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BOFIT Weekly – Russia headlines 2006

5.1.2006 BOFIT Weekly - Russia 1/2006

- Russia and Ukraine agree on natural gas supplies and transit fees.
- Growth in domestic demand accelerated in 3Q05.
- Balance-of-payments figures show large current account surplus, increased financial flows.
- Russian companies further increased foreign borrowing.

13.1.2006 BOFIT Weekly - Russia 2/2006

- Russian inflation slowed towards the end of last year.
- Government approves 2006–2008 economic program.
- Little change in structure of 2006 federal budget from 2005.

20.1.2006 BOFIT Weekly - Russia 3/2006

- Economy ministry forecasts mild slowdown in economic growth during next three years.
- Gazprom's soaring market cap now puts it among the world's top ten companies.
- Finnish investment in Russia on the rise.
- 2006 Index of Economic Freedom.

27.1.2006 BOFIT Weekly - Russia 4/2006

- Russian industrial output up 4 % in 2005.
- Rouble's exchange rate strengthened slightly in 2005.
- Rules tightened on foreign listing of Russian firms.
- Sales of imported cars soar.
- Gazprom and Moldova reach short-term agreement on natural gas prices.

3.2.2006 BOFIT Weekly - Russia 5/2006

- Russian construction, retail trade and services boomed in 2005.
- Budget surplus and stabilisation fund expanded rapidly in 2005.
- Oil production posted modest growth last year.
- Sharp hike in housing costs.

10.2.2006 BOFIT Weekly - Russia 6/2006

- On-year inflation in Russia slowed a bit in January.
- Russian economy expanded 6.4 % in 2005.
- Industrial producer prices down in late 2005.
- Growth in Russian natural gas output slowed in 2005.

17.2.2006 BOFIT Weekly - Russia 7/2006

- Rapid climb in oil and gas prices boosts value of Russian goods exports in 2005.
- Russia proposes another early payment of Paris Club debt at G8 meeting.
- Agriculture posts low growth for 2005.
- Raiffeisen Bank set to become biggest foreign bank presence in Russia.

23.2.2006 BOFIT Weekly - Russia 8/2006

- Russian retail sales continue to grow rapidly in January.
- Growth in wages and pensions accelerated in 2005.
- Central Federal District continues to top the nation in production and consumption.
- Russia's bilateral WTO negotiations with the US continue.

3.3.2006 BOFIT Weekly - Russia 9/2006

- Russian rapid economic expansion should continue.
- Foreign investment continued to pour into Russia last year.
- Housing prices continued to climb in 2005.
- Growth in bank deposits and credit accelerated in the second half of 2005.
- New limits on duty-free goods into Russia.
- Population declined in 2005.

10.3.2006 BOFIT Weekly - Russia 10/2006

- Russian inflation accelerates in February.
- Russia was Finland's top export destination last year.
- Finland recorded strong increase in passenger car transit to Russia last year.
- Efforts to boost housing construction.

17.3.2006 BOFIT Weekly - Russia 11/2006

- Russian investment focus shifted in 2005.
- Booming banking sector growth in 2005.
- Western creditors petition for Yukos bankruptcy.
- Russian billionaires saw their assets double last year.

24.3.2006 BOFIT Weekly - Russia 12/2006

- Sharp rise in Russia's consolidated budget surplus for 2005.
- Largest share of investment went to Central Federal District in 2005.
- G8 energy ministers meet in Moscow.

31.3.2006 BOFIT Weekly - Russia 13/2006

- Strong growth in Russian retail sales continues.
- Russia drops export revenue conversion requirement and cuts deposit requirements for securities investments.
- Regional budgets end 2005 slightly in surplus.
- No progress in WTO membership talks.

7.4.2006 BOFIT Weekly - Russia 14/2006

- Russian current account surplus grew in 2005; higher financing flows.
- Russian inflation down slightly in March.
- Corporate borrowing from abroad continued to rise in late 2005.
- Stock market volatility.

13.4.2006 BOFIT Weekly - Russia 15/2006

- Rosstat releases Russian fourth quarter GDP figures and adjusts quarterly numbers back to 2003.
- Rouble up in first quarter.
- Proposal on investing stabilisation fund assets abroad.
- Euromoney and Institutional Investor release country-risk polls.

21.4.2006 BOFIT Weekly - Russia 16/2006

- Moderate growth of industrial output continues in Russia.
- Federal budget revenues and expenditures up in first quarter.
- Public sector budget plan for 2006-08.
- Number of civil servants in Russia continues to rise.

28.4.2006 BOFIT Weekly - Russia 17/2006

- Russian first quarter GDP growth slightly slowed.
- Stabilisation Fund assets may be invested in foreign government bonds and currencies.
- Industrial producer prices climbed rapidly in the first quarter.
- Russia responds to EU energy security worries.

5.5.2006 BOFIT Weekly - Russia 18/2006

- IMF raises its economic growth forecast for Russia.
- Rapid wage growth continued in first quarter.
- Incremental system for Russian mineral resource extraction taxes proposed.
- Minimum charter capital for new banks raised to €5 million.
- Sales of mobile phones and subscriptions cooled in first quarter.

12.5.2006 BOFIT Weekly - Russia 19/2006

- Russian inflation drops below 10 % in April.
- Russia's foreign currency reserves continue to swell.
- Energy companies continue to drive the RTS index.
- Putin’s annual state-of-the-nation address stresses declining population and national security.

19.5.2006 BOFIT Weekly - Russia 20/2006

- Rapid growth in Russian foreign trade continues.
- End of foreign currency controls expected to have little impact on rouble exchange rate.
- Putin launches anti-corruption campaign at Federal Customs Service.
- Putin proposes measures to counteract Russia’s population decline.

29.5.2006 BOFIT Weekly - Russia 21/2006

- Russian production growth accelerated slightly in April.
- FDI inflows to Russia double.
- Russian stocks track movements on other exchanges.
- Government frames 2007–2009 tax policies.
- Residents paying more and more of the costs of housing.

2.6.2006 BOFIT Weekly - Russia 22/2006

- Finance ministry issues guidelines on investment of stabilisation fund assets.
- Yukos sells off majority stake in Mazeikiu Nafta.
- Steelmakers Severstal and Arcelor to merge.
- Russian and EU leaders meet in Sochi.
- Small and medium-sized Finnish firms active in exports to Russia.

9.6.2006 BOFIT Weekly - Russia 23/2006

- Russian inflation further down in May.
- Putin gives annual budget address.
- Putin unexpectedly sacks chief prosecutor.
- Finland-Russia trade and freight transit to Russia via Finland continue to boom.

16.6.2006 BOFIT Weekly - Russia 24/2006

- Modest adjustments to Russia's growth outlook.
- CBR increases euro's share in foreign currency reserves.
- Services trade continues to grow.
- Reform of electricity sector continues.
- G8 finance ministers meet in St. Petersburg.

22.6.2006 BOFIT Weekly - Russia 25/2006

- Rosstat releases first quarter GDP figures.
- Increase in foreign bank presence partly illusory.
- International carmakers rush to Russia.
- St. Petersburg hosts tenth economic forum.

30.6.2006 BOFIT Weekly - Russia 26/2006

- Production growth accelerated in May.
- Russia to pay off Paris Club debts.
- Government approves changes to main parameters of 2007 federal budget.
- Head prosecutor and justice minister switch jobs.
- CBR tweeks key rates.
- Nordea divests stake in International Moscow Bank.

7.7.2006 BOFIT Weekly - Russia 27/2006

- Russia posts record current account surplus in the first quarter.
- GDP demand components see some changes in the first quarter.
- Currency controls on the rouble abolished.
- Russia and Paris Club sign deal on debt repayment.
- Ukraine and Moldova sign gas delivery contracts with Gazprom.

14.7.2006 BOFIT Weekly - Russia 28/2006

- Russian inflation continues to slow.
- Mild rouble appreciation in second quarter.
- IMF mission concerned about growth in Russian budget spending and slowness of economic reforms.
- Parliament approves bill on natural gas export monopoly.

21.7.2006 BOFIT Weekly - Russia 29/2006

- Industrial output climbs 4.4 % in 1H06.
- Federal budget posts first-half surplus.
- Duma approves increase in deposit insurance coverage.
- Energy security discussed at the St. Petersburg G8 summit.
- Rosneft lists on Moscow and London exchanges.

28.7.2006 BOFIT Weekly - Russia 30/2006

- Economic growth in Russia accelerated in second quarter.
- Producer prices continue to rise rapidly.
- Fitch raises Russia's creditworthiness a notch.
- Shareholdings from Finland to Russia triple.
- Russia makes early repayment of its Soviet-era debts to Finland.
- CIS cooperation at the crossroads.

4.8.2006 BOFIT Weekly - Russia 31/2006

- Investment of Russia's stabilisation fund assets begins.
- Finance sector pays best in Russia.
- Yukos declared bankrupt.
- Housing prices continue to soar.
- Quiet launch for oil trading on Moscow RTS exchange.
- Duma has productive legislative session ahead of summer vacation.

11.8.2006 BOFIT Weekly - Russia 32/2006

- Russian inflation holds steady in July.
- Metal sector grows in the first half.
- Investment commission approves first projects to be financed from Federal Investment Fund.
- Number of unemployed up slightly in 2Q06.
- US-Russia relations strained.

18.8.2006 BOFIT Weekly - Russia 33/2006

- Russian foreign trade expanded rapidly in the first half.
- Economy ministry raises GDP growth forecast.
- Oil production continues to grow slowly.
- Foreign investment in Russia sees strong growth in the first half.
- Russia makes final settlements of Paris Club debt.

25.8.2006 BOFIT Weekly - Russia 34/2006

- Russian retail sales and construction lead growth in January-July.
- Central and Northwestern Federal Districts lead industrial output growth in first half; retail sales up strongly nationwide.
- Rapid growth in banking sector continued in first half.
- Volume of car imports passing through Finland to Russia continues to rise.

1.9.2006 BOFIT Weekly - Russia 35/2006

- 2007 federal budget submitted to Duma.
- Central bank increases reserve requirement of credit institutions.
- Russia's forest sector experiencing mild growth.
- Aircraft builders consolidate into new giant.
- Three-way merger in aluminium sector underway.

8.9.2006 BOFIT Weekly - Russia 36/2006

- BOFIT raises its forecast for Russian growth.
- Russian inflation exceeds expectations in August.
- Standard & Poor's surprises markets with BBB+ upgrade in Russian credit rating.
- Further deregulation of Russia's electricity sector.
- Over half of foreign investments went to the Central Federal District in 1H06; fixed capital investment spread fairly evenly across entire country.

15.9.2006 BOFIT Weekly - Russia 37/2006

- Russian GDP growth accelerates.
- Russia continues to post a huge federal budget surplus.
- Turkmenistan negotiates higher price for natural gas sold to Gazprom.
- Grain harvest estimation raised.
- World Bank survey finds only slight improvement in Russian business environment.

22.9.2006 BOFIT Weekly - Russia 38/2006

- Russian industrial output growth accelerated in August.
- IMF revises upwards its forecast for Russian economic growth.
- Russia strengthens banking supervision and fight against financial crime following assassination of central banker.
- Sakhalin-2 oil and gas project hits resistance; natural resources minister cancels environmental permit.
- Government approves 2007 privatisation plan.

29.9.2006 BOFIT Weekly - Russia 39/2006

- Russian core production sectors up 5.3 % y-o-y in August.
- Duma approves 2007 budget in first reading.
- Oil export taxes raised.
- Cabinet suggests easing rules on foreign ownership of shares in Russian banks.
- New legislation on intellectual property rights.
- Gennady Melikyan heads Banking Supervision Committee.
- Russia and China lose ground in competitiveness survey.

6.10.2006 BOFIT Weekly - Russia 40/2006

- Russia’s public consumption up in the second quarter.
- Russian labour productivity lags growth in real wages.
- Government presents plan for reasonable buy-out pricing of commercial lots.
- Société Générale increases its stake in Rosbank.
- Stock of Finnish direct investment in Russia and China continues to increase.

13.10.2006 BOFIT Weekly - Russia 41/2006

- Russian inflation slows slightly in September.
- Russian oil industry continues to suffer from low refining efficiency
- Gazprom to develop massive Shtokman gas field without foreign partners.
- Aluminium producers merge.
- Nordea sells its stake in International Moscow Bank.

20.10.2006 BOFIT Weekly - Russia 42/2006

- Russia posts yet another current account surplus in 1H06.
- Government accepts proposal on nuclear power industry development.
- Growth in industrial production slowed in September.
- Euromoney and Institutional Investor release their semi-annual country-risk assessments.

27.10.2006 BOFIT Weekly - Russia 43/2006

- Retail sales and construction lead Russian GDP growth.
- Stabilisation fund assets converted to foreign currencies.
- CBR lowers key interest rates.
- Rosneft and CNPC establish joint venture.
- Fortum increases investment in Russia.
- Russia and Ukraine agree on 2007 natural gas price.
- Russian housing market takes off.

3.11.2006 BOFIT Weekly - Russia 44/2006

- Russian foreign investment flows nearly in balance.
- Little change in structure of manufacturing industries.
- Experts see huge potential in Russian gas industry waste.
- Big earnings differences among Russian cabinet members.

10.11.2006 BOFIT Weekly - Russia 45/2006

- Russian inflation slowed further in October.
- CBR publishes next year's monetary policy guidelines.
- IMF board's Article IV concluding statement focuses on fiscal policy and inflation fighting.
- Third reading of new Forest Code sails through Duma.
- Nordea buys majority stake in Orgresbank.

17.11.2006 BOFIT Weekly - Russia 46/2006

- Robust foreign trade growth continues in Russia.
- Russian metal producers launch IPOs on the London stock exchange.
- NATO says Russia attempting to establish an international gas cartel.
- Plenty of room for improving economic freedom in Russia and China.

24.11.2006 BOFIT Weekly - Russia 47/2006

- Duma moves ahead on 2007 budget and 2006 supplemental budget.
- United States removes last major hurdle to Russia's WTO membership.
- S&P sees slight improvement in bank transparency.
- Norilsk Nickel buys large nickel unit in Finland.
- Russian corruption still at 1999 level.

1.12.2006 BOFIT Weekly - Russia 48/2006

- Russia's GDP growth accelerates.
- Grain harvest nearly matches 2005 level.
- EU and Russia agree on Siberian overflight fees.
- CIS president summit yields few overall results; focus on bilateral discussions.
- OECD sees oil prices and structural reform as the largest challenges facing Russia.

8.12.2006 BOFIT Weekly - Russia 49/2006

- Falling oil prices help control Russian inflation.
- Duma approves 2007 federal budget bill.
- Russian investment abroad matches investment flows into Russia.

15.12.2006 BOFIT Weekly - Russia 50/2006

- Russian GDP increased 6.7 % in January-September.
- Producer prices up 8 % in October.
- Government decides domestic rate policies for electricity and gas.
- EBRD: Russia still in mid-transition to market economy.

22.12.2006 BOFIT Weekly - Russia 51-52/2006

- Rouble deposits rising faster than cash in circulation.
- Relaxation of bank ownership rules for foreigners.
- Russia still Finland's leading source of imports.
- Russian companies expand abroad.
- Russia wants out of production-sharing deals.

BOFIT Weekly – China headlines 2006

5.1.2006 BOFIT Weekly - China 1/2006

- China's forex markets continue to evolve.
- Revised corporation and securities laws enter into force.
- China's foreign debt modest, but climbing.
- Massive subsidy to Sinopec adds to pressures to change energy pricing.

13.1.2006 BOFIT Weekly - China 2/2006

- China revises output figures for 1993–2004.
- PBoC announces 2006 monetary targets.
- US and EU raise textile and clothing quotas as agreed.
- Trade surplus triples in 2005.
- Improved grain harvest in 2005, agriculture tax eliminated.

20.1.2006 BOFIT Weekly - China 3/2006

- Foreign trade surplus swells China's foreign currency reserves.
- Faster-than-expected rise in tax revenues in 2005.
- Citigroup acquisition of majority stake in Guangdong Development Bank awaits government approval.
- China increases its oil holdings in Africa; India seeks cooperation in securing energy supplies.

27.1.2006 BOFIT Weekly - China 4/2006

- China releases 2005 economic numbers.
- Wen warns of increased rural unrest.
- China and Saudi Arabia agree on energy cooperation.

3.2.2006 BOFIT Weekly - China 5/2006

- Growth in Chinese oil imports slowed substantially in 2005.
- Government moves to resolve wage payment disputes.
- Share markets open up further to foreign investors.
- China's largest bank ICBC sells a stake to western financial consortium.

10.2.2006 BOFIT Weekly - China 6/2006

- Unofficial lending a widespread phenomenon in China.
- Non-performing loan problem persists.
- China establishes personal credit registry.
- China rises into the top ten in patent activity.

17.2.2006 BOFIT Weekly - China 7/2006

- Chinese foreign trade surplus continues strong in January.
- Brisk auto sector growth in 2005.
- US demands that Chinese live up their WTO commitments.
- Slight appreciation of yuan against the dollar.

23.2.2006 BOFIT Weekly - China 8/2006

- Slight pickup in Chinese money supply growth and consumer prices in January.
- EU considering import tariffs on China-made footwear.
- China adopts international accounting system.
- Hong Kong economy boomed in 2005.

3.3.2006 BOFIT Weekly - China 9/2006

- China eases capital export rules further to counteract yuan appreciation pressures.
- State enterprises posted record profits in 2005.
- Rise in housing prices slowed last year.
- IMF emphasises the role of Mainland China's economic development on the Hong Kong economy.

10.3.2006 BOFIT Weekly - China 10/2006

- NPC makes improvement of rural conditions its top theme.
- Latest five-year plan has few hard economic targets.
- 2006 budget released.
- February PMI anticipates steady growth.

17.3.2006 BOFIT Weekly - China 11/2006

- China's National People's Congress wraps up.
- Chinese consumer price inflation slows in February, pace of producer price inflation remains unchanged.
- China battles trade policy disputes on several fronts.

24.3.2006 BOFIT Weekly - China 12/2006

- Chinese foreign trade surplus climbed in January-February.
- Robust January-February figures for industrial output, retail trade and investment.
- Energy tops agenda during Putin's China visit.

31.3.2006 BOFIT Weekly - China 13/2006

- European Union rules on anti-dumping tariffs for Chinese leather footwear.
- Yuan makes only minor gains ahead of president Hu's visit to the US.
- Fuel prices go up.

7.4.2006 BOFIT Weekly - China 14/2006

- China's currency reserves now largest in the world; yuan appreciates against the dollar.
- China's foreign debt still relatively small.
- Direct Japanese investments in China up in 2005 despite political tensions.
- Macao's economic growth figures return from the stratosphere.

13.4.2006 BOFIT Weekly - China 15/2006

- China posts huge trade surplus in March.
- Business confidence indicators suggest belief in continued rapid growth.
- Which Chinese firms have the best shot at international dominance?

21.4.2006 BOFIT Weekly - China 16/2006

- China's strong economic growth continued in the first quarter.
- China further eases capital controls.
- Foreign direct investment in China remains sizeable.
- China pursues engaged foreign policy in the South Pacific and Cambodia.

28.4.2006 BOFIT Weekly - China 17/2006

- China's inflation rate continues to fall despite rapid money supply growth.
- Industry profits continue to impress.
- No new initiatives during president Hu's visit to the US.
- EU-China relations top agenda of Finnish prime minister's China visit.

5.5.2006 BOFIT Weekly - China 18/2006

- China raises key interest rates to quell credit and investment growth.
- Outside estimates put true size of non-performing loan stock well above official figures.
- China's current account surplus reached $160 billion in 2005.

12.5.2006 BOFIT Weekly - China 19/2006

- Chinese share prices up sharply since start of year.
- IMF expects China's growth to continue.
- Supervision of intellectual property rights remains insufficient.

19.5.2006 BOFIT Weekly - China 20/2006

- US treasury department criticises China's foreign exchange policy, but refrains from taking tougher line.
- China's foreign trade surplus and FDI inflows continue to rise.
- Low inflation, high money supply growth.
- Doubts continue over actual size of non-performing loan stock.

29.5.2006 BOFIT Weekly - China 21/2006

- Rapid growth in China's fixed investment and industrial output continued in April.
- Minimum wage raised in Pearl River Delta region.
- Moratorium on IPOs lifted.
- Officials reject sale of majority stake in Chinese bank.

2.6.2006 BOFIT Weekly - China 22/2006

- Highest investment growth in inland China.
- Further hikes in fuel prices.
- Hong Kong bourse hosts Bank of China IPO.
- Robust economic growth in Hong Kong and Macao SARs.

9.6.2006 BOFIT Weekly - China 23/2006

- China vows to continue with reform policies.
- New crude oil pipeline from Kazakhstan goes on stream.
- Authorities struggle to cool real estate sector.

16.6.2006 BOFIT Weekly - China 24/2006

- China's money supply growth accelerated in May; inflation remains modest.
- Industrial output growth surprisingly stable even as many sectors suffer from overcapacity.
- Rapid growth of foreign trade surplus.
- Government's cash holdings to be better invested.

22.6.2006 BOFIT Weekly - China 25/2006

- China's central bank raises reserve requirement; investment growth still on fire.
- Participants agree to broaden cooperation at meeting of Shanghai Cooperation Organisation.
- International uncertainty, central bank tightening and IPOs provide exciting times on Chinese bourses.

30.6.2006 BOFIT Weekly - China 26/2006

- Bank inspectors uncover widespread fraud and irregularities at Agricultural Bank of China.
- China Post Savings Bank set to become China's fifth largest bank.
- China revises up figures for GDP and direct investment.
- Law unifying corporate taxation finally set to advance.

7.7.2006 BOFIT Weekly - China 27/2006

- Rapid growth in tax revenues continued in 2005.
- Electricity rates go up.
- New US Treasury Secretary an old China hand.
- Bank of China lists on Shanghai bourse, share prices continue to rise.

14.7.2006 BOFIT Weekly - China 28/2006

- China's monthly foreign trade surplus breaks record in June; credit growth remains strong.
- Chinese oil companies invest in Russian oil producers.
- China's steel industry streamlines.

21.7.2006 BOFIT Weekly - China 29/2006

- China's rapid GDP growth raises concerns about economic overheating.
- Money supply growth slowed in June, consumer price inflation remains low.
- Plans to issue yuan bonds in Hong Kong.
- First direct air cargo flight between Taiwan and the mainland.

28.7.2006 BOFIT Weekly - China 30/2006

- China's central bank continues to tighten monetary policy.
- Chinese industrial profits continue to grow, but are concentrated in a handful of sectors.
- Slow yuan appreciation since one-time revaluation.
- Chinese exports to Finland expand rapidly.

4.8.2006 BOFIT Weekly - China 31/2006

- S&P boosts China's credit rating.
- China issues first licenses for new QDII scheme.
- New rules on land sales enter into force.
- Rising incomes and larger income disparities.

11.8.2006 BOFIT Weekly - China 32/2006

- Trade surplus swells; PBoC hints it may allow further yuan strengthening.
- Consolidation in the steel industry continues.
- Mood on Chinese stock markets turns cautious.

18.8.2006 BOFIT Weekly - China 33/2006

- July economic growth in China slightly off first-half pace.
- Despite strong money supply growth, inflation remains low.
- Poor China-Japan political relations strain development of energy resources in South China Sea.

25.8.2006 BOFIT Weekly - China 34/2006

- China's central bank continues monetary tightening, interest rates hiked for second time this year.
- Expanding steel production reflects in the size of steel producers.
- Official figures show stock of non-performing loans has stabilised, but analysts sceptical.
- China seeks to become a major car exporter.

1.9.2006 BOFIT Weekly - China 35/2006

- China's dependence on oil imports grows as search for new oil suppliers intensifies.
- China adjusts 2005 GDP growth upwards to 10.2 %.
- China finalises new bankruptcy law.
- Hong Kong and Macao continue rapid growth and integration with Mainland China.

8.9.2006 BOFIT Weekly - China 36/2006

- Yuan exchange rate dips below 7.95 to the dollar.
- China further tightens control over real estate sector.
- Electrical power shortages plague China again this summer.
- Asian Development Bank sees strong Asian growth.

15.9.2006 BOFIT Weekly - China 37/2006

- IMF optimistic about China's economic prospects.
- China posts record trade surplus in August.
- Helsinki summits' biggest achievements: climate change declaration and launch of drafting of a new EU-China framework agreement.

22.9.2006 BOFIT Weekly - China 38/2006

- Prices continue to rise slowly; moderation in growth of money supply.
- Economic data weaken slightly in August.
- China cuts exports subsidies.
- China's growing role at the IMF.

29.9.2006 BOFIT Weekly - China 39/2006

- Paulson completes successful China visit; yuan keeps on rising.
- China becomes world's third-largest carmaker; fight on car parts goes to the WTO.
- Shanghai pension fund scandal widens.

6.10.2006 BOFIT Weekly - China 40/2006

- EU extends anti-dumping duties on leather shoe imports from China for two more years.
- China makes progress in bilateral talks on free trade.
- Over 2,000 state-owned enterprises temporarily exempt from new bankruptcy law.
- Chinese companies engage extensively in bribery when doing business abroad.

13.10.2006 BOFIT Weekly - China 41/2006

- Japan's new prime minister meets Chinese leaders.
- China releases first half balance-of-payments data.
- Rapid growth in foreign trade surplus.
- China begins filling its strategic oil reserves.

20.10.2006 BOFIT Weekly - China 42/2006

- Yuan appreciation levels off in October.
- GDP growth remains brisk.
- Foreign direct investment to China remains strong.
- Despite safeguard measures, China's exports of textiles and clothing continue to rise.

27.10.2006 BOFIT Weekly - China 43/2006

- China's money supply growth slows; inflation remains modest.
- Good summer grain harvest.
- Dual listing of ICBC rocks markets.
- Chinese patent activity on the rise.

3.11.2006 BOFIT Weekly - China 44/2006

- EU releases new trade and investment guidelines for China.
- Rural income level only one third of that in urban areas.
- Chinese share prices headed up.
- China tightens laws on money laundering and corruption.

10.11.2006 BOFIT Weekly - China 45/2006

- China continues to tighten monetary policy.
- Foreign currency reserves break trillion-dollar mark.
- China-Africa summit showcases China’s Africa agenda.
- China shifting to liquefied natural gas.
- Corruption remains a huge problem in China.

17.11.2006 BOFIT Weekly - China 46/2006

- Stable price development in China; money supply growth accelerates slightly.
- China posts record trade surplus in October.
- Energy and raw materials dominate Chinese-Russian economic cooperation.

24.11.2006 BOFIT Weekly - China 47/2006

- Hu’s visit to India yields modest results.
- Slight slowing in investment and industrial output growth.
- China’s banking sector opens up.
- Citigroup consortium purchases majority stake in Chinese bank.

1.12.2006 BOFIT Weekly - China 48/2006

- Yuan strengthens further against the dollar.
- Stocks hit record highs.
- China considers raising retirement age.

8.12.2006 BOFIT Weekly - China 49/2006

- China posts huge trade surplus in November.
- China surpasses Japan in R&D spending.
- Rapid economic growth continues in Hong Kong and Macao.

15.12.2006 BOFIT Weekly - China 50/2006

- Higher food prices fuel inflation in November; money supply growth close to target.
- China looks back on five years of WTO membership.
- Stock of non-performing loans unchanged.

22.12.2006 BOFIT Weekly - China 51-52/2006

- China and United States continue to have widely different views concerning pace of yuan's appreciation.
- Growth in industrial output and investment somewhat slower in November.
- Chinese footwear manufacturers haul EU regulators into court.

BOFIT Weekly

1 • 5.1.2006

Russia

Russia and Ukraine agree on natural gas supplies and transit fees. Under the new five-year agreement struck yesterday (Jan. 4), natural gas deliveries to Ukraine will be handled by Swiss-registered RosUkrEnergo, a company jointly owned by Gazprom, Naftogaz Ukrainy, Gazprombank and Raiffeisenbank. RosUkrEnergo will purchase Russian gas from Gazprom at a price of $230 per thousand cubic metres and mix it with cheaper gas from Central Asia. The mixture will cost about $95 per 1,000 m^3 at delivery to the Ukrainian border. The transit fee paid by Gazprom to Ukraine will rise from $1.09 to $1.60 per 1,000 m^3 per 100 kilometres of pipeline.

Gazprom CEO Alexei **Miller** announced the days of barter are over; from now fee payments and gas payments will be in cash. Last week, president Vladimir **Putin**, fed up with the wrangling, proposed his own compromise, whereby Ukraine would continue to pay the previous rate of $50 per 1,000 m^3 price during the first quarter of 2006 and thereafter $230 per 1,000 m^3.

Observers note that Russia has recently been using its vast energy reserves to regain its international clout, e.g. through sharp hikes in natural gas prices charged to former Soviet states. Some analysts believe Russia has lost its political motivation for supporting Ukraine with cheap gas, especially since steel giant Krivorizhstal was transferred to foreign ownership. The company competes heavily with Russian steel producers.

To decrease its dependence on Russian gas, Ukraine last year penned a number of gas delivery contracts with Turkmenistan and other Central Asian countries.

Gazprom natural gas rates by country, US$ per 1,000 m^3

	2005	2006 (preliminary)
Germany	200	
Slovakia, Slovenia	180	
Western Europe	174*	250*
Poland	120	
Turkey	75	
Estonia, Latvia, Lithuania	85–95	120–125
Moldova	80	160
Georgia	68	110
Azerbaijan	60	110
Armenia	56	110
Ukraine	50	95
Belarus	47	47

* Average

Growth in domestic demand accelerated in 3Q05. Rosstat reports GDP growth picked up to 7 % y-o-y in the third quarter of last year, a reflection in part of an increase in fixed capital investment by over 10 %. Growth in private consumption also continued at nearly a 13 % pace. Inventory growth was also brisk. At the same time, the volume of Russian exports of goods and services moderated to 5–6 %. After slowing slightly in the first half of 2005, the growth in imports of goods and services accelerated in the third quarter to more than 20 % y-o-y.

Balance-of-payments figures show large current account surplus, increased financial flows. The Central Bank of Russia reports Russia posted a current account surplus of nearly $63 billion in the first three quarters of 2005. The amount corresponded to 11.5 % of GDP (10 % of GDP in the same period in 2004). The current account balance broke down as follows: there was an increase in the goods trade surplus to 16 % of GDP, the services trade deficit was unchanged (2 % of GDP), and the income balance deficit grew to nearly 3 % of GDP due to increased dividend payments and interest costs.

In the financial account, foreign direct investment inflows into Russia climbed to nearly $20 billion in the first nine months of 2005. The combination of a brisk third quarter and an upwards revision of the first-half figure boosted the FDI inflows to over 3.5 % of GDP. FDI outflows from Russia rose to $8.5 billion and Russian portfolio investment abroad grew to almost $7 billion. The item "non-repatriation of exports proceeds, non-supply of goods and services against import contracts, remittances against fictitious transactions in securities" registered nearly $18 billion in capital outflows. On the other hand, the foreign borrowing of Russian firms and banks was substantial in January-September.

Russian companies further increased foreign borrowing. The combined foreign debt of Russia's public and private sectors as of end-September stood at $228 billion. The amount corresponded to about a third of GDP. The federal government's debt shrank in the third quarter to just over $70 billion, thanks largely to the early repayment of debt owed to the Paris Club of sovereign creditors.

Meanwhile, the foreign indebtedness of companies operating in Russia (excluding banks) continued to increase, standing at over $100 billion as of end-September. The figure was lifted mainly by corporate borrowing, which boosted the credit stock to $78 billion. Bonds issued by the corporate sector on international financial markets further increased their stock of international bonds issued to $10 billion. The foreign debt of banks operating in Russia also increased; as of end-September it was just shy of $44 billion.

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EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly

1 • 5.1.2006

China

China's forex markets continue to evolve. On Wednesday (Jan. 4), the People's Bank of China introduced over-the-counter trading in the inter-bank spot foreign exchange market. The new system will coexist with the earlier centralised electronic price matching trading system in the inter-bank market, which has been dominated by authorities and the state-controlled Bank of China. In addition, the PBoC launched the new market-maker system that should increase market liquidity. At the end of last year, market-maker status was granted to 13 banks, five of which are foreign banks.

Following the changes, the central exchange rate against the US dollar, the euro, Japanese yen and the Hong Kong dollar will be announced at 9.15 am local time, while earlier the central parity for trading was the closing price of the day before. The new rates will be calculated on the basis of exchange rates announced by the market-maker banks. The PBoC does not expect the reform to substantially impact yuan's exchange rate. The daily fluctuation band for the yuan against the US dollar was kept unchanged at ± 0.3 %, while the band against ten currencies of China's other major trading partners still is ± 3 %. The yuan has appreciated about 0.5 % since last July's 2 % revaluation, and started the year at a rate of 8.07 to the dollar. On Wednesday after the new system took force, the yuan strengthened slightly against the dollar.

Revised corporation and securities laws enter into force. Officials expect the major overhaul of company and securities laws to promote the establishment of new businesses, improve corporate governance and develop capital markets. The new corporation act makes it easier to establish a company (e.g. limited companies owned by one person are allowed for the first time). In addition, the minimum initial capital requirement for starting a limited liability corporation has been lowered to 30,000 yuan (3,000 euro), while the lowest minimum rate earlier was 100,000 yuan. Corporate governance of listed companies should be improved by changing shareholder meeting practices and by spelling out independence of management. The overall position of minority shareholders has been improved.

The revised securities law seeks to stimulate development of capital markets by allowing the introduction of new financial instruments. The law also allows more effective measures for dealing with illegal activities in the capital markets. Increased shareholder trust in the capital markets will be promoted through improvements in their legal protections. The new law also covers compensation for losses caused by insider trading and embezzlement. The revised law includes rules on share emissions and listings. The China Securities Regulatory Commission is also expected to soon release new rules that shift e.g. the authority for deciding on whether to list a company or suspend trading in a company's shares from officials to the stock exchange operators.

China's foreign debt modest, but climbing. China's foreign debt stood at $270 billion as of end-September, an increase of 15 % from a year earlier. While the growth in foreign debt slowed slightly compared to all of 2004, short-term foreign debt's share of the debt stock has grown rapidly. As of end-September, it represented 54 % of the entire debt stock. China's total foreign debt is still quite small by international standards, amounting to only about a third of the foreign currency reserves and just under 14 % of revised 2004 GDP.

Massive subsidy to Sinopec adds to pressures to change energy pricing. Strong regulation of retail energy prices causes huge economic policy headaches in rapidly developing China. The most recent example is a state decision to pay state-dominated Sinopec a one-time payment of $1.2 billion to cover its refining losses. Internationally listed Sinopec is China's largest oil refiner. Last year's losses were the result of the squeeze from the over 40 % increase in world oil prices when regulated prices for refined oil products were raised just 16 %.

China's current policy of subsidising cheap energy is inefficient, damaging to the environment and difficult to square with the needs of Chinese corporations seeking to internationalise their operations. Pressure from Chinese oil companies pushed the National Development and Reform Commission to announce last week that energy pricing will gradually become more market-based. Under the new scheme, natural gas pricing will employ a two-tier arrangement, with rates depending on the field of production. The upper-tier price of gas to industry and municipal power stations will go up by $6–18, making the base rate $121 per thousand cubic metres. The NDRC said that prices will be reviewed annually and producers will have the possibility to deviate 8 % from the base price. Lower-tier prices will be raised to the higher-tier level over the next 3–5 years.

The NDRC also announced that coal price controls implemented at the end of 2004 had been lifted and that producers and consumers can now freely agree on prices. The NDRC said that coal supplies have now increased sufficiently to end the controls. Many see the announcement as an admission by the authorities that regulation had so badly distorted the coal market that coal producers could no longer justify selling coal at state-set prices.

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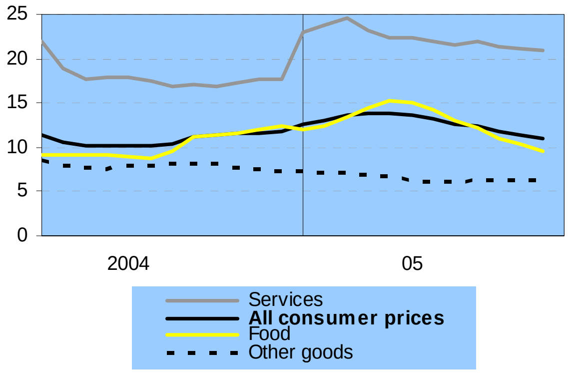
2 • 13.1.2006

Russia

Russian inflation slowed towards the end of last year. On-year inflation was 10.9 % in December. With the inflation rate slowing substantially in late autumn, government measures to reduce consumer price inflation appear to have worked. On-year inflation was within the government's 11 % inflation target for 2005 as updated in October.

Despite a 19 % increase in meat prices, the on-year rise in *food prices* slowed to 9.6 % in December. Inflation for *other goods* was 6.4 %. The price of gasoline climbed 16 %, after shooting up over 30 % in 2004. *Prices of services* were up 21 % y-o-y. Housing (rents and housing-related services) soared around 33 %. The rise in prices of services was generally faster than for goods.

Change in consumer prices, % y-o-y



Source: Rosstat

Government approves 2006–2008 economic program. After a year-and-a-half in preparation, the government approved its 2006–2008 economic program at the end of December. The program focuses on enhancing competitiveness of Russia at the individual, corporate and state levels. The sections of the program include inflation-fighting measures, development of the oil sector (including revision of mineral extraction taxation and related excise taxes) as well as advancing public-private partnerships. The government last year established a special investment fund for such partnership projects. This year, the government will put nearly €70 billion (approx. €2bn) in the fund.

Other program initiatives relate to so called national projects (health care, housing, education and agriculture), promoting innovation, supporting exports, development of land markets and housing finance, as well as reducing bureaucratic red tape.

Little change in structure of 2006 federal budget from 2005. About 80 % of revenues this year are expected to come from export and import tariffs, value-added taxes and natural resource use fees. The biggest spending categories are transfers to the pension fund, defence, transfers to regions and national security. The amount of money from the federal budget to the pension fund has been increased since social tax revenues fell at the start of 2005. Spending shares on defence and national security remain almost unchanged in the budget, but rise in real terms. Transfers to regional budgets this year represent a smaller share of overall spending and GDP, and decline in real terms. President Vladimir **Putin's** priority areas – the national projects in health care, housing, education and agriculture – will be better funded this year. However, direct budget funding of these projects still represents less than 10 % of total federal budget spending. Other funding for the priority projects comes out of transfers to regional budgets.

Russian federal budget for 2006

	2006, RUB bn	**2006, % of GDP**	**2006, %**
Revenues	**5,046.1**	**20.7**	**100.0**
Revenues (excl. social tax)	4,744.0	19.5	94.0
VAT	1,634.3	6.7	32.4
Profit tax	344.8	1.4	6.8
Excise taxes	88.5	0.4	1.8
Resource use fees	753.3	3.1	14.9
Export and import tariffs	1,662.9	6.8	33.0
Expenditures	**4,270.1**	**17.5**	**100.0**
excluding social tax	3,968.0	16.3	92.9
excluding interest payment on debt	4,071.6	16.7	95.4
General administration*	440.4	1.8	10.3
Defence	666.0	2.7	15.6
National security	541.6	2.2	12.7
Production, transport, etc.	339.3	1.4	7.9
Housing	38.9	0.2	0.9
Environment	6.3	0.0	0.1
Education	201.6	0.8	4.7
Culture, media	51.2	0.2	1.2
Health care	149.1	0.6	3.5
Social programs	205.3	0.8	4.8
Transfers to pension fund	873.5	3.6	20.5
Transfers to regions	558.3	2.3	13.1
Surplus	776.0	3.2	

* does not include debt servicing costs for domestic and foreign public debt as in Russian budget classification.

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China

China revises output figures for 1993–2004. The extensive economic census conducted at the start of last year revealed that the earlier methodology of statistics officials had substantially underestimated the contribution of China's service sector. Accordingly, the National Bureau of Statistics has revised the value of China's 2004 GDP upwards by 17 %. The NBS also adjusted the output figures from 1993 forward to conform to the latest estimates of the economy's size and structure. The revision is an attempt to eliminate the cumulative error since 1993; the annual figures are adjusted by making use of a trend deviations method. The GDP series for 1978–1992 were adjusted following a 1992 census of the service sector.

With the adjustments, the average annual real GDP growth in 1993–2004 went up from 9.4 % to 9.9 %. The 2004 real GDP growth figure was lifted from 9.5 % to 10.1 %. These changes are due almost exclusively to adjustments to average growth in the service sector, which increased from 8.6 % to 10.0 %. There were no substantial changes in any other components of GDP. The revised data show the service sector generated about 41 % of GDP in 2004 (compared to 32 % previously). Industry contributed 41 % (46 %), construction 5 % (7 %) and primary production 13 % (15 %).

PBoC announces 2006 monetary targets. As in previous years, the People's Bank of China announced its main monetary policy targets for money supply and credit growth. This year, PBoC's target for broad money supply (M2) growth is 16 %, for narrow money supply (M1) growth 14 % and for yuan-denominated loans growth by CNY 2,500 billion (€250bn). The loan growth target will thus remain unchanged from 2005. The M2 target has been raised a percentage point from last year, while the M1 target has been lowered a percentage point.

M2 growth accelerated in the latter part of 2005, and exceeded 18 % y-o-y at the end of November. The PBoC also adjusted upwards its original target for 2005 to 17 %. High broad money growth has helped sustain high real economic growth without leading to higher inflation. Some observers interpret the still relatively high narrow money growth target for 2006 as a measure to head off deflationary threats. In addition to growth targets, China's central bank wants to implement a more effective mechanism for interest-rate setting during this year.

US and EU raise textile and clothing quotas as agreed. On the cusp of this year, export quotas on Chinese textiles and clothing increased 12.5–15 % to the US and 10–12 % to the EU. The US quotas cover 21 product categories, while the EU quotas affect ten categories. The EU's export agreement entered into force last summer; the US agreement entered into force at the start of this year. The agreed restrictions will continue through to the end of 2007, when, under WTO commitments, the use of safeguard measures to protect domestic producers will no longer be allowed. The limits on exports, however, did not substantially slow the growth of Chinese textile and clothing exports last year, as exports climbed about 20 % y-o-y. On the other hand, there was a big change in the structure of exports; the share of clothing exports to the US and EU climbed 10 percentage points, which accounted for about a third of total clothing exports. The EU is also considering import quotas on Chinese-made footwear.

Trade surplus triples in 2005. China Customs reports the country's foreign trade surplus was $11 billion in December. For all of 2005, the surplus rose to $100 billion. The 2004 surplus was $32 billion. The surplus expanded rapidly last year as export growth continued near 30 %, while import growth slowed to below 20 %. Over 50 % of exports consisted of electromechanical devices.

Improved grain harvest in 2005, agriculture tax eliminated. China's agriculture ministry estimates that the 2005 grain harvest reached 484 million tonnes or nearly 15 million tonnes more than in 2004. During the last two years, grain production has increased a total of 50 million tonnes. The agriculture ministry also noted that the record productivity of the land area under grain cultivation reflected advancement in farming technology. Officials hope to increase grain production by five million tonnes annually in the coming years (2006–2010).

China also abandoned the vestigial agricultural tax at the start of the year. In recent years, the tax did not have a significant role in fiscal policy; in 2004, it accounted for only 1 % of tax revenues.

Farmers have seen their standard of living improve in recent years, boosted especially by the rise in prices of agricultural products and inter- and intra-regional remittances (mostly money sent home by relatives working in cities). The Consultative Group to Assist the Poor (CGAP) estimates inter- and intra-regional remittances reached nearly $30 billion in 2005. That amounts to $8 billion more than Indians, the most active remittance-senders internationally, sent home last year.

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Russia

Economy ministry forecasts mild slowdown in economic growth during next three years. Under the ministry's optimistic scenarios for the 2006–08 medium-term economic outlook, GDP growth would slow to 5.7–5.9 % a year (after exceeding 6 % in 2005) if the world price of oil falls 10 % from its current level. If oil prices remain at 2005 levels, Russian economic growth would continue at about 6 %. The world price of Urals-grade crude oil averaged just under $51 a barrel last year. Growth in both domestic consumption and investment is expected to remain brisk this year and then slow somewhat in 2007 and 2008.

The ministry's forecasts assume Russian crude oil production will increase 2–3 % this year and next, and that the volume of crude oil exports will rise 3–4 % a year. Natural gas production is forecast to increase about 1–1.5 % a year, while natural gas exports will decline slightly over the next two years. Growth in the volume of Russia's total exports is expected to slow substantially, although export earnings during 2006–08 should be roughly the same as in 2005. Import growth should remain brisk.

The nominal rouble-dollar exchange rate over the next two years is expected to remain close to 2005 level. Consumer price inflation it expected to slow this year to 7–9 %, while the rouble's real exchange rate should strengthen 6–7 %.

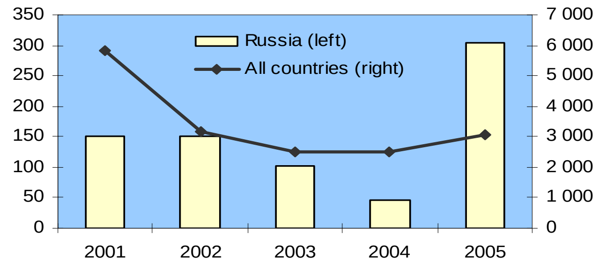
Gazprom's soaring market cap now puts it among the world's top ten companies. President Vladimir **Putin** signed into law last month an act permitting foreign investors to trade in shares of Russian gas giant Gazprom on Russian stock exchanges. Foreign investors earlier could only buy pricier Gazprom's American Depositary Receipts (ADRs) listed on the London Stock Exchange. Trading in Gazprom shares and the rise of the shares' value have been brisk since the rules changed at the start of the year. Early this week, Gazprom's market capitalization broke through the $200 billion dollar mark, making Gazprom the world's seventh largest company after Royal Dutch Shell in terms of market value. This week's retreat in Gazprom share prices bolsters analyst arguments that the shares are overvalued. Gazprom is by far Russia's most valuable company. Trading in Gazprom shares accounted for 44 % of the entire turnover of RTS shares this week.

Finnish investment in Russia on the rise. A recent investment survey conducted by the Confederation of Finnish Industries (EK) finds that Finnish industrial producers substantially increased their investments in Russia in 2005. EK member companies invested about €300 million in Russia last year, which corresponds to about a tenth of international investments by Finnish industries in 2005. Finnish investments in Russia were dominated by investments in the food and construction industries.

The latest investment survey of the Research Institute of the Finnish Economy (ETLA) finds that the stock of large Finnish firms' investments in Russia at the end of 2005 was €1.8 billion. Of that, 23 % of investment came from the forest and paper companies, 13 % from electrical power and heat generation companies, 12 % from wholesalers and retailers and 10 % from Finnish food producers.

The definitions of investment and research methodologies used by EK and ETLA differ from those used by central banks in recording direct investment in the balance of payments. The EK and ETLA definitions include investments made through foreign subsidiaries.

Finnish industrial investments abroad,* 2001–2005, €m



*includes acquisitions of stakes of at least 10 % in companies
Source: Confederation of Finnish Industries

2006 Index of Economic Freedom. Last week, the US-based *Heritage Foundation* released its annual Index of Economic Freedom, which this year surveyed 157 countries. Twenty of the countries achieved the status of "free," and another 52 made it into the "mostly free" category (score of 2.0–2.99). The 2006 rankings show 99 countries improved their index numbers, while 51 saw their figures slip. Both *Russia* and *China* moved up slightly in the rankings. All countries surveyed have shown progress towards greater economic freedom during the 12-year history of the survey. In 2006, the average of all countries surveyed tipped into the "mostly free" category for the first time.

Index of economic freedom 2004–2006

Country	Rank 2006	Index score		
		2006	2005	2004
Hong Kong	1	1.28	1.35	1.34
Finland	12	1.85	1.90	2.00
Ukraine	99	3.24	3.16	3.49
China	111	3.34	3.51	3.59
India	121	3.49	3.53	3.53
Russia	122	3.50	3.61	3.51
Average	*68*	*2.98*	*3.02*	*3.03*

Source: Heritage Foundation

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EUROJÄRJESTELMÄ
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China

Foreign trade surplus swells China's foreign currency reserves. The People's Bank of China made record interventions to the market last year to purchase the massive amounts of foreign currency and counteract appreciation pressures on the yuan against the dollar. As a result, the central bank's foreign currency reserves hit $819 billion at the end of last year (almost 40 % of estimated GDP) – an increase of $210 billion from a year earlier. Since the end of June, China's currency reserves have grown over $100 billion. The biggest factors ballooning the reserves were the huge trade surplus ($102bn) and strong foreign direct investment inflows ($60bn). Even so, the net flows of other types of capital into China apparently ebbed, particularly in the second half of 2005. If the growth in foreign currency reserves continues at its present pace, China should surpass Japan as the world's largest holder of foreign currency reserves during this year.

Last week, the State Administration of Foreign Exchange (SAFE), which is responsible for managing the reserves, caused a stir in international currency markets when it revealed its intentions to seek higher returns on its reserve investments and diversify its holdings. The authorities followed with reassurances that no big changes in the SAFE's investment strategy were contemplated. The PBoC backed this up with an announcement that it had no plans to sell its dollar investments, but was considering also other investment possibilities such as the oil sector. While China does not publish the composition of its foreign currency and gold reserves, analysts believe that about 70 % of those reserves have been invested in dollar-denominated bonds.

Faster-than-expected rise in tax revenues in 2005. Preliminary figures from Chinese tax officials show 2005 tax revenues (excluding customs tariffs) increased 20 % y-o-y (26 % in 2004). Total tax revenues amounted to CNY 3 trillion (€300bn), or 16 % of estimated GDP. Indirect taxes (value-added, consumption and sales) represented about half of the tax take, while corporate and personal income taxes accounted for another third.

The ceiling on non-taxed income was doubled with the change in the personal income tax law that entered into force at the start of this year (see *BOFIT Weekly 44/2005*). Tax officials expect the change will only reduce revenues to the state this year by about CNY 20 billion (€2bn). To compensate, they plan to increase audits of higher-income taxpayers to discourage tax evasion. Tax officials also expect to introduce nationwide the consumer value-added tax pioneered in Northeast China. A producer value-added tax is currently collected nationally.

Officials are also preparing to unify the income tax regime for foreign and domestic firms. Introduction of a fuel tax is currently under discussion.

Citigroup acquisition of majority stake in Guangdong Development Bank awaits government approval. The acquisition of an 85 % stake in troubled Guangdong Development Bank by a consortium, led by Citigroup, the world's largest private banking and finance company, has yet to get official approval from Beijing. The $3 billion deal is significant as foreign investors have previously been limited to stakes of less than 25 % in a single financial institution. Chinese officials probably want to shore up the shaky financial position of Guangdong Development Bank.

At the end of December, Chinese officials limited Temasek, Singapore's state-owned holding company, to a 5 % stake in Bank of China, even though Temasek was prepared to buy a 10 % stake. Earlier this week, Chinese officials also announced that the state will seek to preserve its majority status in China's four large state banks.

China increases its oil holdings in Africa; India seeks cooperation in securing energy supplies. China's number-three energy company, CNOOC, last week announced it had paid $2.3 billion for a 45 % stake in a Nigerian off-shore oil field. CNOOC estimates it paid about $4.60 a barrel for the Nigerian oil, which, compared to other recent deals, is cheap. The Nigeria acquisition still requires the approval of the Nigerian national oil company and Chinese officials. CNOOC still only has a few small foreign stakes in Asia, and last year US officials blocked the sale of the American Unocal to CNOOC.

The Nigeria deal came about after the Indian government spiked the efforts of its own national oil and gas company (ONGC) to acquire part of the Nigerian field. Media reports suggest the Indian government considered the investment too risky. Last August, ONGC lost a bidding competition for a Canadian-owned oil company operating in Kazakhstan to CNPC, China's largest oil producer. India also suffered similar defeats against Chinese bidders in Angola and Ecuador. Despite the confrontation elsewhere, ONGC and CNPC acquired joint stakes in an oil field in Syria.

The topic of tighter China-India energy cooperation was discussed at last week during a visit by Indian oil minister Mani Shankar **Aiyar** to China's National Development and Reform Commission (NDRC). The countries signed a cooperation agreement to keep their energy companies from getting into heavy bidding wars over new energy sources. The agreement makes possible cooperation in the energy field from oil exploration to marketing.

The actual significance of cooperation agreement could be minor, since it may be difficult to get competing Chinese and Indian firms to exchange information.

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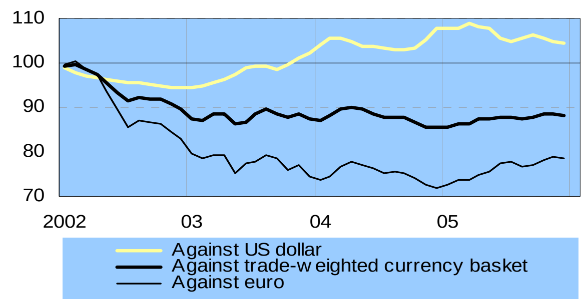
Russia

Russian industrial output up 4 % in 2005. Output growth accelerated slightly in the fourth quarter to 4.5 %. For all of 2005, the increase in output of mineral extraction industries was only slightly above 1 %. Manufacturing industries, however, saw output rise over 6 %. Within mineral extraction industries, crude oil production growth slowed to just over 2 % (down from 9 % in 2004), while natural gas production increased 0.5 % (2 % in 2004). Electrical power production was up over 2 %. Growth in manufacturing industries was led by a boost in production of gasoline and fuel oil. Strong growth in output of individual products in the forest and construction material industries, and machinery and equipment (including televisions) continued.

Rouble's exchange rate strengthened slightly in 2005. Between December 2004 and December 2005, the rouble's nominal exchange rate weakened 3 % against the dollar, but strengthened over 9 % against the euro. The rouble's exchange rate also appreciated over 3 % against the Central Bank of Russia's trade-weighted currency basket.

The rouble's external value has been quite stable against the currency basket for the last three years. As in previous years, the CBR was active in the currency markets throughout 2005 buying up foreign currency to subdue rouble appreciation. Due to relatively high domestic inflation, the rouble appreciated 4 % against the dollar and 19 % against the euro. The real exchange rate against the currency basket appreciated over 10 % in 2005. In the period 2003–2005 the real exchange rate gain amounted to 19 % overall.

Rouble's nominal exchange rate, December 2001 = 100
(Rising line signifies rouble appreciation)



Source: Central Bank of Russia

Rules tightened on foreign listing of Russian firms. Under new rules issued by Federal Service for Financial Markets (FSFM), only 35 % of shares of a Russian company can be listed on foreign exchanges. The earlier limit was 40 %. The new regulations also require that no more than 70 % of company shares offered in an IPO can be listed abroad. The FSFM designed the tighter listing rules to encourage listing on Russian exchanges and help capitalise domestic stock markets. The number of Russian firms launching IPOs abroad grew significantly last year. Investment banks estimate Russian firms anticipate IPOs worth \$15–25 billion this year, of which \$5–8 billion would remain in Russia according to the new rules.

Sales of imported cars soar. Russians bought about 1.8 million cars last year, a 14 % increase from 2004. Russian brands, which represented about half of the cars sold, saw sales drop 6 % y-o-y.

Meanwhile, imports boomed. Russia imported 450,000 new cars and 311,000 used cars. New car imports jumped 58 % y-o-y, while used car imports were up 39 %. In addition, some 155,000 foreign brands assembled in Russia were sold last year, an increase of 28 % from the previous year. Many of the major foreign carmakers now assemble cars in Russia to circumvent the high import duties on foreign cars.

The rapid growth in car imports reflects Russia's growing middle class and development of a market for car loans. The strongest growth in demand also shifted from cars priced at less than \$10,000 to vehicles in the \$10,000–\$20,000 price category. Russian cars still dominated the market, led by AvtoVaz vehicles (including the Lada and Chevy Niva), with 650,000 vehicles sold in 2005. The most popular foreign makes were Hyundai (87,000 vehicles sold), Chevrolet (67,000), Toyota (61,000) and Ford (61,000).

Gazprom and Moldova reach short-term agreement on natural gas prices. After two weeks of intense negotiations, gas giant Gazprom agreed to reopen its pipeline to Moldova under the terms of a temporary agreement. For the next three months Moldova has agreed to pay a rate of \$110 per thousand cubic metres of gas. While that is \$30 more than under the earlier contract, it is substantially less than Gazprom's original \$160 demand. The parties will renegotiate the gas price at the beginning of April. In connection with the pricing negotiations, Gazprom proposed taking a larger stake in Moldova's state gas company Moldovagaz. Gazprom currently owns 50 % plus one share of Moldovagaz. It dominates Moldova's domestic gas markets as well as gas transit shipments via Moldova to the Balkans.

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China

China releases 2005 economic numbers. According to the National Bureau of Statistics (NBS), Chinese GDP climbed last year to CNY 18,232 billion ($2,230bn). GDP grew 9.9 % in real terms from 2004. Strong economic growth helped China surpass France and Great Britain in nominal GDP, making China the world's fourth largest economy after Germany, Japan and the United States.

While primary production grew about 5 % y-o-y in real terms, its contribution to GDP fell to below 13 %. Industrial output and construction increased 11 %; their combined share of total output grew to 47 %. The service sector's importance expanded nearly 10 % so that it now accounts for about 40 % of GDP.

Although no demand-side national accounting figures on investment or consumption are available, investment activity trends can be inferred indirectly from growth in fixed capital investment, which was up 26 % in nominal terms. That amount suggests the pace of investment growth remained at the same level as in previous years (see figure). Growth in investment in the country's poorer central and western provinces was clearly higher than in eastern China. Foreign direct investment inflows into China ($60bn) remained at the 2004 level.

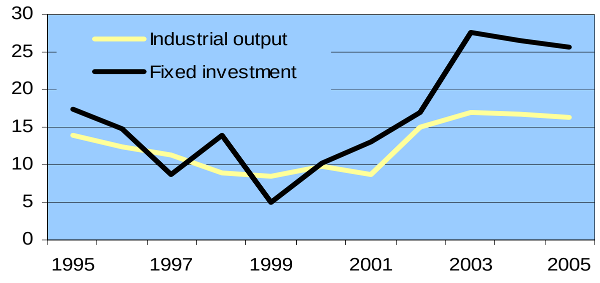
Real disposable household incomes of urban dwellers climbed nearly 10 % to about 10,500 yuan ($1,300) per person. In the countryside, incomes growth was about 6 %, with average incomes still less than a third of their city counterparts. Observers are also quick to note that the income differences between the cities and rural areas are actually substantially greater than even the official figures suggest. Retail sales, which are typically driven by income trends, increased 12 % in real terms last year.

Chinese goods exports ($762bn) rose 28 % last year, slowing a bit from 2004's blistering 35 % pace. Growth in imports ($660bn) slowed to 17 % (down from 35 % in 2004). The disparity caused the trade surplus to balloon to $102 billion, a tripling from the $32 billion surplus posted in 2004.

Consumer price inflation remained surprisingly modest, with 12-month inflation up just 1.6 % in December (compared to 2.4 % a year earlier). Core producer prices were up 5–8 %, depending on the price indicator used.

In the wake of last year's economic census, GDP figures have been revised upwards by nearly a fifth. The census revealed that development in the service sector has been consistently underestimated for years. Even with the adjustment, Chinese statistical methods still leave much to be desired. There is a lack of basic demand-side data (consumption and investment) and proper price series as well as little information on the public sector economy. For example, China lags well behind Russia in terms of its statistical data.

Industrial output and fixed capital investment, annual nominal growth, %



Source: National Bureau of Statistics

Wen warns of increased rural unrest. In his earlier speech published last week, Chinese premier **Wen** Jiabao declared that the increase in land-ownership disputes and related demonstrations could be signs that rural stability is at risk. Wen said actions by local officials have had a lot to do with the dissatisfaction. There are many stories of government official appropriating farmland for other economic purposes without paying the disenfranchised farmers just compensation for loss of possession or arranging alternative livelihoods. Farmers do not own the land they farm.

The number of demonstrations in China has risen rapidly, as has international reporting of demonstrations, partly thanks to faster dissemination of information. Some 10,000 demonstrations in 1994 were reported. A decade later the number of demonstrations exceeded 70,000. Chinese officials announced last week that the number of demonstrations was even higher in 2005. The protests were directed mainly against local officials for land seizures, environmental pollution or corruption.

China and Saudi Arabia agree on energy cooperation. During the visit of Saudi Arabia's king **Abdullah** to China this week, the countries announced that they would be increasing cooperation in the energy field. It was the king's first visit to China since the countries established diplomatic relations in 1990. Saudi Arabia is China's most important oil supplier. During the January-November period last year, Saudi Arabia accounted for about 17 % of China's crude oil imports.

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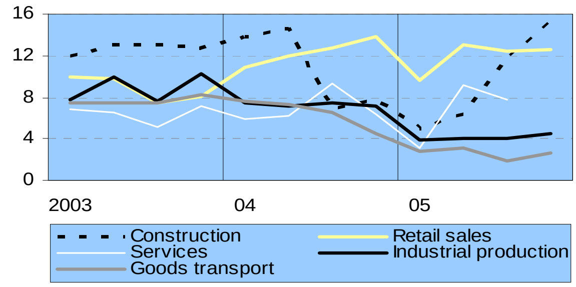
Russia

Russian construction, retail trade and services boomed in 2005. Construction activity gathered strength in the 4Q05, and was up over 10 % for 2005. The growth in retail sales continued strong through 2005, and grew 12 %. Rosstat reports that growth in the service sector, which was up 7–8 % for the year, picked up further towards the end of the year. On the other hand, growth moderated in industry (4 %), goods transport (nearly 3 %) and agriculture (2 %).

Industry's share of GDP was almost 28 % in 2005. The trade sector's share was 18 %. The next-largest groups of value-added sectors were transportation and telecommunications (9 %) and real estate (8 %).

Growth in core economic sectors, % change from four quarters previous



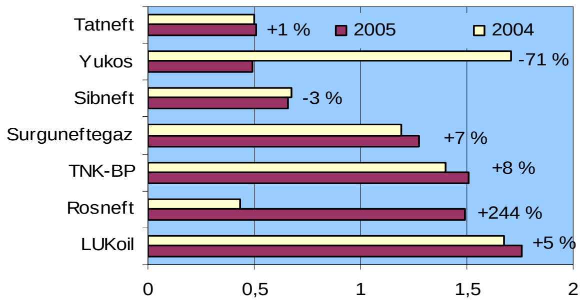
Source: Rosstat

Budget surplus and stabilisation fund expanded rapidly in 2005. Finance ministry figures show that federal budget revenues rose to nearly 24 % of GDP (20 % in 2004). The initial revenue prediction, 18 % of GDP, was based on a cautious oil price assumption that assumed the price of Urals-grade crude would average $28 a barrel in 2005. In fact, the average price last year was $51. Budget revenues were also boosted by payments of back taxes, including the high-profile disgorging of the Yukos oil company. Budget spending climbed to the point where its share of GDP (excluding interest payments) exceeded 15 %.

The budget surplus swelled last year to 7.5 % of GDP. As of year's end, the state stabilisation fund stood at $43 billion, or slightly below 6 % of GDP.

Oil production posted modest growth last year. Rosstat reports that Russian oil production grew 2.2 % last year (over 9 % in 2004). National production averaged 9.4 million barrels a day, making Russia the world's second-largest producer after Saudi Arabia. Despite higher production, crude oil exports began to taper off. Rosstat's latest figures show crude oil exports fell 2 % y-o-y in January-October. Exports of refined oil products grew 17 % in the same period. A powerful hike in the crude oil export tariff last year got oil companies to increase their refined oil product exports in place of crude. Russia's largest oil producers last year were LUKoil, Rosneft and TNK-BP. Yukos oil production collapsed after the company was forced at the end of 2004 to sell its core production unit to Rosneft in order to pay off its tax debts. Rosneft's output, in turn, more than tripled. Growth in the output of other large oil companies was still fairly rapid.

Production of Russia's largest oil companies, 2004–2005, bpd million, and on-year change, %



Source: Aton

Sharp hike in housing costs. Russia officially ended federal housing supports at the start of the year. In principle, residents should now pay the full burden of housing costs. In addition to transferring housing costs to residents, the authorities approved rate hikes for housing services. Together, the measures lifted average housing costs 30 % nationwide. The rate hikes, which are part of the government's housing policy, have also complicated its inflation-fighting policies.

Residents now pay 60–100 % of their housing costs. Under the federal housing act, families that devote more than 22 % of their incomes to housing are eligible for individual housing support. Regions also have the right to use a lower percentage for tailoring the housing support.

Russia's housing sector is going through a confused phase. Some pricing structures have been liberalised and some are now subject to stricter state regulation. The overall housing stock continues to age and fall into disrepair, and there is massive demand for adequate housing. Each of these factors works to impede improvement of housing standards, weaken services and contribute to corruption. Public opinion surveys find most residents are unsure about the housing situation and distrust government reform efforts. Protests against the dire housing situation have been staged across the country.

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China

Growth in Chinese oil imports slowed substantially in 2005. China imported 127 million tonnes (2.5 million barrels per day) of crude oil, a 3.3 % increase from the previous year. High world oil prices boosted the cost of oil imports 41 % to $48 billion. Despite the higher prices, crude oil imports constituted just 7 % of total goods imports.

According to the IEA's latest estimate, China's share of global oil demand growth contracted from 27 % in 2004 to 18 % last year. Imports supplied about 40 % of China's crude oil needs.

The slowdown in oil import growth reflected changes in China's energy markets: growth in domestic crude oil demand and domestic production increased just 3 %. In contrast, electricity production climbed 13 %, which was slightly above overall economic growth. It appears that the strong push in recent years to build coal-burning, hydroelectric and nuclear power plants has reduced the need for small diesel generators and reduced demand for oil. Higher prices for oil products have also dampened demand.

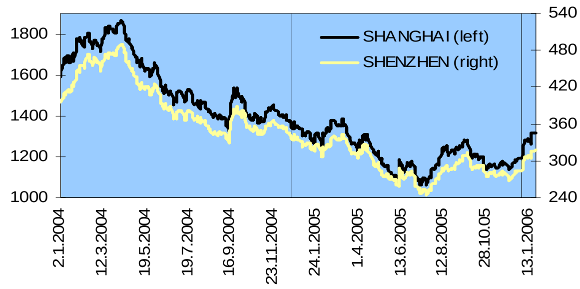
Government moves to resolve wage payment disputes. The eight employers arrested in southern Guangdong province stand accused of withholding 7 million yuan (700,000 euro) in wages owed to 1,200 workers. Newspaper reports suggest this is the first time in the PRC's history that officials have raised charges against employers for unpaid wages in court. Late payment of workers' wages or simply stiffing them (especially migrant workers) has become fairly common practice in China. According to a survey for the National People's Congress, 8 % of employees were late in receiving their wages last year. The average delay was over three months. In addition, a study by All China Federation of Trade Unions found that migrant workers' incomes have also risen substantially slower than average.

The government announced in January its concerns over countryside migrant workers' labour problems. Suggested ameliorative measures include improving monitoring of employers and implementing a wage guarantee system to ensure the minimum wage and workers being paid on time. In addition, the social safety net for migrant workers would be improved. The government has yet to give a timetable for the proposed reforms.

Share markets open up further to foreign investors. Foreign strategic investors have had the possibility to purchase A-shares of firms listed on Chinese stock exchanges since Tuesday, January 31. The reforms affect only shares of companies that have already implemented the conversion of non-tradable state shares to exchange-tradable shares (see BOFIT 18/2005). About a third of listed companies had made the conversion as of January 20. Foreign investors will be required to have at least $100 million in capital or show that they control assets of a least $500 million. According to the new rules, foreign investors must hold their shares for at least three years. Before the change, only a small group of foreign investors with special permission were allowed to purchase A-shares. Foreign investors can purchase B-shares, but in practice, such shares represent a tiny fraction of tradable shares.

The news of foreign strategic investors entering the markets revived stock market turnover and prices. Shanghai A-share prices, for example, jumped about 8 % in January.

Shanghai and Shenzhen bourses, A-share indexes



Sources: Shanghai and Shenzhen bourses

China's largest bank ICBC sells a stake to western financial consortium. Goldman Sachs, Allianz and American Express have reached a deal with Industrial and Commercial Bank of China (ICBC) on the sale of a reported 10 % stake in the Chinese bank for $3.8 billion. If authorities approve the sale, it would be the largest foreign investment in China's financial sector ever.

Goldman Sachs, which is making the largest financing contribution, will concentrate on developing activities related to corporate governance, risk management, asset management and corporate banking. Allianz will focus on development and sales of ICBC's insurance products, while American Express will handle the card business. ICBC is China's largest commercial bank and has about 18,000 branch offices in China. The bank serves some 100 million private individuals in addition to its corporate customers.

Under China's WTO commitments, Chinese bank and financial markets must open to international firms by December 11. This has given Chinese banks and officials an urgent need to modernize and overhaul their commercial banking operations. Western financial institutions, in turn, have had to consider the fastest and safest way to enter new markets in China. While these markets hold considerable potential they are also fraught with huge risk and uncertainty.

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Russia

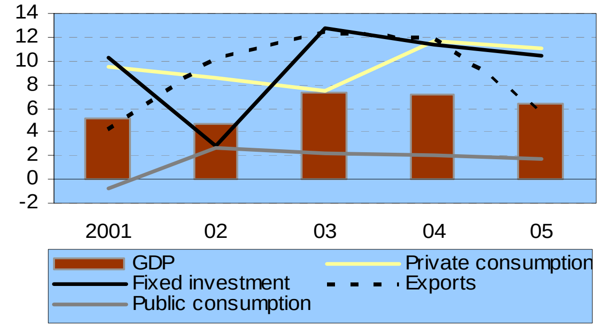
On-year inflation in Russia slowed a bit in January. Russian 12-month inflation fell to 10.6 % last month. The figure was slightly under the December 2005 score of 10.9 %. The rise in *food* prices, however, accelerated slightly to 10.2 % y-o-y. On-year inflation for *other goods* in January was 6.5 % and *services* 18.1 %, both declining slightly from December.

There was a notable pickup in prices of fruits and vegetables in January. The price of gasoline, on the other hand, after climbing sharply since spring of 2005, has been quite stable since October. Prices of municipal services and housing costs were hiked by 14 % in January (although this was not as the January 2005 hike of 19 %).

Russian economy expanded 6.4 % in 2005. Rosstat's initial GDP data for 2005 show private consumption growth continued to rise at a rate above 11 %. Although the pace of investment growth slackened somewhat, it remained above 10 %. Growth in public consumption remained at about 2 %. Export volume growth slowed from over 10 % to below 6 %, mainly because crude oil exports were no longer growing. Growth of import volume, while still a brisk 16 %, also slowed.

The share of private consumption in GDP contracted slightly to 47 %, as did public consumption (16 %). Growth in fixed capital investment held almost steady at over 18 %. The share of exports increased slightly to 35 %, due mainly to the sharp rise in world energy prices. Imports' share of GDP fell to about 21 %.

Growth in volume of GDP demand components, % change



Source: Rosstat

Industrial producer prices down in late 2005. Producer prices fell 1 % in November and 2 % in December. From end-2004 to end-2005, industrial producer prices were up more than 13 % (the on-year rise in producer prices at the end of 2004 was 29 %). Producer prices for manufacturing industries rose an average of 8 % last year (over 21 % in 2004), while for mineral extraction industries they were up over 30 % (compared to 65 % in 2004).

Prices in the mineral extraction sector, however, were down more than 12 % in the last two months of the year. Almost none of the seasonal drops in producer prices in earlier years matched last year's sharp drop for crude oil (-16 % in November-December) or natural gas (-12 %).

The rise in prices in manufacturing industries moderated in November-December along with lower producer prices for fuel oil (-8 %) and gasoline (-17 %). Last year, the rise in producer prices slowed for several other branches of manufacturing, particularly metal production.

Growth in Russian natural gas output slowed in 2005. Rosstat reports that Russia produced 636 billion cubic metres of natural gas last year. Russia is the world's largest gas producer and has the world's largest natural gas reserves. Russian natural gas production increased just 0.5 % last year, a considerable deceleration from previous years. Gas production, which lagged gains in oil output, increased at a rate of just over 2 % a year during 2001–2004. In 2005, the largest gas producer was Gazprom, which produced 85 % of all Russian natural gas. The second-largest producer was private gas company Novatek with a 4 % share. The companies with the biggest production gains last year were Rosneft and TNK-BP. Gazprom's production increased a mere half per cent. Gas constituted 12 % of Russian exports of goods and services last year as the value of gas exports soared 44 %. In the most recent goods-specific foreign trade statistics, the export quantity of gas grew just 3 % y-o-y in January-November. The engine of growth in export values was the rise of export prices for gas during the year.

Russian natural gas production 2004–2005, billion m^3

	2004	2005	On-year change, %
Gazprom	544.4	547.3	0.5
Novatek	n.a.	25.3	n.a.
Surgutneftegaz	14.3	14.4	0.7
Rosneft	9.4	13.0	38.3
TNK-BP	6.8	8.7	27.9
LUKoil	5.0	5.7	14.0
Yukos	3.4	2.0	-41.2
Sibneft	2.0	2.0	0.0
Total	***633.0***	***636.0***	***0.5***

Sources: Aton and Rosstat

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China

Unofficial lending a widespread phenomenon in China. A survey conducted by Beijing's Central University of Finance and Economics found new unauthorised lending amounted to about CNY 800 billion (€80bn) in 2003. That amount corresponded to 28 % of all new lending by properly licensed banks. The study also found that over a third of external borrowing by small and medium-sized firms came from unauthorised sources. In the poorer provinces of e.g. western China, the share was even larger. Some 110 small and medium-sized firms and 1,200 entrepreneurs from 20 provinces participated in the survey.

According to media reports, the interest rate charged on one-year loans from unauthorised banking operations fell last summer to below 10 %, compared to about 7 % from licensed commercial banks. Although commercial banks have been free to set lending rates since November 2004, small and medium-sized firms continue to have problems getting loans from commercial banks. Management at commercial banks has little incentive to take on risk from small private firms as long as lending to state enterprises remains a safer proposition. Private firms also have trouble finding guarantors and providing adequate collateral to secure loans.

Raising money from other legitimate sources is even harder for small companies. For example, only 50 companies to date have been admitted to the Shenzhen exchange's list of small and medium-sized enterprises.

Non-performing loan problem persists. The official ratio of the stock of non-performing loans to the total loan stock of the banking sector was less than 9 % at the end of 2005. The NPL ratio of the four large state banks, however, was still above 10 %. NPL ratios showed no improvement in last summer's transfer of Industrial and Commercial Bank's non-performing loans to an asset management company are included.

The NPL ratios at the four large state banks differ considerably. The NPL ratio of China's second largest bank, Agricultural Bank of China, exceeds 26 %, while the NPL ratio of the other large banks are all under 5 %. In the smaller commercial banks, the ratio of NPLs on average is lower than in the four large banks. Although bank risk management is developing thanks to the positive influences of foreign strategic investors, the stock of NPLs is feared to increase in coming years. It is generally estimated that the actual quantity of NPLs in relation to China's banking sector loan stock is over 20 %.

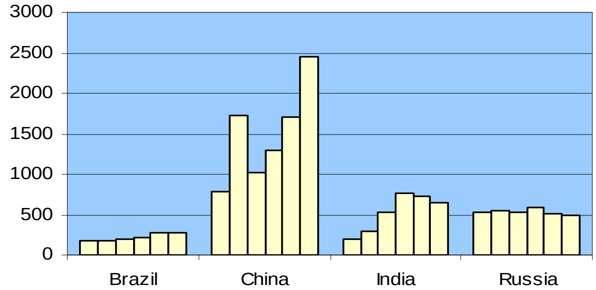
China establishes personal credit registry. A personal credit registry overseen by the central bank officially launched its operations last month. Commercial banks and credit cooperatives with sufficient technical means will all contribute to maintaining the register. Banks in large cities have already operated the registry on a trial basis for over a year. The registry currently contains the personal credit histories of 35 million people and covers 98 % of issued credit. To access credit information in the registry, a party requesting access must have written approval from the person to be evaluated. The registry should make it easier for commercial banks and credit cooperatives to assess the credit risk of a potential borrower and hopefully reduce the likelihood of loan defaults. The People's Bank of China expects the personal credit registry to eventually incorporate the database of social services agencies and tax officials. A separate credit registry is also planned for companies.

China rises into the top ten in patent activity. The World Intellectual Property Organization (WIPO) reports that the number of patent applications from China rose last year to nearly 2,500 – an increase of 44 % y-o-y. The total number of applications (about 130,000) filed by agents within the international Patent Cooperation Treaty (PCT) increased 9 %. China accounted for almost 2 % of global patent activity last year, boosting it to the rank of tenth among the 128 PCT signatories.

Asia continues to gain importance in innovation; the number of patent application filings has increased strongly in Japan and South Korea. Japan ranks second and South Korea sixth among PCT members. China's counterparts among the great emerging global economies (the so-called BRIC countries) Brazil, India and Russia still lag far behind China in terms of patent activity (see chart).

The US continues to dominate on patent filings, accounting for a third of all global patent activity last year. Following the US and Japan are Germany, France and Great Britain. Finland is still a heavy-hitter in terms of patents, ranking 15th overall. The number of Finnish patent application filings rose 12 % last year to over 1,800.

Number of patent applications filed in BRIC countries, 2000–2005



Source: World Intellectual Property Organization (www.wipo.int)

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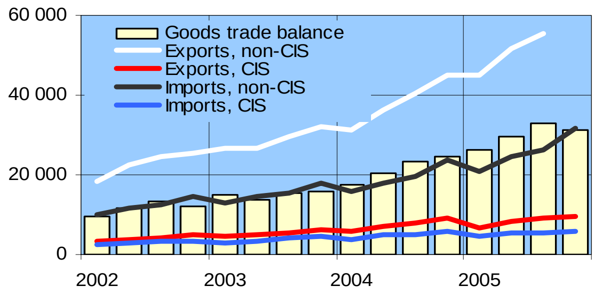
Russia

Rapid climb in oil and gas prices boosts value of Russian goods exports in 2005. The Central Bank of Russia reports the on-year increase in the value of goods exports was 34 % and imports 28 %. Exports totalled $245 billion and imports $125 billion. The goods trade surplus swelled 40 % y-o-y to a level comparable to 16 % of GDP. Non-CIS countries increased their share of goods trade to 85 % last year.

The breakdown from Russian customs showed that crude oil represented 33 % of goods exports, refined oil products 14 % and natural gas 13 %. The value of crude oil exports rose 44 % y-o-y, but fell in volume terms 3 %. Exports of refined oil products were up 77 % by value, but only 14 % by volume. Gas exports climbed 46 % in value terms and 4 % in volume terms. The value gains reflect last year's soaring prices for energy products. The average increase in the export price of natural gas was 40 %, while export prices for crude oil and oil products were up 48 %. Other leading export goods included metals, wood, and machinery and equipment. Growth in goods imports was accelerated by the growing demand for foreign consumer goods. Machinery and equipment constituted 48 % of goods imported from non-CIS countries (9 % in the form of passenger cars), chemical products 18 % and foodstuffs 17 %.

The federal customs service also reports that Russia's largest trading partners in 2005 continued to be Germany, the Netherlands, Italy, China and Ukraine. Finland ranked 12th. EU countries accounted for 52 % of foreign trade.

Foreign trade in goods, 2002–2005, US$ million



Source: CBR

Russia proposes another early payment of Paris Club debt at G8 meeting. At last weekend's gathering of G8 finance ministers, Russia announced it would pay down some $11–12 billion in Soviet-era debt to Paris Club creditors and extend $690 million in debt forgiveness to 16 of Africa's poorest countries. The Russian delegation further suggested that Paris Club creditors use the early prepayments to provide debt forgiveness to African countries. Germany, Russia's largest Paris Club creditor, responded cautiously to the idea, noting it had already issued bonds backed by Russia's payment commitments. Russia has to negotiate the terms of early debt repayment with all Paris Club members. Russia paid down about $15 billion in Soviet-era debt ahead of schedule last June using money from the national stabilisation fund. The finance ministry reports that as of beginning of this month, the assets of the stabilisation fund stood at $52 billion. That amount is sufficient to cover over two-thirds of Russia's federal foreign debt.

Agriculture posts low growth for 2005. Total agricultural output rose just 2 % last year, significantly below the pace of overall GDP growth (6.4 %) and industrial output (4 %). In 2004, agricultural output grew 3.1 %.

Trends in crop cultivation and animal husbandry diverged last year; crops were up 3.7 % while animal husbandry increased just 0.1 %. The grain harvest matched the 2004 level, with a total clean weight of some 78 million tonnes. Production of potatoes and other vegetables increased more than 4 %. The number of cattle in Russia continued to decline, reflecting the low productivity of cattle farms and stiff foreign competition. Many cattle farms operated in the red last year. Revival of Russian agriculture was designated a national priority project last autumn. Measures to help farmers include low-interest government loans, increased use of leased farm equipment and restrictions on foreign imports.

Raiffeisen Bank set to become biggest foreign bank presence in Russia. At the beginning of this month, Austria-based Raiffeisen Bank contracted to purchase the Russian Impexbank in its entirety. Impexbank, with assets of over RUB 50 billion (about €1.5bn), ranks among Russia's 25 largest banks. The deal still requires the blessing of the CBR and Russia's antimonopoly authority. Raiffeisen Bank already has a subsidiary in Russia bearing its name. Even the subsidiary, with over RUB 120 billion in assets, is a significant player in the Russian banking business. The largest foreign bank in Russia is presently International Moscow Bank. Measured by assets (over RUB 140bn), IMB ranks as the seventh or eighth largest bank in Russia. IMB's majority shareholder is the German HypoVereinsbank (which is owned by the Italian UniCredit). Its minority shareholders are Nordea, a French subsidiary of Vneshtorgbank, as well as the European Bank for Reconstruction and Development. As of end-September 2005, banks with at least 50 % foreign ownership held 8.5 % of the total assets of the Russian banking sector.

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China

Chinese foreign trade surplus continues strong in January. The value of exports climbed 28 % y-o-y in January to $65 billion. Imports were up 25 % to $56 billion. Although import growth was highest since November 2004, the trade surplus in January still hit $9.5 billion ($6.5 billion in January 2005). The January surplus was larger than anticipated. January is traditionally one of the weakest months of the year in terms of trade balance as the two-week Chinese New Year celebration usually falls on January or February.

Brisk auto sector growth in 2005. Domestic production of passenger cars in 2005 rose to nearly 3 million units last year, an increase of 27 % y-o-y. The rapid expansion in car manufacturing combined with lower growth in demand led to excess supply, stiffer competition and an overall drop in prices. The National Development and Reform Commission reports that the capacity of carmakers operating in China was sufficient to produce over two million more cars than needed to satisfy domestic demand. The drop in prices reduced the profit of carmakers to 4 % of turnover last year. Chinese-owned carmakers, however, generally did quite well in the increasingly competitive environment and boosted their domestic market share to 26 %.

China exported 170,000 vehicles last year, an impressive on-year increase of 120 %. It was also the first year that China exported more cars than it imported. Trucks and specialised vehicles accounted for the largest share of exports. Most of the vehicles were exported to developing countries. Passenger cars accounted for 18 % of vehicle exports. Observers expect exports of Chinese cars continue to increase strongly in coming years. Chinese carmakers have set their sights on the European and US markets. Chinese carmaker Chery has just built a production facility in Iran, and the company is currently planning assembly plants in Russia and Eastern Europe.

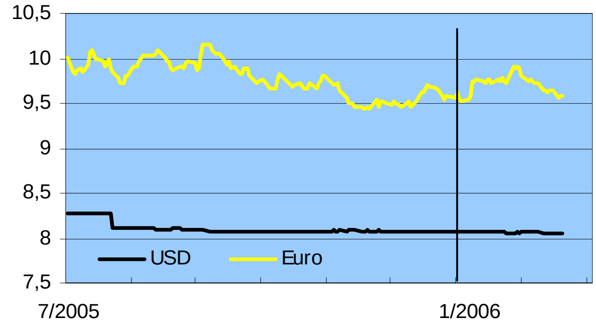
US demands that Chinese live up their WTO commitments. In his presentation this week of US-China trade relations, US trade representative Robert **Portman** turned a critical eye to China's performance since it joined the WTO in 2001 and demanded realignment in US-China trade policy. Portman's report reflects the views of the US congress, US-based China experts, as well as influential industrial bodies and key government agencies.

The report observed that China's period of transition for implementing its WTO commitments was almost over. It is the US contention that China, as a developed and powerful force in global trade, should now be expected to assume its full responsibilities in upholding its international trade commitments. The US would especially like to see improvements in the areas of access to Chinese markets, protection of intellectual property rights, labour laws, reduction in supports paid to Chinese enterprises and environmental protection. In order to secure the benefits of US trade policy, the report suggested that a range of trade negotiation mechanisms needed to be modified. It also saw a need for the US to increase personnel dedicated to dealing with China, as well as the establishment of a China Enforcement Task Force. The creation of such a body would be unique in the history of US trade policy and illustrates the exceptional importance the US now places on its economic relations with China. US officials plan to discuss the report's findings and use them as a basis for discussions with Chinese officials in April.

The tensions between two countries continue to be exacerbated by the United States' huge and persistent trade deficits with China. US trade figures show that the country last year ran a trade deficit with China of $202 billion. Chinese trade figures put the imbalance at $114 billion. The report did, however, mention that US exports to China have grown five times faster since 2001 than its exports generally. At the same time, China has risen to become the fourth largest destination country for US exports.

Slight appreciation of yuan against the dollar. There has been almost no change in China's exchange-rate policy since last July's 2.1 % revaluation. The yuan has strengthened less than 1 % against the dollar over the past eight months. Due to the relative stability of the yuan-dollar rate, fluctuations in the yuan-euro rate essentially track the dollar-euro rate.

Yuan exchange rate vis-à-vis the dollar and euro



Sources: Reuters, Bank of Finland

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Russia

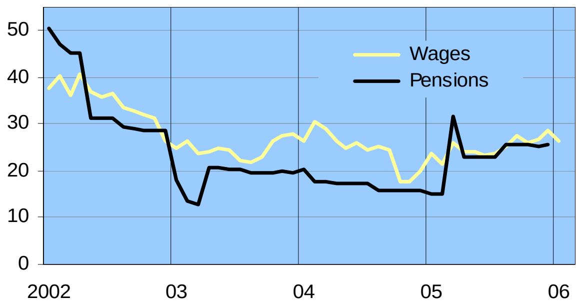
Russian retail sales continue to grow rapidly in January. Last month, retail sales (up 11.7 %) led growth in Russia's core economic sectors. *Industrial output* rose 4.4 %. Growth in manufacturing also remained strong (4 %), while the mineral extraction industries expanded just 2 %. *Agricultural output* was up 1.4 %, while *freight transport* fell 1.3 %. *Construction* decreased by 7.5 %, which was an exceptionally steep decline in construction in January.

Growth in wages and pensions accelerated in 2005. The average nominal wage in 4Q05 was 26 % higher than a year earlier. Real wages were 11 % higher. Wages in mineral extraction industries increased less than 15 %, i.e. clearly lower than a year earlier. Wages in manufacturing, construction and trade all increased around 20–25 %, matching the growth of 2004. The push for higher wages was strongest in key public services such as education and health care (35 %), as well as public administration (nearly 45 %).

Ignoring under-the-table earnings (estimated to represent about a quarter of total wages in 2004), the average monthly wage in late 2005 was about 8,800 roubles (about 260 euro). Highest wages continue to be paid in the fuels extraction industries and finance (on average over 20,000 roubles). The average wage in manufacturing was about 9,000 roubles, while trade paid about 6,300 roubles a month. Thanks to last year's increases, wages in health care and education have risen to about 6,000 roubles, and public administration to about 11,000 roubles.

In nominal terms, average pensions were about 25 % higher late last year compared to a year earlier. The average monthly pension was about 2,500 roubles (about 75 euro) a month.

On-year growth in average nominal wages and pensions, %



Source: Rosstat

Central Federal District continues to top the nation in production and consumption. Official statistics show that in 2005 industrial output (an indicator of production trends) grew fastest in the Central Federal District, which continued to dominate. An indicator of consumption, retail trade was also largest in the Central Federal District. Even so, retail trade growth in the district slowed three percentage points. Growth in retail trade in the City of Moscow slowed to 6 % last year, even though Moscow had a 23 % share of total retail activity in Russia. Moscow also generated 9 % of industrial output.

In the North West and South Federal Districts, industrial output growth also outpaced average increase. St. Petersburg accounted for 3 % of industrial output, and enjoyed a 4 % increase in output last year. St. Petersburg's share of retail trade was slightly below 4 %, even though trade in the city was up 13 % in 2005.

Retail sales grew fastest in the Ural Federal District, including the oil-rich Khanty-Mansi Autonomous District, which alone generated 11 % of total Russian industrial output, but accounted for less than 2 % of retail sales. The Khanty-Mansi Autonomous District saw industrial production grow nearly 8 % last year.

Growth in industrial output and retail sales with Federal District shares in 2005, %

Federal District	Industrial output		Retail sales	
	growth	share	grow	share
Central	16.7	23.4	9.8	37.4
North West	5.9	11.0	11.9	8.9
South	8.9	6.2	16.2	11.5
Volga	3.2	22.3	15.6	17.1
Ural	3.7	22.0	21.0	9.4
Siberian	2.2	12.6	14.3	11.8
Far East	2.2	3.2	11.2	4.1
All Russia	***4.0***	***100.0***	***12.0***	***100.0***

Source: Rosstat

Russia's bilateral WTO negotiations with the US continue. Economy minister German **Gref** reports that, with the exception of the US, Russia's bilateral negotiations with WTO members are essentially completed. Official agreements are still outstanding with Australia and Columbia. Gref claims that the talks with the US have been drawn out by American strict line on financial market liberalisation, although foreign banks do not insist on having branch offices in Russia. In addition, Gref noted that the US demands the lowering of tariffs on agricultural products that Russia does not import from the US. There has also been no agreement on protective measures for Russia's aerospace industry. Gref believes that the talks can realistically be wrapped up by mid-2006 and the formalities of membership completed by the end of this year.

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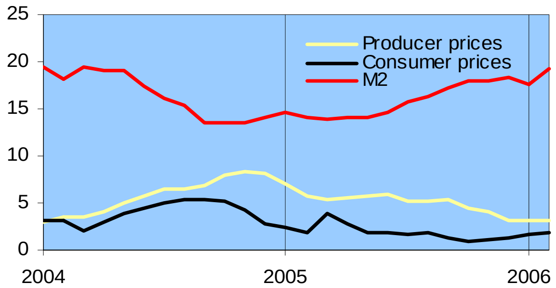
China

Slight pickup in Chinese money supply growth and consumer prices in January. The People's Bank of China reports that broad money supply growth (M2), which accelerated towards the end of last year, exceeded 19 % y-o-y in January. Despite the rapid increase in money supply, inflation has so far remained quite modest. The PBoC has targeted M2 growth of 16 % this year.

Consumer prices rose 1.9 % y-o-y in January, continuing the trend of slightly accelerating inflation since last September. In January, inflation was driven by higher food prices (up nearly 4 % y-o-y). There were also sharp increases in prices for fuel and automobile spare parts (11 % y-o-y), as well as prices for municipal services (8 %). On the other hand, there seems to be no end to the five-year-long slump in clothing prices – down another 2 % y-o-y in January. Inflation has been equally slow in both the countryside and in urban areas. In conjunction with its revision of December GDP, the National Bureau of Statistics announced that it was changing weightings in the consumer price index. Publication of the new weights is still forthcoming. The PBoC forecasts that consumer price inflation will accelerate to an on-year rate of 3 % this year (it was below 2 % in 2005). The rise in producer prices slowed in January to 3.1 % y-o-y, the lowest growth since 2003.

Price development and broad money (M2) growth, % y-o-y



Sources: NBS and PBoC

EU considering import tariffs on China-made footwear. A recent EU Commission survey found that Chinese and Vietnamese producers receive substantial state support in the form of cheap credit and tax breaks, which allows Asian producers the possibility of driving European shoe prices below their actual production cost. Since the relaxing of restrictions on footwear imports to Europe at the beginning of last year, imports from China and Vietnam have expanded many-fold. Due to the dumping suspicions, the EU Commission proposes the imposition of a tariff of up to 19.4 % on some of the leather footwear produced in China and Vietnam. The punitive tariff would apply to about 8 % of footwear sold in Europe. The decision on whether to impose the tariffs could be reached as early as next week. If the plan goes ahead, the tariffs would become effective at the beginning of April.

After the liberalisation of textile trade at the beginning of 2005, southern European countries called for additional measures to stem the flood of Chinese clothing and textile imports. In contrast, textile-makers that had already adjusted to the new circumstances felt that the proposed restrictions were unnecessary and costly for consumers. The same adversarial alignment has re-emerged with southern European shoemakers pushing for protective restrictions and northern European countries and international shoemakers pushing the consumer's interests.

China adopts international accounting system. Last week, the finance ministry announced that companies listed on Chinese exchanges will be required to follow the new Chinese Accounting Systems (CAS) from the start of 2007. The revised CAS closely resembles the international IFRS accounting standard, which is already in use in 73 countries. Due to heavy state ownership in China, the revised accounting system includes several departures from the IFRS standard. The International Accounting Standards Board has been closely involved in drafting China's new accounting standards. The shift will help foreign firms in their operations directed at China, as well as ease the integration of Chinese firms into the global economy.

Hong Kong economy boomed in 2005. GDP grew 7.3 % y-o-y in real terms. The strong economic growth was driven mainly by robust growth in exports of goods and services. Investments were up 4 % y-o-y, and, thanks to the return of rising wages, private consumption was up nearly 4 %. Years of deflation finally ended last year when prices rose slightly more than 1 %. The good growth also helped diminish unemployment to 5 % at the end of December. Hong Kong officials expect the rapid growth to continue in coming years.

Mainland China's go-go economy has not only boosted the volume of goods freight moving through Hong Kong but also exports of Hong Kong-made products and services. Trade with Mainland China has been accelerated by the Closer Economic Partnership Arrangement (CEPA), which has been instrumental in removing or lowering trade barriers between Mainland China and Hong Kong. The third CEPA agreement entered into force at the beginning of the year (see *BOFIT Weekly 48/2005*).

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Russia

Russian rapid economic expansion should continue. BOFIT's *Russia Forecast*, released last week, sees GDP growth of 6.2 % for 2006. A combination of historically high crude oil prices and growth of consumption-driven industries should sustain GDP growth. Assuming oil prices decline slowly after 2006, economic growth will decline to 5.1 % in 2007 and 4.2 % in 2008, while rapid consumption growth will continue to support GDP growth. The long-range growth trend for the Russian economy is forecast at around 4 % given the current production structure. The Russia Forecast is posted in its entirety on our website.

Foreign investment continued to pour into Russia last year. Rosstat reports that nearly $54 billion in foreign investment flowed into Russia last year, a 32 % increase from the previous year. Of that amount, $40 billion was in the form of loans. The largest flow came from Luxemburg, raising the country's stock in Russia highest before Cyprus and the Netherlands.

Strong consumption growth attracted most investment in trade, and nearly as much investment went to manufacturing industries. Foreign direct investment, while still modest relative to the size of the Russian economy, climbed nearly 40 % to $13 billion. FDI represented nearly a quarter of total foreign investment. Almost half of FDI last year went to manufacturing industries and another third to mineral extraction industries.

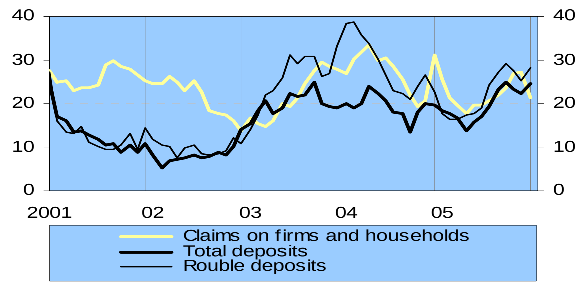
Foreign investment from Russia abroad amounted to $31 billion in 2005, or 8 % less than in 2004. Under half of that amount was FDI. A large chunk of Russian foreign investment was directed at the US. Other important investment destinations included Austria and Cyprus.

Housing prices continued to climb in 2005. Rosstat reports that nominal rouble prices of new and existing apartments rose an average of 18 % last year. Prices for new apartments increased at about the same rate as in the two previous years, while the rise in prices for existing apartments slowed slightly from 2004. In Moscow and St. Petersburg, the rise in prices slowed notably. Prices of new apartments were up about 9 % in both cities. Prices of existing apartments rose 12 % in Moscow and 5 % in St. Petersburg.

Growth in bank deposits and credit accelerated in the second half of 2005. As of end-December, the stock of deposits at banks operating in Russia was up nearly 40 % on year in nominal rouble terms. In real terms, the deposit stock grew 25 %. As in 2003 and 2004, growth in rouble deposits outstripped growth in foreign-currency deposits. The deposit stock at the end of the year was €152 billion (24 % of GDP), of which rouble deposits amounted to €117 billion.

The overall amount that firms and households owed banks increased last year 35 % in nominal terms and over 20 % in real terms. The credit stock as of end-2005 totalled €168 billion, or nearly 27 % of GDP.

Bank deposits and credit stock, real on-year change, %



Source: Central Bank of Russia

New limits on duty-free goods into Russia. Under new customs rules introduced last week, travellers to Russia are only exempt from duties on the first 65,000 roubles (about 2,000 euro) worth of goods they bring into the country. Moreover, the quota amount can only be brought in once a month and can weigh no more than 35 kilograms. The earlier limit was 50 kilos of goods once a week. The economy ministry plans tighter regulations from the start of 2007.

Russian customs has long sought to curb "border-shuttlers" seeking to avoid duties and sell their wares on the black market. Nearly a third of clothing and shoes sold in European parts of Russia have likely been brought in by border-shuttlers and in Far East Russia, nearly two-thirds of textiles and footwear enter the country in this way.

Population declined in 2005. Russia's population dropped 0.5 %, or nearly 736,000 people, in 2005 to 142.7 million at year's end. In 2004, the country lost a net of 694,000 persons. Following the trend of recent years, birth rate declined further and mortality increased slightly. Last year, deaths exceeded births by over 840,000.

Immigration and emigration flows brought in a net of just over 100,000 new residents to Russia (up from less than 40,000 in 2004). The largest groups of immigrants came from Kazakhstan (net gain nearly 40,000) and Uzbekistan (nearly 30,000). The most popular destination for emigrants was Germany (over 18,000). Russia was the world's seventh most populous country in 2005.

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China

China eases capital export rules further to counteract yuan appreciation pressures. Early this week a representative of the state agency for foreign exchange (SAFE) announced that the convertibility of the yuan would soon be expanded as the relaxation of capital export rules will be continued in accordance with earlier SAFE statements. While no timetable was announced, officials apparently plan to give certain Chinese institutional investors the possibility of investing abroad. The change will particularly benefit Chinese insurers, which are eager to get more possibilities in international markets. SAFE announced in January that also foreign investment by other Chinese firms would be liberalised.

Yuan convertibility is essentially no longer an issue with regard to foreign trade (i.e. the current account) or foreign direct investments into China. Movements of capital are still heavily regulated, however.

SAFE last year increased the possibilities for companies to make direct foreign investments abroad, raised the ceiling on foreign currency purchases allowed for foreign travel and lowered the required percentage of foreign earnings that large companies must repatriate. While the recent policy emphasis has generally been tighter control on foreign currency entering the country, SAFE decided to give foreign institutional investors the possibility of trading in Chinese-exchange-traded A-shares at the end of January.

The liberalisation of capital export rules is intended to decrease appreciation pressure on the yuan and simplify monetary policy. Even with the change, capital outflows from China remain modest relative to other balance-of-payments items. On Wednesday (Mar. 1), the dollar-yuan rate fell below 8.04 for the first time since the mini-revaluation of July 2005.

State enterprises posted record profits in 2005. The Ministry of Finance reports that profits of state-owned enterprises rose 25 % last year to a total of CNY 900 billion (€90bn). The biggest earning jumps were posted by producers of oil, coal and non-ferrous metals, all of which benefited from higher commodity prices. A ministry spokesperson said that the increase in profits partly reflected extensive state investments in state-owned firms over the past five years to cover losses and raise profitability. Many unprofitable companies were shut down in the period.

Despite the huge earnings of state enterprises, they continued their long-standing practice of retaining earnings rather than giving dividends to state. Listed state companies, however, may pay some dividends to minority share holders. State-owned companies typically use their profits to finance capital investment. In December, central bank governor **Zhou** Xiaochuan took a personal stand on dividends. The World Bank also supports payment of dividends to the state so that the state would not be treated differently from other owners.

Rise in housing prices slowed last year. Prices of new apartments were up 6.5 % y-o-y in major cities during the fourth quarter of 2005. Prices climbed over 10 % in 2004. The rise in prices moderated after spring last year when China eliminated special benefits on housing loans. Interest rates on housing loans now move in step with changes in other lending rates. The rise in prices of existing housing also slowed significantly last year.

Housing price developments vary substantially from city to city. The fastest rise in housing prices last year was seen in Beijing (up nearly 20 %). Beijing has now surpassed Shanghai as China's most expensive city in terms of the cost per square-metre of apartment floorspace; the average price of a square metre of living space in Beijing jumped to 6,700 yuan (670 euro) in 2005. Housing price growth slowed in Shanghai last year after regional administrative measures were introduced that require sellers to pay a 5 % tax based on the apartment's final selling price when the apartment has been held for less than two years. Prices for certain types of housing in certain areas of Shanghai have fallen for several months now.

IMF emphasises the role of Mainland China's economic development on the Hong Kong economy. The IMF's latest report on its Article IV consultations with Hong Kong finds that the special administrative region owes some of its recent booming economic growth to the rapid economic expansion on the mainland. The IMF forecasts GDP growth in Hong Kong will slow to around 5.5 % this year as external demand weakens and hence inflation remains in check. In order to maintain robust economic growth, the IMF argued that Hong Kong must keep its position as a significant financial market centre and supporter of Mainland China's growth as a financial intermediary. IMF board members expressed satisfaction with Hong Kong's measures to support supervision of its financial markets and structural reforms as well as efforts to increase the use of the yuan in Hong Kong.

While the IMF board noted that Hong Kong's fiscal policy stance had improved thanks to a sharp rise in tax revenues, it stressed the strategic need for having a long-term fiscal policy that will deal with the Hong Kong's rapidly aging population. Broadening the tax base was also seen as a way to reduce the variability in tax revenues. The IMF expects Hong Kong's budget to reach balance already this tax year – quite a bit sooner than earlier predictions.

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Russia

Russian inflation accelerates in February. On-year inflation exceeded 11 % last month. While the rise of food prices picked up to around 12 % y-o-y, inflation in prices of services slowed to under 17 %. Prices of other goods rose about 6.5 %.

Inflation came in well above analysts' expectations for February. In the first two months of this year alone, prices increased 4.1 %. This severely limits the chances of the government actually hitting its inflation target range for 2006 (7–8.5 %). Some observers suggest that the central bank should allow the rouble to strengthen substantially in order to subdue inflation. Not everybody, however, believes that the central bank's actions will have much impact since the causes of the pick-up in inflation are not entirely monetary. The economy ministry claims that the main reasons for the jump in inflation at the start of the year were one-time rate hikes for housing services. The rapid increase in food prices was driven by an exceptionally sharp rise in prices for salt, sugar and root vegetables. President Vladimir **Putin** criticized his government's inadequate efforts to quell inflation.

Russia was Finland's top export destination last year. The foreign trade figures from Finnish Customs show Finland's *exports* to Russia increased 32 % y-o-y in 2005, and were valued at €5.7 billion. Towards the end of the year, Russia surpassed Sweden as Finland's number-one export destination.

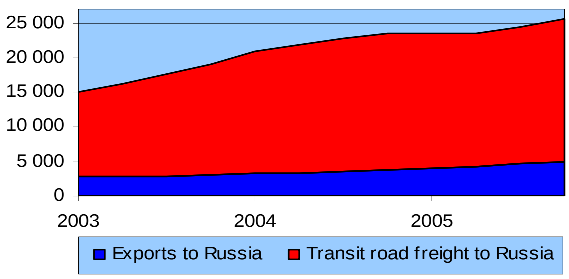
Nearly half of exports to Russia were investment goods, with about half of that (22 percentage points) mobile phones. Finland exported nearly 9 million mobile phones to Russia last year. Mobile phone exports increased 68 % y-o-y, and last year Russia was the top destination for mobile phones exported from Finland.

About a quarter of Finnish exports to Russia were raw materials and production goods, while durable goods constituted another 15 %. Automobiles represented about 7 percentage points of durable goods, and their exports increased by 44 % y-o-y.

Finland's *imports* from Russia were up 23 % y-o-y and were worth €6.5 billion. Russia was the second largest source of imports to Finland after Germany. Finland imported about €400 million more from Germany than Russia. Two-thirds of Finland's imports from Russia were energy products, of which crude oil and oil products alone were 54 percentage points. Other energy imports included natural gas and electricity. Other imports mostly consisted of raw materials and production goods. These accounted for about a third of imports, of which metals' share was 11 percentage points and raw wood's share 8 percentage-points.

Finland recorded strong increase in passenger car transit to Russia last year. Road freight to Russia moving through Finland last year was valued at €22 billion, a 13 % increase from 2004. The value of transit freight was estimated to be about 3.9 times the value of Finland's exports to Russia. The sharpest increase (88 % y-o-y) was seen in transit shipments of passenger cars, which accounted for 22 % of all transit road freight. Transit shipments of electrical devices also increased rapidly. In terms of tonnage, transit rail freight's share was about 7 % of all transit freight going to Russia. In terms of tonnage, transit rail freight fell 16 % from the previous year.

Transit road freight and Finnish exports to Russia, 2002–2005, moving four-quarter sum, € million



Source: Finland's National Board of Customs

Efforts to boost housing construction. Russia's 2002–2010 national housing program strives to raise annual production of new residential living space to 80 million square metres by 2010. The goal is ambitious: last year Russia built just under 44 million m^2 in new housing. In 1990, the comparable figure was about 62 million m^2. It is still unclear how well industries serving the construction sector are able to respond to such a rapid ramp-up in housing output.

Housing is a pillar in president Vladimir **Putin**'s "four national priorities" program announced last autumn. Reforms in the housing sector include changing the state subsidy system, increasing interest supports and loans, as well as elimination of administrative barriers to construction activities. Funding sources for the estimated RUB 900 billion (€27bn) 2006–2010 housing program are anticipated to break down as follows: private investors and creditors (52 %), federal budget (26 %), apartment buyers' own money (11 %) and local and regional budgets (10 %).

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China

NPC makes improvement of rural conditions its top theme. Topping the agenda at the ongoing week-long National People's Congress (the parliamentary organ with limited powers) was the next five-year plan to improve living conditions in rural areas. The plan's centrepiece is the "New Socialist Countryside" program to raise farmers' incomes and assure stable levels of grain production. The plan also includes better access to drinking water and electrical power supplies, as well as other improvements in basic infrastructure. The plan further seeks to bring free basic health care services to all rural residents. Farmers' rights would be strengthened to curb attempts by local officials to exercise domain over agricultural land without providing farmers with sufficient justification or compensation.

The ambitious program also commits government to elimination of all fees for attending elementary schools by the end of 2007. The change will be particularly hard on local administrations, which already have difficulties realising their commitments. Rural schools have been forced to impose fees due to the inadequacy of state funding. The high-end estimate for the cost of elementary school student is about 800 yuan (80 euro) a year, which equals approximately a quarter of the average yearly income of a rural household.

Latest five-year plan has few hard economic targets. The National Development and Reform Commission (NDRC) announced the main aspects of the eleventh five-year plan at the National People's Congress this week. The 2006–2010 plan seeks to increase social benefits for citizens such as government spending on education and health care systems, raising incomes, as well as tackling China's worsening environmental problems. Economic goals include the doubling of per capita GDP in 2000–2010 and reducing energy consumption per unit of output over the next five years.

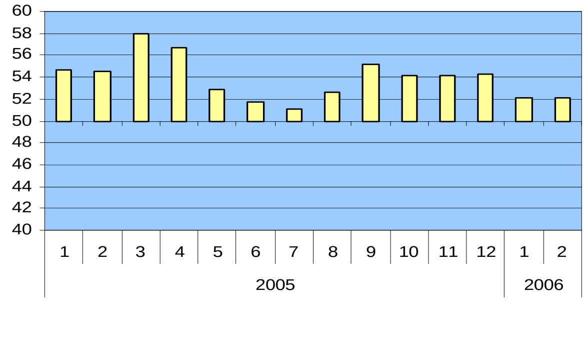
It has become increasingly difficult to set precise economic targets due to the growth of dynamic private sector, as evidenced by forecasting errors in recent years. An NDRC representative said that the government's role now is focused on providing a favourable operating environment. The government also wants to jettison a development approach that over-emphasises economic growth at the expense of the environment.

2006 budget released. China's Ministry of Finance reports that this year's budget spending (including central and local governments) will exceed CNY 3,800 billion (€380bn), which is 14 % more than in 2005. The budget is about 18 % of forecast GDP. The state this year posts a deficit of nearly CNY 300 billion (1.5 % of GDP). Although the budget deficit has persisted for fifteen years, China has been making progress on reducing its budget deficits for several years now. Growth in state revenues this year is expected to slow to about 12 % y-o-y. Revenues gained 19 % in 2005. The presentation of the budget was accompanied with a debate on how to make spending more effective. According to the national audit office, nearly CNY 300 billion (€30bn) in funds were misappropriated during the first eleven months of 2005.

Money for development of science and technology receives the strongest boost in this year's budget (nearly 20 %). China also plans to spend more on rural subsidies. Overall, however, the money going to the countryside only increased as much as average overall spending (14 %). Spending aimed at rural areas is CNY 340 billion (€34 billion). Many local governments face bleak fiscal outlooks as an increasing share of state revenues is diverted to the central government. For example, agricultural taxes that have traditionally gone to fund local governments were eliminated last year.

February PMI anticipates steady growth. The seasonally adjusted Manufacturing Purchasing Managers' Index (PMI) value was 52.1, the same as in January. The PMI is based on a survey of managers working in 700 industrial firms operating in China. It comprises five areas of analysis (new orders, output, employment, suppliers' delivery times and stocks of finished goods). It gives an idea of the economic activity of industrial firms in the reporting month relative to the previous month. The PMI is a diffusion index, i.e. values above 50 indicate that a majority of firms report their situation is the same or better than in the previous month. Conversely, values under 50 anticipate a general decline in economic conditions. China began to release the PMI index in summer 2005.

Manufacturing PMI (seasonally adjusted)



Source: www.lifunggroup.com

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Russia

Russian investment focus shifted in 2005. Rosstat estimates that total investments grew almost 11 % last year. Excluding growth of small firms and of estimated unofficial investment, investment was up 8 %. Rosstat estimates three-quarters of total investments came in through official channels. On official ledger, growth in investment in energy and mineral extraction (which includes crude oil and natural gas production) fell in volume terms nearly 3 %, and the sector's share in overall official investment fell to under 14 %. On the other hand, investments in value-added industries climbed 11 % (18 % share), due largely to heavy investments in metallurgy and the chemicals industry. Investment in the construction sector also grew briskly; together with real estate operations, the sector took in over 14 % of all investment. Investments in the transport sector were up strongly and accounted for over a fifth of total investment. The share of telecommunications was about 7 %.

Booming banking sector growth in 2005. The banking sector's total assets increased 37 % y-o-y in nominal rouble terms and nearly a quarter in real terms. Total assets at the end of 2005 amounted to €285 billion or $340 billion, and equalled 45 % of Russian GDP.

On-year growth in the stock of household bank deposits accelerated to nearly 40 %, while growth in corporate deposits slowed to 35 %. Household deposits constituted about 28 % of total assets, while the share for corporate deposits was 26 %. The share of capital shrank to under 14 %. Debt securities issued by Russian banks and liabilities to non-resident foreign banks each constituted for about 8 % of total balance sheet liabilities.

The stock of loans to non-financial companies climbed 30 % (slightly less than in previous years), and represented about 42 % of balance sheet assets at year's end. Household borrowing doubled for the third year in a row, although such loans still only account for 12 % of balance sheet assets. Banks have been rapidly building up their share portfolios and investments in corporate securities. Even so, their share of the balance sheet at the end of the year was just a few per cent.

Western creditors petition for Yukos bankruptcy. A creditor group led by French bank Sociéte Générale wants Yukos declared insolvent. The creditor group filed a $482 million claim with a Moscow court. The claim covers part of a one billion dollar loan that an international bank syndicate granted Yukos before the company's troubles with tax officials started in 2003. The Moscow court is expected to take up the petition at the end of this month. It is unclear whether the western banks will succeed in recovering any money even if Yukos is driven into bankruptcy. Russian tax officials, which have presented Yukos with about $30 billion in tax demands, have yet to recover more than $10 billion. The collection of tax arrears included the forced sale of Yukos' core production unit, which made Yukos shares essentially worthless. 34 Yukos owners and employees either face fraud charges or have already been convicted.

Russian billionaires saw their assets double last year. Business magazine *Forbes* reports that Russia is currently home to 33 persons whose property is worth at least a billion dollars. Collectively, the group controls assets of about $172 billion, an amount equal to 23 % of Russian GDP. Seven new faces made this year's list and the total value of billionaire assets nearly doubled. All of the ten richest were involved in the oil and metal sectors.

Chukotka governor Roman **Abramovich** continues to top the list as Russia's richest man. His assets of $18 billion also make him the eleventh richest man in the world. His worth climbed 37 % with the sale of his Sibneft oil company to Gazprom last autumn. Other fast risers on the list included LUKoil board chairman Vagit **Alekperov** and TNK-BP board member Viktor **Vekselberg**. Alekperov saw his assets more than double last year, and his current $11 billion valuation makes him the second richest man in Russia. Vekselberg also doubled his value last year to $10 billion, making him Russia's fourth richest man. Russia has the third largest group of billionaires in the world after the US and Germany.

Russia's 10 richest people in 2006, US$ billion

Rank	Name	Company	Age	Assets
1.	Roman Abramovich	Sibneft	39	18.2
2.	Vagit Alekperov	LUKoil	55	11.0
3.	Vladimir Lisin	Novolipetsk MK	49	10.7
4.	Viktor Vekselberg	TNK-BP	48	10.0
5.	Mikhail Fridman	Alfa Group	41	9.7
6.	Oleg Deripaska	Basic Element	37	7.8
7.	Alexei Mordashov	Severstal Group	40	7.6
8.	Suleiman Kerimov	Nafta-Moskva	40	7.1
9.	Vladimir Potanin	Norilsk Nickel	45	6.4
10.	Mikhail Prokhorov	Norilsk Nickel	40	6.4

Source: Forbes

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China

China's National People's Congress wraps up. Tuesday's (Mar. 14) final session of the annual National People's Congress reiterated improving rural conditions as the theme for the 2006–2010 five-year plan (see *BOFIT Weekly 10/2006*). The 11th five-year plan also stresses improvements in education, development of the healthcare system and better use of natural resources. China seeks to become one of the world's leading technology developers by 2020. To achieve that goal, research funding will be increased substantially over the next five years. The research thrust will be directed at information technology, biotechnology, energy and environmental science. China's space program will proceed on a fast track.

The Hong Kong and Macao special administrative regions are mentioned in the plan for the first time ever, although there will be no change in either SAR's position vis-à-vis the Mainland. Discussing monetary and foreign exchange policy, premier **Wen** Jiabao said that the state still wants to retain its majority stakes in large commercial banks. While no revaluations of the yuan like last summer's are contemplated, the Chinese currency's value will be allowed to fluctuate more broadly than at present.

Chinese consumer price inflation slows in February, pace of producer price inflation remains unchanged. *Consumer price inflation* slowed to 0.9 % y-o-y in February, down one percentage point compared to January. A modest on-year increase in food prices of just 1.2 % and fast inflation in February 2005 helped bring down overall inflation rate. The Chinese New Year holiday period, which started earlier this year in January instead of February as last year, typically places pressure on food prices and leads to general upward pressure on the inflation rate. The inflation rate in cities rose a mere tenth of a percentage point more than in rural areas. Clothing prices continued to fall in February (-2.0 % y-o-y). The strongest rise was seen in housing costs, of which rates for water, electricity and fuels rose by 8.4 % y-o-y.

On-year *producer price inflation* in February remained essentially unchanged from January, slowing a mere tenth of a percentage point to 3.0 %. The producer price inflation trend has been falling since October 2004.

China battles trade policy disputes on several fronts. EU Trade Commissioner Peter **Mandelson** this week convinced the European parliament to take action in the footwear dispute between the EU and China. Mandelson asked the EU to impose temporary anti-dumping duties on imports of certain types of leather shoes made in China and Vietnam. The EU suspects that China and Vietnam use indirect state subsidies (e.g. cheap financing, tax benefits, low leasing costs) that allows shoemakers to sell their products below actual cost. Mandelson proposed that the temporary duties be imposed incrementally starting next month and raised over the next five months to a lever of 16.8 % for Vietnam and 19.4 % for China. The gradual introduction of the duties is intended to give importers an opportunity to make the transition to the new regime without problems similar to those experienced last year after the imposition of textile import quotas. The duties affect less than 10 % of shoes sold in the EU zone and do not apply to sports shoes and children's footwear. However, in the March 16 consultative voting, only three of the EU's 25 member states supported Mandelson's initiative in its presented form. The final decision on sanctions will be made next week.

Trade relations between the EU and China have also been strained by the fact that the EU has yet to grant China the much-coveted market-economy status. The EU says it will grant market-economy status only when China changes its industrial subsidy policies and lifts artificial barriers to trade. Market-economy status would help China defend itself against dumping claims.

The US also wants China to take measure to address the trade imbalance between the two countries. The US sees Chinese foreign exchange policies as a major cause of the problem, i.e. the external value of the yuan has not been allowed to appreciate in accordance with market expectations. The US says that China should quickly end restriction that prevent American companies from penetrating China's telecommunications and computer technology sectors as well as participating in major public projects. The US also wants China do a better job of supervising and protecting intellectual property rights. Trade issues are expected to top the agenda when Chinese president **Hu** Jintao visits the US next month.

Chinese officials announced they will get involved in setting a price ceiling for iron ore imports by Chinese companies. After Chinese demand pushed up the price of iron ore by more than 70 % in 2005, Chinese officials became reluctant to allow the country's steelmakers to pay any more for their raw material feed. The intervention of officials in price negotiations between companies has aroused consternation, particularly on the part of Australia, China's main supplier of iron ore. Chinese iron ore importers contract for their requirements on a yearly basis. The current contract expires at the end of March.

China is also dissatisfied with its energy cooperation with Russia. National Development and Reform Commission (NDRC) vice chairman **Zhang** Guobao claims Russia does not understand China's energy needs, Russia's competitiveness is poor, and that Russians are unwilling to cooperate with Chinese energy companies.

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Russia

Sharp rise in Russia's consolidated budget surplus for 2005. Russia's consolidated budget, which combines federal and regional budgets, saw realised revenues last year climb over 40 % in nominal terms and expenditures 27 % from 2004. Revenues relative to GDP increased over three percentage points, while the proportion of spending to GDP remained unchanged. The budget surplus grew from 4.5 % of GDP in 2004 to 7.7 % in 2005.

Compared to 2004, strongest growth was seen in revenues from export and import tariffs. In 2004 they represented slightly less than 16 % of total revenues, but last year their share gained to 22 %. Revenues from profit tax and natural resource extraction fees also increased from the previous year. Growth in all revenue categories reflected last year's surge in energy prices.

The reclassification of budget expenditure categories for 2005 makes direct comparison with 2004 difficult. The largest spending categories in the 2005 budget were social and cultural spending, as well as spending associated with production, transport and general administration.

Realised 2005 consolidated budget 2005

	2005, RUB bn	2005, % of GDP	2005, %
Revenues	**7,612**	**35.1**	**100.0**
Revenues, excl. UST	7,344	33.9	96.5
Export and import tariffs	1,681	7.8	22.1
VAT	1,472	6.8	19.3
Profit tax	1,333	6.2	17.5
Resource extraction fees	1,002	4.6	13.2
Income tax	707	3.3	9.3
Excise taxes	254	1.2	3.3
Expenditures	**5,941**	**27.4**	**100.0**
Expenditures, excl. UST	5,674	26.2	95.5
Non-interest spending	5,702	26.3	96.0
Social and cultural sector	2,009	9.3	33.8
Production, transport, etc.	762	3.5	12.8
General administration	751	3.5	12.6
National security	585	2.7	9.8
Defence	582	2.7	9.8
Housing	472	2.2	7.9
Surplus	**1,670**	**7.7**	

Source: Rosstat

Largest share of investment went to Central Federal District in 2005. Rosstat's regional statistics show that last year over half of foreign investment (direct and portfolio investment, as well as loan tranches) went to the Central Federal District, with the Moscow City and the Moscow Region capturing the largest share. Foreign investment flowing into Moscow and the Moscow Region soared 62 % from the previous year. Investments in Moscow City and Moscow Region constituted about a fifth of all fixed investments.

In the North West Federal District, the City of St. Petersburg and the Leningrad Region attracted 7 % of fixed investment and 3 % of foreign investment. Foreign investment in regions near Finland was up sharply: 54 % y-o-y for the City of St. Petersburg and the Leningrad Region, 83 % for the Republic of Karelia and 97 % for the Murmansk Region. Fixed investment and foreign investment in the oil-rich Ural Federal District fell from 2004. In the major oil-producing area, the Khanty-Mansi Autonomous District, fixed investment declined one per cent and foreign investment was down 97 % y-o-y. Investments soared in the new Sakhalin gas and oil fields of the Far East Federal District. Fixed investment flows to the Sakhalin Region grew one per cent and foreign investment climbed 24 % y-o-y. The Sakhalin Region last year attracted 9 % of all foreign investment in Russia.

Investment by federal districts in 2005, %

Federal district	Fixed investment		Foreign investment	
	Share	Volume change	Share	Value change
Central	26.3	2.3	53.9	50.1
North West	13.7	10.8	6.5	20.9
South	9.1	5.9	1.8	43.4
Volga	16.8	8.5	4.1	-10.0
Ural	17.4	-4.6	10.0	-23.7
Siberian	9.9	15.1	12.6	115.3
Far East	6.9	5.5	11.1	17.0
All Russia	***100.0***	***10.7***	***100.0***	***32.4***

Source: Rosstat

G8 energy ministers meet in Moscow. According to a statement from meeting host Viktor **Khristenko**, Russia's industry and energy minister, the G8 ministers agreed that global energy security must be achieved by making the sector more subject to market conditions, by making regulation and tax policies more predictable and by allowing fair and reciprocal access to energy markets. The ministers also called for greater attention to the energy needs of developing nations. They said the fossil fuels will remain as the major energy source, while alternative ecologically stable energy sources such as nuclear power should also be developed.

President Vladimir **Putin** told the attendees that Russia was preparing concrete energy proposals for the G8 summit in St. Petersburg this July. Putin noted that the Duma is working amendments to mineral extraction laws and taxation, as well as ways to increase opportunities for foreign companies operating in the sector. The president expressed hope for harmonisation of interests of all parties in the world energy sector and unrestricted access to information on prospects for energy consumption.

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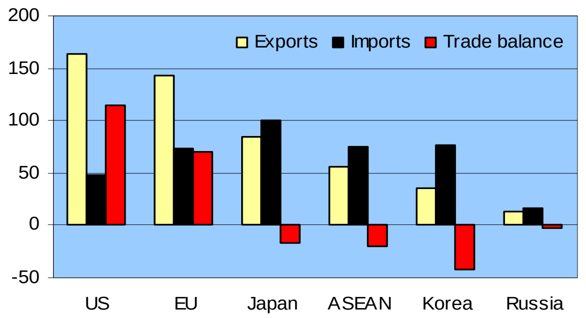
China

Chinese foreign trade surplus climbed in January-February. The foreign trade surplus exceeded $2 billion in February. For the first two months of the year, the surplus totalled $12 billion, up from $11 billion in the same period a year earlier. China's largest trading partner was the European Union, followed by the US and Japan. In the January-February period, *import* growth accelerated to over 27 % y-o-y, the highest since end-2004. The increase reflected a huge rise in aircraft imports, which were up over 200 % y-o-y. China's national airlines have made large orders for foreign-built aircraft in recent years, and deliveries of the aircraft are now in full swing. Car imports doubled. Crude oil import volumes grew 34 %, while import volumes of refined oil products fell 8 %.

Exports were up nearly 26 % y-o-y in the first two months of 2006. Machinery and equipment again constituted more than half of all Chinese exports (up 34 % y-o-y). Rapid export was also seen in ship-building (51 % y-o-y), as well as radio and phone equipment (70 %). Exports of clothing and textiles grew 15 %, while the volume of steel exports rose 23 %.

Chinese foreign trade by country in 2005, US$ billion



Source: China's Ministry of Trade

Robust January-February figures for industrial output, retail trade and investment. Industrial output continued its amazingly steady expansion at a rate of 16.2 % y-o-y in the first two months of this year. On-year industrial output has thus remained between 16 and 17 % in every month since April 2005. Further, there is no indication of any slowdown in investment in the Chinese economy; fixed investment posted nominal growth of 26.6 % y-o-y in January-February period.

Retail sales climbed 12.5 % in nominal terms, unchanged since December 2005. Growth in retail prices, an important inflation indicator, has remained below headline consumer price inflation for several months now. In January, the on-year increase in retail sales prices was a mere 1 %, which was nevertheless the highest figure since March 2005. The strong figures for production and investment may suggest oversupply in the Chinese economy and could explain the rather slow pace of inflation at the moment.

The National Bureau of Statistics this year combined its key monthly economic indicators for January and February as the Chinese New Year holiday fell in different months in 2005 and 2006 and thereby reduced the information value of individual monthly figures.

Energy tops agenda during Putin's China visit. During this week's two-day (Mar. 21–22) visit to China, Russian president Vladimir **Putin** and Chinese president **Hu** Jintao both praised the good relations between their countries. Regarding progress in the relations between the two countries 2006 is declared "Russia Year" in China, while Russians will celebrate "China Year" in 2007. More importantly, the countries last year finally resolved their four-decade-long border dispute, and organised high profile joint military exercise involving 9,000 troops. According to Chinese trade figures for 2005, trade between the two countries increased 37 % to $29 billion. The increase was driven by higher import volumes and prices for oil and raw materials. In spite of fast growth, Russia accounts for only two per cent of China's foreign trade turnover.

The visit showcased increased energy cooperation between the two countries. National energy companies signed three potentially important documents (although timetables for implementation remain partly open). China's national oil company CNPC and Russia's state-owned Rosneft agreed on establishing two joint ventures. One would concentrate on oil exploration in Russia and the other would build an oil refinery in China. CNPC and the Russian Gazprom also continue to study the possibilities of gas exports to China. The goals are ambitious; Gazprom is said to have promised to construct two gas pipelines to China. The pipelines would have a total annual capacity of 60–80 billion cubic metres (Russia's total gas exports were 187 billion m^3 in 2005). Construction costs are estimated at around $10 billion. The third document dealt with initial fact-finding for an oil pipeline from the oil fields in Eastern Siberia to China. The pipeline would branch off from Russia's main pipeline planned to extend to the Pacific Ocean. China currently gets 5 % of all of its oil imports as rail shipments from Russia.

Despite progress on the diplomatic front, the Chinese have been frustrated with Russia's lack of cooperation in the energy sphere. The Russians, in turn, are concerned with the implication of increased Chinese economic activity in Russia's Far East. Both countries are competing for access to energy resources in Central Asia.

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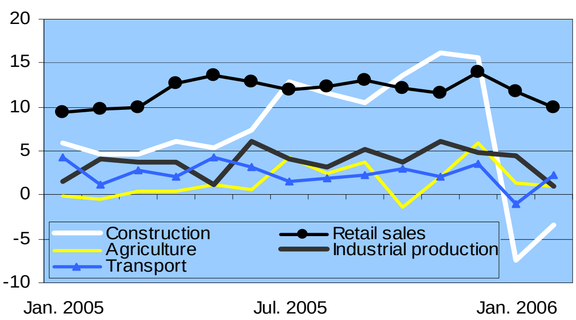
Russia

Strong growth in Russian retail sales continues. Of core production sectors, *retail sales* were up 10.8 % y-o-y in the first two months of the year. *Industrial production* increased 2.7 %, with manufacturing growth slowing to about 2 % and growth in mineral extractive industries continuing to plod along at a mere 1 % pace. *Agricultural output* rose 1.2 % and *transportation* rose 0.5 %. *Construction* fell 5.4 % y-o-y in January-February (for all of 2005 construction growth exceeded 10 %). Preliminary figures from the economy ministry suggest GDP growth in the first two months of this year was 4.1 %.

Core production sectors, % change from 12 months previous



Source: Rosstat

Russia drops export revenue conversion requirement and cuts deposit requirements for securities investments. On Monday (Mar. 27), the Central Bank of Russia decided to end the requirement that Russian companies convert their foreign currency earnings to roubles. The decision will become official when it is published. Currently, firms must convert 10 % of their exports earnings to roubles. In the wake of the 1998 financial crisis, the conversion demand was initially set at 75 % for about two years, and lowered incrementally thereafter. In actuality, the strong rouble encourages firms to convert a larger part of their export earnings anyway. The requirement that companies repatriate 100 % of their export earnings remains in force.

The central bank also decided to halve the deposit requirement for certain international capital transfers from the start of May. For example, the deposit requirement on major government securities will fall to 7.5 % for capital amounts from abroad and other securities (e.g. corporate bonds) to 1 %. No interest is paid on deposits with central bank of up to a year. The relaxation of currency controls is part of CBR efforts to eliminate all restrictions on foreign currency operations by the beginning of 2007.

Regional budgets end 2005 slightly in surplus. Nominal regional budget revenues and expenditures in 2005 grew by nearly a fifth last year. The surplus in relation to GDP, however, remained close to the 2004 level (0.3 % of GDP in 2005 and 0.2 % of GDP in 2004). The main sources for regional income were also the same as in 2004, while the share of the profit tax increased and transfers from the federal budget to regions relative to total revenues shrank. Changes in spending classifications have made finer comparisons of 2004 and 2005 expenditures problematic. Spending on social and cultural programs, education and housing remained the largest spending categories in regional budgets.

Realised 2005 consolidated regional budgets

	2005, RUB bn	2005, % of GDP	2005, %
Revenues	**2,998**	**13.8**	**100.0**
Profit tax	955	4.4	31.9
Income tax	707	3.3	23.6
Transfers from federal budget	425	2.0	14.2
Property taxes	253	1.2	8.5
Excise taxes	147	0.7	4.9
Expenditures	**2,940**	**13.6**	**100.0**
Social and culture sector*	904	4.2	30.7
Education	629	2.9	21.4
Housing	465	2.1	15.8
Administrative, national security, justice system	259	1.2	8.8
Transportation	202	0.9	6.9
Surplus	**57**	**0.3**	

* Consists mainly of spending on health care and social programs other than education. Source: Rosstat

No progress in WTO membership talks. There was little accomplished at this week's 30th meeting of the WTO working group in Geneva. Of the working group's 58 members, bilateral agreements are still outstanding for Argentina, Australia, Columbia and the US. Talks with the US remain highly contentious, with Russia refusing to give in to US demands that Russia improve access of foreign operators to its banking and insurance sectors. Open questions also remain for copyright protection, Russia's aerospace industry and import tariffs on sugar. After the working group meeting, president Vladimir **Putin** accused the US of dragging out the talks and revisiting matters already agreed on. Putin reiterated his position that Russia will not join the WTO under unfavourable conditions.

EU transportation commissioner Jacques **Barrot** last week warned Russia that EU can forfeit Russia's entry to WTO, if Russia does not honour the agreement in the issue of Siberian overflights. In May 2004, Russia agreed with the EU to eliminate Siberian overflight charges by 2013, yet to date Russia has done nothing to implement the agreement. The deal was part of the 2004 agreement package to expedite Russia's WTO membership.

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China

European Union rules on anti-dumping tariffs for Chinese leather footwear. The EU Commission decided last week (Mar. 23) to impose temporary anti-dumping duties on leather shoes made in China and Vietnam in accordance with a proposal made by EU trade commissioner Peter **Mandelson**. The EU Commission claimed it had found evidence that the two countries extensively subsidise their shoe industries, which distorts competition. To reduce problems for European importers, the punitive duties on leather footwear will be introduced gradually from April 7 and raised incrementally over a five-month period to a level of 16.8 % for Vietnam and 19.4 % for China. Children's shoes and high-tech sports shoes are exempt from the duties. The Commission claims that the duties only apply to 9 % of the footwear sold in Europe and that the overall impact on consumer prices will be negligible. EU members disagree on the necessity of new tariffs as some countries consider the measures too weak, while others see them as unnecessary or even harmful to consumer and trade interests.

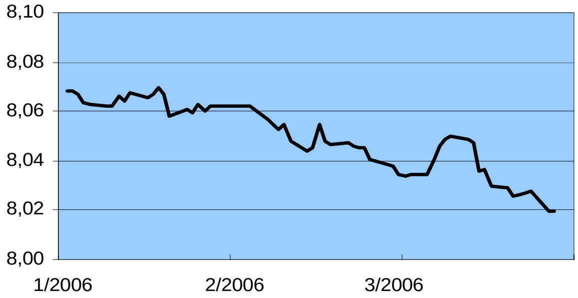
The EU is also presently considering raising a complaint with the WTO for China's decision a year ago to raise import tariffs on auto parts as they discriminate against producers outside China. Since the matter directly affects American carmakers, the EU and US may join in this matter.

Yuan makes only minor gains ahead of president Hu's visit to the US. The United States' yawning trade imbalance with China has fuelled a loud debate on whether and how much the yuan might be undervalued in relation to the dollar. It now appears that the 27.5 % punitive tariff on goods imported from China proposed by the US senators Charles **Schumer** and Lindsey **Graham** has been taken off the Senate's agenda until next autumn. Some US legislators are also nervous about the US treasury department's threat to officially classify China as a "currency manipulator." which Senate finance committee members Charles **Grassley** and Max **Baucus** this week also introduced a bill that would permit the US to take measures against countries with exchange rates "fundamentally misaligned" with the dollar. The exercise is somewhat cosmetic as it is impossible to determine unambiguously what an equilibrium exchange rate might be for a country like China.

Most economists feel that even a substantial yuan appreciation would do little to close the trade gap between China and the US, because the US no longer competes with Chinese imports. A surge in the yuan's value or punitive tariffs would merely cause US importers to shift from China to other developing Asian countries. It is also possible that importers could accept lower profits in the US and not pass on exchange rate changes to final consumer prices. Finally, a large part of China's exports are made by US-owned firms, which means that any yuan appreciation would hurt Chinese exports and thereby reduce the profitability of those American companies.

The Chinese have allowed the yuan to appreciate slightly against the dollar since last July's revaluation. In recent days, the yuan's exchange rate in relation to the dollar has fluctuated around 8.02. In other words, the yuan has appreciated only about 1 % since end-July 2005. Market rumours of a boost in the yuan's external value are widespread ahead of president **Hu** Jintao's visit to the US in April. On the other hand, prime minister **Wen** Jiabao and spokesperson for the People's Bank of China have publicly declared that no major revaluation like last July's is contemplated. Thus, any yuan appreciation will have to occur through gradual increases in the exchange rate.

Yuan-dollar exchange rate, January–March 2006



Sources: Reuters, Bank of Finland

Fuel prices go up. Last weekend China's National Development and Reform Commission (NDRC) raised gasoline and diesel fuel prices an average of 5 %. Shanghai residents, for example, now pay 4.13 yuan (0.41 euro) per litre for 90-octane unleaded gasoline. Fuel prices in China are extremely low by international standards and strictly regulated. Prices were last raised in July 2005. The NDRC has been reluctant to make further hikes for fear of adding to the burden on farmers. The transport sector is also loudly opposed to increases. Nevertheless, large increases may lie ahead. The NDRC announced last week that China would introduce a new system to reimburse farmers, fishermen and organisations engaged in public transport for fuel price increases.

Chinese oil refiners have suffered as world prices for crude oil have risen faster than domestic fuel prices. The sector is estimated to have suffered losses of around CNY 30 billion (€3bn) last year. Even with the latest hike in fuel prices, China's largest oil refiner Sinopec announced prices still need to be raised another 17 % simply to make refining of imported oil a break-even proposition.

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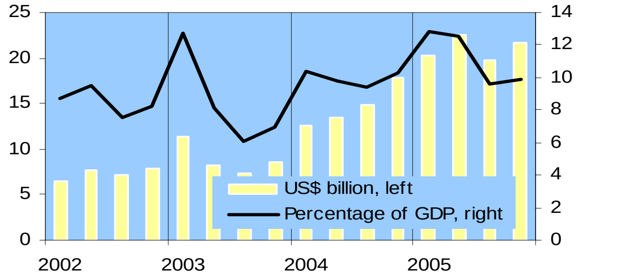
Russia

Russian current account surplus grew in 2005; higher financing flows. The latest Central Bank of Russia balance-of-payments figures show a current account surplus for 2005 of over $84 billion, or 11 % of GDP (10 % of GDP in 2004). In the second half of last year, growth of the surplus stabilised with the slight easing of fast growth in export earnings. For all of 2005, revenues from exports of goods and services grew 35 %; import expenditures were up 22 %. Services accounted for nearly a quarter of all imports, although their share declined slightly. Included in the current account surplus, the trade surplus exceeded 15 % of GDP. The services account remained in the red (2 % of GDP) as did the investment income account (nearly 2.5 % of GDP), which consists mainly of dividends and interest payments.

In the financial account, foreign direct investment inflows to Russia remained nearly unchanged at around $15 billion in 2005. Direct investment outflows from Russia grew slightly to about $14 billion (both items amounted to less than 2 % of GDP). Portfolio investment from Russia climbed to nearly $11 billion (mainly purchases of debt securities by federal authorities and banks). Companies substantially increased their international lending activities. Capital transferred abroad by using fictive import and securities deals was estimated at $27 billion, about the same level as in 2004. Corporate net borrowing (excluding banks) from abroad increased from $16 billion in 2004 to over $40 billion last year. Banks also saw their international claims and especially their liabilities increase appreciably.

Russian current account surplus



Source: CBR

Russian inflation down slightly in March. On-year inflation slowed slightly from February to 10.7 % in March. On-year inflation in the prices of *services* slowed to 16 %, though inflation in prices of housing and housing-related services remained high. The on-year rise in *food* prices slowed slightly from February to 11 % but was still driven by the high on-year rise in prices for sugar and vegetables. Prices of *other goods* rose at about 6.5 % y-o-y, about the same rate as last month. Consumer prices are up 5 % (food over 6 %) since the start of the year, which makes it highly unlikely that the government will meet its inflation target range of 7–8.5 % for 2006.

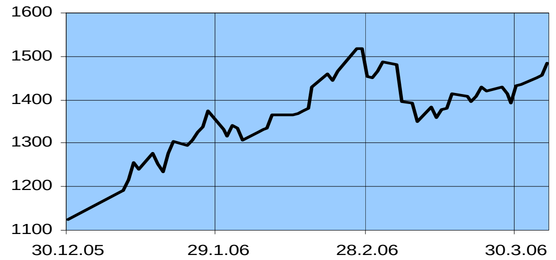
Corporate borrowing from abroad continued to rise in late 2005. The foreign debt of companies in Russia (excluding banks) increased from $76 billion at the end of 2004 to $126 billion (almost 17 % of GDP) as of end-2005. Loans taken by firms amounted to $99 billion at the end of the year. The amount of corporate debt issues abroad also increased (the debt stock exceeded $12 billion). Other forms of corporate debt consist mainly of debts to foreign parent corporations (over $13 billion). The gross foreign debt of banks operating in Russia was about $50 billion at year's end.

Timely and early retirement of foreign debt reduced the federal government's foreign debt in the period due. Federal foreign debt at the end of 2005 was $70 billion, or just over 9 % of GDP. Half of that was Soviet-era debt.

Stock market volatility. Russia's RTS index broke through the 1,500 level for the first time at the end of February, raising concerns in the cabinet and among some analysts of an impending stock bubble. Other analysts, however, still consider Russian shares undervalued. The long rise in stock prices has been supported by low interest rates in Western markets and increasing interest in emerging markets, as well as higher oil prices, which have also boosted the supply of available domestic capital.

After peaking at the end of February, the index fell on fears of overheating, an impending drop in oil prices and expectations of higher interest rates in Western markets. This week the RTS index climbed back to a level of 1,485 and had a market capitalisation of $114 billion. The index, which is heavily weighted with oil companies, is highly sensitive to changes in oil prices.

RTS index



Source: RTS

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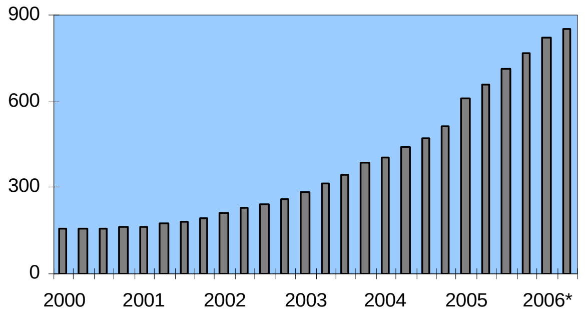
China

China's currency reserves now largest in the world; yuan appreciates against the dollar. China's foreign currency reserves grew from $819 billion at the end of December to $854 billion at end-February. China now surpasses Japan as the country with the world's largest foreign currency reserves (the Bank of Japan reports reserves of $850 billion at end-February). The rapid reserve accumulation largely reflects China's $12 billion trade surplus in the first two months of the year. Other factors contributing to the soaring surplus include direct investment and other capital imports related to revaluation expectations.

The growth in foreign currency reserves is due to the fact that the People's Bank of China has been reining in appreciation of the yuan against the dollar through active buying operations on currency markets. However, recently the PBoC has been somewhat more tolerant of modest appreciation of the yuan against the dollar. This likely has something to do with president **Hu** Jintao's upcoming visit to the US this month. The yuan-euro exchange rate still largely tracks the euro-dollar rate. On Thursday (April 6), the yuan-dollar rate was 8.01 (i.e. the yuan has appreciated 0.7 % against the dollar since the start of the year). The yuan-euro exchange rate was 9.82 (i.e. the yuan has lost about 3 % against the euro since the start of the year).

Quarterly growth in China's currency reserves, US$ billion



Source: PBoC

China's foreign debt still relatively small. China's State Administration of Foreign Exchange (SAFE) reports that China's foreign debt at the end of 2005 was $280 billion, an increase of nearly 14 % from 2004. In recent years, the share of short-term debt in the overall debt stock has increased, reaching almost 56 % at the end of last year. Much of that growth has been driven by a sharp rise in trade debt. Although SAFE tightened its supervision of trade debt last summer, the debt now represent nearly a third of the total loan stock. Enterprises see such debt as a way to profit from the expected appreciation of the yuan. China's foreign debt remains quite small; the debt stock corresponds to only about 12 % of GDP or a third of the country's foreign currency reserves.

Direct Japanese investments in China up in 2005 despite political tensions. The Japan External Trade Organization (JETRO) reports that direct investment by Japanese firms in China grew 19.8 % in 2005. Investment rose to $6.5 billion, about a tenth of total foreign direct investment inflows into China. Investment was focused on companies involved in car manufacturing and electronics.

Growth in direct investment reflects a steady increase in economic cooperation between China and Japan despite emerging political conflicts between the two countries. Last year's anti-Japan demonstrations in China and boycotts of Japanese products, along with territorial and natural resource disputes, have tried the political relations of the two countries. Japan is worried about China's increasing military presence in the region, while China is offended by Japanese prime minister Yunichiro **Koizumi**'s annual visits to the Yasukuni war memorial in Tokyo. In late March, Japan announced it was postponing decisions on further yen-denominated lending to China.

The JETRO study found that a large share of the responding Japanese companies did not feel that they needed to take measures against higher country risk associated with China. The survey covered Japanese companies operating in six ASEAN countries and India.

Macao's economic growth figures return from the stratosphere. The Census and Statistics Department of Macao reports that GDP in the special administrative region was up 6.7 % y-o-y in real terms. The decline from 2004 spectacular 28 % economic growth was seen to reflect a normalisation brought on by slower growth (8 % y-o-y) of the all-important gaming industry. Since the state monopoly on the gambling sector was lifted in 2002, gambling has been the primary engine of Macao's economic growth and has attracted foreign investment on a massive scale. Economic growth was also dampened by a nearly 12 % y-o-y contraction in goods exports, due largely to the elimination of quotas on textiles and clothing in agreement with WTO commitments at the beginning of 2005. About two-thirds of Macao's goods exports are textiles and clothing. Investment increased 57 % y-o-y, with a large part of that going to the gambling and tourism sectors. Macao's high economic growth has been particularly beneficial to the banking sector, which saw profits double last year.

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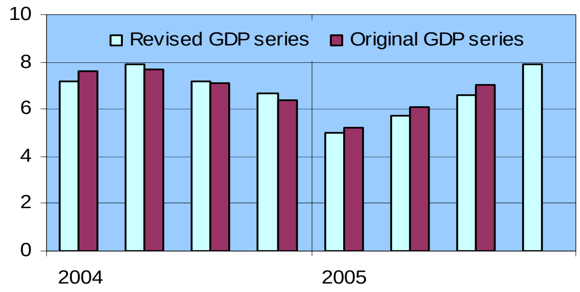
Russia

Rosstat releases Russian fourth quarter GDP figures and adjusts quarterly numbers back to 2003. GDP growth in the fourth quarter of last year was 7.9 %. Growth accelerated towards the end of the year in consumption-driven sectors, particularly retail trade, construction and manufacturing. Rosstat also adjusted its quarterly 2003–2005 figures for GDP (but left annual growth figures untouched). On the demand side, export volume growth slowed to just over 6 % in 2005. The 2005 figures for annual private and public consumption growth were revised slightly downwards to just under 9 %, while investment growth was adjusted up a bit to over 11 %. Both exports and investments accelerated strongly in the just-released fourth-quarter figures. GDP growth for 2005 overall remained at 6.4 %.

Quarterly change in GDP, 2004–2005, % y-o-y



Source: Rosstat

Rouble up in first quarter. The rouble's nominal exchange rate appreciated in 1Q06 over 3 % against the dollar, 2 % against the euro and over 2 % against the CBR's trade weighted currency basket. The Central Bank of Russia has allowed the rouble to appreciate in order to rein in inflation. The rouble's real exchange rate climbed nearly 6 % in the first quarter and was up almost 11 % y-o-y in March. CBR chairman Sergei **Ignatyev** recently noted that the central bank would not let the rouble strengthen further in the months ahead. He said that the higher real exchange rate may begin to affect industrial output, and, in fact, industrial output slowed in the first months of this year. Arkady **Dvorkovich**, head of the Russian Presidential Experts' Directorate, said a strong rise in the rouble's nominal exchange rate would cause an unnecessary shock to the economy.

Proposal on investing stabilisation fund assets abroad. With oil revenues pouring in, Russia's stabilisation fund has swelled, which has provoked a debate on investment and spending of fund assets. At the beginning of April, the stabilisation fund contained assets of nearly RUB 1,700 billion ($61bn), which corresponds to about 8 % of GDP. Finance minister Alexei **Kudrin** said the money in the stabilisation fund should be invested in foreign securities and that the investment program could be launched within a few months. Kudrin stated that the government is unanimous in its view that most assets should be invested in foreign government bonds because the offer low risk and are fairly liquid. A small part of the funds could be invested in higher yield, higher risk shares of large foreign companies. Kudrin added that the government also intends to use stabilisation fund assets this year to pay down $12 billion in Paris Club debt ahead of schedule.

Russia's finance minister has consistently rejected proposals to use stabilisation fund assets in domestic markets, because he feels they would accelerate inflation regardless of whether they go to investments, tax cuts or covering other budget spending. Economy minister German **Gref** voiced support for the finance ministry's position.

***Euromoney* and *Institutional Investor* release country-risk polls.** In the country risk evaluations published last month, *Euromoney* queried 185 countries and *Institutional Investor* considered 173 countries. The comparisons measure creditworthiness in terms of country risk. Among the countries BOFIT monitors, Ukraine showed the greatest improvement in both polls. Russia's also raised its standing in both polls and did especially well in the Institutional Investor report. The country risk for EU membership candidates Bulgaria and Romania fell in both comparisons.

Euromoney gave China special scrutiny, giving special attention to the country's need to open up its banking sector, improve enforcement of copyright laws, modernise its industrial capacity and deal with unemployment.

Country-risk poll numbers and on-year change, March 2006 (100 = lowest country risk)

	Euromoney		Institutional Investor	
	3/2006	on-year change	3/2006	on-year change
Hong Kong	82.74	0.3	78.7	3.0
China	61.71	0.5	69.8	3.8
India	56.45	0.1	57.1	1.8
Russia	54.65	1.1	62.1	6.9
Bulgaria	54.31	2.2	57.0	5.0
Romania	53.22	1.3	52.8	4.4
Ukraine	45.74	3.1	46.5	9.0

Sources: Euromoney, Institutional Investor

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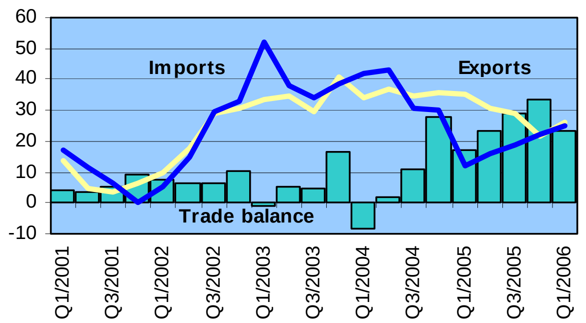
China

China posts huge trade surplus in March. China's foreign trade surplus climbed to $11.2 billion in March, a near doubling in size from March 2005. March exports were valued at $78.1 billion (up 28 % y-o-y), while imports were worth $66.9 billion (21 % y-o-y). The on-year pace of growth in exports matched January 2006, while import growth slowed to the same level as November 2005. The burgeoning foreign trade surplus is expected to incite shriller US calls for a yuan revaluation ahead of president **Hu** Jintao's visit to the US next week.

Imports and exports (y-o-y, %); trade balance (US$ billion)



Source: China Customs

Business confidence indicators suggest belief in continued rapid growth. The National Bureau of Statistics last week issued its confidence index readings for the first quarter of 2006. The Business Climate Index (BCI), at 131.5, was nearly unchanged from 4Q05. The BCI is based on interviews with 19,500 firms; values over 100 indicate a general expectation of improving economic conditions. With the exception of an up-tick in 3Q05, the BCI trend has generally been declining since end-2004.

The Entrepreneurs' Confidence Index (ECI), a measure of business sentiment on the macroeconomic situation and macroeconomic policy, increased significantly in the first quarter of 2006. After falling throughout 2005, the ECI rose by nearly eight points to 133.1. The ECI indicators making notable gains were manufacturing and the transportation sector, which had both shown sharp drops in 2005. Despite conflicting trends in the BCI and ECI for the first quarter, both had values well above 100 (the point of neutral sentiment), indicating strong and widespread confidence that China's robust economic growth will continue.

Which Chinese firms have the best shot at international dominance? At the beginning of this month, the IBM Institute for Business Value, in association with Fudan University, published an assessment of the readiness of various Chinese companies for international expansion. The assessment focused on large firms operating in the industrial and raw material sectors. The report is premised on the view that Chinese companies are just embarking on international expansion and have a long way to go before they become major international players.

In the first phase of identifying companies with internationalisation potential, researchers categorised companies on the basis of size. Companies with turnover greater than one billion dollars were selected for the group with internationalisation potential. The report notes Chinese companies are still small by international standards. Only 14 companies had annual turnover above $15 billion, less than a tenth of the number of companies in the US making that amount. The study identified 290 Chinese companies whose turnover exceeded the one-billion-dollar level.

In the second screening round, companies were classed by field of activity. Only industrial branches of global significance were taken. Internationalisation potential criteria here included importance to the Chinese economy or exports, degree of consolidation and state support for global expansion efforts. Some twelve fields were identified, and the number of potential companies whittled down to just 124.

The final criteria were the company's position in the Chinese market, a requirement that at least 15 % of company's turnover was generated from foreign operations and a clear vision of the company's global expansion plans. Of the 60 firms meeting all the above criteria, 47 are majority state owned, while the majority of shares in the remaining 13 companies were held privately.

The report's makers believe these 60 companies include the firms that will rise in the next ten years to become major international corporations. The group includes some well known actors already well along the path to globalisation (e.g. Chinese energy giants Sinopec, CNPC and CNOOC; steel giant BaoSteel; home appliance maker Haier; and Lenovo, the company that bought out IBM's PC business), as well as a sizeable number of companies unknown outside China. The newcomers are actively pursuing internationalisation strategies in all twelve designated fields.

The global march of Chinese companies will be based on organic growth and corporate acquisitions. Companies set on the globalisation path claim to be motivated by a desire for growth, broader technological and business management capabilities and tough competition on China's domestic markets. Companies complain that their largest obstacles to international success at present are a lack of competent personnel and poor recognition of Chinese brands.

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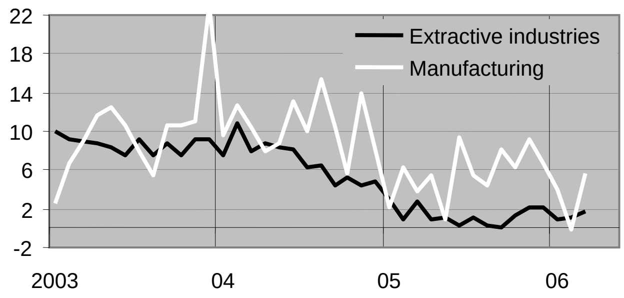
Russia

Moderate growth of industrial output continues in Russia. Rosstat reports Russian industrial output increased 3 % y-o-y in the first quarter. On-year growth in mining and mineral extraction industries (including oil) accelerated slightly in March and was 1.3 % in the first quarter. Oil production was up 1.8 % and natural gas production 2.3 %. On-year growth in manufacturing production rebounded in March, bringing first quarter growth overall up to 2.8 %. In manufacturing, fuel oil production increased about 8 %. Production and distribution of electricity, gas and water was up 6.5 %.

Monthly output of extractive industries and manufacturing, % change y-o-y



Source: Rosstat

Federal budget revenues and expenditures up in first quarter. Preliminary information from the finance ministry show federal budget revenues as a share of GDP reached a record level of nearly 27 % in January-March (while revenues were also substantial in the same period last year, most of that increase came from one-time collections, most notably the money collected from back tax demands on the Yukos oil company. Revenues this year reflect the sustained record highs in world oil prices.

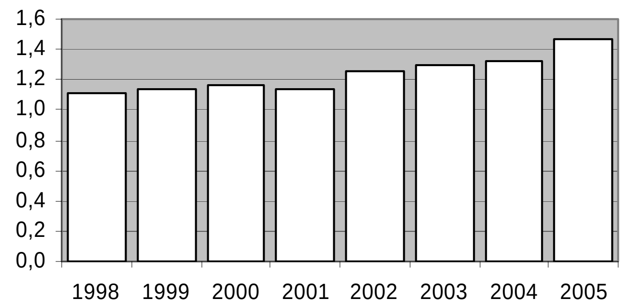
Compared to the first quarter of 2005, total budget spending as a share of GDP rose slightly to nearly 16 %. With the decline in debt-servicing costs, the GDP share of money available for actual spending rose more substantially. Higher revenues boosted the budget surplus to almost 11 % of GDP.

Public sector budget plan for 2006–08. Under the government-approved plan for public sector finances (includes federal, regional and local budgets, as well as public funds such as the pension fund), revenues would fall next year to about 34 % of GDP, while spending would drop to about 31 % of GDP. Both revenues and expenditures, however, would increase in real terms. The budget plan assumes the world price for Urals crude will fall from an average of $51 a barrel last year to an average of $46 a barrel for the period 2007-08.

Nearly all of the public sector surplus, which is intended to remain at over 3 % of GDP, will accrue to federal coffers. Using the oil price assumptions, federal revenues would fall to 20 % of GDP in 2007 from nearly 24 % in 2005. As in earlier years, most revenue collections would go first to the federal budget. Thereafter, about a quarter of revenues would be distributed onwards, mainly to the pension fund and regional budgets. Total federal expenditures will grow as a share of GDP this year, although their share is expected to fall again in relation to GDP in 2007-08. The same applies to spending of the federal funds available after transfers and debt interest payments. These are expected to reach about 12.5 % of GDP in 2007-08. Federal government debt is expected to contract from over 14 % at end-2005 to about 10 % of GDP by end-2008. In the next three years, the state stabilisation fund is expected to increase to over 12 % of GDP (assuming none of the fund is spent).

Number of civil servants in Russia continues to rise. Despite president **Putin's** attempts to reduce the size of Russia's bureaucratic machinery, Rosstat reports the number of public officials has grown by a quarter since he took office. The number of public officials employed in 2005 increased over 10 %, reaching nearly 1.5 million by year's end (or about 1 % of the entire population). In some of the least populated regions in Siberia and the Far East, public officials constituted as much as 5 % of the population. The civil servants are mainly federal officials and working in the organs of the executive branch. The largest concentrations of public officials worked for the tax authorities, Russia's supreme court system and the federal customs service.

Number of public officials in Russia, in millions



Source: Rosstat

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China

China's strong economic growth continued in the first quarter. China's GDP increased 10.2 % y-o-y in the first quarter – the highest growth in three years. The sizzling growth was driven by fixed capital investments in urban areas, which accelerated to nearly 30 % y-o-y. Industrial production continued to enjoy steady on-year growth of around 17 %. In addition, the inflation rate in March was 0.8 %. Some observers expect continued rapid GDP growth to provoke government measures to cool fixed capital investment. Several international agencies saw China's economic growth slowing this year to the 8–9 % range. Based on the first quarter data the IMF has raised its 2006 growth projection by more than a percentage point to 9.5 %. China surpassed France and Great Britain last year to become the world's fourth largest economy. Although the GDP figures were only officially released yesterday (Apr. 20), president **Hu** Jintao surprisingly announced the headline numbers already last weekend ahead of his trip to the United States.

China further eases capital controls. Chinese officials announced last week that they were relaxing controls on capital flows out of the country and that the change would apply to both private individuals and certain institutional investors groups. When the new rules go into effect next month, private individuals will be able to purchase up to $20,000 worth of foreign currency a year instead of the current $8,000 amount. Certain Chinese banks will also gain the right to invest in foreign bond markets and some insurance companies will be permitted to hold foreign fixed-income instruments. Investment in foreign stock markets will also become easier and the quotas on foreign direct investment of Chinese companies will be eliminated. The new rules should reduce revaluation pressures on the yuan and they make it possible for Chinese investors to take advantage of high-yielding foreign financial markets. However capital outflows may be limited by investor expectations of further yuan appreciation against the dollar.

The freeing of capital movements is generally viewed as a needed step in the process of transforming the yuan into a fully convertible currency. In recent months, China has implemented several reforms in its currency markets, including the launch of a market-maker system and the opening of OTC currency trading among banks. The new liberalised rules on capital movements were announced on the eve of president **Hu** Jintao's US visit and apparently intended to pre-empt US demands for a yuan revaluation.

Foreign direct investment in China remains sizeable. China's Ministry of Commerce (MOFCOM) says that foreign direct investment (FDI) inflows climbed over 6 % y-o-y in the first quarter. Investments slightly exceeded $14 billion, of which $10 billion went to companies that were 100 % foreign owned. International car manufacturers, logistics companies and retail chains are leading the charge to invest in China this year.

In the first three months of this year, Germany registered the highest growth in FDI for a particular country; German FDI quadrupled from a year ago to nearly $800 million. Finnish investment in China tripled to $17 million. Hong Kong continued to reign as China's leading FDI source. At the same time, investment flows from Japan, Korea, Taiwan and the US dropped significantly. Investment flows channelled via tax havens rose 20 % y-o-y, and now constitute nearly 23 % of all foreign direct investment. This trend helped the Virgin Islands secure its position as China's second largest source of FDI.

China attracts FDI by offering e.g. tax breaks to companies that take on foreign capital. As a result of the tax advantages, recycled Chinese investment is mixed in with true foreign investment. Chinese companies simply move their money through third countries to get the tax benefit. This week, the director of MOFCOM's foreign investment office announced that China would continue policies designed to attract FDI. Efforts to equalise corporate income tax treatment of domestic and foreign-owned companies have been long under preparation and the reform will be revisited by legislators in the autumn.

China pursues engaged foreign policy in the South Pacific and Cambodia. Chinese prime minister **Wen** Jiabao has committed to broader economic assistance to the island nations of the South Pacific. China will reduce barriers to trade from those poorest nations in the region that have diplomatic relations with China. China also promised to support economic development in the South Pacific region through packages that include loans, debt forgiveness and support for Chinese investment in the region.

Wen's visit was the first by a Chinese prime minister to the South Pacific. It took place in conjunction with the China-Pacific Island Countries Economic Development and Cooperation Forum.

The prime minister has also offered Cambodia $600 million in economic assistance and loans. Much of the money will go to infrastructure projects that also benefit Chinese industry. China's increased activity in providing economic assistance reflects its intention to strengthen its strategic position in the Asia-Pacific region, which is motivated by such needs as increased access to raw materials.

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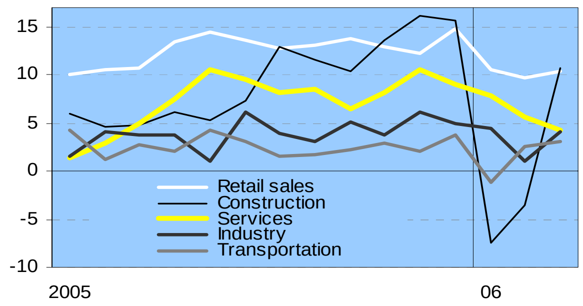
Russia

Russian first quarter GDP growth slightly slowed. Growth revived in March in most core economic sectors. Growth of retail sales continued at a brisk 10 % rate, while chargeable services saw only modest increases. After a slowdown in construction in the first two months of this year due to a drop in housing construction, growth revived in March. Industrial output growth also revived. Growth in the transportation sector continued at a 2 % y-o-y pace, while agricultural output growth hovered around 1 %. Preliminary figures from the economy ministry show GDP growth was 4.6 % y-o-y in the first quarter.

12-month change in core economic sector growth, %



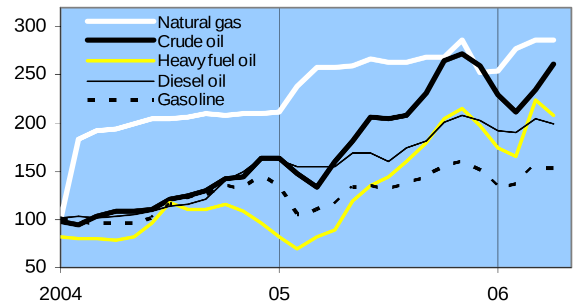
Source: Rosstat

Stabilisation Fund assets may be invested in foreign government bonds and currencies. Last week, prime minister Mikhail **Fradkov** signed a resolution on managing the Stabilisation Fund's assets. The resolution allows purchases of dollars, euros and pounds, as well as government bonds with the highest credit ratings issued by the US, UK and euro-area countries. The assets will be invested through the Central Bank of Russia. The finance ministry will manage the investment of Stabilisation Fund assets and report to the government quarterly on the operations performed. Finance minister Alexei **Kudrin** said his ministry was preparing the necessary paperwork that the investment of the fund's assets could begin within a few months.

Some politicians and economists have criticised the resolution because it still does not allow the investment of fund assets in securities of major international corporations. The World Bank notes that diversified investment of Stabilisation Fund assets has a long-run advantage of increasing yields and possibly hedging the Russian economy against the risks of oil price shocks as returns on certain types of stocks are bound to increase when oil prices decline.

Industrial producer prices climbed rapidly in the first quarter. Prices were up 6 % from the beginning of the year (compared to 4 % in the corresponding period last year). March producer prices climbed 15 % y-o-y. As last year, oil sector prices continued to drive up producer prices.

Natural gas and oil product prices in Russia, December 2003 = 100



Source: Rosstat

Russia responds to EU energy security worries. Last week in Moscow, Gazprom CEO Alexei **Miller** warned EU ambassadors on attempts to interfere with Gazprom's entry into European internal energy markets. Miller was referring to EU initiatives to prevent Gazprom from directly operating in EU internal energy markets. After Miller said Russia was ready to take its business to energy markets in North America and Asia, an EU representative responded by reminding Gazprom of its existing contractual obligations.

President Vladimir **Putin** proposed last month to EU Commission president Jose Manuel **Barroso** an arrangement whereby Russia would permit foreign participation in energy transport and transmission in Russia in return for allowing Gazprom to participate in energy distribution and electricity production in EU countries. Energy security was also a major theme this week when German chancellor Angela **Merkel** met with president Putin in the Russian city of Tomsk.

Following interruptions in natural gas deliveries last winter, the EU has become much more sensitive to the reliability of its energy supplies. EU countries want to reduce their exposure to supply interruptions by using a greater number of energy suppliers and transportation routes. The International Energy Agency (IEA) has also commented on the EU's overdependence on Russian energy resources.

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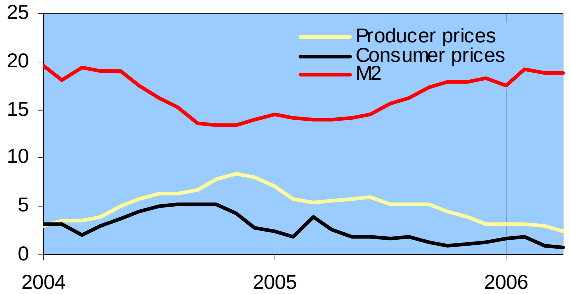
China

China's inflation rate continues to fall despite rapid money supply growth. Consumer price inflation continued to slow in March, reaching a level of 0.8 % y-o-y. On-year growth was a tenth of a percentage point lower than in February. Food prices, which have a significant impact on Chinese inflation, were up 0.8 % y-o-y. Producer price inflation also continued to decelerate, falling to just 2.5 % y-o-y in March.

Strong growth in the broad money supply (M2) and rapid expansion of credit in the first quarter have yet to aggravate inflation. M2 growth at the end of March was 18.8 % y-o-y, which well out-paced the central bank's target of 16 % for all of 2006. The volume of new yuan-denominated lending in the first quarter alone amounted to more than half of the government's target for all of 2006. This situation has rekindled fears among economists that China's economy is overheating. It is also possible, however, that the lending boom and large investment projects are creating oversupply in the domestic economy. Private consumption remains at a low level and therefore generates little inflationary pressures. On Thursday (Apr. 27), the People's Bank of China raised its benchmark interest rate – the one-year lending rate – from 5.58 % to 5.85 %.

On-year growth in prices and broad money supply (M2), %



Sources: China's National Bureau of Statistics and the PBoC

Industry profits continue to impress. In the first quarter of this year, industrial profits were up over 20 % y-o-y to nearly CNY 340 billion (€34bn). Profits were shared almost evenly between state-owned enterprises and privately owned companies, but profit growth was much faster in private corporations. Profits of foreign-owned firms more than tripled, although the actual amount was quite modest (less than CNY 100 million). In fact, the profit figures for foreign firms call in question reliability and usefulness of these statistics as firms may manipulate their profit figures by transfer pricing. China's figures for industrial profitability include all state-owned enterprises and firms with net sales exceeding CNY 5 million (€500,000).

The strongest profitability growth was registered by producers of crude oil and natural gas (up 65 % y-o-y), non-ferrous metals (nearly 100 %) and electrical power (over 50 %). Overcapacity in the steel industry and high raw material prices cut into profits and caused steelmaker profits to shrink by over 60 % y-o-y. Profits in the chemical industry were also down. As expected, oil refining suffered huge losses in the first quarter. The losses are the result of regulated fuel prices, which have not increased fast enough to keep up with skyrocketing oil prices on world markets. The huge losses of oil refiners have reignited the discussion on revising the current fuel pricing scheme.

No new initiatives during president Hu's visit to the US. Last week's discussion between presidents George W. **Bush** and **Hu** Jintao focused on the international political situation and the Chinese economy. On the former topic, president Bush said the US and China had joint strategic interests in global security issues, particularly peaceful resolution of the situations in Iran and North Korea. Bush expressed his wish that China would take a more active role in international organisations that deal with global problems. On the economic front, the US repeated its earlier position that China needs to increase its domestic consumption by reforming its social security system, easing access of American products to the Chinese market, improving protection of intellectual property rights and increasing the flexibility of the yuan's exchange rate. President Hu stressed the importance of economic cooperation in bilateral relations. The critical issues in the eyes of the Chinese media, however, were Hu's statements on Taiwan and US support for the One-China policy.

The visit saw no new initiatives from either side. The themes of discussion indicate that the countries place different emphasis on what is important. For China, the Taiwan question and trade relations topped the list, while US concerns centred on nuclear security, human rights and the massive bilateral trade imbalance. If nothing else, president Hu's visit showed that despite differences in emphasis, the two countries are capable of engaging in normal dialogue.

After the US, Hu continued his world tour with visits to Saudi Arabia and Africa. On Monday, Hu visited Morocco, before moving on to Nigeria and Kenya.

EU-China relations top agenda of Finnish prime minister's China visit. Finnish prime minister Matti **Vanhanen** met with Chinese prime minister **Wen** Jiabao on Wednesday (Apr. 25) in Beijing. With Finland set to assume the rotating EU presidency in July, discussions naturally turned to ongoing EU-China trade disputes, as well as the agendas for the upcoming ninth EU-China summit and the sixth EU-ASEM summit, both to be held in Finland next autumn.

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Russia

IMF raises its economic growth forecast for Russia. In its latest semi-annual *World Economic Outlook*, the IMF predicts Russia's economy will grow 6 % this year and 5.8 % next year. The growth projections for both 2006 and 2007 were raised 0.8 percentage points from last autumn's estimates. The new projections assume that the world price for crude oil will average slightly over $61 a barrel this year, or 15 % higher than in 2005, and rise nearly 3 % in 2007 to $63 a barrel.

The IMF expects Russia's current account surplus to reach nearly 12 % of GDP this year and then fall next year to under 10 %. The 2006 federal budget surplus is expected to amount to 7–8 % of GDP and then fall slightly to 6–7 % of GDP in 2007.

Rapid wage growth continued in first quarter. Preliminary Rosstat information shows the average recorded monthly wage in the first quarter was 9,400 roubles (280 euro), an increase of 23 % y-o-y. In real terms, the average wage climbed nearly 11 % y-o-y. In manufacturing industries, the rise in wages continued at an on-year pace of about 20 %, with the average wage in February just under 8,900 roubles. Thanks to recent wage hikes, budget sector wages (excluding those in education) rose considerably faster than wages generally. However, the average wage in the education sector remained about two-thirds the average in manufacturing. Jobs in the healthcare sector paid about three-quarters of those in manufacturing.

Budget sector wages were raised at the beginning of this month by an average of 15 % and are set for yet another hike towards the end of this year. The minimum wage was also raised by over a third to 1,100 roubles a month.

Incremental system for Russian mineral resource extraction taxes proposed. The government submitted to the Duma this week a bill proposal on scaling natural resource use taxes. The amendment is intended to extend the operational lifetimes of existing oil fields and increase interest in exploration for new fields. Under the proposed legislation, oil pumping would be tax-exempt for ten years and oil exploration operations for 15 years. The government wants to limit the proposed exemptions in the incremental system to the East Siberia region, but deputy finance minister Sergei **Shatalov** said it was possible the Duma could choose instead the economy ministry's original proposal, which also includes oil deposits in the Timan-Pechora region and off-shore deposits on the continental shelf.

Moreover, the government affirmed that, effective from the start of next year, oil company operations would be entitled to a lower base tax rate for all operating oil fields based on the rate of extraction. The tax break could be set up to 70 %.

Economy minister German **Gref** estimates that the tax breaks would apply to about 11 % of the 480 million tons of oil produced in Russia this year. Tax authorities report that income from resource use fees amounted to nearly RUB 260 billion (€7.6bn) in the first quarter.

Minimum charter capital for new banks raised to €5 million. Recent amendments to laws on banking activities and the central bank require that any bank established after 2006 must put up rouble-equivalent capital of at least €5 million. For credit institutions other than banks, the minimum charter capital requirement is set at the rouble equivalent of €500,000. However, banks founded before the changes came into effect with charter capital below €5 million may continue after January 1, 2007 as long as their charter capital does not fall below the amount recorded on that day.

Sales of mobile phones and subscriptions cooled in first quarter. On-year growth in the number of mobile phone subscriptions in Russia slowed substantially from recent years, falling to a mere 2 % y-o-y rise in the first three months of 2006. Mobile phone penetration as of end-March had reached 92 % of the entire country (compared to 87 % at the end of 2005 and a mere 35 % at end-2004). As of end-March, Russia had 132 million mobile phone subscriptions, of which 18 % were held by users located within Moscow city limits. Moscow's mobile phone penetration is around 136 %, which means there are more phone subscriptions than residents in the city. Many people subscribe to services from more than one operator, so all their accounts are not in active use. Russia's largest mobile phone operator at the end of March was MTS with a 35 % share of the market. The next largest mobile phone service providers were VimpelCom with a 34 % share and MegaFon with an 18 % market share.

Growth in mobile phone sales slowed in the first quarter to 17 % y-o-y. The slowdown reflected the drop in new subscription growth. The average price of a mobile phone, however, rose to $175 in January-March. The average price of a mobile phone purchased in Russia in 2004 was $140. The higher prices reflect a shift by Russians to pricier handset models and the fallout from a major seizure of smuggled mobile phones last autumn by Russian customs. The bust has led to a sharp decline in the practice of double-invoicing by mobile phone importers and the increased payment of customs duties have raised average price of mobile phones.

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China

China raises key interest rates to quell credit and investment growth. Economic data for the first quarter of this year have unleashed a wave of concerns from both the government and government agencies. Fixed investment and credit growth in the first quarter were both well above official targets, raising the spectre of an investment bubble.

As in 2004, the government has again implemented several measures to slow investment growth. The PBoC increased interest rates on loans of one-year or more by 0.27 percentage points, effective April 28. The one-year reference lending rate is currently 5.85 %. The lending rate of commercial banks has a floor of 90 % of the central bank's reference rate, while there is no upper limit on the rate of interest that can be charged. To stem the massive inflows of foreign currency and savings growth, deposit interest rates were left untouched, which implies that the commercial banks will benefit from a wider margin between deposit and lending rates. The reference rate on a one-year deposit remains at 2.25 %, which is the same as the ceiling rate commercial banks can pay on deposits. The central bank also requested that commercial banks cool their lending growth. In particular, the PBoC wants to see a pull-back in lending to businesses in industries that suffer from overcapacity. Officials could also limit growth of the credit stock by tightening the rules on short-term credits (commercial bills). Short-term financing is currently considerably cheaper for companies than taking a bank loan, which is why its share of corporate finance has soared recently.

The National Development and Reform Commission (NDRC) has released measures to fight overcapacity. The latest NDRC guidelines limit the further establishment of coal mines and investment in cement production. Measures to stabilise growth in the steel and aluminium sectors were implemented earlier. The NDRC is currently contemplating guidelines for the car industry, which is also wrestling with overcapacity problems. The biggest worries, however, come from the real estate sector, where rapid investment growth and price increases have continued for several years now. Reports have begun to trickle in about oversupplies of new housing in some cities and declines in local housing prices. Official statistics show that the volume of unsold real estate at end-March had increased 24 % y-o-y, and was reflected with increased share of non-performing loans. Several measures to limit growth in the real estate sector were implemented about a year ago. The next regulatory push is expected to focus on limiting land use.

Outside estimates put true size of non-performing loan stock well above official figures. The latest figures from China's Banking Regulatory Commission (CBRC) show that the amount of non-performing loans (NPLs) held by banks remained essentially unchanged in 1Q06 at just over CNY 1,3 trillion (€130bn). NPLs as a share of the entire loan stock declined slightly, however, due to a rapid expansion of the credit stock. The CBRC nevertheless warned that the official figure for NPLs could increase as the government moves ahead with plans to shutter inefficient plants in branches that suffer from overcapacity. About 80 % of NPLs are held by China's four large state banks, which have had to support unprofitable state enterprises to preserve jobs. The risk management of state banks has also been inadequate.

The large state banks have transferred NPLs to four asset management companies. In the first quarter, asset management companies (AMC) succeeded in unloading some CNY 27 billion in NPLs for a price of CNY 4 billion. The AMCs on average have succeeded in recovering about 20 % of the nominal value of NPLs. They currently hold NPLs with a nominal value of about CNY 400 billion.

Official figures on the non-performing loan stock are generally considered to grossly underestimate the true size on the NPL stock. A recent study by consultancy Ernst & Young suggests that NPLs in the entire financial sector (banks, AMCs, state investment companies) amount to about CNY 7 trillion (€700bn). The figure includes loans that are likely to move into the NPL category within the next few years. Other consultancies concur that China's NPL problems are a lot worse than official estimates suggest.

China's current account surplus reached $160 billion in 2005. As in 2004, last year's current account surplus was driven by a massive trade surplus. The surplus in traded goods, under $60 billion in 2004, exceeded $130 billion in 2005. The services deficit remained virtually unchanged. The surplus on the capital and financial account fell by nearly half to $63 billion. The decline was caused mostly by a substantial reduction in the financial surplus. Chinese foreign direct investment abroad increased from less than $2 billion in 2004 to over $11 billion in 2005. Direct investment flows into China reported in balance-of-payment figures were $79 billion. China's foreign currency and gold reserves climbed by nearly $210 billion in 2005. The net errors and omissions item turned negative for 2005.

Main items in China's balance of payments, 2005 and 2004, US$ billion

	2005	2004
Current account	161	69
Capital and financial account	63	111
Growth in foreign exchange reserves	207	206
Net errors and omissions	-17	27

Source: SAFE

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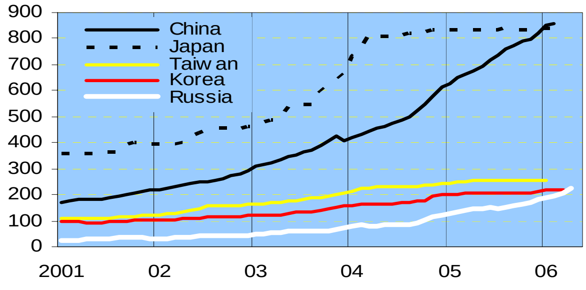
Russia

Russian inflation drops below 10 % in April. On-year inflation in April fell to 9.9 %, or nearly a percentage point off the March pace. All core components of inflation were lower than in March, with a particularly sharp deceleration in the rise of food prices. On-year inflation for *foodstuffs* declined from the previous month by nearly one-and-a-half percentage points to 9.5 %. Prices for sugar, as well as fruits and vegetables, which have been major drivers of on-year food price inflation over the past year, were lower in April than in March. Food price inflation last year was driven by soaring meat prices, which have moderated as of late.

Prices of *other goods* were up 6.3 % y-o-y in April, a slight decline from the previous month's pace. Gasoline prices continued to lead, although the increase in gas prices has slowed substantially since the start of the year. Growth in prices of *services* slowed to a rate of 15.8 % y-o-y, where on-year increases in costs of housing and housing-related services remaining brisk. Since the start of the year, consumer prices have risen 5.4 % (foodstuffs 6.4 %). The government's original target inflation range for all of 2006 is 7–8.5 %.

Russia's foreign currency reserves continue to swell. The Central Bank of Russia reports its foreign currency reserves increased to $226 billion at the beginning of May, up from $182 billion at the start of the year and $125 billion at the start of 2005. Growth in the reserves has been largely sustained by ongoing current account surpluses and little change in the country's net capital outflow situation. Growth in Russia's foreign exchange reserves also reflects the CBR's operations in currency markets this year to stem rouble appreciation. Despite rapid growth in imports, Russia's currency reserves are currently sufficient to cover about 16 months of goods and services imports.

Countries with larges foreign currency reserves, US$ billion



Sources: International Financial Statistics (IMF), Central Bank of Russia

Energy companies continue to drive the RTS index. Following a minor mid-March correction, Russia's RTS share index has roared back to hit all-time record levels. At the beginning of May, the RTS index broke the 1,700-point barrier for the first time. It climbed to a record 1,765 points ahead of the May 9 Victory Day holiday. Continued high energy prices have led the exchange's rising trend in spite of occasional concerns about possible overheating. Oil and gas companies have a combined weighting that accounts for over half of the RTS index's value.

In terms of market capitalisation, oil and gas companies clearly rank among the largest companies in the index. Gas giant Gazprom's account for more than half of the half-trillion-dollar combined market value of RTS oil and gas companies. Gazprom became the world's third largest company in terms of market capitalisation in May. Only ExxonMobil and General Electric are larger.

Other major companies in the RTS index are mostly involved in metals and mining or telecommunications. They are all considerably smaller than energy companies.

Putin's annual state-of-the-nation address stresses declining population and national security. The president began his speech by remarking the goal of all government actions is to benefit the welfare of citizens. Thus, he said, he could not ignore the facts that some people became very rich in the 1990s at the expense of the majority and that corruption is still rampant in Russia. The president reported healthy macroeconomic growth, noting that his administration's goal of doubling GDP within the decade remains within reach. He proposed that remaining CBR controls on rouble convertibility be lifted on July 1, a half year earlier than originally planned. He also observed that while Russia has secured a major role in global energy markets, Russia needs to quickly find ways to raise the efficiency of domestic energy use. He did not touch on the controversial subject of raising domestic energy prices. Referring to the four great national projects, the president said implementation of housing, education and health care project must from now on be moved ahead at regional and local levels.

Putin commented that innovation in the civil and defence spheres would help Russia gain in international status and competitiveness. He said Russia would continue its WTO accession talks based solely on its economic interests, and warned that WTO talks should not be confused with issues unrelated to WTO membership. The CIS states remain Russia's key foreign policy region, but the country also is now engaged in a positive dialogue with the EU. He remarked on the special relations Russia holds with the US, China and India. Though expected, Putin did not raise the issues of Russia playing the energy card or civil rights in Russia.

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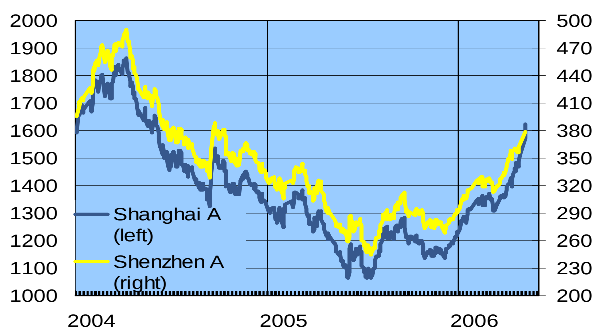
China

Chinese share prices up sharply since start of year. The price of Shanghai bourse A-shares has jumped by a third in just the past four months. The rise in share prices has been driven by strong performances on the Hong Kong stock exchange and other foreign bourses. There has been particularly strong growth in the shares of Chinese companies operating in the commodities sector. In addition to the international linkage of share prices, an interesting issue is the impact of a gradual liberalisation of Chinese securities markets, as the opportunities for large foreign strategic investors to buy A-shares have improved since the end of January. Foreign investors were previously restricted mainly to trading in B-shares, which account for a tiny share of the market. About 1,200 companies are listed on Chinese exchanges.

The cheerier outlook of stock investors also reflects the fact that the process of absorbing the massive conversion of non-tradable state shares to tradable shares is nearing completion. Officials estimate that 70 % of listed companies are in the process or have already converted their state shares to tradable shares. The conversion process is currently scheduled for completion in December 2006. Due to progress in the share conversion and the run-up in share prices, the authorities decided at the beginning of May to lift a ban imposed last year on companies attempting to raise money by selling their own shares or other securities. Company possibilities to seek financing in this manner remain strictly regulated, however. No new IPOs are allowed, even though preparations for lifting of the ban are already under way.

Share prices on China's major exchanges, A-share indices



Source: Shanghai and Shenzhen exchanges

IMF expects China's growth to continue. According to the latest *IMF Asia-Pacific Regional Economic Outlook* released May 1, China is expected to enjoy continued robust economic growth. The Fund raised its GDP growth forecast for 2006 by more than a one percentage point to 9.5 %. The IMF expects Chinese GDP growth to slow to 9 % next year. The current surge in economic growth has been largely driven by fast growing capital investment, which will likely create overcapacity that in turn has the potential to increase the stock of non-performing loans. The IMF would therefore like to see the People's Bank of China raise interest rates sufficiently to curtail over-investment. To stimulate domestic demand, the government also needs to rethink current social security policies. Presently, Chinese households must save much of their income just to secure modest pension security and carry them through a possible serious illness or injury. Following a doubling of the current account surplus last year, the IMF sees a similar performance unlikely this year. The IMF also wants China to widen its exchange rate fluctuation band.

The IMF suggests China's economic growth could slow in coming years if domestic demand weakens in the US. A bird flu pandemic could also lower growth.

Supervision of intellectual property rights remains insufficient. Industrialised countries have long criticised China for its failure to adequately supervise and enforce intellectual property rights (IPR). China announced at the end of April for the first time its annual action plan for IPR supervision. According to the plan, China will introduce or amend several laws, as well as increase IPR supervision and enforcement. This year's plans include operations to remove illegal audiovisual copies from the market and efforts to inform citizens and firms about IPR issues. Chinese officials report that many Chinese companies know practically nothing about the subject. The action plan even allows for hauling local officials into court for failing to adequately supervise the protection and enforcement of intellectual property rights. The US attorney's office has promised to help China in IPR matters. China's WTO commitments require IPR supervision and enforcement. Although the plan appears comprehensive on the surface, the creation of a system of IPR surveillance comparable to those found in industrialised countries will take years.

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Russia

Rapid growth in Russian foreign trade continues. In 1Q06, the value of good exports grew 34 % from last year to $67 billion. The value of goods imports was $31 billion, up 22 % from a year ago.

Crude oil and oil products constituted 59 % of all Russian goods exports. While the volume of crude oil exports remained at last year's level, the value of exports climbed 46 % due to an increase in export prices. Exports of oil products grew 13 % by volume, while their export value soared 58 %. Natural gas accounted for 18 % and metals 17 % of goods exports in the first quarter. The volume of gas exports was up just 4 %, but soared 63 % y-o-y in terms of value.

Machinery and equipment continues to account for slightly over 40 % of goods imports. Imports of foodstuffs from non-CIS countries represented 17 % of goods imports, with meat imports, in particular, growing rapidly. Chemical products accounted for 16 % of goods imports.

Some 55 % of Russian trade last year was conducted with the EU area and 15 % with CIS countries. Growth in trade with CIS countries has been slower than with the rest of the world. Germany remains Russia's largest trade partner, with $9.5 billion in annual goods trade. The Netherlands and Italia retained second and third positions. The value of Finnish-Russian trade in 2005 was $2.8 billion, up 13 % from a year earlier, and Finland was Russia's 11th largest trading partner.

End of foreign currency controls expected to have little impact on rouble exchange rate. In his state-of-the-nation address last week, president Vladimir **Putin** proposed the lifting of Russia's remaining foreign currency controls from July 1, rather than wait until the start of 2007 as originally scheduled. The president noted the move would help enhance the rouble's prestige and usefulness as an international currency. The remaining currency controls, partly a legacy from the 1998 financial crisis, are designed to discourage capital flight through such measures as deposit requirements.

The controls have gradually been relaxed over time as worries over capital movements have subsided. Although elimination of the remaining restrictions could somewhat increase capital flows both into and out of Russia, the rouble's nominal exchange rate will still be determined by Russia's forex markets and central bank market interventions. The central bank can step up its forex purchases whenever capital flows into Russia rise. While such buying increases the CBR's foreign currency reserves and adds to inflation pressures, the remaining foreign exchange controls are so modest that they do not have much impact on capital movements.

Putin launches anti-corruption campaign at Federal Customs Service. On May 11, president **Putin** signed a decree modifying the status of the Federal Customs Service (FCS) from a service under the economy ministry to an independent body reporting directly to the government. Planning of customs policies and legislation concerning customs were also taken out of the hands of the economy ministry. FCS head Alexander **Zherikhov** was replaced by Andrei **Belyaninov**, head of Federal Defence Order Service. Several other high-level state officials were also sacked.

The changes relate to a government program approved in April to reform the customs office during 2007–09. One of the key goals of the program is to get a handle on corruption within customs. Already a month ago, Putin commented on the excessively close relationship of customs officials with certain business circles. To study the effectiveness of customs operations, average tariff collected were recently compared to the nominal tariff set by law. The comparison indicated that reported tariff collections amounted to only about three-quarters of the nominal tariff, implying that substantial amounts of customs duties were never collected. The FCS last year contributed over €60 billion in revenues to state coffers, about 40 % of total federal budget revenues.

Observers say that power struggles within the government and the Kremlin were behind the shake-up. The general view is that the changes have strengthened the position of the Federal Security Service.

Putin proposes measures to counteract Russia's population decline. The topic of population decline was a major theme in the president's annual state-of-the-nation address last week. Noting Russia's population has lost an average of 700,000 persons a year in recent years, and without the net gain from migration, the decline would be even more precipitous, the Russian leader offered surprisingly concrete proposals on dealing with the problem. Putin stressed measures to increase the birth rate, including raising childcare benefits, boosting the minimum benefits for maternity and childcare to realistic levels, and partially compensating the cost of caring for small children with state money. He also brought up the issue of orphans and abandoned children, and demanded support payments for families willing to adopt such children. The president said women giving birth to their second child should receive a one-time payment of 250,000 roubles (7,600 euro), an amount 2.5 times the average annual Russian wage in 2005. Finance minister Alexei **Kudrin** estimated these new measures proposed by the president would require RUB 30–40 billion (about €1 billion) in spending to the 2007 budget. The second-child payment program would require even larger sums, but probably the payments would not begin until 2010.

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China

US treasury department criticises China's foreign exchange policy, but refrains from taking tougher line. In its semi-annual *Report to Congress on International Economic and Exchange Rate Policies* released last week, the US Treasury Department focused heavily on China's foreign exchange rate policy. The report strongly criticised China for restraining yuan appreciation. Although in the US there are presently under discussion more than a dozen initiatives to limit Chinese imports, the Treasury Department was careful not to blame China for manipulating the yuan's exchange rate as it would only irritate Chinese relations and possibly impede China's declared intention to reform its exchange rate policy.

The report finds it is difficult to identify specific aspects of China's current foreign exchange rate policy that would allow a conclusion that the country is intentionally striving for an unfair competitive advantage. The report further balances its critiques by noting many recent positive developments in China. In addition to last summer's change in the exchange rate regime, the report noted yuan's appreciation against a trade-weighted currency basket and praised the country's recent steps to liberalise foreign currency controls. The Treasury Department also was heartened by the commitment of top management in China to a more flexible yuan exchange rate, as well as the country's efforts to ease its current account imbalance through measures that lift household demand and eliminate existing barriers to trade and market access. The report stressed China's increasing international role and said that the G7, Asian Development Bank, IMF and OECD have all recently called on China to increase exchange rate flexibility.

On Monday this week, the yuan strengthened to a yuan/dollar rate below 8. Today (May 19), the dollar bought 8.02 yuan.

China's foreign trade surplus and FDI inflows continue to rise. Chinese goods exports rose in January-April to $274 billion, up nearly 26 % more than in the same period a year earlier. The value of imports rose at the start of the year nearly 23 % to $241 billion, although the value of imports in April was just 15 % more than in April 2005. The January-April goods trade surplus amounted to $33 billion, compared to a $21 billion surplus in the same period last year.

It appears direct investment in China has returned to growth this year after stalling last year. The Ministry of Commerce reports that FDI inflows to China in January-April amounted to $18 billion, or nearly 6 % more than a year earlier.

The developments in China's foreign trade and direct investment in the early part of this year are bound to fuel US demands for a substantial yuan revaluation.

Low inflation, high money supply growth. Consumer prices were up 1.2 % y-o-y in April, with a very slight pick-up in the inflation rate from March. The acceleration in inflation was due largely to higher food prices. Prices for vehicle fuels and spare parts also rose quickly (over 11 % y-o-y). Prices for municipal services climbed nearly 7 %. Prices fell, however, for medicines, clothing and telecommunications services. The rise in consumer prices so far has been limited by good grain harvests, stiffer competition and modest hikes in administratively set prices (e.g. for fuels). Recent weather conditions have not been particularly favourable to farmers, however, which could put upward pressure on grain prices. The rise in producer prices slowed in April to 1.9 % y-o-y.

The broad money supply (M2) at end-April was up 18.9 % y-o-y. Money supply growth has been driven by a galloping expansion in bank lending. In 1Q06 alone, banks granted loans amounting to half of their projected lending for the entire year. The central bank has this year targeted a 16 % increase in the money supply. The central bank's lending rate hike at the end of April was part of the measures to slow the rate of money supply growth.

Doubts continue over actual size of non-performing loan stock. Consultants Ernst & Young have retracted their assessment of the China's non-performing loan stock published in their May 3 *Nonperforming Loan (NPL) Report* on China (see *BOFIT Weekly 18/2006*). The report claimed China's financial sector was burdened by as much as CNY 7,000 billion (€700bn) in NPLs. The central bank, in particular, was quick to dispute the report. Ernst & Young announced last week that the report had seriously overestimated the amount of NPLs held by the four large state-owned banks (nearly CNY 2,900bn). Following the media tempest, Ernst & Young announced that it had used incorrect figures in assessing the large state banks and that China's official figure (about CNY 1,100bn) was, in fact, credible.

Ernst & Young are the auditors for the giant state-owned Industrial and Commercial Bank of China (ICBC). The bank is preparing for an international IPO this autumn. China's second-largest state-owned commercial bank, the Bank of China, also is planning to list on the Hong Kong stock exchange.

To calm the controversy, the China Banking Regulatory Commission decreased the ceiling on NPLs in big banks to no higher than 5 % of the total loan stock.

The controversy is far from settled. Other consulting agencies have also recently issued estimates of China's NPL stock well above official figures.

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Russia

Russian production growth accelerated slightly in April. Growth in the core indicators for industrial output, construction, and retail sales picked up sharply in April from the first quarter. On-year growth in *industrial production* in the January-April period was 3.5 %, led by manufacturing as well as production and distribution of gas, water and electricity. Growth in mineral extraction industries continued to poke along at about 1 % a year. Crude oil production increased slightly over 2 % y-o-y and natural gas output 2 % y-o-y. On-year growth in *construction* accelerated to 4.8 % after a slump at the start of the year. *Retail sales* were up 10.3 %, driven by growth in sales of non-food products. On-year growth of *agricultural output* and *transportation* in the first four months of the year remained around 1.5 %. Initial figures from the economy ministry indicate GDP growth in January-April was 5.1 % y-o-y.

FDI inflows to Russia double. Rosstat reports foreign investment flows into Russia in the first quarter totalled $8.8 billion, or 46 % more than a year earlier. Inflows of foreign direct investment doubled from last year to $3.8 billion. FDI's share of total foreign investment also increased slightly, although more than half of the investment flow still came in the various forms of credit. The share of portfolio investment remained small. FDI represented 47 % of the stock of foreign investment in Russia (just under $114 billion) at end-March.

India was the largest source of FDI flows to Russia in the first quarter. Over half of investment to mineral extraction industries came from India. With persistently high oil prices, FDI inflows to mineral extraction industries more than doubled. Refining industries and the financial sector were the next largest receivers of FDI; in those branches the investment flow more than tripled from a year earlier.

The flow of Russian investment abroad rose nearly 60 % in the first quarter to over $10 billion. The top investment destinations were the United States and the Virgin Islands.

Russian stocks track movements on other exchanges. Along with stock markets in many emerging economies, Russia's RTS index shed about 25 % of its top value between early May and the start of last week. The index recovered several per cent as the week wore on, and by the close of May 26 was up about 35 % from last December. Analysts consider the decline in Russian stock prices to be linked to worries in the West over slightly rising inflation and possible central bank rate hikes. As a result, large international investors have become skittish and sought to reduce their holdings in emerging markets. The pullback has been further suggested to reflect investor uncertainty over prices for oil and other key commodities. The dip on the Russian exchange was also seen as a correction after several months of soaring share prices. Top Russian officials have also recently mentioned insider trading as a possible problem.

Government frames 2007–2009 tax policies. From the start of 2007, the government will change the tax rules to encourage oil production. The main features are lower taxes for producers operating oil fields already far exploited and a tax holiday for companies opening up new fields in East Siberia. The practice of linking the crude oil production tax to world oil prices will extend to 2017.

From the start of next year, those seeking value-added tax refunds will no longer require a permit, but merely the filing of a declaration for eligibility. The possible lowering of VAT rates will be considered after assessment of the VAT changes in 2006–07. Next year, the deduction ceilings will be raised for company losses, continuing education and health care. The goods tax on cigarettes will increase 30 % and the basis for the tax will be based on the retail price of cigarettes.

Farmers will switch to a simplified tax model at the start of next year. Agricultural consumer cooperatives will also be eligible to use the model.

Residents paying more and more of the costs of housing. Residents in 68 of Russia's 88 regions pay for at least 90 % of the housing-related municipal services costs (e.g. electricity, heating and water). In 37 regions, residents are in principle fully responsible for the costs of municipal services. Not all residents in those regions, however, have been able to come up with their payments. Preliminary information suggests that the payment arrears of residents rose sharply in March-April compared to 2005.

All Russian regions officially have been required since the beginning of this year to limit assistance in paying for municipal services to low-income residents meeting specific criteria. This reform, however, has taken longer than expected to implement, with some regions still subsidising the costs of all residents. The federal government, which sets rates for municipal services, itself engages in "cross-subsidisation" – a practice outlawed in principle in 1995 for electricity and heat supplies. Cross-subsidisation is a situation where the rates charged to households are kept low by charging higher rates to the corporate sector. The Russian government's information, however, suggests that the rate gap between companies and private consumers has been narrowing for some time.

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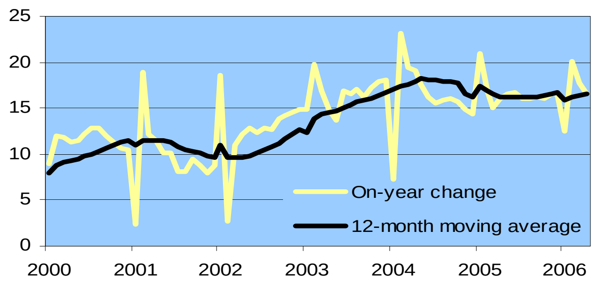
China

Rapid growth in China's fixed investment and industrial output continued in April. Fixed investment climbed 30 % y-o-y in January-April. Growth accelerated from a year earlier, boosted e.g. by the transportation sector, which has seen an increase in public investment in the railway system. In contrast, growth in investment has been curbed in the ferrous-metal smelting and processing, which is suffering from overcapacity. In recent weeks, China's government and central bank have introduced a range of measures to slow growth in fixed investment. These include limits on investment in e.g. the auto, steel, aluminium, coke and cement industries, as well as raising reference lending rates and tightening the rules on bank lending. It will take some time, however, before the effects of the measures show up in investment growth figures.

The value of industrial output in April was up nearly 17 % y-o-y, the same high growth that has continued since the start of the year. Production has grown rapidly in all major industrial sectors. For example, the rapid growth in passenger car production has continued since last autumn (for the first four months of the year, car manufacturing climbed 44 % y-o-y). Growth was also particularly strong for producers of building materials such as steel and cement.

On-year industrial output growth, %



Source: NBS

Minimum wage raised in Pearl River Delta region. Officials in the Guangdong Province of southern China have decided to raise the minimum wage from the beginning of July by 17–42 % depending on the city. The lowest monthly wage in Shenzhen will increase to 850 yuan (up 23 %), while in Guangzhou the minimum wage will go up to 800 yuan (up 17 %). Under a central government decree, local administrators are required to increase their minimum wage at least once every two years. The hikes in the minimum wage in Guangdong are expected to trigger similar wage hikes in Beijing and Shanghai, where minimum wages are presently 580 and 690 yuan, respectively.

Companies in the greater Pearl River Delta produce nearly a third of China's exports. The advent of a higher minimum wage has raised concerns about their impact on production costs for Chinese exporters. The fear is that labour-intense industries could shift operations inland or to cheaper production countries such as India, Cambodia or Bangladesh. On the other hand, a rise in production costs due to real exchange rate appreciation could reduce China's foreign trade imbalance by eroding the trade surplus. Higher minimum wages also increase the amount of household disposable income, which has a positive impact on domestic demand. Consumption of rural residents could be boosted through larger remittances from relatives working in urban areas.

Moratorium on IPOs lifted. As expected, China's securities regulatory commission will again allow initial public offerings on domestic exchanges. The year-long ban on IPOs was a response to last year's massive conversion of non-tradable shares of state-owned companies to regular tradable shares. The flood of new shares depressed share prices even as the Chinese economy roared ahead.

With the lifting of the ban, revised listing rules were also introduced. Under the new rules, a company proposing an IPO would have to show it has turned a substantial profit for the three previous years and that its board has independent members. In addition, IPO-seekers need permission to list from the government of the province where the company is domiciled. An IPO listing must have a value of at least CNY 30 million (€3 million). The rules governing buyers of IPO shares have also been changed. The first new IPO is expected in June. Several of China's largest companies are yet to be listed on domestic exchanges, including such state-owned companies as China Construction Bank, Air China, PetroChina and China Mobile.

Officials reject sale of majority stake in Chinese bank. A new bidding round for a controlling stake in the sickly Guangdong Development Bank was launched on May 19. Initially, the American Citibank and the French Société Générale submitted bids for a majority stake in the GDB last December (see *BOFIT Weekly 3/06*). After several months of discussion, China's banking regulatory officials decided, however, to preserve their strict rule on foreign investors in Chinese banks. The largest stake a single private foreign investor can hold in a Chinese bank is 20 %, and the largest total foreign ownership is generally limited to 25 %. High-bidder Citibank was officially informed at the beginning of May that its bid was rejected. Both Citibank and Société Générale together with their Chinese partners have already announced that they will leave a revised offer in the current bidding round.

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Editor Timo Harell

EUROJÄRJESTELMÄ
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Russia

Finance ministry issues guidelines on investment of stabilisation fund assets. Under guidelines issued last week, 45 % of stabilisation fund assets should be invested in assets denominated in dollars, 45 % in euro and 10 % in British pounds. Finance minister Alexei **Kudrin** said a certain amount of leeway in the mix would be allowed so that holdings in either dollars or euro could rise as high as 50 % without a formal announcement. Investments in government paper would be restricted to maturities between three months and three years. Kudrin said the Central Bank of Russia, the holder of stabilisation fund assets, would handle day-to-day management of assets. Income from the investment activity would be paid by the CBR on the basis of a separately defined portfolio of securities. The state is expected to formalise its agreement with the CBR next week. The finance ministry stressed the measures would not effect Russian currency markets. Stabilisation fund assets exceeded €55 billion last week.

Yukos sells off majority stake in Mazeikiu Nafta. As part of its bankruptcy conditions, oil company Yukos last week agreed to sell its 54 % stake in Lithuanian oil refiner Mazeikiu Nafta to the Polish PKN Orlen. Yukos would get $1.4 billion from the sale. The Lithuanian state would sell a 31 % stake in the refinery to PKN Orlen for a price of $0.9 billion. Observers say that the deal could be completed in the first quarter of 2007.

After holding up the deal for a while, a US court involved in the bankruptcy gave its permission for the sale to go ahead. The delay was caused when the bankruptcy administrator designated by the Russian court sought an injunction in the US court on fears that money raised from the sale would go to purposes other than paying off Yukos $22 billion tax bill. At the start of this week, Transneft vice president Sergei **Grigoryev** wondered what oil PKN Orlen expected to refine at Mazeikiu Nafta, noting that PKN Orlen had not been in negotiations with Transneft, which operates the oil pipelines that feed the Mazeikiu Nafta refinery.

Steelmakers Severstal and Arcelor to merge. On May 26, Luxembourg-based Arcelor and the Russian Severstal announced plans to go ahead with the largest merger ever between a Russian and foreign enterprise. The resulting company would be the world's largest steel producer. Russian oligarch Alexei **Mordashov**, who owns 90 % of Severstal, would control 32 % of the new entity. The Russian government has already announced it will approve the merger and promote its realisation. Some analysts say the government's positive attitude towards the merger may signal a shift in Russian attitudes to foreign ownership. On the other hand, it could merely indicate the good relations of Mordashov with cabinet members and the president. The merger needs to be approved by the Arcelor shareholders' meeting on June 28. The Russian government says the deal could be finalised as soon as mid-July.

Russian and EU leaders meet in Sochi. At the 17th Russia-EU summit held in Sochi May 24–25, the parties signed agreements on easing visa requirements and readmission of illegal immigrants. Strong efforts went to calming cooperation on energy, which has been a nervous topic since the Russians halted gas deliveries temporarily last winter. The partners acknowledged that they understood each others' positions, and promised to work towards better cooperation. In his statement to the western press, president Vladimir **Putin** said he emphasised the importance of reciprocity in the discussions, referring to the EU's wish to participate in developing Russian oil and natural gas infrastructure, as well as refining and transport. As the EU is unable to offer such cooperation in energy refining or transportation, Putin said Russia expects in return e.g. support in diversifying its economy and development of its technical capabilities.

Russia's current Partnership and Cooperation Agreement (PCA) with the EU expires next year. At a press conference for the Russian media, the president stated the upcoming partnership agreement would hopefully give Russia greater chances to influence matters related to further EU enlargement, so that Russian bilateral relations with countries accepted as EU members would not be harmed.

Small and medium-sized Finnish firms active in exports to Russia. Finnish Customs report that in 2005 Finland had over 3,000 small and medium-sized enterprises (SMEs) exporting to Russia. In number terms, that corresponded to about 80 % of all firms involved in exporting to Russia. The total value of SME exports to Russia, however, amounted to less than a fifth of Finland's total exports to Russia. About a quarter of Finnish SMEs involved in export business, export to Russia. In the industrial sector, the share of SMEs in exports to Russia was largest for SMEs involved in machinery and equipment, and chemical production.

About 900 SMEs, or 70 % of importers from Russia, were responsible for only about 5 % of Finland's total imports from Russia. The share of SMEs in Finland's total imports was clearly larger both in terms of the number of firms and the value of imports. Of all SMEs involved in imports, less than 3 % worked with Russian imports. The largest share of SMEs involved in industrial imports from Russia worked with foodstuffs, sawn goods or wood products.

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China

Highest investment growth in inland China. While over half of fixed investment still went to coastal provinces in the first four months of the year, the pace of investment going to the wealthiest provinces was slower than in provinces with lower income levels. Many Chinese firms are expanding production towards inland to exploit lower production costs. There are also signs foreign direct investment has started to spread further inland from coastal provinces. Companies are attracted to inland investment by lower wages, cheaper land, opportunities for favourable tax treatment and in some cases even the lax environmental regulations. Chinese authorities are encouraging the shift with infrastructure improvements.

Among China's wealthiest provinces, growth was clearly lowest in Shanghai, where fixed investment increased a mere 5 % y-o-y in January-April. In areas around Shanghai, the rate of growth was higher. With the approach of the Olympic games, investments in Beijing have focused on construction. Fixed investment in the capital region was up 20 % y-o-y in the first four months of 2006. In the Guangdong province in southern China, recognised for its intense cluster of international manufacturers, investment increased 21 %. On the other hand, in low-income coastal provinces and central and northeastern China, investment surged ahead almost without exception at rates of 30–45 % y-o-y. Investment growth in western China varied from province to province and was generally lower than in central China.

Further hikes in fuel prices. China's National Development and Reform Commission (NDRC) raised prices of gasoline, diesel fuel and jet fuel by more than 10 % last week. After the increase, the price of a litre of 90-octane gasoline in Shanghai was 4.5 yuan (0.44 euro) and 4.6 yuan for diesel. Fuel prices were last raised in late March. The price hikes follow increased world market prices and may encourage fuel users to become more efficient in their fuel consumption habits.

China's heavily regulated fuel prices are among the lowest in the world at the moment. Prices have not risen as rapidly as global prices for crude oil. The price of gasoline has been raised only 50 % since the start of 2004, while the world price for Brent crude has soared 130 %. The modest price hikes have also transformed oil refining into a money-losing business and companies focused solely on refining have posted gargantuan losses. This has led to a debate on how to change the price formation mechanism to better reflect developments in the global market. No major changes in the system, however, have yet been implemented.

Hong Kong bourse hosts Bank of China IPO. China's second largest bank, the Bank of China (BoC) made its debut listing on the Hong Kong stock exchange with an IPO of a 10.5 % stake. The IPO raised $9.7 billion. Some 95 % of the emission was directed to institutional investors. Despite estimates by international consultants that the true size is of the stock of non-performing loans held by Chinese banks is far larger than official figures, demand for BoC shares far outstripped available shares. The amount of shares offered to institutional investors was oversubscribed by a factor of ten, while the oversubscription factor for private investors reached a whopping factor of 70. Demand was so high the bank had to print additional emission forms. On the first trading day (June 1), BoC share prices rose 15 %. BoC is also preparing to list on a mainland China bourse.

The listing was the world's largest in six years. Last autumn, a 12 % stake in China Construction Bank (CCB), one of China's largest banks, was listed on the Hong Kong stock market. That IPO raised $9.2 billion. Since the Hong Kong listing, CCB shares have risen over 40 %. Industrial and Commercial Bank, China's largest bank, is planning an IPO for the Hong Kong exchange this autumn. The mid-sized Bank of Communications is also listed on the Hong Kong exchange. The China Merchants Bank, Citic Bank and Minsheng Bank are all preparing IPOs. Citic Bank, the closest to IPO, selected its underwriters last week.

Robust economic growth in Hong Kong and Macao SARs. Statistics authorities in Hong Kong and Macao have released their first quarter growth figures for real GDP. Hong Kong growth accelerated to 8.2 % y-o-y in the first quarter, topping 4Q05 adjusted on-year growth of 7.5 %. The driving factors for economic growth included a pick-up in foreign trade, as well as higher domestic consumption and investment. Higher interest rates in the US had yet to dampen Hong Kong economic growth. In addition, tourism, especially from mainland China has grown and use of the yuan in Hong Kong has become widespread. For Hong Kong to secure long-term growth, however, it is critical that the special administrative region retain its status as an important financial and logistics centre.

In Macao, where tourism and gambling are major money-earners, real GDP soared 19 % in the first quarter. Growth was highest since the third quarter of 2004. Goods exports increased 37 % y-o-y and investment 68 % in conjunction with construction projects. Growth rates in the Macao SAR have fluctuated wildly over the past six years.

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Russia

Russian inflation further down in May. The flood of foreign currency pouring into the country has made it tough on monetary authorities in fighting inflation. The liquidity inflow has been seen as a main driver of high inflation as the Central Bank of Russia has restrained further appreciation of the rouble's nominal exchange rate. May 12-month inflation was 9.5 %, a slight deceleration as growth in prices for food and services slowed from their pace earlier this spring. The on-year rise of *food prices* declined from April by nearly a percentage point to 8.8 %. The rise in *services prices* also went down a bit to 15.6 % y-o-y. Prices for *other goods* increased 6.3 % y-o-y in May, the same rate as in April. The CBR cautiously allowed the rouble's nominal exchange rate to rise in the first quarter, which has helped diminish inflation pressures for the moment. Consumer prices have risen 5.9 % since the start of the year.

Putin gives annual budget address. In his annual budget speech, president Vladimir **Putin** emphasised that Russia's budget policy was in line with strategic goals for economic growth despite Russia's stubbornly high inflation. He noted that recent achievements in budget policy included growth in real wages, pensions and scholarships, the launching of national projects, reforms in the budget process and the reduction of Russia's foreign debt.

The president remarked that the goals of budget policy will continue to be raising living standards, achieving positive structural change and supporting macroeconomic balance and transparency. Putin listed ten central tasks to support these goals, among them defining non-interest expenditure based on long-term oil prices and economic growth, result-based spending policies, more efficient administration of state property and procurement as well as increased financing for state investment institutions. Stabilisation fund assets would be divided into a "reserve" portion and a portion set aside for future generations. The reserve part would be used to cover budget expenditures when the oil price is low. The size of the reserve would be defined against GDP.

Putin noted that the goal of tax policy would continue to be reducing the overall tax burden, and that this would be supported with better tax administration and tax breaks for producers of quality goods. While Putin saw reasons to keep basing the mineral extraction tax on world oil prices, he said a zero mineral extraction tax rate should be introduced this year to support development of new oil fields in East Siberia and on the continental shelf. He also called for lowering of the tax on older fields to encourage extension of production life. He said the lowering of the social tax at the start of 2005 had helped cut the tax burden on manufacturing industries, but had not resulted in the desired reduction in under-the-table wage payments.

Putin unexpectedly sacks chief prosecutor. Last Friday (June 2), the Federation Council affirmed the president's proposed dismissal of General Prosecutor Vladimir **Ustinov** by a vote of 140–0. Only a year ago the Federation Council had voted by a large majority to give a second five-year prosecutor term to *silovik* (power player) Ustinov. Federation Council chairman Sergei **Mironov** said the canning had nothing to do with politics. Some observers speculate that the dismissal of Ustinov, who has a reputation for sometimes doing things his own way, may have been a strategic move on Putin's part to divide positions ahead of the power struggle that will ensue when he completes his second term as president. Others suggest the firing could be seen as a sharpening in Putin's anti-corruption campaign launched last month.

Finland-Russia trade and freight transit to Russia via Finland continue to boom. Foreign trade figures from Customs Finland show Finnish exports to Russia increased 29 % y-o-y in 1Q06 to an estimated €1.5 billion. Nearly half of exports from Finland to Russia were investment goods (and 18 percentage points of that were mobile phones). Finland exported 1.8 million mobile phones to Russia in 1Q06. The growth in phone exports slowed substantially on year, with exports increasing just 5 %. Raw materials and production goods accounted for about a quarter of exports, while durable goods were slightly less than a quarter. Cars accounted for 10 percentage points of durable goods exports; car exports from Finland to Russia increased 128 % y-o-y. Finland exported 7,100 cars to Russia in 1Q06.

Finnish imports from Russia rose 21 % in 1Q06 and were valued at €1.9 billion. Some 72 % of imports were energy products (and 54 percentage points of that was crude oil and refined oil products with the remainder consisting of gas and electricity). Other imports were mainly raw materials and production goods.

In the first quarter, road freight moving via Finland to Russia increased 8 % y-o-y. 95 % of goods destined for Russia that arrived by ship were then transported by road. Road freight transit to Russia in 1Q06 was worth some €5.2 billion, or 3.5 times the value of Finnish exports to Russia. The sharpest increase was seen in transit shipments of automobiles. In 1Q06, some 91,000 cars were imported to Russia via Finland and accounted for about a fifth of all road freight transit. Other transit freight to Russia was mainly consumer electronics or machinery and equipment. Freight shipped from Russia via Finland to other markets, however, fell 22 % y-o-y in tonnage terms. It consisted mainly of ores, concentrates and chemicals.

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China

China vows to continue with reform policies. Early this month, the Communist party's mouthpiece, *The People's Daily*, published an article on reform policy that was widely noted in other Chinese media. The article stated that, despite challenges, China should unwaveringly continue with – and deepen – its efforts at reform. The article, quoting the remarks of president **Hu** Jintao, was widely interpreted as defending China's reform policy against domestic criticism. Criticism has been building in recent years in China against the rapid liberalisation of the economy and the growing influence of private and foreign entities. Communist party officials and Chinese scholars are currently engaged in a vigorous debate on the roles of private ownership and the state in the economy. At the most recent session of the National People's Congress this spring, a proposed law on protection of property rights, long in preparation, was blocked by those within the party favouring more leftist economic policies.

For a long time there was a broad consensus among the country's leadership on the general direction of reform policy. The economy would be opened incrementally, avoiding sudden and risky reforms. Current measures, however, have done little to solve major structural problems such as the need to streamline state-owned enterprises or make state banks more efficient. Most recently, widespread opposition has been aroused against sales of shares in state-owned banks to foreigners.

China's current leaders Hu Jintao and **Wen** Jiabao have been more cautious than their predecessors about rapid opening up of the economy. Both regularly bring up rural problems, increasing income disparities and unbalanced development among regions in their speeches. Such talk has raised doubts about the commitment of China's leadership to nearly three decades of policies geared to integrating the Chinese economy with the world economy. By stressing the importance of reform, the article allayed such concerns. On the other hand, the article emphasised the leading role of the state-owned sector of the economy and the pre-dominance, in principle, of public ownership in China's economic system.

New crude oil pipeline from Kazakhstan goes on stream. An over-960-kilometre oil pipeline running through Kazakhstan to the border of China was completed at the end of last year. This week that pipeline was commissioned as the first oil arrived from Atasu in central Kazakhstan at China's northwestern border. The pipeline has a planned annual throughput of 20 million tonnes of crude oil, which corresponds to 16 % of China's 2005 oil imports (127 million tonnes). China paid $700 million to construct to pipeline.

Growth in Chinese oil imports slowed sharply in 2005, as the volume of oil imports grew just 3 % y-o-y. However in the first four months of 2006, China imported 49 million tonnes of crude, which was 17 % more than in the same period a year earlier. This relatively strong growth in imports could suggest China is building its oil reserves, since growth in consumption of oil products has been expected to be considerably lower. The International Energy Agency (IEA) estimates that domestic demand for oil products in China should grow only about 5 % this year (2 % in 2005), although growth in various categories may vary widely. It is difficult to estimate Chinese oil consumption as the country does not publish information about its oil inventories. Although China has built storage capacity for its strategic oil reserves, no information has yet been given on whether it has begun to actually fill those facilities.

Authorities struggle to cool real estate sector. Chinese officials have invoked a number of new measures to calm a sizzling housing market and increase construction of affordable housing. The tightening measures have to do with government fears of a possible housing bubble in certain cities. To dampen speculation in the housing market, China introduced a national 20 % capital gains tax on real estate sector. Earlier the tax was imposed only in a few large cities, including Guangzhou. In addition, owners who want to sell their apartment or house before five years will be subject to a stamp tax. Earlier owners only had to own their apartment for two years to get out of the tax. The tax is still 5.5 % of the real estate's sale price. In addition, the minimum down-payment required on purchases of apartments with floor areas greater than 90 square metres was raised from 20 % to 30 % at the start of June.

China has also imposed additional restrictions on land use. The Ministry of Land and Resources forbid the use of land for construction of luxury villas and has committed to increasing the amount of land available for affordable housing. In practice, Chinese show little inclination to compliance with zoning regulations. A 2005 ministry study found that over 60 % of new buildings were constructed in violation of zoning laws and regulations.

Developers' access to financing has also been tightened. Builders must now come up with at least 35 % of the project financing costs themselves. In addition, the China Banking Regulatory Commission (CBRC) has encouraged banks to reduce lending to the real estate sector, which currently accounts for 15 % of all bank lending. Officials fear a bubble in the housing market could substantially increase the amount of non-performing loans held by banks. Central bank governor **Zhou** Xiaochuan said no further interest rate hikes were likely in the near future.

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Russia

Modest adjustments to Russia's growth outlook. The economy ministry revised its economic outlook in May. It said the differences in its growth scenarios depended on the competitiveness of Russian firms and the success of state policies rather than shifts in world market commodity prices. GDP growth this year is expected to hit 6.1 %, assuming the average price of Urals-grade crude is $62 per barrel or 23 % above its 2005 average price. In the March forecast, the oil price was expected to increase 7 % this year and GDP growth expected to reach 6 %. During 2007–08, growth expectations were revised slightly downwards: GDP is forecast to rise about 5.7 % each year if oil prices remain high. If oil prices fall 7–9 % per year GDP growth would be 5.6–5.7 % in the basic scenario.

CBR increases euro's share in foreign currency reserves. Central Bank of Russia chairman Sergei **Ignatyev** said that about half of the central bank's foreign currency assets are presently invested in dollar-denominated assets and about 40 % in euro-denominated assets. The rest is invested in pound or yen assets. According to earlier CBR statements, the euro's share of foreign currency reserves was about a third in autumn 2005 (the CBR does not regularly report the currency structure of how its foreign reserves are invested). The strong growth in foreign currency reserves has continued this year; at the beginning of this month, reserves exceeded $247 billion ($182 billion at the beginning of January).

Services trade continues to grow. The CBR says Russian *services imports* in 2005 rose to nearly $40 billion, an increase of 16 % from a year earlier. Services accounted for nearly a quarter of Russia's total imports. Russia imported less than 13 % of its services from CIS countries, which was slightly less than the share of goods from the CIS. Some 42 % of Russia's services imports came from EU countries. Russia imported the most services from Turkey, Great Britain and Germany. Finland provided about 5 % of services imports and was Russia's fourth most significant source of imported services.

The value of Russian *services exports* increased by a fifth to nearly $25 billion in 2005. The share of services in Russia's total exports, however, was just 9 %. The share of services exports from Russia to CIS countries remained at just over 17 %, and slightly exceeded the share of goods exports. Some 40 % of services exports went to EU countries. The main destinations for services exports remained the United States, Germany and Great Britain. Almost 3 % of Russian services exports went to Finland, making Finland the ninth largest destination for Russian services exports.

Reform of electricity sector continues. Russia intends to deregulate electricity production and sales, increase investments in the electricity sector and make the operations more efficient. At a high-level meeting on June 2, president Vladimir **Putin** said that an underdeveloped electricity sector will hold back economic growth. Putin said that the government must invest especially in infrastructure, but must also look to private ownership in development of the entire energy sector. Over the past 15 years, investments in the electricity sector have been small. Russia's Ministry of Industry and Energy now estimates Russia's investment requirements by 2010 will amount to around €70 billion.

At a June 7 cabinet meeting, the industry and energy ministry proposed price increases for electricity. Under the plan, electricity rates would rise 10 % in 2007, 9 % in 2008 and 8 % in 2009. Households currently pay less than industrial enterprises for electricity. The rate hikes would reduce cross-subsidies in the electricity market and ultimately bring electricity prices up to the market level. The government also approved the splitting up of state electrical power monopoly UES into power generation companies and state-monitored grid and distribution operators. Finance minister Alexei **Kudrin** said the state will for the present remain the main investor in the electricity sector.

G8 finance ministers meet in St. Petersburg. The central theme of the ministers' meeting last week (June 9–10) was global energy security. Russia, which holds this year's G8 presidency, also wants energy security at the top of the agenda when it hosts the G8 summit in St. Petersburg next month. It is Russia's position that the outlook for energy consumption is difficult to predict because markets today are not sufficiently transparent. The finance ministers agreed that responsibility lies not just with producers, but also with consumers. There must also be joint efforts to make investment in the field easier, improve energy efficiency, increase access to information and raise the role of the private sector in the energy sector. Meeting resolutions included developing a global standard for reporting oil reserves.

The finance ministers said the general development of the world economy has been favourable and the growth base for the world economy is widening. On the downside, high oil prices and increased volatility in energy markets have recently caused worries of a slowdown in the global economy. The ministers remarked on the importance of the Energy Charter, even if Russia has not ratified the Charter and would like to make substantial changes in the document.

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China

China's money supply growth accelerated in May; inflation remains modest. The People's Bank of China reports the broad money supply (M2) increased 19.1 % from end-May 2005. Growth was slightly higher than at the end of April, when it was 18.9 %. The pace of broad money growth this year has every month significantly exceeded the central bank's target pace of 16 % for 2006. The flood of money has fuelled fears of economic overheating. The PBoC raised its 12-month lending rate at the end of April and encouraged commercial banks to curb lending growth. The measures have yet to show an impact on M2 growth.

Despite the fast broad money growth, inflation has remained low. May *consumer price inflation* was a mere 1.4 % y-o-y. The inflation rate picked up two-tenths of a percentage point from April. Consumer price inflation was slightly higher in cities than in the countryside, and was driven mainly by the rise in food prices (1.9 % y-o-y). Inflation in prices for services was of similar order (2.0 % y-o-y). *Producer price inflation* strengthened slightly from April and in May was 2.4 % y-o-y. Producer price inflation, however, has slowed substantially since the start of 2005, when it was still running at nearly 6 % y-o-y.

Investor nervousness over emerging markets was also reflected on Chinese stock markets. After a strong run-up in the first months of the year, the Shanghai A-share index declined about 9 % this month.

Industrial output growth surprisingly stable even as many sectors suffer from overcapacity. The National Bureau of Statistics reports industrial value-added output climbed 17 % y-o-y in January-May (17.9 % y-o-y in May). Industrial output growth has remained astonishing stable for a couple of years now. Production figures seem impervious to factors other than Chinese New Year. The recorded growth in value added for the lion's share of industries continues to fall in the range of 16–23 %. Slower growth among major industries was only seen in machinery and equipment (13 %) and electrical power generation (11 %). Higher-than-average growth was posted by auto manufacturers (28 %).

The steady growth in industrial output has yet to reflect complaints from a number of industries about overcapacity and overproduction due to excessive investment. Greatest attention has been focused on overcapacity problems in the steel, aluminium, car and cement industries. However, overcapacity appears to afflict a dozen other industries as well, including the coal and textile industries. Despite the problems, many fields continue to invest in additional capacity, leading to higher inventories, lower prices and eventually eroded profitably. Both the government and the central bank have attempted to quell investment in problem industries by issuing guidelines and tightening credit requirements. Even so, the measures to date seem to have had little impact. This has led some analysts to speculate that China's economy and financial markets have opened and changed so much that administrative measures no longer have the same effect they did just five years ago.

Rapid growth of foreign trade surplus. China posted a record foreign trade surplus in May – $13 billion. Exports grew 25 % y-o-y in May and were valued at $73 billion. Imports climbed nearly 22 % to $60 billion. The total surplus for the first five months of the year was $47 billion ($30 billion in January-May 2005). Observers estimate China's foreign trade surplus this year will far exceed last year's record $102 billion surplus. The burgeoning foreign trade surplus has exacerbated the international discussion on China's foreign exchange policies.

Chinese exports of machinery and equipment accelerated in January-May to over 30 % y-o-y. Machinery and equipment represented nearly 60 % of Chinese exports. Clothing exports grew 27 %.

Imports were up sharply in January-May, driven by strong increases in imports of cars and aircraft (both up 80 % y-o-y). Nevertheless, cars and aircraft represent only a tiny share of total imports. The volume of crude oil imports surged 18 %. Copper and steel imports contracted over 20 %.

Government's cash holdings to be better invested. The Ministry of Finance and the PBoC recently announced that, since the start of this year, they have pursued a policy that allows diversified investment of finance ministry cash assets. The ministry must deal with great seasonal variations in liquidity. As of end-April, the ministry held approximately €120 billion in liquid assets. Before the change, liquid assets were mainly deposited in special accounts at the central bank, instead of being invested in money markets as in many other countries.

The new rule initially allows the making of short-term deposits with commercial banks or for repurchasing of finance ministry papers from the market. The policy's immediate goal is to put state liquidity to work and get a higher return. State assets will be invested cautiously to avoid flooding the markets with excess liquidity and disturbing monetary policy efforts. The Ministry of Finance and the PBoC coordinate their market operations.

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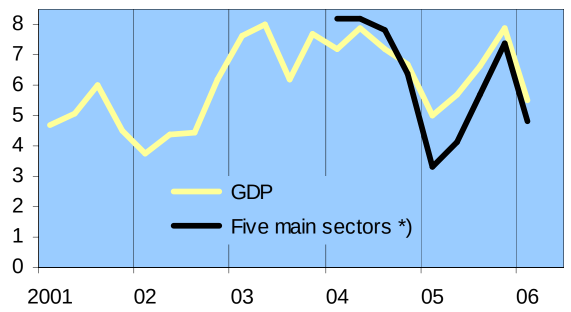
Russia

Rosstat releases first quarter GDP figures. According to preliminary Rosstat calculations, GDP grew 5.5 % y-o-y in the first quarter. Growth was slightly higher than in 1Q05 (5 %), but significantly lower than for all of 2005 (6.4 %). Russian growth typically slows in the first quarter.

Growth in the first quarter was driven largely by consumer demand; trade was up 11 % y-o-y and it remained the largest sector in the GDP. Its weight in the GDP was nearly a fifth in 2005. Growth in services also outpaced industry and agriculture growth in the first quarter. The manufacturing industry grew less than 5 %, which was a bit faster than in the entire last year. Its weight in the GDP is about 15 %.

Percentage change in GDP and main sectors of the economy from four quarters previous



*) agriculture, industry, construction, transport, retail and wholesale trade
Source: Rosstat

Increase in foreign bank presence partly illusory. Central Bank of Russia figures show that the total assets of banks operating in Russia that are either wholly or majority owned by foreign banks reached nearly 11 % of total banking sector assets as of end-March. Such banks held just over 8 % of the sector's total assets at the end of 2005 and 7.5 % as of end-2004. CBR noted, however, that since last autumn foreign banks' share has partly grown through acquisition of stakes by foreign investors, whose activity is significantly influenced by Russian investors.

The CBR figures highlight two banks where foreigners have majority stakes. One bank is registered in the Sverdlovsk oblast. The other is Rosbank, Russia's seventh largest bank in terms of total assets. Through issuance of new shares this year, Rosbank became majority-owned by a "foreign investor" that is actually an offshore company of Russian investors.

On the other hand, Rosbank really did divest its subsidiary Monchebank at the end of 2005 to the Norwegian DnB NOR financial group. DbB NOR now controls nearly all shares in Monchebank, which serves the Kola Peninsula. At the beginning of June, Rosbank also entered into a deal to sell 10 % of its shares to the French Société Générale group.

International carmakers rush to Russia. Russia manufactured 1.1 million passenger cars last year, 4 % less than in 2004. So far Russia continues to produce mainly Russian makes, but *General Motors* and *Ford* are among the few international companies already manufacturing cars in Russia. Car imports to Russia have exploded in recent years, causing many carmakers to take note. Car imports were up over 50 % last year, when Russia imported 770,000 cars. Nearly half were brought in via Finland. Now the largest international automakers consider siting production in Russia. In recent months, General Motors, *Nissan*, *Toyota*, *Volkswagen* and *Peugeot* have all announced plans to make significant investments in Russia. All but Volkswagen plan to site new greenfield plants near St. Petersburg, suggesting St. Petersburg is about to become the car-making capital of Russia. Volkswagen plans to build a plant in Kaluga near Moscow. The new plants are expected to come on stream between 2007 and 2009.

St. Petersburg hosts tenth economic forum. In his opening speech to government officials and business leaders from over 60 countries at last week's economic forum (June 13–14), president Vladimir **Putin** reminded his audience that Russia holds a strong competitive position in world commodity markets. Nevertheless, he said, Russia still needs to move ahead with structural reform to diversify production and improve the quality and competitiveness of Russian products and services. Putin further noted that the West has not always competed openly and fairly e.g. in allowing foreign investors to enter their markets.

On the first day, the main topics were anti-corruption measures and the future of energy cooperation (e.g. the efforts of Russian energy giants Gazprom and UES to penetrate markets in Western Europe).

On the second day, finance minister Alexei **Kudrin** mentioned his concerns about Russia's slowing economic growth in this decade and the lack of domestic investment. Kudrin said the government needs to implement such measures as cheaper loans to encourage investment and do a better job fighting inflation and managing the rouble's exchange rate if it wants to stimulate economic growth. Kudrin criticised wasteful spending on projects such as special economic zones. During the forum, Russia's investment commission also announced major investment projects eligible for financing from Russia's Investment Fund.

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EUROJÄRJESTELMÄ
EUROSYSTEMET

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25 • 22.6.2006

China

China's central bank raises reserve requirement; investment growth still on fire. Last Friday (June 16), the People's Bank of China announced it would raise its reserve requirement for commercial banks a half percentage point to 8 %. The new reserve requirement comes into effect July 5; it is intended to restrain the expansion of credit and promote stable development of financial markets. The PBoC expects the higher reserve requirement to reduce market liquidity by CNY 150 billion (€15bn). It is unclear, though, whether this particular measure actually contributes to monetary tightening as some banks already voluntarily keep large reserves on deposit with the central bank. On the other hand, the PBoC recently has tried to soak up market liquidity by making banks it considers to have overly enthusiastic lending practices purchase central bank bills. It has also raised its reference rate for lending and enjoined commercial banks to cut back on lending.

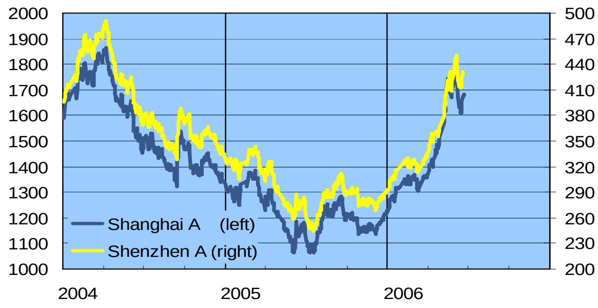
In any case, a tighter monetary policy seems justified in light of real economy developments. In urban areas, fixed capital investment was up 30.3 % y-o-y in the first five months of this year. Investment growth accelerated somewhat in May. Highest investment growth was seen in coal mining (up 64 %) and railways (94 %). Officials have focused their efforts on curbing investment in sectors afflicted by overcapacity.

Participants agree to broaden cooperation at meeting of Shanghai Cooperation Organisation. Chinese president **Hu** Jintao hosted the latest summit of the Shanghai Cooperation Organisation (SCO), which comprises China, Russia, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. The leaders of India, Pakistan, Iran and Mongolia also participated under observer status. Iran caught the attention of the meeting with its proposal for expanded energy cooperation with SCO member states. The meeting concluded resolutions among others on establishing a business council, arranging joint actions in anti-terrorism efforts, as well as providing financial guarantees for multilateral investment projects within the SCO framework. The meeting participants also issued a declaration pledging that member states are working on a multilateral legal document, designed to cement cooperative relations among member countries, especially in security matters. China and Russia both promised financing for investment projects in Central Asia. Russian president Vladimir **Putin** and Hu Jintao also met to broadly discuss bilateral economic relations and ways to increase cooperation.

The SCO, which was established in 2001, has yet to define a clear focus for its widening agenda. The organisation grew out of cooperation on solving lingering border issues between China and the former Soviet Union. To date, the organisation has made its mark on security issues. The concerns of US officials, who suspect the SCO's unspoken agenda may be to diminish US influence in Central Asia, have been fuelled by joint military exercises and the possibility of full membership for Iran. While Russian media have been quick to compare the SCO to NATO, Putin reminded reporters after the meeting that is was wrong to characterise the SCO as a military alliance.

International uncertainty, central bank tightening and IPOs provide exciting times on Chinese bourses. Although development of China's stock markets has typically not reflected trends on the world's main exchanges in recent years, this month's dip in world stock markets dragged down Chinese shares. The drop, however, was far less than the average decline on emerging market bourses as domestic factors still seem to drive Chinese share prices. A new factor in Chinese share trade is this week's launch of trade in previously non-tradable state-owned shares of listed enterprises. When the massive state share conversion was announced a year ago, it was estimated that the newly tradable shares could constitute as much as 70 % of the entire stock of all listed firms. Thus, the conversion has been carefully managed. A listed state company converting its shares to tradable shares can only offer new shares comprising 5 % of its total shares to the market in first year and only 10% of its total shares in the second year (see *BOFIT Weekly 18/2005*). The ultimate impact from the issuance of new shares is unclear. Although the flood of new shares onto the market could initially depress share prices, the reform may eventually promote business restructuring through acquisitions and mergers, and hence improve the prospects of listed companies.

Chinese stock markets, A-share indices



Source: Bloomberg

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Russia

Production growth accelerated in May. Rosstat reports Russian industrial output growth accelerated in May to 10.6 % y-o-y. For the first five months of the year, output was up 4.8 % from the same period in 2005. Growth of manufacturing industries accelerated to 5.6 % and 2.3 % in the mineral extraction industries. Production and distribution of water, gas and electricity continued to grow at an on-year pace of 5.9 %.

Rosstat's main composite index of production based on industrial production and four other core sectors of the economy showed growth of 10.1 % y-o-y for May. Retail sales continued to grow fastest at a rate of 10.8 % y-o-y, while construction maintained a rate of 6.4 % y-o-y. Transportation was up just 1.7 % in the first five months of the year, and agricultural output grew a mere 1.4 %.

The accelerated growth in both industrial output and retail sales reflects increases in consumption and higher investment. Fixed capital investment growth in January-May remained above 9 %. Among the fastest growing items in industrial production were certain foodstuffs and cars. Higher investment was also seen in the construction field and in production of construction-related goods.

Russia to pay off Paris Club debts. Russia's rescheduled plan was to pay off its Soviet-era debt to sovereign creditors of the Paris Club between 2006 and 2020. Russia was able to pay down some $15 billion last summer and now plans to pay back the remaining $22 billion of the debt this August. In addition to the debt, Russia will pay creditors a compensation of $1 billion for early repayment, of which $700 million will go to Germany. Finance minister Alexei **Kudrin** estimates that Russia will nevertheless save $7.7 billion in debt servicing costs by the early repayment. Kudrin said the savings will go to the state investment fund. Russia will finance the payment out of the stabilisation fund that has swollen thanks to high oil revenues.

Government approves changes to main parameters of 2007 federal budget. At last week's cabinet meeting, the government dealt with the financial plan for 2007–2009, revising upwards its revenue and spending forecasts for the federal budget. 2007 *revenues* are expected to reach nearly 22 % of GDP, and then contract to just over 19 % of GDP by 2009. The projection assumes export prices of crude oil will decline 6–9 % in each year. Under the earlier approved financial plan for 2006–2008, revenues amount to about 20 % of GDP in 2007. Realised 2005 budget revenues were nearly 24 % of GDP. *Expenditures* for the three-year period would be highest in 2007, when they are expected to reach 17.5 % of GDP. Thereafter, expenditures would fall in relation to GDP to less than 17 % of GDP in 2009.

On the expenditure side, the hikes are directed to population policy measures, implementation of national priority programmes, defence and national security, regional support, and road construction and maintenance. The preliminary 2007 budget also sets aside money for the planned phase-out of cross-subsidies in monopoly fields and increased state-ownership in new electrical power companies created from the break-up of UES.

Head prosecutor and justice minister switch jobs. President Vladimir **Putin** last week appointed Vladimir **Ustinov** as his new justice minister. Putin had called for Ustinov's resignation from his post as Prosecutor General at the beginning of the month. Justice minister Yuri **Chaika's** appointment to the Prosecutor General post was also approved by the upper-house Federation Council.

CBR tweeks key rates. Effective last Monday (26 June), the Central Bank of Russia lowered its refinancing rate from 12 % to 11.5 %. While the refinancing rate only indirectly influences market interest rates, the CBR has lowered it with the gradual slowing of inflation in recent years. As earlier, the CBR also lowered its overnight lending rate to 11.5 %. Both rates have converged with corporate lending rates in recent years. Rouble denominated lending rates of one-year or less averaged 10–11 % in the first four months of this year. On the other hand, the central bank raised in March and April rates on one-day and one-week deposits offered to commercial banks. Deposit rates are still a mere 1.5–2 %, so they have a rather minor impact on banking system liquidity.

Nordea divests stake in International Moscow Bank. Just before midsummer, Nordea made a deal to sell its slightly more than 23 % stake in IMB to Bayerische Hypo- und Vereinsbank (HVB), a subsidiary of the Italian UniCredit bank. The transfer of ownership is expected to be completed in the third quarter of this year when official approval is expected to be granted. The sale gives HVB over 79 % of the voting shares in IMB. The rest of IMB's voting shares are held by the French BCEN bank. Just under 5 % of shares are controlled by the European Bank for Reconstruction and Development (EBRD), a multi-government agency. IMB was established in 1989 and is Russia's eighth largest bank with 1.6 % of banking sector assets.

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China

Bank inspectors uncover widespread fraud and irregularities at Agricultural Bank of China. In their audit of Agricultural Bank of China (ABC) focusing on activities in 2004, bank inspectors from China's Banking Regulatory Commission (CBRC) found 51 cases of fraud amounting to nearly €900 million. The fraud involved 157 bank employees and mostly involved car loans and real estate development. In addition, the inspectors also identified a substantial number of irregularities and accounting problems.

Although the inspection report has resulted in remedial measures at ABC, the findings reinforce the view that ABC is by far the most troubled of China's four large state banks. According to official figures, non-performing loans (NPL) account for about 25 % of ABC's loan stock, while the non-performing loans stocks of other large state banks are less than 5 % (although the actual NPL figures are possibly larger). The state has not dealt with ABC's non-performing loan problem in recent years with the same aggressiveness it has with the other state banks. Due to the severity of ABC's problems, the bank's future is still under discussion. Hence, unlike the three other banks, ABC has expressed no plans to list on the stock market. ABC has 31,000 branch offices in China and controls about 12 % of banking sector total assets.

China Post Savings Bank set to become China's fifth largest bank. On Monday (June 26), the CBRC announced government plans to organise the banking services of China's post office under the newly created China Post Savings Bank. Post offices around the country currently manage the savings accounts of 260 million account holders. With deposits of about CNY 1,500 billion (€150bn), the new bank would become the country's fifth largest. China's 36,000 post office branches should facilitate expansion of banking services into rural areas. Consequently, the new bank is expected to become a strong competitor to Agricultural Bank of China, which until now has shouldered most of the rural lending burden.

Postal savings bank activities in China were launched in 1986. The post office has traditionally taken received savings deposits and placed them with the central bank. It has not been involved in lending activities. A large part of the China's post office's income has come from the margin it earns on the difference between the interest paid to it for its deposits with the PBoC and the amount it pays out to depositors.

China revises up figures for GDP and direct investment. In the first quarter of this year, GDP growth on-year was raised a tenth of a percentage point upwards to 10.3 %. The adjustment was mainly due to increasing the figure for service sector growth from initial calculations. China also released further data from last year's economic census. This time the revision implied higher figures for energy production and consumption.

National Bureau of Statistics officials adjusted upward also their figure for direct investment into China last year from slightly more than $60 billion to over $72 billion. The new figure now includes also direct investment into China's financial sector that grew considerably last year.

Law unifying corporate taxation finally set to advance. After years of calls to do something to unify corporate income tax systems, it now appears that the Standing Committee of the National People's Congress will finally review a draft law in August. The progress was announced by tax authorities, who added that a unified corporate tax system is now a top priority in China's tax reforms.

Companies in China are currently subject to separate tax regimes; Chinese firms officially pay a rate of 33 %, while foreign firms usually pay a rate of 15 %. There is evidence that even after taking into account widely available tax concessions, Chinese companies still pay double the amount of foreign companies. The exception is foreign firms operating in service industries such as the financial sector, which pay a rate of 33 %. Chinese firms have long complained about the inequities in tax treatment, noting that it violates WTO principles of fairness. Multinationals operating in China and authorities in special economic zones have responded by actively lobbying against the changes. China's deputy trade minister **Ma** Xiuhong sought to calm foreign firms with assurances that the government will give them a reasonable time to make the transition to the new unified tax system.

Authorities announced the new tax percentage will be set at below 30 %. Observers expect the unified corporate tax rate to be in the range of 24–27 %.

Based on available information, the criteria for qualifying for tax breaks will also be revised. The current regional tax concessions will be replaced by sector-specific benefits. The change will allow the state to more effectively channel investment to sectors it sees as critical (e.g. high-tech and environmentally sound technology). Investors may be able to identify potential tax treatment from the annually published official investment handbook, wherein officials specify industries where investment is encouraged, forbidden or permitted.

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Russia

Russia posts record current account surplus in the first quarter. The Central Bank of Russia reports the country's current account surplus rose to around $30 billion, or about 15 % of GDP in the first quarter. Russian earnings on exports of goods and services increased a third compared to 1Q05. Thanks to high export prices, export earnings were up about 50 % for crude oil and oil products and 60 % for natural gas. Other export revenues grew about 10 %. Expenditures on imports of goods and services increased more than 20 %. The trade surplus, which is included in the current account balance, amounted to nearly 18 % of GDP. Trade in services and the investment income account remained in the red (3 % of GDP), driven mainly by corporate debt servicing costs and income from direct investments in Russia.

The financial account shows the net inflow of direct investment into Russia climbed to $6.5 billion. Russian direct investment abroad rose to $5 billion. Portfolio investment from Russia (mainly investments by federal authorities in debt securities) increased substantially. Corporate borrowing from abroad declined sharply from 2005 and the total stock of corporate foreign debt rose only slightly to $131 billion at end-March. Even if unrecorded net outflow of capital reflected in the errors and omissions entry shrank, capital transferred abroad by using fictive deals ("non-repatriation of exports proceeds, non-supply of goods and services against import contracts, and remittances against fictitious transactions in securities") was still about $7 billion. Bank receivables from abroad and debts to foreigners increased sharply.

GDP demand components see some changes in the first quarter. Rosstat's latest report on GDP demand components shows investment growth in the first quarter slowed to 5.8 %, compared to 8.2 % in 1Q05 and 12.2 % in 4Q05. Fixed investment corresponded to 13 % of GDP. Private consumption continued to grow rapidly in the first quarter, 10.7 % y-o-y. Public consumption growth accelerated slightly to 3.3 %. Net exports declined as growth in import volumes was again substantially higher (25.7 %) than exports (7.8 %).

Currency controls on the rouble abolished. Following president Putin's announcement last spring of full rouble convertibility as early as July 1, the cabinet at its June 29 meeting approved a legislative proposal on the matter to the Duma. Finance ministry press releases said the amendment would discontinue from July 1 onwards the rights of the government and central bank under the currency law to impose deposit requirements on short notice in order to restrict capital movements or place restrictions, for example, on trade credits, securities trades, transfers between bank accounts or the exchange of cash.

Russia and Paris Club sign deal on debt repayment. Under an agreement prepared in mid-June and signed at the end of June, Russia will pay off all of its outstanding $22 billion in Soviet-era debt to the Paris Club of sovereign creditors by August 21 (see *BOFIT Weekly 26/2006*). Russia will agree bilaterally on specific payment schedules with 17 creditor nations. Russia's total government foreign debt was about $70 billion as of end-March.

Ukraine and Moldova sign gas delivery contracts with Gazprom. Last January, Russia and Ukraine agreed on the price for natural gas for the first half of 2006 – $95 per thousand cubic metres. Now deliveries will continue at the same rate for the next three months until the end of September. The agreement, which involves the Ukrainian state, Gazprom and RosUkrEnergo, which handles gas deliveries from Russia and Turkmenistan to Ukraine, was reached on the final day before the earlier agreement expired. Gazprom CEO Alexei **Miller** indicated that the pressure to raise prices has merely been shifted to the fourth quarter and a new conflict over prices could arise. Efforts to resolve the impending price impasse in the longer term will be complicated by Turkmenistan's insistence on raising its own prices to $100 dollar/1,000 m^3 from the beginning of September. Gazprom manages Turkmenistan's gas pipelines and most of the gas Russia sells to Western Europe passes through Ukraine.

The next move may be made by Ukraine's newly formed coalition government after the largest opposition party just seems to have stopped blocking the official appointment of the "orange" government of prime minister Julia **Timoshenko**. Timoshenko earlier demanded revisiting the January gas agreement and renegotiating the whole deal without the middlemen.

Meanwhile, Moldova has agreed with Gazprom on the gas price until the end of this year. Moldova's gas price has gone up 43 % from the $110/1,000 m^3 in the first half of 2006 to $160/1,000 m^3 for the second half of this year. Gazprom will continue to pay Moldova a transit fee of $2.50/1,000 m^3 per hundred kilometres of pipeline throughput. The parties hope to sign a long-term agreement in September on gas sales to Moldova as well as gas transit.

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China

Rapid growth in tax revenues continued in 2005. Chinese finance minister **Jin** Renqing released the final figures for last year's realised budget at the end of June. According to the data, tax revenues collected by the central and local authorities rose nearly 20 % y-o-y and amounted to 17.3 % of 2005 GDP. Public sector spending rose 19 % y-o-y, which corresponded to 18.6 % of GDP. Public sector debt was thus 1.3 % of GDP, about the same level as for 2004. Preliminary information also suggests that the rapid increase in tax revenues continued in the first half of this year.

Although official figures for the size of China's public sector seem modest in relation to the size of the Chinese economy, the role of the public sector is actually much larger. The amount of off-budget revenues and expenditures in China remains quite substantial, especially at the local level. Budget figures also omit revenues of publicly owned enterprises.

Electricity rates go up. Officials raised electrical power rates an average of 3 % at the end of June. Higher producer costs for fuel (e.g. coal and coal transport) were given as the reason for the increase. The rate hike was the second since a new price-setting mechanism was introduced in the first half of 2005. Under the new pricing mechanism, electricity prices more rapidly reflect major changes in coal prices. Electricity rates were last raised about 5 % in May 2005.

New US Treasury Secretary an old China hand. Henry **Paulson** probably has the most China experience of any US treasury secretary ever. The former Goldman Sachs chairman and CEO is known for his long-term engagement with and frequent trips to China. Goldman Sachs has played a central role in arranging IPOs for China's large corporations. In his senate confirmation hearings, Paulson had to persuade suspicious senators that he would not become an apologist for the Chinese government. Americans are annoyed by their country's huge trade deficits with China and China's intransigence on allowing the yuan's exchange rate to appreciate faster. Strengthening of the yuan against the dollar has been painfully slow. On Thursday (July 6), one dollar bought 7.996 yuan.

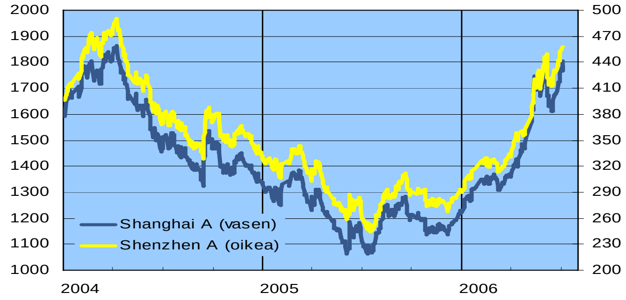
Ahead of the senate's finalisation of his appointment, Paulson called for greater flexibility in the yuan's exchange rate and more active efforts to boost Chinese domestic demand. He also showed understanding for the Chinese government's concerns that China's financial markets still are not ready for a fully convertible currency. Paulson said that banking reform takes priority in China's financial reforms. The new treasury secretary has a significant personal investment in the state-owned Industrial and Commercial Bank of China (ICBC), which he has to divest before assuming his new post.

Bank of China lists on Shanghai bourse, share prices continue to rise. Trading in shares of state-owned Bank of China commenced Wednesday (July 5) on the Shanghai exchange. With its recent listing on the Hong Kong stock exchange, the Bank of China became the first bank in which the state holds a majority stake to list on the mainland Chinese stock markets. The Shanghai exchange listing was the largest IPO ever in mainland China, valued at nearly CNY 20 billion (almost €2bn). The IPO saw the sale of 2.6 % of the bank's shares and was oversubscribed 50-fold. The share price rose 23 % in the first day of trading. The huge interest and the soaring share price is understandable as the share's listing price was more than 10 % below the price on the Hong Kong stock exchange. With the rise in its share price, the Bank of China now has the largest market capitalisation of any company listed on the Shanghai exchange.

The Bank of China IPO was the first major listing event since the one-year hiatus on listings on Chinese stock markets ended in May (see *BOFIT Weekly 21/2006*). The new listing rules and other current reforms intended to help the bourses function more smoothly have increased investor interest in the Chinese stock market.

Share prices have been mostly trending up in recent weeks, despite a brief hiccup in mid-June when investors were worried about an oversupply of shares caused by a new wave of IPOs and the impending completion of a year-long effort to convert non-tradable state-owned enterprise shares to tradable shares. On Wednesday (July 5), the Shanghai and Shenzhen A-share indexes stood at their highest levels since April 2004.

Chinese share prices, A-share indexes



Source: Bloomberg

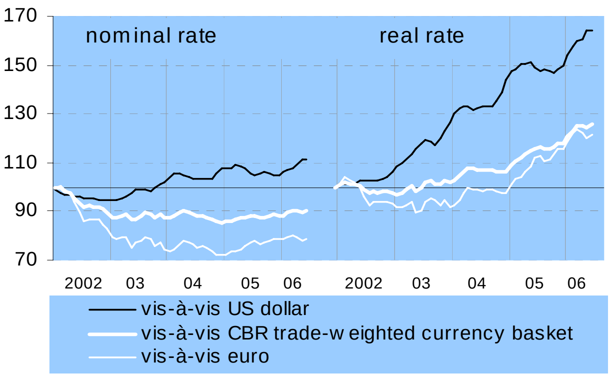
BOFIT Weekly
28 • 14.7.2006

Russia

Russian inflation continues to slow. Rosstat reports on-year inflation was 9.1 % in June and that consumer prices rose 6.2 % since the start of the year. Growth in consumer prices for *foodstuffs* continued to slow; the rise for June was 8 % y-o-y, 0.8 percentage points less than in May. On-year inflation in *other goods* was 6.3 %, matching May's pace. Despite a sharp on-year rise in gasoline prices (nearly 16 %), their rise in this year has been under 3 %. The rate of increase in prices for *services* was unchanged from May at 15.6 % y-o-y.

Mild rouble appreciation in second quarter. The rouble's nominal exchange rate in relation to the Central Bank of Russia's trade-weighted basket of currencies rose by 0.5 % between March and June. The CBR curbed rouble appreciation in April and May through market operations, but in June the rouble gained over 1 % in value. The rouble's exchange rate has increased 2.7 % since last December and more than 3 % since June 2005. The rouble rose over 3 % against the dollar in the second quarter and nearly 7 % since the start of the year. The rouble lost about 2 % against the euro in the second quarter. Its value relative to the euro in June was about the same as last December. The rouble's real exchange rate climbed 0.5 % in the second quarter against the trade-weighted currency basket. The real exchange rate in June was almost 7 % higher than in December and 8.5 % higher than in June 2005. The rouble's real exchange rate has appreciated over 10 % y-o-y against the dollar and 8.4 % y-o-y against the euro.

Rouble exchange rate, December 2001 = 100
(rising line indicates rouble appreciation)



Source: CBR

IMF mission concerned about growth in Russian budget spending and slowness of economic reforms. As part of its yearly Article IV consultation, the IMF mission found that resource constraints on production in Russia are tightening and growth in domestic demand continues to outpace Russia's potential GDP growth and increase imports. The IMF expects GDP growth to reach 6.5 % this year and at least the potential growth rate (6-6.5 %) in 2007.

Acknowledging the federal budget surplus, the IMF mission observes a notable relaxation of Russia's fiscal stance over the past 12 to 15 months. The mission expressed concern that a possible 2006 budget amendment and preliminary plans for the 2007 budget would add to inflationary pressures and speed up the real appreciation of the rouble. The mission statement noted that increases in public sector wages may not lead to improved efficiency as public sector reforms are on hold and increases in budget expenditures are not sufficiently allotted to reforms that could improve economic growth potential. The recent slowdown in inflation was said to partly reflect the substantial appreciation in the rouble's nominal exchange rate since early 2005. According to the IMF experts, the CBR faces the choice of allowing real appreciation to take place either through nominal rouble appreciation or higher inflation. They recommend that the CBR focus its monetary policy more openly on containing inflation and refrain from stating even indicative nominal and real exchange rate targets.

The IMF also expressed concern that Russia's current rapid economic growth cannot be sustained unless Russia speeds up economic reforms and deals with the current unevenness in reform implementation. The mission asked Russia to prioritise reforms of natural monopolies, other state-controlled economic sectors and public administration. The mission also called into question the impact of increased state holdings in the oil and gas sector on the development of these sectors. The IMF commended Russia's decision to accelerate reforms in the electricity sector and plans to increase transparency in tax administration. It recommended that Russia clarify its plans for legislation of subsoil resources as well as strategic sectors. In the area of banking, the IMF said it would like to see banking supervision that covers entire banking consortiums, broader coverage of connected party banking, improved fit-and-proper tests for bank owners and top management as well as better transparency of the structures of bank ownership, adoption of international accounting standards and a time-bounded action plan for the future of state-owned banks.

Parliament approves bill on natural gas export monopoly. The bill is an acknowledgment that Gazprom is Russia's de facto gas exporter. The bill passed its second and third readings in the Duma on July 5 and was accepted by the Federation Council on July 7. The bill now awaits president Putin's signature to become law.

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China

China's monthly foreign trade surplus breaks record in June; credit growth remains strong. Chinese exports in June climbed 23 % and imports 19 % from a year earlier to hit a record monthly surplus of $14.5 billion. The total value of exports was $81 billion; imports were valued at $67 billion. The surplus for the first half of the year exceeded $61 billion, up 55 % from 1H05.

China's massive trade surplus has added further liquidity to financial markets. Credit growth in the first half of 2006 was nearly double the pace targeted by the People's Bank of China. The PBoC has tried to quell lending growth by raising reference interest rates on loans and selling bonds to siphon liquidity from the markets. Official media report that China's large state-owned commercial banks are complying with the new policy; their yuan-denominated lending in June decreased substantially. Other commercial banks and rural credit institutions, on the other hand, considerably increased their lending. An increase in the reserve requirement of deposit-taking financial institutions by 0.5 percentage point came into effect on July 5. The central bank expects the move will reduce market liquidity by about CNY 150 billion (€15bn).

Chinese oil companies invest in Russian oil producers. In the latter half of June, the Russian joint venture TNK-BP announced it had sold its subsidiary oil company Udmurtneft to Sinopec, China's second largest oil company. Udmurtneft produces 115,000 barrels of crude oil a day and has proven oil reserves of about 550 million barrels. At the current rate of production, Udmurtneft's reserves are sufficient to last 13 years. The deal is valued at around $3.5 billion and is the first major Chinese acquisition in Russia's oil industry. Russian sources report, however, that it has been agreed that Russia's state-dominated Rosneft will take a 51 % stake in the resulting Sinopec-Udmurtneft oil company. In other words, Sinopec is essentially financing the purchase of the Rosneft's stake and Rosneft's acquisition would be financed out of Udmurtneft share dividends.

Media reports also indicate that China National Petroleum Corp (CNPC) has plans to invest in the upcoming Rosneft IPO. Estimates of the planned investment run as high as $3 billion. The diversification of Chinese companies into new energy fields suggests the Chinese appetite for oil has returned to levels last seen two years ago. In the first five months of this year, oil demand (refinery production plus net imports of oil products) grew nearly 7 % y-o-y. In April, however, it climbed 11 % y-o-y and in May 14 % y-o-y. Demand for oil last year grew just 2–3 %, down significantly from the 14 % pace set in 2004. Crude oil imports were up about 18 % in January-May, and in May import volumes were over a fifth larger from a year earlier. Estimating China's actual oil consumption is difficult because China does not publish figures on changes in its oil reserves.

China's steel industry streamlines. China has overwhelmingly become both the world's largest steel producer and largest consumer, accounting for over 30 % of the world market share. Over the past three years, China has built new steel production capacity roughly equivalent to the EU's current total production capacity. However, China's central administration is now concerned about the impact of overcapacity in steel production and has announced that it will eliminate as much as 100 million tonnes of steel-making capacity over the next five years through the shuttering of older mills. China produced 349 million tonnes of steel in 2005.

For the moment, European fears of cheap Chinese steel flooding world markets have yet to materialise. China has become a net exporter of steel, but the impact from exports is mainly felt in long steel products (e.g. beams and rods) going to countries neighbouring China. Chinese steel imports, on the other hand, have declined precipitously in certain product segments. Over half of steel demand in China still comes from long steel products used by the construction industry, but demand for flat products (e.g. rolled steel sheet) has grown dramatically in the face of booming demand from producers of cars, ships and home appliances.

Despite China's dominant position in global steel markets, Chinese companies have yet to play a leading role in the global realignment of production or in annual negotiations on raw material prices. Thus, up to now, the Chinese have had to accept whatever deal the others negotiated for themselves.

Thousands of small steel producers currently operate in China's fragmented domestic market. A year ago, only one Chinese steel company, Baosteel, ranked among the global leaders. As of last year, China's central government supports the consolidation of Chinese steel producers in order to prevent Chinese producers from being gobbled up by the major international players. The central government embraced a policy, whereby no foreign investor could own a majority stake in a Chinese steel company. The Chinese government seeks to create three giant steel producers, each with capacity in excess of 30 million tonnes by 2010. Over the past twelve months, three major steel mergers have been announced in China.

Editor Timo Harell

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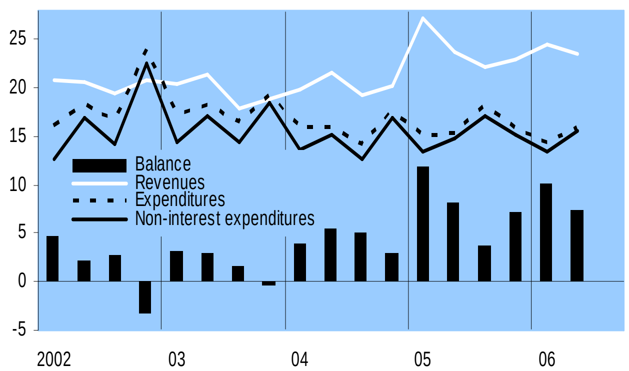
Russia

Industrial output climbs 4.4 % in 1H06. Even with May's scorching on-year pace giving way to more sedate growth in June, industrial output in the second quarter still grew 6 %, and 4.4 % for the first half of the year. On-year growth in mineral extraction industries was 2.3 % y-o-y in the first half of 2006, slightly faster than in the 1H05. Within the mineral extraction category, oil and natural gas production showed an on-year increase of 2.3 %. Manufacturing was up 4.5 %, holding to a growth pace similar to the same period last year. Within the manufacturing category, fuel production showed rather strong gains. Production and distribution of gas, water, and electricity increased 5.7 % y-o-y in the first half, which was clearly more than the same period a year earlier.

Federal budget posts first-half surplus. Preliminary finance ministry figures show Russia's federal budget surplus hit RUB 1,067 billion (€31bn), or 8.7 % of estimated GDP for the first half of 2006. While the nominal surplus grew 14 %, it fell slightly relative to GDP compared to 1H05. Budget revenues corresponded to 24 % of estimated GDP, while budget expenditures were 15 % of GDP. Revenues rose 23 % and expenditures 29 % in nominal terms. Relative to GDP, however, revenues fell slightly and spending remained at essentially unchanged from the same period a year ago. High oil revenues boosted Russia's stabilisation fund to RUB 2,067 billion (€61bn) as of June 1.

Russian budget, % of GDP



Source: Ministry of Finance

Duma approves increase in deposit insurance coverage. At the beginning of this month, the Duma approved an amendment to the act on deposit insurance that raises the ceiling on coverage per individual from 100,000 roubles to 190,000 roubles (5,600 euro). Under the new rules, private persons with deposits in an insolvent bank will be reimbursed in full up to 100,000 roubles and 90 % for anything above that up to a reimbursement of 190,000 roubles. The purpose of the reform is to extend protection of individual depositors and further increase confidence in the banking system. At the beginning of 2006, over 95 % of deposits by private individuals amounted to less than 100,000 roubles. Savings and deposits, however, are expected to increase as average incomes rise in Russia.

Energy security discussed at the St. Petersburg G8 summit. Even as the crisis in the Middle East drew attention from the initially chosen topics of the summit, the summit host Russia worked to keep the focus on energy security. The G8 leaders signed an official summit communiqué, in which they committed to open, transparent, efficient and competitive energy markets. The communiqué however, was non-binding on the signatories and was unspecific on concrete measures to achieve the goals. Russia did still not ratify the Energy Charter Treaty, which would require it to open up its energy markets, but it did approve abiding by the principles of the treaty as a goal of the communiqué.

Russia and the US failed to reach a deal on Russia's entry to WTO at the G8 summit. Problems resulted especially from the certification of US meat products imported to Russia. The discussions, however, did make progress on issues relating to access to financial services and copyright protection. The parties set a goal of resolving their differences this autumn, in which case Russia could join the WTO next spring.

Rosneft lists on Moscow and London exchanges. The recent IPO of 13 % of the shares in state-owned Rosneft, was the largest IPO in Russia and one of the largest in the world. Rosneft saw shares sell at price of $7.55 a share and raised $10.4 billion from the issue. Rosneft announced that about 49 % of the issued shares went to only four companies: the British BP, the Malaysian Petronas, China's CNPC and a fourth company whose identity was not revealed. The Yukos oil company made a last-minute attempt to challenge Rosneft's London listing by claiming that it was selling stolen property. A large share of Rosneft's production comes from Yuganskneftegaz, the core Yukos production unit it acquired through a forced auction. Yukos lost its challenge and trade in Rosneft share launched on schedule on Wednesday (July 19) on the London stock exchange. The markets were underwhelmed by Rosneft's debut – trading opened at $7.45 a share.

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China

China's rapid GDP growth raises concerns about economic overheating. The National Bureau of Statistics figures for the first half of 2006 suggest possible economic overheating. Several economic activity indicators showed distinct increases in June. For the first six months of 2006, Chinese GDP grew 10.9 % y-o-y, and hit 11.3 % y-o-y in the second quarter. For January-June, industrial output rose at a rate of 17.7 % y-o-y; fixed investments in urban areas increased 31.3 % y-o-y. The highest investment growth was seen in rail freight infrastructure (88 %) and food industries (65 %).

There is still little evidence that the measures taken by China's State Council and the People's Bank of China (PBoC) to curb excessive economic growth have had much of their desired impact. Fears of overheating continue to be fed by the ballooning loan stock and the eagerness of firms to invest. Moreover, the effects of the PBoC's tighter monetary stance have yet to impact lending by smaller banks. Other factors feeding the desire of Chinese firms to channel their profits into new investments include robust profitability, small dividend payouts and low real interest rates.

Money supply growth slowed in June, consumer price inflation remains low. The broad money supply (M2) was up 18.4 % y-o-y as of end-June. M2 growth slowed slightly from 19.1 % y-o-y in May. The on-year growth in the money supply was the lowest since December 2005, but still well above the pace needed to hit the central bank's target of 16 % for the entire year. Slowing growth could indicate that tighter monetary policies (higher lending rates, higher reserve requirements for commercial banks, and administrative measures) are starting to bite. The PBoC has also tried to soak up excess market liquidity by issuing bonds. In the first half of this year, banks nevertheless granted 87 % of the amount of loans targeted for all of 2006. China's foreign currency reserves are the largest in the world; they stood at $941 billion at the end of June.

Despite rapid economic growth, consumer price inflation has remained low, and was a mere 1.5 % y-o-y in June. Producer price inflation, on the other hand, accelerated in June by more than a percentage point from May to 3.5 % y-o-y. The rise in producer prices has been driven by rapid economic growth and probably by higher prices for fuels and raw materials.

Plans to issue yuan bonds in Hong Kong. At the end of last month, officials in Mainland China and Hong Kong SAR announced plans to permit the issuance of yuan-denominated bonds in Hong Kong. Hong Kong firms would also be allowed to pay for imports from Mainland China in yuan. A precise timeline of the proposed reforms was not given. A recent change in PBoC policy to ease the possibilities of using yuan in Hong Kong (see *BOFIT Weekly 48/2005*) has increased the use of the Chinese currency in the special administrative region. Hong Kong's financial sector has hoped for an even faster pace of reform.

With the deepening integration of Hong Kong and Mainland China and the growing economic importance of Chinese companies, there will be a shift in the composition of Hong Kong's Hang Seng share index and how that index is calculated. The index now will include five "H-share" companies, i.e. shares of companies registered in Mainland China but listed in Hong Kong. The names of the companies have yet to be released.

First direct air cargo flight between Taiwan and the mainland. The first air cargo flight between Taiwan and Mainland China since the two broke off relations in 1949 flew from Taipei to Shanghai late Wednesday (July 19), albeit via Hong Kong airspace. Despite extensive economic integration, direct Cross-Strait trade, travel and postal services have yet to be launched. In 1997, limited sea cargo transshipment was allowed. Direct charter flights for mainland-based Taiwanese have also been permitted during the Chinese New Year holidays in the past four years. Wednesday's chartered cargo flight was the next step in restoring direct links. Under the new rules, Taiwanese firms can apply with the Taiwanese government for specific permits for direct air freighting of equipment and related components needed in production, but not finished goods. Most air cargo between Taiwan and the mainland must presently be loaded onto other planes in Hong Kong.

Regular direct air cargo links to Mainland China are high on the wish lists of many companies, as the current arrangement generates substantial additional costs. The value of annual trade crossing the Taiwan Straits stands at $100 billion. Much of that trade is generated by Taiwanese computer manufacturers operating on the mainland that import significant quantities of components and semiconductors from Taiwan. For electronics manufacturers already operating with wafer-thin margins, the added transportation costs and unnecessary delays in component deliveries are competitive disadvantages. Enterprises and Western chambers of commerce have for years pressured authorities to open up direct links. The opening of connections has been slowed by tense political relations between Beijing and Taipei, as well as Taiwanese government concerns about security threats arising from direct connections.

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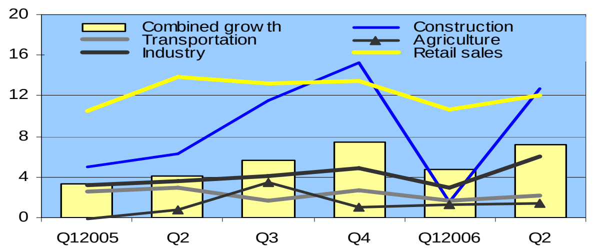
Russia

Economic growth in Russia accelerated in second quarter. On-year growth picked up sharply in all of Russia's five core production sectors in the second quarter. The combined core sector growth of 7.2 % suggests that the economy overall grew faster than expected in the second quarter. Initial figures from the economy ministry indicate that GDP growth in 1H06 was 6.3 % y-o-y. Higher output growth was driven by continued high growth in construction and retail sales. After a slump in the first quarter, construction roared back to post growth of 8.3 % for the first half of the year. Retail sales were up 11.3 %, industrial output 4.4 %, transportation 1.9 % and agricultural output 1.4 %.

Growth in core economic sectors, % change for a year earlier



Source: Rosstat

Producer prices continue to rise rapidly. Industrial producer prices rose 9.4 % in June from the beginning of the year, nearly the same pace as a year earlier. While the rise in producer prices in mineral extraction industries slowed significantly from 1H05, they were still up nearly 14 % from start of the year. Producer prices in manufacturing industries rose slightly faster than a year earlier at a pace of nearly 8 %. Producer price increases in 1H06 were fast especially in refined oil and metal products.

Fitch raises Russia's creditworthiness a notch. On Tuesday (July 25), Fitch Ratings raised its rating for Russia's long-term sovereign debt one step to BBB+, putting Russia in the same category as South Africa and Mexico. Fitch justified the increase by noting macroeconomic improvements and the strong financial position. Both conditions have helped lower Russia's international credit risk. Fitch also expects the Russian state to become a net external creditor later this year. The rating agency still warned about Russia's overdependence on natural resource industries, slow pace of structural reforms, the relatively weak foundation of its rapidly growing banking sector, and rising bureaucracy and corruption. In March 2004, Fitch became the second ratings agency to raise Russia to lowest investment grade. The move opened doors for international investors to the country. Fitch took the lead this week in raising Russia's rating to BBB+. Moody's and Standard & Poors are expected to follow Fitch's lead sometime this autumn.

Shareholdings from Finland to Russia triple. The Bank of Finland reports that Finnish portfolio investment stock in Russian shares reached €1.1 billion at the end of 2005, tripling from end-2004 and amounting to 3.3 % of all Finnish portfolio investments in stocks abroad. During 2005, the RTS index of Russian stock market performance nearly doubled. Thus, the surge in the stock is explained by both new investment and an increase in value of earlier investment. While the overall stock of Finnish-owned shares in Russia grew thirty-fold between 2001 and 2005, the value of the RTS index increased nearly eleven-fold. The figures do not include Finnish investment in Russian shares via international funds.

According to Bank of Finland figures, Finnish portfolio investment in Russia was clearly favoured over direct investment (investments to gain control of at least 10 % of a Russian company's shares). The overall stock of direct investment as of end-2005 was estimated to be worth around €450 million. The situation with China was the reverse. Direct Finnish investment in China was substantially greater than investment in Chinese shares.

Russia makes early repayment of its Soviet-era debts to Finland. Russia inherited Soviet debt to Finland of about €600 million. Under the original schedule set by Paris Club creditors, Russia was to pay off that debt in the period 2002–2020. Since 1997, Russia has paid for part of the debt to Finland in the form of goods and services for the Finnish defence ministry and universities. Russia has also reduced its debt in recent years through accelerated payments. The remaining debt is currently estimated at just under €250 million, of which about €25 million is set to be repaid in the form of scientific and technical equipment to Finland's state research institutions and universities. The remaining Soviet-era debt will be paid to Finland at the end of August.

CIS cooperation at the crossroads. The unofficial CIS summit in Moscow last week (July 21–22) was attended by just eight heads of state. Notably absent were the presidents of Armenia, Georgia, Turkmenistan and Ukraine. Kazakhstan's president Nursultan **Nazarbayev**, set to outline a plan for CIS reform, said that the ineffective CIS decision-making process needs to change so that decisions reached by consensus would be binding on all members. Observers interpret the comment as a signal to Ukraine and Georgia to leave the CIS. In addition, Nazarbayev also argued that the CIS should concentrate on just five agendas (migration, transportation, education, security matters and humanitarian assistance). The rest, he said, should be handled through bilateral agreements.

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China

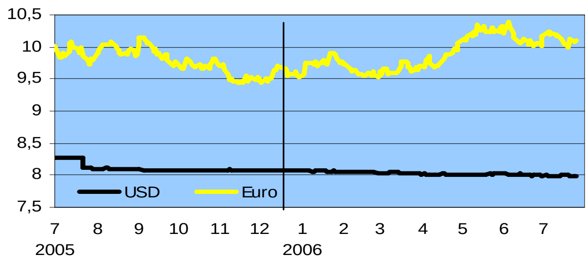
China's central bank continues to tighten monetary policy. The People's Bank of China has raised reserve requirements for commercial banks by a half percentage point for the second time this year. From mid-August, the minimum reserves commercial banks keep with the central bank need to represent 8.5 % of total deposits. The previous reserve requirement hike occurred in mid-June. The central bank expects the half-percentage point boost to reduce market liquidity by about CNY 150 billion (€15bn). Growth in the broad money supply and credit this year has been far higher than central bank targets, and has further accelerated rates of investment and GDP growth. However, the increase in reserve requirements is believed to have a minor impact as commercial banks already place excess reserves with the central bank. The PBoC also raised lending rates at end-April to tighten its monetary stance. Some observers expect the central bank to raise rates yet again in the near future to calm lending and money supply growth.

Chinese industrial profits continue to grow, but are concentrated in a handful of sectors. State-owned enterprises and other companies with turnover greater than CNY 5 million posted profits in January-June exceeding CNY 810 billion (€81bn), up 28 % from a year earlier. The rise in profitability accelerated throughout the first half of the year, slightly outpacing overall turnover growth. Profits skyrocketed in non-ferrous metal refining (up 99 % from a year earlier) and transportation equipment production (61 %). The largest industrial profits in China were made in just a few sectors; mainly companies involved in oil, chemicals, energy production or metals. Many of the companies in these sectors are state-owned. Since Chinese companies finance much of the current investment boom out of cash flow, surging profits seem unlikely to help authorities in their efforts to calm investment euphoria.

Slow yuan appreciation since one-time revaluation. July 21 was the one-year anniversary of the yuan's revaluation and the end to the fixed peg with the US dollar. Since then, the Chinese currency has been pegged to a basket of currencies with the heaviest weightings going to the US dollar, the Japanese yen, the euro and the Korean won. Chinese officials, meanwhile, have resolutely fought to stave off currency appreciation against the dollar. The yuan last week went below 7.99 to the dollar, which corresponds to a 1.6 % appreciation since the revaluation. The yuan-euro rate tracks the movements in the dollar-euro rate. The daily fluctuation range for the yuan relative to the dollar in the currency basket is set at ± 0.3 %. Movements in relation to the other ten basket currencies are set at ± 3 %.

Despite only minor appreciation of its currency, China has implemented a number of market reforms to gradually make the yuan freely convertible and perhaps also reduce appreciation pressures. Regulations have been eased to allow companies to hold more forex and let private individuals purchase more forex for trips abroad. In January, China introduced spot trading on the OTC market to give banks the possibility to conduct forex trade among themselves. Chinese officials have also decided to give permission for domestic banks to invest in foreign bond markets and insurance companies in foreign fixed-income instruments. Investing in foreign stock markets is expected to become easier.

Yuan/dollar, yuan/euro rates, July 2005–July 2006



Source: Reuters, Bank of Finland

Chinese exports to Finland expand rapidly. Finnish customs reports that Finland ran a €1.3 billion trade deficit with China in 2005. The yawning trade gap in recent year has been created almost exclusively by a rapid rise in Finnish imports and stagnant growth in exports. *Imports* from China last year grew 43 % y-o-y. Imports from China constituted 6 % of total Finnish imports and were estimated at €2.8 billion. Large Finnish companies accounted for 70 % of Chinese imports, which mainly involved imports of electronic and electrical devices (up 65 % y-o-y). Imports of rubber and plastic products were also up sharply, although they still represent a tiny fraction of all imports. Import items brought in by small and medium-sized companies were mainly intended for wholesale or retail trade.

Finnish *exports* to China fell 23 % y-o-y in 2005 and represented 3 % of total Finnish exports. The decline in exports was mainly due to the fact that 2004 export figures were inflated by large paper mill deliveries. The transfer of manufacturing to China has also decreased exports. As earlier, nearly 90 % of Finnish exports to China last year came from large-sized firms. No matter what the size of the Finnish company, however, the exported goods have tended to be machinery, equipment or electronics. Exports of goods for wholesale and retail trade by small and medium-sized companies continued to grow strongly.

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Russia

Investment of Russia's stabilisation fund assets begins. The finance ministry reported that on July 24 a part of stabilisation fund assets were converted to foreign currency holdings allocated as planned: 45 % to dollars, 45 % to euro and the remaining 10 % to British pounds. The conversion was conducted by official Central Bank of Russia exchange rates. On the assets, the CBR pays to the federal budget an annual interest equivalent to the return of a portfolio of liquid bond holdings issued by foreign governments. Gradual investment of stabilisation fund assets is due to continue. The finance ministry reports quarterly to the government on the performance of the stabilisation fund investments. Observer reports put the size of the stabilisation fund as of August 1 at RUB 2,200 billion (€65bn), of which RUB 400 billion is held in foreign currencies.

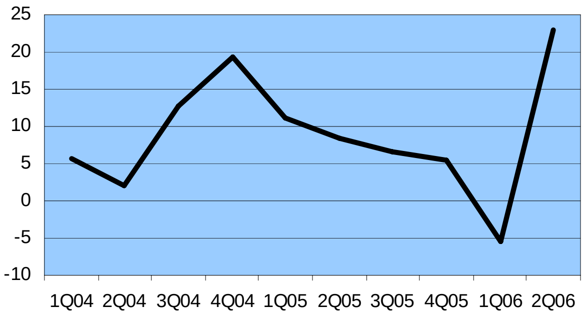
Finance sector pays best in Russia. Preliminary Rosstat figures show the average Russian reported monthly wage in the first half of 2006 was 9,900 roubles (almost 300 euro). Thus, average wages were up 23 % in nominal terms and 12 % in real terms compared to 1H05. According to finalised May figures, the average monthly wage varied from 4,400 roubles for agriculture and forestry worker to over 27,000 for personnel in the financial industry. Wages in finance, health care and social services all experienced nominal on-year increases of nearly 40 %.

Men's wages in Russia continued to average higher than those paid to women. According to 2005 figures, the average woman's salary was 60 % of a man's salary. Low-wage sectors were dominated by female employees, while the well-paid fields tended to employ male workers.

Yukos declared bankrupt. A Moscow arbitration court declared the long-troubled Yukos oil company officially bankrupt on Tuesday (Aug. 1) after the company's main creditors rejected a debt-servicing plan and demanded the company be taken into bankruptcy. The judge found the company's debts to reach $18.2 billion, which was more than the accounting showed for the value of the company's total assets by about a half billion dollars. Yukos representatives claim the company's assets are worth considerably more – about $38 billion. Yukos' top creditors are the Russian tax bureau, which demanded $13 billion in back taxes, and state oil company Rosneft, which wants $4 billion from Yukos. The court appointed a receiver, who will have about a year to sell off the company's assets. It is widely estimated that Rosneft was behind the bankruptcy demand. Rosneft has been eyeing the remaining Yukos production units, Tomskneft and Samaraneftegaz, for some time. Rosneft gained control of Yukos core production unit Yuganskneftegaz in December 2004.

Housing prices continue to soar. Russia's federal agency for construction and housing, Rosstroi, reports housing prices in Russia climbed 23.5 % y-o-y in the first half of 2006. The spike in housing prices is particularly remarkable given construction of new housing was up 9.8 % y-o-y. In the Moscow region, for example, housing prices were up over 20 % y-o-y, even though the volume of new housing completed was up 15 %. Housing demand has strengthened with the accelerated growth in real incomes, which were up over 11 % y-o-y in January-June 2006. Incomes rose 8.5 % y-o-y in 1H05.

Housing construction in Russia, quarterly volume change 2004–2006, % y-o-y



Source: Rosstat

Quiet launch for oil trading on Moscow RTS exchange. Moscow's RTS exchange initiated trade in futures for Urals-grade crude oil on June 8, about a month after president **Putin** said the country needs a rouble-based crude oil exchange. The daily volume on the Moscow oil exchange to date has averaged only a few million roubles in values and only about a dozen contracts a day. In contrast, tens of thousands of Brent oil contracts are made daily.

Duma has productive legislative session ahead of summer vacation. The Duma passed a number of important bills before adjourning for its summer holidays. Approval of the natural gas export act officially acknowledged Gazprom's de facto status as Russia's sole gas exporter. The Duma also approved Russia's first laws on personal information and information security. In addition, the CBR's remaining currency controls were abolished from July 1 and after years of comprehensive work a renewed competition act was passed. New brackets for setting mineral extraction taxes were approved, along with higher ceilings for bank deposit insurance and a reduction in mandatory military service to twelve months. The long-awaited water act also enters into force at the beginning of next year.

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China

S&P boosts China's credit rating. International credit rating agency Standard & Poor's raised by one notch its ratings for China's long-term foreign and domestic currency bonds from A– to A. S&P noted the efforts to strengthen China's banking sector and country's economic outlook were excellent. S&P also mentioned that Chinese officials have reacted rapidly in the current phase of the business cycle by tightening monetary policy and limiting non-productive investment. On the other hand, S&P expects officials will continue to strive at bringing growth rates down to sustainable levels. The current S&P rating for China's long-term foreign currency sovereigns puts it in the same category as South Korea and Greece. The increase in creditworthiness is expected to increase interest among foreign investors in Mainland China, especially in the banking sector.

Earlier in July, Moody's lifted its outlook from stable to positive for China's foreign currency bonds. Moody's raised China's credit rating to its current A2 rating in October 2003. Fitch raised its rating for Chinese foreign currency sovereigns to A at the end of 2005. Thus, each of the three credit rating majors put China in their sixth-best category.

China issues first licenses for new QDII scheme. As part of its effort to increase yuan convertibility, China granted six banks "qualified domestic institutional investor" (QDII) licenses. Four of the banks are Chinese and two are foreign banks' subsidiaries operating in Mainland China. At the end of July, it was announced that under the scheme three of the six banks (Bank of China, Industrial and Commercial Bank of China and Hong Kong-based Bank of East Asia) will have permission to exchange yuan for foreign currency up to a total of $4.8 billion for clients investing abroad. Officials subsequently granted similar exchange quotas totalling $3.5 billion to China Construction Bank and Bank of Communications. Chinese authorities have received license applications from several other financial institutions that potentially qualify for QDII status.

The keenness of investors for the scheme may be dampened by the fact that Chinese citizens are currently limited to purchases of low-risk fixed income bonds, the yields of which are not much higher than what is available locally. Moreover, they carry currency risk and could cause an investor to miss out on a yuan revaluation. On the other hand, the QDII scheme could reduce revaluation pressures by increasing currency outflows from China.

New rules on land sales enter into force. Under the new rules introduced at the beginning of August, the sale of land use rights for commercial purposes must be based on a transparent, public bidding. Most land deals presently are neither transparent nor public. The new rules go to the core of rapid economic growth as surging fixed investment is supported by the widespread transformation of farmland into industrial or construction use.

In China, the right to own land derogates to the state. A private individual or a corporation can only acquire rights to use land. As private persons and collectives are not protected by property ownership rights, local officials have used their administrative authority to expropriate use rights from farmers and sell them to companies. Currently, income from land sales is not included into budgets, which has increased the local authorities' interest to sell land. As a result, land use rights have become a nexus for administrative abuse and corruption in China. Most local level corruption is tied to land use arrangements. China's central government announced at the end of July that China would establish nine land inspectorates nationwide.

Rising incomes and larger income disparities. A recent survey by the National Bureau of Statistics finds that the disposable monthly income of an average city-dweller in the first half of 2006 was about 1,000 yuan (100 euro), an increase of 10.2 % y-o-y in real terms. In the countryside, cash incomes were up 11.9 % y-o-y in real terms, averaging 300 yuan (30 euro) per month. The National Development and Reconstruction Commission (NDRC) expects rural income growth to slow in the second half of this year as production costs have outpaced the rise in prices of grain and meat. However, about half of rural income is derived from sources other than sales of agricultural products.

China is also planning to raise and unify civil servant wage scales in the near future.

Although Chinese incomes have risen rapidly on average, income disparities continue to widen. The long-term trends in wage development have been quite varied among economic sectors and between urban dwellers and their country counterparts. China's Ministry of Finance reports that the Gini coefficient of inequality has already yawned to 0.46, which is far beyond the internationally recognised danger level of 0.40. While president **Hu** Jintao is committed to reducing income disparities, however, so far the measures taken have been insufficient.

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Russia

Russian inflation holds steady in July. On-year inflation was 9.2 % in July, a very modest increase from 9.1 % in June. Consumer *food* prices were up 8.7 % y-o-y, led by prices for sugar, fruits and vegetables. Sugar prices were up 34.2 % y-o-y in July, while fruits and vegetables were up 11.9 %. Prices for *other goods* remained steady at 6.3 % y-o-y for the fourth month in a row. Prices for *services* were down from 15.3 % y-o-y in June to 15 % in July. Prices for housing and municipal services were up 18.8 % y-o-y in July and 16.2 % since the start of the year.

Metal sector grows in the first half. Increases were registered in rolled products (7.3 % y-o-y), steel pipe (16.2 %), aluminium (2.4 %) and nickel (8.1 %). Cast iron production saw output rise 7.7 % and steel 7.2 %. Demand for metal products rocketed in the first half: consumption of rolled ferrous metal products was up 21.1 % and steel pipe 22.3 %. Demand was driven by large oil and gas industry projects, as well as booming housing and commercial construction. Russia's industry and energy ministry expects the domestic market strength to continue at least through the rest of the year.

Russia was the world's fourth largest raw steel producer last year with an output of about 66 million tonnes. Russia's raw steel producers are led by Evraz, Magnitogorsk (MMK), Severstal and Novolipetsk (NLMK), which together produce 69 % of all Russian raw steel.

Russia was also the world's second largest steel exporter last year. The value of exported metals and metal products was $33 billion, which corresponds to over 14 % of the value of Russia's entire goods exports in 2005. In the first half of this year, however, the value of exports of metals and metal products fell 6.7 % y-o-y. Export values were off sharply for ferrous metals (19 %), with declines in both export volumes and prices. On the other hand, the value of nonferrous-metal exports climbed over 14 % in the first half due largely to higher metal prices.

Although the planned merger of steel giants Arcelor and Severstal was scrubbed in June, speculation about a potential merger remains rife. Several newspapers have suggested that Severstal's next step will be an IPO on the London stock exchange later this year. Analysts suspect that Severstal, which hopes to raise $1.5 billion from its IPO, will use the money to finance a merger or corporate acquisitions. Evraz and NLMK have already listed on the London bourse. MMK is expected to follow the others' example and list in the near future.

Investment commission approves first projects to be financed from Federal Investment Fund. The Fund, created last year by government, will allocate RUB 182 billion (€5.3bn) for the first seven projects, which are to be completed on public-private basis. Observers note that payback times on most of the projects are quite long, as much as 25–30 years, even when there is little evidence how the arrangement will work. Economy minister German **Gref** expects at least six more projects to get the green light before the end of 2006.

Projects receiving federal investment funding

Investment project	Total investment, RUB billion	Fund contribution, RUB billion
1. Krasnoyarsk region development	358.7	34.2
2. Oil refinery, Nizhnekamsk	130.3	34.1
3. Western ring road, St. Petersburg	82.7	28.0
4. Railway, Chita region	59.0	41.0
5. 43-km highway section, Moscow–St. Petersburg	54.9	25.8
6. Road tunnel, St. Petersburg	26.0	8.7
7. Ring road connector, Moscow	17.0	10.5
Total	**728.6**	**182.3**

Number of unemployed up slightly in 2Q06. Rosstat estimates unemployment averaged 5.6 million in the second quarter when calculated according to ILO methodology. Some 1.8 million persons were officially registered as unemployed in the period. The second quarter saw a slight on-year gain in the number of unemployed persons for the first time in over a year. Growth in the number of unemployed was 2.4 %. The overall unemployment rate for 2Q06 was 7.6 %, about the same as is 2Q05. Rosstat estimates that over 10 million Russians work outside the official labour markets, particularly in retail businesses and agriculture.

US-Russia relations strained. Diplomatic relations between Russia and the US continued to stumble after the US imposed sanctions for two years on Russian arms-maker Rosoboronexport and aircraft builder Sukhoi at the end of July. The US based its sanctions on suspicions that the companies were providing high-tech weaponry to Iran and Syria. Both the Russian government and representatives of the firms vigorously denied they were selling high-tech weapons to either country and said the sanctions were entirely political. Russia's relations with the US have been chilly lately, as US vice president Dick **Cheney's** loudly critiqued Russia's authoritarian tendencies in June. That barrage was followed by president George **Bush's** more restrained snubs at the July G8 summit in St. Petersburg. In addition to different views on democracy, the countries did not manage to agree about Russia's admission to the WTO ahead of the G8 summit. It now appears Russia's WTO accession will not happen until spring 2007 at the earliest.

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China

Trade surplus swells; PBoC hints it may allow further yuan strengthening. China's trade surplus hit $14.6 billion in July, up over 40 % from July 2005. For the first seven months of the year, the trade surplus rose to $76 billion, an increase of more than 50 % from the same period a year earlier. Exports climbed 25 % in the first half to $508 billion, while imports rose 21 % to $433 billion. The EU remained China's largest trade partner, beating out both the US and Japan.

The second-quarter monetary policy report of the People's Bank of China, which was published just before the release of trade figures, suggest more clearly than earlier statements by the PBoC that authorities may use the exchange rate to deal with the large balance-of-payments imbalance. However, the central bank stresses that correction of these imbalances require other measures and cannot simply be realised through adjustments in exchange rate policy. As a result, changes in exchange rate policy are likely to remain modest and the speed of yuan appreciation may accelerate only a little.

In the past two months, the yuan's exchange rate has been allowed to strengthen the most since last summer's 2.1 % one-time revaluation. The recent loosening trend may indicate the PBoC has in fact actually changed its exchange rate policy direction as suggested in the quarterly report. This week the yuan-dollar rate hovered around 7.97, a level that corresponds to an appreciation of 1.8 % since the revaluation.

Consolidation in the steel industry continues. Last week, the integration of Shandong's two largest steel producers, Laiwu Steel and Jinan Steel, was officially announced. The resulting entity will not be an actual merger but rather a close alliance of the two companies under the name Shandong Iron & Steel Group. The new group will produce over 20 million tonnes of steel a year, making it China's second largest and the world's sixth largest steel producer. It was also the third major provincial consolidation of steel companies in a short time, following on the heels of mergers in Liaoning and Hebei provinces.

The "defensive merger" between Laiwu and Jinan is partly a reaction to the interest of international steel companies in the Chinese steel sector. European steel giant Arcelor recently offered to acquire a 38 % stake in Laiwu. Local officials then pushed ahead with the Laiwu-Jinan alliance in an effort to block the Arcelor deal. The operations of the two companies will not be combined nor are there any synergy benefits under the new arrangement.

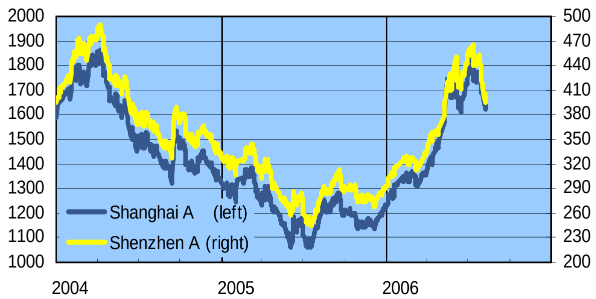
According to China's steel sector strategy published last year, the government's goal is to create at least three 30-million-tonne steel giants by 2010. The strategy program also calls for a ban on foreign companies acquiring majority stakes in Chinese steel companies.

Figures from the China Iron & Steel Association (CISA) show the country's massive steel production capacity continued to grow in the first half of 2006 at a rate of 18 % y-o-y and that China produced nearly 200 million tonnes of steel in the period. Despite the central government's orders, smaller steel plants in particular continue to increase production. Even with the robust output growth, estimates of China's overcapacity in steel production have recently been lowered to account for the strong demand.

Mood on Chinese stock markets turns cautious. The recent lifting of a year-long ban on IPO listings was initially met with huge investor interest. In early July, the Bank of China's $20 billion IPO was heavily oversubscribed and its share prices jumped 23 % in early post-IPO trading. Then the markets turned sour on new offerings. This week, for example, Air China announced it would reduce its planned share emission by nearly 40 % after interest among institutional investors was more tepid than hoped. By some estimates, the scaling-back indicates the supply of new shares on offer exceeds demand. Some observers expect authorities may re-impose some listing restrictions. Others claim that the problems surrounding the Air China IPO have more to do with the poor outlook for airlines generally caused by high fuel costs. Stock market uncertainty also reflects expectations of a tighter monetary stance in the second half of 2006 as the authorities work to cool an overheated economy.

Although daily volatility on Chinese stock exchanges can be quite high, share prices have generally trended downwards lately. The Shanghai bourse is down about 10 % from a month ago.

A-share indices, Shanghai and Shenzhen bourses



Source: Bloomberg, Bank of Finland

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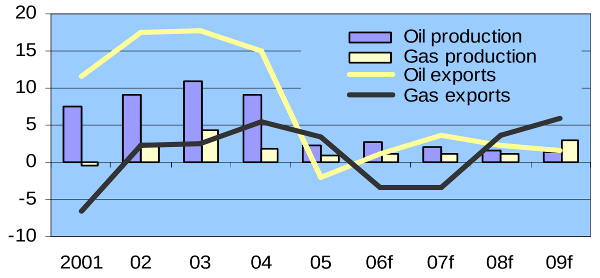
Russia

Russian foreign trade expanded rapidly in the first half. Central Bank of Russia figures reveal that in January-June the value of Russian exports increased 31 % y-o-y and imports 26 %. The trade surplus for the period was nearly $75 billion, up 17 % from 1H05. CIS countries accounted for nearly 14 % of exports and 16 % of imports.

There were no significant changes in the structure of exports and imports. Two-thirds of all *exports* were energy products. The huge increase in the value of exports mainly reflected higher energy prices. Russian customs reports that the volume of oil exports to non-CIS countries declined about 1 % y-o-y in January-June and the volume of gas exports to non-CIS countries grew more than 5 % y-o-y. Exports of energy products to CIS countries were down. Machinery and equipment dominated *imports* with a 44 % share. Of that amount, 9 percentage points were passenger cars. Russia imported 432,000 cars in 1H06, a 27 % increase from a year earlier. Over half of Russian car imports were brought in via Finland.

Economy ministry raises GDP growth forecast. Last week the economy ministry lifted its GDP growth estimate for 2006 by a half percentage point to 6.6 %. It also raised its most optimistic projection for 2007–2009 to an annual growth rate in the range of 5.8–6 %. The forecast sees the structure of the Russian economy gradually diversifying and consumption growth remaining strong. The price of Urals-grade crude oil is expected to fall this year from $65 a barrel to about $48 a barrel in 2009. Inflation is expected to come in at 9 % this year and 6.5–8 % next year. The rouble real exchange rate is expected to appreciate 7–9 % this year and 4.8 % in 2007. With the price of oil remaining consistently above assumptions, the main forecasting institutions have decided to revise their estimates for this year upwards. The Bank of Finland's newest Russia forecast comes out at the beginning of next month.

Oil and gas production, exports, volume change, % y-o-y



Source: Russian economy ministry

Oil production continues to grow slowly. In the first half of 2006, the volume of Russian oil production increased 2 % y-o-y. Although cold weather depressed production growth in the first quarter, growth rebounded in the second quarter. Oil refining was also up in the first half 6 % y-o-y. The share of oil refined in Russia rose to 45 %, up from 43 % a year ago. Growth in exports of refined oil products was substantially higher than growth in crude oil exports both in terms of volume and value.

LUKoil, Rosneft, TNK-BP and Surgutneftegaz remained Russia's largest oil companies, together accounting for about 65 % of Russia's total oil output in the first half. State-owned oil companies, led by Rosneft, were able to increase production considerably faster than privately owned oil companies.

Foreign investment in Russia sees strong growth in the first half. Rosstat reports that in January-June foreign investments made to Russia were worth over $23 billion, 42 % more than a year earlier. About 70 % of the investment flow consisted of various credits. Portfolio investments nearly tripled, but their amount remained small, less than $500 million. Direct investment in Russia amounted to $6.4 billion, an increase of 44 % y-o-y. Direct investment continued to go mainly to mineral extraction and refining industries, although the share going to the financial sector increased to above 10 %. The total foreign investment stock in Russia as of end-June was $128 billion, of which FDI constituted 48 %. Cyprus and the Netherlands were the largest sources of FDI in Russia.

The flow of Russian investment abroad in the first half was up 13 % y-o-y to $15.5 billion. The stock of Russian foreign investment abroad as of end-June was $8.2 billion, of which half was direct investment. The biggest stocks of direct investment as of end-June Russia had in the Netherlands, the US and Gibraltar.

Russia makes final settlements of Paris Club debt. Deputy finance minister Sergei **Storchak** reports Russia this week signed bilateral agreements with each Paris Club member on early repayment of a total of over $21 billion. In addition to the remaining debt, Russia will pay a billion-dollar premium to creditors for permitting the early repayment. The money for repayment will come out of Russia's stabilisation fund. Russia's biggest Paris Club creditors are Germany and France, both of which are owed over $8 billion. Storchak claims Russia will save nearly $8 billion in interest charges from the early repayment. He noted that the savings are planned to be gradually transferred to the Federal Investment Fund.

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China

July economic growth in China slightly off first-half pace. China's National Bureau of Statistics (NBS) reports real value-added industrial output grew 18 % y-o-y in January-July. Growth in July was 17 % y-o-y. Depending on the sector, growth in chemicals, metals, machinery and equipment manufacture and production of transport vehicles was in the range of 15–25 % in July. Among China's major industries, low growth was seen only in the textile industry (4 %). Energy sector output was up in July; 10 % y-o-y in coal, 2 % in oil and 14 % in electricity. The July figures diverged little from the first-half trend.

Although the NBS only publishes nominal cumulative data on fixed investment, the pace of investment in July appears to have dipped clearly below 30 % y-o-y in July. The first seven months of year showed growth of 31 %. FDI reported for the last three months is lower than a year earlier. Chinese sources explain this is the result of more stringent permitting policies aimed especially at limiting foreign investor involvement in real estate. Retail sales growth on the other hand remained at the first-half pace in July, climbing 14 % y-o-y.

The non-trivial task of assessing China's actual economic situation is made all the more difficult by incomplete and hard-to-interpret statistics. Statistical data are often ambiguous, they may fail to distinguish between real and nominal growth and monthly figures may give an incongruent view of the economic situation compared to yearly figures. Moreover, China has yet to establish valid price indexes, and on the GDP demand side, only year-to-year figures are available. Major adjustments in GDP figures last year also made it more difficult to compare current trends against economic performance in previous years.

Despite strong money supply growth, inflation remains low. July *consumer prices* rose 1.0 % y-o-y. Good harvests depressed inflation in food prices and thus lowered the rise in consumer prices overall last month. Clothing prices continued to fall. Indeed, inflation has been slow throughout this year. Factors restraining consumer price inflation include overcapacity in certain sectors and stiffer competition. However, consumer price inflation is expected pick up again in the wake of substantial hike in fuel prices at the end of May. *Producer prices* rose in July 3.6 % y-o-y. The rise in producer prices was boosted mainly by higher prices for nonferrous metals and fuels.

The broad measure of *money supply* (M2) was up 18.4 % y-o-y as of end-July. The amount of money in the economy has grown especially fast with the increase in the credit stock and massive trade surpluses. The central bank's 2006 credit growth target will be surpassed already this month. The central bank has tried to control money supply growth by forcing commercial banks to purchase central bank papers. It also raised lending rates at the end of April by 0.27 percentage points to 5.85 % for one-year loans. The People's Bank of China has hiked reserve requirements for commercial banks twice this summer. The PBoC's target for M2 growth this year is 16 %.

Poor China-Japan political relations strain development of energy resources in South China Sea. Political relations between China and Japan have already been long tense and no high-level summits have taken place since prime minister Junichiro **Koizumi** took office in April 2001. A major reason for the diplomatic chill has been prime minister Koizumi's annual visits to the Yasukuni Shrine, which commemorates the approximately 2.5 million Japanese fallen – including more than a dozen convicted class-A war criminals. The Chinese felt particularly snubbed this year when Koizumi decided to make his annual pilgrimage on August 15, the anniversary of Japan's surrender and day that marks the end of WWII in Asia. However, Koizumi's term as head of the Liberal Democrats is nearly up and a new prime minister will be selected in September. Rising star Shinzo **Abe** is expected to become the new party chief and prime minister. Opinions are mixed as to how much Abe can do to mend damaged China-Japan relations.

The China-Japan political schism also has an economic dimension. Violent protests last year at the Japanese embassy and Japanese consulates in China spread quickly and property of Japanese companies operating in China was destroyed.

The tensions also reflect disputes over development of energy resources in the South China Sea. The dispute heated up last week when Chinese oil giant CNOOC announced on its website that it had started pumping natural gas at the disputed Chunxiao (*Shirakaba* in Japanese) oil and gas field. CNOOC was forced to quickly retract the posting after the Japanese government demanded that China confirm the truth of the information and threatened with counter-measures if the Chinese actually intended to move forward. The Chunxiao gas field is located in an area claimed by both China and Japan. The gas field drill site abuts Japanese territorial waters. Under the 200-nautical-mile territorial rule recognised under international conventions China and Japan's economic zones overlap in several places. The countries have engaged in a series of official-level negotiations to resolve the dispute, but to date the talks have yielded no results.

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Russia

Russian retail sales and construction lead growth in January-July. Russian industrial output increased 4.2 % in the first seven months of this year compared to the same period in 2005. Mineral extraction industries increased production 2.3 % y-o-y. Growth in manufacturing industries was 4.1 % y-o-y, led by metal fabricators with growth in excess of 11 % y-o-y. Production of oil products was also up over 6 %. Production of machinery and equipment, down 8 % y-o-y, was the only sector to see a drop in production. Production and distribution of water, gas and electricity rose 5.5 %.

Among other core sectors, rapid growth was seen in retail sales and construction. For January-July, retail sales climbed nearly 12 % y-o-y and construction 10 %. Growth in transport accelerated slightly to 2.5 %. Agricultural output was up just 0.7 %.

Central and Northwestern Federal Districts lead industrial output growth in first half; retail sales up strongly nationwide. R*etail sales* activity remained concentrated in the Central Federal District in the first half of this year, but increased faster in other districts. In the City of Moscow retail sales were up 6 % y-o-y, i.e. slower than in the rest of the Central Federal District. Moscow accounted for 22 % of all Russian retail sales and St. Petersburg 4 %. Growth exceeded 16 % y-o-y in St. Petersburg in the first half. The highest growth in retail sales was posted in the Volga, Ural and Siberia federal districts.

Industrial output grew fastest in the Central and Northwestern Federal Districts. Production was up over 18 % y-o-y in Moscow and 6 % in St. Petersburg. In the Moscow and Leningrad regions, industrial output was up about 30 % in the first half.

Growth and share of industrial output and retail sales by federal district, 1H06, %

	Industrial output		Retail sales	
Federal district	**growth**	**share**	**growth**	**share**
Central	14.7	23.3	9.8	36.9
Northwestern	11.4	10.3	13.3	9.7
Southern	7.9	6.0	9.8	11.1
Volga	5.1	22.6	18.0	17.2
Ural	4.4	23.1	17.8	9.4
Siberia	4.3	12.2	16.0	11.8
Far Eastern	4.1	2.9	12.5	4.1
Russia	***4.4***	***100.0***	***11.3***	***100.0***

Source: Rosstat, economy ministry

Rapid growth in banking sector continued in first half. Total assets of the banking sector as of end-June were up 40 % y-o-y in nominal terms and nearly 30 % y-o-y in real terms. Growth in bank deposits of households slowed from last year, but still showed a nominal gain of 35 %. Deposits of domestic firms climbed 40 %. Household deposits continued to account for 28 % of total bank sector assets, while corporate deposits had a 26 % share. Assets of foreign firms and banks in Russian banks grew rapidly to 8 % and 5 % of total assets, respectively. Banks' capital increased over 30 % to 13 % of total assets.

Bank lending continued to increase at a brisk pace. The stock of loans granted to domestic companies as of end-June was a third larger than a year earlier in nominal terms. The stock of household loans soared 90 % y-o-y. The share of corporate loans declined slightly to 41 % of total assets, while the share of loans to households rose to 13 %. Banks strongly increased their investments in domestic corporate bonds and shares, with each accounting for about 3 % of bank assets. Bank assets in foreign banks represented 4 % of total bank assets. The cash reserves of banks and their funds at the central bank together remained high, above 8 % of total assets.

Volume of car imports passing through Finland to Russia continues to rise. The value of road transit traffic passing through Finland to Russia increased 9 % y-o-y in the first half of the year to €10.6 billion. Nearly all of the transit freight heading east enters Finland by southern coastal ports and is then taken by road to Russia. Highest growth was seen in road freight transit of passenger cars. Transit freight passing through the ports of Hanko, Kotka and Turku to Russia in the first half included 244,000 new passenger cars and vans – a 77 % increase from 1H05. Cars accounted for 29 % of the value of all road transit freight and corresponded to over half of all Russian car imports (in item terms) in the January-June period. Most other transit freight to Russia consisted of consumer electronics and machinery and equipment.

While transit traffic from Russia through Finland to western markets was more than a third higher in tonnage terms than transit to Russia, the value of westbound transit was significantly less. Transit freight to western markets grew 4 % y-o-y in volume terms in the first six months of the year. More than half of transit freight moving west was ores and concentrates. Another third was in the form of chemicals and most of the remainder was oil products. Nearly all transit freight from Russia to Finnish ports moves by rail.

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China

China's central bank continues monetary tightening, interest rates hiked for second time this year. On Monday (Aug. 21), the People's Bank of China raised its lending and deposit rates by 0.27 percentage points to put the brakes on investment and stifle an economy growing at an annual rate of 11 %. The new reference rate for one-year bank loans is 6.12 %. Although there is no set upper limit, interest charged by commercial banks must be at least 90 % of the reference rate. The reference rate for a one-year deposit, now 2.52 %, sets the ceiling commercial banks can pay on deposits. When the central bank increased its reference rate for lending last April, it left the deposit rate untouched. Although the interest rate hike was ostensibly to rein in the expansion of credit, the PBoC's decision to leave deposit rates unchanged in practice lifted the interest margins of commercial banks and increased their appetite for lending. To calm investment in real estate, rates on long-term loans were raised more than the one-year reference rate. The reference rate on a five-year loan rose 0.45 percentage points to 6.84 %, while the five-year deposit rate climbed to 4.14 %.

It is hard to identify, what is the impact of the recent increases in interest rates on the Chinese economy. On one hand, higher interest rates should cool credit growth and diminish the amount of money in the economy. On the other hand, an increase in deposit rates and expectations of a yuan revaluation could increase speculative inflows of capital into China unless recent rate hikes in the US and Europe prove sufficient to reduce investor enthusiasm for China. The immediate impacts of the hikes on China's financial markets have been minimal. The stock markets barely blinked at the modest interest rate adjustment.

Working with the PBoC, the government determines the monetary policy framework. Moreover, the government's price-setting power gives it additional influence in the monetary policy sphere. The implementation of monetary policy is complicated, however, by the fact that the authority of the agencies that actually implement monetary policy measures overlap and by the use of non-traditional measures to influence the functioning of markets. As China's money and foreign exchange markets gradually liberalise, it has become more difficult to assess the effects of monetary policy measures.

Expanding steel production reflects in the size of steel producers. National Bureau of Statistics figures show steel companies last year dominated the list of China's largest manufacturing companies. Indeed, ten of China's twenty largest manufacturers in terms of turnover were steelmakers. The manufacturer list was topped by Baosteel. The list does not include oil and energy companies, which are among the largest firms in China. Although the list of leading manufacturing companies includes several electronics, mobile phone and computer manufacturers, the huge presence of basic industries in the Chinese economy is notable. China accounted for 78 % of world growth in steel production capacity since 2000. The rapid capacity increases and stiff domestic competition have forced Chinese steelmakers to lower their domestic prices at a time when steel prices internationally are soaring.

Official figures show stock of non-performing loans has stabilised, but analysts sceptical. China Banking Regulatory Commission (CBRC) reports that the stock of non-performing loans held by Chinese banks at end-June amounted to CNY 1,300 billion (€130bn), an amount about the same as at the end of 2005. Due to the rapid expansion in lending, however, the ratio of non-performing loans to bank's total loan stocks has fallen slightly. Over 80 % of non-performing loans are held by the four large state-owned banks. Officials claim the situation is slowly improving and that only 1–2 % of loans granted since 2003 are presently in default.

Several outside observers argue that China's non-performing loan problem is substantially larger than the official figures suggest. Moreover, they see an increasing risk of defaults, as investment growth has remained strong. Most susceptible to default risk are investments in the real estate sector. In some areas real estate prices have fallen and stock of unsold real estate have increased rapidly. To keep things from getting out of hand, Chinese officials have tightened borrowing requirements for builders.

China seeks to become a major car exporter. To promote its auto industry, China has created eight special zones devoted to production of cars and car parts for export. Carmakers operating in these zones will enjoy access to cheap credit and export tax breaks. Chinese car exports have grown rapidly in recent years, although the quantities of cars exported remain modest. In 1H06, China exported 34,000 passenger cars, slightly more than all of its car exports in 2005. While the most of export destinations are developing countries, China's carmakers have their sights set on the European and US markets. China's central administration has designated car manufacture as a support pillar of the Chinese economy.

China's domestic car market continues to grow rapidly. In January-July, car sales grew 40 % y-o-y and production 17 %. A large share of the world's main car manufacturers produce in China and competition on Chinese car markets is extremely stiff. By some estimates, car production capacity could exceed demand two-fold in 2010.

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Russia

2007 federal budget submitted to Duma. Last week the Russian government completed its discussion on the 2007 budget proposal and sent it on to the Duma for action. The draft budget anticipates *revenues* of 6,965 billion roubles ($261 billion or 22.3 % of GDP) and *expenditures* of 5,464 billion roubles ($205bn or 17.5 % of GDP). It sees a nominal increase in revenues of 13 % from this year's projected budget, while spending would rise nearly 25 %. The 2007 budget assumes 6 % GDP growth and an 8 % inflation rate. The budget has been calculated using an average rouble exchange rate of 26.7 roubles to the dollar and an average price for Urals-grade crude oil of $61 per barrel.

The large spending boost reflects the upcoming parliamentary and presidential elections. The largest spending hikes affect public sector wages and pensions, the national priority projects (i.e. improvements in healthcare, education, housing and agriculture) and infrastructure development.

Central bank increases reserve requirement of credit institutions. The Central Bank of Russia's board voted last week to raise the reserve requirement from 2 % to 3.5 %, effective October 1. The new reserve requirement applies to credit institutions' rouble and foreign currency liabilities to non-resident banks. According to a CBR press release, the banking sector has suffered from excess liquidity since the elimination of currency controls on the rouble and this has fuelled inflation. It is expected that the increase in the reserve requirement, combined with appreciation of the rouble's exchange rate and higher deposit interest rates, will reduce the growth of money supply.

Russia's forest sector experiencing mild growth. In the first half of 2006, forest sector *production* was up 2 % y-o-y. While pulp and paper industry output climbed over 5 %, production of key wood products – raw wood and sawn goods – contracted about 7 % and fibreboard over 3 %. Veneer production increased 7 %, chipboard nearly 16 %, paper 2 % and cardboard 10 %.

Russian customs reports the value of forest sector *exports* climbed over 11 % y-o-y in January-June. Highest growth was seen in exports of raw wood and sawn goods. In the same period, the value of *imports* increased nearly 18 %. Russia's industry and energy ministry said the goal for the forest sector is to increase value added in order to diminish the country's dependence on imports of finished wood products and reduce the share of raw wood in exports.

Development of the forest sector has been held back by the lack of a legislative framework. In 2005, only 1.3 % of Russian fixed capital investment went to the forest sector. Foreign firms have largely invested in low-tech businesses, because serious investment in technically demanding pulp and paper mill projects requires a more predictable operating environment. The new forests act, which has been under preparation since 2002, is expected to go before the Duma sometime this month for its second reading.

Aircraft builders consolidate into new giant. This week the anti-monopoly service gave the green light to the merger of Russia's eight major aircraft manufacturers into a single entity – United Aircraft Building Corporation. The arrangement, a proposal revived by president Vladimir **Putin** last February, would have four segments: military, non-military, transport and unmanned aircraft. While a state council plan from 2004 called for state participation in the company in the range of 25–50 %, according to a subsequent presidential decree the corporation should be at least 75 % state owned. Of the eight aircraft companies to be merged, only two are presently fully state owned. The state's intention to take a large controlling interest at first seriously diminished the enthusiasm of private owners in the other six companies to participate in the venture. United Aircraft Building Corporation is expected to be registered this month and could be active in international aircraft markets within a couple of years.

Russia's civil aviation industry, in particular, has seen a dramatic loss in its international competitiveness. There has been a constant brain drain and a lack of innovative design. Russian commercial aircraft currently lose out to both American and European competitors in terms of operational efficiency and safety. The president said the achievements of Russia's military aircraft manufacturers must now be exploited to the advantage of Russia's entire aircraft industry.

Three-way merger in aluminium sector underway. Several newspapers have reported an impending merger of Russian aluminium producers RusAl and SUAL with the Swiss Glencore trading company's aluminium operations. The parties last week signed a memorandum of understanding, whereby RusAl would take a 64.5 % stake in the new company, SUAL 21.5 % and Glencore 14 %. The binding agreement is scheduled for signing after an economic feasibility assessment is completed this month. None of the companies involved confirmed details of the merger. It is estimated that the market value of the new company will be around $30 billion, which would put it among the world's largest aluminium producers.

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China

China's dependence on oil imports grows as search for new oil suppliers intensifies. In the first half of the year, net crude oil imports amounted to 70 million tonnes, an increase of 18 % from 1H05. In the same period, China boosted domestic oil production 2 % to 92 million tonnes. Imports of oil products rose 48 % y-o-y to 12 million tonnes. In 2005, China imported 127 million tonnes of crude oil.

In order to reduce its dependence on Gulf oil imports, China has actively cultivated relations with oil suppliers elsewhere in the world for several years. A milestone occurred this summer when oil began to flow in the newly constructed pipeline running from Kazakhstan to China. The pipeline's annual capacity, initially 10 million tonnes a year, will eventually rise to 20 million tonnes a year. During his August visit to China, Venezuela's president Hugo **Chavez** declared his country would boost oil exports to China and that Chinese companies would help increase Venezuelan oil output by investing $5 billion. Two years ago China imported almost no oil from Venezuela; this year it will import almost 8 million tonnes.

Chinese companies are also seeking to purchase stakes in oil producers overseas. Last month, for example, Chinese (Sinopec) and Indian (ONGC) state oil companies announced that they will each acquire 25 % stakes in Omimex de Colombia, the Colombian subsidiary of US-based Omimex for $800 million.

China adjusts 2005 GDP growth upwards to 10.2 %. China's National Bureau of Statistics (NBS) revised its GDP estimate for 2005 upwards to 18,300 billion yuan (€1,830bn). The original estimate of GDP growth last year was raised from 9.9 % to 10.2 %. Under the current practice, the NBS publishes two GDP estimates before issuing a final figure. The date for release of the final 2005 figures has yet to be announced.

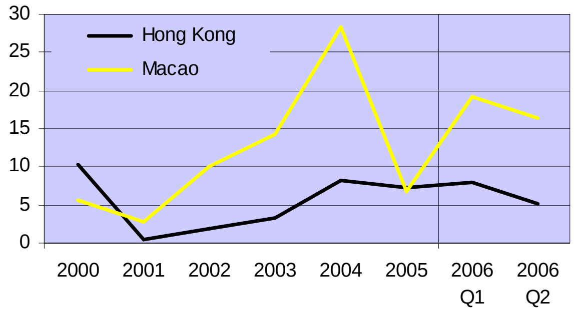
China finalises new bankruptcy law. China will finally have a modern bankruptcy law, following last week's approval by the Standing Committee of the People's Congress. The corporate bankruptcy law is set to enter into force in June 2007. China has had rudimentary bankruptcy legislation in place since 1986, but the law only applied to state-owned enterprises. The new law covers private companies, foreign-owned companies and financial institutions as well. The earlier law, widely recognised for its deficiencies, also failed to specify how assets of a bankrupt corporation should be liquidated or rules on creditor standing. Preparation of the new law was launched more than a decade ago. It gives better protection to creditors, who can now seek bankruptcy of a defaulting debtor company without getting its board's approval. The law places creditors ahead of workers in the order of satisfaction with regard to assets used as debt collateral. Workers back wages can in the future only be paid from assets not used as collateral. The law is expected to raise the confidence of foreign investors in China.

Hong Kong and Macao continue rapid growth and integration with Mainland China. Preliminary estimates from *Hong Kong's* census and statistics department show real GDP in the special administrative region grew 5.2 % y-o-y in the second quarter. Economic growth was slowed by lower growth in exports of goods and services. Growth in investment and domestic consumption remained nearly unchanged compared to overall figures for 2005. Consumer prices were up just 2 % in 2Q06. Officials expect GDP growth this year to come in at 4–5 %. In connection with the release of the new figures, the statistics office revised the SAR's first quarter figure for real GDP growth downwards slightly to 8.0 % y-o-y.

Macao's census and statistics department announced real GDP growth of 16.3 % y-o-y in 2Q06. First quarter growth was adjusted upwards to 19.2 % y-o-y. Macao's all-important gaming sector saw earnings rise 11 % y-o-y in nominal terms in the second quarter, while the number of visitors to Macao increased 16 %. Investment soared 55 % y-o-y as both foreign-owned and domestic gambling companies built new casinos or expanded their existing facilities.

Both Hong Kong and Macao recently completed the fourth round of negotiations with Mainland China on reducing barriers to trade between the regions under the Closer Economic Partnership Arrangement (CEPA). The latest reductions concern transport, tourism and the construction sector, as well as legal services. The new agreements enter into force at the start of next year. Hong Kong and Mainland China also agreed in August on uniform elimination of double taxation on incomes.

Hong Kong and Macao real GDP growth, on-year %



Source: SAR census and statistics departments

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Russia

BOFIT raises its forecast for Russian growth. In our semi-annual outlook for Russia (II/2006), BOFIT's economists now expect record-high oil prices will boost economic growth to 6.4 % for all of this year. High oil prices will also reflect in continuing rapid growth of private consumption in coming years. Growth in the volume of imports is expected to continue to outpace export growth. Currently, this poses no threat to Russia's external balance as the country has consistently posted massive current account surpluses. Stable fiscal policy also supports economic growth. The outlook also sees growth dropping to 6.1 % next year and 5.6 % in 2008 as oil prices retreat slightly. The complete Russia outlook is posted on our website.

Russian inflation exceeds expectations in August. Against forecasts of the economy ministry and several analysts Russian on-year inflation accelerated to 9.8 % in August. Higher prices were led by hikes in the price of gasoline, which was up over 5 % from July. While food prices declined slightly in August, it was much less than the drop in August 2005, so food prices showed an on-year gain of over 9 %. Prices of other goods rose almost 7 %. Services were up nearly 15 % y-o-y.

Economy minister German **Gref** announced the government will hold talks with oil companies to deal with higher gasoline prices. Despite the higher-than-expected August inflation figure, the economy ministry is sticking to its 9 % inflation target for 2006. As of end-August, prices were up 7.1 % from the start of the year.

Standard & Poor's surprises markets with BBB+ upgrade in Russian credit rating. Investors were caught off guard this week, when S&P, widely seen as the most conservative of the three major international credit rating agencies, bumped up its rating on Russian sovereign debt one notch. The agency said Russia's fiscal policies justified the ratings boost. S&P noted Russia's premature repayment of the rest of its Paris Club debt, steady growth in the central bank's foreign currency reserves, and holding down budget spending in the face of strong earnings from oil exports.

Further deregulation of Russia's electricity sector. The government last week green-lighted reform of the whole sale electricity market. Fully regulated electricity pricing was phased out at the beginning of this month. By the end of the year, wholesale prices for electricity will be based on regulated bilateral contracts between parties based on estimated consumption. Electricity production outside contract parameters will be sold on spot markets at unregulated prices. Next year, 5% less of wholesale electricity will be sold under regulated contracts and the share will fall each year.

The gradual liberalisation of the sector, combined with electricity prices approaching world market levels, should make Russia's electricity sector more attractive to private investors. Russian power companies have plans to raise money e.g. through IPOs. Two goals of the government reform are to increase production capacity by about 10 % over the next five years and improve the overall condition of the transmission grid. St. Petersburg and Moscow have already experienced power shortages, which has limited production growth in those regions. UES reports Russian electricity use was up 6.4 % y-o-y in August, while production capacity is ageing rapidly. UES chief executive Anatoli **Chubais** warned that the pace of reform has been too slow and that dire winter power shortages can be expected in several regions.

Over half of foreign investments went to the Central Federal District in 1H06; fixed capital investment spread fairly evenly across entire country. Rosstat regional figures show 40 % of foreign investment flowing into Russia in the first half of 2006 went to Moscow city and 8 % to the Moscow Region. Some 11 % of fixed investment went to Moscow and nearly 5 % to the Moscow Region. Foreign investment grew strongly in the North West Federal District. In the St. Petersburg city, investment more than tripled to a nearly 7 % share, while investment in the Nenets Autonomous District increased nearly five-fold as a result of oil and natural gas projects. Some 4 % of fixed investment went to the St. Petersburg city and 3 % to the surrounding Leningrad Region.

Nearly half of foreign direct investment went to oil and gas projects in the Sakhalin Region. The Central Federal District received 29 % of all FDI nationally (includes 17 % of FDI going to Moscow). The North West Federal District received 9 % of FDI and the Volga Federal District 5 %.

Growth in foreign investment, fixed capital investment and federal district shares, January-June 2006, %

Federal District	Fixed investment		Foreign investment	
	Share	Volume change	Share	Value change
Central	23.4	4.3	50.9	43.4
North West	15.2	25.9	11.4	110.8
South	8.4	9.5	2.0	6.3
Volga	15.8	8.8	3.6	22.2
Ural	18.6	10.8	10.4	96.1
Siberian	10.0	14.1	3.4	-42.7
Far East	7.0	6.4	18.3	36.0
Russia	***100.0***	***10.8***	***100.0***	***41.9***

Source: Rosstat

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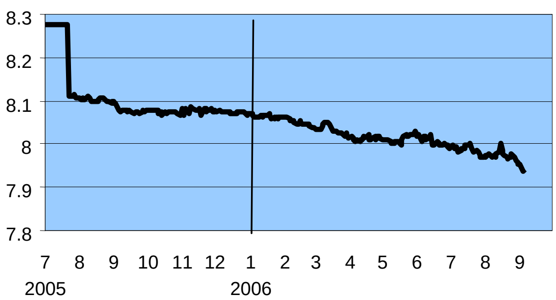
China

Yuan exchange rate dips below 7.95 to the dollar. After a brief weakening in mid-August, the yuan resumed its appreciation trend with a vengeance greater than at any time since the July 2005 revaluation and the abandonment of the official dollar peg (8.28 yuan to the dollar). This Monday (Sept. 4), the yuan had one of its biggest daily gains ever, rising 0.19 % against the dollar. China's current system in principle permits daily fluctuations in the yuan-dollar rate of ±0.3 %. Even with the yuan's rise, however, there is no evidence that China is ready to tolerate a rapid yuan readjustment. Swings in the yuan's exchange rate have widened in recent weeks.

The US and the EU, China's largest trading partners, continue to demand that China allow the yuan to strengthen. China, on the other hand, is reluctant to give the idea that foreign states can directly influence its policies. China's exchange rate policy is likely to be discussed at the IMF's upcoming annual meeting this month and is also likely to be mentioned by US treasury secretary Henry **Paulson** during his visit to China in a couple weeks.

Yuan-dollar exchange rates since July 2005



Sources: Reuters and Bank of Finland

China further tightens control over real estate sector. Following measures this summer to curb investment in real estate, further measures were taken at the start of this month to better regulate land use and land leases by local authorities. Tighter oversight will combine with greater powers to haul local officials into court when they permit illegal land deals. Illegal land use is quite common in China. A study by the Ministry of Land and Natural Resources found that about half of land used for construction was acquired illegally last year.

This summer restrictions were also imposed on foreign investment in the real estate sector. One purpose of the new rules is to reduce speculation. The rules governing foreign sellers of real estate properties were also amended this week. All real property sales now require official approval. Officials expect the new requirements to dampen foreign enthusiasm for Chinese real estate investment.

Officials fear the current boom in real estate investment will end with more non-performing loans on bank balance sheets. In some areas, real estate prices have begun to fall and available floor space has increased.

Electrical power shortages plague China again this summer. Despite China's increased electrical power generation capacity and improvements in the power grid, the power shortages of summer 2005 were essentially repeated this summer. Officials claim there were slightly fewer power outages than last summer and factories were able to operate with fewer restrictions during peak demand periods.

Most of China was exceptionally dry this summer, which reduced hydropower generation. Southern China, on the other hand, suffered from power outages caused by typhoons and tropical storms. Peaks in electricity consumption occur on hot summer days when air conditioners are in use. China moved to reduce electricity consumption by raising rates 3 % at the beginning of June. In addition, China has set efficient energy use as a major goal.

China also seeks to increase electricity imports to provinces suffering from power shortages. The major transmission line between Russian and China, completed this summer, will go into service in October. It will mainly supply Northeast China. China and Russia are negotiating construction of more lines.

Asian Development Bank sees strong Asian growth. The Asian Development Bank (ADB) raised its aggregate economic growth outlook for Asian nations (excluding Japan) to 7.7 % for 2006 and 7.1 % for 2007. Rapid growth in the region will be driven by ongoing expansion in international trade and strong growth of both the Indian and Chinese economies.

The Chinese economy's surging second-quarter growth was a major factor behind ADB's decision to upwardly revise its previous estimates. ADB raised its growth estimate for the Chinese economy to 10.4 % this year and 9.5 % next year. ADB sees it critical that Asian countries deal with high oil prices head on if they wish to sustain robust growth. Currently, nearly all countries in the region extensively subsidise fuel prices. Thus, governments are left to absorb the impact of high crude oil prices themselves. Among the largest risks facing the region, ADB noted the possibility of sudden collapse in the value of the US dollar and drops in demand in Europe and the US.

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Russia

Russian GDP growth accelerates. Rosstat reports Russian GDP growth picked up to a pace of 7.4 % in the second quarter. Highest growth was concentrated in the construction sector and refining industries. For the first half, Russian GDP grew 6.5 %, or one percentage point higher than in 1H05. The Russian government's official growth estimate for the year is 6.6 %.

Russia continues to post a huge federal budget surplus. Realised federal budget revenues for January-June equalled 24.1 % of GDP and expenditures 15.2 % of GDP. Both revenues and spending were relatively smaller in GDP terms than a year ago. This was due to the fact that 1H05 budget revenues included settlements of the delinquent tax claims owed by the Yukos and Sibneft oil companies. In real terms, however, revenues and expenditures were up substantially. The budget surplus corresponded to 8.9 % of GDP (10.2 % of GDP in 1H05).

The bulk of revenues continue to come from just three sources – customs fees (36 % of total federal budget revenues), value-added taxes (24 %) and natural resource use fees (19 %). The relative share of customs fees and natural resource payments increased substantially from last year, while the significance of VAT revenues diminished. This is estimated to have resulted from higher VAT refunds and changes in VAT accounting methods.

The largest budget spending category is "transfers to regions" (38 % of total expenditures). About two-thirds of the category consists of transfers to off-budget funds (e.g. the Pension Fund). In the first six months of this year, 17 % of total federal budget spending went to defence, 13 % to national security and law and order, and 13 % to social and cultural programs. In percentage terms, allocation of spending was essentially unchanged from last year. Federal interest costs continued to contract, accounting for just 4 % of federal budget expenditures in the first half of the year.

Turkmenistan negotiates higher price for natural gas sold to Gazprom. Gazprom CEO Alexei **Miller** and Turkmenistan president Saparmurat **Niyazov** agreed last week that Turkmenistan would annually provide Gazprom with 50 billion cubic metres natural gas during 2007–2009 at a price of \$100 per 1,000 m^3. For the rest of 2006, Gazprom will pay just \$65 per 1,000 m^3 of Turkmenistani gas.

Russia and Turkmenistan signed a 25-year gas cooperation agreement in April 2003. Observers are keenly waiting whether the coming price hike will affect the prices at which Gazprom sells gas e.g. to Ukraine and Belarus.

Turkmenistan also signed a 30-year framework agreement on gas cooperation with China last April. Under the agreement, China is entitled to an annual allotment of 30 billion m^3 of Turkmenistani gas starting from 2009. The price will be decided separately from year to year. A 7,000 km pipeline would be built to deliver the gas.

Grain harvest estimation raised. Agriculture minister Alexei **Gordeyev** said that the dried weight of the grain harvest in 2006 will exceed 73–74 million tonnes (78 million tonnes in 2005), which is three million tonnes more than the agriculture ministry's initial estimate in June. The ministry boosted its harvest estimate in response to news of an outstanding barley harvest, which is estimated to account for nearly a quarter of Russia's grain harvest. Russia's main cereal crop continues to be wheat, which normally accounts for about 60 % of the grain harvest. The agriculture ministry added that this year's target of 10 million tonnes of grain exports will likely be realised.

Russia, which has about 10 % of the world's land dedicated to grain production, currently accounts for 3 % of world grain production. Looking back in history, Czarist Russia posted a record harvest of 90 million tonnes in 1913. That corresponded to a third of total global grain production at the time.

World Bank survey finds only slight improvement in Russian business environment. In the World Bank's newly released *Doing Business* survey of conditions for doing business in 175 countries, Russia ranked 96th (up from comparable ranking 97 last year). However, the survey found that Russia's reforms had lost steam from earlier years and the country was lagging relative to some other countries. For example, barriers to doing business have been removed significantly faster in China than in Russia. As a result, China, which was among the ten fastest reformers, overtook Russia this year in the rankings, climbing from 108th place in 2005 to 93rd place this year.

The survey further found Russia still needs to simplify its licensing practices and foreign trade and improve access of businesses to bank credit. However, it also found that courts are doing a better job in enforcing company law and there have been improvements in protecting minority shareholder rights. Establishing a new business in Russia is also easier than before.

The slowing of reforms and increased state ownership in several economic sectors have given experts cause for concern. Nevertheless, economy minister German **Gref** assures that Russia will continue to liberalise its economy and the government will continue to honour its principle of non-interference in business life. According to Gref, further reforms to support business operations, e.g. in the sphere of property rights, are expected by year's end.

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China

IMF optimistic about China's economic prospects. The IMF executive board's concluding report of its Article IV consultations with China finds the outlook for the Chinese economy surprisingly bright, despite risks posed by high rates of investment and credit expansion. To get them under control, the Fund said China probably needs more monetary tightening measures. Emphasis should be on increased use of open-market operations in regulating the money supply rather than administrative measures in order to give banks the possibility to operate fully on a commercial basis. Banking supervision should also be strengthened to encourage closer monitoring of non-performing loans.

The IMF stressed that China can make its monetary policy more effective by tolerating greater fluctuations in the yuan's exchange rate. Several board members felt the need for greater exchange rate flexibility, which, they said, could be implemented gradually so as not to upset economic stability. Other members argued that China cannot achieve external balance solely through exchange rate adjustments.

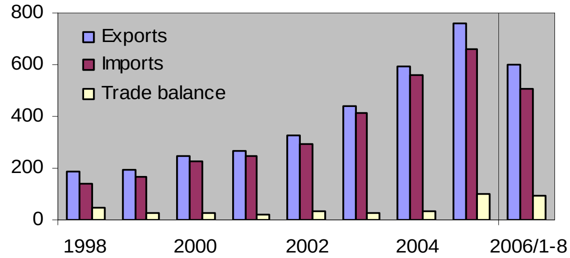
The IMF hoped China's central administration will provide local officials with adequate resources to carry out their duties. Schools, in particular, have suffered from underfunding. Some have even been forced to break the law and charge tuition. To boost state budget revenues, the Fund recommended that China's state-owned firms pay dividends to the state.

China posts record trade surplus in August. China customs reports the foreign trade surplus in August was $18.8 billion. The total goods trade surplus for the first eight months of this year was $95 billion. The trade surplus is expected to continue to grow rapidly in the next four months and substantially exceed last year's total of $102 billion. The growing surplus will probably amplify discussion about yuan's exchange rate, especially in the US and the EU. Trade minister **Bo** Xilai said China was considering ways to reduce the trade imbalance.

In August, the trade surplus swelled as exports climbed 33 % y-o-y. Export growth this year has been sustained by exports of machinery and equipment (30 % y-o-y). Machinery and equipment account for over half of all Chinese exports. Exports of steel and cars have also risen sharply, although they still only constitute small fractions of total exports.

Imports rose 25 % y-o-y in August. Imports of machinery and equipment to China were up 26 % y-o-y. Volumes of imported crude oil and fuels have also increased sharply this year.

China's foreign trade development, $bn



Source: China customs

Helsinki summits' biggest achievements: climate change declaration and launch of drafting of a new EU-China framework agreement. Leaders of 38 Asian and European nations gathered this week at the ASEM summit in Helsinki. Although the meeting delivered little in the way of concrete results, the ASEM summit provided a valuable forum for leaders to discuss a broad range of international issues. Perhaps the biggest achievement of the meeting was a resolution on global climate change that showed converging positions of European and Asian countries. The members also voted to invite six new parties to join the ASEM process: Bulgaria, India, Mongolia, Pakistan, Romania and the Asean secretariat.

Numerous smaller meetings were also held around Helsinki at the same time. The 9th EU-China summit marked the launch of preparation work between the EU and China on a new framework agreement to guide relations. The current EU-China trade agreement, designed in 1985 to cover economic cooperation between western Europe and China, is narrowly tailored to economic relations. Given the transformation and integration of Europe and China, the agreement is clearly outdated. The EU is today China's largest trading partner and China is the EU's second largest trading partner. Despite China's demands, the EU was still unwilling to grant China market economy status or lift its arms embargo.

In connection with the EU-China business summit held after the ASEM summit, premier **Wen** Jiabao presented a proposal on developing economic relations between China and the EU. He stressed broader technological cooperation, promotion of interaction among small and medium-sized firms, as well as greater cooperation in the fields of energy, the environment, agriculture and services. Premier Wen also promised China would soon introduce legislation to increase intellectual property rights protection, which is still a concern for many foreign firms operating in China.

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Russia

Russian industrial output growth accelerated in August. After a brief summer slowdown, industrial output picked to 5.6 % y-o-y last month. For the first eight months of the year, industrial output was up 4.3 % y-o-y. *Mineral extraction* increased 2.4 %, with oil production up 2.4 % and natural gas production 2.6 %. *Manufacturing industries* grew 4.3 %. Gasoline production rose 6.5 % y-o-y and diesel fuels 7.6 %. *Production and distribution of water, electricity and gas* was up 5.4 % y-o-y in the January-August period.

IMF revises upwards its forecast for Russian economic growth. In its latest *World Economic Outlook*, the International Monetary Fund foresees Russian GDP growth of 6.5 % this year and in 2007. The 2006 spring forecast was revised up 0.5 percentage points and the 2007 figure was boosted 0.8 percentage points. The outlook assumes world oil prices average $69 a barrel this year and just over $75 a barrel next year. The IMF expects Russia's current account surplus to reach 12.3 % of GDP this year and 10.7 % of GDP in 2007. The IMF expects no significant changes in China's GDP growth and current account.

GDP growth and current account surpluses of Russia and China, %, 2005 (realised) and 2006–2007 (estimated)

	GDP growth			Current account		
	2005	2006	2007	2005	2006	2007
Russia	6.4	6.5	6.5	10.9	12.3	10.7
China	10.2	10.0	10.0	7.2	7.2	7.2

Source: IMF

Russia strengthens banking supervision and fight against financial crime following assassination of central banker. Central Bank of Russia first deputy chairman Andrei **Kozlov**, 41, was shot to death in Moscow last week. The hit on Kozlov has been linked to his push for banking sector reform and campaign against money laundering. Immediately after the shooting, the government declared it would continue with planned reform of the banking sector. President Vladimir **Putin** followed with an initiative to establish a working group consisting of members from the prosecutor general's office, the tax office, security services, interior ministry and central bank. Putin said Russia faces more problems with financial crime and noted that each month billions of roubles with suspicious origins are cycled through the banking system to fund criminal activity such as bribery of public officials, terrorism and narco-mafia operations.

Sakhalin-2 oil and gas project hits resistance; natural resources minister cancels environmental permit. While the natural resource ministry officially cited environmental violations as its reason for pulling Sakhalin Energy's permit, observers saw the move as an attempt by Russian officials to pressure foreign companies in the energy sector to renegotiate contract terms more favourable to the Russian state. Strong-arming has also been applied to Gazprom's competitors Exxon and Total operating on the Sakhalin Island as well as TNK-BP, which is developing the Siberian Kovykta gas field. Japan, which is highly dependent on energy imports, warned the ministry's decision could hurt bilateral relations. EU energy commissioner Andris **Piebalgs** also expressed serious concern about the announcement.

The Sakhalin-2 project evolved out of a production-sharing agreement made in the 1990s and is totally owned by foreign companies: 55 % by Royal Dutch Shell and the rest by Japan's two leading trading companies, Mitsui (25 %) and Mitsubishi (20 %). Economy minister German **Gref** noted that while production-sharing agreements are no longer economically advantageous for Russia, existing contracts will be respected. Gref added that it was highly unlikely that Russia would enter into any further production-sharing agreements. Shell and Gazprom agreed last year in principle on an asset swap that would bring Gazprom onboard the Sakhalin-2 project. The negotiations were halted, however, after Shell revised the total project cost estimate from $12 billion to $20 billion.

Government approves 2007 privatisation plan. Under the plan, 652 state enterprises would be privatised, stakes in 927 companies would be divested, and 307 real estate properties sold off. The share package sales mainly involve firms in which the state already holds a minority stake. The privatizations of telecom giant Svjazinvest and air carrier Aeroflot were still off the list, but economy minister German **Gref** gave assurances that their sales will materialise in the future. Both companies are still considered strategic enterprises, meaning they are not eligible for privatisation. Gref said 2007 privatisation sales should raise about 41 billion roubles (€1.2bn). The biggest privatisation sales will be metal-working tool and equipment importer Stankoimport, subway builder Moskovskiy Metrostroy, the Salehard Airport in the Yamalo-Nenets Autonomous District and the Ufa International Airport in Bashkortostan Republic.

Privatisation has moved ahead more slowly than anticipated in recent years. The government blames the delay on factors such as the poor financial condition of some companies on the list, the lack of company information available and ministerial interference. 2005 privatisation revenues amounted to just 35 billion roubles or 80 % of planned. Revenues from privatisation sales scheduled this year are expected to exceed 31 billion roubles.

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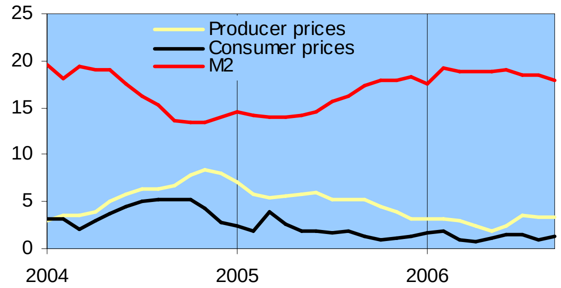
China

Prices continue to rise slowly; moderation in growth of money supply. The National Bureau of Statistics reports *consumer prices* climbed 1.3 % y-o-y in August. The pace of price growth has been quite steady this year. In August, prices for municipal services rose nearly 6 %. Although officials hiked rates for electricity and fuels this summer, their impact on inflation has been less than expected. *Producer prices* rose 3.4 % y-o-y in August. Prices for oil, refined oil products and nonferrous metals rose rapidly, while steel prices declined.

The *broad money* (M2) supply was up 18 % y-o-y in August, with money supply growth slowing a half percentage point from July. Since last spring, Chinese officials have tightened the monetary stance through such measures as raising interest rates and reserve requirements for commercial banks. The central bank's M2 growth target for 2006 remains 16 %.

Price and money supply (M2) growth, % y-o-y



Sources: PBoC and NBS

Economic data weaken slightly in August. NBS figures show growth of *industrial output* fell to below 16 % y-o-y in August. It was the lowest such figure this year and it pulled down January-August growth to 17 % y-o-y. While on-year growth remained around 17 % in most sectors, growth in textile manufacturing was slightly lower.

Electricity production increased 15 % y-o-y, while growth in crude oil production remained flat. Industrial output figures only include state-owned enterprise and private companies with annual sales exceeding 5 million yuan (500,000 euro).

Growth of *fixed investment* in urban areas slowed in January-August to 29 % y-o-y. In January-July, growth was still 31 %. The largest increases in investment during January-August went to production of coal and nonferrous metals, as well as railway infrastructure. NBS figures only report the aggregate amount of investment from the start of the year; they are not broken down into monthly figures. *Retail sales* were up in August 14 % y-o-y, matching growth in earlier months this year.

Most observers interpret the slowdowns in growth of industrial output and investment as signs that tighter monetary policy and administrative measures to curb growth have begun to take effect. Nevertheless, the actual amount of slowing remains quite modest.

China cuts exports subsidies. China will reduce VAT refunds paid to export companies by 3–5 percentage points for product groups including textiles, leather goods and products fabricated from steel and nonferrous metals. Refunds for above mentioned products are currently 8 % or 11 %, while the basic VAT rate is 17 %. Subsidies were completely eliminated for coal and natural gas. While supports for certain high-tech exports will be boosted, the actual volume of such exports remains quite modest. VAT refunds were introduced over 20 years ago when China sought to increase exports. The current move should help China in its efforts to control a ballooning trade surplus and promote exports in high-tech fields.

China's growing role at the IMF. At the International Monetary Fund's annual meeting in Singapore this week, governors moved to increase the quotas and voting shares of China, South Korea, Mexico and Turkey – countries currently under-represented in relation to the size of their economies. The readjustment of quotas and voting shares is part of the IMF's internal reform program to bring its administration and operating procedures into line with the current global economic structure. The reallocation of quotas and voting shares are the first step in the reform program set to be completed by the 2008 annual meeting. China's IMF quota was raised 0.7 percentage points to 3.7 %.

In Singapore, China's exchange rate policy was not debated as much as one might have been expected. Part of the reason is that the new US treasury secretary Hank **Paulson** has apparently redirected the focus of China relations away from simply demanding immediate revaluation of the yuan to stressing China's need to implement a longer term strategy of liberalisation of its financial markets. Although this was Paulson's first visit in his capacity as treasury secretary, he is an old China hand, having visited China many times. On Friday (Sept. 22), the yuan strengthened against the dollar to a rate of 7.92.

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Russia

Russian core production sectors up 5.3 % y-o-y in August. Growth in Russia's five core production sectors was again led by *retail sales*, which soared 12.1 % y-o-y in January-August. Food sales accounted for nearly half of all retail sales, and were up 9.4 %. Retail sales of other goods climbed 14.5 %. *Construction* continued to increase rapidly and was 10.1 % y-o-y. *Industrial output* increased 4.3 %. *Transportation* was up 2.4 % y-o-y in the first eight months. Pipeline and rail shipments accounted for most growth in the transportations sector. Rail freight growth (4.9 % y-o-y in January-August), outpaced growth in pipeline shipments (1.7 %). *Agricultural production* fell 1 % in the period.

Duma approves 2007 budget in first reading. A clear majority of Duma deputies voted to accept the first reading of the federal budget last week (Sept. 22). The main budget parameters, based on the proposal submitted by the government, remained unchanged in the first reading. The 2007 budget features revenues of 6,965 billion roubles (22.3 % of GDP, €205bn) and expenditures of 5,464 billion roubles (17.5 % of GDP, €160bn). The resulting budget surplus of 1,500 billion roubles would correspond to 4.8 % of GDP.

Oil export taxes raised. The government decision increases the customs duty to $237.60 dollars per ton for crude oil and $172.40 a ton for oil products from October 1. Export taxes are reviewed every two months and calculated based on the world price of Urals crude.

The Russian Institute for Energy Policy reports oil exporting companies in 2004–2005 kept an average of $23 a barrel after paying export tariffs and mineral extraction fees. The amount after taxes for the companies was quite stable throughout the period despite a near-doubling in the world price of oil. The government was the main beneficiary of high oil prices as the export tax take is 65 % of the share exceeding $25 dollar a barrel. Thus, at the beginning of 2006, the export tax accounted for over 40 % and mineral extraction fees for 20 % of the oil export price ($59 a barrel). In addition to export taxes and mineral extraction fees, oil companies also pay e.g. profit taxes and excise taxes on oil products.

Cabinet suggests easing rules on foreign ownership of shares in Russian banks. The cabinet proposal would make it as easy for foreigners to purchase shares in Russian banks as ordinary Russian citizens. Currently foreigners face a bureaucratic jungle when seeking share purchase permission. The government still wants to reserve the right to limit foreign ownership to 50 % of the total assets of the Russian banking sector. About 13 % of Russian bank shares are currently in foreign hands. The government also decided that foreigners should be required to declare their purchases to the central bank if they acquire 1 % or more of a credit institution. In the event that a foreigner wants to acquire a stake of 10 % or more, official permission is required. To enter into force, the government proposal needs Duma and presidential approval.

New legislation on intellectual property rights. First deputy prime minister Dmitri **Medvedev** announced regulations pertaining to intellectual property rights have been gathered together under Part IV of the Civil Code. The Duma approved a bill on the matter in the first reading by a vote of 421–0. The bill extends the sphere of intellectual property rights protection, and e.g. toughens sanctions for piracy. Software and scientific research used by authorities will have special protection. The 400-page legislative proposal has been criticised as inconsistent and against interests of copyright holders. The law would enter into force at the start of 2008.

Piracy of intellectual property has been a sore subject in Russia's WTO negotiations with the Americans. International associations in the sector claim that only China exceeds Russia in the extent of piracy of intellectual property.

Gennady Melikyan heads Banking Supervision Committee. Gennady **Melikyan**, 58, deputy chairman of the CBR and head of the main inspectorate for credit institutions was tapped last week to replace CBR first deputy chairman Andrei **Kozlov** as head of the Banking Supervision Committee. He has held earlier posts as labour minister and deputy chairman of the state-run savings bank, Sberbank.

Russia and China lose ground in competitiveness survey. Russia this year ranks 62 in the World Economic Forum's 2006 *Global Competitiveness Report.* The survey covers 125 countries, and put Russia just ahead of Egypt and Azerbaijan. The comparative ranking of Russia in 2005 was 53rd. The report found Russian competitiveness had been eroded by problems with the Russian legal system. The private sector has serious doubts about the independence of the justice system and finds the legal process tedious, costly and capricious. In particular, laws protecting property rights were seen as deteriorating from previous years. Russia's property law indicator showed a serious decline, falling from 88th place in 2004 to 114 this year.

China also lost ground in the competitiveness rankings, falling from 48th place last year to 54th behind Jordan and Costa Rica. The ranking categories offer a conflicted picture of China's competitiveness. China's macroeconomic indicator was the report's sixth highest, while the institutional operating environment had degraded severely. Competitiveness was also hurt by problems in the state-controlled banking sector and the low penetration of latest technologies.

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China

Paulson completes successful China visit; yuan keeps on rising. US treasury secretary Henry **Paulson** met last week with China's president **Hu** Jintao and prime minister **Wen** Jiabao. The parties created a strategic economic dialogue, a twice-a-year meeting to be chaired by Paulson and China's deputy prime minister **Wu** Yi. The dialogues are intended to help resolve bilateral and global economic issues. In spite of the fact that both parties were satisfied with results of Paulson's visit, observers note that an earlier China-US strategic dialogue on foreign policy produced no results.

Topics discussed included the yuan's exchange rate issues, intellectual property rights and reform of China's financial sector. Paulson has departed from his predecessor's heavy-handed insistence on yuan revaluation, choosing instead to emphasise China's need for broad-based reforms in its financial sector and tying the yuan's exchange rate development to the broader goals of Chinese reform policies such as reducing dependence on exports and increasing domestic demand. Paulson's new policy direction has been warmly welcomed, even if the parties still have differences on an appropriate pace for yuan appreciation.

As a result of Paulson's visit to China, the US senate will no longer consider a bill that would impose an additional 27.5 % tariff on imports from China if the Chinese do not let the yuan to appreciate. Senators Charles **Schumer** and Lindsey **Graham** dropped their demands and indicated they would prepare a new initiative to press China to meet its commitments.

Since July, yuan appreciation and swings in its value have increased. This week, the yuan fell below the 7.90 yuan-to-the-dollar mark for the first time since China abandoned its dollar peg a year ago. The yuan has strengthened 4.7 % against the dollar since the peg was ended.

China becomes world's third-largest carmaker; fight on car parts goes to the WTO. A German study finds that China will surpass Germany this year in annual car production, making China the world's third largest car manufacturer after the US and Japan. Chinese car production climbed 24 % y-o-y in the first eight months of 2006. The German research institute estimates China will build 5.9 million cars this year. Nearly all vehicles are sold on the domestic market, with Chinese car exports remaining quite modest. Car production has grown rapidly as several large international carmakers have made major investments in China. Car production is expected to continue to increase rapidly and annual production should exceed 10 million cars within the next ten years.

Supported by the US and Canada, the EU has appealed to the WTO for what is sees as China's protectionist measures favouring the domestic car-part industry through illegal import rules. The case went to the WTO after a half year of fruitless negotiations and is the first EU dispute with China to reach the WTO. The dispute has become intractable as the EU claims China is treating car-part imports as "complete vehicles", if imports include separately car doors, tops and six key engine parts, and applying the import tariff of 25 % for cars. Under its WTO commitment, China agreed on import tariffs for car parts of just 10 %. China defends its customs practices, arguing that it merely seeks to discourage the import of unassembled cars to avoid tariffs and that its practices are in line with WTO rules. The EU annually exports about €3 billion worth of car parts to China. If WTO handling of the case proceeds normally, the WTO should issue its ruling within a year. China would have three months to appeal the ruling. The parties are free to settle with each other at any time during the WTO proceedings.

Shanghai pension fund scandal widens. Charges of pension fund abuses in one of China's main financial centres reached a new level when Shanghai's highest party leader, party secretary and Politburo member **Chen** Liangyu was sacked from all his posts. It was the highest level firing of a public official since Beijing's mayor was canned a decade ago. Previously, several mid-level city government leaders and several CEOs have already been deposed for malfeasance. Beijing has sent a special force from the party's Central Committee for Disciplinary Inspection to deal with the situation. The passports of Shanghai's top officials have also been confiscated.

Apparently, about a third of the metropolis' approximately one-billion-euro pension fund has been invested illegally in high-risk real estate deals and road construction projects. China has been building up its national social security reserves at 20 % a year, reaching about €180 billion in 2005. Many local funds, however, suffer from ballooning financing deficits, non-transparent investment policies and widespread abuses. The incident has led the government to declare that social security funds can only be kept in special bank accounts it has established or be invested in state bonds. Some local fund assets may be nationalised.

It is generally believed that behind the Shanghai scandal lies next year's party congress and president **Hu** Jintao's attempts at ridding the Politburo of members still faithful to previous leader **Jiang** Zemin. In recent months, Beijing deputy mayor and Tianjin's prosecutor general have lost their jobs for corruption or abuse of office.

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Russia's public consumption up in the second quarter. In the second quarter, overall growth of Russian GDP was 7.4 %. Although growth in *public consumption* exceeded 4 % for the first time in years, its share of GDP remained around 18 %. *Household consumption* was up 12 % y-o-y with a 47 % share of GDP. After slowing somewhat in the first quarter, on-year growth in *fixed investment* accelerated in the second quarter to nearly 14 %. Fixed investment corresponded to 17 % of GDP. *Net exports* declined by 12 % in the second quarter, representing about 15 % of GDP.

Russian labour productivity lags growth in real wages. Rosstat reports that labour productivity in 2005 climbed 5.5 % y-o-y. During the same period, real wages grew 12.6 %. *Manufacturing industries* improved their productivity by 5.6 %, and w*holesale and retail sales* saw gains of 7.2 %. These sectors are the largest employers in Russia employing 34 % of the Russian employed. Over 10 % of Russian workers had jobs in *agriculture and forestry*; the sector saw minor gains in productivity in 2005 from 2004. Substantial productivity gains, however, were registered in *real estate services* (8.1 %), *construction* (5.9 %), *hotel and restaurant services* (12.2 %), and *mining and mineral extraction industries* (6.1 %). Only minor productivity improved only slightly in activities involving *production and distribution of electricity, gas and water*, as well as *transportation and telecommunications*.

Real wages growth has outpaced gains in labour productivity already for a while. This has eroded the competitiveness of domestic producers and fuelled inflation. Real wages dropped at the end of the 1990s, but roared back in subsequent years. Part of Russian wage growth, however, may be explained by the reduction of the grey economy. As a result, a larger share of employee income and benefits now show up in official statistics.

Government presents plan for reasonable buy-out pricing of commercial lots. Under a government proposal submitted to the Duma, the price to companies for commercial lots would be 20 % of the land-survey-certified value for lots in Moscow and St. Petersburg, and 2.5 % for lots elsewhere in Russia. Annual leasing cost would then be 2 % of the commercial lot's certified value. Agricultural land could be leased up to the full equivalent of the land tax. Parties interested in leasing land will find certified values listed on local registries posted on the real estate agency's website. The economy ministry estimates that the government proposal will lower buy-out prices for land an average of 75 % nationwide and the total buy-out sum for currently available lots result about 190 billion roubles (€5.6bn). The government says lost tax revenues from land deals should be taken into consideration in the Duma 2007 budget readings. Finance minister Alexei **Kudrin** and Russian Union of Industrialists and Entrepreneurs say the buy-out pricing for lots in Moscow and St. Petersburg requires no different percentage and violates market principles.

For the time being, companies occupy their lots without paying any fee. By the end of 2007, however, they will be required to buy their lot or make a lease agreement for it. Economy minister German **Gref** said the high buy-out prices for lots demanded by regional governments have been delaying the buy-out process. Less than a quarter of the commercial lots available have been privatised. The economy ministry reports 31 % of freely tradable land, or 130 million hectares, is currently held by private landowners. There are nearly 37 million private landowners in Russia.

Société Générale increases its stake in Rosbank. Last week, the French Société Générale (SG) purchased an additional 10 % in Rosbank, one of Russia's largest banks, bringing its holdings in the bank to one share short of 20 %. SG paid $317 million for shares to the Russian holding company Interros, matching the amount it paid in June for a similar amount of shares. The deal, worth over $600 million, represents the largest corporate acquisitions ever in Russia's financial sector.

SG and Rosbank also agreed on an options scheme, whereby SG retains the right to buy another 30 % + 2 shares from Rosbank to acquire the majority stake in the bank. The option expires at the end of 2008. The value of the deal based on the option exercise price would be $1.7 billion. Part of the purchase could be made with shares, making Interros an SG shareholder.

Stock of Finnish direct investment in Russia and China continues to increase. Preliminary figures from the Bank of Finland released last week indicate that the stock of Finnish direct investment in Russia reached nearly €1.1 billion at the end of 2005, a near doubling from a year earlier. Russia, however, represented less than 2 % of Finland's total FDI stock, putting it on par with Hungary and Estonia. Personnel employed by Russian subsidiaries of Finnish firms doubled in 2005 to nearly 15,000 persons. Russian subsidiaries posted total net revenues of €1.5 billion.

In China, the stock of Finnish FDI in 2005 rose to nearly €1.6 billion. Personnel employed by subsidiaries of Finnish companies operating in China increased nearly 40 % to around 21,500 persons. The combined revenues of Finland's Chinese subsidiaries exceeded €10 billion.

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China

EU extends anti-dumping duties on leather shoe imports from China for two more years. Last April, the EU imposed penalties on Chinese leather shoe imports for six months. The EU anti-dumping committee has now decided to extend the tariff for two years. The new duties will be 16.5 % of the import price, compared to the 19.4 % duty set last spring. The EU claims China sells leather shoes at prices well below their actual production cost, which, under China's WTO-commitments, constitute grounds for imposing anti-dumping measures. China denies the dumping claims.

The EU will also maintain its policy of higher tariffs on leather shoes imported from Vietnam. EU members themselves are at odds over the need for import duties. Southern European countries have led the push for duties as they have sizable shoe industries. The EU has been unwilling to grant China much-coveted market economy status, which would make it easier for China to dismiss the dumping charges.

Chinese shoe exports grew 25 % y-o-y in 2005 and were valued at $19 billion. The market share of Chinese footwear in Europe has increased rapidly. China provided half of all the footwear sold in the EU area in 2005. Leather shoes represented about a third of Chinese footwear imports to the EU. Shoes, in turn, constituted about 2.5 % of China's total exports.

The EU and China are also locked in a nasty dispute over imports of car parts to China. At the end of last month, the EU took its case to the WTO. The EU and China reached agreement on limiting textile and apparel imports from China in 2005.

China makes progress in bilateral talks on free trade. A free-trade agreement between Chile and China entered into force at the beginning of this month. The agreement eliminates import tariffs on nearly 3,000 products from Chile (including copper). The accord removes tariffs on 92 % of Chilean exports to China. Chile, in turn, agreed to drop import tariffs on about 6,000 Chinese products, or 50 % of China's exports to Chile. The listed products include machinery and equipment, one of China's most important export categories. China did $7 billion in trade with Chile last year, an increase of about 20 % from 2004. China mainly imports raw materials from Chile, which is the world's largest copper producer. China satisfies about half of its copper needs from Chile.

China's free-trade agreement with ASEAN countries entered into force in the summer of 2005. Trade between the parties is scheduled to liberalise gradually so that by 2015 nearly all customs tariffs are eliminated.

China is presently negotiating bilateral free trade deals with Pakistan, the South Africa Customs Union and the Persian Gulf Cooperation Council. A free trade agreement with New Zealand should be finalised by the spring of 2008. Talks with Australia will begin in December.

China has made the granting of market economy status by the counterparty a condition for entering into free trade negotiations. The WTO is unhappy with the Chinese bilateral approach to free trade, and says China should instead actively seek the elimination of trade barriers worldwide.

Over 2,000 state-owned enterprises temporarily exempt from new bankruptcy law. At least 2,100 state-owned enterprises (SOEs) will remain outside the new bankruptcy law (enacted at the end of August and entering into force at the start of June 2007) at least until end-2008. Officials are worried about the social repercussions of allowing failing SOEs to enter into bankruptcy. Although the profits of state companies overall have risen rapidly in recent years, most profitability gains have been enjoyed by just a few industries (notably the energy sector). Most SOEs have operated in the red for years, relying on bank loans to keep going. Observers consider the bankruptcy law a major milestone for China, even if many SOEs are temporarily exempted.

Chinese companies engage extensively in bribery when doing business abroad. Transparency International's *2006 Bribe Payers Index* (BPI) provides a survey of the behaviour of companies representing the world's 30 largest exporting powers. The survey, which involved interviews with 11,000 business leaders in 125 countries, found that Chinese companies operating abroad were only slightly less prone to resort to bribery than the survey-topping Indians. Chinese companies were seen to be most likely to pay bribes in dealings in East and Southeast Asia or countries with low average incomes. To reduce its use of bribery, Transparency International recommended that China voluntarily sign on to the OECD anti-corruption convention. The Chinese, however, defend their bribery practices with the argument that bribery is a common practice in certain markets. The best-behaving firms globally were the Swiss, while Russian firms ranked as the third-worst offenders on the BPI.

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Russia

Russian inflation slows slightly in September. Rosstat reports on-year inflation slowed in September to 9.5 %. Food prices were up 9.3 % y-o-y. On-year inflation for other goods ran at 6.2 %. The rise in gasoline prices eased slightly in September, but was still 13 % y-o-y. Prices for construction goods climbed nearly 10 %. Services were up 14.4 %.

The price of a basket of basic foodstuff was dearest in the Chukotka Autonomous District, costing 4,590 roubles (135 euro) as of end-September. The basket was cheapest in the Chuvash Republic, where it could be had for just 1,130 roubles. The base basket's average price at the end of September was 1,430 roubles, an increase of 10 % from a year ago.

Russian oil industry continues to suffer from low refining efficiency. With the recent increase in crude oil export tariffs, Russian oil producers have increased their domestic refining capacity to boost the added-value of the oil production. In January-August, the share of Russia's total crude oil production refined domestically was 45 %, up from 44 % last year and 42 % in 2004. Yet in Russian refineries the oil processing depth accounts for 72 % of the crude oil feed into saleable distillates and raffinates. The corresponding efficiency of refineries in Western Europe and the United States is 90 %. Even though Russian refiners have a conspicuous need to modernise, no dramatic efficiency gains should be expected in the near future. Russia's energy strategy seeks to raise the oil processing yield to 75 % by 2010 and 84 % by 2020. However, these goals will require substantial investment.

Of the most important distillates, production of gasoline climbed 7 % in the first eight months of 2006, diesel fuel production grew 8 % and fuel oil 4 %. Customs figures show that in January-August Russia exported 20 % of its gasoline production, 57 % of diesel fuel and 82 % of fuel oil. With little demand for fuel oil on the domestic market, nearly all production is shipped abroad for further refining. However, domestic demand for fuel oil is expected to rise in the coming months as Gazprom has announced it will reduce its gas sales to domestic electrical power plants, forcing the plants to turn to either coal or fuel oil.

Gazprom to develop massive Shtokman gas field without foreign partners. On Monday (Oct. 9), Gazprom announced it is not accepting any foreign partner for development of the giant Shtokman gas field on the continental shelf of the Barents Sea. Instead it will continue to develop the field by itself. Considered one of the world's largest gas finds ever, Shtokman has gas reserves estimated to be on the order of 3,700 billion cubic metres. The top candidates for cooperation were the Norwegian Statoil and Norsk Hydro, the French Total, and US-based ConocoPhillips and Chevron. Gazprom also reported that most Shtokman gas would primarily go to serve European markets with transmission via the yet-to-be-built Nord Stream gas pipeline to Northern Europe. The announcement reversed the earlier plan to ship the gas in LNG-form to the US.

Some observers continue to doubt Gazprom's ability to develop the technically challenging offshore gas field without foreign assistance. The project has been under planning since the early 1990s with little progress to date. Nevertheless, Gazprom hopes to get Shtokman production on stream by 2011 and ramp up production to 60–70 billion m^3 a year by 2015. Russia's total gas production in 2005 was about 640 billion m^3.

Aluminium producers merge. Under an agreement signed between *Russian Aluminium* (RusAl), *Siberian-Ural Aluminium Company* (SUAL) and Switzerland-based *Glencore International*, a merged form of those companies would be completed by April 2007. The new entity would continue under the name Russian Aluminium and would be the world's largest aluminium producer. RusAl will have a 66 % stake in the venture, SUAL 22 % and Glencore 12 %. The partners still have to resolve disputes with SUAL minority shareholders opposing the merger.

The market capitalisation of off-shore registered Russian Aluminium is estimated at $25–30 billion. Annual aluminium production should reach 5 million tonnes. SUAL chief executive Viktor **Vekselberg** said the new company expects an IPO on the London stock exchange before the end of 2008.

Nordea sells its stake in International Moscow Bank. Under an agreement made this summer, Nordea Bank has divested its 23 % stake in IMB to the German Bayerische Hypo- und Vereinsbank (HVB), a subsidiary of the giant Italian UniCredit bank. The sale was valued at $395 million (€315m), yielding Nordea a €200 million profit. Nordea plans to apply for an own banking licence in Russia or acquire a small to mid-sized Russian bank.

The sale increased HVB's stake in IMB to over 70 %. However, HVB plans to sell its entire IMB holdings later this autumn to Bank Austria Creditanstalt (BA-CA). IMB shareholders include the French BCEN-Eurobank and the EBRD. Since IMB's founding at the end of the 1980s, it has grown into Russia's eighth largest bank, controlling almost 2 % of the banking sector's total assets.

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China

Japan's new prime minister meets Chinese leaders. Japan's new prime minister Shinzo **Abe**, who took office just last month, kicked off his term with an exceptional state visit to China. No Japanese prime minister has made China the destination of their first foreign visit since World War II. Abe's predecessor Junichiro **Koizumi** made no official visits to China nor met in Japan with China's highest leadership during his five-year term. The Chinese say the chilly relations between China and Japan were the result of Koizumi's annual visits to the Yasukuni shrine, where Japanese war dead are buried, including over a dozen Japanese war criminals. During Abe's two-day visit, the shrine issue dominated the Chinese media's talking points.

Japan's prime minister met his host and colleague premier **Wen** Jiabao as well as president **Hu** Jintao, who described the visit as a turning point in the two countries' relations. The talks were generally amicable and forward looking. Among other things, the parties agreed to begin regular meetings and the Chinese accepted an invitation from Abe to visit Japan. The visit was marked by North Korea's detonation of a nuclear device, which Japan and China jointly denounced.

China releases first half balance-of-payments data. According to balance-of-payments figures released by the State Administration of Foreign Exchange (SAFE), China posted a current account surplus of $92 billion in the first half of the year (8 % of GDP). Some $80 billion of the current account surplus came from a goods trade and $14 billion from current transfers. The services account showed a $6 billion deficit. The current account surplus increased sharply from 1H05, due almost entirely to the increase in the trade goods surplus.

Balance-of-payment highlights, US$ billion

	Current account	Financial account	Net errors and omissions	Change in foreign reserves
2004 H1	8	67	-7	+67
2004 H2	61	44	34	+139
2005 H1	67	36	-2	+101
2005 H2	94	23	-12	+106
2006 H1	92	37	-8	+122

Source: SAFE

The surplus on the financial account remained essentially unchanged from a year ago, standing at $37 billion. Of that the largest chunk ($31 billion in net terms) consisted of direct investment to China.

The payments surplus swelled China's foreign currency reserves in January-June by more than $120 billion. At the end of June, China's foreign currency reserves stood at $925 billion, the largest in the world.

Rapid growth in foreign trade surplus. China Customs reports a September trade surplus of $15 billion, a slight decline from the $19 billion record set in August. The September trade surplus was boosted by over 30 % y-o-y growth in exports, while imports were up 22 % y-o-y. The total trade surplus for the first nine months of this year reached $110 billion, compared to just over $100 billion for all of 2005. As China generally has large monthly trade surpluses at the end of the year, the overall 2006 surplus is expected to reach $150 billion. China's Ministry of Foreign Trade and Economic Cooperation announced this week that it expected trade to be in balance by 2010.

China's top trading partner during January-September was the EU. According to China Customs showed a $60 billion surplus in China's favour. The Chinese also had a $100 billion trade surplus with the US and a trade deficit of $20 billion with Japan. China runs trade deficits with most of its Asian trading partners. It also has a $2 billion trade deficit with Russia.

China begins filling its strategic oil reserves. Several news agencies report China has begun to fill its strategic oil reserves, located in the Zhejiang province. No official information on the matter has been released and official comments have been ambiguous. The Chinese are afraid that such information could increase world oil prices, making filling the reserves more costly. China cannot fill its strategic reserves merely by boosting domestic oil production, so it must depend on increased imports either directly or indirectly. Observers say that only low-sulphur grades of crude oil are suitable for reserve storage due to the technology in use at Chinese oil refineries. China currently imports substantial amounts of crude oil from Russia and Angola. The latter recently became China's number-one oil supplier.

The International Energy Agency (IEA) reports China's oil demand will rise 6.5 % this year to about 7 million barrels a day. Last year, total oil demand rose just 2.6 %. The estimate, however, includes a wide margin of error as China does not publish information about its oil reserves. The IEA would like to see China show greater transparency in this respect.

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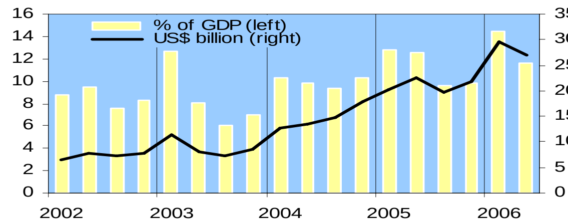
Russia

Russia posts yet another current account surplus in 1H06. The Central Bank of Russia reports the current account surplus for the first half of 2006 exceeded $56 billion, or 13 % of GDP. The combined value of goods and services exports climbed 30 % y-o-y, while total imports rose 24 %. The trade surplus in goods corresponded to about 17 % of GDP and the services balance remained in deficit at 1.5 % of GDP. The income account deficit in January-June reached nearly 3 % of GDP, up from 1H05 when it was under 2 %. The widening deficit reflects a rise in dividends, debt servicing costs and compensation for employees paid abroad.

For 1H06, the financial account showed foreign direct investment in Russia surpassed $14 billion. FDI relative to GDP was slightly over 3 %, down from 4 % in 1H05. FDI outflows from Russia amounted to nearly $7 billion, or slightly less than in the same period in 2005.

Russian current account balance, 2002–2006



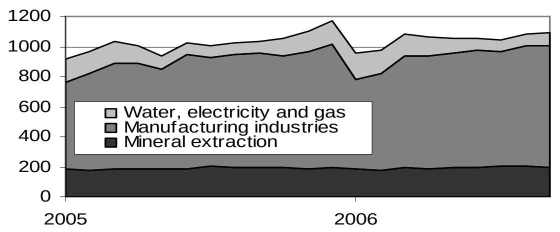
Source: CBR

Government accepts proposal on nuclear power industry development. The program covers the years 2007–2015, during which it would add nearly 10 GW of additional nuclear-powered generation capacity. The program involves an investment of nearly 1,500 billion roubles (€44bn), of which the state will provide some 700 billion roubles. The project includes the ongoing construction of additional 1,000 MW units at the Rostov and Kalinin power stations (set for completion in 2009 and 2011, respectively), as well as a planned 800 MW unit for Beloyarsk. Construction work is expected to get underway in 2007–2008 at the Leningrad and Novovoronezh power plants. Starting from 2009, Russia would launch construction of two nuclear plants each year. It is estimated to take about five years to bring a greenfield plant on line.

Russian nuclear power plants supplied the country with approximately 143 TWh of electrical power in 2004, which corresponded to about 16 % of the country's total electricity production. The development program seeks to raise nuclear's share to 22 %. The generating capacity of current nuclear power facilities is about 23 GW. Over a fifth of this power is made at plants that will reach their originally designed lifespan by the end of this year. The capacity utilisation of these plants will not rise during their 15-year service extensions as they face rising maintenance and repair demands. The capacity utilisation of an average Russian nuclear plant in 2004 was just 73 %, which is quite low by world standards (the corresponding figure for Finland, for example, is around 90 %).

Growth in industrial production slowed in September. Industrial output rose last month by 4.1 % y-o-y, slowing slightly from August. For the first nine months of 2006, industrial output growth was 4.2 % y-o-y. Production in the *mineral extraction* category was up 2.4 %, including a 2 % rise in oil production and a 3 % increase in natural gas production. Production of *manufacturing industries* increased 4.4 % in January-September, driven by higher production of gasoline and diesel fuel (up 7 %) and car production (up 9 %). Distribution and production of *water, electricity and gas* was up 5.2 % y-o-y in January-September.

Industrial output, 2005–2006, RUB billion (in constant 1/2005 prices)



Source: Rosstat

Euromoney and Institutional Investor release their semi-annual country-risk assessments. The survey in the September issue of *Euromoney* covered 185 countries, while *Institutional Investor*'s overview of country risk compared 173 countries. Euromoney found China's creditworthiness eroding, while Institutional Investor found no change. Euromoney gave the downgrade in anticipation of lower Chinese economic growth and global uncertainty over energy supplies. Euromoney raised its assessment of Russia, despite concerns that its economy could be susceptible to Dutch Disease, the situation where overdependence on natural resources causes a decline in manufacturing.

Country standings and changes in risk index, March/September 2006 (100 = lowest risk)

	Euromoney		Institutional Investor	
	9/2006	change from 3/2006	9/2006	change from 3/2006
China	59.89	-1.8	69.8	0.0
Russia	56.50	1.9	60.4	-1.7
India	55.99	-0.5	57.1	0.0
Ukraine	44.91	-0.8	41.6	-4.9

Sources: Euromoney and Institutional Investor

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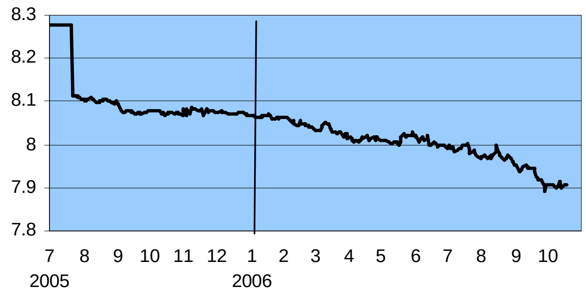
China

Yuan appreciation levels off in October. Since late last spring, fluctuations in the yuan's exchange rate relative to the US dollar have widened, and especially since mid-August it has been appreciating much faster than in previous months. In the first two weeks in October, however, the yuan's exchange rate remained quite steady. The pause is likely to be temporary; the PBoC's deputy governor explained this week that the yuan would be allowed to rise gradually in the face of ongoing appreciation pressures.

China's foreign currency reserves as of end-September stood at $988 billion, with growth in reserves slowing in summer and early autumn relative to last spring's growth pace. Recent monthly increases in reserves correspond with monthly trade surpluses. This has led some observers to suggest the speculative capital movements in anticipation of yuan appreciation may have diminished with the rise in international interest rates and China's measures to promote investment abroad. The yuan's exchange rate is currently about 7.91 to the dollar. Based on current pricing of non-deliverable forward contracts, the markets expect the exchange rate reach a level of about 7.87 by the end of this year.

Yuan-dollar exchange rate, July 2005–October 2006



Sources: Reuters, Bank of Finland

GDP growth remains brisk. The National Bureau of Statistics reports GDP climbed 10.7 % y-o-y in the first nine months of the year, slightly off the 10.9 % pace of the first half. Officials explained that economic tightening measures have begun to bite. Even with economic slowing, GDP growth this year is still expected to come in at 10.5 %. Foreign observers have lifted their estimates for future economic growth substantially, and for 2007 forecasts are now around 10 %.

Economic growth this year has been fuelled by higher rates of investment, as well as rapid growth in industrial output and foreign trade. In January-September, fixed capital investment rose 27 % y-o-y. While Chinese officials do not release monthly investment figures, it appears investment growth decelerated considerably in September. China has sought to rein in investment by e.g. tightening access to credit. Industrial output rose 17 % y-o-y. Retail sales, seen as an indicator of domestic demand, have increased 13 % y-o-y in real terms, outpacing 2005 growth. Consumer price inflation remains low, standing at just 1.5 % y-o-y as of end-September.

Foreign direct investment to China remains strong. China's Ministry of Commerce reports foreign direct investment (FDI) inflows to Mainland China amounted to $43 billion in the first nine months of 2006, matching the amount in the same period in 2005. The largest share of investment still came from Asia, although investment from the region fell 7 % from the same period a year earlier. US investment also appeared to dry up, while European investments increased. The highest investment growth came from tax havens, from which approximately one-quarter of Chinese direct investments originated. Some of this investment is likely Chinese capital recycled to avoid taxes. Companies with foreign participation enjoy preferable tax treatment in China. The Ministry of Commerce figures do not include investment in China's financial sector.

UNCTAD's annual investment report shows Mainland China received $72 billion in FDI in 2005, making it the third largest FDI recipient in the world. The largest recipient of investment was the UK, followed by the US. Hong Kong was in sixth place. UNCTAD also notes robust growth in China's FDI outflows, which are concentrated strongly on low-income countries.

Despite safeguard measures, China's exports of textiles and clothing continue to rise. The EU and the US agreed last year with China on specific import quotas for Chinese clothing and textiles. Similar quotas were imposed this year by Brazil, Turkey and South Africa. Current quotas must be lifted by the end of 2008. Under WTO rules, restrictions on textiles and clothing trade were abolished globally at the start of 2005. Chinese clothing and textile exports have soared since then.

Despite the protectionist safeguards, the value of Chinese clothing and textile exports increased 24 % y-o-y in the first nine months of 2006. Much of this growth has been driven by pricing gains; EU statistics officials note import volumes from China have actually fallen this year. Chinese officials decided in mid-September to reduce export subsidies to the textile and clothing industries by two percentage points, which, in turn, should reduce industrial earnings overall by about 8 billion yuan (€800m). Although exports have increased rapidly, China still has no internationally recognised product brands. Instead, most Chinese textile and clothing manufacturers work to specification on orders from foreign companies.

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Russia

Retail sales and construction lead Russian GDP growth. On-year growth has been above 10 % in construction since spring and in retail sales for the past two years. Among the five core segments of the economy in the first nine months of this year, *construction* climbed 11.4 % y-o-y and *retail sales* were up 12.3 %. *Transport* growth continued its stable pace at 2.5 % in January-September. *Industrial output* growth slowed slightly to 4.1 % y-o-y, while *agricultural output* contracted, falling 0.1 % y-o-y. According to the economy ministry's preliminary estimate, GDP growth for January-September was 6.6 % y-o-y.

Stabilisation fund assets converted to foreign currencies. A press release from Russia's finance ministry announced that *all* stabilisation fund assets had been invested in foreign currencies during the July 24–October 16 period. In accordance with an earlier decision, the breakdown of asset investments was allocated among three currencies: dollars (45 %), euros (45 %), and pounds (10 %). As of mid-October, stabilisation fund assets were valued at approximately 1,900 billion roubles (€56bn). Some €17 billion in fund assets were withdrawn in August to pay off outstanding Soviet-era debt.

CBR lowers key interest rates. The Central Bank of Russia lowered its refinancing rate and overnight lending rate for commercial banks to 11 %, effective on October 23. The CBR implemented a similar half-percentage point drop in these interest rates last June. The central bank's refinancing rate plays only a minor role in monetary steering as banks do not take refinancing loans from the central bank. It is mainly used in setting penalty interest rates for belated payments.

Rosneft and CNPC establish joint venture. Under a deal signed last week, the Russian Rosneft will take a 51 % stake and the China National Petroleum Corp (CNPC) a 49 % stake in a new entity, Vostok Energy. The joint venture will pursue exploration and development projects involving Russian hydrocarbon reserves, and will be tasked with arranging all necessary licences for exploitation of energy finds. Rosneft is expected to benefit from CNPC participation, as the Chinese partner has considerable assets to invest. This will allow extensive exploration operations. CNPC's main goal is to secure stable oil and natural gas supplies for the Chinese market.

Fortum increases investment in Russia. It was confirmed last week that the Finnish energy company Fortum acquired an additional 12.5 % stake in the St. Petersburg power generating company. Three Northwest Russian power generators (the St. Petersburg, Karelia and Kolskaya heat and power companies) will be merged to form the regional generator TGK-1 as part of reforms of Russia's electrical power sector. The merger is expected to be complete by May 2007. Fortum's participation in the upcoming enterprise has risen to slightly over 25 %. TGK-1 produced over 12 TWh of electricity and nearly 16 TWh of heat in the first half of 2006. The new entity will account for over 30 % of electrical power generation in the Northwest Russia market. Fortum is so far the only strategic foreign investor in Russia's electricity market.

The selling of shares to a foreign investor should help electricity giant UES raise funds needed for modernisation and increasing production capacity. UES is in the process of divesting its production monopoly and several share offerings are expected in the near future. The wholesale power generator OGK-5 has announced plans to hold next month an international IPO for almost 15 % of its share capital.

Russia and Ukraine agree on 2007 natural gas price. Under the contract with RosUkrEnergo, which is 50 % owned by Russian gas giant Gazprom, Ukraine would be assured of annual gas supplies of at least 55 billion cubic metres during 2007–2009. The gas would come entirely from fields in Kazakhstan, Uzbekistan and Turkmenistan. Under the deal, the gas price increases to $130/1,000 m^3 in 2007 from its current price for 2006 of $95/1,000 m^3. Gas prices in 2008-2009 would be adjusted later based on the price of Turkmenistan gas. Following a realignment of prices in September, Gazprom now purchases gas from Turkmenistan producers at $100/1,000 m^3 and delivers it on to RosUkrEnergo.

Russian housing market takes off. Rosstat reports nearly 300,000 new apartments were completed in first nine months of 2006. The amount of living floorspace was calculated at 26 million square metres, 12 % more than in the same period in 2005. About a quarter of apartments, measured in terms of living floorspace, were built in and around Moscow.

There has been particularly strong demand for new housing in the Moscow region. Real estate analysts report the average price of Moscow apartments has risen to over $4,000 per square meter, a doubling from a year ago. The housing crunch partly reflects last year's slowdown in housing construction that has reduced the amount of new housing currently available. Housing demand has been fuelled by the rising real incomes of Russians and development of a home loan market. During 1H06, home loans were up 50 % y-o-y. Russia's home loan market overall (200 billion roubles, or €5.6bn) is still small relative to the country's size.

The rise in prices of Moscow apartments has slowed in recent months as potential buyers have balked at the steep asking prices. Many members of Moscow's middle class can no longer afford to buy an apartment.

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China

China's money supply growth slows; inflation remains modest. The People's Bank of China reports growth in the broad money supply (M2) slowed in September to 16.8 % y-o-y. M2 growth accelerated last year and reached a 19 % average on-year growth pace in the first five months of this year. The PBoC's M2 growth target this year is 16 %. At the end of September, credit supply growth also appeared to be slowing. The effects of monetary tightening measures are apparently beginning to take effect.

The National Bureau of Statistics announced that end-September consumer price inflation rose to 1.5 % y-o-y (1.3 % in August). Consumer inflation has been held in check by the modest rise in food prices and drops in prices of clothing, transportation and communication. In September producer prices jumped to 3.5 % (3.4 % in August), driven by higher prices for crude oil, fuels and nonferrous metals.

Good summer grain harvest. The National Bureau of Statistics reports that the early summer grain harvest (which includes beans, maize, potatoes, rice and wheat) reached 110 million tons, a 7 % increase over last year. The rice harvest, which accounts for over a third of the entire grain harvest, was about the same as in 2005, even if several important rice-growing provinces suffered major droughts last summer. Official also expect the late-year harvest to be good, bringing the year overall harvest to more than 490 million tons, or about 10 million tons more than last year.

After China's annual grain harvest hit its all-time record of 510 million tons in 1998, it declined to 430 million tons in 2003, at which point officials actively launched new agricultural policies designed to revive production. China's harvest strongly depends on the amount of arable land under cultivation, even with recent advances in farming efficiency such as more productive plant varieties and better use of fertilisers. China has declared that it wants to increase the grain harvest to above 500 million tons by 2010. Officials estimate that the country currently suffers annual storage losses of about 20 million tons.

Dual listing of ICBC rocks markets. China's largest bank by assets, the Industrial and Commercial Bank of China (ICBC) listed simultaneously on the Hong Kong and Shanghai stock exchanges. The IPO involved the sale of about 15 % of the bank's shares and raised $19.1 billion. The offering was heavily oversubscribed, with about $500 billion in submitted bids. The strong response has encouraged the bank to possibly extend the emission to 17 % of its shares, and thereby bring the IPO's value up to about $22 billion. Even without the extension, however, the ICBC listing is the world's largest IPO ever. Share trading opened today (Oct. 27) and by midday ICBC shares had already gained 15 %.

China's fourth largest state bank, China Construction Bank, listed last year on the Hong Kong bourse. It was followed this summer by the Bank of China. The share prices of both banks have risen sharply from their initial listing prices. Of China's four large state banks, only the ailing Agricultural Bank of China has yet to list its shares publicly.

The mid-sized Bank of Communications and China Merchants Bank have also listed on the Hong Kong exchange. At least two other mid-sized commercial banks have also announced plans to list on the Hong Kong exchange.

Chinese patent activity on the rise. This month, the UN's World Intellectual Property Organization (WIPO) released its first comprehensive survey of Chinese patent activity. The report covers patent activity through 2004. China's State Intellectual Property Office has witnessed a dramatic increase in patent applications and has overtaken Europe in terms of patenting activity. China still trails Japan, the United States and South Korean patent offices in terms of numbers of patent filings.

About 130,000 patent applications were submitted in China in 2004, and about half were of foreign origin. Thus far the Chinese, like the Russians and the Indians, deal mainly with their own patent offices. China's technological advance and opening up to the world, however, has increased the need for international patent protection. WIPO, which enforces the international Patent Cooperation Treaty (PCT), saw the number of internationally registered patent applications increase by about 9 % y-o-y in 2005. While the number of international patent applications from China climbed 47 %, China's share of PCT applications was still only about 2 % (see *BOFIT Weekly 6/2006*). Almost half of all international patents are filed through the PCT.

Of the approximately 1.6 million patent applications submitted worldwide in 2004, about 600,000 were granted patent protection. About three-quarters of all patent applications and granted patents were handled by just five patent offices. The number of patents in force globally currently exceeds 5.4 million. Patents are normally granted for up to 20 years at most.

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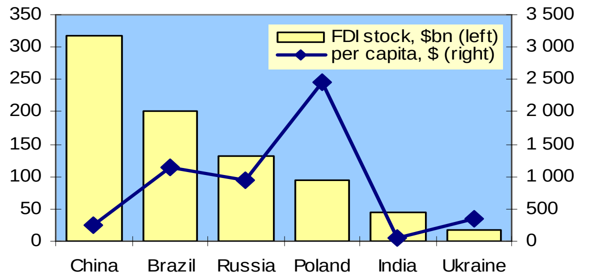
Russia

Russian foreign investment flows nearly in balance. UNCTAD's latest *World Investment Report 2006* put the end-2005 stock of foreign direct investment into Russia at $132 billion and outward FDI stock at $120 billion. Russia accounted for about two-thirds of direct investment in CIS countries last year, even if the flow of investment to Russia fell 6 % y-o-y.

Russia ranked third among the BRIC countries, lagging Brazil and China, but clearly beating out India. The measures should be taken with a grain of salt, however – foreign direct investment figures and accounting methods vary widely among countries and national statistics offices. Rosstat, for example, estimates the total FDI stock in Russia at just $40 billion.

Foreign direct investment stocks as of end-2005



Sources: UNCTAD, IFS

Little change in structure of manufacturing industries. Metal fabrication (22 %), food processing (18 %), and oil products and coke production (12 %) stayed the leading categories among manufacturing industries last year. Other important categories included vehicle manufacture (10 %) and chemical industries (8 %). All the above-mentioned categories, with the exception of food processing, have experienced modest share declines in the 2000s relative to total manufacturing activity. Vehicle manufacture has given about three percentage points since 2000, while the other fields have lost about one percentage point. Among Russia's emerging industries, the electronics and optical equipment manufacture category has seen the largest gain in its relative economic contribution (its overall contribution rose from just 3 % in 2000 to nearly 6 % in 2005). The overall contribution of manufacturing industries to GDP has remained relatively unchanged at 15 % in recent years.

Experts see huge potential in Russian gas industry waste. Russian oil companies still flare off massive amounts of natural gas generated as a by-product of oil production as oil producers have no way to utilise the gas. Gazprom not only controls Russia's gas pipeline grid, it even regulates access of other gas producers to the grid. Official figures for 2005 show Russian oil producers burned off 15 billion cubic metres of natural gas. The IEA, however, estimates flaring losses at four times that. Capturing the burned off gas could increase Russia's annual gas production by nearly 10 %.

Deteriorating gas pipelines are a second major cause of gas losses in Russia. By some estimates, some 10 % of gas transmitted through Gazprom's pipelines is lost. About half of these losses would be eliminated by infrastructure modernisation and operational efficiencies.

Finally, the end-use of Russian gas is inefficient mostly due to cheap gas rates. Raising gas rates and metering at the consumer level would almost certainly make household gas-users more energy conscious. It would also give electrical power generators, who currently account for half of gas use, incentive to modernise their aging electrical power generation capacity.

Big earnings differences among Russian cabinet members. Russian daily *Rossiiskaya Gazeta* has released a survey of the 2005 incomes of Russian cabinet ministers. Natural resources minister Yuri **Trutnev** topped the list, while the basement was shared by economy minister German **Gref** and regional development minister Vladimir **Yakovlev**. Most of Trutnev's nearly $8 million was dividend income from the EKS corporation. Trutnev is the largest owner of the Perm district retailer; a second large shareholder of EKS is Perm district governor Oleg **Chirkunov**. Transportation minister Igor **Levitin** and IT and communications minister Leonid **Reiman** also made most of their money on corporate incomes. For comparison, a Finnish prime minister's salary is about $150,000 a year and a cabinet minister's around $120,000. President Vladimir **Putin's** annual income was not mentioned in the survey, but according to civil service pay scales the Russian president's annual salary is $65,700.

Russian cabinet minister incomes in 2005, US$

Minister	Portfolios held	Income
Yuri **Trutnev**	Natural resources minister	7,900,000
Igor **Levitin**	Transportation minister	446,482
Leonid **Reiman**	IT and communications minister	410,800
Dmitri **Medvedev**	First deputy prime minister	82,714
Mikhail **Fradkov**	Prime minister	69,000
Sergei **Ivanov**	Second deputy prime minister and defence minister	63,000
Alexei **Kudrin**	Finance minister	48,000
German **Gref**	Economy minister	44,000
Vladimir **Yakovlev**	Regional development minister	44,000

Source: Rossiiskaya Gazeta

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China

EU releases new trade and investment guidelines for China. A new EU policy paper finds that the EU has generally benefited from China's economic growth, even if that growth has resulted in tougher international competition. The EU doesn't consider its large trade deficit with China alarming as imports from China have for the most part simply displaced imports from elsewhere in Asia. The EU's trade deficit with all of Asia has remained rather stable for years. The paper further noted that China's opening and integration with the global economy has given European companies opportunities to shift production to China and thereby preserve competitiveness. The EU's main complaint is that European companies often encountered obstacles on their access to Chinese markets. There are still high tariffs on some important EU export products such as automobiles, and Chinese rules often depart from international standards and practices. Moreover, China still forbids the establishment of completely foreign-owned firms in some sectors. Oversight of intellectual property rights remains deficient and China still heavily subsidises its companies in certain sectors.

While the EU, China's largest trading partner, stresses the importance of resolving differences through negotiation, it is not averse to taking matters to the WTO when it gets no traction with the Chinese on issues. Last month, the EU imposed increased tariffs on Chinese leather shoes and filed a complaint with the WTO on Chinese import practices regarding car parts. It was the first complaint against China submitted to the WTO for resolution.

Rural income level only one third of that in urban areas. A National Bureau of Statistics survey finds the average disposable income of city dwellers increased 10 % in real terms this year. Per capita urban average monthly incomes in January-September were 980 yuan or about 100 euro. Wages accounted for three-quarters of an average city-dweller income, with most of the remainder coming from income transfers. While the amount of capital income has risen rapidly, its share of total income remains modest.

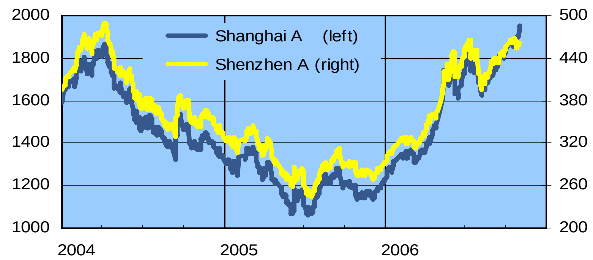
Although rural cash incomes were up over 11 % in January-September, average monthly incomes per capita were just 280 yuan or about 30 euro. The main sources of rural incomes were sale of agricultural products (43 % of all incomes) and wages paid to farmers (34 %). Wage incomes from the service sector, industry and construction, together with income transfers and property incomes, accounted for a quarter of an average rural income.

Although lower price levels in the countryside somewhat compensate by reducing differences in purchasing power, the widening income disparities has become a major topic of discussion in China. The United Nations has warned of the dangers from allowing further growth in China's income discrepancies. China's Gini index, which the UN uses as an indicator of income disparity, has risen to 0.45 – a level widely held to be the trigger threshold for social unrest.

Chinese share prices headed up. After a decline in July and August, share prices have risen sharply. The Shanghai and Shenzhen A-share indices are now up more than 50 % since the start of the year. Some comments say the summer slump simply reflected market fears the supply of shares on the market was expanding too fast in the wake of a spate of large IPOs at the start of the summer, when a moratorium on new listing was lifted. On the other hand, investor confidence has been bolstered as the ongoing process of converting non-tradable state shares to tradable shares launched last year is reaching completion. At the start of October, over 90 % of listed companies had completed their share conversions. The conversion has increased market transparency. In addition, several foreign institutional investors have this year been granted permits to invest in Chinese stock markets.

Commercial banking giant *Industrial and Commercial Bank of China* successfully completed the world's largest IPO last week. On Wednesday (Nov. 1), ICBC shares of were up from their initial trading price 5 % in Shanghai and 14 % in Hong Kong. Much of the share price increase occurred in the first day of trading.

Chinese share prices, A-share indices



Sources: Bloomberg, Bank of Finland

China tightens laws on money laundering and corruption. China's regulations against money laundering are presently aimed at discouraging transactions related to drug dealing, organised crime, terrorism and smuggling. The new law approved this week expands the range of criminalised money-laundering activities to include various forms of corruption and bribery. The law requires financial institutions to carefully identify customers' activities and report large, suspect money transfers. The *People's Bank of China* has been given the authority to investigate suspicious cases. Chinese observers say the new rules are a response to booming white-collar crime.

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Russia

Russian inflation slowed further in October. Russian 12-month inflation declined to 9.2 % in October. *Food* prices rose less than 9 % y-o-y, which helped to restrain the overall rise in consumer prices. Within the foods category, seasonal prices for fruits and vegetables showed an on-month decline in October. Sugar prices were also lower than in September. Prices for *other goods* were up 6 % y-o-y. In the other goods category, the price of gasoline, which climbed sharply past months, declined slightly month-on-month. The on-year rise in prices of *services* slowed to 14 %.

Food items make up over 40 % of Russia's consumer price index and have a significant impact on inflation. The largest weighting is given to meat products, alcoholic beverages, and fruits and vegetables. About a third of the CPI consists of items in the other goods category, notably clothing, textiles, footwear and passenger cars. Services account for about a quarter of the CPI.

CBR publishes next year's monetary policy guidelines. The Central Bank of Russia stated that the main principles of monetary policy applied in previous years will remain in place in 2007. The CBR's 2007 consumer price inflation target range will be 6.5–8 %, a half-percentage-point shift from this year's target of 7–8.5 %. The CBR only cautiously touched the issue of the real effective appreciation of the rouble, forecasting strengthening in the range of 0–10 % depending on economic developments and its success in holding down inflation. Four scenarios of economic development, each using different assumptions for the price of Urals crude oil ($45–85 per barrel), were considered in developing the monetary policy strategy. The four scenarios see 2007 GDP growth coming in at somewhere between 5–6.6 %, growth in fixed investment in the range of 9–12 % and growth in real disposable incomes on the order of 9–11 %.

IMF board's Article IV concluding statement focuses on fiscal policy and inflation fighting. Released last Monday (Nov. 6), the IMF executive board's statement on Russia's Article IV consultation in June warned that Russia should refrain from further fiscal relaxation. In the monetary sphere, the inflation target should be given a clear priority and allow wider fluctuation in the rouble's nominal exchange rate. The statement noted that structural reforms have proceeded slowly, and that there is a pressing need to speed up reforms of natural resource monopolies, and public administration. The IMF also presented its concern over the impact of increased state ownership on development of the oil sector, and stresses the importance of strengthening the investment climate to sustain economic growth. While Russia's banking sector is noted to have strengthened, the need for vigilant banking supervision has not diminished. Concern was also raised that favourable economic development could obscure weaknesses in the banking sector that would be exposed suddenly in the event of a major drop in oil prices.

Third reading of new Forest Code sails through Duma. After years of processing, the Code had its first Duma reading in April 2005. After that, progress met with difficulties over such issues as private ownership of forests. With this week's Duma approval, the Code now only needs to be approved by the Federation Council and a presidential signature to become law. While bill proponents would like to see the code in force from the start of 2007, many observers consider this timetable hasty, noting that application of the Forest Code requires approval of a mass of other legislation.

The new code implies a deep decentralisation of the forestry sector and, for the first time in Russian forestry history, the transfer to regional officials of control over forest management, use of forest resources, sylviculture and forest protection. The federal government will continue to set forest policy, perform forest inventories, and be responsible for satellite monitoring of forest fires, illegal cutting and phytosanitary damage. Federal authorities will also be charged with seed production, research and training.

Forests would continue to be owned by the federal government. Forest tracts would be leased solely for wood-cutting purposes and each tract would have to be acquired through open auction. The maximum lease period would be 49 years (compared to 99 years in the current code and the version approved in the first reading). Leases made under the old code will have to be renewed when the new code enters into force. New lease contracts will make the lessee responsible for forest cultivation. Rights attaching to the leased tract would transferable to third parties, e.g. the tract can be subleased or used as collateral.

Nordea buys majority stake in Orgresbank. Nordea, the largest bank in the Nordic region, has purchased for €246 million just over 75 % ownership in the Russian Orgresbank. The remaining quarter of Orgresbank shares will be distributed among previous owners and the European Bank for Reconstruction and Development. The deal still requires official approval before it goes through.

Orgresbank is a mid-sized bank specialised in serving small and medium-sized businesses. Nordea claims Orgresbank ranks among Russia's 50 largest banks by international accounting standards. Most of its branches are in Moscow and St. Petersburg, but it also has branches in the Volga Federal District, including the cities of Samara and Penza. Nordea would like to see the number of Orgresbank branches increased in Moscow, as well as in other growth centres. International credit rating agency Fitch gives Orgresbank a modest rating of B- and RusRating BB-, which put the bank in the mid-range of those few Russian banks that have credit ratings.

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China

China continues to tighten monetary policy. China's central bank has raised the minimum reserve requirement for commercial banks a half percentage point to 9 % of deposits. It was the third hike in the reserve requirement this year. Certain troubled banks, including the *Bank of Agriculture*, will be required to keep minimum reserves of 9.5 %. The new reserve requirement goes into force on November 15, and the hike is expected to siphon 150 billion yuan (€15bn) in liquidity from the market.

Monetary policy has recently been geared to putting the brakes on money supply and investment growth. The tightening measures seem to be getting results as growth in the broad money supply slipped to 16.8 % y-o-y at end-September. The 2006 M2 growth target set by the People's Bank of China is 16 %. Investment growth also seems to be losing steam, despite persistent high growth in the real estate sector – an area where China has redoubled its efforts to control growth. Premier **Wen** Jiabao last month gave assurances that China would continue with monetary tightening even if third-quarter figures suggest economic growth is slowing slightly.

Foreign currency reserves break trillion-dollar mark. Several newspapers have reported that the value of China's foreign currency and gold reserves surpassed $1 trillion at the end of October. As of end-December 2005, the central bank's currency reserves stood at $820 billion. China overtook Japan, the previous world leader in piling up reserves, at the end of February 2006. The growth in reserves has been stoked largely by China's huge trade surpluses and foreign direct investment. Speculative currency flows into China on the expectation of a sudden yuan revaluation seem to have abated in recent months. The composition of China's foreign currency reserves is secret, but it is generally believed that dollar investments account for the lion's share of reserve assets. In recent years, China has started to diversify more its currency holdings to other currencies.

China-Africa summit showcases China's Africa agenda. Nearly all African heads of state attended last week's China-Africa summit in Beijing. At the summit, China announced plans to invest a total of $5 billion in African countries by 2009 and double its development aid spending on the continent. China also committed to broaden the number of duty-exempt products from Africa, debt forgiveness for the poorest African countries and special training for 15,000 professionals from Africa countries. Finally, Chinese leaders pledged to offer Chinese trade with African countries has grown rapidly in recent years. The value of China-Africa trade last year was $40 billion. China mainly imports raw materials from Africa. About a third of China's crude oil imports come from Africa, and Angola this year became China's largest oil supplier. China is currently negotiating the creation of a free-trade area with the Southern African Customs Union.

China shifting to liquefied natural gas. To secure adequate energy supplies for economic growth while reducing fossil fuel emissions, China plans to substantially increase the role of natural gas in total energy supply from its current level of 3 %. The shift will require a massive growth in gas imports as China's domestic production is insufficient to cover the burgeoning demand for natural gas.

Despite a structural "buy high-sell low" predicament (world prices for natural gas are high, but Chinese suppliers must sell to the domestic market at low regulated prices), China's third largest oil and gas company CNOOC seems eager to move ahead into an LNG-rich future through the securing of major import contracts. At the end of last October, CNOOC announced it had agreed with the Malaysian *Petronas* on a 25-year LNG import deal worth $25 billion. In the last two months, CNOOC has also announced framework agreements with four other LNG suppliers. The company's first LNG shipment from Australia arrived at its Guangdong terminal in May. In addition to the Guangdong terminal, CNOOC has LNG offloading facilities in the Fujian province and is planning construction of five more terminals. China's two largest oil companies, *Sinopec* and *PetroChina*, are also planning LNG imports and are making the necessary port facility investments.

Corruption remains a huge problem in China. *Transparency International* 2006 Corruption Perception Index ranks China in 70th place. Despite a modest improvement from 78th place last year, TI is still worried about the ubiquity of Chinese corruption. This year's survey covered a total of 163 countries using data gathered in 2005 and 2006. The report crowns Iceland, Finland and New Zealand with the titles of least corrupt countries, while Hong Kong placed 15th and Macao 26th. Russia rose slightly in the rankings to 121st place.

A number of major corruption scandals have taken place in China this year, including last summer's revelation of embezzlement of Shanghai pension fund assets. The national audit office of China reported in the first half of 2006 nearly a hundred major embezzlement and fraud cases, involving losses totalling 32 billion yuan (€3.2bn). China ratified the UN anti-corruption treaty at the end of 2005.

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Russia

Robust foreign trade growth continues in Russia. The Central Bank of Russia reports that the value of Russian goods exports in January-September was $224 billion and that the value of imported goods was $112 billion. Both exports and imports were up 28 % from a year earlier in value terms. The growth in exports, however, slowed in the third quarter, while the growth in imports accelerated slightly. The trade surplus also rose in the first nine months of the year by 28 %, and amounted to $112 billion for the period.

Russian Customs said the value of crude oil exports to non-CIS countries climbed 31 % in January-September, while the value of natural gas exports soared 41 %. The volume of crude oil exports fell 1 %; the volume of natural gas exports remained unchanged. The volumes of crude oil and natural gas exports to CIS countries fell 18 % and 29 % y-o-y, respectively. The value of crude oil exports increased 11 %, while the value of natural gas exports was worth 2.4 times more. The average export price of natural gas to CIS countries rose from $52 per 1,000 cubic metres a year ago to $174. Passenger cars, the largest import product group, represented nearly 10 % of all imports.

Russian metal producers launch IPOs on the London stock exchange. The world's number-two steel pipe manufacturer, the Russian *TMK*, held a successful initial public offering on the London stock exchange at the end of October. The offering, which consisted of 23 % of TMK shares, sold out quickly. TMK got its top asking price of $5.40 and raised about one billion dollars.

The London listing of *Chelyabinsk Zinc* was also heavily subscribed. Taking advantage of a doubling in world zinc prices this year, the company offered more shares than originally planned (33 %) and sold them at prices above their target range. The IPO raised $336 million. Chelyabinsk Zinc accounts for about 2 % of the world zinc production.

In contrast, the London IPO of Russia's third largest steelmaker *Severstal* was less successful. The company managed to offload only about 9 % of its shares instead of the expected 15 %. Severstal raised just over one billion dollars from the IPO. About 10 % of Severstal shares were already freely traded in the Russian Trading System (RTS). The remaining shares are held by Alexei **Mordashov**, Severstal's CEO. The price of Severstal shares, which listed at $12.50, went into decline in early trading. Even so, a number of other Russian metal producers are still considering their own IPOs.

NATO says Russia attempting to establish an international gas cartel. Some press reports claim NATO experts are privately warning member countries that Russia is trying to set up a cartel of major natural gas producers along the lines of OPEC. The speculation is that a global gas cartel would at minimum include Algeria, Qatar, Libya, gas-producing CIS countries and possibly Iran. If the claim has credence and the cartel is formed, it would control about half of the world's gas reserves and a third of world gas production. Many experts, however, doubt the effectiveness of a natural gas cartel. There is no world price of natural gas; gas trading is based on long-term export contracts. Gas is not as readily shipped as oil and is a harder industry for export competition. Companies seeking to export gas are generally at the mercy of whoever owns the gas pipelines.

Plenty of room for improving economic freedom in Russia and China. The Canadian Fraser Institute's annual survey of economic freedom uses an index comprising a number of key figures and survey responses. Among factors that can limit economic freedom are an overly large role of the state in the economy, high inflation, heavy tariffs and other barriers to foreign trade.

The survey, which was based on the 2004 data, ranked *Russia* this year at 102 out of 130 counties surveyed. The score put Russian at a level of Nigeria and Cameroon. Russian economic freedom was particularly limited by problems with the judicial system, the length of mandatory military service and price regulation. Factors promoting economic freedom included the low levels of income taxes and minimum wages. Russia's economic freedom has slightly increased during the past decade. In 1995, Russia was in 116th place out of 122 countries.

China ranked 95th this year, which was on par with Romania and Pakistan. Among the most important factors limiting economic freedom in China were regulation of prices, interest rates and exchange rates, heavy bureaucracy, as well as a lack of diversity in the banking sector. China got high marks for low inflation and extensive involvement in foreign trade. In 1995, China ranked 88th. The Fraser index rated *Hong Kong* the most economically free country in the world in both 1995 and 2004.

Fraser Institute economic freedom rankings

	1995	2004
Countries		
Total surveyed	122	130
Hong Kong	1	1
India	75	53
China	88	95
Russia	116	102
Ukraine	123	111

Source: Fraser Institute

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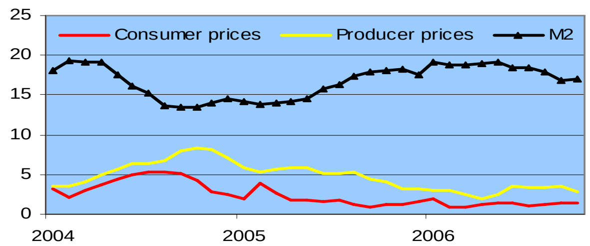
China

Stable price development in China; money supply growth accelerates slightly. China's National Bureau of Statistics reports consumer prices were up 1.4 % y-o-y in October. The largest price increases, 5 % y-o-y, were seen in housing-related costs such as interior decoration materials and municipal services. Prices of vegetables and clothing declined. Large hikes in fuel prices last summer have had surprisingly little impact on the consumer price index, and inflation is expected to remain modest in the coming months. Producer prices in October rose 2.9 % y-o-y. The rise in producer prices was moderated by falling steel prices.

The broad measure of money supply (M2) was up 17.1 % y-o-y as of end-October. Money supply growth in the economy accelerated slightly as at the end of September it was 16.8 %. Even so, the increase was lower than in the early months of this year, when M2 growth was around 19 % y-o-y. The overall M2 growth target of the People's Bank of China, which has had a tighter monetary stance since April, is 16 %. Last month, the PBoC decided to raise the reserve requirement for commercial banks by a half percentage point. The increase entered into force this week.

12-month change in prices and broad money supply (M2), %



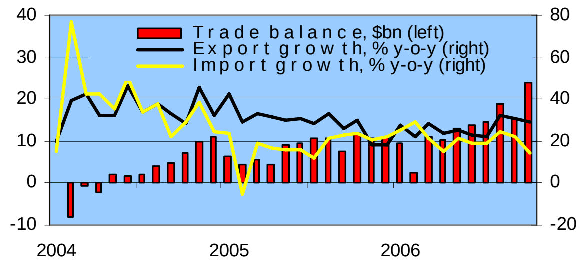
Sources: People's Bank of China and National Bureau of Statistics

China posts record trade surplus in October. China Customs reports the country's foreign trade surplus was $24 billion for October. Last month's surplus reflects a widening gap from continuing fast growth in exports (up 30 % y-o-y) and slowing import growth (15 % y-o-y). China's trade surplus for the first ten months of 2006 was $134 billion. Hefty monthly surpluses are expected for both November and December. The 2005 surplus was $102 billion. China top three trade partners this year continue to be the EU, the US and Japan.

Ma Kain, head of China's influential National Development and Reform Commission, said China must reduce its trade surplus. The NDRC imposed temporary additional export tariffs on 110 products, with tariff levels varying from 5 % to 27 %. Officials also cut import tariffs on 58 products.

It now appears the incoming US Congress will consider measures to reduce the United States' trade deficit with China. A bill that is still in committee would allow the US to implement measures against any country with "currency misalignments." On the other hand, US trade secretary Carlos **Gutierrez**, admits the US should not rely on punitive legislation to reduce its trade deficit with China.

Chinese foreign trade, monthly figures



Source: China customs

Energy and raw materials dominate Chinese-Russian economic cooperation. Chinese and Russian joint energy projects have had a higher profile recently with Russian plans to boost energy supplies to China. The Russian state-majority-owned Rosneft and the China National Petroleum Company (CNPC) last week announced their intent to build an oil refinery in China with an annual capacity of about 10 million tonnes. The partners had earlier revealed plans to establish a chain of 300 gas stations in China. In June, the CNPC became a stakeholder in Rosneft with the purchase of $500 million Rosneft shares.

Other commodities besides energy are also playing major roles in China-Russia economic cooperation. At an investment forum held in Beijing at the beginning of November, Russia and China signed ten cooperation agreements worth a total of $1.4 billion. The largest deals in terms of value were development of iron deposits in the Chita Region of the Siberia Federal District ($494 million), a wood processing plant ($107 million) and a $500 million credit line from China's State Development Bank to Vnesheconombank.

Economic cooperation between China and Russia has been hampered in practice by various problems, which has led to the abandonment of many agreed investment projects. According to Victor **Ishayev**, governor of Russia's Khabarovsk Region, Russia and China agreed a couple of years ago on 13 investment projects in the region worth $800 million. Of these projects, only five have been implemented and their combined value remains at just a few million dollars.

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Russia

Duma moves ahead on 2007 budget and 2006 supplemental budget. The Duma approved the third reading of next year's budget act with no substantial changes. The main alterations affected transfers between certain spending categories. The proposed budget assumes the average price of Urals crude oil next year will be $61 a barrel. Revenues are estimated at 22 % of GDP ($263bn) and expenditures at 18 % of GDP ($312bn). The projected surplus would correspond to 4.8 % of GDP ($57bn). The fourth and final reading of the 2007 budget is set for today (Nov. 24).

The Duma also approved at the beginning of this month the first reading of a supplemental budget for this year. Revenues this year have been running substantially above the original budget thanks to high energy prices. In the supplemental budget, revenues are up 22 % and spending 4 %. The surplus is projected to increase by about a quarter and correspond to 6.4 % of GDP. Most of the increased spending will go to transfers to regions (27 %), defence (15 %) and spending on "national economy," which includes infrastructure (13 %). The Duma is expected to complete passage of the amendments by early December.

United States removes last major hurdle to Russia's WTO membership. At last week's APEC summit in Hanoi, Russia and the US signed a bilateral agreement on Russia's WTO membership. Russia will allow the import of US meats, which safety is guaranteed by US officials. In the finance sector, it was agreed that branch offices of insurance companies will be allowed after a nine-year transition period from the moment Russian joins the WTO. Foreign banks, however, are still not permitted to establish branch offices in Russia. Russia will also reserve the right to restrict overall foreign ownership in the financial sector to 50 %. Russian import duties on food products and industrial products will be lowered an average of three percentage points. The most significant reductions affect passenger cars, electronics and technology products.

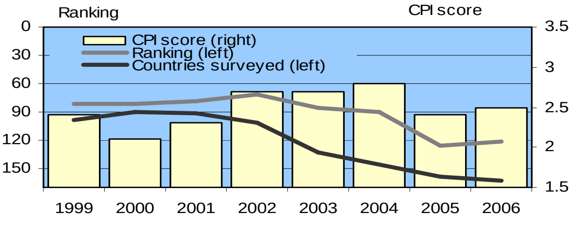
The economy ministry reports Russia has now completed all of its bilateral WTO talks with willing parties. Only Moldova and Costa Rica have yet to sign accession agreements with Russia. In addition, Georgia continues to raise the question of illegal customs points in Abkhazia and South Ossetia. Once all bilateral agreements are signed, Russia still face a process of multilateral talks before it can gain final membership. Economy minister German **Gref** noted that, while Russia would like to see membership by next summer, the ultimate duration of remaining negotiations is difficult to forecast.

S&P sees slight improvement in bank transparency. *Standard & Poor's* has released its second analysis of bank transparency in Russia. The survey covers Russia's major banks, examining information availability for investors and customers (e.g. ownership, financial structure and operations). S&P's findings suggest that the largest Russian banks typically release only about half the relevant data, while Russia's global peers release about 80 % of such data. The transparency of Russian banks overall has seen only slight improvement in the past year, although the availability of information on bank ownership structures has increased substantially. Information on management compensation arrangements is still lacking. The leading banks in terms of openness are private but the largest state banks also ranked high. The study also showed that the ownership structure of Russia's banking sector is still highly concentrated and that the state has reasserted its ownership presence in the banking sector.

Norilsk Nickel buys large nickel unit in Finland. Norilsk Nickel, the world's largest nickel producer, has purchased the nickel refining operations of the US-owned OM Group for €318 million. The largest part of OMG's nickel operations is the Harjavalta nickel smelter in Finland. Norilsk Nickel accounts for 19 % world nickel production. Analysts say the acquisition will bolster the company's refining activities and international competitiveness. The purchase of OMG's Finnish nickel unit is one of the largest corporate acquisitions ever by a Russian company in Finland.

Russian corruption still at 1999 level. *Transparency International's* annual Corruption Perceptions Index (CPI) continues to find evidence of deep-seated corruption in Russia. Russia had a CPI value of 2.5 on a scale of 0–10, with 10 signifying a highly clean nation. Russia this year ranked 121st out of 163 countries surveyed, along with the Philippines, Nepal and Rwanda. Corruption indicators from other research institutions corroborate TI's finding that Russian corruption has been on the rise in recent years. The nature of Russian corruption also seems to be changing; the amounts and risk premia have increased, while everyday bribery has apparently decreased slightly. Russia's Prosecutor General's Office estimates that the total value of bribes accepted last year in Russia reached $240 billion. Only 3,600 bribery cases, however, were prosecuted last year. All cases focused on the bribe-giver; no bribe-takers were charged.

Russia's CPI rankings and scores, 1999–2006, (10 = highly clean, 0 = highly corrupt)



Source: Transparency International

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China

Hu's visit to India yields modest results. This week's visit to India by China's president **Hu** Jintao was the first visit by a Chinese head of state in a decade. Discussions between president Hu and Indian prime minister Manmohan **Singh** focused on the importance of bilateral efforts to support a multipolar world and the emergence of both countries as major players internationally. The dozen-plus cooperation agreements signed during the visit are seen to have only minor significance.

The fact that the visit yielded so little results speaks volumes about tensions between the two countries. The troubles date back to a 1962 border war in which China prevailed. Although the countries last year signed a treaty on the Sikkim border dispute, India still demands China return an area near Kashmir almost as big as Switzerland. On the other hand, China claims that India rules an area of Chinese territory two times larger in the eastern Arunaschal Pradesh state. Other matters scraping on relations between China and India include China's friendly relations with India's archenemy Pakistan; India's support for the Tibetan expatriate and spiritual leader, the Dalai Lama; improved relations between India and the US; and the fact that China does not support India's efforts to become a permanent member on the UN Security Council. Although both countries speak for a multipolar international system, India is afraid that China wants to dominate Asia.

The political problems also reflect economic relations and a lack of progress in free-trade talks. Although the visit highlighted the rapid growth in trade, the value of bilateral trade of nearly $20 billion only corresponds to about 3 % of China's total foreign trade this year. (China accounts for about 7 % of India's foreign trade). India is also dissatisfied with the structure of trade; it mainly exports raw materials to China and imports industrial products. The lack of trust between the two countries further reflects the low level of investment between the two countries. China and India, however, recently entered into cooperation deals to acquire foreign oil assets.

Slight slowing in investment and industrial output growth. Fixed capital investment in January-October was up 27 % from the same period a year earlier. Although the National Bureau of Statistics only publishes cumulative figures from the start of the year, it is evident that the pace of investment over the last couple months has been substantially lower than at the start of the year. The highest investment growth was registered in railways, which saw investments more than double from the first ten months of 2005. On-year growth in industrial output in January-October was 17 %, although it dropped off a couple of percentage points in October from the pace early in the year. The slight drop in growth in industrial output and investment was offset by a slight pick-up in growth in retail sales in January-October to 14 % y-o-y.

China's banking sector opens up. China's WTO commitments included opening up access to its banking sector. Last week the State Council issued new banking regulations that will enter into force on December 11. Under the new rules, foreign banks can offer broader yuan-based services and issue credit cards. Banks will also be released from geographical limitations. Foreign banks will have to establish a bank in China with a minimum registered capital of at least one billion yuan (€100m) and an additional 100 million yuan (€10m) for each branch office. Foreign banks will also be allowed to grant loans worth up to 75 % of their deposits. The old rule that banks must first operate in China for a minimum of three years with the two most recent years profitable before they can offer yuan services will remain in place. Thus the new rules will continue to limit foreign banks' operations in China. Nevertheless, the changes were generally what foreign banks and observers had expected. At the end of last year, 70 foreign banks had operating branches in China.

Citigroup consortium purchases majority stake in Chinese bank. A consortium of investors led by US-based *Citigroup* has acquired an 86 % stake in the Southern Chinese *Guangdong Development Bank* for 24 billion yuan (€2.4bn). Citigroup's share is 20 %, the largest individual foreign ownership share of a Chinese bank allowed under current law. The Citigroup consortium includes four major Chinese corporations. In addition, the US computer services giant IBM purchased a 5 % stake. Foreign investors can collectively own no more than 25 % of a Chinese bank. The ownership restriction rules only cover banks controlled by Chinese, and new banking sector rules do not change the situation. Citigroup is the only member of the banking sector in the consortium; the other participants in the deal are expected to merely participate as investors. It was the first time a foreign investor consortium sought a majority stake in a Chinese bank. The deal had been awaiting official approval for 18 months. The original bidding competition included a consortium led by the French *Société Générale*.

Guangdong Development Bank, which maintains about 500 branch offices located mostly in Southern China, has about 12,000 employees and estimated net assets of $48 billion. The bank is said to be in very poor condition. Nonperforming loans represented 22 % of the bank's total lending at the end of 2003. Citigroup sees the existence of a branch office network as an advantage for foreign investors, since establishing new branch offices is quite costly and time consuming.

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Russia

Russia's GDP growth accelerates. October saw growth slow in just one (*transportation*) of Russia's five core production sectors. Instead growth accelerated in *construction* (13.2 % y-o-y), *retail sales* (12.5 %), *industrial output* (4.3 %) and *agricultural output (*1.3 %). Growth in *transportation* in January-October increased 2.5 %. Russia's economy ministry figures show on-year GDP growth in the first ten months of this year was 6.8 % compared to the same period a year earlier. The economy ministry's official projection of 6.6 % for this year matches the consensus forecast released by the Russian *Tsentr Razvitiya* in September. However, Russian economic growth has been running above forecast for the last three months, leading several forecasters to revise their growth outlook for Russia upwards for the year overall.

Grain harvest nearly matches 2005 level. Rosstat reports the net dry weight of this year's harvest reached 76 million tonnes (78 million tonnes in 2005), or nearly 6 million tonnes above the agriculture ministry's initial forecast last June. Russia's grain harvest has averaged 77 million tonnes annually during the past six years.

EU and Russia agree on Siberian overflight fees. At last week's EU-Russia summit in Helsinki, the European Union and Russia finally came together on the long-disputed issue of extra fees charged by Russia to European airlines of Siberian overflight. Under the deal, Russia can retain the current fee regime until 2010, after which the fees must be phased out incrementally through 2013, when they will be eliminated. The ending of fees should substantially increase the competitiveness of European carriers flying to Asian destinations. European carriers will pay Russia about €250 million this year in overflight fees.

The summit did not manage to start the negotiations of a new Partnership and Cooperation Agreement (PCA) as Poland used its veto power to table the discussion. Poland is currently in a feud over meat exports to Russia. The new PCA would replace the 1997 PCA that expires next autumn.

In connection to the Summit an updated Northern Dimension programme was agreed on to by EU, Russia, Norway and Iceland. The new programme replaces the initial ND programme agreed up on 1999. New action plans were announced for the environment, healthcare and social services, as well as the four "common spaces" which cover economic integration, justice and internal matters, security, and research, education and culture. In addition, the parties looked into possibilities to start a partnership on transportation and logistics and increased cooperation in energy matters.

CIS president summit yields few overall results; focus on bilateral discussions. Major decisions on reforms were again postponed at Tuesday's (Nov. 28) summit of Commonwealth of Independent States presidents in Minsk. Even so, CIS Commission chairman Vladimir **Rushailo** said the presidents did engage in productive discussions that included illegal immigration and fighting terrorism. Moldova president Vladimir **Voronin** praised the Commonwealth for its ability to deal with complicated problems and proposed the creation of a CIS free-trade area.

According to several heads of state, the loose alliance of twelve former Soviet states, which celebrates its 15th anniversary this month, is in dire need of reform. For example, Ukraine has consistently avoided multilateral projects, favouring instead bilateral agreements, because it sees national interests of CIS members at odds. Ukraine president Viktor **Yushchenko** nevertheless considers the CIS a good forum for diplomacy. Work on reforming the organisation has now been pushed back to June 2007. Reform is most needed to ease cross-border finance, movement of goods and services, as well as harmonisation of customs rules and legislation.

OECD sees oil prices and structural reform as the largest challenges facing Russia. According to the OECD economic survey of Russia released Monday (Nov. 27), Russia needs to take into account the possibility of sustained high oil prices. The survey emphasizes disciplined fiscal policy as the primary tool in dealing with the dangers created by high oil prices, i.e. real appreciation of the rouble's exchange rate and inflationary pressures. As a practical tool of fiscal policy, the OECD mentioned the stabilisation fund, but noted that further regulatory changes and clarifications in legislation related to it are needed. Proposals included, e.g. the placement of all windfall revenues related to oil and gas in the stabilisation fund and a recommendation that the fund's minimum reserve be raised from the current 500 billion roubles.

The OECD also stressed the importance of structural reform in promoting sustainable economic growth, and noted that the pace of reform has slowed sharply since 2004. Public administration, innovation policy and healthcare were specifically mentioned as areas needing reform. The OECD expressed concern with increased state ownership in strategic sectors of the Russian economy as an excessive state presence often reduces economic efficiency and increases corruption. Russia's thick bureaucracy was broadly cited as one of the worst obstacles to investment in Russia. The OECD recommended making the use of public resources in innovation policy more effective and supporting private R&D activities through tax breaks, but noted targeted initiatives such as creating special economic zones and technology centres should be used with caution. Russia should limit free health services where there is a realistic chance that the services can actually be rendered and should employ more cost-effective treatment strategies.

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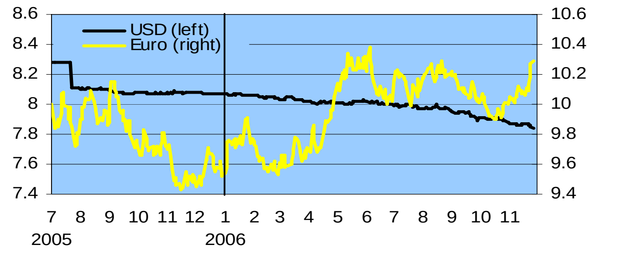
China

Yuan strengthens further against the dollar. The ongoing weakening of the US dollar in recent weeks against other major currencies has motivated the People's Bank of China to allow faster appreciation against the dollar. Nevertheless, daily fluctuations in the yuan-dollar rate have remained well within the permitted daily variation range of ± 0.3 %. On Friday (Dec. 1), one dollar bought 7.83 yuan. Thus, since the 2.1 % revaluation of the yuan in July 2005, the yuan has appreciated an additional 3.6 %. In spite of its appreciation against the dollar, the yuan has lost value against the soaring euro in recent weeks, which has boosted China's price competitiveness against its largest trading partner, the EU.

China's foreign trade surplus in January-October hit a record $134 billion. The country's foreign currency reserves exceeded $1 trillion as of end-October. Because the lion's share of reserves is apparently invested in dollars, the dollar's decline and the yuan's appreciation might imply large losses for the PBoC. Indeed, one of the factors driving down the dollar is said to be the fear among international investors that China will seek to reduce its dollar exposure faster than earlier. However, China for some time has been in the process of shifting part of its foreign currency holdings into other major currencies than dollars and there is no hard evidence that its investment strategy has actually changed much in recent weeks.

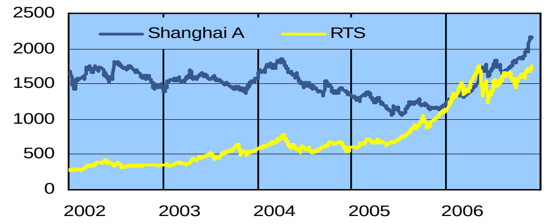
Exchange rate trends: yuan-dollar and yuan-euro, 2005–2006



Sources: Reuters, Bank of Finland

Stocks hit record highs. Shanghai's A-share index has risen more than 70 % since the start of the year, surpassing in November its previous high set in 2000. Underlying soaring share prices are a number of economic reforms that include the conversion of nontradable state shares into tradable public shares and the listings of several giant enterprises. In addition, pension fund investment in exchange-traded shares has increased and China has granted to foreign institutional investors larger A-share investment quotas. Insurance funds are also being encouraged to invest in stocks. Most insurers have yet to take full advantage of the rule that allows them to invest up to 5 % of their assets in shares. Share price movements on the Shanghai and the Shenzhen exchanges have long closely tracked each other.

Shanghai A-share index and Moscow RTS index



Sources: Bloomberg and RTS

China considers raising retirement age. Chinese officials are considering lifting the retirement age to prepare the country for an ageing population and reduce underfunding problems with the national pension fund. The official retirement age is currently 60 years for most men and 55 years for most women. The working population is expected to peak in about five years, so that by 2020 persons 60 years and older will comprise 17 % of the population. Several international bodies, including the OECD and IMF, have long recommended that China raise its retirement age. China's central bank governor **Zhou** Xiaochuan also last month demanded rapid pension reform.

Despite China's massive labour force, only about 200 million people are covered by the pension system. Last year, pensions were paid out to about a fifth of people in retirement age, i.e. about 40 million people. The pension fund presently has assets of about two trillion yuan (€200bn), and by some estimates is underfunded by 800 billion yuan. China's pension assets correspond to a mere 5–7 % of GDP, compared to 33 % for Korea and 50 % for Japan. A large share of fund assets is held in low-yield accounts in Chinese banks. Most of the remainder is invested in domestic bonds or shares. The national pension fund this year was granted permission to invest up to 20 % of assets in foreign securities. This week, the fund's trustees designated ten foreign fund managers to oversee the investment of over one billion dollars in foreign bonds and shares. Railway construction has also recently emerged as another investment option.

Misappropriation of pension assets has been widespread in China, resulting in the loss of billions of yuan. The huge embezzlement of pension monies in Shanghai revealed last summer has led to the sacking of a number of high-level officials. Investigation of the embezzlement is still under way and officials are preparing new regulations to improve oversight and management of pension assets.

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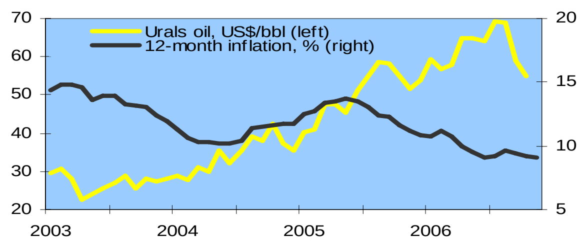
Russia

Falling oil prices help control Russian inflation. Russia currently has few options for neutralising impacts from the massive liquidity flows generated by oil and gas export earnings. Most liquidity has been channelled to the central bank's foreign exchange reserves and the national stabilisation fund. At the beginning of November, the CBR's foreign exchange reserves stood at $273 billion (32 % of GDP), the world's third largest reserves after China and Japan. As of end-November, the assets in the stabilisation fund stood at a record $83 billion (9 % of GDP) – despite Russia's use of fund money last August for early final repayment of its Paris Club debts. The rapid rise in world commodity prices in recent years has been manifested by real appreciation of the rouble and high inflation.

The fall in world oil prices since July has relieved appreciation pressures on the rouble, giving hope to government efforts to get inflation under control. Russia's present monetary policy must tolerate higher inflation as a consequence of efforts to hold the rouble's nominal exchange rate steady. Russia's 12-month inflation was running at 9 % in November, driven e.g. by a persistent rise in prices of services (up 14 %). Foodstuffs were up 9 % y-o-y, while prices of other goods rose 6 %. The shift in oil prices has helped bring inflation down to the government's 9 % target value for the first time this year. Lower inflation can also be seen in the rouble's effective (i.e. trade-weighted) real exchange rate, which strengthened in January-October 9.8 % y-o-y. Rouble appreciation has slowed slightly from last spring.

Price of Urals oil, Russian on-year inflation (2003–2006)



Sources: Russian economy ministry and Rosstat

Duma approves 2007 federal budget bill. At the end of November, a clear majority of Duma deputies voted to approve the fourth and final reading of next year's budget. The budget bill still requires approval from the Federation Council and a presidential signature to become law.

The budget assumes the price of Urals-grade crude oil will next year average $61 a barrel (40$ in 2006), an inflation rate of 6.5–8 % (7–8.5 %) and an average exchange rate of 26.5 roubles to the dollar (28.6 roubles). Revenues from natural resources fees and export tariffs related to oil are to be placed in the stabilisation fund when the Urals crude price exceeds $27 per barrel. Thus, the threshold price will stay the same as this year. In the new budget revenues rose by 13 % in nominal terms and expenditures by nearly a quarter compared to the 2006 budget, corrected by the 2006 supplemental budget passed in November.

Structurally, the 2007 budget resembles the 2006 budget with just a few exceptions. VAT revenues should rise next year, while revenues from natural resource fees and export and import tariffs are expected to decline. All of the main spending categories, with the exception of social policy, will see nominal increases of 20–40 % compared to this year's adjusted budget. Some 75 % of spending will go to transfers to regions, defence, general administration and security.

Russian 2007 federal budget*

	2007*, RUB bn	2007*, % of GDP	2007*, %
Revenues	**6,965.3**	**22.3**	**100.0**
Total, excluding social tax	6,596.5	21.1	94.7
VAT	2,071.8	6.6	29.7
Profit tax	580.4	1.9	8.3
Excise taxes	106.3	0.3	1.5
Natural resource fees	1,069.0	3.4	15.3
Export and import tariffs	2,393.2	7.7	34.4
Other revenues	744.6	2.4	10.7
Expenditures	**5,463.5**	**17.5**	**100.0**
Total, excluding social tax	5,094.7	16.3	93.2
General administration	808.2	2.6	14.8
Defence	822.0	2.6	15.0
Security	662.9	2.1	12.1
Production, transport, etc.	497.2	1.6	9.1
Housing	53.0	0.2	1.0
Education	277.9	0.9	5.1
Healthcare	206.4	0.7	3.8
Social policy	215.6	0.7	3.9
Transfers to regions	1,841.9	5.9	33.7
Other expenditures	78.3	0.3	1.4
Surplus	1,501.8	4.8	

* includes some original draft figures (mainly revenues).
Sources: Russian finance ministry and Interfax

Russian investment abroad matches investment flows into Russia. Foreign investment inflows into Russia in January-September amounted to $35 billion, a 32 % increase from a year earlier. Foreign investments consisted mostly of trade and other credits. Foreign direct investment represented 29 % of all investment in Russia; portfolio investment was 2 %. FDI inflows soared 56 % y-o-y to over $10 billion. The largest of FDI inflows to Russia in January-September were Dutch and Indian investments in Russian extractive industries and investments from Cyprus in Russia's finance and real estate sectors. FDI originating from Cyprus and the Netherlands as of end-September accounted for over 60 % of Russia's entire FDI stock.

Investments abroad by Russians during the first three quarters of the year were valued at $35 billion, a 51 % increase from the same period in 2005. Two-thirds of Russian foreign investment outflows in January-September went to the US and Austria.

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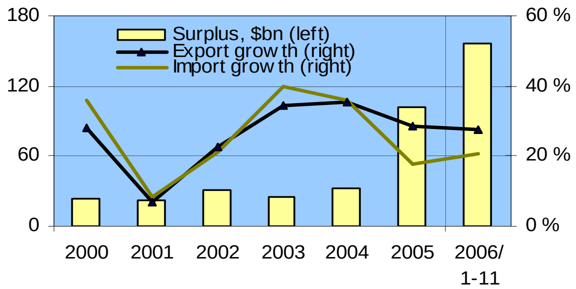
China

China posts huge trade surplus in November. China's foreign trade surplus last month was $23 billion, nearly matching October's performance. In the first eleven months of the year, China amassed a record $157 billion surplus. China's export growth has continued to outstrip import growth for a second year in a row, making such surpluses inevitable. Chinese exports consist mainly of machinery and equipment, while imports are mostly raw materials and intermediate goods. By some estimates the trade surplus next year could break the $200-billion mark as long as demand in Europe and the US remains strong.

China's ever-burgeoning trade surplus is expected to sharpen the global debate over China's foreign exchange policy. According to preliminary reports, the newly elected US congress is considering measures to reduce the United States persistent large trade deficits with China. In recent weeks, China has allowed the yuan to appreciate against the dollar faster than before. However, against the euro the yuan has depreciated.

US treasury secretary Henry **Paulson** travels to China next week accompanied by Federal Reserve chairman Ben **Bernanke**. Observers expect China's exchange rate policy to be a major theme during the visit.

China's foreign trade in the 2000s



Source: China Customs

China surpasses Japan in R&D spending. The Organisation for Economic Cooperation and Development (OECD) expects Chinese investment in research and development this year to reach $136 billion, a more than 20 % increase from 2005 spending. The higher spending means that China this year will surpass Japan in R&D spending to become the world's second largest R&D investor after the United States. US R&D spending is expected to reach $330 billion this year. Russian research and development spending was $17 billion in 2004 or about a sixth of Chinese spending that year.

Although Chinese R&D has tripled since 2000, it corresponded to just 1.2 % of GDP in 2004, about a percentage point less than the OECD average. Companies fund two-thirds of R&D spending in China. The OECD estimates China had 900,000 full-time researchers in 2004, and notes that most of China's R&D spending is focused on adapting products for the Chinese market. A number of large multinational corporations have shifted their R&D activities to China in recent years.

Rapid economic growth continues in Hong Kong and Macao. According to preliminary figures from the *Hong Kong* Census and Statistics Department, real GDP growth accelerated in the third quarter to 6.8 % y-o-y. Economic growth in the special administrative region has been underpinned by continuing strong domestic demand. In real terms, investment growth accelerated to 13 % y-o-y, the highest rate of growth since 2000. In particular, high investment growth was registered in machinery and equipment (22 %). The rise in consumer prices remained steady in the third quarter. October prices were 2 % higher than a year earlier. Growth in household consumption also picked up slightly. Hong Kong's rapid economic growth has helped reduce unemployment. According to the statistics department, the SAR has created over 300,000 new jobs during the last three years. Mainland China's rapid economic growth has also fuelled Hong Kong's 9 % y-o-y growth in exports of goods and services. Mainland China and Hong Kong have sought to reduce barriers to trade through three Closer Economic Partnership Arrangement (CEPA) agreements. CEPA IV enters into force at the start of 2007.

The *Macao* Census and Statistics Department reports real GDP growth in the special administrative region fell to 11.4 % y-o-y in the third quarter, a somewhat lower growth pace than in earlier quarters. Macao's high economic growth has been sustained by it popular casinos – a huge draw for tourists from Mainland China, where casinos are forbidden. Last year, tiny Macao, which has just a half million inhabitants, was visited by nearly 19 million tourists. This year the number is expected to well exceed 20 million. Income from casino gaming operations climbed 19 % in real terms in the third quarter. By some estimates, Macao's earnings on gambling this year exceeded those of Las Vegas. In addition, Macao's investments increased rapidly (27 %), reflecting construction of several major new casinos and other tourist attractions. Consumer prices were up in November nearly 10 % from a year earlier.

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Russia

Russian GDP increased 6.7 % in January-September. Rosstat's third-quarter GDP figures show growth of 6.5 % from a year earlier in 3Q06 and 6.7 % y-o-y for the first nine months of the year. Strongest growth in January-September period was registered in retail sales (9 % y-o-y). Retail sales represented 24 % of total economic output. Services accounted for an expanding share of output (61 % of GDP). Industrial output grew 6 % (17 % of GDP). While Rosstat reports only modest 3 % growth for mineral extraction industries (6 % of GDP), the actual contribution of mineral extraction (including energy production) is larger. The reported share is diminished by e.g. transfer pricing and classification of some extraction activities in refining and transportation. The Russian government estimates the energy sector actually accounts for about a third of Russian GDP. At the beginning of December, the economy ministry raised its forecast for 2006 by two-tenths of a percentage point to 6.8 %, reflecting higher consumption and investment.

Producer prices up 8 % in October. Although producer prices overall continued to rise in October, producer prices in mineral extraction industries fell by 1 % y-o-y. Within the mineral extraction category, oil producer prices declined 6 % y-o-y. Producer prices for manufacturing industries rose 12 %. Highest growth was registered in producer prices for metal products and electrical appliances. October producer prices for refined oil products fell slightly, although producer prices for gasoline were up a bit (2 % y-o-y). Consumer prices for gasoline rose 12 %. Producer prices for production and distribution of gas, water and electricity climbed 10 %. Agricultural producer prices for cultivated crops rose 16 %, while producer prices for animal products were up just over 2 %.

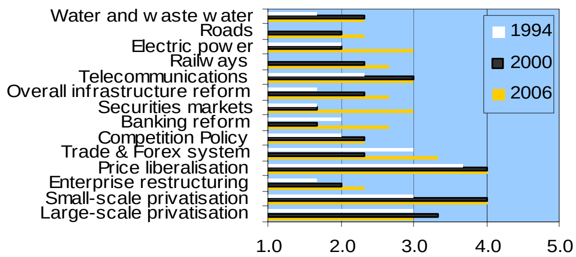
Government decides domestic rate policies for electricity and gas. The government has declared plans to increase the role of market-determined pricing in wholesale electricity markets incrementally over the next four years. Starting next month, 5 % of the electrical power market will shift to market pricing. The share would rise to 10 % in July 2007 and then be increased every six months through 2011, when wholesale prices would be set entirely by the free market.

The government estimates Russian electricity production will reach 1,400–1,600 terawatt hours by 2015, or 50–70 % more than last year. The increase will require considerable investment in new production capacity. Russia has launched a program to build new nuclear power plants (see *BOFIT Weekly 42/2006*), which could add 80 TWh of nuclear-generated electricity by 2015. Even so, nuclear power's proportional contribution to total electrical power generation will fall over the near term. The government has decided to augment power generation capacity over the next four years with natural-gas burning plants. Thereafter the emphasis will shift to building coal-burning plants and gas' share in electrical production will begin to decline.

The Russian state continues to subsidise heavily domestic natural gas prices. Subsidies last year compensated for 57 % of the market gas price. Under a government decision, the price of gas will be allowed to rise as much as 15 % next year and 25 % in 2008. Further hikes will be reviewed every six months thereafter until 2011, when the price paid for gas by domestic industrial users would match export prices, i.e. it would rise from the current $44 to $125/1,000 m^3. Even then, the domestic price would be about 45 % lower than the world price. The low domestic prices are explained in part by higher transport costs and tariffs for gas export. The government hopes independent producers will step up to meet growth in domestic demand, and thereby reduce Gazprom's overwhelming position. By 2015, the government projects independent producers will account for over half of the domestic gas market (from under 30 % in January-September 2006). Access of independent producers to the Gazprom-controlled pipeline grid would be assured through long-term gas transmission contracts.

EBRD: Russia still in mid-transition to market economy. The European Bank for Reconstruction and Development's latest annual *Transition Report* rates transition countries in Eastern and Central Europe using 14 economic indicators and a measuring scale running from 1 to 4.3, with 1 a centrally planned economy and 4.3 meeting the standards of a modern market economy. Russia's rating for 2006 was 2.9. Russia won highest praise for price liberalisation and progress in privatising small and medium-sized businesses. Russia was criticised for state competition policy and lack of business sector reforms. The EBRD upgraded Russian progress in banking and securities and financial market reforms. Upon the report's release, the EBRD's chief economist praised Russia's tight fiscal stance, but warned Russia of the need to diversify its economy to avoid excessive dependence on energy earnings.

Russia key figures: 1 = planned economy, 4.3 = market economy



Source: EBRD

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China

Higher food prices fuel inflation in November; money supply growth close to target. November consumer prices were up 1.9 % from a year earlier and on-year inflation rate accelerated from 1.4 % in October. The rise in prices was driven largely by a 3.7 % y-o-y increase in food prices. Non-food goods were up just 1.0 % y-o-y.

Growth in the broad money supply (M2) remained steady in November. At month's end, M2 was up 16.8 % y-o-y, approaching the People's Bank of China's 16 % target for 2006. While in the first half of this year credit granted by commercial banks grew at a rate well above the PBoC's target, the expansion of credit has slowed in recent months. As of end-October, credit stock expanded at a rate of 14 % y-o-y.

The central bank has steadily tightened its monetary stance this year with interest rate hikes, higher reserve requirements on banks and issuance of rules to curb bank lending. The PBoC has also sold central bank bills to commercial banks in order to absorb excess market liquidity. By doing so, the PBoC has sterilised approximately a trillion yuan (€100bn) or about a half of the interventions it has made into the currency market this year. However, the yields on government bonds remain low, e.g. 12-month paper this month pays 2.8 % p.a.

China looks back on five years of WTO membership. China this week celebrated its fifth anniversary as a member of the World Trade Organization. China has implemented nearly all of its WTO commitments in timely fashion during the past five years. These include opening its markets to foreign companies, reducing import tariffs to agreed levels and eliminating import quotas. Since 2001, the country's foreign trade has tripled and international corporations have increased their presence in China.

China's spectacular success in increasing exports has driven many countries to take protectionist measures against China (e.g. anti-dumping sanctions). With most of its WTO commitments now implemented, China's largest trading partner, the EU, wants China to reduce import tariffs further and continue to increase access to its markets beyond its WTO commitments.

Many of China's trading partners are increasingly critical of how China has implemented its WTO commitments. The loudest complaints have to do with China's failure to supervise intellectual property right abuses. Moreover, potential punishments for violating industrial patents or copyrights are inadequate to have much effect. China has promised to improve its monitoring and enforcement of intellectual property rights, but so far action has been limited to isolated cases. Last summer, for example, state officials organised high-profile raids of CD and DVD vendors in several provinces. China's trade partners are also focusing more on China's subsidy policies, which they believe significantly distort competition.

China's last important remaining WTO commitment, opening its banking sector to foreign banks, was implemented on Monday (Dec. 11) (see *BOFIT Weekly 47/2006*). China's Banking Regulatory Commission (CBRC) has to date granted eight foreign banks permission to establish local subsidiaries. A local subsidiary is required to offer unlimited yuan-based banking services to private Chinese individuals. After a transition period, regulations governing subsidiaries would be harmonised with Chinese banking regulations. It will still be difficult for foreign banks to compete against the dense branch networks of Chinese banks, as each branch office has to meet high capital requirements.

Although foreign firms will theoretically gain the right to engage in wholesale of oil products in a couple weeks, most observers consider the rules so restrictive that foreign firms will continue to shun the market.

Stock of non-performing loans unchanged. China's Banking Regulatory Commission (CBRC) valued the official amount of non-performing loans (NPLs) held by commercial banks at end-September at just under 1,300 billion yuan (€130bn), or about the same as at the end of 2005. While China's rapid credit expansion has decreased the size of the NPL stock relative to the credit stock, commercial banks have been unable to make any headway in reducing their NPL portfolios. Instead, reductions in NPL exposure are largely the result of state assistance in moving the NPLs off the books of troubled banks. The size of NPL portfolios vary dramatically from bank to bank. State-reported figures also omit rural credit cooperatives, which many believe have the worst NPL problems. A number of foreign analysts have raised suspicions that the true scope of China's NPL problem is much larger than officially reported.

A large amount of NPLs have been shifted off major commercial bank balance sheets since China established four asset management banks in 1999 to clean up the mess. Unfortunately, the asset management banks have been unable to repackage and dispose the problem loans as fast as originally planned. They are estimated to still hold NPLs nominally valued at about 800 billion yuan. The CBRC's latest figures on the holdings of asset management banks are from 1Q06.

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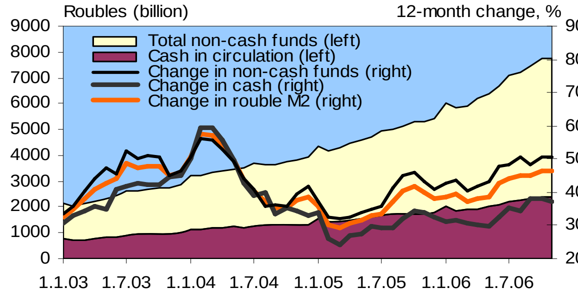
Russia

Rouble deposits rising faster than cash in circulation. Russia's rouble money supply (M2) was up 43 % y-o-y at the beginning of November. The figure includes cash in circulation and non-cash funds. In November, rouble cash was up 37 % y-o-y and non-cash funds 51 % y-o-y. The sharp increase in rouble cash this year reflects the impact of high oil prices, which have swelled export earnings and increased liquidity in the economy. The modest decline in oil prices since mid-2006 should translate into lower money supply growth in coming months. Rouble cash at the beginning of November was roughly equivalent to 13 % of annual GDP; rouble non-cash funds equalled 29 % of GDP.

Rouble M2 and 12-month change, 2003–2006



Source: Central Bank of Russia

Relaxation of bank ownership rules for foreigners. The Duma approved the third reading of a bill amending banking laws that would hold foreign and domestic bank owners to a common standard. Under the amendment package, foreign bank owners would no longer have to seek special permission from the Central Bank of Russia as long as their ownership share remained below 20 %. On the other hand, both Russian and foreign owners would have a reporting duty to the central bank whenever their participation exceeded 1 % of the bank's shares. Previously, Russian legal persons had the reporting duty with holdings of more than 5 % of the bank's shares. The law would enter into force at the beginning of 2007.

Russia still Finland's leading source of imports. Finnish imports from Russia increased 19 % y-o-y in the first nine months of the year. The value of imports was nearly €6 billion, or nearly 15 % of Finnish imports.

Finnish exports to Russia rose 12 % in January-September. The value of exports was €4.5 billion, with Russia accounting for 10 % of Finnish exports. While Russia remained Finland's third largest export destination, growth in Finnish exports was hurt by lower mobile phone exports.

The volume of road transit freight from Finland to east rose 12 % in January-September to more than 2 million tons, while the value of such freight increased to €17 billion, a 10 % increase from the same period a year earlier. The largest category of transit freight – both in terms of value and volume – was passenger cars. Some 367,000 cars were brought into Russia via Finnish roads in January-September. Transit shipments fell in the next-largest product group – radios, televisions and computers.

Russian companies expand abroad. Russian companies this year continued their ventures into international markets through corporate acquisitions worth several billion dollars. Leading the foreign expansion are Russian energy and metals companies that have benefited from high world commodity prices. Energy companies focused on acquiring companies in Europe as part of a downstream integration move to gain control of refining and distribution operations. For example, LUKoil recently purchased the Jet gas station chain in Europe from their strategic partner ConocoPhillips with the aim to expand their distribution networks in Eastern Europe, Belgium and Finland. Russian metal companies have invested in raw materials and production facilities around the world to improve their international competitiveness in consolidating markets. Russia's service sector companies have focused on acquisitions in CIS countries. For example, Russian telecom company Vimpelcom and the state-owned Sberbank have spent hundreds of millions of dollars buying up companies in the CIS region.

The expansion plans of Russian firms, however, have not always been welcome in certain markets, particularly Europe. The resistance has been fuelled by suspected Kremlin influence and insecurity over the business practices of Russian firms. State-owned gas giant Gazprom has long sought to buy a stake in the German E.On energy company. LUKoil made several failed attempts this year at acquiring refining capacity in Europe.

Russia wants out of production-sharing deals. After a year of grumbling in Russia over the much criticised conditions of production-sharing agreements made in the 1990s, the consensus among the power elite seems to be that the state should assume majority control in any company operating in Russian oil and gas fields.

Sakhalin-2, Russia's largest foreign investment project, is the first major target for agreement renewal. The largest foreign participant is Shell. Gazprom and Shell yesterday agreed that Gazprom buy 50 % plus one share in Sakhalin-2 for a higher-than-expected price of $7.45 billion. The project is geared to development of the Piltun-Astokhsk and Lunsk deposits which have estimated reserves of 150 million tons of oil and 500 billion cubic metres of gas. The project includes construction of 800 kilometres of oil and gas pipelines, a liquefied natural gas plant and an oil terminal.

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China

China and United States continue to have widely different views concerning pace of yuan's appreciation. US treasury secretary Henry **Paulson**, six other cabinet members and Federal Reserve chairman Ben **Bernanke** met last week in Beijing with their Chinese counterparts. The Chinese contingent was led by vice premier **Wu** Yi and discussions centred on the two countries' economic relations. This meeting was the first in a series of strategic dialogues the parties agreed to during Paulson's visit to China in September. The parties intend to hold such high-level dialogues twice a year.

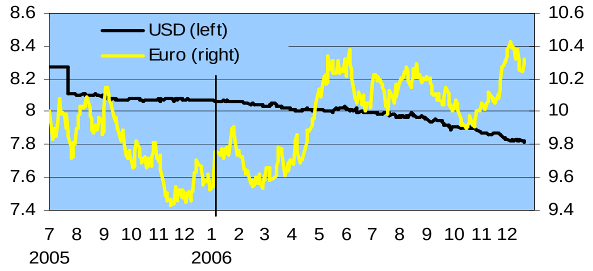
A major irritant of US-China relations is the massive trade imbalance between the two countries. The Americans continue to press China to stop undervaluing the yuan, taking the view that China's rise to the status of the world's third largest economic power demands that it allow market forces to play a substantial role in setting the yuan's value. In addition to their call for faster yuan appreciation, the Americans asked for greater access to China's markets, better protection and enforcement of intellectual property rights, and accelerated reform of China's service sector.

Vice premier Wu responded that the Americans failed to recognise the tremendous extent and progress of Chinese reforms. She also made it clear that China could not allow excessive appreciation of the yuan due to the adverse impact it would have on those working in the agricultural sector. While the parties agreed to disagree about the speed of Chinese reforms, there was common consensus on the direction of reform.

Following Paulson's earlier policy of stressing the benefits of cooperation in achieving common goals with China, the US delegation abstained from directly blaming China for using exchange rate policy to promote exports. Further, the US treasury department on Tuesday (Dec. 19) issued its semi-annual report to Congress on the state of the international economy and foreign exchange policies. The report also refrained from accusing China of manipulating its exchange rate. Members of the incoming Democratic majority in the US congress have strongly criticised Paulson for being soft on China by giving China too much time to fulfil its commitments and as result forcing US legislators feel to take active measures to stem the flood of Chinese imports. The last Congress considered 27 bills on limiting Chinese imports.

In the background, the yuan has continued its leisurely rise against the dollar. In recent weeks, the yuan-dollar rate has been quite steady. On Friday (Dec. 22) one dollar bought 7.82 yuan. Since the 2.1 % revaluation in July 2005, the yuan has appreciated 3.6 % against the dollar.

Yuan-dollar and yuan-euro exchange rates, 2005–2006



Sources: Reuters and Bank of Finland

Growth in industrial output and investment somewhat slower in November. China's National Bureau of Statistics reports industrial output grew 15 % y-o-y in November. Industrial output growth has slowed in recent months (also 15 % in October). In the January-September period, industrial output growth averaged 17 %. China's industrial output statistics cover all state-owned enterprises and other firms with annual net sales in excess of 5 million yuan (€500,000).

Although fixed capital investment in urban areas climbed 27 % y-o-y in January-November, it appears that growth is slowing slightly. This year investment in railways doubled, reflecting the emphasis the Chinese government on improving rail infrastructure. The NBS does not report monthly investment figures; rather it aggregates the numbers from the start of the year. Retail sales rose 14 % y-o-y in November and growth in sales has remained steady throughout this year.

Chinese footwear manufacturers haul EU regulators into court. Four Chinese shoe manufacturers are going to file a complaint with the European Court of First Instance for using incorrect price calculations as a basis for imposing restrictive tariffs. The companies claim that prices of their products were not assessed properly or that they were completely ignored in EU anti-dumping reviews. Last October, EU regulators imposed for two years an extra 16.5 % tariff on leather shoes made in China. The four petitioners include *Aokang*, one of China's largest private footwear manufacturers. The EU disputes the charges. About half of shoes sold last year in the EU zone were Chinese-made, and imports of leather shoes from China have increased more than five-fold since 2004.

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Editor Timo Harell

Central Bank of Russia / Exchange rates 2006

Source: http://www.cbr.ru/eng/currency_base/dynamics.asp

Date	US Dollar	Euro
11.1.2006	28.4821	34.3352
12.1.2006	28.4834	34.3538
13.1.2006	28.3966	34.4763
14.1.2006	28.4740	34.3539
17.1.2006	28.3007	34.3684
18.1.2006	28.2697	34.2940
19.1.2006	28.3023	34.2769
20.1.2006	28.2863	34.2010
21.1.2006	28.2909	34.1613
24.1.2006	28.0512	34.3459
25.1.2006	27.9898	34.3939
26.1.2006	27.9805	34.3321
27.1.2006	27.9698	34.2742
28.1.2006	28.0240	34.1949
31.1.2006	28.1207	34.0373
1.2.2006	28.1305	34.0492
2.2.2006	28.1042	34.1354
3.2.2006	28.1901	33.9944
4.2.2006	28.1732	34.0389
7.2.2006	28.2349	33.9016
8.2.2006	28.2524	33.8549
9.2.2006	28.2642	33.8436
10.2.2006	28.2496	33.8487
11.2.2006	28.2411	33.8244
14.2.2006	28.2369	33.6217
15.2.2006	28.1844	33.5733
16.2.2006	28.1994	33.5939
17.2.2006	28.2225	33.5396
18.2.2006	28.2182	33.5260
21.2.2006	28.1451	33.6531
22.2.2006	28.1908	33.5837
23.2.2006	28.1827	33.5741
27.2.2006	28.1550	33.4397
28.2.2006	28.1223	33.3305
1.3.2006	28.1211	33.3291
2.3.2006	28.0245	33.4472
3.3.2006	28.0279	33.4373
4.3.2006	27.9305	33.5753
7.3.2006	27.8810	33.6552
8.3.2006	27.9945	33.4786
10.3.2006	28.0000	33.4320
11.3.2006	28.0203	33.3946
14.3.2006	28.0079	33.4862
15.3.2006	27.9929	33.5215
16.3.2006	27.8432	33.4814
17.3.2006	27.8171	33.5224

18.3.2006	27.7028	33.6811
21.3.2006	27.6615	33.6834
22.3.2006	27.7027	33.6172
23.3.2006	27.7383	33.5356
24.3.2006	27.7680	33.5021
25.3.2006	27.8470	33.3356
28.3.2006	27.7730	33.4415
29.3.2006	27.8019	33.3984
30.3.2006	27.8043	33.3930
31.3.2006	27.7626	33.4734
1.4.2006	27.6996	33.6273
4.4.2006	27.7737	33.4618
5.4.2006	27.6921	33.6127
6.4.2006	27.5602	33.8191
7.4.2006	27.5332	33.8466
8.4.2006	27.6077	33.6814
11.4.2006	27.7985	33.5356
12.4.2006	27.6797	33.5782
13.4.2006	27.6625	33.6072
14.4.2006	27.6985	33.5595
15.4.2006	27.7002	33.5449
18.4.2006	27.6336	33.6577
19.4.2006	27.5675	33.7702
20.4.2006	27.4650	33.9303
21.4.2006	27.4666	33.8993
22.4.2006	27.5198	33.8136
25.4.2006	27.4331	33.9485
26.4.2006	27.4244	33.9596
27.4.2006	27.3921	34.0073
28.4.2006	27.3621	34.0631
29.4.2006	27.2739	34.1906
3.5.2006	27.2424	34.2546
4.5.2006	27.1590	34.3670
5.5.2006	27.2085	34.2882
6.5.2006	27.1258	34.4091
7.5.2006	27.0801	34.4703
11.5.2006	27.0359	34.5438
12.5.2006	27.0755	34.4779
13.5.2006	26.9431	34.6892
16.5.2006	26.9187	34.7359
17.5.2006	27.0209	34.6165
18.5.2006	26.9569	34.7016
19.5.2006	27.0663	34.5095
20.5.2006	26.9987	34.5988
23.5.2006	27.0965	34.4532
24.5.2006	26.9876	34.6764
25.5.2006	27.0168	34.5815
26.5.2006	27.0381	34.5385
27.5.2006	27.0349	34.5479
30.5.2006	27.0652	34.4973
31.5.2006	26.9840	34.6367

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2.6.2006	27.0474	34.5368
3.6.2006	26.8868	34.4366
6.6.2006	26.7089	34.5800
7.6.2006	26.7331	34.5392
8.6.2006	26.8582	34.3704
9.6.2006	26.8801	34.3366
10.6.2006	27.0079	34.1407
14.6.2006	27.0836	34.0576
15.6.2006	27.0895	34.0705
16.6.2006	27.0369	34.1206
17.6.2006	26.9869	34.1465
20.6.2006	27.0379	34.0623
21.6.2006	27.0450	34.0307
22.6.2006	27.0163	34.0919
23.6.2006	26.9738	34.1596
24.6.2006	27.0491	34.0251
27.6.2006	27.1021	33.9508
28.6.2006	27.0334	34.0486
29.6.2006	27.0611	34.0077
30.6.2006	27.0789	33.9759
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4.7.2006	26.8735	34.3598
5.7.2006	26.8397	34.3978
6.7.2006	26.8559	34.3648
7.7.2006	26.9111	34.2821
8.7.2006	26.8781	34.3421
11.7.2006	26.8558	34.3647
12.7.2006	26.9125	34.2354
13.7.2006	26.8670	34.3011
14.7.2006	26.9189	34.2220
15.7.2006	26.9631	34.1448
18.7.2006	26.9277	34.0151
19.7.2006	27.0194	33.8661
20.7.2006	27.0554	33.8247
21.7.2006	26.9674	33.9789
22.7.2006	26.9122	34.0332
25.7.2006	26.9223	34.0136
26.7.2006	26.9073	34.0673
27.7.2006	26.9878	33.9291
28.7.2006	26.8431	34.1713
29.7.2006	26.8718	34.1084
1.8.2006	26.8197	34.2112
2.8.2006	26.8416	34.1720
3.8.2006	26.7605	34.3016
4.8.2006	26.8040	34.2126
5.8.2006	26.7710	34.2508
8.8.2006	26.6962	34.3633
9.8.2006	26.7348	34.2954
10.8.2006	26.7391	34.3009
11.8.2006	26.6738	34.3852

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17.8.2006	26.7804	34.2495
18.8.2006	26.7225	34.3625
19.8.2006	26.7364	34.3162
22.8.2006	26.7050	34.4014
23.8.2006	26.6964	34.3770
24.8.2006	26.7614	34.2599
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26.8.2006	26.7998	34.2019
29.8.2006	26.7672	34.2540
30.8.2006	26.7446	34.3080
31.8.2006	26.7379	34.3127
1.9.2006	26.7295	34.3180
2.9.2006	26.7542	34.2668
5.9.2006	26.7222	34.3434
6.9.2006	26.6406	34.1932
7.9.2006	26.6714	34.1927
8.9.2006	26.6708	34.1893
9.9.2006	26.7625	34.0339
12.9.2006	26.7965	33.9887
13.9.2006	26.7764	34.0435
14.9.2006	26.7980	34.0147
15.9.2006	26.8015	33.9977
16.9.2006	26.7667	34.0446
19.9.2006	26.8048	33.9724
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21.9.2006	26.7974	33.9577
22.9.2006	26.7674	34.0160
23.9.2006	26.6712	34.1525
26.9.2006	26.6665	34.1465
27.9.2006	26.7263	34.0600
28.9.2006	26.7944	33.9726
29.9.2006	26.7498	34.0284
30.9.2006	26.7799	33.9783
3.10.2006	26.7948	33.9651
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5.10.2006	26.7671	34.0745
6.10.2006	26.7803	34.0458
7.10.2006	26.8102	33.9900
10.10.2006	26.8919	33.8757
11.10.2006	26.8890	33.8828
12.10.2006	26.9537	33.7945
13.10.2006	26.9508	33.7963
14.10.2006	26.9314	33.8393
17.10.2006	26.9690	33.7247
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19.10.2006	26.9288	33.7983
20.10.2006	26.9351	33.7820
21.10.2006	26.8510	33.9048

24.10.2006	26.8804	33.8532
25.10.2006	26.9307	33.7603
26.10.2006	26.9025	33.8003
27.10.2006	26.8305	33.9272
28.10.2006	26.7884	33.9677
31.10.2006	26.7477	34.0284
1.11.2006	26.7811	33.9852
2.11.2006	26.7285	34.0842
3.11.2006	26.7277	34.0778
4.11.2006	26.7007	34.1075
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9.11.2006	26.7044	34.1015
10.11.2006	26.6982	34.1096
11.11.2006	26.6195	34.2380
14.11.2006	26.6194	34.2299
15.11.2006	26.6509	34.1798
16.11.2006	26.6548	34.1741
17.11.2006	26.6551	34.1718
18.11.2006	26.6888	34.1216
21.11.2006	26.6402	34.1900
22.11.2006	26.6548	34.1741
23.11.2006	26.6122	34.2499
24.11.2006	26.5560	34.3555
25.11.2006	26.5199	34.3937
28.11.2006	26.3666	34.5983
29.11.2006	26.3503	34.6296
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1.12.2006	26.3081	34.6899
2.12.2006	26.2465	34.8186
5.12.2006	26.2056	34.8718
6.12.2006	26.1840	34.8797
7.12.2006	26.1883	34.8671
8.12.2006	26.1917	34.8847
9.12.2006	26.2356	34.8356
12.12.2006	26.2977	34.7130
13.12.2006	26.2609	34.7616
14.12.2006	26.2332	34.8115
15.12.2006	26.2645	34.7558
16.12.2006	26.3298	34.6526
19.12.2006	26.3884	34.5741
20.12.2006	26.3830	34.5776
21.12.2006	26.2759	34.7341
22.12.2006	26.2928	34.7065
23.12.2006	26.2941	34.7082
26.12.2006	26.3528	34.6197
27.12.2006	26.3600	34.6054
28.12.2006	26.3365	34.6536
29.12.2006	26.3789	34.6249
30.12.2006	26.3311	34.6965