Kong off-shore rate have stabilised around the 6.3 level. Moreover, expectations of yuan appreciation in the forex markets appear to have evaporated; 12-month yuan futures rates are no different from the current exchange rate level.

According to media reports, the central bank sees the current yuan-dollar exchange rate at or near equilibrium. One piece of evidence cited is that the trade balance overall was near perfect balance in the first quarter of 2012. On the other hand, it is typical for China to post its weakest trade balance figures for the year in the first quarter, which always embraces the Chinese New Year holidays. Growth in China’s foreign currency reserves slowed in January-March, even if the PBoC appeared to be purchasing foreign currencies on the market to prevent yuan appreciation. Should the trade surplus start to increase rapidly in the current quarter and growth in the foreign currency reserves accelerates, the debate about the yuan exchange rate will no doubt resurface again.

Yuan-dollar exchange rate, Shanghai and Hong Kong

Source: Bloomberg
Russia

Weak first-quarter growth in demand. Not only was the volume of seasonally adjusted retail sales in March rather unchanged from February, but retail sales for the entire first quarter were not changed from 4Q2011. They were up, however, well over 7% relative to 1Q2011. Growth in real household incomes was also stagnant in the first quarter. Fixed capital investment was notably down in March and for the first quarter overall, reflecting e.g. weakness in construction activity. Compared to 2011, investment in 1Q2012 was up over 5%, however. Based on data on the volume of oil and gas exports, export volumes overall seem to have developed weakly in the first quarter (export volumes were up less than 0.5% for all of 2011).

Weak demand has begun to affect supply, according to some observers because strong post-recession growth in inventories has subsided. The economy ministry reports seasonally adjusted GDP contracted in March and grew slowly in the first quarter overall. Industrial output dipped in March, even if first-quarter growth overall was still quite good. GDP and industrial output were up 4% y-o-y in 1Q2012. Seasonally adjusted import growth was at a standoff in February-March, but import growth in the start of the year was so strong that if the level of import value reached in the first quarter is maintained during the rest of the year, import growth for the year overall would hit 15%.

Several prominent forecasting agencies have revisited their forecasts from a few months ago and revised upwards their GDP growth projections for the year, mainly on the expectation of higher oil prices than assumed earlier. The forecasts at the moment see GDP growing 3.5–4.0% in 2012. The economy ministry’s latest forecast is 3.4%.

Seasonally adjusted supply and demand indicators for Russian economy (volume, unless otherwise mentioned), 2006=100

Russian consumer demand also visible in Finland. The value of tax-free purchases by Russian shoppers in Finland was up 30% y-o-y in the first three months of 2012. Russian overnight stays in Finnish accommodation establishments were also up about 20% y-o-y for the January-February period.

Russian tourists today are by far the largest group of foreign visitors to Finland — and the importance of Russian tourists to the Finnish service sector increases every year. In 2011, Russians accounted for over 6% of all overnight stays in Finnish accommodation establishments and over 1% of Finnish retail sales. In 2010 (latest available figures), Russian tourists spent about €650 million on goods and services in Finland.

The impact of Russian tourists is concentrated on certain regions and activities. Early January is an important tourist season for Russians as it encompasses their New Year’s holidays. Russian tourism is relatively most important for the region of Southern Karelia, which lies along the Russian border and close to St. Petersburg. Russians accounted for 40% of overnight stays in accommodation establishments in 2011 in Southern Karelia, whereas in January that share rose to around two-thirds of total occupancies. In the town of Lappeenranta, for example, tax-free purchases by Russian tourists accounted for over 7% of total retail sales in 2010. When purchases other than tax-free purchases are included, the total contribution of Russian shoppers was even more impressive.

Russian shoppers are particularly important for clothing and jewellery shops. About 4% of net sales of such business were generated by Russian tax-free purchases in 2010.

The trend to expanding Russian tourism is likely to continue as forecasts see incomes in Russia on a rising path. Over the past decade, the volume of Russian trips abroad has nearly tripled. Despite that about 70% of Russians (nearly 100 million people) have never travelled outside former states of the Soviet Union according to a recent survey by the Levada Center. Even today, less than 20% of Russians carry passports that allow international travel.

In 2010, Finland beat out visa-free Turkey and Egypt as the top tourist destination for Russians outside the CIS. This especially reflects the huge number of short-time cross-border shopping expeditions to Finland.

Russian households spend an average of 3–4% of their income on tourism and recreation. For 2011, this amounted to some €150–200 per person. With higher income level, the spending is higher for residents of Moscow (€300–400 last year) and St. Petersburg (€200–250). A recent survey by the Romir consulting group asked Russians to name three activities they associate with luxurious lifestyles: nearly a third mentioned travel to exotic islands and 14% said sea cruises.
China

China set to be a global leader in economic growth in 2012 and 2013. The latest IMF World Economic Outlook (WEO) expects China to post annual GDP growth in the range of 8–9% over the coming years. Higher growth is forecast only for countries recovering from wars in Africa and the Middle East, as well as Mongolia, where economic growth is being driven by a booming mining sector. In addition to China, the outlook is also bright for the other BRICs (Brazil, Russia and India). Weak recovery is expected for most advanced economies, and especially those strongly linked to the European debt crisis. The IMF noted that Europe’s sovereign debt problems remain the biggest risk to the global recovery.

IMF baseline forecasts for BRIC GDP growth, %

![Chart showing GDP growth forecasts for Brazil, China, India, and Russia from 2004 to 2014.](chart)

Source: IMF

Like most major forecasting agencies, the IMF expects the Chinese economy to experience a soft landing rather than a severe decline in growth. As in many emerging economies, overheating poses a threat to the Chinese economy, but it has been subdued by Chinese officials through active use of fiscal and monetary measures. A sign that China’s counter-cyclical measures are working was already evident this winter with the downturn in apartment prices in Chinese cities. Tracking inventory levels remains a serious challenge for forecasters, however, as Chinese statistics officials release very little data on inventories. China is known to maintain huge inventories of certain raw materials, including energy products, metals and foodstuffs, so changes in inventory levels translate directly to import figures and thus affect the headline figures for GDP growth. China’s inventory levels also affect global commodity prices.

The IMF noted that the rapid reduction in China’s current account surplus has come as a big surprise to most observers. China’s current account surplus last year was just 2.8% of GDP, down from levels well above 10% as recently as 2007. Among the many factors contributing to a shrinking current account surplus has been the fall in demand for Chinese products in developed countries struggling with recession. Strong growth in China’s own investment demand, rising domestic production costs and yuan appreciation against the dollar have all also contributed to a smaller current account surplus. The IMF expects China’s current account surplus to increase modestly this year.

Incomes continued to rise sharply in the first quarter. China’s National Bureau of Statistics reports incomes continued to rise rapidly in the first quarter of 2012. Monthly disposable income averages 2,460 yuan (about €300) for urban households and 850 yuan (about €100) for rural households. Real incomes were up over 10% y-o-y. About two-thirds of household income in cities came from wages and slightly over 20% from income transfers. In the countryside, over half of income was derived from farming activity and a third from wage incomes. Surveys suggest urbanites generally expect the robust wage rise to continue.

Chinese tax rates for small and mid-range incomes are quite low. Indeed, most wage-earners pay no income tax. Since September 2011, the first 3,500 yuan of the monthly wage has been exempt from tax and income from between 3,500–5,000 yuan taxed at just 3%. Rates on monthly wage income above 5,000 yuan increase stepwise to a top rate of 45% (monthly wage over 83,500 yuan). Taxation on income earned from agriculture was abolished in 2006.

The rapid rise in incomes has made China a stellar performer in eradicating global poverty. According to a new World Bank estimate, the number of Chinese living below the poverty level (income of less than $1.25 a day) fell from 832 million in 1981 at the start of economic reforms to 172 million people in 2008. In the same period, the number of people globally rising out of poverty was about the same number as in China. While the absolute number of people living in dire poverty has not fallen elsewhere, population growth has meant that the relative share of the population living in poverty in most other countries has shrunk. Despite the fall in poverty rates in China, income gains have not been shared equally. Income disparity in China continues to increase from year to year.

Rapid growth in incomes in China will fuel the restructuring of the economy. Increased purchasing power translates to higher consumption levels. The rapid rise in labour costs also reduces the competitive advantage of export industries relative to other countries. This especially affects labour-intensive branches such as the textile industry. At the same time, real yuan appreciation works parallel to wage growth by decreasing prices of imported foreign goods and raising Chinese purchasing power of foreign goods, while eroding the price competitiveness of domestic products against imports.
Russia

Russia seeks to attract Chinese investment in Far Eastern Russia and Eastern Siberia. As part of last week’s Sino-Russian trade and investment meeting in Moscow, Chinese deputy prime minister Li Keqiang took part in the signing of 27 agreements between Russian and Chinese companies. Although most of the agreements had in practice been finalised a long time before, they were publicly formalised at the meeting. The $15 billion deal package provides insight into just how rapidly economic relations between Russian and China are developing.

The state Russian Direct Investment Fund (RDIF) agreed with China’s sovereign investment fund, China Investment Corporation (CIC), on the establishment of a joint investment fund by the end of July. A memorandum of understanding on creation of the new fund was signed by the parties last autumn. RDIF and CIC will initially invest $1 billion each. Other Chinese investors are expected to follow with another $2 billion in investment. The fund would direct 70 % of investment to Russia and other CIS countries. The remaining 30 % would go to Chinese firms working in cooperation with Russian firms. The first investments will go to companies involved in the machine-building, forestry, agriculture and transportation sectors.

The Russians expect the new fund to attract hundreds of millions of dollars in investment already this year.

Russian officials note that China offers Russia a relatively inexpensive source of long-term financing, as well as unique skill sets. Russia, in turn, offers China large state-supported investment projects, particularly in development of natural resources in Eastern Russia. In his discussions with Li Keqiang, Russian deputy prime minister Igor Shuvalov said the Chinese were welcome to invest in projects in Eastern Siberia and the Russian Far East, for whose development Russia was creating a new state corporation.

Cooperation in the energy sector has not proceeded as hoped. After many years of wrangling over pricing schemes, Russia’s state-owned oil company Rosneft last year finally began to supply crude oil to China by pipeline. The Chinese, however, continued to insist the price was too high, and Rosneft lowered the price earlier this year. Russia’s prosecutor general office is now investigating the deal due to a complaint claiming that the decrease of the price results in lost profits to Rosneft and harms Russia’s economy.

Russia and China have yet to resolve their years-running differences on construction of a natural gas pipeline that would run via Altai to China. The go-ahead has also been delayed by failure to agree on a gas-pricing scheme.

Last year, China was Russia’s second largest export market and the largest source of imports.

Cabinet members at odds over how to develop Siberia and the Russian Far East. Russia’s ongoing shift of economic focus eastwards has major implications for the thinly populated, resource rich regions of Eastern Siberia and the Russian Far East. The biggest challenge is development of resources that are in remote areas with harsh conditions. The eastern parts of Russia have gained more geopolitical significance with the rise of the Asia-Pacific region.

Sergei Shoigu, Russia’s current emergency situations minister and soon-to-be Moscow region governor, proposed in January to prime minister Vladimir Putin the creation of a new state corporation to oversee development of Siberia and the Russian Far East. The economy ministry, tasked by the prime minister to prepare legislation on the envisioned state corporation, handed its draft to the government in March. The focus of the state company would be on construction of infrastructure to support large investment projects, but it could also participate in other projects.

The economy ministry has proposed that the state corporation be financed for the next 10 years by dedicating the interest from oil tax revenues allocated to the National Welfare Fund. Last year, the National Welfare Fund generated interest amounting to 48 billion rubles (€1.2 billion). In addition, the state corporation would be capitalised with shares of various state-owned enterprises. The corporation would also be eligible for large tax breaks. It would receive exceptional powers to decide on the region’s investment projects and land use and have the authority to issue licences for the use of natural resources without competitive bidding stipulated by law.

State corporations are a special feature of the Russian economy. There are seven at the moment; they function under the president and are exempt from normal supervision. They deal with special missions (e.g. construction of the Sochi Olympic facilities) or are involved in sectors of the economy of special importance. Many organisations such as the State Inspection Office, have long criticised state corporations for their inefficiencies and lack of transparency. The finance ministry and earlier also the economy ministry have called for converting these state corporations to e.g. normal limited liability corporations subject to the corporate law.

At the end of April, finance minister Anton Siluanov sent a letter to Igor Shuvalov, the deputy prime minister tasked with responsibility for the project, strongly opposing the creation of a new state corporation for developing Siberia and the Russian Far East. As a reaction, this week Shuvalov proposed an alternative: an administratively much lighter development fund under the state development bank VEB. VEB just launched a development fund for the Baikal region and the Russia Far East at the start of this year. The proposed fund would expand the scope of the VEB fund without the need to create a new large organisation.
China

Foreign direct investment inflows to China continue to decline. In the first three months of 2012, foreign direct investment inflows into China amounted to just over $29 billion, about 3% less than in the same period a year earlier. The downturn in FDI inflows (y-o-y) started last November.

One reason for the decline in investment has been the low growth in demand from Western economies. A substantial share of inbound investment to China is targeted at component assembly plants that produce finished goods for re-export. Although China’s rise in real incomes and increased domestic demand will undoubtedly attract future investment, the drop in investment inflows reflects cyclical conditions and may provide evidence that China has entered a period where production based solely on cheap labour is being shifted to countries with lower production costs.

In Q2012, Hong Kong accounted for nearly 65% of FDI inflows into China. Asia’s pre-eminence as a source of Chinese FDI was further bolstered by investment from Japan, Taiwan and Singapore. In contrast, FDI inflows from the EU fell below 5%, and the US contributed an approximately 3% share. As the major role of Hong Kong suggests, companies can currently channel investment flows through locations most suitable for them so these figures should be read with caution.

FDI by Chinese companies internationally nearly doubled to about $17 billion in the January-March period. The figure does not include the financial sector. More detailed statistical data on investment outflows of Chinese firms abroad will be released later.

China’s air traffic on the rise. The number of air travellers increased about 9% last year, with the total number of passengers reaching nearly 300 million. Air transport in general has a bright future in China, where flying is a rarity for most of its huge population. In 2010, there were only about 2,500 civil aircraft in service and fewer than 200 manned airports. The air industry employed less than 300,000 persons in 2010.

Air travellers in China typically fly in fairly new planes and most of the airports they visit are shiny and new. The biggest frustration for passengers are flight delays, which have only increased in recent years. Frustrated by delays, travellers have sometimes even endangered air traffic by running onto the tarmac to protest their stranding. Observers attribute the delays to a lack of fleet, the lack of competition, old-fashioned administrative structures and the relatively small amount of air space set aside for civil aviation.

Indeed, the majority of Chinese airspace is reserved for military purposes; civil aviation is confined to less than a third of the national airspace. Foreign airlines are banned from flying any domestic routes inside China, and over 90% of domestic air routes are controlled by four airlines (Air China, China Eastern Airlines, China Southern Airlines and Hainan Airlines). The first three are state-majority owned.

The world’s largest aircraft manufacturers, the European Airbus and the American Boeing, see China as a promising market for their products in coming years if the projected demand for more air travel, planes and airports materialises.

China’s own aerospace industry would like to hang onto its piece of the growing civilian aviation business. While domestic aircraft makers have seen little success in head-on competition against the majors, cooperation is available. Boeing and the Commercial Aircraft Corporation of China (COMAC), for example, are creating and technology centre for study of aviation energy conservation and emissions reductions in Beijing. Currently on the drawing board is a fuel-efficient jumbo passenger jet that will be entirely Chinese-built. The jet is scheduled to be in service in 2016.

Shake-out ahead for China’s shipbuilding industry. Before the international financial crisis, world trade and sea shipping grew briskly and many shipyards enjoyed bulging order books for new vessels. High demand helped China establish itself in the top tier of shipbuilders along with Korea and Japan. Measured in dead-weight tons, Chinese ship production increased nearly ten-fold between 2005 and 2011, and the number of shipbuilding companies doubled.

Shipbuilding boom, financial crisis and prevailing uncertainty created vast overcapacity of ships that will depress demand for new ships for years to come. Although the volume of ship production in China in the first quarter matched that of Q2011, the volume of new orders booked in January-March was half that of a year earlier. A decline in production seems inevitable.

Chinese shipbuilders compete against their international rivals on the basis of price, while Korea and Japan compete on construction of the most advanced and energy-efficient ships. The Chinese have focused on increasing the range of vessels available and improving quality, but their competitors have a large lead in these areas. With orders drying up, Chinese shipbuilders have turned to large discounts; some observers claim the most desperate builders are selling ships at prices below actual production cost.

While the shipbuilding industries in Korea and Japan are controlled by a few large players, China has 1,500 shipbuilders. Low demand at the moment will force mergers of Chinese shipbuilders into larger entities. Some observers believe that half of Chinese shipbuilders will survive the impending shake-out, but the most pessimistic expect only about 10% of companies to survive.
Russia

Government finances may be close to balance this year. The finance ministry says in the draft federal supplemental budget for this year, recently discussed by the cabinet, that the budget would produce just a tiny federal budget deficit this year (0.1 % of GDP). If the pattern of previous years holds, overall state finances, i.e. consolidated budget (federal budget, regional and local budgets, plus state social funds) would also be close to balance.

The reduced deficit projection reflects substantially higher-than-expected revenue growth relative to the budget forecast approved last December. The revised revenue estimate is largely driven by the assumption that the price of Urals-grade crude oil will average $115 a barrel this year rather than the original budget assumption of $100 a barrel. The additional revenue over the original federal budget amounts to over 1 % of GDP. In nominal terms, revenues would be up more than 10 % from last year.

Naturally, a budget balance this year will also require that budget spending does not increase much from the spending approved in December. The fresh supplemental federal budget draft (the only one so far this year) will only slightly add to spending (though from 2011 it is up 17 %).

State budgets: revenues, expenditures and surplus, % of GDP, average of last four quarters

The fresh tax policy framework does not deal with the level of taxation as regards the largest tax revenue streams (i.e. value-added tax, labour income tax, and corporate profit tax), and these are generally expected to remain unchanged. Moreover, the policy does not discuss oil production fees, or export tariffs on oil and gas. The mandatory social contributions for employers on worker wages, which represent 17 % of total state revenues, would remain at the current level of 30 % of the gross wage. During the past year, officials have made suggestions to hike the social contributions after 2014. The finance ministry notes the social contributions may still be affected by pension reform, expecting to see the pension reform plan this year.

The natural gas production fee, which presently generates less than 1 % of state revenues, would be doubled for Gazprom and quadrupled for other producers. This would effectively unify the production fee rates paid by Gazprom and other producers. The fee would be just over 1,000 rubles ($35) per thousand cubic metres in 2015. The average price for exported gas from Russia in the first two months of this year was about $350 per 1000 m³.

Hikes in excise taxes on motor fuels, tobacco, as well as beer, wine & spirits will continue through 2015, when the excise on tobacco and alcohol should be 2–2.5 times as high as currently. Taxes on expensive privately owned real estate and high-volume cars will also increase.

Putin’s promise about tax breaks spurs wave of joint oil development projects with international firms. During his final days in the role of prime minister, Vladimir Putin oversaw the creation of three major joint ventures with state oil company Rosneft for development of arctic oil and gas resources. In mid-April, then prime minister Putin publicly promised that new continental shelf projects would enjoy exemptions from export tariffs and substantial reductions in other tax obligations. Thereafter, Rosneft announced these joint ventures in rapid succession. The ventures to identify and develop arctic hydrocarbon deposits involve the American ExxonMobil, the Italian Eni and the Norwegian Statoil. Although the promised tax breaks have yet to be enshrined in law, the prime minister outlined the needed amendments in a decree on May 3.

The three agreements should bring a substantial infusion of international expertise and investment to discovery and development of hydrocarbon resources in Russia’s arctic regions. Moreover, the deals enhance Rosneft’s position as Russia’s premier oil producer. Under the deals, Rosneft provides the joint ventures with licences to explore certain areas and the foreign partners contribute their expertise and capital. Rosneft will hold a majority stake in each joint venture, and the agreements grant Rosneft to gain knowledge also by participating with its partners in projects outside Russia.

Tax policy guidelines for 2013–2015 take shape. The cabinet last week approved a taxation policy framework, although some modifications may arise when drawing up the state budget policy framework for the 2013–2015 period. The three-year state budget guidelines are made every year, published usually in July and considered by the cabinet in September. In fact, taxes may be adjusted e.g. from year to year as needed.

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China

Trade surplus swells on slowing import growth. China’s overall foreign trade growth in April was lower than expected, reflecting Europe’s ongoing difficulties and the gradual slowing of the Chinese economy. Nevertheless, the value of China’s goods exports in April was still $163 billion, up 5 % from a year earlier. Imports of $145 billion in April were essentially unchanged from year earlier. Adjusted for seasonal factors, the import performance looks particularly poor. However, it was largely attributed to lower commodity prices, above all metal prices, which were down substantially from last year. Volumes of commodity imports, in contrast, continued to rise.

The trade surplus surpassed $18 billion in April. The cumulative surplus for the first four months of this year reached $20 billion, up from $11 billion in the same period last year.

The slowing growth in foreign trade was evident in both traditional trade sectors and assembly industries (which accounted for roughly 40 % of exports in January-April). Many Asian countries have recently noted slowdowns in export growth.

China’s exports, imports and trade balance, US$ billion

Mobile phone subscriptions surpass one billion. In the first quarter 2012, the number of mobile phone connections in China increased 14 % y-o-y to over one billion. The number of land line subscriptions, in contrast, dipped to below 300 million.

Smartphone internet use has soared. Last year, 3G (third generation) connections increased 146 % to 150 million connections. China only introduced Internet-enabling 3G services in 2009, so the high growth for smartphones should continue. 4G services, which give full broadband connectivity, are now being introduced on a trial basis. China needs new investment to develop its mobile phone networks as data transfer rates on mobile phones in average are ten times slower than in the developed world.

China Mobile, which provides over two-thirds of all Chinese mobile phone connections, is by far the world’s largest mobile phone operator. Its main competitors are the dominant land-line provider China Telecom and the fast-growing China Unicom. The Chinese state is the majority shareholder in all three companies.

Samsung has recently found particular success on the Chinese mobile phone market, gobbling up nearly 25 % of market share according to Gartner Inc. China’s former market leader, Nokia, has seen its market share dwindle to below 20 % and now has the second largest market share. Huawei and ZTE, China’s own mobile phone giants, hold third and fourth place, each with market shares on the order of 10 %. Fifth-ranked Apple now has a market share surpassing 7 %.

The increasing adoption of smartphones has caused an explosion in the market for phone applications, particularly mobile gaming. China has become a critical market for game-makers. For example, the Finnish Rovio, developer of Angry Birds, reports that China is now its second largest market after the United States. Net sales of China’s own mobile gaming industry grew nearly 50 % last year to 3.9 billion yuan (€480 million). China also exports mobile applications abroad, especially to markets in Korea and Japan.

Chinese hoard gold. Figures from the World Gold Council show that China was the world’s second largest gold consumer after India in 2011. China, however, is on track to become the world’s biggest gold consumer this year as Chinese gold buying has been rising rapidly in recent years, while Indian growth has been much lower. In the first quarter of the year, Chinese buying remained strong: Chinese gold purchases from Hong Kong were up many times from a year ago. About half of the world’s gold is consumed by jewellery making, while 40 % goes to investment and 10 % to industrial applications.

Most gold in China is purchased by private consumers and investors. IMF figures show China’s gold and foreign currency reserves contain 1.054 metric tons of gold, which the central bank has increased last time in 2009. China’s central bank is the world’s fifth largest gold owner after the US, Germany, Italy and France.

In addition to buying gold abroad, China has been the world’s largest gold producer since 2007. China last year produced 360 tons of gold, or nearly 13 % of global production. China’s declared gold reserves are the world’s third largest.

The value of gold traded on world markets has reached record levels in recent years. Gold is seen as a secure investment and demand for gold tends to rise whenever the global economy struggles.
Russia

President Putin declares targeted measures with deadlines to promote a “new economy.” Immediately after taking the oath of office on May 7, president Vladimir Putin signed eleven decrees laying out the goals of his third six-year term as Russia’s president. The goals largely formalise campaign promises made by Putin relating to the economy, living standards and improvement of the social infrastructure. The novel aspect is that the measures are fairly detailed and subject to tight implementation schedules that mostly fall within the current presidential term.

In the decree concerning long-term development of the economy Putin gave the government the following five concrete goals to focus on: 1) creation of 25 million “high productivity” jobs by 2020 by either establishing new jobs or modernised existing ones, 2) lifting the ratio of investment to GDP to 27 % by 2018, 3) increasing high-tech production to 30 % above the 2011 level by 2018, 4) boosting labour productivity by 50 % by 2018, and 5) raising Russia’s position in the World Bank’s Doing Business rankings from its current rank of 120 to 20 by 2018.

Observers note that achieving such targets in the tight timeframe is quite challenging. For example, the labour productivity target alone requires annual productivity gains on the order of 6 % a year. Economists find it hard to imagine how this could be achieved when consensus forecasts see medium-term economic growth running at around 4 % a year with only a slight decrease expected in the size of the labour force. Observers also see little reason to expect investment will increase fast enough to substantially raise its share of GDP. Investment currently corresponds to around 20 % of GDP. Higher investment growth would require e.g. a major transformation of Russia’s business environment - something that would take years even in a best-case scenario.

The social policy decree tasks the cabinet with attaining real wage growth of 40–50 % by 2018, including substantial hikes in wages in the fields of education and health care.

Other cabinet jobs in the health care sphere include specific reductions in the numbers of deaths caused by cardiovascular disease, tuberculosis and traffic accidents, as well as a reduction in infant mortality by 2018. The birth rate, in contrast, should rise by 2018, bringing the fertility rate per woman up to 1.75 children from about 1.6 in 2011. The average lifespan of Russians overall is also targeted to climb to 74 years by 2018. In 2011, the average life expectancy of a Russian was 70 years.

Plans to reform the Russian education system have been under preparation for years with little to show for it. The new goals are hoped to instil progress. The presidential decree calls for the cabinet to submit to the Duma a draft bill on education no later than June this year.

Bright lights, big city – Russian style. Research by Natalya Zubarevich, programme director for the Moscow-based Independent Institute for Social Policy (Nezavisimyi institut sotsialnoi politiki), finds the area of land in Russia that is populated and in economic use is currently decreasing, while the area of uninhabited land is increasing.

The ongoing trend means a gradual shift away from the industrial policy legacy of the Soviet era, when it was common to build complete towns near major natural resource deposits. These industrial operations were often remote from major cities and located in harsh climatic conditions. The resulting geography of production units is economically inefficient from both the standpoint of the companies and the economy in general. Municipalities with such companies face depopulation as these dinosaurs of Soviet industry have been or are being shut down. Workers involved in natural resource extraction in harsh climatic conditions prefer to live in more hospitable surroundings and today increasingly rotate through a few weeks at site and then commute home in a manner similar to workers in the Canadian north or the outback of Western Australia.

Russia’s population density is just 6 people per square kilometre. While 73 % of Russia’s land area lies east of the Urals, it holds only 29 % of the total Russian population. In comparison, the population density for Finland is around 16 persons per square kilometre.

During the 2000s, the only significant population gains were registered in the City of Moscow, the Moscow region, St. Petersburg and the three Caucasian republics: Chechnya, Dagestan and Karachay-Cherkessia. Modest growth was also registered in wealthy oil-producing regions. The trend is partly due to internal migration; 60 % of migrants head to Moscow or the Moscow region, while 20 % go to St. Petersburg. Zubarevich notes that Russia’s long-standing obsession with centralising political and economic power in the capital is one of the factors creating an unnecessary population boost in Moscow. At the start of 2012, Rosstat put the official number of Moscow residents at 11.6 million.

Growth in the Caucasian populations reflects a high birth rate relative to the rest of Russia. While the national fertility rate for women is about 1.6, it is 3.4 for Chechnya and 2.0 for Dagestan. (In comparison, the Finnish fertility rate is 1.9.)

Concentration of the population means that 28 % of Russia’s urban population lives in cities with a million or nearly a million inhabitants. Russia has more than 10 such large cities. About 27 % of the rural population lives in the most southern parts of Russia, i.e. the North Caucasus and Southern federal districts.
China’s economic growth continued to slow in April. On-year growth in industrial output slowed in April to 9%, down from 12% in March. The signs of falling output were visible across the board, with output growth sliding in both light and heavy industry. While electrical power generation was up 5% y-o-y in the first four months of 2012, in April electrical power generation was only a couple per cent higher than year ago.

Lower growth was especially evident in construction activity and capital investment. For example, cement production rose just 3% y-o-y in January-April. Although a record volume of new apartments were completed in recent months, the volume of new apartment starts measured in planned square metres of living space was down about 8% from the early months of 2011. Land use right sales were down 20% y-o-y in the first four months of this year.

Seasonally adjusted fixed capital investment declined to 0.8% m-o-m in April, which largely reflects the drop in sales of land use rights.

The volume growth of retail sales slowed in April by a percentage point to just under 11% y-o-y. January-March freight volumes also indicated slowing economic activity.

Both exports and imports showed signs of weakness. Weakening growth in both domestic and foreign demand creates new challenges for economic policymakers. The slowing of investment growth was expected, however, so it would be inappropriate to dramatise the situation.

Industrial output and retail sales, %-change y-o-y

Inflation slows in April; PBoC relaxes monetary stance. Consumer prices were up 3.4% y-o-y in April, down from 3.6% in March. Prices declined in April 0.1% from March. The slowdown in the inflation rate reflects the People’s Bank of China’s relatively tight monetary stance, lower economic growth and a 0.9% decline in food prices in April. Food prices in April, however, were still 7% higher than in April 2011. Producer prices in April were unchanged from a year earlier.

The slowdown in economic growth and inflation has provided the PBoC with an opportunity to relax monetary policy. Reserve requirements, the PBoC’s most actively used monetary policy tool, were lowered a half percentage point today (May 18). The reserve requirement falls to 20% of total deposits for the large commercial banks and 16.5% of deposits for smaller commercial banks. The reserve requirement means that a specified share of a bank’s deposits must be held as cash in vaults or as deposits with the central bank.

The cut in reserve requirements was the second this year. Easing of the PBoC’s monetary stance is expected to continue.

Growth in Chinese car production slows. About 14.5 million passenger cars were manufactured in China last year, an increase of about 5% from 2010. Production growth has slowed significantly from recent years and was just 3% y-o-y in the first quarter of 2012.

China’s car exports are still modest, with growth hampered at the end of the last decade by the global recession and more recently the emergence of economic uncertainty in Europe. During the last 12 months China has exported over 400,000 passenger cars. Exports of Chinese cars are especially directed to emerging economies. For example, Iran and Russia each accounted for about 10% of Chinese car exports in January-March.

Car imports took a hit during 2009, when subsidies for domestic car production were increased in response to the global financial crisis. Over the past twelve months, some 880,000 cars were imported to China. In 2009, the share of imported cars sold to total car sales bottomed at around 3%, but since then has come back to pre-crisis levels of about 6%. German makes accounted for about three-quarters of the nearly $6 billion in car imports in the first quarter of this year.
Russia

Slower economic growth. Rosstat figures show GDP grew at a rate of 4.9% y-o-y in the first quarter of this year. For the January-April period, domestic demand and the major production indicators were up briskly (retail sales climbed over 7% y-o-y, fixed investments nearly 14% and industrial output well over 3%).

Nevertheless, y-o-y growth figures are expected to diminish as the year wears on, for the fact that growth in the second half of 2011 was quite rapid. Those high growth figures, in turn, reflected the exceptionally strong recovery in agriculture following the disastrous harvest of 2010. Nearly all major forecasts see Russian GDP growing in the range of 3.5-4% this year.

Economic growth slowed in March and April. Retail sales and growth in investment from a year earlier remained quite brisk, but industrial output growth fell below 2% and manufacturing to around 3%. Seasonally adjusted industrial output in the March-April period fell from earlier months and retail sales held at about the same level as at the end of last year. Fixed investments declined.

In January-March, the value of imports was up about 15% y-o-y. The value of imports from non-CIS countries was up about 13% in January-April. Seasonally adjusted imports from non-CIS countries continued to contract in April after increasing sharply at the start of the year.

Seasonally adjusted supply and demand indicators (volume unless otherwise specified), 2008-100

First road maps for improving Russia’s investment climate approved. The first four “road maps” to improving the investment climate deal with improving access to the electrical grid, simplification of the construction permitting process, improved customs operations and supporting the exports and market access of Russian firms. Among the goals in the just-approved road maps are e.g. a shortening of the construction permitting process from 423 days to 56 days by 2018 and doubling the number of exporting firms by 2020. The government is expected to process the propositions in the road maps further to legislative changes in the coming years. The first concrete road map measure will be put into force already in mid-June. It should help customs officials by requiring an electronic import declaration in advance. The measure was proposed last year.

Prime minister Putin late last year requested preparation of the road maps to improve Russia’s poor investment climate. The road maps under preparation tackle over 20 areas proposed by representatives of business. The Agency for Strategic Initiatives in charge of preparing the road maps was established last year by Putin’s decree. The working group includes experts from the public and private sectors.

New cabinet likely to stick with current economic policy framework. At the start of this week, president Vladimir Putin announced his appointments of key personnel in the new cabinet and presidential executive office. Many of the new ministers in current government served earlier as deputy ministers or in the presidential executive office, so no big changes in economic policy are expected. A number of former ministers were named as advisers to the president.

Igor Shuvalov retains his post in the new cabinet as first deputy prime minister, along with most deputy prime ministers. Igor Sechin, deputy prime minister with the industry portfolio, has been replaced by former president’s economic adviser Arkady Dvorkovich, who is generally considered more liberal than his predecessor.

Among the ministers retaining their posts are finance minister Anton Siluanov and industry and trade minister Denis Manturov. Andrei Belousov, who earlier served as a deputy minister and a presidential aide, was appointed economic development minister. A rare surprise was the appointment of deputy finance minister Andrei Novak as natural resources and environment minister. The new ministry for development of Russia’s Far East will be headed up by presidential regional envoy Viktor Ishayev.

The highest positions in the presidential executive office remained largely unchanged with Sergei Ivanov continuing as chief of staff. Ministers migrating to new advisory posts in the presidential administration include economic development minister Elvira Nabiullina, interior minister Rashid Nurgaliyev and transportation minister Igor Levitin.

Prime minister Dmitri Medvedev set forth the goals of the new cabinet through the end of the year; mostly a reiteration of implementing earlier plans. Objectives include making a new timetable for privatization sales of state enterprises, implementation of wage hikes in the social sector and starting the implementation of “road maps” to improving the investment climate (see following item).
China

Pilot efforts to improve financing for small and medium-sized firms. Access to credit varies tremendously among Chinese firms. In particular, small and medium-sized enterprises (SMEs), which mainly drive economic output and employment, face much larger hurdles to bank financing than state-owned enterprises. As a result, SMEs often turn to the informal financial sector, where financing costs are often substantially higher they could have had with access to commercial banks.

In the east coast city of Wenzhou in the Zhejiang province, officials are embarking on an experiment to harness the city’s vast informal network of money lenders by allowing the conversion of designated shadow banks into “investment companies.” The experiment aims at creating competition for state-owned banks. This will hopefully reduce loan costs for SMEs and simultaneously introduce official supervision into the currently unregulated parts of the market. It is unclear, however, whether shadow bankers are willing to accept formal regulation. Authorities are also considering a trial that would liberalise some international capital outflows from Wenzhou.

In July, the Shenzhen stock exchange will launch an experiment that gives SMEs the opportunity to issue their own debt securities. The yield on corporate bonds will be limited to no more than three times the applicable reference rate of the People’s Bank of China. Currently, the PBoC’s reference rate for a one-year credit is 6.56 %, while its recent figures show the average lending rate in the informal Wenzhou market was around 22 % in April.

Few dispute the need for such pilot programmes as development of a functioning corporate bond market would bring much-needed diversity to China’s financial markets. On the other hand, the Wenzhou trial is unlikely to do much in meeting broader needs for reforms in corporate finance or monetary and stability policies in China. For officials to get better control of monetary policy and increase competition, there would need to be liberalisation in interest rate policy. Thus, new initiatives in this area can be expected.

Lending trends suggest weaker outlook for corporations and households. The slowdown in Chinese economic growth is reflected in the financial markets already, even if growth in the total credit stock is still running at around 15 % a year. Growth in the credit stock has been sustained by a trend among firms to switch to short-term borrowing (a trend that began last year and has since accelerated). This trend suggests companies are strapped for cash. At the same time, growth in the volume of medium- and long-term loans issued to firms and households has been slowing. This indicates firms are less eager to invest and households less willing to buy apartments or durable goods. Recent trends in the real economy confirm this pattern of credit growth.

Short-term interbank rates fell a percentage point over the past four weeks, suggesting diminished credit demand. The one-month Shibor rate this week hovered around 3.0 %. Data from China’s big state banks suggests that growth in the credit stock has remained weak in May.

Official estimates put the yuan-denominated credit stock of financial institutions at around 58 trillion yuan (€7.3 trillion), or 123 % of China’s 2011 GDP. Corporate loans represented about three-quarters of the total loan stock. Over half of corporate loans are medium- or long-term loans. The stock of forex loans was about €440 billion.

Change in total loan stock and corporate loan stock, %

![Graph showing change in total loan stock and corporate loan stock](image)

Source: Macrobond

Trilateral free-trade talks for China, Japan and South Korea planned this year. On May 13 in Beijing, China, Japan and South Korea agreed to embark this year on talks aimed at establishing a free-trade zone. If implemented, trade barriers would be lowered in a market area with over 1.5 billion people. In addition to agreeing to free trade talks, the countries signed their first trilateral economic agreement – an agreement on lowering barriers to investment between countries.

Even without free trade, trade among the countries is brisk. China is the largest trade partner of both Japan and South Korea; Japan is China’s fourth largest and South Korea sixth largest trading partner. None of these countries have bilateral trade agreements with each other. The three countries accounted for about 20 % of global GDP in 2011. Even under the most cautious scenarios, a free-trade zone would have profound implications for the global economy. The notion of a free-trade zone has been highly praised in the Chinese media.

It will be a long slog before any trilateral free-trade agreement is finalised, however. In particular, South Korea would prefer to first have a bilateral trade deal with China that would give Korean goods preferred status over Japanese goods. Historical tensions between the countries also pose substantial political challenges.
Russia

 Russians show increased willingness to take a loan to buy an apartment. A recent Rosstat survey finds that about 4% of Russian households are planning to change apartments in the next 2–3 years. Half of prospective apartment-switchers said they planned to buy a newly built apartment or house.

Based on average prices last year, a new apartment with 50 square metres of living area would cost just over 2 million rubles (£50,000), or about eight years of an average Russian worker’s wages. Russians have traditionally bought apartments with savings, and most survey respondents said they would still use savings in buying their future apartment. Many are also planning to use their maternity grant for financing the purchase of new apartment (families with more than one child are eligible for state money that can be used for designated purposes).

The importance of bank financing in housing deals continues to increase. The survey found that nearly a third of new apartment buyers plan to use housing loans for financing their acquisition. The stock of housing loans has increased nearly ten-fold over the past five years, and as of end-March the housing loan stock was valued at 1,700 billion rubles (£40 billion). The average ruble-denominated housing loan granted this year was around 1.4 million rubles (£35,000), with an average interest rate of 12% p.a. and an average duration of 14–15 years. As most Russians do not have housing loans, the loan stock averages out to under £1,000 per household.

The Rosstat survey also tracked general attitudes about housing. Only 10% of respondents characterised their current housing conditions as bad or very bad. The biggest complaints about current Russian apartment living were poor sound insulation and inadequate space heating. The most commonly mentioned issues related to neighbourhood surroundings were the lack of road maintenance, traffic safety, alcohol abuse and poor municipal services.

Stock of ruble-denominated housing loans (billions of rubles) and average interest rate on a new loan (%)

![Graph showing stock of housing loans and interest rates]

Source: CBR

Plans to move most federal administrative offices to newly created Moscow expansion zone take shape. The southwest expansion of Moscow city limits, proposed last summer by president Dmitri Medvedev and subsequently approved by the Russian parliament in December, becomes official on July 1, 2012.

Bureaucrats hope to move ahead swiftly with the project. A design competition for the new district is underway, along with negotiations with land owners on suitable construction sites. The plans on location and construction should be ready by July, and the winners of the design competition should be announced in September. If the schedule holds, construction would begin at the end of next year and the first occupancies would occur in 2015.

In March, Medvedev declared that several federal agencies would be moved to the new district. The only agencies that would keep their offices downtown are the interior ministry, the defence ministry, the justice ministry and the Federal Security Service. The new administrative zone includes a parliamentary centre, with relocation of both houses of parliament to a single location.

The project is massive. In addition to the new administrative centre and related services, it is necessary to build infrastructure such as roadways and municipal services, as well as residential housing and social services. The combined floorspace of the main government buildings is currently around 400,000 m²; this would be much greater in the new centre. Part of the financing plan calls for selling off current administrative offices to pay for construction of the new administrative centre.

The construction plans have been criticised for their steep price tag, as well as possible environmental effects. The new administrative centre was a pet project of former president Medvedev and current president Putin’s enthusiasm for project is still unclear.

The wealthy Moscow suffers from unequal income distribution. The average monthly wage of a Moscow resident is 42,000 rubles (£1,040), or nearly double that of the average monthly wage nationally, about 24,000 rubles (£580). Income distribution in the capital region is more uneven, however, than elsewhere in Russia, and a greater proportion of the population lives in poverty than the national average. Income differences in Moscow are also greater than in other major European cities.

According to a published draft of the City of Moscow development strategy for 2025, the huge income disparities among Moscow residents threaten the city’s development and could create social tensions. As a group, families with small children are the worst off; 20% of Muscovite kids live in families classified below the poverty line.

The purchasing power of the wealthy population puts upward pressure e.g. on housing prices. Only about 30% of Muscovites can afford to buy a house or flat of their own.
China

Direct yuan-yen trade lifts yuan’s profile as an international currency. Starting today (June 1), direct exchange of Japanese yen and Chinese yuan begins in Tokyo and Shanghai. Previously, Chinese and Japanese firms had to change their domestic currencies into dollars before purchasing yen or yuan. In Tokyo, the yuan-yen rate will now be set on the open market. However, the People’s Bank of China will post a daily exchange rate from which rates can deviate by a maximum of 3% in either direction. The allowing of direct currency exchange does not imply a general lifting of controls on capital movements and thus does little to enhance yuan convertibility in this respect.

Liberalisation of currency exchange in this case is part of efforts by China and Japan to shore up their bilateral economic relations; direct currency trade reduces foreign exchange costs for firms. China is Japan’s largest trading partner, accounting for about a fifth of total Japanese exports and imports. After the EU and the US, Japan is China’s third largest export market (8% of China’s total exports). About a tenth of China’s imports come from Japan, putting Japan on par with the EU as a goods supplier.

In addition to strengthening China-Japan economic ties, direct yuan-yen exchange should eventually reduce the US dollar’s importance in Asia. From China’s standpoint, an important motive for permitting direct currency sales is to support international acceptance of the yuan.

In recent years, the yuan market has gradually been deregulated in Hong Kong, increasing yuan use in the Special Administrative Region and raising demands for further measures to deregulate yuan use. Consequently, the liberalisation of markets with Japan suggests that authorities have already prepared for further opening-up steps. Along with increased international acceptance of the yuan, China needs to implement reforms of its domestic financial markets and increase transparency.

Slowing economic growth not reflected in share prices. Despite lower economic growth and lower corporate profitability in China this year, the A-share indexes of both the Shanghai and Shenzhen stock exchanges were still up about 10% from the start of the year as of end-May. Chinese exchanges largely avoided the big drop seen on many emerging market exchanges in May. China’s unconventional stock index trend reflects the fact that Chinese stock exchanges are still underdeveloped and not yet fully integrated with global markets.

Several new reforms are planned for China’s financial markets. The hope this year is to launch trading in crude oil futures in Shanghai which may open to participation of foreign investors. In addition, China plans this year to begin national trading with shares of companies outside the stock exchange (OTC markets) to improve the access of small firms to market financing. China’s pilot OTC launch in 2006 involved the trading with shares of companies in Beijing’s Zhongguanchun Science Park, sometimes called China’s “Silicon Valley.”

Stock market trends, 2007–present

Source: Bloomberg

Hong Kong still China’s most competitive city; Inner Mongolia coming on strong. The latest urban competitiveness survey by Chinese Academy of Social Sciences (CASS) ranks Hong Kong as China’s most competitive city. The CASS study also covered Taiwan, whose capital Taipei rose to number-two in the rankings, noting that Taipei’s competitiveness has improved as a result of the rapid growth of trade between Taiwan and mainland China, an outcome of the Economic Cooperation and Friendship Agreement (ECFA) between the two states in 2010.

The survey released on May 21 evaluates the competitiveness of 294 Chinese cities using criteria such as the size of the local economy, growth rates, productivity, investment in human capital and the quality of life for residents. At a national level, the competitive differences among Chinese cities are shrinking.

Shanghai came in fourth and was outranked for the first time by Beijing. Shanghai’s lower ranking reflects a number of trends, including the city’s explosive population growth and structural changes that have hurt the region’s economic growth.

The report notes that the competitiveness of east coast cities improved more slowly last year than inland regions. The Inner Mongolian cities of Erdos and Baotou have seen their competitiveness improve over the past decade faster any other Chinese cities.

The CASS survey finds comport with those of the World Economic Forum’s global assessment of national competitiveness, which currently ranks Hong Kong 11th place, Taiwan 13th and mainland China 26th in terms of global competitiveness.
Russia

Ruble drops along with crude oil prices. The ruble has lost ground against its binary dollar-euro currency basket since the end of April. Last weekend, the ruble’s value brushed against the 38.15 basket ceiling set by the Central Bank of Russia. The market uncertainty was enhanced by the fact that the CBR has according to its modified exchange rate policy during the past few years gradually allowed wider swings in the ruble’s exchange rate. The situation calmed after the CBR interventions and the bank’s announcement that it would not let the ruble stray above the basket’s upper band limit. This week the ruble showed modest appreciation.

Since the end of April, the ruble has lost 11% of its value against the dollar and 6% against the euro. The steep drop in the ruble-dollar rate also reflects the appreciation of the dollar in international currency markets as worried investors fled to safety. Despite the ruble’s recent recovery against the dollar, it is still weaker than at the start of this year. The ruble has strengthened slightly against the euro since the start of the year.

Dollar-ruble, euro-ruble and basket-ruble exchange rates

The drop in world oil prices is a big reason for the ruble’s decline. The price of North Sea Brent crude fell last week below the $100-a-barrel mark, a level not seen since early February. Although Russia’s main export oil grade, Urals, is slightly cheaper than Brent due to its higher sulphur content, it closely tracks changes in the Brent price.

Depreciation of the ruble also reflects uncertainty in the global economy that is causing investors to retreat from emerging markets. The CBR estimates that net exports of private capital from Russia in May amounted to around $6 billion. Since the start of the year, the net capital outflow has been $47 billion. Capital exports have been driven largely by non-bank firms in the form of direct investment. Banks have also been active in capital exports, and in addition they have seen reductions in their stocks of deposits, loans and investments from abroad.

The high level of capital exports is in part a natural consequence of Russia’s massive earnings on energy exports. Russia at the moment is simply unable to offer adequate investment opportunities. Investors also see the risk-return ratio better abroad than domestically.

Cabinet braces for possible shocks from euro-area crisis. Finance minister Anton Siluanov says the government is preparing for eurozone problems by including in the next year’s budget an emergency fund to supply liquidity to firms and banks in the event of sudden pressure from external shocks. This year’s budget includes funding for state guarantees that can be granted as collateral to firms seeking investment loans. Such guarantees can also be used to support firms facing operational difficulties if necessary. The economy ministry is preparing a list of firms that play core roles in the Russian economy and would qualify for state support in an emergency.

Finance ministry calculations indicate that a 1% contraction in GDP reduces annual budget revenues by about 150 billion rubles ($3.7 billion), or more than 1% of state budget revenues. A drop of $1 in the price of a barrel of Urals crude reduces government revenues by 36 billion rubles ($1.4 billion), or slightly less than 0.5% of revenues.

Skolkovo innovation centre takes shape, state-owned companies grudgingly contribute to funding. A cornerstone of the Skolkovo Project launched in 2010 was the creation of the Skolkovo Institute of Science and Technology (Skolkovo Tech). Its mission is become an internationally unique cross-discipline pioneer, linking education, research and commercialisation of scientific innovations. Since the start of the project, the institute has sought foreign partners. Last October, Skolkovo Tech and the Massachusetts Institute of Technology (MIT) penned a three-year cooperation agreement. The institute is set to begin operations in 2014 and be fully operational in 2020.

Skolkovo Tech’s operations will be funded through a special foundation created last year to administer donor funds from e.g. private firms. Current prime minister Medvedev ordered in March that participation in the financing of Skolkovo Tech was mandatory for state enterprises, and would cost them 1% of current annual R&D spending.

The order upset many large state enterprises which had sharply boosted R&D spending over the past two years (at least on paper). The spending jump came out of a 2010 government order requiring large state-owned enterprises and corporations to spend heavily on innovation and research.

To reduce the burden of company contributions to the foundation, firms now have the option to contributing either 1% of their R&D budget or 3% of profits.
China

China implements battery of stimulus measures; reference rates cut today. Slowing growth in investment demand and an export sector hurt by a floundering Europe have led to lower economic growth for China in the first five months of this year. Slack growth was reflected in the May reading of the official purchasing managers index (PMI), suggesting that the outlook for manufacturers remains weak.

In response, Chinese officials have moved ahead with modest stimulus policies, albeit nothing on the scale of the massive stimulus of 2009 and 2010. For example, permitting processes have been streamlined to speed up work on major public investment projects. During spring the central government gave go-aheads for six new airport projects, and local administrations moved ahead on numerous smaller investment projects. Officials, however, have yet to lift temporary measures imposed last year on the construction sector to lower apartment prices.

To spur household consumer demand, the government announced a subsidy programme for purchases of energy-efficient home appliances. The benefits are available to households from the start of this month (June 2012) to end-May 2013 and run as high as 400 yuan (£50) per appliance qualified under the programme. Also local administrations are considering their own subsidy programmes. For example, the city of Chongqing announced this week that it would grant subsidies to buyers of new cars with engines displacing less than 1.6 litres.

The People’s Bank of China relaxed its monetary stance by dropping its key reference rates by a quarter percentage point today (June 8). In May, the PBoC lowered its reserve requirements for commercial banks. Although consumer price inflation has fallen to a level of around 3 % y-o-y, the central bank has shown reluctance to loosen monetary policy, suggesting it still fears a potential flare-up in inflation.

President Putin’s China visit does little to move gas pipeline project forward. Russian president Vladimir Putin paid an official 3-day visit to Beijing this week. Putin’s meeting with president Hu Jintao produced the usual statements on the importance of Sino-Russian partnership along with a promise to double trade between the two countries by 2020. The visit produced little in the way of concrete commitments to economic cooperation.

The project to build a gas pipeline running from Russia via Altai to China tops the joint project checklist. Despite a nearly complete framework agreement, the project remains deadlocked as the parties continue to disagree on gas pricing. Media reports claim Russia is demanding a gas price in the range of $350–400 per 1,000 cubic metres, which is about the same price its European customers are paying. The Chinese, who are helping construct the pipeline, are only willing to pay $200–250 per 1,000 cubic metres. The deal would last 30 years and transmission at full capacity would reach 68 billion m³ a year.

Bilateral China-Russia trade has grown briskly. In January-April, the value of China’s exports to Russia increased 14 %, while imports from Russia were up over 40 % y-o-y. Russia today accounts for about 2 % of China’s total exports and nearly 3 % of China’s imports. The rise in imports largely reflects the fact that the volume of Russian crude oil supplies to China has increased over 60 % from last year. Russia also now accounts for about 10 % of Chinese oil imports. So, after a trouble-plagued commissioning last summer, the new oil pipeline between Russia and China today seems to operate as planned.

Although the countries’ strategic partnership is intended to give an impression of extensive cooperation, the reality of economic relations is that there is no clear framework or direction, and most cooperation is limited to a few huge infrastructure projects. There have been very few efforts to harness the potential benefits of economic cooperation, and investment flows between the two countries have been modest. Conflicting interests between China and Russia as well as the superficiality of cooperation are reflected also on the work of the Shanghai Cooperation Organization, in the summit of which Putin participated during his visit.

Increasing number of European firms contemplate pulling investments out of China. The latest member survey of the EU Chamber of Commerce in China finds nearly a quarter of its member companies are considering taking investments out of China. Lower labour costs in nearby countries and rapidly growing markets in Southeast Asia, India and South America are becoming more attractive than remaining in China, where business regulation and legal structures still invite capricious interpretation. Promises of Chinese officials to improve the treatment of foreign enterprises do not hold much credibility with foreign businesses.

The survey also points out other problems in the business environment. For example, there are huge challenges in recruiting the right people. Chinese workers often have excessive wage expectations, while the living conditions present a major obstacle in attracting to and keeping foreign workers in the country.

The problems of foreign workers have been in the news in Chinese media lately. Racist online postings have increased concern about xenophobia. The communist party has tried to calm the discussion with assurances that foreigners are welcome in China. However, the fact that racist comments have managed to get through the censorship might suggest the party is using nationalist sentiments to safeguard its status.
Russia

Cabinet approves latest programme to privatise state-owned enterprises; exact schedule and scope remain unclear. The cabinet last week green-lighted its latest version of the programme for privatising state-owned companies. First version of the current privatisation programme was approved back in 2010. Implementation of the programme has been partly delayed referring to unfavourable market conditions.

In addition, when Dmitri Medvedev was still president last autumn, he tasked the cabinet with expansion of the privatisation agenda with respect to e.g. energy companies. The suggestion of reducing state ownership in energy companies, however, touched off a broad debate and issue has remained open. After assuming the prime minister’s post last month, Medvedev declared confirmation of the privatisation programme as one of his cabinet’s top tasks for this year.

Last week’s cabinet decision declares that the privatisation programme will include stakes in a number of state energy companies, including oil giant Rosneft, electricity grid operator FSK and hydropower producer RusHydro. The state ownership in these companies could be diminished by 2016, but each sale will be considered separately by the cabinet taking into account e.g. the company’s financial condition and the state of the economy overall.

In May, president Vladimir Putin placed a number of the energy companies included in the privatisation programme on the list of “strategic” firms. Hence the sales of the shares in these companies require presidential approval. The president’s decree concerning state holding company Rosneftegaz particularly left observers scratching their heads. Under the decree, it would be possible for the state to sell its stakes in energy companies to Rosneftegaz. On the other hand, the decree states that the government must confirm the 2013–2015 privatisation programme also for Rosneftegaz assets (currently including e.g. a majority stake in Rosneft and a minority stake in Gazprom).

The privatisation programme covers approximately 1,400 firms (mostly small and medium-sized enterprises) that the state intends to divest partly or entirely. The first sales of stakes in large state-owned enterprises this year will include the sale of a nearly 8% stake in Sberbank, and stakes in the shipping giant Sovkomflot and diamond miner Alrosa. The state expects to raise about 300 billion rubles (€7.5 billion) from privatisation sales this year. The privatisation programme calls for reducing state ownership in a number of large Russian state enterprises by 2016, including VTB Bank, state railways RZD and shipbuilder OSK.

European Commission expresses concern over protectionism as Russia’s WTO accession approaches. Responding to the international financial crisis at the end of 2008, the EU Commission began to report on trade and economic policy practices of individual countries to identify possible impediments to international trade. The latest report finds that since end-2008, Russia, out of the 31 countries tracked, has introduced the second-most measures that can potentially restrict trade. Russia’s problematic measures mostly involve restrictions on exports and imports, as well as public sector policies that favour domestic firms over foreign firms. The report found that some of Russia’s protectionist measures could conflict with its WTO commitments (e.g. a planned recycling charge for imported cars).

With WTO membership looming, Russian firms have grown increasingly shrill about the problems WTO membership will cause them and are demanding the government compensate them for their hardship. Economy minister Andrei Belousov last week described to the cabinet available measures that might help companies adjust to the changed operating environment of WTO membership.

Belousov noted that many import duties or state supports can actually be increased after membership as their current levels are still below the limits agreed in Russia’s membership negotiations. In addition, public sector policies to support e.g. the aerospace industry, shipbuilding and manufacturing of farming equipment could, according to Belousov, be easily reshaped to harmonise with WTO rules.

Belousov said service sector firms were still eligible for unlimited state support even after WTO membership. Moreover, state procurement can still favour domestic firms as Russia opted out of the public procurement section of the WTO treaty. The competitiveness of domestic firms could also be supported by e.g. price controls on natural monopolies and the domestic market could be protected with technical regulations and phytosanitary rules. Belousov said his ministry was also already making preparations to be able to respond to possible complaints against Russia by other WTO members.

Russia still has more than a month to ratify its WTO membership. The cabinet approved Russia’s WTO agreement at its meeting last week and sent the document on to the lower-house Duma for approval. The Duma is expected to take up final approval on July 4. Russia’s WTO membership would become official 30 days after ratification.

Thanks to everybody who responded to our February reader survey!
China

Price pressures moderate; central bank relaxes monetary stance. China’s consumer prices in May were up only 3% from a year earlier. April on-year inflation, in contrast, was still running at 3.4%. On-month prices declined slightly overall on lower food prices and a lack of change in prices of non-food goods and services from their April levels. The abatement of upward pressure on prices in May was also evidenced by a 1.4% y-o-y drop in producer prices.

The easing of inflationary pressure reflects China’s lower economic growth. The slowdown was also reflected in slower credit demand earlier this year. In May, however, origination of new loans was considerably higher than expected, resulting in an acceleration in growth of the loan stock to nearly 16% y-o-y. A rise in long-term corporate borrowing is a particularly positive sign.

The growth in the credit stock reflects looser monetary policies. There is evidence that many infrastructure projects are now finding it easier to get financing than just a few months ago. Moreover, the People’s Bank of China again lowered its key reference rates by a quarter of a percentage point last week (June 8). The reference rate on a one-year loan currently stands at 6.31%, while the reference one-year deposit rate is 3.25%. At the same time banks were given more leeway to deviate from the reference rate.

China’s foreign trade bounced back in May; US exports surged. Defying general expectations, exports and imports boomed in May. The value of goods exports in May reached $181 billion, a 15% jump from May 2011. The surge was pronounced, growth was still just 5% in April. The revival in growth in May was largely driven by the exports to the United States, which rose 23% y-o-y. For January-May, exports to the US were up over 14% y-o-y.

Exports to the EU showed modest 3% growth, the first positive growth since February. However, for January-May, exports to Europe were down slightly from a year earlier. Exports to Japan, in contrast, were up in the first five months of 2012, and reached 13% y-o-y in May. The situation in the first five months of the year reflects trends in the global economy and strengthens the status of the US as China’s biggest export market together with the EU.

Imports also recovered. The value of goods imported exceeded $162 billion, up about 13% y-o-y in May. The numbers suggest a distinct change from April, when on-year growth was clearly under 1%. The shift is largely explained by record crude oil import volumes triggered by falling oil prices and rising Chinese demand for US goods.

The May trade surplus climbed to nearly $19 billion. The cumulative trade surplus for the first five months of the year exceeded $38 billion. In the same period last year, the trade surplus was about $24 billion.

China’s exports, imports and trade balance, US$ billion

Slowdown in China’s industrial output growth continued in May. Industrial value-added increased nearly 10% y-o-y in May. Although growth was a bit stronger than in April, it was clearly below the long-term trend. Indeed, on-year growth levels under 10% have not been seen since the 2008–2009 global recession. Unlike most branches, China’s car industry turned in 16% y-o-y growth performance for the month. The near-term outlook for China’s car industry is fairly bright thanks to falling gasoline prices and lower interest rates that make it easier for buyers to purchase cars on credit.

The uneven growth in May was also apparent in parts of the retail sales sector, which saw overall sales up 11% y-o-y in real terms. Growth in sales of home appliances lagged (0.5% y-o-y in nominal terms), while sales of telecommunications devices exploded (up over 25%) thanks to insatiable Chinese demand for mobile phones. Sales of pharmaceuticals, as well as goods for construction and home re-modelling were also up nearly 25% in nominal terms.

Industrial output and retail sales, real 12-month change, %

Thanks to everybody who responded to our February reader survey!
Russia

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

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

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

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

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

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

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

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

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

![Graph showing bank credit and deposit flows for households and firms](image-url)

Source: Central Bank of Russia

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

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Source: Central Bank of Russia
China

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

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

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

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

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

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

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

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

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


The global Doing Business report, which comprises over 180 countries, has ranked Russia around 120th in recent years. At the same time, Russia is among the 30 countries that have made the greatest strides in improving the business climate as measured. In the global comparison based on composite results for eleven areas of assessment, Russia is represented by Moscow. In both the 2008 and 2012 sub-national evaluations, however, Moscow ranked last among the cities examined (the surveys are not completely comparable as they cover partly different areas of assessment).

The new sub-national Doing Business in Russia 2012 focuses on four categories: “starting a business”, “getting construction permits”, “getting electricity” and “registering property”. Figures on permitting processes, time required, and official costs & fees are based on national and local regulations, and on the experience of professionals (e.g. lawyers) who regularly deal with these processes.

The category rankings for most cities in the new survey vary considerably, but Moscow ranked low in all categories. St. Petersburg was 22nd in the overall standings. Cities in western parts of Russia who reached the top include Rostov-on-Don, Kazan and Kaluga. The ten cities surveyed in 2008 have improved processes for getting construction permits and registering property. Seven of those cities have also made progress in easing rules for starting a business.

Out of the 30 cities surveyed, St. Petersburg was the easiest city to establish a domestic firm with 10–50 workers. Cost of registering a firm was just €150–220. In terms of cost relative to national income per capita, Russia is today among the 30 cheapest countries in the world for starting a business. The fees for registering warehouses and lots were around €750 in nearly all 30 cities, and relative to the value of real estate, were among the lowest in the world (0.2 % compared e.g. to the EU average of nearly 5 %). In some other respects, Russia’s best cities would also perform well in the global survey of 183 countries. St. Petersburg, however, ranked poorly among the 30 cities rated.

Construction permitting for warehouses and water connections scored well in St. Petersburg. The number of procedures involved in permitting varied widely. The shortest permitting process, around five months, was near the OECD average. Longer times were caused by e.g. the lack of city planning. Even Moscow had almost halved the time since 2008 when it still took nearly two years to get a permit. Permit fees ranged from €3,000 to over €30,000.

Getting electricity to a warehouse in a city was a challenge if compared to most of the 183 countries. Costs (including business services) ranged from €8,500 to €140,000.

<table>
<thead>
<tr>
<th>Starting a business</th>
<th>Range for all 30 cities</th>
<th>Moscow</th>
<th>St. Petersburg</th>
<th>Ranking of the best city if included in 183-country survey</th>
</tr>
</thead>
<tbody>
<tr>
<td><em>number of procedures</em></td>
<td>7–12</td>
<td>9</td>
<td>7</td>
<td>86</td>
</tr>
<tr>
<td><em>time, days</em></td>
<td>16–33</td>
<td>30</td>
<td>17</td>
<td>87</td>
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<tr>
<td><em>cost</em>**</td>
<td>1.7–3.0</td>
<td>2.1</td>
<td>2.1</td>
<td>21</td>
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<tr>
<td>Registering property</td>
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<td>3–5</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td><em>time, days</em></td>
<td>13–60</td>
<td>43</td>
<td>44</td>
<td>28</td>
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<tr>
<td><em>cost</em>**</td>
<td>0.2–0.5</td>
<td>0.2</td>
<td>0.2</td>
<td>9</td>
</tr>
<tr>
<td>Construction permits</td>
<td><em>number of procedures</em></td>
<td>16–47</td>
<td>47</td>
<td>18</td>
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<td><em>time, days</em></td>
<td>150–448</td>
<td>392</td>
<td>361</td>
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<td><em>cost</em>*</td>
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<td>172</td>
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<td>Getting electricity</td>
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<td>6–10</td>
<td>10</td>
<td>9</td>
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<tr>
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<td>238</td>
<td>120</td>
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<tr>
<td><em>cost</em>*</td>
<td>112–1852</td>
<td>1852</td>
<td>1080</td>
<td>47</td>
</tr>
</tbody>
</table>

**Moscow and St. Petersburg rankings
***percentage of 2010 gross national income per capita ($9,910)
****percentage of appraised value (warehouse structure and lot)

Source: Doing Business in Russia 2012, World Bank

Government commits to agricultural subsidies. The June 25 agenda at the cabinet presidium led by prime minister Dmitri Medvedev included this year’s crop forecast. Attention was also devoted to pressures of change arising from the approaching WTO membership. An agreement between the government and oil companies has been in place for several years to assure farm producers of large discounts on fuel supplies. In 1H2012, the discount was 30 % of the domestic fuel price. The discount for the rest of this year should be resolved over the next few days. Domestic prices of key fertilizers are regulated, but with WTO membership, direct price-setting as well as the subsidies will probably be phased out. Russia’s goal in coming months is to devise other subsidy approaches. Use of fertilizers is relatively minor in Russia. In 2010, farmers applied just 24 kilograms of fertilizer per hectare, a fraction of fertilizer use in other BRIC countries. The government also discussed measures to promote the use of farm insurance and a possible increase in the length of farm loans, up to 15 years.

Agriculture employs about 6 million Russians (about 9 % of the employed), but accounts for less than 4 % of GDP. Most grain crops are grown by private company farms, while half of vegetables (including potatoes) and milk production occurs on small household plots. Over the last ten years, companies have come to account for 60 % of meat and poultry production, but households still account for a large share. Russia exports substantial amounts of grain (mainly wheat), but in the case of other agricultural products, about 20–30 % of consumption is made up with imports. A core objective of Russian agricultural policy is to raise self-sufficiency in meat and milk consumption.

The subject matter here has been compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.
China

Chinese firms increase investment in Europe. At the beginning of June, the Rhodium Group released a report on direct investment by Chinese firms in Europe. The report is a compilation of available information on green-field investment and acquisitions of Chinese firms that gave Chinese investors stakes of over 10% in the European firm.

The report found that investments last year were on the order of $10 billion. Although this amount of investment was still relatively small, the rate of growth in Chinese investment is striking. The report notes that the stock of direct investment of Chinese firms in Europe is estimated to rise from about $21 billion at present to $250–500 billion by 2020. Chinese investment currently represents less than 0.1% of the total FDI stock in EU countries, so China is in no way poised to displace European or American firms as the top investor in Europe in the near future.

Contrary to the perception that Chinese firms focus on raw materials, strategic sectors or sectors that allow easy access to European markets, the numbers suggest a much more diverse approach. Investment of Chinese firms is largely motivated by traditional business concerns, particularly profit-seeking. About two-thirds of the completed 573 acquisitions or green-field projects examined involved privately held Chinese firms or non-state-owned listed firms. China’s state-owned enterprises, however, accounted for two-thirds of the stock of investment as they tend to operate in capital-intensive branches. In terms of investment, about a quarter of FDI went to green-field projects. However, the number of green-field projects covered about three-quarters of all projects. Although the gathering of data on FDI is known to be difficult, Rhodium’s researchers believe their compilation covers the bulk of Chinese investments greater than $1 million in Europe.

In the case of Finland, the survey-makers noted a green-field project in the consumer goods sector and in total four major investments in the IT and life sciences sectors. The value of these investments totalled nearly $50 million.

The report treats the growth of investment of Chinese firms in Europe as a natural and healthy development, but it also raised concerns about potential negative consequences: (i) greater Chinese investment could expose Europe to macroeconomic volatility in the event of a significant economic disruption in China, (ii) Chinese firms could have a preference to reorganise operations and move high-value activities to China, (iii) Chinese companies may spread unorthodox business practices that might affect healthy competition, and (iv) there is potential for a race to the bottom in attracting Chinese investment that could negatively impact European welfare. It is not possible to rule out completely the possibility that China’s government might try to use investment as a political tool, even if Chinese firms are more independent than most believe.

15th anniversary of Hong Kong handover to China. The former British colony of Hong Kong was returned to China on July 1, 1997 under the “one country, two systems” framework. The Hong Kong Special Administrative Region’s constitution (Basic Law) includes a high degree of autonomy outside foreign policy and defence matters and preserves Hong Kong’s status as a capitalist economy in a socialist country until 2047. In this respect, Hong Kong has flourished. The Special Administrative Region routinely tops Heritage Foundation and Fraser Institute surveys as the world’s freest economy. Hong Kong also clearly surpasses China’s other cities in most competitiveness evaluations.

The mainland and Hong Kong enjoy tight economic relations. Since 1985, mainland China has clearly been Hong Kong’s biggest trading partner. Its share of foreign trade has risen from 10% in 1978 to the current level of nearly 50%. Hong Kong last year accounted for 60% of FDI inflows to mainland China and it was mainland China’s third largest trading partner. The lion’s share of exports and imports, however, involves re-exporting activities. In January 2004, the introduction of the Closer Economic Partnership Arrangement (CEPA) reduced trade barriers and deepened economic integration of Hong Kong with the mainland. The CEPA has been expanded annually and currently applies to nearly all goods trade. After the latest enlargement round it also covers 47 service trade sectors.

The ultimate goal is to eliminate all barriers to trade between Hong Kong and mainland China.

Although Hong Kong has struggled with a number of crises since the handover, it has benefitted immensely from mainland China’s rapid economic growth. However, Hong Kong’s GDP growth was just 0.4% y-o-y in the first quarter of 2012, and for all of 2012 the entire year’s growth is estimated to remain at just 2%.

Concerns have been expressed in recent years on implementation of the special administrative region’s constitutionally guaranteed rights to free speech and press freedom. For example, the Press Freedom Index published by Reporters Without Borders has gradually lowered Hong Kong’s ranking over the past ten years from 18th to 54th. The rise in self-censorship is repeatedly stressed as a reason for the downgrades.

For Hong Kong to preserve its special status, it needs to offer something unique. Currently, Hong Kong’s biggest advantages are its liberal business environment, independent judiciary, aggressive implementation of anti-corruption measures and greater civil rights. However, the goal of universal suffrage, which is specified in the Basic Law, has yet to be implemented.
Russia

Cabinet confronts realities of tighter budget discipline. President Vladimir Putin delivered on June 28 the annual presidential budget plan, laying out the basic framework of fiscal policy for the next three years. The budget talk acts as a starting point for drafting of the 2013 budget.

Putin noted that the room to manoeuvre for those drafting the federal budget depends largely on revenues from energy taxation and set spending on social entitlements. Thus, any opportunities for increasing spending are limited at the moment, even if economic development requires more spending – especially in such areas as research, education and infrastructure. As a way out of this conundrum, Putin suggested that the cabinet focus on finding the most effective use for budget outlays through a total revamp of the budget system. Under the system currently in development, budget expenditures would be allocated to 41 sectors in the form of special “state programmes.” The reforms would take effect in 2014.

In response to uncertainty over trends in the global economy, the government next year will restart the regular funding of off-budget reserve funds that halted during the 2009 financial crisis. The cabinet and presidential administration have revisited the rules for reserve funding that determine how much of oil revenues should go to the reserves and how much should be used to finance budget spending. The basic principle is that the budget should be protected from the short-term swing in oil prices by using longer-term price trends as a basis for drawing up the budget.

In his budget address, Putin announced the crude oil price assumption used in calculating budget spending next year would be based on the average world oil price over the past five years. The number of years used in the average would be increased incrementally so that in 2018 a ten-year average would be used. If the oil price exceeds the average price, the excess in revenues to the state would be set aside in reserve funds. It the oil price undershoots the average, budget funding would be supplemented from reserve funds.

Under the above-mentioned framework, next year’s budget would assume a Urals crude price of about $92 a barrel, down from $100 a barrel this year. The lower revenue target calls for a tighter fiscal stance and slashed spending.

According to experts, meeting budget targets will be challenging with the announced spending increases. Putin e.g. promised hikes in social spending as part of his presidential campaign platform. There is also a new spending category running from 2013 to 2020 that allocates a total of 20.7 trillion rubles (over €500 billion) for development of Russia’s defence forces. Putin reaffirmed the military spending timetable on Monday.

Special agency to handle state loans and investments. As part of his budget speech, president Putin tasked his cabinet with establishing a special organisation to manage the government’s international borrowing and productively invest off-budget reserve funds. Putin noted that management of state debt and investments demands particular expertise in the currently volatile international financial markets.

The need for an organisation to manage state investments has been discussed for years. The current goal is to launch the new organisation by the beginning of 2013.

Rates for municipal services hiked on July 1. Annual adjustments in administratively regulated prices of municipal services are normally implemented at the start of the year. This year, however, due in part to the presidential election in the spring, rate hikes were postponed. As a result, inflation in the first part of the year was exceptionally low by Russian standards. At the end of June, consumer price inflation was running at a mere 4.3 % p.a.

From the start of this month, municipalities have raised regulated rates an average of 9–12 % for e.g. district heating, water supply, natural gas, electricity and waste handling. A second round of rate hikes is scheduled for early September. As in the past couple of years, the annual ceiling on any rate hikes of municipal services remains at 15 %.

Prices of alcoholic beverages hiked on July 1. The excise tax on alcoholic beverages is typically adjusted each year in January. This year, however, the hikes were split in two, with the bigger hike occurring on July 1. At the same time, the lowest permitted retail prices for alcoholic beverages were increased. Today, for example, the lowest price on a half-litre of vodka has been increased by 27 % to 125 rubles (about €3). The use of minimum allowed retail pricing of alcoholic beverages was introduced in 2010 as part of efforts to reduce sales of cheap illegal alcohol. Retail prices on alcoholic beverages have been raised regularly since then. The government seeks to reduce alcohol consumption overall, and prices have continued to climb ever since 2010, when then-president Dmitri Medvedev focused attention on the social impacts of alcohol use.

A change in the law on alcoholic beverages reclassifying beer as an alcoholic beverage entered into force at the start of this month. The law itself was passed by the Duma in summer 2011. The change means that restrictions on alcohol sales also apply to beer. Now retailers are only allowed to sell beer in shops and licensed pubs and restaurants. Sales of beer from kiosks, the traditional beer vendor in Russia, is forbidden, and shop sales are limited to the hours of 8.00–23.00. It is prohibited to drink beer on the street, in parks or other public spaces, and beer advertising on radio, TV and public transport is forbidden.
China

China experiments with further liberalisation of capital movements. During president Hu Jintao’s visit last weekend to Hong Kong, China’s central bank announced the introduction of a new experiment in freeing up capital movements between the mainland and Hong Kong. The trial only affects capital movements between Hong Kong and Shenzhen’s newly created Qianhai special financial zone. While details of the trial are yet unavailable, companies operating in Qianhai will apparently have easier access to financing from Hong Kong. Moreover, investment funds to be established in Qianhai can accept investments from Hong Kong.

Although China has introduced a variety of measures to increase the use of the yuan internationally (particularly in Hong Kong), it still strictly regulates capital movements. The only allowed capital movements are direct investment, and even then, special permission is required in certain cases. Purchase of an apartment from abroad is also permitted. Other capital transfers are completely banned or subject to strict quotas and approval processes.

Despite its modest scale, the Qianhai experiment represents a step towards what observers expect to be the extensive lifting of capital movements by 2015. Ending of capital controls is a necessary part of making the yuan a widely used international currency.

Economic cooperation between Hong Kong and Mainland China deepens further. As part of the 15th anniversary celebrations of the Hong Kong special administrative region, the government announced reforms aimed at increasing economic cooperation between Hong Kong and mainland China and stimulating Hong Kong’s economic growth. Many of the new reforms were written into the ninth expansion of the Closer Economic Partnership Agreement (CEPA) between mainland China and Hong Kong. The 9th round additions enter into force at the start of 2013. Although the agreement is between the mainland and Hong Kong, it also offers foreign firms access to the Chinese market as long as they are registered in Hong Kong and meet the conditions promulgated last year.

The latest CEPA round offers service-sector firms freer access to the mainland market. Educational services are an entirely new branch included in the agreement. Of the 47 service branches already enjoying access of varying degree, 21 saw their restrictions lifted further. Service providers will now find it easier to work in China as they can expand the scope of operations geographically (e.g. tourism), engage in broader cooperation with a mainland Chinese firm (e.g. legal services), increase their holdings and operate more independently (e.g. telecommunications) or offer a wider palette of services (e.g. social services).

Some of the rule-easing involves companies in the fields of information technology services, accounting services, and printing introduced on a trial basis in Shenzhen’s newly created Qianhai special financial zone. As part of efforts to attract Hong-Kong-based firms and workers to the special zone, companies are being offered low corporate and income tax rates (e.g. the corporate tax rate is 15 %) and an environment with a strong legal regime, i.e. the same approach used in Hong Kong.

CEPA’s 9th round expansion also includes aims to increase co-operation between Hong Kong and mainland China’s financial sectors. Under the Qualified Foreign Institutional Investor (QFII) programme, the threshold qualification criteria will be lowered to allow a greater number of Hong Kong financial institutions to buy and sell securities in mainland China. In addition, the listing of mainland Chinese enterprises on the Hong Kong stock exchange will be supported by easing mainland’s listing requirements on foreign exchanges.

Developers still waiting for official actions to stimulate construction activity. Chinese officials remain reluctant to ease up on the strict measures implemented in 2010 and 2011 to deal with overheating in the construction sector. Even with the slowdown in economic growth, officials continue to press with the measures. Economic experts and representatives of the construction sector are now calling for a lifting of restrictions. Some local and provincial administrations have even moved ahead with their own measures to revive their flagging building sectors. Construction activity is especially important for local administrations as it allows them to raise money from the sale of land use rights.

Apartments prices continue to decline. Official figures show that May prices for both new and old apartments were about 1 % cheaper than at the start of this year. Official figures for apartment prices indicate the changes are quite modest, and the statistical data is believed to be somewhat sketchy. Builders themselves claim prices have dropped substantially more than the official numbers and say they expect the decline to extend through this year. Falling prices translate into fewer apartment sales.

Several corporate surveys indicate builders remain broadly pessimistic about the outlook for their industry. Builders have purchased fewer land use rights this year than earlier. In the January-May period, new housing starts were down nearly 10 % y-o-y. Differences across provinces are large, however. For example, housing starts in Beijing are down by a third from last year, but in some interior provinces starts on new apartment construction are still climbing rapidly.
Russia

Duma approves Russia’s WTO accession agreement by a narrow majority. In the Duma vote on Tuesday (July 10), United Russia representatives went 238 for WTO accession, while a coalition of A Just Russia, the Communists and the Liberal Democrats were 208 against. The upper-house Federation Council should most certainly approve the agreement at its July 18 session. After that, president Vladimir Putin will sign the ratification agreement into law. Russia’s WTO membership would take effect 30 days after signing. The deadline for passage of the WTO agreement is July 23. If Russia fails to ratify its agreement in a timely fashion, it must restart accession talks from the beginning to join the WTO.

The Duma vote on the WTO agreement was originally scheduled for July 4, but delayed after 131 deputies challenged the WTO agreement in Russia’s Constitutional Court on the basis that certain clauses in the agreement were in conflict with the Russian constitution. Furthermore, no official translation of the document was ever available to the Duma for formal review and the issue of membership was not discussed with the Russian regions in spite of the fact that they are affected by the membership.

In its ruling on July 9, the Constitutional Court found the agreement and the Duma approval procedure constitutionally compliant and the ratification process could continue.

Russians have been split on whether to pursue WTO membership ever since the accession process began in 1993. Economists have largely supported membership, pointing out that it should benefit the country overall in the long run by e.g. opening up domestic markets to competition and bringing Russia into conformity with international business practices. The stance of industrial branches has varied depending on whether they perceive accession as beneficial to their interests or not. Ultimately, the decision to go ahead with Russian membership and complete WTO talks was made in 2010 by then prime minister Putin.

The retail sector and industries dependent on inputs from abroad are expected to benefit from WTO membership. On the other hand, companies that operate in the domestic market (e.g. farm producers, consumer goods makers and the domestic car industry) may at least initially suffer from a flood of cheap imports. Consumers should benefit through increased competition and lower prices.

Economy minister Andrey Belousov promised the Duma assembly Tuesday (July 10) that Russia would strive to aggressively exploit the advantages of WTO membership to fight trade barriers and discrimination that many Russian-made products face abroad. In particular, Russian metal and chemical industry products face extensive discrimination. This is, however, challenging as Russia lacks expertise in dealing with the jungle of WTO rules. To overcome this, Belousov announced training of experts into the intricacies of the WTO would soon begin.

In its spring survey of businesses in Russia’s 29 largest cities, Grant Thornton consultants found that 29% of companies expected WTO membership to have a positive impact on their business, while 17% said they expected it to hurt their business. Among the awaited positive effects, businesses mentioned expansion of their markets and increased foreign investment.

Putin names ombudsman to represent business interests. The new business ombudsman will help shepherd company appeals through legal and administrative processes, review decisions by officials to make sure rights of entrepreneurs are upheld, participate in drafting of bills and propose measures to improve Russia’s business climate. The business ombudsman reports directly to the president and is part of the presidential administration.

The initiative to create the business ombudsman post came from business representatives that say the Russian government’s aspirations of improving the business climate are impossible without a reduction in levels of corruption. In June, president Putin appointed Boris Titov as the ombudsman for business. Titov previously headed up the lobby group Delovaya Rossiya (Business Russia), which works on behalf of industrial and service-sector firms.

Titov said his main task is to fight corruption and official abuse. He stated that the situation has deteriorated in recent years: earlier corporate take-overs were mainly carried out by competing firms with the use of corrupted officials to hamstring their target. Today officials themselves – mainly from “the power structures” such as police – are behind company take-overs. A growing body of public officials are seeking to enjoy the fruits of profitable businesses.

Another big challenge facing the ombudsman are the stiff penalties and vaguely defined provisions of financial offenses in the current criminal code. Under the law, a legitimate entrepreneur can easily be imprisoned or threatened with imprisonment. Imprisonment is often used in conjunction with corporate take-overs or as a means for blackmailing company executives.

A reform of criminal statutes was launched during the presidential term of Dmitri Medvedev. One idea was to narrow the room for arbitrariness in dealing with financial crimes. For that, the number of labels for financial crimes was reduced along with possibilities to detain for investigation individuals suspected of committing financial crimes. The result has been a sharp drop in the number of economic crime cases and trials in the system. Titov noted that new ways to bring charges, however, are being devised all the time. The broad and loosely defined term “fraud” is currently the most popular criminal charge for financial crimes.
China

Inflation slowest since January 2010 – PBoC lowers reference rates for the second time in a month. Consumer price inflation fell in June to 2.2% y-o-y, down from 3.0% in May. Prices fell 0.6% m-o-m, led by a 1.6% drop in food prices while prices of other goods and services remained in June at their May levels. Producer prices declined nearly 1% m-o-m in June, and were down 2.1% for the last 12 months. The abating price pressures reflect an overall slowdown in the Chinese economy.

On July 6, the People’s Bank of China continued to relax its monetary stance by lowering reference rates for a second time within a month. The one-year lending rate was cut from 6.31% to 6.0%, and the one-year deposit rate was lowered from 3.25% to 3.0%. Although the rate cut in early June was the first since 2008, the PBoC had relaxed monetary policy earlier this year with two reductions in the required reserve ratio. The lowering of reference rates signals that China is taking stronger measures to stimulate economic growth.

Banks were also given greater flexibility in lending. The loan rate charged by banks can now be as low as 0.7 times the reference rate. In June, the floor on the lending rate was lowered from 0.9 to 0.8 times the reference rate. At the moment, it is possible to get a 1-year loan at a rate as low as 4.2%. The ceiling on deposit rates remained unchanged. The central bank’s goal in relaxing rate restrictions is to make banking more competitive and thereby improve the function of markets.

Reserve requirement (% of deposits), one-year reference rates (% p.a.) and consumer price inflation (% change y-o-y)

Larger-than-expected foreign trade surplus for first half of 2012. The value of China’s goods exports in January-June was nearly $1 trillion, an increase of almost 10% y-o-y. Exports to the US and other Asian countries grew briskly, while exports to Europe declined. China customs reports that the biggest destinations for exports were Europe and the US, each accounting for 17% of total exports. Countries in Asia accounted for nearly half of exports, but many of China’s goods exports to Asia ultimately end up in the European and North American markets.

Although growth in consumer demand has held steady, import growth was lower than expected. For 1H2012, the value of China’s goods imports was up 7% y-o-y. Lower growth in the value of goods imports partly reflects declines in world market prices for certain raw materials. Volumes of China’s main raw materials’ imports continued to rise.

The foreign trade surplus in the first half of 2012 was larger than expected. Earlier forecasts saw a smaller 2012 surplus than in 2011, but it now appears that the 2012 surplus will actually be larger than last year’s.

China’s foreign trade (USD billion)

Source: China customs

China revises household electricity pricing scheme. After two years in preparation, a modified electricity pricing mechanism was rolled out at the start of this month. Under the reform, rates for households will now be based on a multi-tier arrangement based on usage. Households that keep within the lowest tier will pay the same rate as earlier (e.g. the bottom tier rate in Beijing is about 0.5 yuan or 0.06 euro per kWh.) The top-tier rate for consumption over 400 kWh a month in Beijing adds additional 0.3 yuan per kWh to the electricity bill. Electricity rates are set at the provincial level. Under the new multi-tier scheme, most households will see no change in their monthly electricity bills.

The price of electricity is strictly regulated in China. It has been years since electricity rates were adjusted for households. In contrast, rates for industry have been hiked several times in recent years. Households consume slightly over 10% of generated electricity, while industry consumes over 70%.

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Russia

Russia revises its farm subsidy formats as WTO membership looms. The government last week approved its agricultural development programme running through 2020. The programme establishes a direction for agricultural policy within the new WTO context. It includes specific production targets and stresses the importance of higher farm efficiency to enable domestic production to compete against cheaper imports following the WTO membership.

The programme calls for incremental hikes in agricultural supports paid to farmers. In next year’s federal budget, 159 billion rubles (€4 billion) will be set aside for farm subsidies (slightly more than this year’s amount). Supports rise to 218 billion rubles (€5.5 billion) in 2020. In addition, subsidies are paid from regional budgets. The amount of subsidies Russia can pay out is limited by Russia’s WTO agreement.

OECD figures show Russian farm subsidies have been exceeding EU and OECD averages in recent years. Combined supports to Russian producers in 2010 represented 21% of an average farm income, slightly above the OECD average of 18%. Agricultural supports were raised sharply in Russia in 2008 and 2009 in response to the economic recession and major crop failures nationally.

Russia’s agricultural commitments under the WTO agreement will be phased in gradually through 2018. Average import duties will fall from the current 13.2% to 10.8%. Some 60% of these reductions on import duties will enter into force as soon as Russian membership takes effect.

The agricultural development programme also includes a significant change on how agricultural supports are granted so as to bring them into line with WTO rules. One of Russia’s most popular support formats, price supports for production inputs, will be phased out next year. Farm producers have been able to buy fuels and lubricants at discount prices over the past three years. Oil companies have supported the costs of these fuel discounts, which have been on the order of 20–30% of their wholesale price.

In lieu of price supports paid to farmers, income supports based on farmed acreage will be introduced. Meat producers will enjoy larger subsidies as increasing Russia’s self-sufficiency in meat production has long been an agricultural policy priority. More money will also go to regional agricultural development projects. Supports for milk producers will now be based on that amount of milk actually sold. The aim of this policy is to encourage producers to improve the quality of dairy products. According to Russia’s agriculture ministry only 30% of milk produced in Russia meets EU quality standards.

The agriculture ministry reports that last year Russia’s domestic production was sufficient to cover the country’s needs for 73% of meat, 80% of milk and 96% of potato consumption.

The agriculture ministry this year expects the grain harvest to come in at around 80–85 million metric tons. The grain crop estimates are constantly evolving and could well decline as Russia’s grain belt has been affected by bad weather. Last year’s grain harvest was exceptionally good – 94 million metric tons.

The ministry currently projects grain exports from the current harvest to reach around 16 million metric tons. In the last harvest season, Russia exported a record 27 million metric tons of grain (mostly wheat).

Russian railways suffering effects of long-term under-investment. The recently released 2011 annual report of Russian Railways reveals that the average rate of travel of freight cars between stations slowed last year to just 37 kilometres an hour. If time for loading and unloading cars at stations is added in, the average rail freight speed was just 10 kilometres an hour.

Russian Railways blamed the slowdown on its aging stock of locomotives and poor infrastructure that the state rail company is itself obliged to maintain. The situation is further complicated by the approximately 2,000 private operators now handling nearly all of the country’s rail freight shipping. Russia’s rail system, created during the Soviet era, is based on the assumption of a single operator for the entire country.

Delays caused by a lack of freight cars were particularly acute last autumn. In fact, the problem was not the lack of available cars per se, but rather the difficulties operators faced in managing shipments within the Russian Railways system. The situation was further complicated by the fact that private operators gave priority to the most profitable cargo, preferring to let cars travel empty rather than use them to carry less profitable cargo.

The delays in rail freight shipments last year caused large economic losses for clients. As a result, Russian Railways saw the number of reimbursement claims jump three-fold to 100,000. The company paid out over 2 billion rubles (€50 million) in compensation.

To improve the situation, Russia this year has revised certain rules on freight transport and tariff-setting mechanisms. Russian Railways is e.g. increasing the share of freight trains running according to regular schedules in the flow of rail traffic, while reducing transportation of empty cars.

The use of Russian rolling stock is relatively inefficient: Russia has far more rolling stock than, say, the US, which has a more extensive rail network and transports a larger volume of freight.
China

China returns to investment-driven stimulus measures to support growth. China’s National Bureau of Statistics reports second-quarter GDP grew 7.6 % y-o-y in real terms. First-quarter GDP growth was 8.1 % y-o-y. However, NBS figures also show that on-quarter GDP growth was higher in the second quarter (up 1.8 % q-o-q) than in the first quarter (1.6 % q-o-q). The on-quarter figures raised comments about the reliability of official figures, especially when other economic information (e.g. company surveys) note no signs of a pick-up in economic activity.

### 12-month change in real GDP growth, %

![Graph showing 12-month change in real GDP growth, %](source: China National Bureau of Statistics)

Domestic demand continues to drive economic growth in China. Consumer demand continues to climb steadily, accounting for half of all economic growth in 1H12. While the growth of investment demand has slowed from recent years, investment still accounted for half of growth in the six months of the year. However, it seems that investment growth has passed its slowest phase.

The trend in export demand remained weak. Although the value of goods trade surplus in the first half of 2012 was $10 billion larger than in 1H2011, the volume of surplus (net exports) contracted, and had a negative contribution to overall economic growth. The world economy, especially markets in Europe, are not expected to revive much during the latter part of the year, and net exports in the second half are likely to remain below the 2H2011 level.

China has reverted to familiar measures for reviving growth. Premier Wen Jiabao said last week that the government’s main task was to accelerate investment growth. This summer the central bank has lowered reference rates twice and the government has speeded up permitting processes for investment projects. Also consumer demand has been supported through e.g. subsidised purchases of energy-efficient home appliances. While the stimulus measures will be more strongly felt in the second half of the year, economic growth is expected to pick up slightly.

Growth forecasts for spring and summer, however, have been revised downwards. The latest IMF forecast for China, for example, sees GDP growing 8 % this year and 8.5 % in 2013. In last March’s BOFIT forecast, GDP growth was expected to come in at around 8 % in both 2012 and 2013.

Income disparity on the increase in China, even as average incomes keep rising. The NBS reports monthly per capita disposable incomes of urban households were 2,085 yuan (€255) during January-June. Real incomes climbed 11 % y-o-y in the period. Also the fact that low-income earners now constitute a smaller share of the population, while the share of high-income earners has continued to grow indicates overall enrichment of urban-dwellers. Rural households had average monthly incomes of 717 yuan (€90). The pace of rural income growth has long outstripped growth in urban incomes.

### Trend in average monthly wages in 2002–6/2012, yuan

![Graph showing trend in average monthly wages, 2002-6/2012, yuan](source: NBS and CEIC)

The average real incomes for migrant workers rose in the first half of the year by 12.4 % y-o-y. As migrant workers are largely employed in labour-intense branches, the rapid income growth of migrants has eroded the competitiveness of Chinese goods exports and pushed foreign firms to transfer production to countries where production costs are lower. On the other hand, rapid income growth in China boosts domestic consumer demand.

Income disparities are alarmingly large. Although it has been over ten years since officials published a Gini coefficient (the value of 0 expresses perfect equality of income distribution and 1 perfect inequality), they have repeatedly stated that income disparity in China is clearly on the rise. Organisations such as the OECD, IMF and Asian Development Bank all put China’s Gini figure well above the critical 0.4 level considered by most experts to be the point at which social unrest begins to manifest. Income disparity is becoming one of the biggest challenges facing the government.

A warning example can be found in Hong Kong, where economic inequality has already stirred social unrest. With a Gini coefficient of 0.54 (0.48 when taxation differentials and social entitlements are counted in), the area has the highest income disparity in Asia.
Russia

CBR widens fluctuation band for ruble exchange rate. The ruble’s allowed fluctuation band relative to the Central Bank of Russia’s hypothetical dollar-euro basket was broadened on Tuesday (July 24) from six to seven rubles. After the change, the band’s lower limit is 31.65 and the upper limit 38.65.

At the same time, the CBR also relaxed the rule on the basis of which it moves the band. After the change, the position of the band will be shifted 5 kopeks up or down whenever CBR market operations exceed $450 million. Previously, the band adjustment limit was $500 million.

The central bank’s current exchange rate policy, introduced in 2009, is geared to an incremental move away from heavy-handed steering of the ruble’s exchange rate to a market-based float. The final aim is to allow the central bank to focus solely on fighting inflation with interest-rate policy.

Ruble-currency basket rate within fluctuation band

![Ruble-currency basket rate within fluctuation band](chart)

Source: CBR, Bloomberg

The ruble has recently faced both appreciation and depreciation pressures. The CBR’s reduction in market interventions is clearly reflected in the increased volatility in exchange rate fluctuations. Experts posit that the central bank does not want to spend its foreign currency reserves on useless defending of the ruble. By widening the fluctuation band the CBR prepares for possible weakening of the ruble should international economic situation deteriorate further. On Friday (July 27), one dollar bought 32.6 rubles and one euro 39.6 rubles.

Russian economic growth slows slightly. However, on-year growth figures are respectable compared to the figures of many advanced economies. Especially domestic demand has grown rapidly. The volume of retail sales in the first half rose 7% y-o-y, while investments were up 10% y-o-y.

Manufacturing growth held at around 4.5% y-o-y, even if output is still somewhat below the pre-recession highs of 2008. Minerals extraction increased less than 1% y-o-y as crude oil production entered a period of low growth and natural gas production fell.

Seasonally adjusted figures reveal the sluggish trend of recent months. Industrial output growth has lain flat and, according to preliminary figures, growth in imports has nearly zero. Investments have been contracting since last winter. Retail sales growth, in contrast, has continued to increase rapidly on the wings of booming demand for durable goods.

Preliminary economy ministry figures suggest GDP growth slowed in the second quarter to under 4% y-o-y, down from nearly 5% y-o-y in the first quarter. Leading forecasting institutions now expect GDP growth this year to reach (or at least approach) 4%.

Russia’s current account surplus and capital outflows remain substantial. Preliminary CBR balance-of-payments figures show the goods trade balance remained strongly in surplus in the first half of this year (11–12% of GDP). While on one hand the surplus was dinged by the drop in world oil prices in the spring, on the other hand it was supported by a lower growth in imports.

The trade deficit in services increased in the first half slightly from 2011 to nearly 2% of GDP. In the same period, the deficit of other current account items, which largely consists of interest and dividend payments, was nearly 4% of GDP. The overall current account surplus, however, was still robust – nearly 6.5% of GDP.

The net outflow of private capital from Russia has continued for nearly two years now. The outflow dwindled in the second quarter, but the drop appears to be due in part to seasonal fluctuations. Over the past twelve months the net outflow corresponded to 5% of GDP for the period. The figure includes “grey” capital exports such as those associated with tax evasion, amounting to more than 2.5% of GDP.

Over the past twelve months, direct investment outflows from Russia continued to exceed DI inflows into Russia: over 3% of GDP (excl. banks), compared to 2% of GDP.

Russia’s private capital inflows and outflows, % of GDP, 4-quarter moving average

![Russia’s private capital inflows and outflows, % of GDP, 4-quarter moving average](chart)

Sources: CBR, BOFIT
China

Good summer grain harvest. China’s National Bureau of Statistics reports that the summer grain harvest was 130 million metric tons, which was a few per cent higher than summer 2011, and an all-time record. Despite the good number, the harvest was actually slightly smaller than expected. Farmlands in Central China were inundated, while farmlands in North China suffered drought. Grain harvested in the May–June period, mostly wheat, accounts for about a fifth of China’s total annual grain harvest. The bulk of the grain harvest occurs in autumn, and the upcoming autumn grain harvest is poised to be larger than in 2011. Growth in other farm production such as meat production also continued in the first half.

The area of land under cultivation as well as grain crops contracted sharply in the early 2000s as agricultural land was repurposed for e.g. industrial use. Since 2003, China’s harvests have been getting larger as the amount of land under cultivation stopped shrinking and average yields climbed. Farm efficiency has been improved by e.g. increased irrigation and fertilizer use. China now uses more fertilizer per hectare than any other country in the world. However, pressures are growing to cut back on and rationalise fertilizer use.

China seeks self-sufficiency in staple food production, and it imports large amounts of only soybeans and vegetable oil. In recent years, imports of other agricultural products have started to grow, as consumption has soared, prices have risen and consumer habits have evolved. At the same time, exports of many agricultural products have decreased.

In order to maintain self-sufficiency in food production, China, like many countries, actively subsidises its agriculture. The OECD finds that farm subsidies, although they were boosted sharply in the 2000s, are still well below the OECD average in 2008–2010. Agriculture accounts for about 10 % of China’s GDP, but official statistics show it employs a third of the workforce.

Direct investments in China contract – China’s investments abroad grow rapidly. In the first six months of this year, foreign direct investment inflows to China were $59 billion, or 3 % less than in H12011. The drop was largely driven by contractions of investments in manufacturing and real estate – sectors that traditionally have attracted most investments.

The slowdown in demand from Western economies has a direct impact on the investment enthusiasm of foreign firms as a large chunk of corporate investment in China has focused on manufacturing for export. Soaring production costs have also hurt corporate investment in China. The Financial Times reports China plans to respond to the drop in FDI by e.g. significantly lowering tax rates on repatriated profits of foreign firms. The reforms, however, only apply to those countries that have signed a double-taxation agreement with China.

The bulk of investments in China comes from Asia, particularly Hong Kong, which accounts for 63 % of China’s FDI inflows. The massive investment presence of tiny Hong Kong reflects the fact that foreign and mainland Chinese firms channel much of their investment flows through Hong Kong to take advantage of its numerous benefits. There are also large investment inflows to China from Taiwan, Japan and Singapore. Investment flows from the United States fell slightly, but the US continued to account for about 3 % of all investment. Investment from the EU grew slightly, accounting for 6 % of all investment in China.

Direct investments of Chinese firms abroad climbed 48 % y-o-y to $35 billion. (Investment from China’s financial sector is not included in this figure.) Part of the rapid growth can be attributed to the “go out”-policy pursued since 2000. The policy continued to be stressed in the most recent five-year plan approved in 2011. China’s investment abroad is supported in many ways: banks are encouraged to lend, institutions specialised in foreign investment have been bolstered and access to investment permits has been gradually eased. Further easing of permitting processes is expected.

Chinese firms tend to invest abroad in natural resources. This week, China’s state-owned oil company CNOOC committed to purchase the Canadian oil company Nexen for $15 billion. Nexen has claims on vast energy reserves around the world. The deal still has to be approved by e.g. Canadian and US officials. If the deal goes through, it would be the largest ever foreign acquisition by a Chinese corporation.

China’s direct investment inflows and outflows, US$ bn

Source: CEIC
Russia

Ukraine and Russia remain deadlocked over the price of natural gas. At the July meeting of presidents Vladimir Putin and Viktor Yanukovych in Yalta, no agreement was reached on the price of gas Ukraine pays Russia. Ukraine has requested a discount for a couple years. In 2009, the two countries signed a 10-year agreement on gas supplies that called for Ukraine to pay more for Russian gas than many countries in Western Europe. Ukraine has also sought to reduce its annual purchase volume commitments, but Gazprom has refused to budge.

Russia says that the price of gas can go down if Gazprom is allowed to take over ownership of Ukraine’s gas pipeline grid operator Naftogaz or if Ukraine joins the Russia-Belarus-Kazakhstan customs union. Putin claims that there would be massive synergy benefits from having Ukraine in the customs union. Yanukovych, in response, noted that he would like to have experts evaluate the impacts of membership before making any decisions. The talks on gas will continue in October after the Ukraine parliamentary elections.

About 80 % of Russian natural gas exports to Europe flow through Ukraine. From time to time, Russia has accused Ukraine of diverting gas for its own use that was destined for customers elsewhere in Europe. The most recent gas spat between the two countries occurred at the start of this year.

Russia actively planning new gas projects and pipeline routes. Gazprom has announced that when planned investments are implemented, Russia will no longer need to transport gas to Europe via pipelines that cross Ukraine.

At his July meeting with Italian prime minister Mario Monti, president Vladimir Putin strongly advocated for the South Stream gas pipeline project. The planned pipeline would carry gas from the Caspian Sea region through a pipeline running under the Black Sea to Southern Europe. Participants in the South Stream project include Gazprom (50 % stake), the Italian ENI (20 %), the French EDF (15 %) and the German Wintershall (15 %). Russian sources say the parties are expected to finalise the investment decision in November.

Putin has called for investment decisions on the massive Shtokman gas field located on the continental shelf of the Barents Sea. Investment decisions of the Arctic offshore project have been long awaited, and were expected at the St. Petersburg economic forum last June. The delay of the decisions is due to current transformation of the global gas market, as well as the project’s huge technical challenges and record-high costs. Participants of the project, launched in 2008, are Gazprom with a 51 % stake, followed by the French Total (25 % stake) and the Norwegian Statoil (24 %). Rumours of possible changes in the consortium makeup have swirled recently, and production plans have been revised as the emphasis has shifted to production of liquefied natural gas (LNG) from the original plan of transmitting part of the gas via pipeline to mainland and further to the shores of the eastern Baltic Sea, where it would have fed into the Nord Stream pipeline that runs under the Baltic to Germany.

Gazprom is currently planning extensions of the Nord Stream gas pipeline. It noted that the UK was interested in importing gas via Nord Stream. The first of Nord Stream’s two main gas pipelines to Germany was completed last year in November. The second gas pipeline should be commissioned in October.

Gazprom cuts natural gas export prices. Several European gas importers have recently received discounts of about 10 % off their long-term contract prices with Gazprom. The latest discount receiver was German energy giant E.ON.

Gazprom is under pressure to change its pricing mechanism in its supply contracts. The pricing is largely based on prices of key petroleum products that have seen much stronger price development recent years than natural gas on spot markets. In 2010, Gazprom granted temporary contract modifications to some of its clients to allow about 15 % of its gas supplies to be spot priced.

European energy companies have demanded a change in the pricing mechanism for a few years already. Some of them, e.g. E.ON, have taken the matter to an international arbitration court. None of the arbitration hearings have ever reach the ruling phase, however, as the parties have always settled beforehand.

Ukraine approves CIS free-trade zone agreement. CIS members agreed last October on the formation of a free-trade zone. The agreement was signed by Russia, Belarus, Kazakhstan, Armenia, Kyrgyzstan, Moldova, Tajikistan and Ukraine. The treaty participants were expected to ratify the agreement before the end of 2011, but the ratification process was delayed. It was only this April that the first countries, Russia and Belarus, ratified the free-trade agreement.

Russia’s leaders have repeatedly requested that the other signatories, e.g. Ukraine and Armenia, move ahead with the ratification process. Russia sees the project as a crucial step towards enhancing the CIS economic cooperation. The free-trade agreement eliminates most import and export duties after transition times of varying duration. The free-trade zone is also to harmonise foreign trade practices among participating states.

Ukraine’s parliament ratified the free-trade agreement and became the third ratifying state on July 30, 2012. The parliament quickly moved on the matter after Russia again forbids a Ukrainian cheesemaker from importing to Russia. A ban on Ukrainian cheese was in effect also in February–April. 
China

IMF concerned about China’s investment trends. At the end of July, the IMF released its latest staff report on its Article IV consultations with the Chinese. The report comments extensively the major policy challenges facing China. The assessment notes the moderation of economic growth to around 8% this year, which is in line with China’s stated economic policies. Inflation remains below the official target of 4% for this year. The assessment team was relatively confident that despite the problems in the property sector and high debt loads of local administrations, China should weather the current softness in the global economy in good shape.

The largest immediate threat to China is further destabilisation from the Eurozone. However, China still enjoys a strong fiscal position that would allow it to increase public consumption if faced with ongoing weak export demand. Like last year, the central government budget deficit should be just over 1% of GDP. To prevent the types of problems seen with the earlier 2008–2009 stimulus package, the financing of public consumption this time around should come directly out of the budget rather than through unrestrained bank lending. In addition, the stimulus measures should support consumption and help China shift from a growth model driven by investment to a more sustainable model based on domestic consumption.

Chinese economic growth has become increasingly dependent on investment in recent years. The investment ratio has risen by 7 percentage points since 2007 to a level of nearly 50% of GDP. The IMF also found that in the same period the utilisation of production capacity had fallen from just below 80% to about 60%, suggesting a huge volume of misdirected investment. Persistent overcapacity problems could lead to deflation, bankruptcies, growth in the stock of non-performing loans, as well as trade disputes fuelled by price dumping.

Correcting these skewed economic structures will take time and cannot be solved by a short-term stimulus. Instead, the change from an investment-driven growth to consumption-driven growth will require extensive structural reforms. Without the change, there is a strong risk that investment growth would suddenly halt. This would have a profound effect not just on China’s economic development but the global economy.

The report notes that there is an urgent need to accelerate reforms to avoid a further build-up of risks related to excessive investments. Although China has implemented significant policy measures to change its growth model, the list of needed reforms is long. The IMF mentioned the social safety net, as well as reform of funding of health care and education, the opening of the service sector to foreign competition, bigger dividend payments from state-owned enterprises and the reduction of subsidies on factor inputs to discourage overinvestment. In addition to ongoing reforms of the VAT system and tax experiments targeted at improving the conditions of low-income people, publication of clear medium-term targets for government spending and revenues should help make fiscal policy more credible.

The report gave heavy weighting to reform of financial markets and the need to move to a price-based regulatory system. The change would help increase competition, make investment more efficient and bring China’s vast informal financial markets under regulatory scrutiny. The target is a gradual freeing up of the interest-rate setting mechanism and easing capital movements, while allowing a further yuan appreciation. Supervision of the financial sector should be beefed up to reflect the evolution of the markets.

Although China’s reformers have much to do, the IMF recommendations coincide with China’s 12th five-year plan and other policy frameworks. Where IMF and Chinese officials did not see eye-to-eye are on current account developments and the yuan’s exchange rate. In the view of the Chinese, the reduction of the current account surplus last year to under 3% of GDP shows that structural changes are already underway. The IMF, despite a substantial lowering of its current account surplus estimate, still fears that the surplus will go back above 4% in the medium term.

The report concludes that the yuan’s exchange rate vis-à-vis a large basket of currencies is still somewhat undervalued. In the Chinese view, the exchange rate trend suggests the yuan is already close to equilibrium. With respect to investment, Chinese officials estimate that the reality is perhaps more balanced than the statistical data suggest as the macrodata tend to underestimate the role of consumption.

Opening of China’s bond markets to foreign investors proceeds in small steps. Officials recently declared that foreign institutions listed as qualified foreign institutional investors (QFII) will be allowed to trade in bonds on China’s interbank market. QFII institutions were earlier limited to trading on China’s stock exchanges. Since 2010, foreign central banks and the most important commercial banks involved in foreign trade transactions have been allowed to participate in the interbank market.

Observers say that the investments of QFII institutions on the interbank market are unlikely to be so significant that they substantially impact the function of the interbank market. Nevertheless, the latest decision is seen as part of a larger effort on the part of officials to develop China’s bond markets, which are still tiny relative to the size of the Chinese economy. At the beginning of July, officials gave the green light to the opening of a high-yield junk bond market.
**Russia**

**Inflation accelerates in July as expected.** Consumer prices rose during July by 1.2 % m-o-m, the highest monthly inflation rate registered in over a year. The jump reflected hikes in administratively set rates for municipal services to households. Regulated rates are traditionally adjusted at the start of the year, but the adjustment was postponed due to presidential elections this year. Since the hikes, gas rates are up 13 %, electricity and water 6 %, and heating 5 %.

On-year consumer price inflation was 5.6 % in July. The government’s target for end-year inflation is 5–6 %, but observers expect a slightly higher rate. At the end of 2011, on-year inflation was 6.1 %.

**Consumer price inflation, 12-month percentage change**

![Graph showing consumer price inflation from 2008 to 2012](Image)

*Source: Rosstat*

**Cabinet considers less exclusive rules on development of offshore hydrocarbon deposits.** A 2008 law limited access to offshore oil & gas projects to Russian state-majority-owned energy companies with at least five years of experience in continental shelf operations. The definition effectively limited the pool of eligible firms to two companies: Gazprom and Rosneft. The law also let the government bypass competitive bidding competition by allocating exploration and production rights directly. Other companies (including foreign firms) are eligible to participate in continental shelf projects only in partnership with a Russian state-owned company as minority partners.

Responding to the law, Russia’s large private oil companies Lukoil, Surgutneftegaz, Bashneft and TNK-BP last spring petitioned president Putin for the opportunity to develop deposits independently. Russia’s Federal Anti-trust Service has also proposed that the government end practices that discriminate against qualified private firms. The cabinet is currently considering relaxing the restrictions for domestic firms, but it is expected that the participation of foreign firms will remain restricted also in the future.

At a government meeting at the start of this month it was noted that development of the arctic continental shelf cannot succeed without the participation of private capital.

The natural resources ministry reports that the Russian continental shelf area is largely unexplored compared to e.g. the Norwegian and UK continental shelf areas. A strong push to explore for hydrocarbon deposits is needed to secure adequate levels of oil and gas production in the future.

Gazprom and Rosneft are unable to take care of mapping deposits or getting offshore production going on their own. Their exploration efforts in tracts where they hold licenses on the continental shelf have been very slow. Domestic oil companies have shown little enthusiasm for the current arrangement that allows minority participation of other companies in joint projects. To overcome this problem, the natural resources ministry has suggested that private domestic firms be allowed to implement projects independently.

US-based Exxon Mobil, the Italian ENI and the Norwegian Statoil signed in April cooperation agreements on oil & gas exploration with Rosneft for Russian continental shelf areas after Russia granted substantial tax breaks. In return, the Western oil companies will not only provide the projects with financing but also give Rosneft access to special exploration and drilling technologies for use in Arctic regions which Russia still lacks.

At the beginning of August, prime minister Dmitri Medvedev assembled a working group to formulate a proposal on how to proceed with exploration and exploitation of hydrocarbon deposits on the continental shelf. The working group will be led by Arkady Dvorkovich, deputy prime minister with portfolio for energy policy.

**Russia ratifies agreement with US on bilateral easing of visa rules.** On July 28, president Putin signed a visa agreement with the US. The executive treaty does require ratification by the US Congress and enters into force 30 days after both sides indicate that they are technically ready to handle the rule changes. US officials expect the new visa regime to enter into force by mid-September. Although the countries agreed on an easing of visa rules last November, it took ten months for Russia to ratify the deal.

Under the agreement, business and tourist visas will be granted typically as three-year multi-entry visas that allow a visitor to stay in the country up to six months per visit. Previously, three-year multi-entry visas were issued in principle only after an applicant had received several shorter visas. The visa allowed a maximum stay of 90 days during every 180 day period. The EU-Russia visa agreement of 2007 follows the same principles.

The changes in visa rules will have a greater impact on US travellers than their Russian counterparts as the US has already shifted to granting visas to many Russian citizens in the form of two-year multi-entry visas. US officials report that each year about 10 % of Russian visa applications are rejected. The rejection rate for Russian visa applications to the EU is less than 2 %.
China

China’s service and construction sectors post stable growth. China’s official non-manufacturing purchasing manager index (PMI) was 55.6 points in July, a level well above the critical 50-point threshold between positive and negative outlooks. The number was down slightly from June. HBSC’s Markit services PMI, which is widely watched internationally, registered a slight uptick in sentiment for China’s service sector in August.

Figures released this week show growth in the volume of retail sales remained 11% y-o-y, i.e. unchanged from previous months. In addition to the PMI numbers, this provides further evidence of continued strong growth in the service sector.

NBS/CFLP non-manufacturing PMI

Despite the slight drop in PMI sub-index on expectations, the overall outlook for services and construction remains optimistic. This is welcome news for China’s decision-makers as Europe’s debt crisis has clouded the outlook for China’s export industries. Services and construction together generate nearly half of China’s GDP, and their importance is expected to grow in the future as the emphasis of economic policy shifts from export- and investment-driven growth to growth led by domestic consumption.

China experiences balance-of-payments deficit for the first time in 14 years. The combined financial and capital account deficit was $71 billion in the second quarter. Although there was a first-quarter surplus as capital inflows exceeded outflows, the second quarter deficit reduced the overall first-half deficit to $20 billion. The slight decline of direct investment into China and the rapid growth in Chinese investment abroad contributed in part to the financial account deficit. Data for other balance-of-payments categories will come later.

The $60 billion second-quarter current account surplus was up from $24 billion in the first quarter. Growth of the current account surplus slowed, however; the first-half surplus was 5% smaller than in the 1H2011.

The combined current and financial account showed a slight deficit for the second quarter. The last time the combined quarterly balance was in the red was in 1998 in the wake of the Asian financial crisis.

China’s foreign currency reserves swelled by $59 billion the first six months of this year to $3.24 trillion, despite the fact that the reserves declined in the second quarter.

China promises African countries $20 billion in low-interest loans. The latest China-Africa forum on economic cooperation, which has been held every three years since 2000, took place in Beijing in late July. In addition to announcing the next three years’ credit line for the continent, China committed to increasing its development assistance, gradual elimination of import duties on products from the least developed countries and granting more favourable financing to Chinese companies that invest in Africa.

At the 2009 ministerial forum, China granted African countries $10 billion in low-interest loans. The loans have been mainly dedicated to construction of infrastructure such as roads, power plants, oil and gas pipelines, upgrades to telecommunications networks and improved water supplies. Foreign observers have, however, criticised China’s use of development loans since they depart from standard practice of other donor nations that couple loans to good governance practices and environmental protection.

Cooperation with African states increased dramatically during the 2000s, even though Africa’s overall share in Chinese foreign trade remains relatively small. In 2011, China’s exports to Africa were valued at $73 billion (4% of China’s total exports) and consisted largely of manufactured goods. Imports from African countries were mostly raw materials and had a value of $93 billion (5% of China’s total imports).

Direct investments by Chinese firms in Africa have increased rapidly in recent years, reaching $13 billion in 2010. While the official share of investments in Africa is still just 4% of China’s total investment, the figures do not fully reflect the situation as it is likely that considerable investment flows through Hong Kong and tax havens.

Chinese investment in Africa is driven in part with securing access to natural resources. Indeed, Chinese state-owned enterprises have made large investments in backward states like Niger and Democratic Republic of Congo just to secure energy and raw materials. On the other hand, the dynamism of Africa is hard for investors anywhere to resist – six of the world’s ten fastest growing economies are in Africa. In this respect Chinese investment is like any other investment and the interest of Chinese firms in Africa is essentially market-driven.
Russia

Banking sector growth remains robust. Total assets of the banking sector reached 44 trillion rubles (€1.07 trillion) at the end of June, an increase of about 25% from a year earlier. The value of total assets to GDP at the start of the year was 76%, strong evidence of just how small Russia’s banking sector is by international standards. The same ratio for Finland, for example, approached 300% in 2011, which was close to the EU average.

Much of the recent growth in the Russian banking sector has come from a rapid expansion of credit. In the first half of this year, the stock of corporate loans increased 25% y-o-y, well above the 16% increase of 1H2011. Household borrowing was up 44% y-o-y (compared to 24% growth in 1H2011).

Households deposits climbed 22%, lagging growth in bank lending. The lower growth in deposits forced banks to seek other sources of funding and increased the importance of the Central Bank of Russia as a source of financing. The share of central bank financing to total bank assets rose from 3% in January to 6% in July.

At the request of the CBR, the finance ministry increased the amount of available budget funds to banks through deposit auctions. The CBR noted that the recent tight market liquidity reflects to some extent the fact that the bulk of budget spending takes place in the second half of the year, even if tax revenues are collected at a fairly stable rate throughout the year. As a result, part of the budget funds is unavailable to markets during the first half of the year. During the 2008 financial crisis, the government initiated deposit auctions of budget assets to deal with this imbalance. Since then, deposit auctions have become an important tool in managing seasonal variation in banking system liquidity.

Due to the rapid growth in the loan stock, the banking sector’s capital adequacy ratio (capital to risk-weighted assets) fell in the first half by a percentage point to just under 14%. The banking sector’s overall capital adequacy ratio was still well above the CBR minimum of 10%. The CBR allows a looser definition of certain indicators in calculating the capital adequacy than in the methodology applied under the internationally recognised Basel II framework (used e.g. in the EU). At the beginning of July, the CBR tightened up its own methodology to bring it more into compliance with Basel II rules. By the CBR’s own estimate, the change should cause a drop of about 0.5 percentage points in the banking sector capital adequacy ratio. Basel II demands have been incrementally implemented in Russia; their full implementation is expected to lower the banking sector’s capital adequacy ratio even further.

At the end of June, Russia had 1,102 operating credit institutions, of which 965 were banks. The figure showed a reduction of ten credit institutions from the start of the year. In the first half of 2012, the CBR cancelled the licences of 13 credit institutions, twice the number as in 1H2011. Most banks lost their licences because of financial problems, such as failing to meet mandatory capital requirements or repay their debts.

Russia’s foreign trade showed modest growth in the first half of 2012. The goods trade surplus hit a record $109 billion in 1H2012. However, the pace of growth of both goods exports and imports has slowed in recent months, and in June their values even contracted slightly from a year earlier. According to preliminary data, imports returned to positive growth in July.

The value of Russian goods exports in the January-June period was $263 billion. The value of exports grew nearly 7% y-o-y, thanks to higher export prices. The volume of exports, in contrast, fell by nearly 1%. Russia’s biggest export destination by far was the Netherlands with a 15% share, followed by Germany and China. The structure of goods exports continued to be dominated by oil, petroleum products and natural gas, which together accounted for over 70% of Russian exports. Metals and chemicals were the other major export items. The CBR preliminarily estimates that the value of Russian services exports in the first half amounted to $30 billion, a 20% increase from 1H2011. Transport services accounted for about a third of services exports.

The value of goods imports rose in the first half to $154 billion. The value of imports grew 4% y-o-y due to higher import volumes; import prices fell slightly. China remained Russia’s main source of imports, accounting for 16% of all Russia’s imports. Half of goods imports consisted of machinery, equipment and transport vehicles. Other major import goods were chemicals and foodstuffs. The value of Russian services imports rose by about 20% in the first half to $47 billion. The biggest imports category in services was tourism, which accounted for about a third of all Russian service imports.

Monthly Russian exports, imports and goods trade balance, US$ billion (seasonally adjusted)
China

China’s July economic numbers unnerv global financial markets. China’s foreign trade became an international cause for concern when announced July growth figures came in far below expectations. China’s imports increased just 5% y-o-y in July and exports rose only 1% y-o-y. China’s trade surplus for the month also fell by 20% to $25 billion. It would be unreasonable to read too much into one month’s data, however, as monthly fluctuations in trade figures are often quite large. A better overview of current trends in export markets can be gleaned from examination of the economic data for the first half of the year.

In the first half of 2012, Chinese exports remained fairly robust but there was a change in the structure of exports reflecting impacts from Europe’s debt crisis. While China’s exports overall grew almost 10% y-o-y, exports to Europe were up just 1%. Exports to the financially stable Nordic countries grew, while exports contracted for countries in southern Europe struggling with the debt crisis. For example, exports to Italy fell by 25%, while exports to Portugal and Greece were off about 10% and exports to Spain were down 4%. The big surprise, perhaps, was a 4% drop in exports to Germany.

China’s imports grew in the first half about 7% y-o-y. Although imports from Europe increased only 3%, Chinese demand had a positive effect on some European countries struggling with debt. In particular, Greece and Portugal got a shot in the arm from their China trade. In the first six months of this year, Chinese imports from Greece rose 68% y-o-y, while imports from Portugal rose 64%. Economic relations between China and Greece have improved during the financial crisis, with China investing actively e.g. in the Greek food sector. Not all European countries, however, have benefited from China trade. For example, Chinese imports from Spain fell by nearly 25% and imports from Italy were down almost 10% in the first half of the year. Partly these figures reflect the weakened euro.

July industrial output of 9% growth was also below forecast. Real growth in both retail sales and capital investment held steady, while inflation slowed to an 12-month rate of 1.8%. The main measure of broad money supply growth (M2) was up 14%, slightly exceeding expectations. As growth in export demand and industrial output fades, and inflation falls, Chinese officials are expected to relax economic policy further in coming months.

China’s highest value brands are almost unknown outside the country. China Mobile is China’s most valuable brand according to MillwardBrown’s latest BrandZ Top 100 Most Valuable Brands report. The report mentions 50 Chinese brands according to their calculated values. Brand value is calculated in dollars, and considers e.g. the growth potential in demand for the product and results of customer satisfaction surveys. The survey covers brands of firms producing consumer goods or services directed towards consumers, which is why companies like telecom giant Huawei do not appear on the list.

State-owned enterprises dominated the list – only two of the China’s top ten most valuable brands were privately held. The success of state firms reflects the fact that their brands have greater recognition and better placement in markets with high demand and low competition. In addition, large state-owned enterprises have succeeded better at creating and shaping brand images than their private counterparts.

Compared to the previous BrandZ report, published in December 2010, the brand showing the biggest value gain was Web portal Sina, which provides Weibo, China’s social media answer to Facebook and Twitter. Sina’s value grew an impressive 244%, increasing its ranking to 25th place. In addition, Baidu, the company that operates the world’s second largest search engine, saw its brand value surge to China’s sixth highest value brand. China’s rise as the world’s largest Internet user has opened vast markets to Chinese firms. Tight censorship has also kept most of the Chinese user base in domestic forums.

Many of the newcomers to the list of high-value brands are airlines and tour operators, both indicators that Chinese society is getting wealthier and adopting middle-class consumption patterns.

Chinese brands are high value by international standards: the latest global BrandZ report ranks China Mobile as the 10th most valuable brand in the world. In addition, twelve more Chinese brands make it into the top 100 most valuable brands in the world. However, the high valuation simply reflects the vast purchasing power of 1.3 billion Chinese, as most Chinese brands with multi-billion-dollar valuations are unfamiliar to wider international audiences.

<table>
<thead>
<tr>
<th>Ranking</th>
<th>Brand</th>
<th>Valuation</th>
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<tbody>
<tr>
<td>1</td>
<td>China Mobile</td>
<td>$53.6 bn.</td>
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<tr>
<td>2</td>
<td>Industrial and Commercial Bank of China</td>
<td>$43.9 bn.</td>
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<tr>
<td>3</td>
<td>China Construction Bank</td>
<td>$22 bn.</td>
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<tr>
<td>4</td>
<td>Bank of China</td>
<td>$18.6 bn.</td>
</tr>
<tr>
<td>5</td>
<td>Agricultural Bank of China</td>
<td>$17.3 bn.</td>
</tr>
<tr>
<td>6</td>
<td>Baidu (Internet search engine), privately held</td>
<td>$16.3 bn.</td>
</tr>
<tr>
<td>7</td>
<td>China Life (Insurance)</td>
<td>$15.3 bn.</td>
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<tr>
<td>8</td>
<td>Sinopec</td>
<td>$13.8 bn.</td>
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<tr>
<td>9</td>
<td>PetroChina</td>
<td>$13.8 bn.</td>
</tr>
<tr>
<td>10</td>
<td>Tencent (Web portal), privately held</td>
<td>$12.6 bn.</td>
</tr>
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Source: MillwardBrown
Russia

Russia became a WTO member on Wednesday. WTO accession brings down Russia import duties 3% on average, a small drop as Russian import duties have traditionally been fairly low by international standards. The weighted average import duty will eventually be about 7%. Some tariff cuts go immediately into effect and some are subject to transition periods. Most transition periods are 2–5 years, and the longest, for car imports, is 7 years.

Russia’s WTO commitments apply to both goods and services. In the insurance sector, Russia will raise the ceiling on foreign capital participation from 25% to 50% of the sector’s total capital. After a transition period, foreign insurance companies will also be allowed to establish branch offices. Russia, however, will still not allow foreign banks to set up branch offices, and the banking sector will continue to maintain a 50% limit on foreign ownership.

Russia’s WTO membership commitments with respect to the US are still in limbo as the US Congress failed to continue to maintain a 50% permanent limit on foreign ownership. Russia’s WTO commitments apply to both goods and services. In the insurance sector, Russia will raise the ceiling on foreign capital participation from 25% to 50% of the sector’s total capital. After a transition period, foreign insurance companies will also be allowed to establish branch offices. Russia, however, will still not allow foreign banks to set up branch offices, and the banking sector will continue to maintain a 50% limit on foreign ownership.

Russia’s WTO membership commitments with respect to the US are still in limbo as the US Congress failed to continue to maintain a 50% permanent limit on foreign ownership. Russia’s WTO commitments apply to both goods and services. In the insurance sector, Russia will raise the ceiling on foreign capital participation from 25% to 50% of the sector’s total capital. After a transition period, foreign insurance companies will also be allowed to establish branch offices. Russia, however, will still not allow foreign banks to set up branch offices, and the banking sector will continue to maintain a 50% limit on foreign ownership.

Russia’s WTO membership brings some tariff relief important for Finland. With Russia’s WTO membership becoming official on Wednesday (August 22), lower import tariffs on certain paper products took immediate effect. However, the bulk of import tariff reductions for Finland’s main export goods only go into effect after several years of transition. Although Russia’s import duties on average only decline a few percentage points, some tariffs will be cut as much as to a third from their current level (e.g. certain paper and chemical industry products).

One of the most important impacts for Finland are cuts in export duties on raw timber. To date, Russia’s export duty on the bulk of wood types has been 25% of the export value with a minimum of €15 per cubic metre. With WTO membership, the export duty on raw birch falls to 7%. Pine and spruce are subject to export quotas, and within those quotas the export duty on spruce will fall to 13% and pine to 15%. The EU quotas on pine and spruce amount to double or even triple last year’s actual import volumes. Hence quotas and lower import duties are expected to cover all the import requirements of European buyers.

WTO membership means Russia is committed to more predictable and transparent customs procedures. This should improve trade flows as customs procedures have traditionally been mentioned by Finnish firms as one the most problematic aspects of trade with Russia.

Strong protection of Russia’s car industry will continue even with WTO membership. Russia’s WTO commitments include lowering automobile import tariffs gradually through 2018. At that time, the import duty on passenger cars that are new or new-ish (less than three years old) cannot exceed 15% of the customs value. The import duty on older cars (over three years old) will be 20%. The prevailing import duty since 2008 had been 30% for new cars and 35% for old cars.

The first reduction in tariffs went into effect immediately upon WTO membership, whereby Russia lowered the import duty on new cars by five percentage points to 25% and old cars to 30%.

Lower import duties, however, will not translate into cheaper cars. Under a new law passed in July, the discount will be absorbed by a recycling fee. The law enters into force on September 1, and applies to cars imported into Russia and cars manufactured in Russia. Car importers will have to pay the fee for every imported car, while companies that manufacture cars in Russia will instead commit to making arrangements for the recycling of the cars they produce. For the time being, Russia has no comprehensive recycling system for vehicles nor a law governing the issue, so setting up a functional recycling system will take time. It is also unclear how the system will be funded.

The size of the fee will be decided by the government. According to the proposal submitted by the industry and trade ministry, the size of the fee will be based on the age of the vehicle and volume of engine displacement. The older the car and the larger the engine, the higher the recycling fee. The recycling fee for an old car will be as much as six times higher than that of a new car. Cars manufactured in Russia faced severe competition from imported used cars before the 2008 hike in the import duty on passenger cars. Imports came to a near halt after the tariff hike. The high recycling fee for used cars is meant to keep them out of the Russian market also in the future.

Russia’s car industry in the last decade has grown rapidly. Most growth has been generated by assembly plants established by foreign carmakers on Russian soil. Russia has boosted the development of the industry by significant support measures, e.g. imposing high import duties on foreign cars.
China

**Prices on Shanghai stock exchange tumble.** This week, the Shanghai stock exchange’s A-share index hit its lowest point since autumn 2008. The Shanghai A-share index has dropped about 4% this year, while stock exchanges in other emerging markets are on average up by about 6%. The downturn in Chinese share prices has been fuelled by worries over the slowdown in economic growth. Moreover, listed firms have started to release their second quarter results, which have been weaker than in previous years.

![Share prices trends for the Shanghai A, Moscow RTS and MSCI Emerging Markets indices](image)

*Source: Bloomberg*

**China to continue active development of North Korean special economic zones.** China’s Ministry of Commerce reports that China and North Korea are satisfied with the bilateral cooperation taking place in two special economic zones located along the China-North Korea border. Rason, North Korea’s first special economic zone was established in 1991, while the second, Hwanggumpyong and Wihwa Islands economic zone, was established in July 2011. The infrastructure and relevant regulations governing the zones will now be developed in order to attract more foreign investment. The immediate goal of developing the zones is accelerating North Korea’s economic growth.

China is by far the biggest trade partner of internationally isolated North Korea. Trade between the two nations has grown briskly in recent years. In the first seven months of 2012, for example, Chinese exports to North Korea rose 14% y-o-y and the value of exports was $2 billion. North Korea imports many of its critical commodities, energy and manufactured products from China. China’s imports from North Korea climbed 15% y-o-y in January-July to $1.5 billion. The bulk of imports consisted of coal and iron ore.

China’s role in trade has gained even more significance for North Korea after South Korea tightened trade sanctions on North Korea in 2010. Even so, the Koreans continue to maintain economic ties in North Korea’s 65-square-kilometre Kaesong industrial complex just north of the demilitarised zone. Media reports indicate the value of industrial output has increased sharply from last year and an increasing number of North Koreans work for the area’s joint ventures.

Famine is a most serious problem in North Korea. In a June UN assessment, about two-thirds of North Koreans were found to suffer from chronic food insecurity. The situation worsened recently after flooding from severe July rains damaged grain crops and critical infrastructure in North Korea.

Active development of the special economic zones may indicate broader economic reforms are being contemplated by North Korea. If the current experiments succeed, observers speculate that they might begin to be applied more widely.

Closer cooperation with China could also contribute to stabilising the situation on the Korean peninsula, a further motive for China to actively develop North Korea’s special economic zones beyond straightforward economic purposes.

**Japan is one of the most important trade partners for China.** Relations between the world’s second and third largest economies, China and Japan, have grown tense in recent days after a group of Japanese activists landed on the tiny Senkaku/Diaoyu islands claimed by both Japan and China. The islands lie in a part of the East China Sea with hydrocarbon potential, and the two countries have not been able to resolve their territorial claims or shared utilisation of hydrocarbon reserves.

In recent years, disputes over boundaries have caused a series of spats. For example, in 2010, China banned exports of rare earth metals to Japan after Japan arrested the captain of a Chinese fishing vessel in the disputed area. On top of the demarcation disputes, there is a difficult history between the two countries. In 2005, widespread demonstrations broke out in China against Japan after the Japanese revised school history textbooks on events in the wars between the two countries.

Even so, the countries are inextricably linked economically. Although Chinese imports from Japan fell slight on-year in the first seven months of the year, China still imports more goods from Japan than from any other country. Japan is also China’s third largest export market after the US and the EU. The top goods category, both for imports and exports, is machinery and equipment.

China is by far Japan’s top trade partner; China accounts for about 20% of Japan’s exports and imports. Japanese firms have also made major investments in China.
Russia

**Strong state spending in first half.** The consolidated budget (federal, regional and local budgets plus state social funds) saw first-half expenditures jump over 20 % y-o-y. Part of the spending growth reflects a more balanced distribution of spending over the course of the year (Russian administrations have traditionally held back on spending until the second half of the year). The finance ministry figures budget spending will rise this year about 13 % in nominal terms, which could imply some 6 % in real terms.

Defence spending increased in the first half by over 50 %. After a two-year hiatus, spending on education and health care was ramped up, rising 30 % in 1H2012. Growth is expected to abate somewhat in the second half, however. Social spending was up nearly 15 %.

Similar to 2011, the consolidated budget surplus in the first half was nearly 2 % of GDP. The finance ministry estimates that the consolidated 2012 budget will show a small surplus as long as the average price of Ural-grade crude oil is at least $115 a barrel (first-half average was $112/bbl).

State revenues climbed over 10 % in the first half. Taxes and fees from production and export of gas & oil increased more than 25 %. Their share in state revenues reached the previous record of nearly 30 %. Steady growth continued in value-added-tax revenue, while growth in revenue from mandatory social contributions slowed due to a rate cut at the start of the year. The rapid rebound in corporate profit tax revenues ended.

**Main state spending categories, % of GDP, average of last four quarters**

<table>
<thead>
<tr>
<th>Year</th>
<th>Social (overall), of which pensions</th>
<th>Defence and security</th>
<th>Economy</th>
<th>Health and sport</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>14%</td>
<td>7%</td>
<td>10%</td>
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<td>2008</td>
<td>13%</td>
<td>8%</td>
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<td>7%</td>
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<td>2009</td>
<td>12%</td>
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<td>12%</td>
<td>6%</td>
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<td>2010</td>
<td>11%</td>
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<tr>
<td>2011</td>
<td>10%</td>
<td>8%</td>
<td>12%</td>
<td>6%</td>
</tr>
<tr>
<td>2012</td>
<td>9%</td>
<td>7%</td>
<td>11%</td>
<td>6%</td>
</tr>
</tbody>
</table>

*Sources: Finance ministry, BOFIT*

**New laws diminish Moscow’s tax revenues.** January saw the implementation of legislation on transfer pricing and conglomerate taxation. The laws are intended to reduce the practice of minimising tax obligations through transfer pricing, followed by enterprises related to each other. The laws also change the division of corporate taxes among regions.

The law on transfer pricing increases possibilities for tax authorities to investigate intra-group pricing arrangements. The law on conglomerates allows large enterprises to form groups with related firms. The conglomerates are taxed as a single entity, and the increased monitoring of intra-group pricing does not affect them, as they gain no tax benefit from transfer pricing.

Taxes paid by the conglomerate will now be divided among all regions where it has operations. The bulk of enterprise taxation earlier went to the region where the company’s headquarters were located.

The finance ministry reports that thus far eleven conglomerates have been formed, comprising of a total of 197 firms. These conglomerates consist mainly of groups in the oil & gas sector (e.g. Gazprom, Lukoil and Rosneft), as well as major players in the metals and telecom sectors.

The loss of revenue caused by changes in the tax scheme hits Moscow hardest, but also affects St. Petersburg, Tyumen and some ten other big cities with headquarters of big enterprises. Moscow could lose over 80 billion rubles ($2 billion) a year in revenues. Moscow’s 2012 budget assumes over 1.3 trillion rubles ($33 billion) in tax revenues. The biggest taxpayer is Gazprom.

The Duma this spring approved on Moscow’s initiative a change in the law to shift Gazprom to conglomerate taxation only gradually by 2016. The change reduces Moscow’s tax losses this year to 30 billion rubles. The change was opposed by the Moscow region, whose benefits from the new tax-sharing model are delayed respectively.

**Moscow region seeks ways to boost tax revenues.** Moscow region officials recently proposed that income taxes of private individuals be paid to the municipality where the individual resides rather than where they work.

At present, employers withhold 13 % of an employee’s wages, 70 % of which is sent to the federal government and 30 % to the company’s domicile municipality. The practice is especially unfair to the Moscow region and to a lesser extent the Leningrad region surrounding St. Petersburg. Some 1.2–1.3 million people live in the Moscow region and work in Moscow city. The region’s annual tax revenue losses are estimated at about 50–70 billion rubles (€1.3–1.8 billion). The region’s tax revenues this year will be about 460 billion rubles ($12 billion).

Federal officials do not support a change in the income tax payment practice, arguing that it is burdensome for the employer to pay taxes to each employee’s residential municipality. One possibility would be to change the system so that wage-earners are responsible for paying their own income taxes, but there is low enthusiasm for the idea.

The Moscow region also wants compensation for the loss of 1,500 km² of its land area caused by Moscow’s recent expansion. Due to that, the region lost a significant part of its tax income. The region puts the annual net loss at about 25 billion rubles.
China

Despite economic slowdown, banking sector profits rose in the first half. The first-half financial reports released this month for China’s giant state-owned commercial banks show profitability continued to rise, albeit more slowly. While profit growth had been expected to slow, investors were still disappointed by the financial performances of the big banks, which averaged profits of around 100 billion yuan (€12 billion) per bank in the first half.

Share prices for commercial banks have slumped worse than the Shanghai A-share index this year. Moreover, expectations of further profit growth in the second half are subdued as indicators point to lower economic growth ahead. In June and July, the People’s Bank of China also moved to give commercial banks more leeway in setting lending rates, which will increase competition in the sector and reduce bank profit margins.

There has long been a fear among observers and officials that China’s massive, rapidly rolled out stimulus of 2009–2010 would ultimately result in a large increase in the stock of non-performing loans. At least for now this fear has not materialised. Among the large banks, only about 1% of the loan stock is currently classified as non-performing, and that share decreased slightly in the first six months of this year. Two of China’s four giant banks (Bank of China and China Construction Bank) reported that 6% of their current loans have been granted to investment vehicles set up by local administrations as they implemented stimulus policies at the grassroots level. It has been suspected that commercial banks have rolled over some of these loans, thereby shifting the non-performing loan problem into the future.

China expands service-sector VAT experiment. The pilot tax programme introduced at the beginning of this year in Shanghai made some services subject to value-added tax rather than business tax. Before the end of the year the trial will be expanded to the cities of Beijing and Tianjin, as well as the provinces of Anhui, Fujian, Guangdong, Hubei, Jiangsu and Zhejiang. The areas to be covered under the trial generate about half of China’s GDP.

The transfer of companies providing services into the VAT system should reduce double taxation by allowing “pass-through” deductions on inputs. This is not possible under business tax arrangement. Deductions should lighten the tax burden on service companies even though the business tax rate is lower than the VAT rate.

Asian Development Bank pushes China to reform environmental policy. Despite the steady progress in some areas, the new ADB report finds China’s deteriorating environmental conditions call for an overhaul of environmental policy. As the world’s largest producer of greenhouse gases, how China chooses to deal with its environmental impacts has a massive global significance.

Water pollution and inadequate water supplies are perhaps China’s biggest immediate environmental challenges. Although the government has become more involved in regulating emissions of industry and households, not enough attention has been paid to prevent fertilizers and pesticides from getting into water systems. Air quality is another critical problem. Only a handful of China’s 500 largest cities currently meet WHO air quality standards and seven of the world’s ten most polluted cities are located in China. Solid waste disposal is still poorly handled, and the higher frequency of natural disasters also poses major challenges for China’s economy and society.

China’s current model of economic growth based on export-driven manufacturing has largely been achieved at the expense of the environment. Thus, meeting the large challenges facing China and achieving sustainable development depend on the country’s ability to evolve into a more service-based economy driven by domestic consumption. Sustainability policies should be reinforced by e.g. “green” tax reforms as the current system does not adequately discourage wasteful energy use. In addition, market-based schemes such as emissions trading and subsidies paid to environmentally responsible firms could be increased. Urban planning needs to shift attention from rapid, large-scale construction to high-quality housing and better quality of life.

Despite the bleak outlook, the ADB’s report gives China some credit for progress. In the previous five-year plan (2006–2010), China made some environmental progress even in the face of higher-than-forecast economic growth. Energy efficiency has improved, as products are now produced with substantially lower emissions and energy inputs than in 2005. Sulphur dioxide emissions have declined 10% since 2005, which has helped improve air quality in some provinces. The total forested area in China also increased to nearly 20%. Capacity for municipal waste water treatment nearly quintupled over the past decade, and renewable energy production has increased sharply. Trading in sulphur dioxide emissions is already underway. Last week in Shanghai, a new trading scheme for carbon dioxide emissions was launched; it involves about 200 industrial, service and agricultural sector businesses.

Despite a number of rather remarkable improvements, China should make faster progress in environmental protection given how badly conditions have deteriorated and the fact that a wealthier China inevitably puts a greater burden on the carrying capacity of natural systems. More radical measures will be needed for the situation to improve.
Russia moves to increase port capacity, especially in the Baltic Sea and Pacific coast. Rosmorport, a state-owned company for development of maritime transport, last week released a new version of development plans for Russian ports through 2030. The plan sees port cargo traffic rising from 540 million tons in 2011 to 700 million tons in 2015 and nearly 900 million tons by 2020.

Most Russian sea cargoes are exports that go through ports on the Baltic Sea, Black Sea or Pacific Ocean. The development plan calls for increasing sea export capacity so that Russia is less dependent on transshipment through third countries. Port expansions should increase capacity by 25% or 200 million tons by 2015. Nearly half of new capacity is planned for Pacific coast coal and oil shipping. Far East ports should also attract westbound cargo from Asia. Port development requires massive parallel investment in transport infrastructure.

The biggest expansion is planned for Baltic sea ports, including Ust Luga. By 2015, Ust Luga’s capacity is expected to more than double through e.g. expansion of terminals for oil and petroleum products and construction of a new container terminal. Furthermore, the port of St. Petersburg will add 20 million tons in new container-handling capacity. Another 30 million tons is added by 2020, when the general purpose Bronka port not far from the St. Petersburg port should be in operation.

The development plan asserts that the Baltic Sea will remain Russia’s main sea route for foreign trade in coming years. Russia’s Baltic ports already handle nearly half of the imports arriving by sea. About 30% of Russia’s crude oil and petroleum product exports (112 million tons) went through Baltic ports last year, and by 2015, the volume of such exports is expected to reach nearly 150 million tons.

Russian import cargo by port in 2011 and 2015 (forecast), million tons

<table>
<thead>
<tr>
<th>Year</th>
<th>Baltic</th>
<th>Black Sea</th>
<th>Far East</th>
<th>Caspian Sea</th>
<th>Arctic</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2015</td>
<td></td>
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Source: Rosmorport

Development of Russian Far East. This week saw the opening of the Asia-Pacific Economic Cooperation (APEC) summit in Vladivostok. Russia is hosting the APEC summit for the first time since the organisation was created in 1989 at an Australian initiative. Playing host gives Russia a chance to show its growing influence in the Pacific Rim.

Vladivostok is located in the Far East Federal District, which extends from Siberia to the shores of the Pacific Ocean. The area of the district amounts to over a third of the Russian Federation’s land area, yet is inhabited by just 6 million people (4% of Russia’s population). While the Far East Federal District’s rich natural endowments give it tremendous economic potential, it suffers from a lack of infrastructure and emigration. Between 1989 and 2010, the Federal District lost two million inhabitants – in relation to population a contraction unmatched elsewhere in Russia. The reasons for the exodus include the harsh climate, poor access to services, high living costs and remoteness from European Russia.

Russia wants to make better use of the economic opportunities in the Pacific Rim, so it is making efforts to bring the Far East Federal District into the mainstream of the Russian economy. The economic activity in populous China just across the border and its impact on the scarcely populated Federal District have increased pressure to develop the region. This spring, the government created a ministry for development of the Far East.

In anticipation of the APEC summit, the 600,000-resident city of Vladivostok has seen a massive building boom and dramatic improvements in living conditions. Vladivostok has been deluged with greenfield and modernization projects of its transport network and municipal services such as heating, water, electricity and waste management. The practically uninhabited Russky Island located just offshore is the location for construction of a state-of-the-art congress centre with world-class accommodations and infrastructure. After the summit the facilities will become the campus for the Far Eastern Federal University.

Officials hope the APEC summit will attract foreign investment to the Far East Federal District, even if observers take a more cautious view. A goal of the APEC summit is to give Vladivostok the imprimatur of a regional growth core. The government would like to see Vladivostok become an Asia-Pacific transport and shipping hub, as well as the easternmost terminal for pan-Russia rail shipping between Western Europe and Asia to provide an alternative to sea shipping via the Suez Canal. The vision includes creation of shipyard industry and other value-added industries, and would require massive infrastructure investments.

Around 680 billion rubles (£17 billion) have been spent on construction for the APEC summit. The costs are only surpassed by Russia’s spending on preparations for the Sochi 2014 Winter Olympics. Funding has come from the federal budget and state enterprises, especially Gazprom. The pricey project has been criticised for failing to provide a long-term basis for growth in Vladivostok or the Far East Federal District.
China

Mongolian pressure cuts Chinese investment in development of major ore and mineral deposits. Chalco, China’s giant state-owned mining company, announced Monday (Sept. 3) it was abandoning plans for a massive Mongolian coal mine investment. The plan was unpopular among many Mongolians, who are concerned over the growth of Chinese influence in the country’s mining sector. Under a new law on foreign investment passed this summer, investment in strategic sectors (including the mining sector) must first be approved by the Mongolian parliament. China has traditionally been Mongolia’s biggest foreign investor, and the scrapped coal project would have been China’s largest direct investment in Mongolia.

Mongolia represents just a few thousandths of China’s foreign trade, but China has long eyed Mongolia as a source of raw materials. In recent years, for example, Mongolian coal has accounted for 7% of China’s total coal imports. Mongolian GDP per capita is only about half of that of China, but Mongolia has experienced a major resources boom in recent years and its economic growth has outstripped that of its southern neighbour. In 2011, Mongolian GDP grew 17%, making it the second fastest-growing economy in the world after Qatar (18%).

Mongolia’s economic boom has largely been driven by world demand of metal ore concentrates, particularly from China. Two-thirds of Mongolian exports consist of ore concentrates or commercial minerals. Because Mongolia is landlocked, concentrates and minerals have to be transported by rail nearly 2,000 kilometres to China’s Tianjin port. Even with the transport issues, investment in Mongolia’s mining sector grows rapidly. Last year fixed investment accounted for nearly 70% of Mongolian GDP.

Growth in value of Chinese imports from Mongolia, %

Source: CEIC

Yuan loans coming soon to Taiwan. This week Taiwanese and Chinese officials signed a direct clearing pact that allows Taiwanese banks to offer yuan loans to Chinese corporations in Taiwan. Implementation of the clearing mechanism still requires a decision from Taiwanese authorities on practical arrangements, but the matter is moving ahead swiftly. China’s efforts to increase the use of the yuan outside China helps Chinese firms with international operations by promoting currency exchange.

Access to yuan-denominated loans has been limited for Chinese companies operating outside the mainland due to currency controls. Previously, banks operating in Hong Kong have been allowed to grant yuan loans to Chinese companies operating outside China.

Xinjiang profiled as centre of Eurasian cooperation. China’s Xinjiang Uighur autonomous region is currently arranging the China-Eurasia Expo to bring together representatives of 55 countries, mainly from Asia. The Expo seeks to promote economic cooperation between China and Eurasia, as well as establish Xinjiang as a regional centre for economic cooperation. The new Expo is organised for the second time, but it builds on more modest trade exhibitions that have been running for years. The opening speech was delivered by premier Wen Jiabao, giving some idea of the importance China is placing on the event.

The China-Eurasia Expo is hoped to attract foreign investment to Xinjiang, which is located in Northwest China. Foreign investors have somewhat overlooked the Xinjiang region, despite the fact that its economic growth has recently been rapid. In the first half of this year, regional GDP grew 11% y-o-y.

Development of the autonomous region, which covers a sixth of China’s land area, is a centrepiece of China’s regional development policy. To attract investment, the Korgas and Kasgar special economic zones have been created along the borders of Xinjiang’s major trading partners Kazakhstan, Tajikistan and Kyrgyzstan. Firms operating in the zones enjoy tax breaks and access to cheap loans. In addition, large investments in hydropower and rail connections have been made to support development and nationwide distribution of the region’s vast metal and mineral resources, including coal.

Statistics show Xinjiang’s foreign trade grew 33% last year. This year the growth has slowed; trade increased 9% y-o-y in the first half. Officials say the slowing reflects global economic uncertainty and the launch of the Russia-Kazakhstan-Belarus free-trade area, which has eroded the price competitiveness of products from Xinjiang. There has also been some positive news, however: media report Xinjiang registered 637 foreign firms in the first half of 2012, an increase of 37% from 1H2011.

Development and enrichment of Muslim-majority Xinjiang province brings with it the benefits of social stability. Ethnic unrest has been a hallmark of the region. The largest recent outbreak of unrest occurred in 2009, when nearly 200 people died in strife between Uighurs and China’s majority Han people.
Russia

BOFIT forecast sees Russian economic growth slowing but still relatively high. Having recovered to the pre-crisis levels of 2008, the Russian economy continued to expand rapidly in the first half of the year. GDP grew at a 4.5% annual rate. Imports increased fairly well, although growth tapered off in the second quarter.

The latest BOFIT forecast for 2012–2014 sees the Russian economy growing at over 3.5% per annum this year and next, before slowing slightly in 2014. The oil price is assumed to decline just under 10% during the forecast period. Russian imports have rebounded sharply from the 2009 recession; import growth is expected to moderate to around 10% this year and around 5% in 2013 and 2014.

Growth in private consumption will slow slightly, but remain relatively brisk. Consumption is supported e.g. by hikes in public sector wages. The recovery in fixed investment is expected to slow slightly this year due to global uncertainties, but should begin to gather steam next year. The volume of Russian exports will increase very slowly, reflecting oil production constraints and rising domestic demand that will limit further increases in exports of crude oil and petroleum products. Projections for growth of natural gas exports in the next few years have been lowered.

Most of the risks in the forecast are on the downside. Increased troubles in the global economy could cause a drop in the oil price and weigh on Russian export volumes, as well as hurt Russian consumer confidence and postpone investments. If food prices continue to rise for an extended period, it would add to loss of consumer purchasing power. On the other hand, uncertainties over global oil supplies could cause a rise in the oil price that would benefit Russia.

Growth of Russian GDP and import volumes, BOFIT forecast for 2012–2014, %

Fixed investment remained focused on the energy sector in the first half. The overall volume of fixed investment rose nearly 12% y-o-y in the first half of 2012. As in previous years, investment growth in energy outpaced general investment growth, with investments in oil and gas production rising nearly 20% y-o-y, electricity production 15% and oil refining over 40%. After a boom during the past couple of years, investment in energy pipeline infrastructure dropped. Nevertheless, the energy sector retained a 44% share of fixed investments, unchanged from a year earlier (these part-year fixed investment figures do not include investment by small businesses or in the grey economy). That share in total fixed investments is smaller, a third in 2011, up from around 25% in 2008.

Fixed investment in manufacturing (excluding oil refining) exceeded 10% growth in 1H2012, the highest pace in several years. Its share of fixed investments rose to 14% (excluding small business and grey economy investment). Its share of total fixed investments was 11% in 2011, down from 14% in 2008.

Modest first-half growth in Finnish exports to Russia. In the first half of 2012, the value of Finnish exports to Russia increased 5% y-o-y. The growth in exports was especially boosted by a nearly 20% increase in machinery exports. Exports of textiles and metals grew even slightly faster. In contrast, exports of chemical products contracted slightly in 1H2012, due to a drop in pharmaceutical exports. The biggest declines continued in the categories of electrical equipment and car exports which were mainly due to changes in transport routes. Especially car exports to Russia are practically re-exports of cars manufactured in a third country. The lion’s share of cars imported to Russia via Finland, however, are classified as transit freight. The volume of cars shipped as transit freight through Finland also contracted nearly 40% y-o-y in 1H2012, causing an overall decline in transit freight of 10%.

Finnish imports from Russia fell 12% y-o-y in the first half mainly due to lower commodity prices. Russia remained Finland’s top source of imports in the period, accounting for over 17% of Finland’s total imports.

Finnish exports to Russia of mobile phones, automobiles and other goods, € million (12-month moving average)

Source: Customs Finland
China

BOFIT China forecast sees lower economic growth ahead. The latest GDP figures released by the National Bureau of Statistics show a slowdown in China’s annual growth to 9.3% in 2011. BOFIT forecasts deceleration of Chinese economic growth will continue, with GDP growth falling to 8% in 2012 and 2013, and to 7% in 2014.

China’s on-year GDP growth slowed in the first six months of this year to 7.8%, and even in August there were still no signs of the expected pick-up in growth. Industrial output growth tapered off significantly in the spring, but still remained at about 9% for the summer months. Growth in the service sector, on the other hand, has been relatively stable, with retail sales holding at 11% y-o-y real growth. Fixed capital investment growth also signals relatively stable domestic demand.

Deterioration of the global economy, particularly the problems in European export markets, directly influenced the moderation of growth in the Chinese economy. Although officials relaxed monetary policy in spring and early summer, China’s leaders have been cautious about moving ahead with a second round of economic stimulus. The main reason is that the stimulus package of 2008–2009 led to excessive bank lending that has created widespread debt problems and uncertainty in real estate markets. An interesting issue is how the timing of stimulus measures is influenced by the upcoming transition of power as China’s new president and premier are slated to take their posts next spring. The BOFIT forecast for China sees the leadership moving ahead with stimulus measures that boost economic growth to around 8% this year and next.

Growth in coming years will be constrained by China’s massive resource needs and structural aspects of the economy. Commodity markets cannot support earlier high levels of demand growth without a major increase in raw material prices, and also environmental problems will increasingly restrain growth. The halt and coming decline in the working-age population implies that China’s labour markets will be unable to support growth as in the past. Moreover, China’s investment-driven model has reached the end of its road.

Although the BOFIT forecast for China, particularly for 2013–2014, is below the consensus outlook, it is quite benign given the challenges China faces. Below-forecast growth constitutes a real risk. China’s investment ratio has now reached 46%, so the associated danger of overcapacity has become a central concern in many circles. Any significant drop in investment at this point would cause an immediate and substantial drag on economic growth. Adding to concerns is the fallout from excessive bank lending during the previous round of stimulus and deterioration in the global economy. The difficult task of managing liberalization of the economy together with political developments ensures that interesting times undoubtedly lie ahead.

China’s GDP growth and BOFIT forecast for 2012–2014

Oil and lower commodity prices lead to a contraction in the value of imports in August. The value of China’s imports in August was $151 billion, nearly 3% less than in August 2011. In July, imports were still growing at a rate of 5% y-o-y. The contraction was largely caused by a collapse in the volume of oil imports and a decline in commodity prices.

The value of crude oil imports to China dipped 13% y-o-y, completely reversing the 12% y-o-y growth posted in July. Just 18 million tons of crude oil was imported to China in August, the lowest level seen since October 2010. The value of oil imports fell 21% y-o-y. The difference between value and volume reflects a decline in the price of imported oil.

The volume of iron ore imports rose 6% y-o-y in August (6% y-o-y in July as well). Despite the increase in volume of iron ore imports, their value fell 21% y-o-y as the import price has continued to drop since late December. Among other critical raw material imports, the growth in the volume of copper imports slowed to 5% y-o-y, even as the import volume in July was still up 20%. The value of copper imports declined 12%, while the value of aluminium imports continued to soar.

China’s exports overall were up 3% y-o-y in August, and had a total value of $178 billion. The growth in exports marked a slight pick-up from July’s 1% growth figure. However, exports to China’s key markets in the EU and Japan both continued to show substantial on-year declines.

Due to the contraction in imports and the modest growth in exports, China’s foreign trade surplus in August was $27 billion, making the cumulative trade surplus for the year $121 billion in August. In the January–August period in 2011, the trade surplus was $95 billion.
Russia

CBR hikes key rates as inflation accelerates. The CBR board raised all rates 25 basis points as of 14 September. After the hike, the rate of the CBR’s key policy instrument, the one-day minimum repo auction rate, stood at 5.5%. The minimum repo auction deposit rate is now 5%.

The CBR said accelerating inflation motivated its decision to raise rates. On-year inflation accelerated to 5.9% at the end of August and reached 6.3% in the first weeks of September after hikes in regulated rates for municipal services were implemented at the start of the month. The inflation rate now exceeds the central bank’s 6% target for this year. The CBR noted that higher food prices and poor harvests have added to inflation pressures in the near term.

The CBR said its decision also reflects its view that the economy is growing at a rate near its potential level. According to the bank’s assessment, domestic demand will remain stable due to the good employment situation and the rapid expansion of credit.

Preliminary Rosstat figures show GDP growth in the second quarter of 2012 was up 4% y-o-y. GDP grew 4.9% in the first quarter, and 4.5% in the first half.

CBR sells some of its shares in Sberbank. Russia’s central bank announced on Monday (Sept. 17) that it was selling 1.71 billion shares, or a 7.6% stake, in the Russian savings bank Sberbank. After the sale, the CBR retains its majority (50% + one share) stake in Sberbank.

The shares were sold on the Moscow and the London stock exchanges. On Wednesday, the CBR reported that the final price for Sberbank shares was 93 rubles (€2.30) a share, exceeding the minimum offer price of 91 rubles a share announced on Monday. The final price was about 1% below the closing price of trading on the Moscow stock exchange on Wednesday. The CBR raised 159 billion rubles (just under €4 billion) from the offering.

Reduction of the CBR’s Sberbank holdings has been discussed for years and considered critical by international financial institutions and others for Russia’s integration with the global financial system. Sale of a tranche of Sberbank shares was included in the government’s 2011–2013 privatisation plans. The divestment, initially scheduled a year ago, was postponed due to the weak market conditions. The sale of shares was carried out now as share prices on stock exchanges around the world have recovered, in part due to wide use of stimulus policies.

Measured by market capitalisation, Sberbank is Russia’s largest bank and Europe’s third largest bank. Sberbank controls a 46% share of Russia’s deposit market and has Russia’s largest nationwide network of branch offices (19,000). In recent years, Sberbank has modernised its operations and actively expanded operations internationally. Sberbank acquired the Austrian Volksbank International in February and the Turkish Denizbank in June.

President Putin signs decree to protect Gazprom. On September 11, president Vladimir Putin signed a decree to defend the Russian Federation’s interests in Russian “strategic” firms operating abroad. Under the decree, strategic firms may only comply with rules imposed by foreign national or multinational organisations (including regulators) after getting permission from the Russian government.

The decree applies when a foreign organisation 1) seeks disclosure of information other than information required by Russian legislation (excluding information required of companies planning to issue shares abroad), 2) demands changes in the trade practices or pricing that has been agreed under contract between the Russian firm and its foreign partner, or 3) requires the Russian firm to surrender its license to engage in business operations abroad, divest its holding in a foreign firm or sell property. The government may deny permission if compliance with the requirements could harm Russia’s economic interests.

The decree is intended to protect Gazprom after the European Commission launched an investigation at the start of September into possible antitrust violations in the EU by Gazprom. The European Commission wants to determine whether Gazprom has interfered with the function of Europe’s natural gas market by preventing gas buyers from selling excess gas in third countries and limiting competition e.g. by forcing buyers into long-term supply contracts and requiring minimum annual purchases. The contract terms have led to wide disparities in prices paid for Gazprom gas in EU member countries. The Commission will also look into Gazprom’s pricing scheme that ties the gas price to the oil price. This practice has kept supply contract prices well above prices on spot markets. The problems are worst in the EU’s newest member states in Eastern and Central Europe. The new EU members have less bargaining power with Gazprom than the largest EU members.

The presidential decree directly affects investigations launched by the Commission regarding the disclosure of information to investigators looking into Gazprom operations, as well as any demands for corrective measures.

The presidential decree covers Gazprom and all other state-owned enterprises designated as strategic. Putin approved a list of strategic companies in 2004. The list includes, among others, two internationally active oil companies (Rosneft and Zarubeshneft), as well as national pipeline grid operator Transneft and Russian Railways.

Some observers say the presidential decree conflicts with Russia’s civil code and numerous international treaties and agreements signed by Russia.
China

China-Japan island dispute a remainder of region’s political risks. The dispute over Diaoyu (in Chinese) or Senkaku (in Japanese) Islands in the East China Sea, a subject to territorial claims of both Japan and China, once again sparked protests this week. The trouble started with Japan’s decision to nationalise the islands by purchasing them from a private Japanese owner. The Japanese government says the reason for the purchase was to calm the controversy surrounding the islands.

The move backfired, however, touching off widespread protests throughout China against the Japanese action. Angry Chinese vandalised facilities of Japanese firms, leading many Japanese firms to shutter operations for security reasons. As in earlier incidents, the situation generally calmed down after a few days as Chinese officials called for an end to violent demonstrations.

Japan and China have repeatedly fought over various issues from the content of history school books in Japan to territorial boundaries and rights to hydrocarbon resources in the East China Sea. In 2010, boundary disputes spread to trade policy after China restricted exports of rare earth metals to Japan in response to Japan’s arrest of a captain of a Chinese fishing vessel moving in the disputed waters.

Despite the problems, relations between the countries have generally been moving in a positive direction since the mid-2000s. In 2008, for example, president Hu Jintao travelled to Japan, the first official visit of a Chinese leader to Japan in a decade. During the visit, the two countries reached partial agreement on development of hydrocarbon resources in the East China Sea. In 2010, Japan relaxed visa requirements for Chinese tourists. In May 2012, China, Japan and South Korea signed a trilateral agreement to lower barriers to investment. As part of the deal, the countries agreed to begin talks this year on a trilateral free-trade agreement. The recent events have cast a shadow over the project, increasing the likelihood China and Korea will now move ahead on free-trade talks themselves as Korea tries to gain a competitive edge over Japan in the Chinese market.

Economically speaking, China and Japan are joined at the hip. Any severe damage to economic relations comes at a steep price for both countries. Although imports from Japan to China declined 6% y-o-y in January-August, Japan still account for 10% of Chinese imports, just after the EU, which accounts for 12% of China’s imports. China’s exports to Japan also grew 5% in the first eight months of this year with Japan accounting for 7% of China’s exports, making it China’s third most important export destination after the EU (17% share) and the United States (17%). Tourism from China to Japan and from Japan to China has increased this year faster than travel from other destinations. All of Japan’s biggest car and electronics companies have production facilities in China, and Japanese firms have been instrumental in raising Chinese technological sophistication. China accounts for about a fifth of Japan’s trade.

More trade disputes filed with WTO. This week, the United States filed its third complaint against China this year, alleging China unfairly subsidises its car industry in violation of its WTO commitments. The disputed measures include granting concessions and cheap credit to exporters of cars and car parts. The US protested China’s imposition of antidumping duties on US car in summer, and filed a WTO complaint on China’s restriction of exports of rare earth metals in spring. China countered this week with its own complaint against the US for unjustified imposition of countervailing and antidumping duties on Chinese products. China has submitted similar complaints earlier, the most recently last May.

Rulings on most complaints brought before the WTO take a while. When a complaint is filed with the WTO, the parties will first try work out the problem with themselves. Only after consultation efforts have failed may the parties request that the WTO convene a panel to hear the dispute. Any decision reached by the board can then be appealed, and if the ruling requires changes in practices, the panel is usually expected to grant a reasonable transition period.

The use of antidumping duties is fairly common. Dumping is defined as selling a product for a lower price in an export market than in a country’s own domestic market. Chinese products by far have been the biggest target of antidumping duties. Over the past five years, about 40% of all such duties have been imposed on Chinese products. China itself has also been active in imposing its own antidumping duties. The EU’s recent decision to look into whether China is dumping solar panels in Europe has inflamed trade tensions between China and the EU. The European manufacturers claim that China sells its solar panels in Europe at prices below actual production cost. China is by far the world’s largest producer of solar panels.

Since the global financial crisis hit in autumn 2008, many observers feared that hard times could lead to an upswell of protectionism in world trade. WTO figures at the moment do not bear this out, but the longer world economic growth remains tepid, the greater the temptation for policymakers to favour domestic producers.

Chinese now buy a quarter of the world’s luxury goods. A new assessment from Hong Kong-based HSBC finds that Chinese now purchase 25% of all luxury goods, up from 5% just five years ago. China’s domestic sales of luxury goods continue to rise sharply, but HSBC reports the Chinese still buy most of their luxury goods on travel. In Australia, for example, Chinese travellers spend an average of three times more than American or European tourists.
Russia

**Big plans for Russia’s forest industries.** A joint venture established this summer by the Russian state and China’s sovereign investment funds recently announced their first investment will go to Russia’s forest industries. The joint venture is planning to take a $200 million stake in the Russian Forest Products (RFP) Group. RFP Group operations currently focus on export of raw timber and sawn goods, but it plans to construct a large pulp mill in Russia’s Far East.

A massive pulp mill is also planned for Siberia. The Angara Paper project, under planning for several years, is hoped to get boost as the Japanese trading house, the Marubeni Corporation is planning to participate in the project. The pulp mill should become the largest in the world and focus on serving markets in Asia. If realized, the two pulp mill projects would represent the first major greenfield investments in the Russian pulp & paper industry in decades.

Investments in modernisation and expansions of existing pulp and paper facilities have, however, taken place in recent years. For example, US-based International Paper and the European Mondi Group have modernised their production facilities in Svetogorsk and Syktyvkar. The Ilim Group, which has International Paper as a strategic owner, announced that it is completing this year a five-year investment programme valued at nearly $2 billion. The company’s most recent projects included construction of a pulp line in Siberia and starting production of office and printing paper at its Arkhangelsk pulp & paper mill. Last year, the Russian Investlesprom was the first company starting production of printing paper in Russia.

Printing paper producers complained in summer to the government on the 5% import duty on printing paper agreed in Russia’s WTO accession talks. The 5% duty was effective already before Russia’s WTO accession, but the producers feel the duty is too low in light of their original profitability projections when they went ahead with their investment plans. Russia raised the import duty on printing paper to 15% despite contradiction with its WTO commitments. Russian officials blamed the 5% figure on a typing error in the WTO documents. The WTO is looking into the matter with Russia.

Pulp & paper production accounts for less than 1% of Russian GDP. The sector is critical, however, for some regional economies. Two-thirds of Russia’s current pulp production comes from Ilim Group facilities in Irkutsk and Arkhangelsk. Paper, containerboard and corrugated paper production is concentrated in Northwest Russia: some 60% is produced in the Arkhangel and Leningrad regions, as well as the Karelian and Komi republics. A quarter of Russian paper and containerboard production is situated in the Volga Federal District, mainly in the Perm and Nizhny Novgorod regions.

About a fifth of the paper and containerboard used in Russia is imported, but the aim is to replace imports with domestically produced paper and containerboard.

**Russian adults rank among the best educated in the world, but learning results are below the average of developed nations.** On September 11, the OECD released its latest education report *(Education at a Glance 2012: OECD Indicators)*. The survey found that 88% of Russian adults (25-64-year-olds) had attained at least an upper secondary education. About 54% of adults had completed a tertiary education (e.g. university degree). In OECD countries, the average is 74% for secondary and 31% for tertiary education. The figures for Finland are 83% and 38%, respectively.

The high secondary and tertiary education levels of Russians are partly a legacy of the Soviet era. The older cohorts of Russians are better educated than most of their OECD counterparts. Also the education levels of younger Russians are well above the OECD average. A second factor is the frequency of vocational education; as much as 33% of adults have completed vocational studies. However, a student can begin vocational training in Russia immediately upon completing primary school and the Russian definition of vocational training is looser than the OECD’s. As to university studies, one reason so many Russians hold university degrees is the fact that students can study part time and complete degree work online. More than half of Russian university students receive their degrees by distance learning.

A big challenge for the Russian education system is the low spending on education given the large number of students. In 2009, Russia spent the equivalent of 5.5% of GDP on education, or less than the OECD average of 6.3% of GDP. The biggest financing challenges were faced in primary and secondary education; Russia spends a mere 2.4% of GDP compared to the OECD average of 4% of GDP. Low teacher salaries partly explain the low spending level in Russia. Spending on university and primary school education exceeds the OECD average.

The PISA scores of Russian 15-year-olds continue to lag the OECD average. In 2009, Russian pupils scored poorly in all three of PISA categories (reading skills, mathematics and natural sciences). Out of the 65 countries compared, Russia tied for 43rd with Turkey and Dubai in reading. In the natural sciences, Russia ranked 39th in math and 38th. Those performances were on par with those of Greek pupils.

The rankings of Russian universities have slid in recent years, and Russian curricula and teaching methods often remain outdated. Half of university graduates end up working in fields other than their area of study.
China

China commits to further deregulation of financial markets. Under a just-released plan for financial sector reforms to be implemented through 2015, the People’s Bank of China announces it intends to continue to relax interest rate policy, reduce restrictions on capital movements and continue to move towards freer formation of the yuan’s exchange rate. In addition, financial market reform includes diversification of corporate financing options through development of bond and equity markets to reduce the current dependence of businesses on bank credit.

The plan is part of the current 2011–2015 five-year plan and it does not reveal anything essentially new compared to the policy framework announced by China’s monetary authorities in early 2011 ahead of the five-year plan. At the time, officials said the country would strive to make the yuan fully convertible over the next five years. While the latest announcement gives no timetable of reforms, it has no indications of possible changes in the earlier announced timetable.

The first steps towards making the yuan a widely used international currency were taken at the beginning of the last decade, but serious measures to move the project forward really started in mid-2009 when China allowed use of the yuan in foreign trade payments on a trial basis. With the success of the pilot, the programme was made permanent and rolled out throughout the country. Even if capital movements are still regulated rather strictly, there has been a distinct relaxation in rules on capital movements over the recent years.

Domestic interest-rate policy continues to evolve slowly toward a time when interest-rate policy will become the cornerstone of Chinese monetary policy. Last summer China took small steps towards freer rate-setting, when the PBoC, in conjunction with cuts in reference rates, announced it was giving commercial banks greater leeway in setting deposit and credit rates. The role of interest rates has increased also through the rapid expansion of China’s informal banking sector, highlighting the need for a fundamental rethinking of the financial market regulations.

The rapid evolution of China’s financial markets since 2009 has been driven by measures in mainland China and abroad. As each new measure is implemented, it creates new pressure to further deregulate China’s financial markets. In mid-September, for example, the Hong Kong stock exchange launched a yuan futures market to help firms hedge their portfolios against fluctuations in the yuan exchange rate. Prior to the change, yuan futures trading was limited to the OTC market.

Evidence points to flat growth in fixed capital investment. This summer and autumn, China’s leaders have been talking up the importance of fixed capital investment as a means of stimulating economic growth. For example, the influential National Development and Reform Commission (NDRC) announced that starting last May it was speeding up its permitting processes, especially for infrastructure projects. So far, figures from the National Bureau of Statistics give no indication of a pick-up in total fixed capital investment, which includes infrastructure investment. Indeed, the on-month growth numbers for July and August show a slight slowdown in total investment.

Infrastructure investment represents about 15–20% of fixed capital investment. Although growth in infrastructure investment has modestly accelerated in recent months, growth in January-August was lower than investment overall; only 5% y-o-y in real terms. Much of the weak growth could be attributed to a sharp decline in railway investment from 2011. However, also investments in the road system, airports and waterways have risen less on average than other investments. Investment in the telecommunications network has increased rapidly, but it only accounts for a small share of infrastructure investment.

To stimulate investment, officials have been thought to be considering lifting restrictions put in place in recent years to cool the overheated real estate sector. However, officials are still keeping the restrictions in place for the time being. Due to the falling prices, investment in construction of apartment buildings has grown slowly, but investment in other buildings and facilities has grown more rapidly. About a quarter of total investment goes to the real estate sector.

As economic growth continues to flag, China’s faltering export markets have reduced the motivation of manufacturers to invest in new capacity. For example, investment in capacity for producing electrical devices and computers has increased at a pace below average. On the other hand, investment in branches devoted to serving domestic demand, e.g. foodstuffs and retail sales, remain brisk. Industrial investment represents about 44% of total fixed capital investment. Agriculture accounts for just a few percent of investment, but investment in the agriculture sector has risen rapidly in recent years.

The lack of growth in capital investment can also be seen in the lending of commercial banks. Medium- and long-term loans typical for investment projects have experienced clearly lower growth in 2011 and 1H2012, and the low growth has continued in recent months.

As China resorts again to fixed capital investment to revive its economy, measures may be counterproductive over the long run as the country tries to move from an investment- and export-driven model to a consumption-driven economic growth model.
Russia

CBR looks to phase out ruble exchange-rate steering in 2015. The Central Bank of Russia’s first deputy chairman, Alexei Ulyukayev, has confirmed the central bank’s plan to shift the basis of monetary policy over the next three years to inflation targeting and abandoning the current ruble’s exchange-rate targeting. Simultaneously the CBR will abandon the fluctuation band, within which it keeps the rouble’s exchange rate by interventions. The CBR has used this “managed float” policy for the rouble since 1999, before which the rouble was pegged to the US dollar. The managed float system has been made more flexible over the years and the fluctuation band has been gradually widened.

Over the entire period, the CBR has strived to achieve the sometimes counterproductive goals of fighting inflation and steering the rouble’s exchange rate. This has been particularly challenging during periods of high global oil prices when massive inflows of export earnings have put appreciation pressure on the rouble. This, in turn, has forced the CBR to buy up foreign currency on the forex market, thereby increasing the stock of rubles in circulation and stoking inflationary pressure.

For several years already the official stated goal of the CBR has been to abandon exchange-rate targeting to allow the bank to focus on fighting inflation through interest rate policy. Since the 2008–2009 financial crisis, the CBR has begun to emphasise inflation goal and clearly reduced interventions in the forex markets (which can be seen in wider fluctuations in the rouble exchange rate).

Dollar-ruble and euro-ruble rates, 1997–2012

Source: Central Bank of Russia

Russia sees record-high grain prices; possible import restrictions a hot topic for the government. The exceptionnally dry summer has meant that this year’s grain harvest will come in at just over 70 million metric tons, or 10 % below the average harvest size of the past decade and nearly 25 % below the 2011 harvest. This year’s grain harvest includes about 40 million tons of wheat.

Wheat prices increased rapidly at the end of September, when the large export firms purchased wheat to fulfil existing export contracts. Observers expect the government to decide soon on whether to begin grain sales from state reserves to prevent a sharp rise in domestic grain prices. Russia’s poor harvest has raised discussion on international grain markets as to how the situation will affect Russian grain exports. Thanks to a series of good harvests in the latter half of the 2000s, Russia became a globally significant grain exporter, wheat in particular. Russia currently is the world’s third largest wheat exporter. However, after the 2010 crop failures, the government banned all grain exports for almost a year until new supply was produced. The lack of Russian grain was felt on the international markets.

The economy ministry says grain exports need to be limited to keep domestic prices from rising too sharply. First deputy prime minister with portfolio for agriculture, Arkadi Dvorkovich, however, vigorously opposes any attempts to restrict exports.

Russia’s own grain consumption remained stable at around 70 million tons throughout the 2000s. Due to good harvests in recent years, Russia’s grain reserves are currently about 20 million tons – enough for Russia meet its own needs and still export an estimated 10–14 million tons this year. Last year, Russia exported a record 27 million tons of various grains.

Russian grain harvests, 2000–2012 (million tons)

Source: Rosstat

Government decides on allocation of Sberbank sale proceeds. On Monday (Oct. 1), the Russian government decided that the revenue from last month’s sale of Sberbank shares on the London and Moscow stock exchanges will be transferred directly to the federal budget. According to the government, the CBR is only a formal owner of Sberbank, and acted as an agent of the Federation in the share offering, while the true owner is the Russian Federation. To get the money immediately, the government is formulating a special law. Otherwise, the money would be passed on to the federal budget later on, together with the 75 % of CBR profits that are annually transferred to the federal budget.

One alternative, supported by Moscow city, would have made the CBR pay a 20 % profit tax on earnings from the share sale. The main part of the tax would have gone to the City budget. The government nixed this proposal.
China

Important Communist Party meeting scheduled for November. The Communist Party’s National Congress will convene on November 8 and run for about a week. The starting date of the National Congress was kept secret until the end of September. The National Congress assembles every five years to decide about major policy directions and choose the party central leadership. This time around, seven of the Politburo Standing Committee’s nine members have reached retirement age, including General Secretary Hu Jintao. The person chosen as the new General Secretary will also be nominated as the new President of China at the 2013 People’s Congress next spring. Another member of the Standing Committee will be tapped as premier. The two members of Standing Committee that have yet to reach retirement age are Xi Jinping, the favourite to be China’s next General Secretary and president, and Li Keqiang, who is likely to be China’s next premier.

Despite recent yuan appreciation, exchange rate changes against the dollar have been quite small. The yuan’s exchange rate against the US dollar this year stayed stable up to May, before weakening by over one percent to about 6.39 yuan to the dollar in response to the worsening of the European debt crisis, China’s slowing economic growth and rising flow of capital leaving the country. Nevertheless, without a change for better in China’s economy, the yuan’s exchange rate has been rising against the dollar since July. Last Friday, just ahead of this week’s National Day Holiday period, the yuan-dollar rate stood at 6.28 – stronger against the dollar than it has ever been.

Even so, the shifts in the yuan’s exchange rate relative to the dollar have been modest and have occurred under the strict direction of the People’s Bank of China. There is no obvious single explanation for the yuan’s recent appreciation. Yields on paper issued by the state and the central bank have generally been rising, while rates on interbank markets have shown less consistent trends. Part of the reason for the yuan’s recent strengthening comes from abroad. The recent decisions of the US and Japanese central banks to increase their money supplies (e.g. QE3) may have boosted investment flows to China and thereby strengthened demand for yuan.

The reduction in imbalances in trade and capital movements in recent years has relieved a substantial part of appreciation pressures on the yuan. In the first six months of this year, China’s current account surplus was $77 billion, about $10 billion less than for 1H2011. Due to growth in capital exports the financial account surplus declined to meagre $15 billion, down from $184 billion in 1H2011.

Growth of China’s foreign currency reserves has slowed substantially and in the second quarter of this year the reserves actually contracted.

Although the yuan’s exchange rate strengthened in the yuan futures markets in September, the current offer in Hong Kong (Non-Deliverable Forward, 5.10.) suggests the yuan will weaken to a level of 6.40 to the dollar over the next twelve months. Since last year’s appreciation episode, the yuan’s real effective exchange rate has hardly changed. In long term, much faster economic growth in China than in other countries creates pressure for yuan to appreciate further.

Mainland and offshore yuan-dollar exchange rates (decline indicates yuan’s appreciation)

China’s global competitiveness declines. The latest World Economic Forum Global Competitiveness Report 2012–2013 ranks China 29th out of the 144 countries surveyed this time around. China’s ranking dropped from 26th place last year. This year’s WEF report, which is based on 2011 data, finds the world’s most competitive countries are Switzerland, Singapore and Finland. The World Economic Forum looks at competitiveness from many perspectives, taking into account various sectors of the economy and social institutions.

The decline in China’s competitiveness has been across-the-board; over half of the 110 indicators showed declines in values from the previous survey. While no big individual changes were detected, the indicators showing the most deterioration were costs caused by criminality, barriers to foreign trade and agricultural policy costs. In addition, regulatory changes complicated foreign firms’ operations in China. Most of the handful of indicators showing improvement related to improvements in health. Moreover, a larger share of Chinese now attends school, but the quality of education has fallen.

Although China’s competitiveness weakened, it is still much better than the other BRICs. Brazil currently ranks 48th (53 last year), India 59th (56) and Russia 67th (66).
Russia

Despite high volatility, Russian stock prices post steady gains over past three months. The RTS index for Moscow’s newly merged MICEX-RTS securities exchange has been on an ascending trend since June, closely tracking a rise in crude oil prices. This trend is hardly surprising given the dominant weighting of energy companies in the RTS index. The RTS reached its high point this year in March after a spike in crude oil prices. Its low point in June came at the end of a months-long decline in oil prices. The RTS index is currently up 8% from the start of the year.

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**RTS index and Brent oil price (US$/bbl)**

Source: Bloomberg

Insider trading remains a problem in Russian securities markets. Factors such as the thinness of Russian securities markets make them vulnerable to price manipulation. Although Russia has had a law on insider trading since January 2011, the concept of trading on insider information is still unfamiliar to many market participants. Even Russia’s securities markets overseer, the Federal Financial Markets Service (FSFR), has called for further specification of the legal terminology. The law’s strict limitations often make it impossible for authorities to tackle what would be obvious infringements elsewhere. Insider trading cases demand a high level of expertise that has yet to be developed by Russian authorities. Since the insider trading law has been in force, the FSFR has exposed 16 cases of insider trading.

Russia has long had a debate over the possibility of concentrating general supervision of the financial sector into a single entity. This discussion again flared recently, based on the need to enhance the supervision of capital markets and the financial sector in general. At the moment, the Central Bank of Russia handles bank supervision and the FSFR supervises capital markets and the insurance industry.

The integration strategies currently being studied include ending the SFSR and moving all supervision duties to the CBR or putting the FSFR as is under the CBR.

Although the current account surplus contracted, it remains substantial. Preliminary balance-of-payments figures from the Central Bank of Russia show that the current account surplus for the first three quarters of 2012 was somewhat smaller than in the same period in earlier years. Even so, the current account surplus in January-September still corresponded to over 5% of GDP. In its recent draft of the 2013–2015 monetary policy programme, the CBR sees the current account surplus gradually evaporating away by 2015 if the price of crude oil stays slightly above $100 a barrel.

The small decline in the current account surplus this year reflects trends in trade in both goods and services. The goods trade surplus shrank, but still corresponded to more than 10% of GDP in January-September. The services trade deficit has increased gradually in recent years and continued this year. For January-September, the services trade deficit was 2% of GDP. Other components of the current account balance consist mainly of payments of interest and dividends, the deficit of which this year contracted slightly after growing in previous years.

Earnings from exports of goods and services increased rapidly after the 2009 recession, but growth slowed in the second and third quarters of this year to below 10% y-o-y. Growth in export earnings from oil, petroleum products and natural gas slowed to below 5% on a drop in export prices of oil and gas, as well as a poor performance of the volume of exports. Oil, petroleum products and gas still accounted for 66% of Russia’s total goods exports, and account for 18% of GDP. Growth in other export earnings slowed, although earnings from exports of services continued to increase rapidly, driven mainly by strong growth in transport and logistics services.

Growth in imports of goods and services slowed in both the second and third quarters, even if the increase was more than 10% from a year earlier. Goods imports grew over 10% in January-September, while imports of services were up nearly 20%. Spending by Russian tourists abroad increased 25%. Spending on services grew to nearly a quarter of total spending on imported goods and services.

**Current account balance, % of GDP, four-quarter average**

Sources: CBR, IMF
China

IMF cuts again its economic growth forecast for China. The IMF’s latest World Economic Outlook sees the global economy growth prospects weakening further, with growth moderating to 3.3% this year and 3.6% in 2013. World GDP grew 3.8% in 2011. Noting the ongoing debt struggles in the euro area, the IMF warned that the risk of even poorer performance than forecasted has increased significantly. Growth in the volume of global trade should slow from 5.8% in 2011 to 3.2% this year, but then recover to 4.5% in 2013.

The problems in Europe, the US and Japan were the main reason for the IMF’s decision to lower its China forecast by nearly a half percentage point from April. China’s GDP, however, is still expected to grow 7.8% this year, and growth should pick up again to 8.2% in 2013 as the effects of policy easing start to be felt. The IMF said that a large part of the recent slowdown was due to lower export demand, a situation similar to that seen in 2009.

The IMF expects Chinese inflation to remain at about 3% this year and in 2013, as commodity prices decline and measures taken last year to tighten economic policy remove pressure to raise prices. The IMF expects China’s current account surplus to contract from 2.8% of GDP in 2011 to 2.3% of GDP this year. The current account surplus is expected to grow slightly in 2013.

The growing wealth of the Chinese and the interlinkage of Asian economies have raised the importance of China for the rest of Asia in recent years. Exports to China now account for 16% of Malaysian GDP, 13% for South Korea, 9% for Thailand and 8% for Vietnam. The increased integration and China’s lower economic growth was also noted by the IMF as a reason for lowering its growth outlooks for other Asian economies.

Rapid growth in Chinese tourism abroad. A third of the Chinese population journeyed somewhere during the recent week-long National Day holidays. Although most stayed in the country, the popularity of foreign travel with the Chinese is exploding. According to Chinese sources, the number of people taking trips abroad in the National Day holidays this year was up 50% from the same holiday week a year earlier. In 2010–2011, foreign travel also increased at about 20% a year. The tourism boom reflects the growing wealth and disposable incomes of Chinese.

China’s National Tourism Administration reports that the most popular foreign travel destinations for Chinese are neighbouring areas. In addition to Hong Kong and Macao, Japan, Korea and Taiwan topped the list. Next are countries in Southeast Asia and the United States. The top European destinations are France, Germany, Italy and the UK. The total number of Chinese tourists for these four European countries is about the same as the number of Chinese visiting the US.

Chinese tourists are also flocking to Finland. Statistics Finland reports that in January–July, the number of overnight hotel stays by Chinese tourists increased 14% y-o-y and that the number of Chinese tourists arriving in Finland surpassed those of tourists from e.g. Spain or Denmark.

Share prices in the doldrums. Although the general indices for China’s Shanghai and Shenzhen stock markets rose slightly this week, the increase is likely to be short-lived. Share prices continue to be clobbered by lower macroeconomic growth domestically and abroad and the consequent lowering of corporate profit projections. The decline in share prices has now gone on for nearly two years, and has been accompanied with a decline in trading volumes.

Officials have sought to support stock prices through such measures as increasing the possibilities for foreign investors to buy shares. The qualified foreign institutional investor (QFII) programme launched in 2003 gave international investors access to China’s stock and bond markets. The permitting process for new QFII participants has been accelerated this year. In addition, the investment quota has been raised and conditions for investor participation have been eased. As of mid-September, QFII permits had been granted to 157 foreign institutional investors with granted investment quota of $31 billion in total.

At the end of 2011, a parallel programme to the QFII, the RQFII was launched to allow investors in Hong Kong to use yuan in buying shares traded on mainland China exchanges. Due to the opening up of the financial markets, the significance of B-series shares, initially intended for foreign investors, has diminished. In August, China International Marine Containers became the first listed company to announce that it will get rid of B-shares altogether and convert them to Hong Kong exchange-listed H-shares.

Shanghai A index, Moscow RTS index and Morgan Stanley Capital International Emerging Markets (MSCI EM) index

Source: Bloomberg
Russia

Capital outflow from Russia’s non-banking corporate sector increased. Preliminary balance-of-payments figures from the Central Bank of Russia suggest the overall outflow of private-sector capital abroad declined slightly in the third quarter relative to 3Q2011. During last four quarters, the net outflow of private capital from Russia hit $93 billion, which corresponded to nearly 5 % of GDP.

Net banking sector capital flows this year have turned back to Russia as banks’ foreign debt rose slightly. Part of the shift also reflected the CBR’s divesture in September of its majority stake in Sberbank, Russia’s largest bank, with some of the assets going to foreign investors. Some of the sales impact was offset last month when Sberbank paid about $3.5 billion for Denizbank (Turkey’s sixth largest bank), owned by the French-Belgian Dexia Bank. Otherwise, stocks of foreign assets and liabilities of Russian banks have risen more modestly than last year.

Capital outflows from the non-banking corporate sector have increased. Over the last four quarters, the net amount exceeded 4.5 % of GDP, the largest amount since the 2009 recession. The CBR estimates that grey capital export, i.e. illegal transactions like tax evasion, continued to increase. In the last four quarters, this outflow abroad equalled nearly 3 % of GDP.

Direct investment from Russia abroad began to rise again (even with the acquisition of Denizbank) after contracting slightly relative to GDP in the previous two years. This also applies to direct investment flows from abroad into Russia. In the last four quarters (as in previous years), direct investment outflows from Russia ($69 billion for the period, or over 3.5 % of GDP), have exceeded direct investment flows into Russia ($48 billion or 2.5 % of GDP). Foreign currency held as cash by the non-bank private sector increased for the first time since the winter months of the 2008–2009 recession.

Inflows of direct investment into Russia, stock at year’s end, US$ billion (rankings based on 2011 figures)

<table>
<thead>
<tr>
<th>Country</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
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<tbody>
<tr>
<td>Total</td>
<td>378.8</td>
<td>489.3</td>
<td>455.9</td>
</tr>
<tr>
<td>1. Cyprus</td>
<td>129.9</td>
<td>179.2</td>
<td>128.8</td>
</tr>
<tr>
<td>2. Netherlands</td>
<td>33.6</td>
<td>40.0</td>
<td>59.7</td>
</tr>
<tr>
<td>3. British Virgin Islands</td>
<td>36.6</td>
<td>51.0</td>
<td>56.4</td>
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<tr>
<td>4. Bermuda</td>
<td>27.2</td>
<td>49.8</td>
<td>32.5</td>
</tr>
<tr>
<td>5. The Bahamas</td>
<td>18.7</td>
<td>24.6</td>
<td>27.1</td>
</tr>
<tr>
<td>6. Luxembourg</td>
<td>14.4</td>
<td>19.7</td>
<td>20.3</td>
</tr>
<tr>
<td>7. Germany</td>
<td>15.3</td>
<td>23.1</td>
<td>18.7</td>
</tr>
<tr>
<td>8. Sweden</td>
<td>11.7</td>
<td>18.1</td>
<td>16.1</td>
</tr>
<tr>
<td>9. France</td>
<td>9.0</td>
<td>11.5</td>
<td>15.4</td>
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<tr>
<td>10. Ireland</td>
<td>0.2</td>
<td>3.8</td>
<td>8.9</td>
</tr>
<tr>
<td>11. Jersey</td>
<td>0.3</td>
<td>0.4</td>
<td>8.7</td>
</tr>
<tr>
<td>12. Austria</td>
<td>7.4</td>
<td>7.8</td>
<td>8.3</td>
</tr>
<tr>
<td>13. UK</td>
<td>6.5</td>
<td>7.8</td>
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<tr>
<td>14. Switzerland</td>
<td>5.7</td>
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<tr>
<td>15. Gibraltar</td>
<td>10.2</td>
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<td>5.9</td>
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<tr>
<td>16. Finland</td>
<td>5.5</td>
<td>6.6</td>
<td>5.4</td>
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<td>17. US</td>
<td>13.9</td>
<td>5.4</td>
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<tr>
<td>18. St. Kitts and Nevis</td>
<td>0.1</td>
<td>0.2</td>
<td>2.8</td>
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<tr>
<td>19. Belgium</td>
<td>1.9</td>
<td>2.6</td>
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<tr>
<td>20. Japan</td>
<td>1.2</td>
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<td>2.0</td>
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<tr>
<td>21. China</td>
<td>1.3</td>
<td>2.0</td>
<td>1.4</td>
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<tr>
<td>22. Italy</td>
<td>1.1</td>
<td>1.3</td>
<td>1.2</td>
</tr>
<tr>
<td>23. Denmark</td>
<td>0.9</td>
<td>1.4</td>
<td>1.1</td>
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<tr>
<td>24. South Korea</td>
<td>1.2</td>
<td>1.9</td>
<td>1.0</td>
</tr>
<tr>
<td>Others</td>
<td>25.1</td>
<td>16.8</td>
<td>15.9</td>
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</tbody>
</table>

Source: Central Bank of Russia

Large part of direct investment into Russia still channeled via Cyprus. CBR figures show that as of end-2011, $129 billion of the $456 billion in foreign direct investment inflows into Russia, i.e. almost 30 %, were channeled via Cyprus, where corporate taxation is significantly lower than in Russia and many other countries. Part of the investment from Cyprus and other countries with lower taxation is of Russian origin. Of Russia’s $362 billion outbound foreign investment stock at the end of 2011, $122 billion (30 %) resided in Cyprus. The amount of direct investment from Cyprus to Russia has been on the decline, however, as Cyprus earlier provided more than a third of all foreign direct investment in Russia.

Observers offer differing assessments on the effects of adoption of the Russia-Cyprus Double Tax Treaty (signed in 2010 and ratified this year) on the role of Cyprus in Russian investment. The tax treaty improves information exchange and transparency for officials in both countries.

In recent years, some European countries have increased their importance as sources of direct investment into Russia, most notably the Netherlands, Ireland, France and Luxembourg, as well as some small island countries, like the British Virgin Islands, Jersey and the Bahamas. Direct investment outflows from Russia have increased especially to the Netherlands, British Virgin Islands and Jersey.

Inflows of direct investment into Russia, stock at year’s end, US$ billion (rankings based on 2011 figures)
China

Quarterly data show surprising signs of pickup in GDP growth. China’s National Bureau of Statistics reports the Chinese economy grew 7.4 % y-o-y in real terms in the third quarter, only slightly off the 7.6 % growth pace of the second quarter and 8.1 % in the first quarter. Although on-year growth has slowed over the past three quarters, the more sensitive measure of on-quarter growth has risen since the first quarter of this year (see chart below). The on-quarter growth figures indicate that on-year GDP growth should pick up in the fourth quarter of 2012 and the first quarter of 2013.

The implied pickup in economic growth suggested in the quarterly growth figures has come as a pleasant surprise to many as most economic indicators, including company surveys, failed to capture any acceleration in economic growth in the third quarter. Retail sales, a indicator of domestic consumer demand, have continued to rise steadily all year. Growth in fixed capital investment, a measure of investment demand, has fluctuated month to month, but no significant change in the growth trend is detectable. In addition, the trend in foreign trade volume in July-August did not indicate net exports had risen enough to support significantly higher economic growth.

Real quarterly GDP growth, seasonally adjusted change from previous quarter, %


Consumer prices up 1.9 % y-o-y in September. Inflation appears to have stabilised at around 2 % this autumn after declining for over a year. Food prices in September were up 2.5 % y-o-y, clothing prices 3.6 % and home appliances 1.6 %. The modest gain in food prices was welcome news for economic policymakers, who were struggling with food prices rising faster than 10 % y-o-y just a year ago. The slide in producer prices quickened in September, declining 3.6 %.

Inflation in China has fluctuated quite bit in recent years, largely in response to the global business cycle and shifts in Chinese monetary policy. The low economic growth in developed economies this year has put a drag on world commodity prices for petroleum products, food and metals on the world market, which in turn has lowered pressure to raise prices in China.

As inflationary pressures have abated, China’s central bank has been able to relax its monetary stance gradually to encourage economic growth. Since July the PBoC has not announced any further measures to ease monetary policy. The financial data suggest, however, that banks have been instructed to gradually ease their lending policies. Growth in the loan stock accelerated in September to 16.4 % y-o-y, closely tracking growth in the broad money supply (M2) of 14.8 % y-o-y.

Foreign trade surplus remained large in September. September was an active month from the standpoint of foreign trade as international deliveries were pushed out the door ahead of the week-long National Day celebrations at the start of October. Following the typical September trend, China customs reports that the value of goods exports hit a record high on the month. Exports to some developing economies grew rapidly, while exports to Europe continued to decline. Corporate surveys, however, indicate the outlook for the export sector weakened overall as new export orders have fallen since June. To revive exports, China moved at the beginning of October to permanently or temporarily eliminate customs fees for monitoring, inspection and quarantine.

The value of good imports rose slightly in September. China has benefitted substantially from the decline in global commodity prices as it has slowed growth in the value of imports and thus boosted the trade surplus. China’s trade surplus was $28 billion for September and $150 billion for the January-September period — an amount nearly the total surplus of 2011.

Consumer and producer prices, % change y-o-y

Source: NBS
Russia

Russian economic growth slows. Preliminary figures from the economy ministry show GDP grew at below 4 % y-o-y in the January-September period, with growth falling to 2.5–3 % in August-September. In the first half of 2012, GDP grew at 4.5 % y-o-y. The slowdown had been expected as prices of Russia’s main export goods had fallen for several consecutive months. Growth was further hurt by this summer’s poor grain harvest. In their latest forecasts, Russia’s economy ministry, the IMF and the World Bank expect Russian GDP to grow 3.5–3.7 % this year.

The growth in private consumption, however, has remained strong. Growth in the volume of retail sales accelerated in August and September (seasonally adjusted). The rise in real household incomes still remained strong despite a pickup in inflation. Growth in household credit also remained rapid. For on-year growth, retail sales slowed in January-September to just over 4 % y-o-y, down from 7 % y-o-y in the first half.

Fixed capital investments remained weak. The volume of investments has contracted for several successive months (seasonally adjusted), with the level of investment in August-September basically unchanged from a year earlier. Corporate borrowing from banks slowed considerably.

Industrial output has fluctuated in recent months; seasonally adjusted output in September matched the July level. Industrial output growth in the third quarter was 2.5 % y-o-y, with manufacturing up 4.5 % and mineral extraction (including oil & gas) about 1 %.

Growth in the volume of imports slowed to 3 % y-o-y in the second quarter from 10 % y-o-y in the first quarter. The slowdown had been expected as prices of Russia’s main import goods had fallen for several consecutive months. Growth was further hurt by this summer’s poor grain harvest. In their latest forecasts, Russia’s economy ministry, the IMF and the World Bank expect Russian GDP to grow 3.5–3.7 % this year.

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Growth in the volume of imports slowed to 3 % y-o-y in the second quarter from 10 % y-o-y in the first quarter. Preliminary data suggests a weak trend for imports in recent months.

Seasonally adjusted supply and demand indicators for Russian economy (volume, if not otherwise noted), indexes, 2006=100

Gazprom brings northwestern Siberia gas field on stream. Production at the massive Bovanenkovo gas field located on the Yamal Peninsula will be ramped up gradually to a level of 115 million m^3^ a year in 2017, an amount that corresponds to 23 % of Gazprom’s current annual gas production. Bovanenkovo is one of Russia’s largest gas fields. In the long run, Gazprom hopes to increase Bovanenkovo production to 140 million m^3^ a year.

A gas pipeline running from Bovanenkovo to Ukhta on the European side of Russia is under construction. From there the gas will be transmitted via Russia’s growing pipeline grid into the Nord Stream pipeline, which runs under the Gulf of Finland to Germany.

Bovanenkovo production will make up for the loss of production in maturing gas fields. Observers are somewhat sceptical, however, as to whether there is enough demand in the near future to meet the increasing supply. Gazprom had to cut production 6 % in January-September on reduced exports to Europe and increased domestic competition from independent producers.

At the opening of the Bovanenkovo gas field, president Vladimir Putin noted that the structure of international natural gas markets is shifting. He mentioned the rapid increase in shale gas and fracking, wider use of LNG and changing EU energy policy. The president then tasked Gazprom with formulating a new export policy to reflect changing market conditions. Putin said the policy should take into account e.g. the use of gas as a transport fuel, expanding export markets to Asia and new shipping formats for gas such as LNG.

State hospitals and clinics to charge for certain procedures. A law passed by the Duma a year ago and a cabinet decree at the start of October set forth the types of medical procedures that should be billable to patients. The decree enters into force at the beginning of 2013.

Under the government decision, medical procedures not covered by mandatory health insurance would be billable. These include procedures not covered by basic medical standards such as special treatments, special tests and imaging, as well as nonessential dietary and medicinal treatments. Treatment of anonymous persons will also be billed as will be the treatment of foreigners unless they are covered by Russian mandatory health insurance. Special medical treatments without a referral will also be billed.

Despite criticism that the reform puts an end to free medical care, reform defenders note that high-quality health care for all has not been achieved under the system with free care. Informal payments to medical staff have become increasingly common in recent years. Patients also increasingly turn to the many private polyclinics that have been founded in Russia in recent years. Public health care costs now equal nearly 5 % of Russian GDP. In addition to that, citizens themselves pay for health care a sum amounting to about 3 % of GDP. In developed economies, public and private health care costs are typically around or above 10 % of GDP.
China

HSBC flash PMI for October finds firms more optimistic about outlook for Chinese economy. The latest reading of HSBC Bank’s manufacturing purchasing managers’ index rose to 49.1 in October, the highest reading since July. While it would be unreasonable to make major conclusions on the direction of the Chinese economy based on a single indicator, it is noteworthy that the economic sentiment correlates with national accounts data released last week that included somewhat surprising evidence that output accelerated in the third quarter. International markets are keeping a careful eye on the Chinese economy as the European debt crisis creates drag on the world economy.

China’s foreign currency reserves up slightly. China’s foreign currency reserves rose by $50 billion in July-September to $3.29 trillion, but reserve growth has clearly moderated compared to earlier years.

Growth was supported above all by the increase in the trade surplus for goods. The January-September surplus climbed to $150 billion, or $40 billion more than in the first nine months of 2011. In the same period, foreign direct investment inflows into China declined. January-September FDI inflows into China amounted to $83 billion, a 4 % drop from a year earlier. The fall is in line with global trends, as investment flows have decreased all over the world due to the financial challenges facing firms and uncertainty related to the economic development. Detailed information on the current account and capital account balances has yet to be published.

Rapid rise in incomes continues. China’s National Bureau of Statistics reports that per capita real incomes for people living in cities rose 10 % y-o-y in the first nine months of this year to an average of 2,050 yuan (€253) a month. There are considerable variations in average wage levels and their rates of increase across provinces, however. In fact, wage differences across provinces have continued to increase this year. Real incomes rose faster (12 % y-o-y) in rural areas, of Statistics reports that per capita real incomes for people living in cities rose 10 % y-o-y in the first nine months of this year to an average of 2,050 yuan (€253) a month. There are considerable variations in average wage levels and their rates of increase across provinces, however. In fact, wage differences across provinces have continued to increase this year. Real incomes rose faster (12 % y-o-y) in rural areas, but now over 20 % have computers and internet connections.

Chinese focus turns to corruption ahead of leadership change. As part of its global attitudes project, a new Pew Research Center poll finds that half of Chinese see corruption as a very big problem in their country. There has been a fairly sharp jump in concern over corruption this year. Just a year ago, only 39 % of survey respondents considered corruption a very big problem. According to some estimates, the growing Chinese concern over corruption reflects the high-profile prosecution of Bo Xilai, Chongqing’s former communist party chief and former commerce minister, as well as growing dissatisfaction among average citizens with China’s growing income disparity. China’s central administration reacted to the research findings quickly by releasing information on punishments meted out to corrupt officials. According to the communist party’s Central Commission for Discipline, 3,578 party officials were punished for corrupt acts during 2010–2011. A total of 83,195 officials reportedly confessed to taking bribes and surrendered them.

International researchers find no evidence that corruption in China has increased significantly in recent years. In fact, the latest Transparency International survey found that China has made modest progress in fighting corruption and improved its ranking relative to other countries. TI’s Corruption Perception Index ranks corruption with a value of 1 signifying most corrupt and 10 least corrupt. China’s overall CPI value in 2011 was 3.6. In 2004, when the Hu Jintao administration took office, the CPI for China was 3.4. China ranked 75th in TI’s international corruption comparison, high enough to break into the least corrupted half of countries evaluated.

Perceived Corruption Index values for China, Finland, Russia and US (high PCI indicates low perceived corruption)
Russia

Russia and Belarus stay on daylight saving time. While the rest of Europe shifted back to standard time on October 28, Russia, in keeping with an initiative of president Dmitri Medvedev last year, decided to stay on daylight saving time. Moscow is now three hours ahead of most of Western Europe. Belarus followed suit and also stayed on daylight saving time.

Government decides on next year’s big share sales of state enterprises. Last week’s cabinet decision was based on the privatisation programme approved last summer that included a list of state-owned enterprises (SOEs) eligible for partial or total divestment in coming years. In the case of most SOEs, proposed share offerings involve partial stakes, and complete privatisation is not envisioned.

The cabinet’s decision concerns the sale of stakes in at least eight major SOEs. If the business cycle permits, sales might be extended to include stakes in other state companies as well.

One of the biggest deals is likely the offering of a 6 % stake in the Rosneft oil company. Press reports note that the total stake the state will divest next year is actually around 12 % as last week Rosneft agreed with the multinational BP to give BP 6 % of Rosneft shares in exchange for BP’s stake in the TNK-BP joint venture.

Another big share sale next year involves a 10–25.5 % stake in VTB Bank, Russia’s second largest bank. The offering next year was moved up after Sberbank’s successful share offering in September. The state’s ownership stake in VTB is presently 75.5 %.

Other planned 2013 sales include a 7–14 % stake in the diamond mining company Alrosa, a 25.5 % stake in Sibir Airlines and the state’s 25.1 % stake in regional electricity producer TGK-5. TGK-5 remained partly in state ownership after the sweeping 2010 reform of the electricity sector.

The share sales have touched off a discussion in the cabinet over whether SOEs are eligible to acquire the shares of other SOEs as they come up for offer. Prime minister Medvedev’s position is that SOEs should not be able to participate in these sales; buyers should be private entities as one point of the sales is to reduce the state’s presence in the corporate sector. The cabinet is preparing a decree limiting the participation of SOEs in share purchases of other SOEs, but its exact content is still open.

Russian oil and gas production in 2012–2015: slow growth ahead. Crude oil production rose about 1 % y-o-y in January-September, a slightly brisker pace than in 2011. As in 2011, however, the volume of crude oil exports has continued to shrink as an increasing share of oil production is diverted to domestic refineries. In January-September, the amount of oil going to domestic refining rose more than 4 % y-o-y as Russia secured sufficient supplies to meet its growing domestic demand for refined oil products and refineries increased the share of higher value-added petroleum products in their business. Production of petroleum products has been on the rise for years and grew 2–3 % y-o-y. Exports of refined petroleum products recovered notably after a small dip last year.

After rising in 2010 and 2011, natural gas production fell 3 % in January-September as gas exports contracted. Exports of gas this year have been at about the 2010 level. Notably, gas exports to Ukraine have dropped due to an ongoing dispute over gas prices and Ukraine’s efforts to cut dependence on Russian gas through alternative sources.

This autumn’s forecast from the economy ministry slightly lowers the earlier outlook for gas production and export. Gas production is forecast to increase at about 1.5 % a year during 2013–2015, while gas exports are expected to increase at over 2.5 % a year.

The oil sector is expected to develop more slowly than currently. Crude oil production should plateau as should the volume of crude oil exports. The volume of oil going to domestic refining should also stay about the same but refining operations are expected to evolve especially towards growing production of motor fuels. Export of petroleum products, however, will decline at about 2 % a year as Russia’s demand for petroleum products increases as the domestic economy grows.

Sustaining production and transport of oil and gas will require vast investment. In the economy ministry’s forecast, the volume of investment in natural gas production is expected to more than double from the 2011 level by 2015, and gas pipeline investment should rise about 40 %.

Growth in investment in production of crude oil is estimated to increase nearly 20 %. Investment in oil refining capacity will be boosted e.g. by agreements made between oil companies and public agencies.
China

Problems lurk as China’s financial markets evolve. The latest IMF Global Financial Stability Report risks to the global economy have increased since the April assessment. The top driver of increased risk is the European debt crisis. The report notes that the emerging Asian economies are generally in a stronger position than advanced economies and the emerging economies in Central and Eastern Europe tied to the Euro Area, but still offers a warning to brace for further deterioration in the global economy.

As in many emerging economies, China’s central bank cut interest rates last summer to stave off a sudden slowdown in economic growth. However, the People’s Bank of China’s room to relax monetary policy has been limited by explosive growth in bank lending in recent years and a sharp rise in housing prices, although Chinese officials have focused on reining in rising credit risk and prevent a housing bubble through such measures as limits on lending to local administrations and stricter rules on apartment purchases and financing.

The most intriguing issue facing China’s financial system is how to manage growth and development of the financial system. The country’s banking system remains dominated by the four large state-owned banks, which hold nearly half of all the banking sector assets. While banks are still quite healthy, their profitability will be negatively affected by liberalisation of interest rate policy and intensified competition.

At the end of 2011, the total market for debt securities was about 56% of GDP. The debt securities market is currently dominated by public bonds, but the emergence of robust corporate debt securities markets is expected to vastly increase competition in financial markets by providing companies with alternative access to funding. As of end-2011, the value of China’s stock markets was about 46% of GDP.

A second big issue for financial policymakers is the explosion in financial intermediation outside the formal banking system. This market can be divided into informal lending, the far more transparent trust company sector, and commercial banks’ asset management services. The latest GFSR estimates that these financing activities now equal about 35% of GDP, compared to official corporate and household lending, which is about 140% of GDP. The risks posed by nonbank actors is reflected in the fact that interest rates on informal loans often exceed 20%, while the reference rate for official one-year bank loans is currently around 6%. Some fear that serious problems in servicing trust loans and loans behind wealth management products could spread to the formal banking sector. The report notes signs of debt-servicing difficulties in small enterprises are already evident.

China’s bank and financial markets are undergoing a major upheaval. The GFSR says successful risk management calls for active upgrading of prudential oversight and effective use of market discipline.

China invests in natural gas. Over the past five years, the share of natural gas consumption has nearly doubled, accounting for 5% of all energy consumption last year. The shift to gas reflects increased domestic production, a rapid expansion in domestic gas transmission and distribution, as well as a sharp increase in gas imports.

China has the world’s 14th largest proven gas reserves. Most of that gas is located in western parts of China. To get the gas to the metropolises on the east coast, China is building gas pipelines spanning the country. The first pipeline was commissioned in early 2005, and a second completed in August this year. A third transnational pipeline should be completed in 2015.

China’s transnational pipelines also extend beyond the western borders to Kazakhstan, Uzbekistan and Turkmenistan. China has agreed on substantial deliveries with Turkmenistan through 2039, and reached a major supply deal with Uzbekistan last summer (the gas began to flow in August). Another pipeline running from Myanmar to southern China is currently under construction and should be ready sometime next year. China is still in negotiations on a gas pipeline from Russia. Russian gas giant Gazprom announced this week its go-ahead on the Vladivostok gas pipeline geared to meet at least Japan’s energy needs. The pipeline should be completed in 2017.

Pipeline transmission of gas is nothing new to China, but even last year some 75% of imported gas still arrived in the form of liquefied natural gas (LNG). Australia has been China’s most important foreign gas supplier, but will probably be overtaken by Turkmenistan this year, as gas pipeline transmission has been increasing sharply.

To satisfy its thirst for energy, China is substantially ramping up the use of renewable energy sources such as hydro, wind and solar power. Growth of China’s nuclear industry, in contrast, has been cautious, with nuclear power only providing about 1% of the country’s energy supply at the moment. Plans to build new nuclear power plants were shelved in spring 2011 after the Fukushima disaster. Last month, China announced it was again green-lighting new nuclear projects, but plans are more cautious than pre-Fukushima and long-term production targets for nuclear plants have been lowered.

Coal is still China’s top energy source (68%), with crude oil in second place (19%) and hydropower in third (7%).
Russia

Russia’s large consumer markets. Although growth in private consumption slowed slightly this year, it was still up 7% y-o-y in the first half. The volume of retail sales managed to increase 4–5% still in the third quarter. While growth in food sales clearly slowed, there were no signs of a let-up in the boom in sales of non-food goods (up 8% y-o-y in July-September). Sales of cars and home electronics remained robust. Consumption growth is widely forecast to remain rather strong in coming years.

The volume of consumption growth coupled with rising prices and slight ruble appreciation have contributed to the rapid expansion of Russia’s consumer markets. Over the last four quarters, the total value of retail sales in Russia exceeded €500 billion. If passenger car and gasoline sales are omitted, the amount was about €450 billion, almost the same as in Germany. Retail sales are largely concentrated on Russia’s European side; combined retail sales for the four major Federal Districts (the Central, Northwest, Volga and Southern Federal Districts) amounted to about €350 billion (excluding cars and gasoline). In the Central and Northwest Federal Districts, the amount exceeded €200 billion, nearly matching the level of retail sales in Spain. Moscow and the surrounding Moscow region generated over €100 billion in retail sales, about the same as in the Netherlands.

The rapid growth in retail sales has created a very strong increase in imports of consumer goods. The Central Bank of Russia estimates that consumer goods imports reached about €85 billion in 2011. Consumer spending on services in Russia has also risen briskly. Rosstat notes that spending on services over the past four quarters amounted to nearly €170 billion (including about €40 billion in household spending on energy and housing maintenance).

Key categories for Russian consumer markets, total for four recent quarters, EUR billion

![Graph showing key categories for Russian consumer markets](image)

Sources: Rosstat, CBR

Russian tourists spending more and more in Finland. In first ten months of this year, the number of Russian travelers crossing the border to visit Finland continued to increase. The value of their tax-free purchases in Finland was nearly €230 million, an increase of almost 30% y-o-y.

Based on interviews at the Finnish border, most Russian tourists take day trips to Finland for shopping. The lion’s share of Russian visitors came from St. Petersburg and Vyborg areas. The destination for nearly half of all Russian visitors this year has been the city of Lappeenranta in eastern Finland not far from the Russian border. At least half of Russian tourists buy groceries and clothing in Finland, and many also purchase other household items.

Finland had 3.3 million Russian visitors in 2011, which meant that nearly half of all travellers to Finland last year had Russian passports. Russian travellers spent €860 million in Finland. Russians’ total spending during travel abroad exceeded €23 billion according to CBR balance-of-payments figures.

Russian cabinet approves environmental programme until 2020. The programme notes that Russia’s environmental problems have serious impacts for society and the economy generally. For example, air pollution currently reduces the lifespan of an average Russian by about a year. Environmental problems annually generate economic losses estimated on the order of 4–6% of GDP.

The programme would get about €600–800 million a year from the federal budget. Over half would go to improving the state of environment and environmental monitoring. The state of environment is to be improved by cleaning up environmental damage, reducing emissions and pollutants, as well as developing waste management and recycling. The goals include e.g. cutting emissions from energy production and metal industries by a third by 2020, cleaning up chemicals and toxic metals from contaminated sites at a rate of 0.5 km² a year, constructing an industrial waste treatment facility in the Leningrad region and increasing industrial use of solid household waste.

The programme tries to encourage companies to invest in environmental protection. To support development and application of environmentally friendly technology, it proposes e.g. tax breaks. The programme’s goal is to increase fixed investment in environmental protection by 5% a year in 2013–2020. In 2010, just over €2 billion went to environmental protection, or about 1% of all fixed investments.

Interest in environmental issues is rising and the programme funding would go to sustaining biological diversity, study of arctic regions and protecting Lake Baikal.

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Interest in environmental issues is rising and the programme is the first of its kind in Russia. Environmental experts regard the programme as a positive step, but hope to see more ambitious goals and effective implementation.
China

Unresolved issues likely to try US-China relations in Obama’s second term. For China’s leaders, this week’s re-election of United States president Barack Obama means existing and coming spats with the US will continue to be handled with an administration and views familiar to the Chinese. China showed a keen interest in the recent US election, in part due to Mitt Romney’s pledge to declare China a currency manipulator on his first day in office. Even if the threat was just campaign bluster, sorting it out would have caused additional tensions between the two nations. Obama’s election to a second term means more predictability and as such was good news for the Chinese leadership as it embarked this week on naming its own new leadership for the Communist Party and the central administration. The new leadership will take over the reins in handling US relations this spring.

Simmering disputes have long characterised China-US economic relations. US politicians routinely accuse China of artificially holding down the value of the yuan in a manner that leads to persistent and massive trade imbalances. Americans also repeatedly express discontent over Chinese theft of intellectual property. China has responded to these accusations with its own claims that the US is thwarting Chinese development by limiting technology transfer and blocking investment of Chinese firms in the US.

China-US disputes so far have been constrained, avoiding the widespread use of protectionist measures or a full-blown trade war. US-China Strategic and Economic Dialogues held every six months have played a major role in managing bilateral economic relations. Both sides have not been shy about resorting to WTO arbitration in resolving trade disputes over specific trade practices or violations.

Competition between the two counties is most evident in the Pacific Rim, which Obama made a cornerstone of foreign policy and national security last year in response to the rise of China. The US has been pushing its own alliance for regional cooperation, the Trans-Pacific Partnership (TPP), which does not include China. So, this week it was announced that China would participate in the recently launched talks to create a Regional Comprehensive Economic Partnership (RCEP). The RCEP seeks to reduce barriers to trade between the ASEAN countries, India, Japan, South Korea, Australia and New Zealand. Although China initially had sought to limit free-trade talks between ASEAN members, Japan and South Korea, it now appears ready to support a wider arrangement in order to counteract US influence in the region.

China’s exports to the US this year have increased slightly faster than Chinese exports overall. The US now accounts for about 17% of China’s exports, making it China’s largest single export market. Imports to the US have also climbed, although the US, which provides about 7% of China’s imports, is only the third largest importer after the EU and Japan.

China accounts for 18% of US imports, making it by far the most important importer to the US. After Canada and Mexico, China is the third largest export market for US goods and services with a 7% share. For the January-August period, the US ran a $500 billion trade deficit, of which $200 billion came from its trade deficit with China.

Euro crisis drags down growth in Chinese exports; exports to Finland remain robust. China customs reports that the value of exports to the EU shrank 6% y-o-y in the first nine months of 2012, while exports to other continents grew in the range of 10–17%. The differences in export performance varied widely within the EU. Exports to Germany, France, Italy, Spain and the Netherlands decreased, while exports to the UK rose. The six countries together account for about 75% of China’s exports to the EU. China’s imports from the EU continued to rise, but just barely. The drop in imports sharply reduced China’s trade surplus with the EU. In contrast, Europe’s struggles were not reflected in direct investment flows from the EU to China, which are on track to be about the same as in 2011. Direct investment in China from other parts of the world has declined this year.

China-EU economic relations have been marred by a range of disagreements. China recently took offense to an EU initiative to find out whether China has been dumping solar panels in Europe at prices below their actual production cost. Such behaviour would entitle the EU to impose anti-dumping sanctions on China, the world’s largest producer of solar panels. China is also upset over the EU’s decision to impose a CO2 fee at the start of this year on all airlines arriving and departing from European airports. A longer run goal for China’s leaders is getting the EU to finally grant China market-economy status, which is seen as a politically important recognition. The EU has also refused to lift its ban of arms exports to China imposed in the 1980s.

The EU wants to see China e.g. open its markets further to foreign companies, create a level playing field for domestic and foreign firms in public procurement, as well as improve enforcement of laws. EU-China relations have also been strained by China’s imposition of export restrictions on strategic metals such as rare earths. Despite the disputes, some EU countries are interested in signing on to a free-trade agreement with China.

China customs reports that exports to Finland rose nearly 25% in January-September, while imports from Finland declined more than 10%. The trade development resulted in China’s trade surplus with Finland climbing to $3 billion.
Russia

Slight hike in inflation forecast for this year. After revising upwards their inflation forecasts, the Central Bank of Russia and the economy ministry now expect consumer price growth to approach 7% y-o-y by year’s end. The revised numbers add nearly a percentage point to inflation compared to last year. Earlier 2012 forecasts saw inflation falling from 2011. The new inflation estimate reflects the recent spike in food prices after poor harvests.

The CBR’s inflation target announced in its monetary policy guidelines for 2013 is 5–6%.

Russia wants to quintuple its shipbuilding output by 2030. The government last week approved a long-term development programme geared to reviving Russia’s shipbuilding industry. Shipbuilding fell on hard times after the collapse of the Soviet Union and lags far behind global shipbuilders in terms of technology and skills. Under the programme, Russia would account by 2030 for 2% of the world’s ships built for civil shipping purposes.

A major issue for Russia’s shipbuilders is that as a legacy of the Soviet era its shipyards are mainly engineered for building military vessels. Russia has very few civil shipyards that boast modern production technologies. Expertise and production skills in shipbuilding, particularly civil shipbuilding, have been lost with the decades-long slump in production. Most of Russia’s current shipbuilding capacity is focused on building hulls, and more demanding technology and equipment must be imported.

The programme calls for a substantial amount of state funding. In 2013 and 2014, over 50 billion rubles (€1.25 billion) a year will be allocated directly from the federal budget for civilian shipbuilding. Over the following ten years, annual budget funding would amount to some 115 billion rubles. The development programme also covers military shipbuilding, but no details have been released. The programme emphasises that all proposed methods of subsidy will conform to WTO rules.

According to industry and trade minister Denis Manturov, the priorities of the shipbuilding industry programme will be military vessels, fishing vessels, ships for navigating the icy waters of the Northeast passage and exploiting the continental shelf, as well as river-going vessels. Minister Manturov noted that it would be pointless for Russia to try and compete with China, Japan and Korea in serial-produced ships beyond those for domestic use.

Measures to boost domestic demand for ships include promoting leasing arrangements for fishing vessels and river boats, as well as creating incentive systems for decommissioning old ships. Manturov observed that 85% of Russia’s stocks of commercial fishing and river vessels are outdated.

Modern technology and methods would be developed for Russian shipbuilding. Following the examples of Korea and China, Russia would form special economic zones for construction of vessels, in particular fishing and river boats. The first such zone is being established in the Astrakhan region on the shores of the Caspian Sea.

The programme divides the shipbuilding industry into three clusters. The Southern Russia Cluster would concentrate on shipbuilding in special economic zones, the Far East would be built up around an ultramodern shipyard complex, and Northwest Russia’s historically robust shipbuilding complex would be modernised and optimised.

Russian’s shifting position in global energy markets. The latest annual outlook from the International Energy Agency (IEA), World Energy Outlook 2012, examines trends in global energy markets through 2035.

The new WEO states that one of the biggest changes in world energy markets comes from the recent boom in unconventional gas production, especially in the United States. The change has already hit Russian gas exports. The rise in shale gas production means the US will become a net gas exporter by 2020. The US has reduced its dependence on gas imports, which has increased gas supply to Europe and decreased Europe’s reliance on more expensive Russian gas. The situation is new for Gazprom, which until now has provided about a third of EU gas imports.

Russian natural gas production has risen throughout the 2000s, although it has recently been curtailed somewhat by reduced demand from international customers. In 2010, Russia accounted for nearly 20% of the world’s natural gas output. The IEA expects Russian production to rise in coming years. Even if the US has dethroned Russia as the world’s top gas producer, Russia will remain the world’s biggest gas exporter.

Russia and Saudi Arabia have jockeyed for the top oil producer spot in recent years. Last year, Saudi Arabia regained its position over Russia. Russia’s crude oil production is expected to remain at its current level over the next two years and then contract at a rate of around a half per cent a year. The IEA estimates that in the 2020s, the US will surpass both Saudi Arabia and Russia as the world’s largest oil producer.

Russia will remain the world’s fourth largest energy consumer through 2035, after the world’s biggest energy users (China, the US and India). Russia is one of the world’s largest energy consumers in per capita terms, a reflection of the country’s harsh climate, long travel distances and energy-intensive production structure. In addition, Russia’s hefty energy consumption is due to significant inefficiencies in both energy production and consumption. If Russia raised its energy efficiency to the average of comparable OECD countries, its annual primary energy consumption could, according the IEA, be cut by a third.
China

Xi Jinping takes the helm; leadership change holds few surprises. Xi Jinping this week took the reins from Hu Jintao and was officially declared the new General Secretary of the Communist Party and head of the People’s Army. At next spring’s People’s Congress, Xi will be named China’s president. In his post-appointment speech, the new general secretary promised to continue with economic reform and redouble efforts fighting corruption. Even though the leadership has changed, China’s direction overall is expected to stay broadly the same. As vice president for the past five years, Xi was involved in high-level decision-making and the drafting of the current five-year plan that goes to 2015. The number of members on the Politburo’s Standing Committee was reduced from nine to seven. Xi will be joined on the Committee by six other men: Li Keqiang, the presumptive premier and top economic official; Vice Premier Zhang Dejiang, Shanghai party secretary Yu Zhengsheng; party propaganda chief Liu Yushan; Tianjin party secretary Zhang Gaoli; and Vice Premier Wang Qishan, who will head the party’s internal watchdog panel on fighting corruption. Selections do not contain any surprises.

The Politburo leads the 205-member Central Committee, which also saw a member reshuffle. Notable retirements from the Central Committee included Zhou Xiaochuan, who has headed the People’s Bank of China for the past ten years; Zhang Ping, head of the National Development and Reform Commission (NDRC); finance minister Xie Xuren, and foreign trade minister Chen Deming. All four seem destined for retirement from their official posts soon.

China’s economic growth beat official targets throughout the Hu Jintao era. During the two-five year terms of China’s outgoing administration, GDP climbed at a sizzling average of 10% a year, or three percentage points above the official five-year plan projections. More impressive perhaps is that this high growth was achieved even as the world economy struggled with its deepest slump in eight decades. During the Hu Jintao era, China emerged as Asia’s largest economy and the world’s number-two economy after the US. China rose from 116th to 92nd place in living standards, which moved it into the group of middle-income countries based on purchasing power parity adjusted GDP per capita.

China had just joined the WTO at the start of Hu Jintao’s administration in 2002. Strong business competitiveness and government support fuelled China’s rise to the apex of world trade. China today is the world’s biggest exporter, accounting for 10% of global trade, as well as the world’s second largest importer after the US. China’s foreign trade surplus and its foreign currency reserves are at record levels.

China is today a major participant in international debt markets and investment projects in developing countries. China’s investment policies have provoked backlashes in some countries on fears of growing Chinese influence. Success in foreign trade has also brought with it charges of currency manipulation and numerous trade disputes.

Increased income disparities and environmental damage are the dark side of China’s economic miracle. Hu Jintao’s administration actively pursued development of China’s central and western provinces, along with bolstering of the social security safety net. Government credibility, however, has been eroded by rising income disparity between the rural poor and the urban rich, and corruption. The government has tightened environmental regulations and encouraged development of clean alternative energy sources, but government efforts as yet are insufficient to make much difference in the average person’s life. Many Chinese suffer from poor air quality, polluted water and scandals in the food industry. By international standards, Chinese firms are profligate energy wasters. Most of China’s energy production is still based on coal combustion, and as a result, China accounts for a quarter of all global greenhouse emissions.

While financial markets and currency controls have been gradually liberalised, monetary policy still relies on window guidance of bank lending rather than interest rates as in advanced economies. Hu Jintao’s administration has also been criticised for favouring state firms over private firms. Four out of five listed Chinese firms are state run. Many private companies feel caught between strong state firms and the banks that give preferential treatment to state firms.

Administrative reform has been slow at best. China has made little progress in free speech or democracy. Maintaining social stability still involves rounding up dissidents.

Perhaps the two biggest achievements of Hu Jintao’s administration have been sustained high economic growth and a vast expansion of foreign trade. Hu leaves without taking on tough structural and environmental problems, or administrative system reforms.

Graph: Purchasing power parity adjusted GDP per capita, US$
Russia

Government restricts possibilities for SOEs to acquire other companies. At the beginning of November, prime minister Dmitri Medvedev signed a decree prohibiting subsidiaries of state-owned enterprises (SOEs) from acquiring other firms without the permission of the board of the parent company. An earlier decree already in force concerns direct acquisitions of firms by SOEs. It says such acquisitions require cabinet-approval to move ahead. SOEs, however, have so far circumvented the rule simply by making their acquisitions through subsidiaries.

Now acquisitions by subsidiaries must also be cleared at the line ministry level as every SOE board has a government representative, who takes his or her voting instructions directly from the cabinet. The decree applies to SOEs where the state holding is at least 50 % and sales where the value of the business being bought exceeds 15 % of the purchasing subsidiary’s balance sheet. The decree does not apply to state-owned banks.

President Vladimir Putin in May stepped up the pace of measures to restrict SOEs from expanding into non-core businesses, and prime minister Medvedev’s latest decree basically formalises Putin’s order. Non-core businesses of SOEs include e.g. media companies, real estate ventures and sports teams, but also manufacturing activities outside the core business.

The decree is unlikely to alter the situation decisively as SOEs have quite often been able to get permission to expand into new business areas from the appropriate line minister. This expansion into new fields, often completely unrelated to the core business, has allowed the role of SOEs in the Russian economy to expand in recent years, even if the number of SOEs has remained the same. SOE expansion has reduced market competition as state firms have power and connections.

In connection with the preparation of next year’s federal budget, the government has demanded that SOEs sell their non-core businesses. The money from the divestitures would be used to finance critically needed investment; line ministries this year have requested significantly more federal budget funding for investment than earlier. Medvedev last week issued orders to 63 large SOEs to begin immediately planning on how they will divest their non-core businesses.

Despite cabinet efforts to rein in state ownership, the actual trend seems just the opposite. Last month, state-owned oil company Rosneft agreed to purchase the British-Russian TNK-BP joint venture. After the deal is complete, Rosneft will become the world’s largest stock-exchange-listed oil company. Rosneft has also started upgrading a mid-sized bank it owns to become a major player in Russian financial markets and help in raising financing for the company’s large international projects. State holding company Rosneft has been given an exemption so it can participate as a buyer in privatisation sales of state energy firms. Giant state savings bank Sberbank this January bought Troika Dialog, Russia’s leading private investment bank.

SOEs now generate half of Russian GDP. The economy ministry notes that state-owned companies currently account for about 50 % of Russia’s GDP. The growth of the state sector took place in particular during the 2008–2009 financial crisis as state supported firms and private banks experiencing financial difficulties were merged with state-owned banks.

A recent BNP Paribas Bank survey found state holdings cover 40–45 % of Russian oil production, nearly 50 % of the banking sector and over 70 % of the transportation sector (including pipeline transmission). The state’s share of oil production has risen rapidly; it accounted for only about 10 % in 1999.

The government uses large SOEs as an informal means for dealing with the economy, which reduces transparency of state administration and finances. BNP Paribas notes e.g. that Gazprom is the largest financial sponsor of the Sochi Winter Olympics after the federal budget. Gazprom also spent significant sums of money on construction works related to the APEC Conference held in Vladivostok this autumn. Rosneft finances social projects in regions where it has production, and VTB Bank is currently underwriting the costs of refurbishing Moscow’s Dynamo Stadium.

Central securities depository established. The Federal Financial Markets Service, which oversees financial markets in Russia, has granted the MICEX-RTS settlement depository the status of national central securities depository. The formation of a central national depository has long been in preparation, and should add gravitas to the development of Russian securities markets and their integration with international markets. A central depository that functions according to international principles reduces risk for securities buyers and improves the reliability and transparency of asset custody. An attraction for foreign investors would be the possibility to open nominee accounts.

Other reforms should also soon be announced that will bring the operation rules of Russian securities markets closer to western European practices.

Despite big official plans, there has been little progress in actually making Moscow one of the world’s leading international financial centres. Russian securities markets still function inefficiently and remain quite thin, which tends to drive traders to foreign exchanges. Traditionally, the share of trades of Russian shares on foreign exchanges has been around 30 % for all listed Russian firms, but this year that ratio has risen to around 45 %. One major reason for jump was September’s massive Sberbank IPO in London and Moscow.

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China

No significant shifts in China’s economic policies expected. Early comments from China’s new leaders, and particularly incoming president Xi Jinping and premier Li Keqiang, emphasise the importance of continuing with economic reforms. No new initiatives have been brought out, rather the reforms mentioned are either those outlined in the 2011–2015 five-year plan or themes set out by the departing president Hu Jintao and premier Wen Jiabao. In the current five-year plan there is a 7% annual average GDP growth target, which is broadly in line with the target of doubling the average Chinese income by 2020 set out by president Hu at the national party congress at the beginning of November.

Achieving such growth target will require major changes in economic policy and reforms, which are more challenging to implement than earlier reforms. China’s government has committed, at least on some level, to the reforms laid out in the China 2030 report published by the World Bank and the Development Research Centre (DRC) of the State Council earlier this year.

The reforms mentioned in China 2030 include reducing the state’s oversized presence in the economy by easing the monopoly grip of state firms on the economy and by reducing restrictions on foreign firms operating in China in order to increase competition. Market liberalisation plays a central role in reforms, which include freer interest-rate-setting and capital movements, as well as development of debt markets. China has already announced plans to increase use of the yuan internationally and free up yuan convertibility by mid-decade. Other challenges include innovation policy, environmental policy, social security and pension system reforms, as well as reduction of income inequality.

The goal of the reforms is to secure sustained productivity growth and bolster the role of private consumption as the engine of economic growth. Urbanisation is a powerful trend in which the new leadership is backing on to meet their targets.

The assessments of the desire and ability of China’s new leadership to take on reforms of China’s economic institutions, approaches and structures range from dour scepticism to cautious optimism. The political regime poses a central conundrum for reformers. Anti-corruption campaigns are hardly sufficient to sustain expectations related to the political system in situation, where economic growth continues to slow and greater freedom and competition are required in the economy.

More detailed views on the leadership’s short-term economic policies will be available in December, when China’s decision-makers meet for their annual working conference on economic policy. Selection of the new leaders and the 2013 economic political goals will be finalised at the People’s Congress in March. By some estimates, the specifics of new reform policies are unlikely to be ready before the central committee meeting next autumn. In any case, China’s policy of gradual reform will remain in place unless a sudden slowdown in economic growth forces more radical action.

China’s economy perks up. The National Bureau of Statistics reports that growth of industrial output, led by the metal and chemical sectors, continued to accelerate in October. Moreover, the preliminary reading for this month’s official manufacturing purchasing managers index (PMI) suggests an improving business climate. In addition, new manufacturing orders are up. In the service sector, real growth in retail sales accelerated in October. Service sector surveys also indicate a brighter business outlook.

Little change in China’s current account surplus from 2011, but net capital flows are now outbound. China’s current account surplus hit $148 billion for January-September, up slightly from $141 billion in the same period last year. The current account surplus corresponded to 2.6% of GDP, down from 2.9% last year. For July-September, however, the current account surplus was up nearly $20 billion from a year earlier on a higher goods trade surplus.

The biggest change on China’s balance-of-payments statement appeared in the financial account. In January-September 2011, the financial account showed a net inflow of $250 billion from abroad. This year, there was an outflow of $56 billion from China. Taking into account changes in exchange rates, the value of China’s foreign currency reserves increased by just over $100 billion in January-September, compared to a gain of over $350 billion in the same period last year. As of end-September, the value of China’s foreign currency reserves stood at $3.29 trillion.

The goods trade surplus continued to rise in October as China’s exports grew by nearly 12% and import growth was just 2%. Growth in the trade surplus this year reflects a drop in commodity prices which has lowered the value of imports. In October, demand was driven by the US and emerging markets. Exports to Japan were sluggish and exports to Europe remained weak. The reduction in imports from Japan seems to have accelerated after July, coinciding with the heating up of territorial disputes between China and Japan in August-September. Direct investments of Japanese firms in China were up over 10% y-o-y in January-October, but October FDI was a third smaller than it was a year earlier. It is unclear to which extent this reflects increased uncertainty of Japanese firms and how much comes from normal fluctuation in investment.
Russia

Duma approves federal budget for next year with a slight deficit. The budget calculations, based on the economy ministry’s 2013 forecast, assume a rise of 3.7% in GDP, a drop in the average price of a barrel of Urals oil to $97 and inflation at end-2013 at 5–6%.

Public sector revenues next year are projected to grow 7–8% in nominal terms. Accounting for inflation, real growth would be around 2%. Revenues should decline slightly to less than 38% of GDP. Spending will increase about 10%, rising to more than 38% of GDP (a level still below pre-recession levels). The public sector budget deficit is expected to come in at around 0.5% of GDP.

Federal budget revenues next year are expected to be nearly the same as this year, while growth in expenditures will slow to a couple of percent. The lower spending growth reflects the fact that transfers to regional budgets are being cut, although a third of the federal budget spending will still consist of transfers to regions and contributions to social funds. Hikes in federal budget other spending are intended to keep pace with inflation.

Defence is the fastest growing category of federal budget spending, rising 15% next year and nearly 20% a year in 2014 and 2015. Defence constitutes about a tenth of all public spending and over 3.5% of GDP. Actual defence spending exceeds the budget figure, and the Stockholm International Peace Research Institute (SIPRI) puts it at about 4% of GDP in 2011. Defence spending in 2011–2020 will be boosted by a massive upgrade in hardware and weaponry. While annual spending on armaments, equipment and facilities are not published, they are estimated to constitute about half of defence spending last year and this year. The federal budget deficit next year should stay below 1% of GDP.

Regional and municipal budget revenues are expected to rise over 10% next year on higher revenues from key taxes and despite cuts in transfers from the federal budget. Some observers see current regional and municipal budget estimates as very optimistic. Regional and municipal spending growth will accelerate to 13% next year due to factors such as public sector wage hikes promised by president Putin.

Revenues of social funds (Pension Fund, Social Security Fund and Health Insurance Fund), nearly 45% of which comes out of the federal budget, will rise over 10% next year. Rapid expenditure growth will continue (at 13%), reflecting increases in pension and other social spending. Social spending will remain at over a third of public sector spending, and correspond to about 13% of GDP.

Duma approves changes to the pension system introduced in 2002. The changes were motivated by the persistent deficit of the Pension Fund. Nearly a quarter of public sector spending currently goes to funding pensions.

Reform of the pension system has been the major topic of public discussion in Russia this autumn. The labour ministry in October presented a long-term strategy for development of the pension scheme that included measures to improve funding. The cabinet failed to agree on the changes, however, as they pit economic and social ministries against each other.

In accordance with instructions from president Putin, the Duma last week approved partial reforms to the current pension system as presented by the labour ministry.

Russia’s pension system was fundamentally reformed in 2002 according to internationally accepted practices recommended by various expert agencies, with the Swedish pension system taken as a model. The reformed system introduced a partial shift from a pay-as-you-go arrangement to a funded scheme that allocates part of current contributions to funding of pensions of younger generations. Older workers and current pensioners are paid out by the pay-as-you-go system, i.e. pensions are paid out of the contributions of working people. The employer’s mandatory pension contribution is 26% of the wage bill. Of that 6 percentage points goes to the funded scheme and the rest to cover running pension costs.

The change approved by the Duma rolls back the 2002 reforms by reducing the funded share of the 26% from 6 percentage points to 2, while shifting the other 4 percentage points to covering current pension costs. The change, which goes into force in 2014, is a short-term fix to finance current pension costs but doesn’t help in creating a long-term sustainable footing for the pension system.

The move has received sharp criticism from the finance and economy ministries, as well as expert agencies that see no justification in butchering the funded component of the pension system. To resolve long-term underfunding of the pension system, Russia must consider e.g. raising retirement ages, increasing the length of time a person has to be in the workforce to earn a full pension and elimination of the early pensions offered in many branches.

Reform of the pension system will remain topical as Putin has tasked the government with drafting more amendments to pension laws in the first half of next year.

An aim of the shift to a self-funded pension system has been to support growth of Russia’s capital-starved securities markets and boost the functioning of pension funds so that they can engage in long-term financing activities. In the view of capital market proponents, the roll-back implies weaker development of the sector and postponement of making Moscow a major hub of global finance. On the other hand, pension funds have not been very successful at preserving the value of paid-in contributions; the average return on invested contributions has failed to even keep up with inflation over the past ten years.
China

US stand on China’s exchange rate policy softens. United States legislation requires the US Treasury Department to twice a year assess international economic and exchange rate trends, and specifically determine if any US trading partner is pursuing an exchange rate policy to gain an unfair competitive advantage. In recent years, the focus of the Treasury Department’s report has been on China – and the latest report continues the tradition. Some members of the US Congress continue to demand that China be declared a “currency manipulator,” i.e. artificially undervaluing the yuan, which would allow Congress to move ahead with preparations of reprisal measures against China. However, changes in China’s exchange rate policy in recent years have taken the steam out of the criticism. So, as expected the Treasury Department refused again to accuse China of manipulating the yuan’s exchange rate.

Since June 2010, when China ended its re-imposed peg and allowed the yuan to resume its appreciating trend, the Chinese currency has appreciated 9% against the dollar in nominal terms and 12% in real terms. The Treasury Department assessment notes that the IMF estimated last summer that the yuan’s exchange rate was undervalued by about 5–10% against a basket of currencies of China’s main trading partners. However, the choice of words used by the Treasury Department suggests that the US government still believes there is more room for further yuan strengthening.

The report finds that the role of exports in China’s economic growth has declined slightly. Evidence of this can be seen in China’s shrinking current account surplus, which has fallen from over 10% of GDP in 2007 to below 3% this year. China has also taken steps in recent years to free up capital movements, which has eased adjustment processes in the global economy. These factors, along with yuan strengthening, have lowered estimates of yuan undervaluation. However, sustainable changes in China’s exchange rate policy in recent years have taken the steam out of the criticism. So, as expected the Treasury Department refused again to accuse China of manipulating the yuan’s exchange rate.

China’s health care costs rising rapidly. The latest OECD Health at a Glance: Asia/Pacific 2012 comparative study finds China’s annual public spending on health care last year was $379 per person. While that was only about a tenth of the OECD average, it is well in line with neighbouring East Asian countries. Chinese life expectancies have risen to 75 years for women and 72 years for men, or about the average of Southeast Asian countries. Japan and Hong Kong boasted the longest life spans in Asia (86 years for women).

China’s health care system has evolved rapidly since the early 1980s, when the country’s economic lift-off began. As a sign of this, maternal deaths during childbirth and deaths of newborns are today about a third of what they were three decades ago. The death rate for newborns in 2011 was 1.6 per thousand births and maternal deaths during childbirth about 0.4 per thousand births. There is still plenty of room for improvement as China’s infant and maternal mortality rates are still about four times the OECD average. Another issue to note is China’s relatively high incidence of cancer deaths; China has Asia’s second highest rate of cancer deaths after Mongolia.

During the outgoing administration of president Hu Jintao, health care spending rose more than 10% a year in real terms, slightly outpacing China’s GDP growth. Coverage of the health insurance system was expanded, and currently it covers about 95% of Chinese. Access to health care services has also improved, which can be seen e.g. in the large number of doctors. In mainland China there are 1.8 medical doctors per 1,000 residents, which is a higher ratio than in Hong Kong and nearly as high as in Japan and South Korea.

A recent McKinsey study found that dissatisfaction with China’s health care system is still fairly widespread. Nearly a third of respondents reported that their access to health care was poor, even if the survey was directed at relatively well-to-do households by Chinese standards. Two routinely noted problems with Chinese health care were the low salaries of medical doctors and the poor quality of rural health care. As in many countries, China’s ageing demographic trend poses huge challenges for the health care system.

Growth in health care spending, 2000–2010, % per year

Source: OECD
Russia

Russia works to limit negative effects from joining WTO. President Vladimir Putin took up WTO issues at the November meeting of Russia’s security council. Putin noted that WTO membership will help Russia in modernising its economy and give it a greater role in the international division of labour. However, the risks associated with lowering certain import duties have increased due to weakness in the global economy. The most exposed branches of Russian industry include animal husbandry, farm machinery manufacture, car manufacture, food and pharmaceuticals. Geographical regions dependent on a single major local industry could also suffer from WTO membership.

Officials noted that the contraction of EU markets in particular posed the risk that products earlier exported to the EU might be redirected to Russia. Putin tasked the labour ministry and the economy ministry with assessing the impacts of WTO membership on Russian employment and asked the ministries to submit proposals about ways to minimise the negative impacts. WTO membership will also require Russian officials to show greater competence and become more active in defending national interests in the international arena. The president asked the ministries of the economy, industry and trade, and foreign affairs to assess whether any discriminatory measures are currently directed at Russian exporters.

Officials said Russia will continue to reduce tariffs as called for under its WTO commitments, but may move ahead with other forms of support. Economy minister Andrei Belousov noted that Russia can next year implement protective tariffs on imported agricultural machinery if it can show producers are engaging in dumping practices. The Eurasian Economic Commission that deals with these kinds of questions in the customs union of Russia, Belarus and Kazakhstan, is currently studying the issue by a request from Russian farm machinery maker Rostselmash.

At the end of November, an EU representative presented concerns at the WTO council on goods trade over Russia’s recent moves to apply several protectionist measures, many of which violate international trade rules. Two potential violations of WTO rules mentioned by the EU representative were the ban on importing live animals from the EU and the imposition of recycling fees on imported used cars. The EU representative also noted changes in Russia’s export tariff system for crude oil. The government decided in September to alter the system of export duty reductions so that they enhance the development and exploitation of new oil deposits. The result may be higher average oil export duties that would violate Russia’s WTO commitments.

At the moment, the EU has not filed any formal complaints that might initiate an official WTO enquiry. Russia and the EU are in bilateral talks on the issues.

Russia-Belarus-Kazakhstan customs union assesses trade barriers. The Eurasian Economic Commission set up at the start of this year to oversee customs union implementation has looked into trade barriers its member countries face in exporting to other countries. The most barriers have been imposed by the EU and the US, followed by Ukraine, Uzbekistan, India and China. Barriers imposed by CIS countries account for nearly 40% of all barriers.

A significant share of trade barriers were countervailing duties to prevent dumping. Other barriers include quotas on imported goods and discriminatory excise taxes. The EU and the US have imposed protective tariffs on e.g. certain chemical and metal products. The EU was also found to restrict imports of textiles and grain, while the US had restrictions on arms imports from Russia. Ukraine has protective duties on such products as fibreboard sheet, glass and methanol. Uzbekistan imposes a discriminatory excise tax on over 400 products from customs union countries and employs a large number of administrative measures to restrict imports such as long delays in currency conversion. India and China limit imports of chemical products.

The Eurasian Economic Commission is currently assessing the size of losses suffered by member countries from export restrictions. For example, the commission calculates that restrictions imposed by Ukraine cause customs union members annual losses totalling about $200 million. The commission will next investigate the best ways to deal with export restrictions. Russia tries to get restrictions dismantled under the WTO framework.

Russia assumes G20 presidency. Russia’s one-year term as president of the G20 began last Saturday (Dec. 1). The G20, which has a rotating presidency, provides an informal forum where the world’s largest economies can discuss issues affecting the global economy and financial markets. The G20’s mission is to coordinate political measures to achieve sustainable economic growth and promote stability of the international financial system. Participants to the meetings are G20 finance ministers and central bank governors.

Ksenia Yudaeva, a presidential adviser on economic policy charged with preparing for Russia’s G20 presidency, says Russia wants to focus the agenda on capital investment, structural unemployment and public debt in addition to the standard finance, energy and trade issues. Russia will also push for reforms in the IMF voting system to give emerging economies and developing nations greater decision-making power in the organisation. Given the criticality of the employment issue, Russia is for the first time organising a common meeting of labour and finance ministers at the annual summit. The summit will be held in September in St. Petersburg.
China

Profitability of industrial firms up 20% in October from last year. A small spike in corporate performance of a year of otherwise flat earnings has provided a ray of hope midst a year of generally declining share prices (e.g. the Shanghai Composite Index is down 17% for the year). Despite the good numbers for October, cumulative profits in January-October were about the same as year ago. Privately held firms, however, witnessed profitability growth of about 20% y-o-y in October, while profits of state-owned firms were down nearly 10% y-o-y.

Declining share prices have reduced the market capitalisations of China’s biggest listed companies. China currently has nine companies with market capitalisations that put them among the world’s 100 largest corporations, as well as 23 firms in the Bloomberg Top 500 index of global firms. The giant Chinese enterprises in the Bloomberg ranking operate in the energy sector or financial services. Despite exchange listing, the state retains the voting majority in all of these listed Chinese firms.

Chinese firms in the Bloomberg Top 500 index

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Source: Bloomberg

IEA predicts rapid growth in Chinese energy use ahead.
The International Energy Agency’s (IEA) World Energy Outlook, released in mid-November, forecasts several notable trends in global energy consumption patterns out to 2035. The Paris-based IEA predicts that energy demand will continue to rise rapidly even if governments that have committed to reducing national energy use actually make good on their promises. Most of the increase in energy use is caused by population growth and wealth gains in emerging economies. Energy use in OECD countries, in contrast, is expected to level off. The bulk of energy production will come from coal, crude oil and natural gas. The use of various forms of renewable energy will increase just a few percentage points.

The IEA predicts that even if China achieves the energy saving targets it has set for itself, in the period 2010–2035 China will account for one-third of growth in global energy consumption and half of the growth in crude oil consumption. At the same time, China will strengthen its dominance as the world’s biggest energy consumer. By 2035, the IEA claims, China’s energy consumption will be about 80% greater than US consumption. Per capita consumption at that point will rise to about half the American level. Energy consumption should also soar in India.

China will continue to meet the bulk of its energy needs with coal, even if coal use is expected to level off after 2015 (see chart). The IEA sees most of the growth in energy use in 2015–2035 covered by other forms of energy, particularly natural gas, nuclear, hydropower, wind and solar power.

China has managed to meet part of its growing energy demand through large energy efficiency gains over the last three decades. In 1980, China used about four times more energy per unit of GDP than in 2010. Despite its progress in energy efficiency, there is still plenty of room for improvement. The only parts of the world where greater energy waste is found are in certain countries in Africa, Eastern Europe and Central Asia. China’s two most recent five-year plans have included energy efficiency goals to be achieved through such measures as tax incentives.

The IEA estimates that China currently has an energy self-sufficiency level of about 90%. This high degree of energy self-sufficiency reflects China’s massive coal reserves, domestic oil and gas production and large rivers for producing hydropower. In coming years, China, however, will become increasingly dependent on foreign energy supplies.

Source: IEA World Energy Outlook 2012
Russia

CBR makes first small rate adjustments since September. The Central Bank of Russia raised its fixed deposit rate on December 11 by a quarter of a percentage point to 4.5%. As a background for its decision, the CBR noted that persistent high inflation (currently 6.5%) could sustain inflation expectations but also that economic growth slowed in the third quarter and in October. GDP grew 2.9% y-o-y in the third quarter. The CBR, however, said that the confidence of economic actors has remained generally positive, and that healthy employment and good development of bank credit should support domestic demand.

Gazprom breaks ground on construction of South Stream gas pipeline in Russia. The final go-ahead on the project was reached in November when the final transit country, Bulgaria, agreed to construction of the pipeline on its soil. Turkey last year granted Gazprom permission to run the pipeline under the Black Sea in its territorial waters. The South Stream pipeline will go from the Russian city of Anapa along the seabed of the Black Sea to the Bulgarian coast, and from there on to Serbia, Hungary, Slovenia and Italy. A planned second branch of the pipeline would serve Croatia and Bosnia-Herzegovina. Gazprom holds a 50% stake in the project. Other participants include the Italian ENI (20% stake), the French EDF (15%) and the German Wintershall (15%).

The 1,500-kilometre South Stream pipeline is estimated to cost about $16 billion and it should be completed in 2015. When it reaches full capacity in 2018, it will be able to carry 63 billion cubic metres of gas annually. The construction work has yet to begin outside Russia. The required environmental impact studies have yet to be performed and the technical specification is still incomplete.

Gazprom sees the South Stream pipeline as providing an alternative transmission route to European markets that bypasses Ukraine. At the moment, about 80% of Russian gas exports to Europe pass through Ukraine with current pipeline capacity of just over 140 billion m³. Gazprom would continue to use its other European pipeline, which runs through Belarus and has a capacity of 35 billion m³. The new Nord Stream gas pipeline to Northern Europe was commissioned a year ago. Its annual transmission capacity was boosted to 55 billion m³ in October, although the pipeline only operates at a third of capacity at the moment.

Gazprom caves on gas prices in reaction to global market trends. Gazprom has lost market share in Europe as European energy companies have shifted to buying other gas on spot markets, where prices are well below what they pay on long-term supply contracts with Gazprom.

As buyers have moved away from dependence on Gazprom, several big European gas importers in the last couple of years have managed to negotiate discounts with Gazprom on existing contracts. Gazprom has also been taken to court for overly strict supply contract terms requiring buyers to pay for a certain amount of gas even if the buyer does not take the full amount of gas under the contract.

In November, Poland won 16% discount from Gazprom while Bulgaria got a 20% cut. As part of the deal, Poland withdrew its claims against Gazprom filed with the Stockholm Arbitration Tribunal over Gazprom pricing policies.

No new commitments from Russia on carbon emissions at Doha climate summit. The Doha UN Climate Change Conference wound up on December 8 after agreeing on the next phase of the Kyoto Protocol that will run from 2013 to 2020. While e.g. the EU and Ukraine agreed to a new round of emission reductions, Russia will stay with its commitments under the first phase of the treaty whereby Russia only promises not to exceed its 1990 levels of greenhouse gas emissions. The commitment demands very little from Russia as it has consistently been clearly below 1990 levels in the post-Soviet era. The situation has created opportunities for Russia to sell carbon credits to other countries. Changes in the Kyoto treaty at the Doha round, however, limited Russia’s possibility to sell carbon credits. In any case, Russia has benefited less than officials expected from emissions trading due to the low demand for carbon credits.

The Kyoto Protocol, created in 1997, had a first target phase spanning 2008–2012, during which the treaty imposed binding annual greenhouse gas emission targets for nearly 40 countries. China, the world’s biggest greenhouse gas emitter, has refused to be bound under the Kyoto process, and like other developing nations, its efforts to cut emissions are voluntary. The Doha round agreed on drafting a new global climate treaty by 2015 that would come into force in 2020 when the Kyoto treaty expires. The new treaty would also bind developing nations to emission targets. The US, the biggest greenhouse gas producer in the industrialised world, has never ratified the Kyoto Protocol.

CO₂ emissions of select countries in 2005 and 2010, as well as 2008–2012 targets under Kyoto treaty, billion tons

Source: UNFCC, IEA.
China

**Capital investment and private consumption doing more to support Chinese economic growth, export industries struggle.** After a modest pick-up in September and October, growth in Chinese exports fell to 3% y-o-y in November on an accelerating decline in exports to Europe and as a new feature a contraction in exports to the US and Japan. The value of imports was unchanged from a year earlier, due in part to lower global commodity prices.

Domestic demand increasingly supports Chinese economic growth. Capital investment was up in January-November by about 20% from the same period in 2011. Real growth in retail sales of 13% y-o-y signalled that the robust growth in private demand continues. While higher food prices pushed 12-month inflation up to 2%, inflation still presents little threat to the rise in real consumer purchasing power.

Growth in industrial output accelerated in November to 10% y-o-y. Production of electricity and passenger cars was up 8% y-o-y, while metal production clearly exceeded the average 10% growth rate. In addition to strong retail sales, the services purchasing manager index indicated that growth in the service sector remains robust.

**China and South Korea build on yuan-won swap arrangement to boost bilateral trade.** South Korea and China agreed at the start of this month on increasing the use of their national currencies in bilateral trade. Already earlier, the central banks of China and South Korea established a nearly $60 billion currency swap arrangement, and now this facility will be used to promote the use of national currencies in trade between the two countries. Over the next two weeks, South Korea’s central bank will begin to give Korean banks access to yuan-denominated loans to use in financing imports from China. Correspondingly, the People’s Bank of China will grant won-denominated loans to Chinese companies to help finance their activities in South Korea.

Despite substantial bilateral trade between China and South Korea, virtually all earlier trade has been paid for in currencies other than won or yuan. The move will not only help companies reduce exposure to currency risk, currency conversion costs and vulnerability to financial shocks, it will also promote international acceptance of both currencies. South Korea went into the swap arrangement originally to support liquidity in its financial system during the global financial crisis. China has used the swap arrangement to strengthen the yuan’s position and support Chinese exports.

**China drops in corruption perception index.** At the beginning of December, Transparency International (TI) released its annual Corruption Perception Index (CPI) ranking. The 2012 CPI covers 176 countries, and scores public sector corruption from 0 (absolutely corrupt) to 100 (very clean). This year, about two-thirds of the countries surveyed had CPI scores below 50, suggesting serious corruption problems are fairly ubiquitous. The least corrupt countries included the Nordic countries and New Zealand, while the most corrupt countries were led by Afghanistan, North Korea and Somalia.

China’s CPI score of 39 lowered it five places from 2011 to 80th place. Even with a drop in the rankings, China’s public sector corruption was still less of a problem than in India or Russia. India’s rank in 94th place was unchanged from last year, while Russian climbed ten notches to 133rd place.

TI has revised its index calculation methods, making comparison with earlier years difficult. Nevertheless, it is clear that the Chinese have become more concerned about corruption in recent years. In October, a Pew Research Center released a China survey as part of its Global Attitudes Project that found half of its Chinese interviewees consider corruption a “very big problem.” Four years ago, the same survey found that only 39% of Chinese saw corruption as a major problem. Revelations and public discussion of financial abuses by public officials and politicians in the last six months have brought the issue of corruption to centre stage.

Corruption thrives in environments with vague or complex administrative practices that impede business operations. In the scatter chart below, the x-axis indicates the country’s ranking in TI’s Corruption Perception Index and the y-axis shows each country’s ranking in the IFC and World Bank’s Doing Business 2013 survey. The data reflect 2012 reporting.

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**2012 corruption and business environment rankings**

**Sources:** Doing Business 2013, Transparency International and BOFIT
Russia

United States normalises trade relations with Russia. On December 7, president Barack Obama signed the repeal of the Jackson-Vanik amendment, a Cold War vestige that denied Russia permanent most-favoured nation status in trade with the US for its human rights violations. Trade has been carried out on the basis of annual MFN-decisions by the US government. Denial of most-favoured nation trading status to another WTO member, however, is a violation of WTO rules. Thus, the US had to dismantle the Jackson-Vanik regime for US firms to benefit fully from Russia’s recent WTO membership, including the possibility of taking trade disputes with Russia to WTO arbitration.

Rolled into the legislation signed by Obama, however, was a second part known as the Magnitsky Law, named after lawyer Sergei Magnitsky who died in Russian prison in 2009. It forbids granting US visas to Russians involved in human rights violations. In response, the Duma is considering a bill to deny visas and economic relations for US citizens that have violated Russian rights.

Government approves a programme to boost stock of affordable housing. On November 30, the government approved its latest programme on housing and municipal utilities running through 2020. The plan is to increase the amount of annual housing production by 50 % over the next eight years, from 63 million m² this year to 92 million m² in 2020. Hitting that target will require growth of about 5 % a year. The new goal is far less ambitious than the previous two housing programmes’ targets (80 million m² a year in 2010 and 90 million m² in 2015). Both targets proved unachievable due e.g. to the recession.

The programme calls for fulfilling the volume target by nearly doubling affordable “economy class” housing production during 2013–2020. The needed land is provided by the federation. The mass construction is to help subdue the rise in prices of new houses to a pace much below the pre-crisis years when the economy was booming.

Russia’s current residential housing stock constitutes about 3.3 billion m² of floorspace, which works out to 23 m² per capita. The housing programme seeks to boost the amount of per capita living space to 28–35 m² by 2020. In most advanced European economies, the amount of living space is about 35–45 m² per person.

The estimated regional budgets for housing and municipal services should rise by about 50 % in nominal terms by 2020. Financing indicated in the programme covers only part of the expenditure to the sector. For example, the programme projects spending of 315 billion rubles (nearly $8 billion) next year. In contrast, total 2011 housing investment in Russia was almost 1.6 trillion rubles.

The number of publicly subsidised housing loans is to increase by about a third from the current 650,000. To support the growth in housing loans, Russia’s state-owned mortgage agency will provide more loan guarantees. Real interest rates on housing loans should fall from the current 5–6 % p.a. to 2 % by 2018. Builders and remodelers will be eligible for tax breaks on certain conditions.

Housing completions 1993–2011, million m² of floorspace

Source: Rosstat

Russia rolls out new anti-corruption laws. At the start of 2013, a new law goes into force under which state officials and their family members must declare spending and sources of funds when their spending exceeds reported income. Officials are already required to declare all income. Another bill currently being drafted would ban officials from owning assets abroad. The bill is intended to limit abuses of public officials. Surveys have found that Russians see corruption as one of the country’s biggest problems, but most also see eliminating corruption impossible.

Russia’s Investigative Committee, which looks into alleged instances of corruption, reports that this year it received over 30,000 reports of corruption during January-September, an increase of 20 % from a year earlier. About half of the reports led to criminal investigations. The council estimates that just the investigated cases involved about 8 billion rubles ($200 million) in losses to society. Russian NGOs Indem and the Association of Russian Lawyers for Human Rights estimate that corrupt and illegal activities in recent years account for 30–50 % of GDP.

The larger cases of corruption are related to business. According to the World Bank, e.g. one in five companies participating in public procurements are required to pay kickbacks to officials. The average kickback was valued at around 2.5 % of each procurement.

Russians encounter corruption in their daily lives. A survey last year by Indem for the economy ministry found that every other Russian has encountered corruption when dealing with public officials. Most frequently mentioned motivation for bribing is getting the officials to perform their regular tasks and often people are aware of the bribing motivation. Surveys have found that Russians see corruption as one of the country’s biggest problems, but most also see eliminating corruption impossible.
China

No surprises at Economic Work Conference. The Central Economic Work Conference for 2013 was held December 15–16 in Beijing. Its themes were familiar: China’s needs to shift growth model, deal with migration to cities and stick with structural reform programmes. Current problems in export markets underline the need to change the growth model so that domestic demand will play a bigger role in the future. However, the change from investment-driven growth to consumption-driven growth remains slow. As urbanisation will continue to be an important part of the government’s growth strategy, investments in infrastructure will remain high.

True drivers of these structural changes are economic reforms that aim at opening up the Chinese economy and increasing the competitiveness of sectors currently dominated by state enterprises. In this respect, the Work Conference gave promising signals. News agency Xinhua reported conference participants wanted to see “greater political courage” in reform policies. With urbanisation topping the agenda, the National Development and Reform Commission (NDRC) has already proposed to speed up reform of the hukou household registration system.

The conference release stated “proactive fiscal policies and prudent monetary policy will continue in 2013,” which only indicates that authorities will react when the economic situation demands. Several news outlets reported that the government has set the GDP growth target at 7.5 % also for 2013. Most experts are forecasting actual GDP growth of 8 % next year. The inflation target has been lowered from 4 % in 2012 to 3.5 % in 2013. November inflation was 2 %.

The incoming government should soon announce the nominations of the new central bank governor and other important top leadership appointments.

Chinese university puts national unemployment rate at 8 %. Early this month, Southwestern University of Finance and Economics (SWUFE) in the city of Guanghua, released the findings of its summer survey of 5,000 urban households throughout China. The survey put China’s unemployment rate at 8 %. A similar SWUFE survey in summer 2011 estimated the unemployment rate at 7.5 % at the time. The survey findings were in line with those of a 2008 China Academy of Social Sciences (CASS) survey that put the unemployment rate at 9 %.

The new survey found that those with university degrees had the easiest time finding work, with unemployment for this group below 4 %. For 26 to 40-year-olds, the unemployment rate was 5–6 %, while for those over 50, the rate was 16 %. Unemployment among people under 26 was nearly 10 %, but the figure may exaggerate the situation as the survey coincided with summer, when millions of students graduate and start looking for jobs.

The SWUFE findings are notable in light of the poor quality of China’s official unemployment figures. The National Statistics Bureau only publishes the number of people registered as unemployed. The figure of 4.1 % of the labour force has stayed about the same for the past three decades. The biggest drawback of the official figures is that they omit unemployed who see no benefit in registering and the entire plethora of migrant workers.

SWUFE ambitions include shifting to quarterly surveys, yet it is unclear how willingly officials will tolerate regular and comprehensive informal estimates of politically sensitive issue. On the other hand, the unofficial survey gives officials motivation to develop their methods to improve the accuracy and reliability of official assessments.

Record number of patent applications submitted to China’s patent office in 2011. Figures released by the UN’s World Intellectual Property Organisation (WIPO) show that China’s state IP office (SIPO), took in the most patent applications globally in 2011. In addition to China, only patent offices of the United States, Japan and Germany have held the top position over the past century.

Despite economic difficulties, the number of patent applications submitted climbed over 8 % last year to over 2 million applications. More than 526,000 patent applications were submitted in China, a rise of 35 % y-o-y. SIPO’s share of total patent applications has increased 10 percentage points over the past three years to the current 25 %.

Nearly 80 % of SIPO’s patent applications came from China-registered applicants. Actually, Chinese entities have so far focused applying domestic patents and are not too active in other countries. When total patent applications to all patent offices in the world are considered, Japanese patent-seekers submit the most applications.

About a million patents were granted globally in 2011, an increase of 12 % from 2010. The number of patents granted by SIPO has risen faster than the growth in patent grants overall, but the number of granted patents still lags Japan and the US patent offices.

While there are problems with patent statistics, nobody disputes that Chinese firms are taking greater initiative in protecting their intellectual property. The attention of the Chinese to IP issues is welcome as it signals more interest in systems of enforcement which means also foreign firms should in the future find it easier to protect their IP in China. China’s interest in IP also reflects the rising technical sophistication of Chinese firms. As to international patent applications (PCT) in 2011, the top and third highest numbers of patent filings were submitted by the Chinese telecom giants ZTE and Huawei.
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