



BOFIT

BOFIT Weekly
Yearbook 2009



EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland, BOFIT
Institute for Economies in Transition

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

BOFIT Weekly – Russia 2009

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| 1.1.2009 | <p>BOFIT Weekly – Russia 1/2009</p> <p>Rouble continues to weaken.</p> <p>Growth continued to fade in November.</p> <p>Economic development ministry scenarios see significantly slowing economy in coming year.</p> <p>Government identifies enterprises crucial to economic system.</p> <p>Four trillion roubles in financial sector support already released.</p> |
| 9.1.2009 | <p>BOFIT Weekly – Russia 2/2009</p> <p>Russian oil production in decline.</p> <p>Russia won't openly commit to OPEC production cuts.</p> <p>Russia and Ukraine lock horns again on pricing of natural gas contracts and transmission fees.</p> <p>Stimulus legislation enters into force.</p> |
| 16.1.2009 | <p>BOFIT Weekly – Russia 3/2009</p> <p>Rouble's decline continues after market reopens January 11.</p> <p>Current account surplus shrank substantially in 4Q08.</p> <p>Moscow stock exchanges post worst performance in a decade.</p> <p>Economic woes impairing banking sector growth.</p> <p>Inflation subsided towards the end of 2008.</p> |
| 23.1.2009 | <p>BOFIT Weekly – Russia 4/2009</p> <p>CBR announces new rouble policy.</p> <p>2008 federal budget remained strongly in the black.</p> <p>Finance ministry alters this year's federal budget.</p> <p>Changes in custom tariffs to support the economy.</p> <p>Government approves 2020 development plan.</p> |
| 30.1.2009 | <p>BOFIT Weekly – Russia 5/2009</p> <p>Russian central bank modifies exchange rate policy.</p> <p>Economy continued to falter in December.</p> <p>Further downward revisions in forecasts of Russian economic growth</p> |
| 6.2.2009 | <p>BOFIT Weekly – Russia 6/2009</p> <p>Central bank tightens monetary stance to ease devaluation pressures on rouble.</p> <p>Russian GDP growth down sharply in 2008.</p> <p>Government moves ahead with long-term strategy for development of financial markets.</p> |
| 13.2.2009 | <p>BOFIT Weekly – Russia 7/2009</p> <p>CBR announces rate hikes to support rouble.</p> <p>Fitch downgrades Russia's creditworthiness.</p> <p>Foreign trade down in the end of 2008.</p> <p>Government commits to additional, but selective, bank support.</p> |
| 20.2.2009 | <p>BOFIT Weekly – Russia 8/2009</p> <p>Russian share prices continue to decline.</p> <p>Economic conditions deteriorated further in January.</p> <p>Russia's car industry on the ropes.</p> <p>Banking sector grew thanks to state support and weaker rouble.</p> |

BOFIT Weekly – Russia 2009

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| 27.2.2009 | BOFIT Weekly – Russia 9/2009 New support for a struggling production sector. Russia begins LNG production. Rising unemployment worries Russians. |
| 6.3.2009 | BOFIT Weekly – Russia 10/2009 Rouble exchange rate hit harder than currencies of many other raw material exporters. Russia's currency reserves no longer hemorrhaging. Prosecutor General's office investigating possible abuses at Russia's state investment company. |
| 13.3.2009 | BOFIT Weekly – Russia 11/2009 Inflation remains high amidst economic slowdown. Russia raises oil export duty. Russia's economic troubles reflected in lower Finnish exports. |
| 20.3.2009 | BOFIT Weekly – Russia 12/2009 Falling apartment prices in Russia. Medvedev prioritises the fight against corruption. Nord Stream submits environmental impact report to Finnish officials. |
| 27.3.2009 | BOFIT Weekly – Russia 13/2009 Latest BOFIT forecast sees modest contraction in Russian GDP this year. Weak economic performance in February. Russian state increasingly cautious about refinancing foreign borrowing of private corporations. |
| 3.4.2009 | BOFIT Weekly – Russia 14/2009 CBR signals lower interest rates. Revised 2009 budget draft emphasises measures to deal with the economic crisis. |
| 9.4.2009 | BOFIT Weekly – Russia 15/2009 Small banks called on to increase their capital base or leave the market. Risk of growing bank credit losses causes concern. Putin tells Duma about the impact of economic crisis on reforms. |
| 17.4.2009 | BOFIT Weekly – Russia 16/2009 Klepach estimates GDP contracted 7 % y-o-y in first quarter. Current account surplus shows significant drop in first quarter. Russia's foreign debt declines. |
| 24.4.2009 | BOFIT Weekly – Russia 17/2009 Economic slide continued in March. More gas pipeline options than ever. |
| 30.4.2009 | BOFIT Weekly – Russia 18/2009 Central Bank of Russia lowers interest rates. Although Russia labour productivity is rising quickly, it remains far behind international leaders. |

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| 8.5.2009 | BOFIT Weekly – Russia 19/2009 Inflation declined in April to 13.2 % y-o-y. Government works to make life easier for small and medium-sized businesses. |
| 15.5.2009 | BOFIT Weekly – Russia 20/2009 China now Russia's largest trading partner. Economic crisis tests stability of Russian regions. |
| 22.5.2009 | BOFIT Weekly – Russia 21/2009 Russian industrial output continues to decline. CBR lowers rates for the second time in a month. Proposed customs policy programme favours domestic producers. |
| 28.5.2009 | BOFIT Weekly – Russia 22/2009 Economic contraction continued in April. Change in budget policy needed to deal with prolonged recession. Russia's largest teleoperators declared "strategic enterprises." EU-Russia summit ends with little to show. |
| 5.6.2009 | BOFIT Weekly – Russia 23/2009 Russian shares and commodities prices up. Corruption remains a serious problem for Russia. Finnish and Russian prime ministers met in Helsinki to discuss bilateral and multilateral economic issues. |
| 12.6.2009 | BOFIT Weekly – Russia 24/2009 13th St. Petersburg Economic Forum focuses on finance and business during economic crisis. Putin announcement throws Russia's WTO member-ship goals into doubt. No change in CBR monetary policy. |
| 18.6.2009 | BOFIT Weekly – Russia 25/2009 IMF Article IV mission remarks lay out the implications of lower growth for Russia's future. Fixed capital investment declined 16 % y-o-y in the first quarter. Finland's exports to Russia decline, especially in re-exports and transit freight businesses. |
| 26.6.2009 | BOFIT Weekly – Russia 26/2009 Economic retrenching goes on. Russia tightens regulation of securities markets. Russia, Belarus and Kazakhstan tell the WTO that they are breaking off membership talks. |
| 3.7.2009 | BOFIT Weekly – Russia 27/2009 Declining capital investment diminished GDP. Russia officially launches talks on OECD membership. FDI to Russia contracted sharply in 2008. |

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| 10.7.2009 | BOFIT Weekly – Russia 28/2009 Current account surplus keeps shrinking in second quarter; financial account shows surplus. Rouble strengthened in the second quarter. Foreign debt of Russian firms increased slightly in the second quarter. President Obama makes his first visit to Russia. |
| 17.7.2009 | BOFIT Weekly – Russia 29/2009 Central Bank of Russia lowers rates. Economy ministry says slow recovery of Russian economy is underway. Drinking habits killing Russia. |
| 24.7.2009 | BOFIT Weekly – Russia 30/2009 Economy may have bottomed in the second quarter. First-half federal budget deficit smaller than expected. Mandatory social contribution arrangement set to change next year. |
| 31.7.2009 | BOFIT Weekly – Russia 31/2009 Russia's shrinking car market. Housing construction down slightly, sharp growth in housing loan defaults. Across-the-board pension increases next year. |
| 7.8.2009 | BOFIT Weekly – Russia 32/2009 Cabinet approves 2010 federal budget guidelines. Russian oil output levels in 1H09 largely unchanged from last year. Sharp declines in natural gas production and gas ex-ports. |
| 14.8.2009 | BOFIT Weekly – Russia 33/2009 CBR again lowers refinancing rate. Gazprom and gas supplies to Europe. |
| 21.8.2009 | BOFIT Weekly – Russia 34/2009 Foreign trade picked up in June. Summertime blues for Russian stocks. Construction of Ust-Luga container terminal will be delayed. |
| 28.8.2009 | BOFIT Weekly – Russia 35/2009 Russian economy no longer contracting. Financial crisis has been hard on Russia's forest industries. Situation steady in the banking sector. |
| 4.9.2009 | BOFIT Weekly – Russia 36/2009 Economic development varies significantly across Russian regions. Russia has approximately 400 one-company towns. Russia's tough economic times reflected in trade with Finland. |
| 11.9.2009 | BOFIT Weekly – Russia 37/2009 Launch of massive Vankor oil and gas deposit boosts Russian oil output in August. Russia's metal exports to China increased in 1H09. Russia slips badly in WEF competitiveness rankings. |

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| 18.9.2009 | BOFIT Weekly – Russia 38/2009 Sberbank to take a stake in Opel. Government approves Energy Strategy 2030. Medvedev orders review of state corporations. |
| 25.9.2009 | BOFIT Weekly – Russia 39/2009 Poor economic performance in August. No growth in prices in August. Economic growth of recent years has not increased income disparity in Russia. |
| 2.10.2009 | BOFIT Weekly – Russia 40/2009 Latest BOFIT forecast sees Russian economy returning to modest growth this year. CBR to continue steering rouble exchange rate in coming years. Problems from international economic crisis begin to affect Russia's insurance sector. BOFIT forecast for Russia 2009-2011, published 29.9.2009 |
| 9.10.2009 | BOFIT Weekly – Russia 41/2009 Government tightens budget policy. Current account remains in surplus in third quarter; financial account shows deficit. Russia's foreign debt up slightly in the third quarter. |
| 16.10.2009 | BOFIT Weekly – Russia 42/2009 Government plans additional bailout measures for struggling AvtoVAZ. Telenor and Altimos set to launch joint venture. Putin's visit to China focused on natural resources and regional development. |
| 23.10.2009 | BOFIT Weekly – Russia 43/2009 Russian stock market up, rouble exchange rate strengthens. Economic crisis subdues Russian inflation. Russia reverts to solo approach in WTO talks. |
| 30.10.2009 | BOFIT Weekly – Russia 44/2009 No definite signs of economic recovery yet. Good grain harvest this year. |
| 6.11.2009 | BOFIT Weekly – Russia 45/2009 Central bank lowers interest rates for the eighth time this year. Official report shows Russia deployed a diverse range of measures to help its finance sector. |
| 13.11.2009 | BOFIT Weekly – Russia 46/2009 Slowdown in construction sector continues. Banks still not lending, larger firms turn to bond issues to raise money. Nord Stream pipeline project moves ahead. |
| 20.11.2009 | BOFIT Weekly – Russia 47/2009 Experts say bottom of recession probably past in Russia. Medvedev's state-of-the-nation speech once again stresses need to move ahead with reforms. Russian car industry staggered by GM's decision to scrub Opel sale. |

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27.11.2009 BOFIT Weekly – Russia 48/2009
Duma approves 2010 federal budget.
CBR contemplates new measures to limit inflows of foreign currency into the country.
Russia declares its interest to join WTO as soon as possible at EU-Russia summit in Stockholm on November 18.

4.12.2009 BOFIT Weekly – Russia 49/2009
Russian federal finances better than anticipated.
Finnish exports to Russia continue to contract.
Russia-Belarus-Kazakhstan customs union enters into force January 1, 2010.

11.12.2009 BOFIT Weekly – Russia 50/2009
The 2010 privatisation plan to include stakes in important enterprises.
Limits imposed on scope of official inspections.

18.12.2009 BOFIT Weekly – Russia 51/2009
Russia set to increase minimum capital requirements for banks next year.
Global economic downturn reduces FDI flows into Russia.

23.12.2009 BOFIT Weekly – Russia 52/2009
Duma approves law on retail trade.
Duma takes up bill on technical standards.
Changes in special economic zones.

BOFIT Weekly – China 2009

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| 1.1.2009 | BOFIT Weekly – China 1/2009 China's economic policy makes an about-face in 2008. People's Congress approves new patent law. |
| 9.1.2009 | BOFIT Weekly – China 2/2009 Share prices down sharply in 2008. Foreign strategic investors sell off holdings in Chinese banks. China's December PMI suggests further economic weakening. |
| 16.1.2009 | BOFIT Weekly – China 3/2009 China revises 2007 GDP figures upwards. Growth in foreign currency reserves slowed in the last quarter of 2008. Both imports and exports show negative growth in the final months of 2008. |
| 23.1.2009 | BOFIT Weekly – China 4/2009 China's GDP growth slowed to 9 % in 2008. China's State Council moves ahead with health care reforms. Chinese government implements support for car industry and steelmakers. Cities seek to stimulate local economies by distributing coupons to low-income resident, students and seniors. |
| 30.1.2009 | BOFIT Weekly – China 5/2009 Hopes turn to domestic demand to sustain China's economic growth as export motor stalls. Trying times for US-China relations. |
| 6.2.2009 | BOFIT Weekly – China 6/2009 China's industrial production faltered again in January. China posts surprisingly small 2008 budget deficit despite sharp spending increases. Official unemployment rate rises. China's grain production up for fifth year in a row. |
| 13.2.2009 | BOFIT Weekly – China 7/2009 Inflation cooled further in January. Despite declines in exports and imports in January, China's trade surplus hit record high. International patent activity of Chinese firms continued to rise in 2008. |
| 20.2.2009 | BOFIT Weekly – China 8/2009 Chinese share prices enter third month of recovery. China lends \$25bn to Transneft and Rosneft in exchange for Siberian oil. Chinese investors pursue global natural resources. China surpasses US as world's top car market. |
| 27.2.2009 | BOFIT Weekly – China 9/2009 China and the US to broaden their dialogue agenda. Yuan stable against the dollar, strengthening against other major currencies. Support measures improve outlook for steel industry. |
| 6.3.2009 | BOFIT Weekly – China 10/2009 Outlook for Chinese manufacturers continues to weaken. World Bank examines China's progress under current five-year plan. Recession grips Hong Kong SAR. |

BOFIT Weekly – China 2009

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| 13.3.2009 | BOFIT Weekly – China 11/2009 Deflation hits Chinese consumer prices. January-February figures show no sign of an economic turnaround. Finland-China trade declined in 2008 |
| 20.3.2009 | BOFIT Weekly – China 12/2009 Confidence in rapid economic recovery headlines People's Congress session. China prepares 2009 budget with large deficit. China boosts bank lending to support growth. |
| 27.3.2009 | BOFIT Weekly – China 13/2009 BOFIT sees significant slowing of China's GDP growth in 2009. Mild recovery in share prices continues. China's competition authorities deny Coca Cola's bid to purchase juice giant Huiyuan. |
| 3.4.2009 | BOFIT Weekly – China 14/2009 China expands use of the yuan beyond its borders and calls for new global reserve currency. Increased unemployment among migrant workers and new graduates. |
| 9.4.2009 | BOFIT Weekly – China 15/2009 China wins several lower-profile decisions at last week's G20 summit. Profitability down at China's largest commercial banks. Industrial firms expect a tough year. |
| 17.4.2009 | BOFIT Weekly – China 16/2009 GDP growth slowed in the first quarter. Further contraction in exports and imports in March. Shanghai stock exchange rolls out own board for growth enterprises. |
| 24.4.2009 | BOFIT Weekly – China 17/2009 United States still claims yuan undervalued, but backs off on accusing China of currency manipulation. IMF trims China forecast, gives darker outlook for Russia. |
| 30.4.2009 | BOFIT Weekly – China 18/2009 2008 balance-of-payments figures show continuing rise in China's current account surplus. As many as 30 million migrant workers now out of work. Slow-but-sure progress in economic integration of Southeast and East Asia. |
| 8.5.2009 | BOFIT Weekly – China 19/2009 Share prices on Shanghai stock exchange up 40 % from start of the year. Labour productivity gains remain strong. China arms imports lower than at any time in the past decade. |
| 15.5.2009 | BOFIT Weekly – China 20/2009 April indicators for economic recovery remain mixed. Consumer prices decline 1.5 % in April. Sharp slowdown in cargo transportation growth. |

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| 22.5.2009 | BOFIT Weekly – China 21/2009 Financial snags in roll-out of stimulus package. FDI down sharply in first four months of 2009. |
| 28.5.2009 | BOFIT Weekly – China 22/2009 Yuan's international role continues to expand. EU-China summit focuses on trade and environmental issues. China expected weather global financial crisis in good shape. |
| 5.6.2009 | BOFIT Weekly – China 23/2009 China's purchasing manager indexes suggest cautious optimism. Economy and climate issues dominate Geithner's visit to China. |
| 12.6.2009 | BOFIT Weekly – China 24/2009 Deflation continues in May. China increases VAT rebates to support exporters. State merges two airlines. |
| 18.6.2009 | BOFIT Weekly – China 25/2009 May economic performance reinforces growth prognoses. Share prices continue to soar. BRIC countries gather. |
| 26.6.2009 | BOFIT Weekly – China 26/2009 World Bank raises China's growth outlook. Number of Chinese living in poverty expected to fall despite the world financial crisis. China released new quarterly GDP figures. |
| 3.7.2009 | BOFIT Weekly – China 27/2009 June PMI figures suggest outlook for manufacturers keeps improving. China's appetite for commodities driven by desire to build up inventories. Western countries chafe at China's economic and trade policies. |
| 10.7.2009 | BOFIT Weekly – China 28/2009 China extends yuan use in international trade. Banks remained eager to lend in June. |
| 17.7.2009 | BOFIT Weekly – China 29/2009 China's stimulus package seems to be getting results – economic growth recovers. China's export industry appears to have a pulse. Chinese trade delegation visits Finland. |
| 24.7.2009 | BOFIT Weekly – China 30/2009 China's foreign currency reserves continue to grow. Income continues to rise in real terms in both the countryside and cities. Summer harvest of key crops improves over last summer. |
| 31.7.2009 | BOFIT Weekly – China 31/2009 IMF advises China to improve its social safety net. New share bubble in the offing? US-China strategic dialog continues. |

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| 7.8.2009 | BOFIT Weekly – China 32/2009 Stimulus costs to state higher than originally expected. China's purchasing manager index suggests rising optimism among manufacturers. |
| 14.8.2009 | BOFIT Weekly – China 33/2009 Commercial banks set to pull back on lending. Positive economic figures for July. Asian countries hold the bulk of foreign currency reserves. |
| 21.8.2009 | BOFIT Weekly – China 34/2009 Inflows of foreign direct investment in China declined significantly in July. China continues to buy US treasuries. China continues to hold the yuan's exchange rate stable against the dollar. |
| 28.8.2009 | BOFIT Weekly – China 35/2009 First-half balance-of-payments figures show a reduced current account surplus. Broad-based growth in China's imports. Hong Kong and Taiwan benefitting from China's economic recovery. |
| 4.9.2009 | BOFIT Weekly – China 36/2009 Share prices plunge in response to tighter lending. Outlook for manufacturers continues to improve. China's significance for Finnish trade on the rise. |
| 11.9.2009 | BOFIT Weekly – China 37/2009 China moves ahead with plans to increase yuan use in international settlements. Reliance on green energy technologies on the rise. |
| 18.9.2009 | BOFIT Weekly – China 38/2009 China retaliates against US tariffs on Chinese tires. Slowing rate of price declines in China. Favourable real economic trends continued in August. |
| 25.9.2009 | BOFIT Weekly – China 39/2009 Annual communist party meeting ends with little to show. Asian Development Bank raises its outlook for developing economies in Asia. China promises to limit carbon dioxide emissions at UN conference on climate change. |
| 2.10.2009 | BOFIT Weekly – China 40/2009 Latest BOFIT forecast sees robust growth for Chinese economy in 2009–2011. G20 gathering ends with little to show. CIC investing heavily in natural resource companies. BOFIT forecast for China 2009-2011, published 29.9.2009 |
| 9.10.2009 | BOFIT Weekly – China 41/2009 IMF raises its forecast for Chinese growth and warns of potential risks. September PMI reading suggests growing optimism among manufacturers. China surpasses US as world's biggest CO2 emitter. |

BOFIT Weekly – China 2009

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| 16.10.2009 | BOFIT Weekly – China 42/2009 China and Russia discuss energy cooperation. China's growing energy needs. New trade figures signal revival in foreign trade. |
| 23.10.2009 | BOFIT Weekly – China 43/2009 China's GDP growth accelerated in third quarter. Deflationary episode appears to be ending. Volume of new bank lending continues to expand rapidly. |
| 30.10.2009 | BOFIT Weekly – China 44/2009 China's competitiveness improves as REER declines. Chinese share markets struggle to find direction. |
| 6.11.2009 | BOFIT Weekly – China 45/2009 World Bank expects Chinese economic growth to accelerate slightly in 2010. Purchasing manager index suggests economic recovery underway, but problems also mounting. Household incomes continue to rise. |
| 13.11.2009 | BOFIT Weekly – China 46/2009 China raises fuel prices. China promises more cheap loans to African countries as it builds trade relations. |
| 20.11.2009 | BOFIT Weekly – China 47/2009 Industrial output rose in October. Obama visit to China matches expectations. International pressure for yuan appreciation continues to increase. |
| 27.11.2009 | BOFIT Weekly – China 48/2009 Several branches suffering from overcapacity. China-Taiwan relations continue to improve. China country risk barely changed in Euromoney rankings. |
| 4.12.2009 | BOFIT Weekly – China 49/2009 China rejects EU arguments for a stronger yuan. Weak start for Shenzhen technology list. |
| 11.12.2009 | BOFIT Weekly – China 50/2009 China's leaders set out 2010 economic policies. Commercial banks could be hit with big losses on stimulus lending. |
| 18.12.2009 | BOFIT Weekly – China 51/2009 Broad-based economic recovery continues. Steadier growth in Chinese exports and imports in October and November. Consumer prices on the rise. |
| 23.12.2009 | BOFIT Weekly – China 52/2009 Copenhagen climate conference fails to produce binding treaty. China increases its grip on Central Asian energy supplies. |

Russia

Rouble continues to weaken. The Central Bank of Russia continued to widen the rouble's trading band against its dollar-euro currency basket. Over the past week, the trading band was widened four times for a total of 1.4 roubles. The lower and upper trading band limits are now 24.7 and 34.8 roubles. The rouble has dropped about 7 % against the dollar and 19 % against the euro since November 11, when the CBR began systematically expanding the band.

Russia's foreign currency reserves decreased \$12.6 billion in a week after increasing a week before, reaching \$438 billion on December 26. The value of the foreign currency reserves are affected by the current account balance, capital flows and changes in the exchange rates of the relevant currencies. The CBR reports its foreign currency reserves are allocated as follows: 45 % in dollar-denominated instruments, 44 % in euros, 10 % in British pounds and 1 % in yen.

Growth continued to fade in November. Preliminary Rosstat figures show investment growth slowed further in November, falling to an on-year rate of 4 %. The construction sector still grew 6 % y-o-y, and retail sales growth slowed sharply to 8 % y-o-y. Real wages increased 7 %, while real disposable incomes declined 6 %.

As the data released earlier already indicated manufacturing output contracted about 10 % in November. The fall in production affected all branches of manufacturing. The most severe drop was registered by the chemicals industry (nearly 25 %), while oil products declined less than 1 %.

At end- November, the official number of unemployed in Russia was about 5 million, or 400,000 more than at the end of October. The unemployment rate rose to 6.6 %.

Economic development ministry scenarios see significantly slowing economy in coming year. The ministry's basic scenario foresees economic growth of 2.4 % in 2009, while its pessimistic scenario sees GDP contracting 0.5 %. Both scenarios assume the price of Urals-grade crude oil will average \$50 a barrel and world economic growth in the range of 0-1 %. The basic scenario assumes the implementation of proposed measures to boost the real economy as well as the realization of the investment programmes of natural monopolies and infrastructure firms. The ministry also offered a third mid-range scenario.

The economy ministry sees the rouble's real exchange rate declining about 1 % in the coming year and it expects the rouble's nominal rate with respect to dollar to settle at around 31-32 roubles to the dollar. Inflation is expected to fall slightly to the range of 10-12 %. The ministry expects capital outflows to reach \$90 billion in 2009 and a fall in currency reserves of \$110-140 billion.

Economic development ministry's main 2009 scenarios: On-year change (%) in GDP demand factors

| | 1a | 2 |
|-------------|------|------|
| GDP | -0.5 | 2.4 |
| Consumption | 2.4 | 3.1 |
| Investments | -9.4 | 1.5 |
| Exports | -2.5 | -2.4 |
| Imports | -8.6 | -5.9 |

Source: Russian Ministry for Economic Development

Government identifies enterprises crucial to economic system. A commission under the Russian cabinet approved a list of firms essential to the economic system. The commission can expand its current list of about 300 firms as needed. The list features major enterprises in all core sectors of the economy, including transportation, energy, manufacturing, retail sales and construction. While the state's motivation is to assure listed companies stay solvent (e.g. through access to credit, state guarantees, interest subsidies and trade policy measures), the commission noted that inclusion in the list in itself does not constitute an automatic guarantee of state funding.

Four trillion roubles in financial sector support already released. The government reports that as of end-November, the finance sector had received funding from the CBR and the federal government amounting to around 4 trillion roubles (just over €110 billion), an amount equivalent to about 10 % of estimated 2008 GDP. A total of 9 trillion roubles had been set aside to support the financial sector. Most money so far has gone to commercial banks as various credits, but funds have also been invested in securities to support the stock market as well as used to capitalise special-purpose institutions such as the Housing Loan Fund, the Agricultural Bank and the Federal Deposit Insurance Agency. Some money has also been used to cover costs of winding down and merging insolvent or troubled banks.

CBR has developed its measures to support the financial sector e.g. by extending the terms of its funding. While the longest secured loan presently is just 3 months, the new rules allow for 12-month secured loans for commercial banks. There is also discussion on increasing the limit on unsecured loans to a year. The moves are hoped to encourage commercial banks to provide companies with long-term financing.

To boost liquidity in the system, the CBR is temporarily relaxing its requirements for mandatory reserve deposits. This will be done by easing the classification on new bank loans. Basically, a higher-risk loan requires larger reserve deposits, so the amount of reserve deposits can be reduced if the quality of the loan is more loosely defined.

China

China's economic policy makes an about-face in 2008.

Economic policy emphasis shifted last year from fighting inflation to reviving economic growth. The year started with a nearly 9 % y-o-y spike in consumer price inflation in February that was driven largely by rocketing food prices. In response, China's officials spent most of the first half of the year focused on implementing stricter monetary policies and bolstering food production. As the year wore on, direct price controls on key food items combined with bumper harvests drove down consumer price inflation. The trend was further helped by falling global commodity prices that dampened producer price inflation growth later in the year. Lower commodity prices also allowed Chinese officials to move ahead with much-needed structural reforms, including the deregulation of fuel prices and introduction of a fuel tax on gasoline and diesel fuel at the beginning of 2009. China's inflation dynamics are likely to change now that fuel prices in China more closely reflect world market prices. Both producer prices and consumer prices were up about 2 % y-o-y in November.

After posting economic growth of nearly 12 % y-o-y in 2007, GDP growth slowed in 2008. In the third quarter economic growth was 9 % compared to the same period a year earlier. The slowdown in economic growth was also evident in the gradual fall in industrial output growth, which has been burdened by problems in China's construction sector. To support flagging real estate businesses, officials cut the transaction fees associated with apartment purchases and eased rules on qualifying for a housing loan.

As a result of waning foreign demand, export growth plummeted in November. Although China strives to increase the value-added component in its exports and a shift in emphasis to high-tech products, officials reinstated value-added-tax refunds for exporters specifically to support labour-intensive export industries.

Official measures such as elimination of the stamp tax on share purchases were designed to revive China's stock markets, which saw share prices plunge more than 60 % in the course of the year.

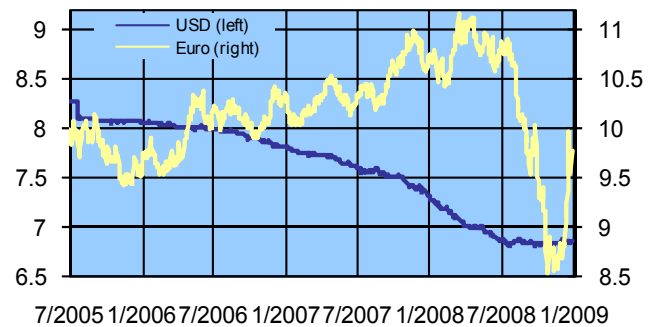
China also reacted with monetary policy measures to deal with slowing economic growth. Interest rates were lowered five times during the autumn along with easing of reserve requirements on commercial banks. Notably, the government put an end to strict credit quotas, which were limiting the access of firms to credit.

In the area of exchange rate policy, the yuan's three-year snail-pace rise against the dollar came to a halt last summer. In the autumn, the yuan's value fell slightly against the dollar. The rise of the dollar relative to the euro in the latter half of 2008 was tracked closely by the yuan, which gained against the euro (reaching about 10 % in end

of this year). This change in the nominal exchange rate led to improved competitiveness of eurozone-produced goods in China. In addition, the yuan's trade-weighted exchange rate strengthened substantially during 2008. Even so, the volatility of the yuan-euro rate was clearly increased by major swings in the value of the dollar.

China raised eyebrows around the world at the start of November with the announcement of a fiscal stimulus package valued at nearly 15 % of China's annual GDP. The measures to be rolled out over the coming two years include increased central government spending, as well as spending by local administrations, state-owned enterprises and banks. At the end of 2008, some money had already been committed to infrastructure projects including construction of roads, railways and airports. China also moved to promote domestic consumption by granting direct subsidies to farm families for the purchase of home appliances.

Yuan-dollar and yuan-euro exchange rates



Source: Reuters

People's Congress approves new patent law. The People's Congress recently revised China's patent law for the third time since it first entered into force in 1985. The amended law will take effect on October 1, 2009. Changes in the law include detailed descriptions of copyright violations and stronger rules on securing patents. Under the earlier law, inventors in China first had to file for a patent in China before seeking an international patent. The new law allows the inventor to seek a new patent directly after Chinese officials review the patent proposal. This procedure is intended to weed out innovations that might affect national security.

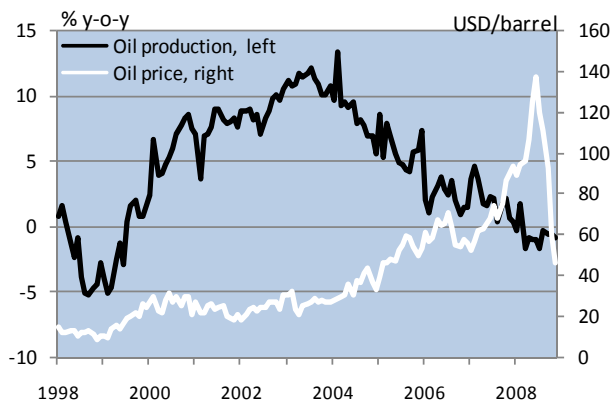
International patent figures show patent filings in China increased more than ten-fold between 1995 and 2007. The number of Chinese international patent filings grew approximately eight-fold between 2000 and 2007. China leads among the BRIC countries in its international patent activity.

Russia

Russian oil production in decline. In the first eleven months of 2008, crude oil production dropped 0.5 % y-o-y. Production rose by more than 2 % in 2007, and the fall in production commenced in the first half of 2008. The growth in Russian oil production began to decelerate in 2004, due in large part to inadequate investment in bringing new fields on stream. The failure to invest in timely fashion reflects a number of Russia-specific factors, including insecurity over property rights in the energy sector and heavy taxation of the oil industry.

Russia's oil production in November was about 40 million metric tons, which translates to just under 10 million barrels a day. This output level places Russia as the world's number-two producer, just behind Saudi Arabia.

On-year change in Russian oil production and average world crude oil price



Sources: Rosstat, Bloomberg

Russia won't openly commit to OPEC production cuts.

At its December meeting, OPEC voted to cut oil output of its members by 4.2 million barrels a day from the start of this year. The reduction corresponds to about 15 % of OPEC production last September. While Russia is not an OPEC member, it participated as an observer at the meeting.

Igor Sechin, deputy prime minister in charge of energy matters and head of the Russian delegation to the OPEC meeting, said he would like to see Russia become a permanent observer at OPEC events although his country has no plans at the moment to seek membership. Sechin acknowledged Russia's support for the OPEC decision, but would not commit officially to lower production. At a separate press conference, Sechin mentioned that Russian oil companies may cut production by 320,000 barrels a day if the price of oil fails to rebound.

Russia and Ukraine lock horns again on pricing of natural gas contracts and transmission fees.

Gazprom justified its decision to shut off gas deliveries to Ukraine's national gas company Naftogaz at the end of December on the grounds that Ukraine had failed to pay for its gas supplies and no contract for 2009 had been signed. Responding to the Ukrainian claim that Russia has reduced all gas deliveries since the start of the year, Gazprom said it had met in full its gas delivery contracts to EU customers through Wednesday evening (Jan. 7). Gazprom then blamed the lack of gas at the EU end on Ukraine, which was stealing gas from the pipelines for its own use. Due to a lack of measurement stations in the border of Russia and Ukraine, it is difficult to establish pipeline pressures. Whatever the truth, gas deliveries to many EU countries have diminished substantially in recent days.

Russia and Ukraine have disputed gas pricing, contract quantities and reimbursements for transmission throughout the post-Soviet era. Russia relies extensively on Ukraine's massive gas storage capacity. Moreover, about 80 % of gas sent to the EU area crosses Ukraine. Ukrainian heavy industry remains highly dependent on abundant, cheap supply of Russian gas. Gas relations between Ukraine and Russia continue to be plagued by poorly drafted short-term contracts, claims of gas stealing, political disputes and reliance on shady gas transmission companies with hidden ownership structures and possible ties to political and economic elites.

Stimulus legislation enters into force. The Duma autumn session generated a record amount of legislation, a large part of which in response to the international financial crisis. Economic stimulus laws taking effect at the start of the current year included a reduction in the corporate profit tax from 24 % to 20 % and a lowering on tax rate on small firms from 15 % to 5 %. While the income tax rate remains at 13 %, the effective tax burden has been reduced through a larger deduction related to acquiring housing.

The president and prime minister have reiterated in recent weeks their commitment to preserving social spending, even as the government reconvenes from the New Year's break to find ways to cut spending from this year's budget. Federal officials got a 30 % pay hike already at the beginning of December. The new wage system will not raise salaries across the board but pay increases will be tied to performance.

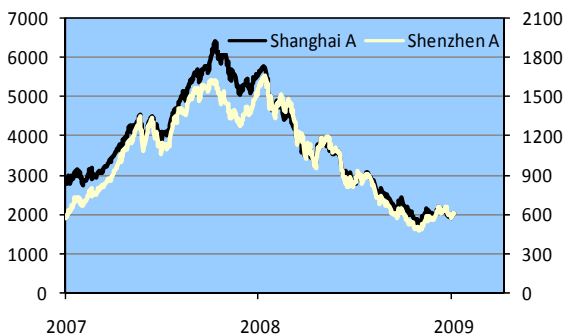
Effective January 1, 2009, the monthly minimum wage was raised 90 % to 4,330 roubles (about €110). Many payments are indexed to the minimum wage. Work pensions will rise over the next two years 50 % in nominal terms from a level of about 4,400 roubles in 2008. The unemployment benefit was increased at the start of the year from 1,500 roubles to 4,900 roubles. Hikes in other social support payments will also take place this year.

China

Share prices down sharply in 2008. Share prices on China's two main stock exchanges have been in decline since autumn 2007. The decline was relentless last year as the Shanghai A-share index shed about two-thirds of its value and Shenzhen's A-share index fell nearly as much. In the fourth quarter of 2008, however, the decline in share prices slowed and nearly stabilized. According to newspaper reports, the Shanghai A-share index last year was the world's second worst performing index among all of the world's major exchanges. (The worst performing index was Moscow's RTS.) Although the international financial crisis has affected China's markets, the decline in share prices largely reflects a bursting of the 2007 share price bubble. Foreign capital still plays a relatively minor role in China's equity markets due to restrictions on foreign investors. The fall in share prices also dampened enthusiasm for initial public offerings. The total value of IPOs by Chinese companies last year was only about a quarter of the 2007 value.

Although observers speculated throughout last year that the state would move to support share prices, the actual measures to date by officials have been quite modest. The stamp tax on share trades was reduced in April, and then eliminated entirely for share buyers last autumn. In addition, the state slightly increased its ownership stakes in large banks. Although state companies were ordered last autumn to buy up shares in their own subsidiaries, the response to date has been underwhelming.

Chinese share prices; Shanghai A-share (left scale), Shenzhen A-share (right scale)



Source: Bloomberg

Foreign strategic investors sell off holdings in Chinese banks. Shares in three of China's four large state banks were sold in late 2005 and early 2006 to foreign strategic investors as part of government efforts to develop China's banking sector. In turn, investors committed to holding

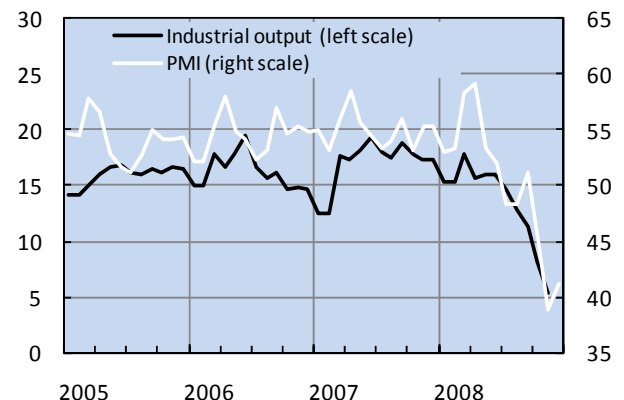
their shares for at least three years. Now that that time limit has passed, foreign investors have begun to sell their shares. At the end of last year, the Swiss UBS sold its entire 1.3 % stake in Bank of China for \$800 million. The Bank of America this week sold of a 2.5 % stake in China Construction Bank for nearly \$3 billion (Bank of America still retains a 16.6 % stake in CCB). On Wednesday, Hong Kong billionaire Li Ka-shing sold off part of his share in Bank of China. The share prices for Chinese banks are now substantially higher than what strategic investors paid for them.

China's December PMI suggests further economic weakening. In December, the industrial purchasing managers' index (PMI) stood at 41.2 %, up 2.4 percentage points from November. Nevertheless, the index remained well below the critical 50 % mark. A reading below 50 % signals a general perception of deteriorating business conditions compared to previous month.

The PMI comprises five subindexes: new orders (weight 30 %), industrial output (25 %), employment (20 %), average delivery times for goods suppliers (15 %) and stocks of major inputs (10 %). All subindex categories had bleak outlooks. In addition, sector-specific figures were dark. Of the 20 industrial branches surveyed, 18 reported index figures below 50 %. Positive outlooks were registered in the beverage and pharmaceutical industries.

The PMI is published by the Li & Fung research centre, which also produces six other indexes. Their index measuring new export orders fell to 30.7 %, suggesting an extremely weak near-term outlook for China's export sector. In addition, the volume of orders and inventories of finished products suggested falling demand and rising inventories. The outlook for industry is generally weak, with the numbers in all six indexes well below 50 %. The wood processing and furniture industries reported exceptionally low readings by nearly all measures.

China's on-year industrial output and PMI, %



Sources: CEIC and BOFIT

Russia

Rouble's decline continues after market reopens January 11. The Central Bank of Russia moved the trading limits on the rouble four times this week, allowing the rouble to decline against its dollar-euro basket by a total of 2.0 roubles. On Thursday (Jan. 15), one dollar bought 32.2 roubles and one euro 42.4 roubles.

The rouble has weakened about 21 % against its basket since November 11, when the CBR began gradual widening of the rouble's trading band. During the same period, the rouble has lost about 19 % of its value against the dollar and about 22 % against the euro. Most observers expect the current devaluation trend to continue.

Current account surplus shrank substantially in 4Q08. CBR preliminary figures show the current account surplus declined to \$8 billion in the fourth quarter. The 4Q07 surplus was \$24 billion. Russia's trade surplus fell by nearly half to \$22 billion. Nevertheless, surpluses for the year were still significant: the current account surplus was \$99 billion and the trade surplus was \$177 billion. The price of Urals-grade oil averaged \$95 a barrel in 2008 and \$54 a barrel in the fourth quarter.

The \$129 billion capital and financial account deficit for 2008 was due entirely to outflows of private sector capital in 4Q08 as companies moved \$56 billion abroad in anticipation of rouble depreciation. In addition, banks and firms paid down \$37 billion in foreign loans. Cash roubles in the fourth quarter were exchanged for \$24 billion in foreign currency (\$30 billion for the year).

The CBR's foreign currency reserves shrank \$160 billion from the peak last summer. Due to deterioration of the balance of payments, the central bank increased its rouble purchases in the currency markets throughout the autumn. In December, for example, the CBR spent \$74 billion on supporting the rouble. Russia's foreign currency reserves stood at \$426.5 billion on January 9.

Moscow stock exchanges post worst performance in a decade. The RTS index declined about 70 % last year, its poorest annual performance since 1998. By branch, the biggest loser was industrials (about 80 %), while the oil and gas sector fared somewhat better (shares down about 60 %). The RTS last year was among of the world's worst performing stock indexes. Part of the reason is that the RTS index remains dominated by commodity producers. The collapse of global oil prices in the last half of 2008 drove much of the slide in share prices on the RTS.

The government has promised 500 billion roubles (about €12 billion) to prop up the stock market as part of its broader rescue package to stabilize the financial sector.

About a third of the money (170 billion roubles) has reportedly already been distributed.

Economic woes impairing banking sector growth.

Growth in deposits slowed last year, and deposit levels even shrank on-month in October and November. Household deposits grew nearly 10 % over the year (down from over 25 % in 2007). Growth was driven largely by the increase in foreign currency deposits. Demand for cash foreign currency increased substantially towards the end of the year as people exchanged their liquid rouble assets for dollars and euros. Growth in corporate deposits fell by half from a year earlier to just under 20 %.

The changes were also reflected in money supply growth. Both the amount of rouble cash in circulation and the M2 (a broader measure of the money supply) contracted sharply at the end of the year. The fall in money supply caused interbank lending and commercial bank deposit rates to soar.

The reduction in deposits has altered the structure of bank balance sheets. The share of deposits to total banking sector assets fell from 60 % at the start of the year to 53 % at the end of the year, while the share of central bank financing grew from essentially zero to nearly 10 %.

Growth of the loan stock slowed as the year wore on, eventually near stalling out at year's end. Growth for the year as a whole, however, still exceeded 30 %. Although bank credit losses have been generally low in the 2000s, recent months have seen a doubling in the stock of non-performing corporate loans. At the end of November, non-performing loans exceeded 2 % of the total loan stock. Payment arrears between companies also grew slightly.

The ongoing deterioration of the economy has led to consolidation in the banking industry. Small banks in particular have faced closure or merger (although the number of closed banks so far is still low, just a few each month). In October, Russia's deposit insurance agency assumed the task of restructuring troubled banks. At the end of November, there were 1,114 banks operating in Russia. Due to ownership arrangements, the 50 largest banks saw their share of total banking sector assets climb from 77 % at the start of the year to 80 % at the end of the year.

Inflation subsided towards the end of 2008. Consumer prices rose 13.3 % in 2008. On-year inflation spiked last summer to over 15 %. Over the year, prices of food items rose nearly 17 %, while services were up 16 %. Higher prices for services reflect continuing gradual increase of rates for municipal services such as heating, water and gas, as well as public transport closer to cost recovery levels.

Consumer prices rose 11.9 % in 2007.

China

China revises 2007 GDP figures upwards. In its revision of 2007 GDP figures, the National Bureau of Statistics raised its estimate of 2007 GDP by about 800 billion yuan (€77 billion). Increases were allocated to industrial production, services and agriculture. Revised GDP for the year was about 26 trillion yuan (€2.5 trillion). The higher figure lifted real GDP growth in 2007 from the earlier announced estimate of 11.9 % to 13.0 %. The revised GDP figure meant that the Chinese economy already surpassed Germany as the world's third largest economy in 2007. The largest economies are the United States and Japan.

China revised its initial 2007 GDP figures last spring. In line with international practice, GDP figures are reconsidered in light of more precise data on the performance of various sectors of the economy once detailed information is available.

Growth in foreign currency reserves slowed in the last quarter of 2008. The People's Bank of China reports the country's foreign currency reserves stood at \$1,950 billion as of end-December. In 4Q08, China's foreign currency reserves increased a mere \$40 billion, the smallest rise since 2Q04. China's currency reserves even shrank in October.

The growth in foreign currency reserves in the fourth quarter of the last year was low, despite a new all-time record of foreign trade surplus. Factors contributing to this included a decline in foreign direct investment in China while investment outflows from China appear to have picked up. Moreover, the strengthening of the dollar against other major currencies such as the euro reduced the nominal value of the reserves. It is estimated that about 30 % of the reserves are kept in non-dollar-denominated assets. It has also been suggested that some of the speculative capital present in China in hopes of yuan appreciation has been pulled out to shelter as the yuan's exchange rate relative to the dollar has been kept more stable. Detailed information on last year's foreign currency movements will be available in June, when China publishes its balance-of-payments figures for 2008.

Both imports and exports show negative growth in the final months of 2008. The value of China's exports grew at an annual rate of about 27–29 % during 2005–2007. Growth in value of exports last year stayed on track to post an annual increase of about 22 % through October. The value of November exports fell 2 % y-o-y, followed by a 3 % drop in December.

The annual rise in export prices was fairly modest during 2005–2007, varying between 3 and 6 %. Indeed,

growth in the value of exports was largely driven by increased export volumes, which climbed at annual average rates of 20–25 %. The growth in export volumes has, however, been slowing. Export volume growth averaged 12 % y-o-y during January–October, but in November it declined 7 % y-o-y. Export prices rose in the first 10 months at an average rate above 9 %, but slowed to around 6 % in November. Figures indicating the changes in volumes and prices for December have yet to be released.

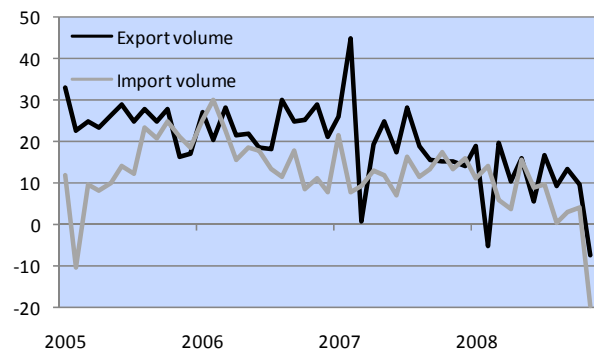
The import growth trend was quite similar to that of exports. The growth in the value of imports accelerated during 2005 to 2007 from about 18 % to 21 %. During January–October 2008, the value of imports grew 28 %, reflecting in part higher prices for commodities. The November collapse was severe, with the value of imports plunging 18 % y-o-y. The drop in the value of imports even accelerated slightly in December (down 21 %).

During 2005–2007, the average on-year growth in the volume of imports varied between 13–17 %. The pace of on-year growth in import volumes slowed to below 8 % during the first ten months of 2008, before the rug was pulled out in November and volumes fell 19 % y-o-y. The recent contraction in imports was due largely to a reduction in import volumes (see chart) as prices on-year still rose slightly in November.

The contraction of import and export volumes affected nearly all branches of the economy. In value terms, however, exports of some industries still appeared to be growing in November. A large part of Chinese imports consist of components and raw materials, so demand for these falls when industrial output and exports decline.

China's exports to all key markets, except Japan and Russia, contracted in value terms on-year in November–December. Imports also fell in November–December with the somewhat surprising exception of imports from the United States, which remained at the same level as a year earlier.

On-year growth in export and import volumes, % (Jan. 2005–Nov. 2008)



Sources: CEIC, own calculations

Russia

CBR announces new rouble policy. At the start of this week, the rouble was still tracking its long and steady weakening path against its dollar-euro currency basket. Between January 15 and 22, the rouble was broadly stable against the euro but lost about 1.5 % against the dollar (to 32.7 roubles).

On Thursday, the central bank announced that as of Friday it would stop the policy of gradually weakening the rouble and established for the dual-currency basket a new boundary of 41 roubles. The new trading limit is about 10 % weaker than Thursday's rate. The CBR says the new boundary is appropriate in light of the current economic situation and external risks.

The rouble's weakening of over 20 % since November 11 against the currency basket has begun to show up in the real exchange rate, which takes into account inflation differences and measures price competitiveness. The CBR estimates the real exchange rate weakened slightly in December, even if it is still about 20 % above its long-term average.

The RTS index has decline about 25 % over the past week as Urals oil dipped briefly below \$40 a barrel.

As of January 16, Russia's currency reserves stood at \$396.2 billion, down more than \$30 billion from the preceding week. It was the largest drop since mid-October.

2008 federal budget remained strongly in the black.

Preliminary figures on actual budget performance indicate a 2008 federal budget surplus of about 1.7 trillion roubles (\$58 billion), or 4 % of GDP. Russia has posted budget surpluses every year since 2000.

At year's end, the off-budget Reserve Fund and the National Welfare Fund held assets of \$225 billion, or 16 % of GDP. The funds, which pool excess tax revenues from oil and gas, increased over 40 % in dollar terms over the year.

Finance ministry alters this year's federal budget.

Prime minister Vladimir Putin tasked the finance ministry to revise the Duma-approved 2009 budget from last November to comply with the economy ministry's latest forecast. The economy ministry now assumes an average crude oil price of \$41 a barrel this year (the earlier assumption in budget calculations was \$95 a barrel). The ministry expects GDP contraction of 0.3 % this year, a rouble average exchange rate against the dollar of 33.4–35.8 roubles and on-year inflation of 13 %.

Finance minister Alexei Kudrin gave assurances budget spending would not be cut. The budget will be in the red this year and at least the next two years. Presidential adviser Arkady Dvorkovich said this year's budget deficit

could exceed 5 % of GDP. The deficit will be funded through bond issues and the Reserve Fund.

Changes in custom tariffs to support the economy. The latest increases in import tariffs, which go into effect at the start of next month and remain in effect for nine months, affect some farming machinery and various metal products. Most of the hikes were from 5 % to 15 %, but the for used farm equipment the hikes were higher. An import tariff hike on passenger cars from 25 % to 30–35 % entered into force on January 12. In addition import quotas on chicken and pork imports have been reduced this year. On the other hand, import tariffs will be eliminated in February for various types of machinery and equipment not produced in Russia, e.g. medical equipment.

The export tariff on crude oil was lowered at the start of January to \$119.10 per ton. The tariff relative to the market price for Urals oil is reviewed monthly. The export tariff on nickel will be lifted entirely. The export tariff hike on raw timber planned for January 2009 has been postponed until 2010. Further changes are possible as customs policies are part of the government's economic stimulus package.

Russia will start charging a road tax to foreign lorries next month. The amount of the fee is 385 roubles (less than €10) a day of stay in Russia. The tariffs apply to trucks registered in the EU, Switzerland or Turkmenistan.

Government approves 2020 development plan. The development programme, long under preparation, highlights developing human potential, institution-building and national competitiveness. The plan builds on an "innovation-based growth" scenario in which Russia should become a high-tech producing country in addition to processing natural resources. Major development projects are planned to be funded by public-private partnership.

Social sector issues are discussed widely in the programme and they range from education and health care to sports and housing policy. The programme also includes traditionally overlooked topics such as the environment.

Competitiveness will be boosted by developing both high-tech production and traditional branches such as the energy sector and other natural resource extraction industries, as well as transport sector. As Russia's most promising high-tech fields are perceived those related to defence, i.e. shipbuilding, aerospace, nuclear energy, radioelectronics and information technology. Development of high-tech branches and improvements in energy and transport infrastructure is strived to be accomplished largely with domestic production. Another goal is to substitute imports with domestic products; fields seen with the best potential here include foodstuffs, construction materials and wood processing.

The plan has been criticised for being unrealistic, especially in light of the current economic situation.

China

China's GDP growth slowed to 9 % in 2008. The National Bureau of Statistics reports China's GDP, which amounted to slightly over 30 trillion yuan (€3 trillion), grew 9 % last year in real terms. Agricultural output growth accelerated slightly, while growth in services, industrial output and construction declined in 2008. On-year growth rates tapered off as the year wore on; GDP grew just 6.8 % y-o-y in the fourth quarter.

China has yet to release official demand-side data for last year. The available demand indicators give a mixed picture. Real fixed capital investment growth slowed last year to about 15 % y-o-y. At the same time, the trade surplus in goods hit a record high and growth in retail sales, a reflection of domestic consumer demand, accelerated in real terms to about 15 % y-o-y.

The pick-up in consumer price inflation from autumn 2007 faded during the course of 2008. At December last year, the rise in consumer prices was just 1.2 % y-o-y. The rise in producer prices decreased in December.

China's State Council moves ahead with health care reforms. The long-awaited reforms finally were approved on Thursday (Jan. 22) as the State Council voted to spend 850 billion yuan (nearly €100 billion) through 2011 on improving health care in China. National spending on health care in 2006 was about 980 billion yuan (€110 billion), of which the WHO reports citizens paid about 58 % out of pocket (compared to 22 % in Finland and 54 % in the United States). Chinese total spending on health care relative to GDP was below 5 % in 2006 (compared to 8 % for Finland and 15 % for the United States).

The goal of the reform is to provide an access to health care at least for 90 % of the population by 2011. The plan also seeks to improve the quality of services and lower costs for patients. To help people afford medical care, those covered by the plan will be eligible for about 120 yuan (€14) annual support. Special attention will also be given to access to medications and health insurance will be extended to fully cover costs to the patient for certain critical medicines.

China has been widely criticized by the international community for its poorly functioning public health care system. Some of the most glaring deficiencies in the system are the fact that adequate health care is simply unaffordable to many people and the fact that people generally have to save for the eventuality of a major illness. As publicly supported health care reduces citizens' need for precautionary savings, it is hoped the plan will reduce the savings rate and increase private consumption over the long run, and thereby bring China one step closer to an

economic growth model based on private consumption demand.

Chinese government implements support for car industry and steelmakers. The rescue package features tax breaks for car buyers and strict production limits on steel producers to increase steel prices.

Effective on Tuesday (Jan. 20), the consumption tax on vehicles with engine displacement volumes of less than 1.6 litres was reduced from 10 % to 5 %. The tax break will remain in effect until the end of the year. The government will also spend 5 billion yuan (over €560 million) to support purchases of vehicles with engine displacement volumes of less than 1.3 litres. This small-engine subsidy is aimed to help farmers and will remain in force from the beginning of March to the end of the year. The government has further promised to spend as much as 10 billion yuan (over €1 billion) on development of alternative energy vehicles over the next three years. The government decided to support the car industry after car sales continued weak in November.

Cities seek to stimulate local economies by distributing coupons to low-income resident, students and seniors.

Approximately 500,000 residents in Hangzhou, the capital of Zhejiang province are eligible for shopping coupons worth a total of about 100 million yuan (€11 million) to help them purchase household appliances and services. The 200 yuan (about €23) coupon for low-income households and retirees corresponds to about 9 % of the average monthly disposable household income in the province.

Coupons can only be used at certain places. For example they can be used for tickets to cultural events, gyms and sport facilities, and for tourism. Although the blunt approach has its critics, the hope is that the coupons will boost economic activity in parts of the service sector affected by a downturn in demand. One advantage of a coupon is that they must be used within a certain time on specific services or goods and cannot be saved. On the other hand, the coupons do not stimulate demand for services when coupon-holders use them to purchase services they already planned to use. However, many low-income households probably do not consume the services covered by the coupons, so they will increase actual demand for such services, or create a secondary market for the coupons.

Officials in Chengdu, the capital of Sichuan province that was rocked by a major earthquake last year, issued 100-yuan coupons to 380,000 low-income residents in December 2008. The coupons, which must be used by the end of January, should be spent on food and necessities.

Support for consumers is welcome as the confidence of Chinese consumers has been shaken during the autumn and the savings rate remains high.

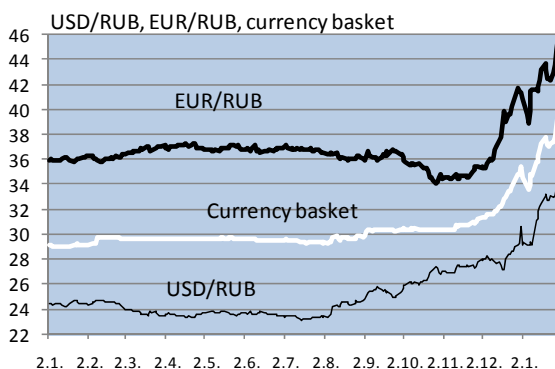
Russia

Russian central bank modifies exchange rate policy. A Central Bank of Russia press release dated January 22 announces the abandoning of the policy of gradual expansion of the trading band of the rouble. The practice launched on November 11 has resulted in an incremental devaluation of the rouble. According to the CBR, the reason behind the incremental devaluation policy was the shift in international markets, which limited the access of Russian banks and enterprises to foreign loans, reduced export earnings and increased capital flight. The CBR noted the policy served its purpose by giving banks and companies time to adjust to the changed circumstances and that the negative effects of a sudden change-over had been avoided.

The CBR also used the press release to announce a new trading band for the rouble. The upper limit is now set at 41 roubles per unit of the euro-dollar currency basket. The new limit is about 10 % higher than the rouble's trading rate at the moment the decision was announced. With the dollar-euro rate hovering around \$1.30 per euro, a dollar would buy about 36 roubles and a euro about 48 roubles at the limit. The CBR noted the new band considers ongoing risks from the global economy, adding that it will not adjust the trading band for at least the next few months. The CBR expects Russia's current account to remain in balance at today's energy prices and exchange rates.

The CBR said it would intervene in the currency markets to steer the rouble's exchange rate within the band, taking into account market conditions. Besides market operations, the CBR can use other monetary policy instruments such as interest rates and refinancing to steer the rouble's exchange rate.

Rouble-dollar, rouble-euro and currency basket exchange rates, Jan. 1, 2008–Jan. 30, 2009



Source: Central Bank of Russia

Pressure on the rouble continues. On Friday (Jan. 30), the rouble's exchange rate relative to a currency-basket unit was 39.5. Following the change in exchange rate policy, the rouble lost about 6 % of its value over the past week.

Economy continued to falter in December. Preliminary Rosstat figures show investments fell 2 % y-o-y in December – the first decline in this decade. Construction growth evaporated to around zero. Industrial output contracted 11 % y-o-y in December due to weaker domestic and export demand. The sharpest drop was seen in manufacturing, where production declined across the board. Falls registering over 20 % included the chemicals and wood processing industries, as well as vehicle manufacture. Oil production fell nearly 1 %, while natural gas output increased nearly 2 %.

Rail, road and sea shipments continued to fall in December, down 12 % y-o-y. Agricultural output grew nearly 5 % due to the good harvest.

Consumption growth seems to have slowed further as growth in retail sales in December fell below 5 % y-o-y. Growth in consumption has been chilled by the loss of consumer purchasing power and increased unemployment. For the month, real wages contracted 5 % y-o-y and disposable income nearly 12 %. The unemployment rate climbed one percentage point to 7.7 % in December.

The overall growth in 2008 in all core production branches was, however, positive. This reflects robust performances in the first half of last year. Still, last year's growth in most branches was down sharply from 2007.

Further downward revisions in forecasts of Russian economic growth. As the global economy continues to slump, forecasts of Russian economic growth have grown increasingly pessimistic. The European Commission's forecast and the consensus forecast of various economic research institutions (revised monthly) both estimate Russian GDP growth will fall to about 1 % this year, down from the 3 % growth foreseen just a month earlier. The latest forecasts of the IMF and Russia's economy ministry expect GDP contraction this year.

The forecasts assume an oil price of \$40–50 a barrel. The wide spread (from –4 % to +3 %) in individual GDP growth forecasts for 2009 reflects the exceptionally great uncertainty among forecasters.

Russian GDP growth forecasts, %

| | 2009 | 2010 |
|-------------------------------|------|------|
| Consensus (Jan. 15) | 1.1 | 3.4 |
| European Commission (Jan. 19) | 1.0 | 2.3 |
| IMF (Jan. 28) | -0.7 | 1.3 |
| Economy ministry (unreleased) | -0.2 | |

China

Hopes turn to domestic demand to sustain China's economic growth as export motor stalls. The IMF this week revised its mid-term forecasts for the global economy sharply downwards from its previous outlook published in November. The latest IMF outlook sees the world economy growing just 0.5 % this year, with a fall of 2.0 % in developed economies and a slowing of economic growth in developing countries to an average of 3.3 %. The IMF expects the Chinese economy to grow 6.7 % in 2009 and then pick up to 8 % growth in 2010. The severity of the change is shown in the fact that in November the IMF was still expecting Chinese economic growth to exceed 8.5 % in 2009.

Shifts in economic indicators have caused many forecasters recently to lower their projections for China's economic growth. While the growth forecasts of investment banks still generally range between 7 % and 8 %, Roubini Global Economics (RGE Monitor) goes as low as 5 %. Chinese research institutes such as the Chinese Academy of Social Sciences (CASS), forecasts growth of around 8 %, matching the government's growth target for the year. It is generally believed that the lousy export prospects for the first half of this year bode poorly for China's economic prospects in the near term. The government's fiscal stimulus measures are expected to only begin to boost domestic investment and consumption in the second half of 2009. Forecasts differ mainly in terms of how much weight is given to the stimulus package and how strongly the problems of exporters affect domestic investment and consumption.

People involved in monitoring the Chinese economy would like to see improvements in China's statistical reporting. The released data show China's GDP grew 9 % in real terms last year, even as on-year growth cooled to 6.8 % in the fourth quarter. Since China does not release quarterly GDP data, researchers find it impossible to determine whether the Chinese economy grew or contracted in the fourth quarter relative to the third quarter. Currently, the views of forecasters as to what happened in October-December are highly contradictory. It would be a big help to the economic policy discussion and economic researchers if China would release its basic figures on economic performance on a quarterly basis.

Trying times for US-China relations. Newly installed US treasury secretary Timothy Geithner set off a firestorm of criticism last week when he accused China of manipulating its exchange rate for its own economic benefit. The Bush administration had scrupulously avoided openly calling China a currency manipulator. The US reviews the

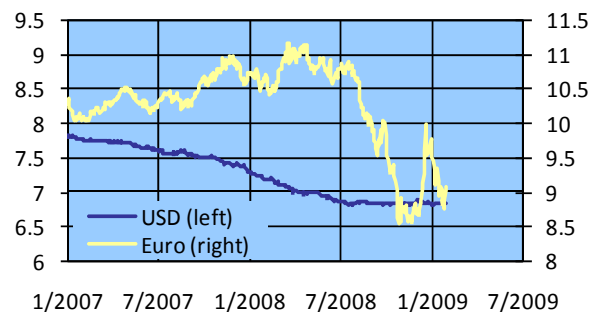
exchange rate mechanisms of various countries twice a year. The first official review of the current administration is scheduled to appear in early April. US law sanctions the use of heavy protectionist tariffs against countries engaged in currency manipulation. Geithner's speech has received a mixed reaction. IMF representatives noted the US has far more serious economic matters to worry about than the yuan's exchange rate, while a number of US senators commended the tough talk. China denies it manipulates its currency.

Much of the US-China debate over China's exchange rate policy has been fuelled by years of large, sustained foreign trade imbalances. Indeed, China customs reports that in 2008 China posted an overall trade surplus of nearly \$300 billion, much of it (\$170 billion) with the United States. China has kept the yuan rate against US dollar fairly stable since mid-July. The yuan's real trade-weighted exchange rate, however, has continued to strengthen steadily since July. On Thursday (Jan. 29), one US dollar bought 6.84 yuan and one euro 8.97 yuan.

In addition to expressing dissatisfaction with an undervalued yuan, the US has filed complaints with the WTO claiming China has failed to comply with its WTO commitments. Under a preliminary ruling on copyright protection and monitoring of intellectual property violations issued this week by the WTO, China must agree to monitor foreign intellectual property rights more aggressively and destroy confiscated illegal products. On the other hand, the WTO ruled that the threshold for commercial-scale copyright infringement set under Chinese law was adequate. Parties on both sides of the dispute can appeal the preliminary ruling. If the ruling stands, China will have to amend its legislation.

In addition to the intellectual property issue and resolution of dispute over tariffs on imported car parts last year, the US has six complaint filings with the WTO on other Chinese trade violations. China is also filing counterclaims on US safeguard measures to restrict imports of Chinese products.

Yuan-dollar and yuan-euro exchange rates



Source: Reuters

Russia

Central bank tightens monetary stance to ease devaluation pressures on rouble. On Monday (Feb. 2), the Central Bank of Russia raised its refinancing rates. The last time the CBR increased these rates was at the end of November. The refinancing rates differ as to the quality of securities accepted as collateral. The highest-tier Lombard rates require the borrower to provide high-quality collateral, typically Russian state or central bank bonds. The one-day, seven-day, and 30-day Lombard rates were raised 0.75–1 percentage point to 11 %. In addition, the 3-month lending rate went up from 11 % to 11.25 %. Poorer quality collateral is accepted for such borrowing.

The overnight and one-week repo rates were also hiked a percentage point to 11 %. In a repo swap, the bank agrees to sell securities to the central bank and then buy them back by a later date. Since autumn, the CBR began to accept a larger range of securities from banks to give them access to refinancing credit in the tight liquidity situation.

Since Monday, the CBR has reduced the lending amounts available in its refinancing operations. According to the CBR, the measures were intended to bring down inflation and stabilise the exchange rate. January inflation was 13.4 % y-o-y.

The rouble's value continued to decline over the past week against its dollar-euro currency basket. In the past couple of days, however, the decline has slowed. The rouble is now close to the 41-rouble trading limit set two weeks ago by the CBR. On Thursday (Feb. 5), one unit of the currency basket bought 40.88 roubles, one euro 46.84 roubles and one dollar 36.01 roubles.

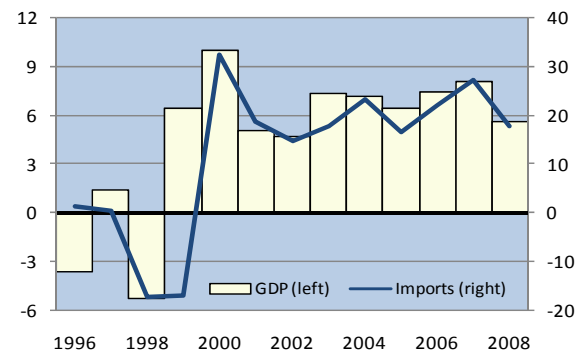
Russian GDP growth down sharply in 2008. Rosstat preliminary figures show Russian total output increased last year 5.6 % (8.1 % in 2007). The value of total economic output was 41.5 trillion roubles (€1.1 trillion). Economic growth was again fuelled by robust consumption growth, even if it slowed to 9 % due to lower income growth. Investment growth fell to around 10 % in 2008, or about half of 2007 growth. The investment ratio to GDP was 22 %. The chill in demand on world commodity markets brought Russian export volume growth almost to a standstill. Import volume growth was up 18 % y-o-y.

The sharp slowdown in investment growth was reflected in lower growth in industrial output and construction activity. Industrial output rose just 2 %. Oil production was 488 million tons, down nearly 1 % y-o-y. Natural gas production was up less than 2 % to 663 billion m³. Manufacturing growth slowed to 3 % and production contracted e.g. in the chemicals and metal industries. Electric-

ity production rose 2 %. Construction overall grew 13 %, while housing construction increased less than 5 %.

Growth in retail sales, supported by rising consumer demand, still declined slightly in 2008 to 13 %. Transport volumes rose nearly 1 %. Agricultural production stood out among core production sectors, up a brisk 10 % y-o-y after years of low growth.

Real on-year change in GDP growth and imports, %



Source: Rosstat

Government moves ahead with long-term strategy for development of financial markets. The “2020” strategy, which has been under preparation since the beginning of last year, is intended to accelerate the evolution of the Russian economy over the next decade by improving the competitiveness of its financial markets.

Russia's securities markets remain underdeveloped and dysfunctional in many respects, so the 2020 strategy addresses needs to increase securities market volumes and transparency, develop market infrastructure, improve supervision and ease taxation. The strategy seeks to make Russia a strong independent financial centre ready to assume a greater role once the upheavals in the current international financial market structure subside.

While Russia has drafted a number of bills in recent years aimed at improvements in securities trading, many large gaps remain. For example, Russian still lacks adequate rules on insider trading, rules for clearing securities trades and control of professional securities brokers. Legislation covering derivatives trading is still inadequate, as is protection of small investors.

The 2020 strategy calls on the government to deal with package of 17 related bills this year. These include collateral and centralised clearing acts, as well as amendments to the acts on limited liability corporations and securities.

Observers have generally praised the strategy, noting that it focuses on much-needed change. Once implemented, the strategy would signal a substantial advance in the evolution of Russia's securities markets.

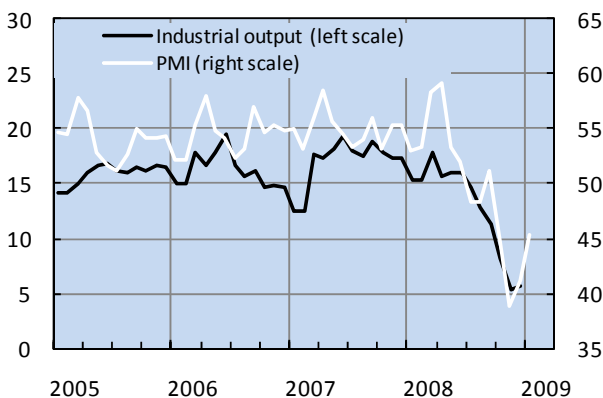
China

China's industrial production faltered again in January. The seasonally adjusted purchasing managers' index (PMI) figure for January was 45.3. Thus, the situation in industry continued to deteriorate, albeit not as fast as in December or November, when PMI values were 41.2 and 38.8, respectively. The continuing weakness was clearly reflected in the core sub-indices for new orders, production and employment. The China Federation of Logistics & Purchasing (CFLP) compiles the PMI from several sub-indices based on surveys of over 700 industrial firms. As a diffusion index, a PMI value below 50 indicates the majority of managers surveyed perceive business conditions in the current month to be worse than in the previous month.

The PMI survey revealed that in recent months Chinese firms have sharply reduced their inventories of both finished goods and raw materials. This was most apparent for metal industry. Other data also found reductions in inventories. A separate survey of 500 Chinese firms in December and early January by the Japanese Nomura Holdings found that 60 % of surveyed companies had cut inventories to one or two months of both use and sales, down from typical levels of three to four months.

Some observers have pointed to the recent drop in inventories and the mild rise in prices for iron and steel as an indication that Chinese economic growth could revive as soon as the first half of this year. More cautious forecasters dismiss the significance of changes in inventories, and claim that they don't have as large impact on overall demand as they used to. Moreover, the impact of a decline in inventories is seen minor compared to the much larger and pervasive problem of excess capacity.

12-month industrial output growth (%) and PMI



Source: CEIC, Li & Fung Research Centre

China posts surprisingly small 2008 budget deficit despite sharp spending increases. Preliminary data from the finance ministry show the realised budget deficit of China's central government last year was just \$16 billion, or 0.4 % of GDP. Rapid economic growth helped boost growth in budget revenues by nearly 20 %. Even so, budget spending grew faster (25 %), due largely to spending related to a spate of natural disasters. Budget expenditures (\$900 billion) corresponded to nearly 21 % of GDP.

Budget expenditures relative to GDP have grown considerably in recent years. The realised budget deficit was only about half the size of the official budget projection presented in March 2008. China will release its final budget figures later this spring in conjunction with the 2009 state budget.

Official unemployment rate rises. Official figures show registered unemployed in China's cities at the end of December represented 4.2 % of the labour force. At the end of 2007, the corresponding figure was 4.0 %. The last time China experienced a rise in unemployment was during the SARS epidemic of autumn 2003. The current rise in unemployment reflects deterioration of global economic conditions. Labour-intensive export businesses, in particular, have been forced to slash their payrolls. Officials expect the registered unemployment rate to reach 4.6 % this year, which would be the highest recorded official unemployment rate in China since 1980.

Statistics on the official unemployment rate are deficient from several perspectives. Notably, the labour figures ignore rural residents and migrant workers. Moreover, urban dwellers do not necessarily gain anything from the system by reporting their employment status. Official estimates claim that 15 % of the migrant worker population, or about 20 million people, cannot find work at the moment. The Chinese Academy of Social Sciences (CASS) estimates overall unemployment reached almost 10 % at the end of 2008. China's leadership takes the unemployment rate seriously as higher employment may translate into civil unrest.

China's grain production up for fifth year in a row.

The National Bureau of Statistics reports grain production increased over 5 % in 2008. The record harvest was nearly 530 million tons. Meat production also rose. Pork production is slowly recovering from the 2006–2007 epidemic of blue ear disease.

Rising consumer incomes have had a strong impact on the China's meat-eating habits. To restrain the rise in food prices, the government heavily subsidises grain and meat production. Since about a third of China's inflation rate is driven by food prices, higher domestic food production can diminish inflationary pressure on food prices and help restrain inflation overall.

Russia

CBR announces rate hikes to support rouble. On February 10, the Central Bank of Russia increased several key interest rates by one percentage point. It was the second rate hike this month. The higher interest rates are hoped to calm inflation and stabilise the external value of the rouble.

The rouble's exchange rate against its dollar-euro currency basket is stabilising after a decline in recent weeks and a close brush last week with the CBR's official 41-rouble ceiling. On Thursday (Feb. 12), 39.2 roubles bought one unit of the currency basket.

Russia continues to burn through its currency reserves, which stood at \$384 billion on February 6.

Fitch downgrades Russia's creditworthiness. The international credit rating agency Fitch lowered its long-term foreign-currency and local currency ratings for Russian sovereigns from BBB+ to BBB. Fitch also declared a negative outlook on Russia's long-term borrowing. The downgrade reflected the drop in world commodity prices and capital outflows that have consumed Russia's foreign currency reserves and thereby impaired the country's ability to service its foreign debt.

Russia's foreign debt at the beginning of October 2008 stood at \$540 billion. Banks accounted for \$200 billion, the corporate sector for \$300 billion and the public sector for the rest. The CBR estimates amortisation on foreign debt in 2009 will be \$120 billion, but some observers say the amount could be higher.

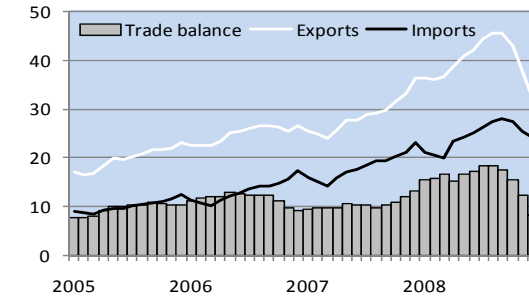
Foreign trade down in the end of 2008. The value of Russian goods exports last year was \$470 billion, while goods imports amounted to \$290 billion. Imports and exports were each up by about a third for the year, and the trade surplus reached a record level again. At year's end, however, foreign trade slowed substantially, with the value of exports declining 26 % y-o-y in December. Imports fell 4 % y-o-y. Imports from CIS countries fell over 25 %, while non-CIS imports were down less than 1 %. The trade balance remained in the black in December, but was only about the third as big as in December 2007.

The EU accounted for over half, and CIS countries about 15 %, of Russian foreign trade last year. China surpassed Germany as Russia's largest import provider, while the Netherlands retained the top slot on the export side.

Nearly 70 % of Russian exports consisted of energy products. The volume of crude oil exports fell 6 %, while volumes of natural gas and oil products grew slightly. Metals' share declined to 12 % of exports. Raw timber exports were down about 25 % y-o-y, and accounted for less than 1 % of the total value of exports.

Over half of imports were machinery, equipment and vehicles. The largest product group was passenger cars, which accounted for 11 % of all imports. Foodstuffs and chemical products had a 13 % share each.

Value of Russian monthly goods trade, US\$ billion (3-month moving average)



Source: CBR

Government commits to additional, but selective, bank support. Over the past two weeks, the cabinet actively discussed ways to provide more aid to banks. Proposals on the table included helping both state-owned and private banks raise capital by having the government participate in share offerings. This week, prime minister Vladimir Putin stated that the government is not planning to acquire shares of private banks, as private bank owners have to take themselves the responsibility for their woes. Putin further noted that state participation could weaken the position of small investors. Instead of direct capital support, the cabinet said it was ready to provide private banks with a total of 100 billion roubles (€2.2 billion) in subordinated loans with certain conditions attached such as a commitment from the banks to increase their lending.

Under the plan, state-owned banks will get more money than private banks. The government is ready to give former state foreign trade bank VTB a 200-billion-rouble capital injection. In recent years, VTB has aggressively increased its retail banking operations and is currently Russia's second largest bank. State development bank VEB, as a channel for the support financing, will get a 100-billion-rouble capital injection and possibly a matching subordinated loan. Sberbank, Russia's biggest bank will also get additional funding, if needed. The sum is estimated at 400–500 billion roubles and would probably be provided by its majority owner, the central bank. The total value of this latest financing round is 900–1,000 billion roubles (about €20 billion).

Private banks have so far received 225 billion roubles (€4.9 billion) in subordinated loans from the state. About \$12 billion of the \$50 billion VEB received last October for refinancing foreign debt of Russian firms has been used, with about 40 % going to aluminium giant RusAl. Media reports say issuing of these refinancing loans will cease.

China

Inflation cooled further in January. Consumer prices rose just 1.0 % y-o-y in January, sharply down from last spring's more than 8 %. December inflation was also just 1.2 % y-o-y. The National Bureau of Statistics reports food prices were up 4.2 % in January, while prices of other goods and services were down 0.6 % from a year earlier. With producer prices falling for two consecutive months, consumer price inflation is expected to moderate further in coming months. Producer prices were down 3.3 % y-o-y in January, and the decline in the producer price index in December was 1.1 %. The broad money supply (M2) increased 18.8 % y-o-y in January.

Subsiding inflation provides China's leadership with an opportunity to further relax their monetary stance to stimulate economic growth – even with uncertainty over longer-term inflationary effects of the government's nearly \$600 billion fiscal stimulus package. At the end of November, China lowered the reference rate on one-year loans to 5.58 % and the deposit rate to 2.52 %. In other words, real lending rates are currently strongly positive.

Despite declines in exports and imports in January, China's trade surplus hit record high. China Customs reports that for January 2009 the value of exports declined 18 % y-o-y and imports 43 %. The sharp drop in imports had the effect of giving China close to a record trade surplus (\$39 billion for the month). The January surplus is nearly as big as the 1Q08 surplus. Interpretation of the January figures is complicated by the five-day Lunar New Year's holiday. This year the holiday fell in January, while last year it was in February. Adjusting the January figures for the New Year's holidays, it appears exports contracted a few per cent and imports were down about a third. With regard to trade volumes, the contraction that began in November continued in December with exports down 8 % y-o-y and imports off by 13 %.

With the international financial crisis deepening and protectionist sentiments on the rise around the world, China has become a serious advocate for free trade. China-India relations took a hit at the end of last month when India unexpectedly declared a total ban on the import of toys manufactured in China. On the other hand, China has moved to support its own exporters through e.g. tax breaks.

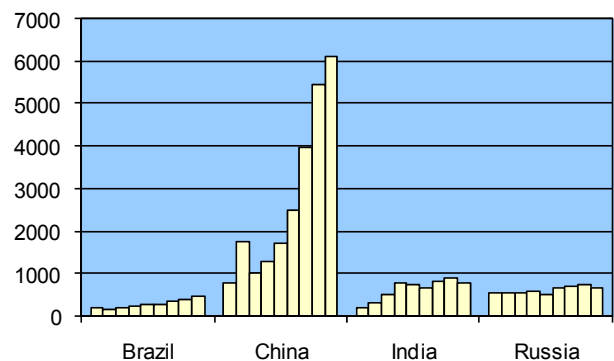
Despite to sharp contraction in foreign trade, the impact of the trade figures to GDP growth in January is hard to detect. Looking at demand-side GDP data, the trade surplus climbed substantially from a year earlier. This suggests net exports supported overall economic growth, although no official figures for January export volumes

have yet been released. Weaker exports, however, mean declines in production output. It is difficult for China to make up for a loss of export demand by stimulating domestic consumption as export firms are under strong pressure to lay off workers and thus cause downward pressure on consumer demand. Given the bleak export prospects, enthusiasm for corporate investment could also decline.

International patent activity of Chinese firms continued to rise in 2008. Patent applications filed under the protocols of the international Patent Cooperation Treaty (PCT) reached 164,000 last year, a rise of more than 2 % from 2007. The amount of international patent filings from China increased 12 %. With over 6,000 patent applications, China surpassed the United Kingdom as the world's sixth most active patent-seeking country. Chinese telecom and network solutions provider Huawei, with over 1,700 patent filings last year, became the world's top PCT patent-seeker (up from fourth place in 2007). Only one other Chinese company, telecommunications equipment manufacturer ZTE, made it into the top 100 patent-filing firms.

The United States retained its dominance in international patent activity, accounting for a third of all PCT patents. Next on the list were Japan and Germany. Korea ranked as the fourth largest patent-seeker, reinforcing Asia's growing role in development of new technology. France was at fifth place, just ahead of China. Finland was the 13th most active PCT patent-seeker with over 2,100 applications. Nokia accounted for nearly half of Finland's patent applications. Ignoring China, the other BRIC economies lagged far behind in the patent-seeking activity.

Annual volume of international patent applications (PCT) in BRIC countries, 2000–2008



Source: WIPO (<http://www.wipo.int>)

Russia

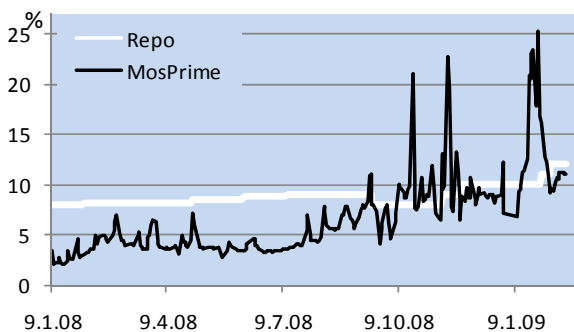
Russian share prices continue to decline. The RTS index slumped about 15 % in the past week, losing most of an almost 20 % gain from the previous three weeks. The price of Urals-grade crude oil returned to below \$40 a barrel, having been as high as \$45 earlier. Moscow stock exchanges underperformed other emerging market exchanges. For example, the Shanghai stock exchange lost just 2 % over the past week, while the Kiev stock exchange index on Thursday (Feb. 19) was practically unchanged from a week earlier.

Interbank rates continued to fall. The overnight and one-week MosPrime rates, which exceeded 20 % in January, are now substantially lower. On Thursday (Feb. 19), the overnight rate was 10.25 % and the one-week MosPrime 14.25 %. The MosPrime rate is a reference rate based on the offered rates for rouble deposits as quoted by eight of the leading banks in the interbank market.

The rouble's exchange rate against its dollar-euro currency basket has fluctuated with no clear direction. A short episode of rouble strengthening ended this week. On Thursday (Feb. 19), the rouble was quoted at 40.3 for one unit of the currency basket, a level close to the CBR's trading limit of 41 roubles per currency-basket unit.

On February 13, Russia's currency reserves stood at \$387 billion, up from \$384 billion the previous week.

Overnight repo and MosPrime rates



Source: Central Bank of Russia

Economic conditions deteriorated further in January. Preliminary Rosstat data show investment declined 16 % y-o-y last month. The bleak investment outlook could be seen in a 17 % decline in construction and a 16 % drop in industrial output. Production of mineral extraction companies fell 4 %, mainly due to lower natural gas production. Manufacturing output was off 24 %.

Consumption growth likely persisted in January, with retail sales up over 2 %. The outlook for consumption

growth, however, appears gloomy as real incomes declined 7 % in January and unemployment rose above 8 %.

Deputy economy minister Andrei Klepach said the economy ministry again revised its economic forecast downwards. The ministry now expects GDP to shrink 2.2 % this year, not 0.2 % as earlier forecast.

Russia's car industry on the ropes. Car production in Russia fell 80 % y-o-y last month, leading the overall drop in industrial output. Nearly all car plants extended their New Year's holidays and now operate with cut capacity. The decline in production largely reflects lower demand. Preliminary figures suggest January car sales were off about a third.

Government measures to support domestic carmakers include hikes in import duties on cars, a 12-billion-rouble (€270 million) expenditure on vehicle purchases by state agencies and 2 billion roubles in interest supports for consumer car loans. The subsidies are estimated to encourage the purchase of 200,000 – 250,000 new cars. Over 3 million cars were sold in Russia last year, more than a third of which were built or assembled in Russia.

Banking sector grew thanks to state support and weaker rouble. Total banking sector assets at the end of 2008 amounted to 28,000 billion roubles (€620 billion), an increase of 40 % y-o-y in nominal terms. Although 2008 growth nearly matched the pace of recent years, the gains largely reflected state support and weakening rouble. Observers estimate banking sector growth would have been about half of that without these two factors.

Commercial banks loaned 3,100 billion roubles from the CBR in 4Q08. As a result, CBR participation grew from below 1 % in October to 12 % of the banking sector's total assets at the end of fourth quarter. The share of central bank financing was clearly higher at larger banks.

Despite state support measures, corporate lending has yet to revive. The stock of corporate loans increased in 4Q08 by 480 billion roubles, i.e. about 15 % of the central-bank support. Banks seem to have used part of the support money on currency speculation in anticipation of a weaker rouble and on balance-sheet reinforcement.

Last autumn's contraction of the deposit stock abated in December. Rouble deposits fell slightly, while currency deposits increased sharply, which partly reflected the weakening of the rouble. Currency deposits represented nearly a third of the deposit stock at the end of December.

Although growth in the stock of non-performing loans slowed in December, the CBR admits the improvement is largely cosmetic, reflecting a change in the way bad loans are reported. A further rise in the stock of non-performing loans could make it difficult for certain banks to meet the capital requirements.

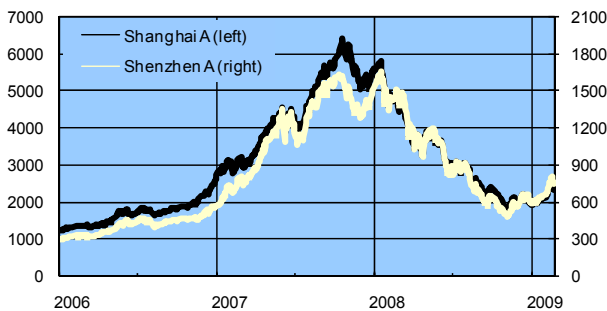
China

Chinese share prices enter third month of recovery.

The Shanghai stock exchange this week climbed above the 2,500-point mark, a gain of 700 points (nearly 40 %) since its November 2008 nadir. Although the rise seemed to plateau later in the week, the index has added over 20 % for the start of the year, putting Shanghai among the world's best-performing exchanges in 2009. Trading volumes have also increased substantially and trading has revived. In the same period, however, shares of Chinese companies listed on the Hong Kong stock exchange have dropped slightly with no sign of revived trading in the near future.

The rise of Chinese exchanges and increased trading volumes is attracting global attention as no similar signs of recovery have been seen elsewhere in the world. One fear is that Chinese firms may be using government stimulus bank loans to leverage share purchases. The Chinese government has urged banks to increase lending to keep companies on track with their capital investment plans, but given that the expected yield on new capital investments is fairly low, companies could be susceptible to seeking higher returns by investing their loans in the stock market. If this is true, government stimulus measures could cause a new share-price bubble in Chinese stock markets.

Trends in share prices on China's stock exchanges



Source: Bloomberg

China lends \$25bn to Transneft and Rosneft in exchange for Siberian oil. China Development Bank this week granted \$10 billion in loans to Russia's state oil pipeline operator Transneft and \$15 billion to state oil company Rosneft in exchange for oil supply contracts. The Russian firms will use loan money to strengthen their balance sheets, develop oil fields in East Siberia and construct the major East Siberia Pacific Ocean (ESPO) pipeline. Under the deal, Russia will provide China with 15 million tons of crude oil through the pipeline annually over the next 20 years. After years of contentious negotia-

tions, China's state oil company CNPC and Transneft agreed in principle last October that China would construct the branch pipeline from the ESPO into China. The financing details, however, remained unresolved. Transneft says the branch pipeline to China should be operational next year.

China's domestic oil production in 2008 was about 190 million tons, an increase of 2 % from the previous year. In contrast, the volume of crude oil imports climbed nearly 10 % to 179 million tons. China imported nearly 12 million tons of crude oil from Russia (mostly by rail) in 2008. Imports were down about a fifth from the previous year.

Chinese investors pursue global natural resources.

China's largest aluminium producer Chinalco last week announced plans to invest nearly \$20 billion in Australian mining giant Rio Tinto. Slightly over \$12 billion of the sum will come as direct investment, with the remainder taken in the form of corporate bonds. The deal constitutes the largest-ever foreign direct investment of a Chinese firm. The Chinese Minmetals also reports plans to acquire outright the Australian mining company OZ Minerals for \$1.7 billion. Both deals await approvals from Chinese and Australian officials. A number of other Chinese companies and country's sovereign wealth fund have announced plans to invest in foreign natural resources. In addition, China is considering creation a special oil investment fund that would be funded out of foreign currency reserve assets.

FDI of Chinese companies has increased in recent years. The most recent data (taken from 1H08 balance-of-payments figures) show China's FDI investments abroad amounted to \$33 billion during the six-month period.

China surpasses US as world's top car market. The volume of monthly cars sales in China surpassed the United States in January. The China Association of Automobile Manufacturers (CAAM) reports that 736,000 cars were sold in China last month. While car sales in China have also suffered from weak economic conditions, the effect is far less pronounced than in the US. Since last July, monthly sales figures (measured on-year) have been negative with the exception of October.

Officials have sought to increase demand for cars by e.g. reducing taxes on cars with small engines. Moreover, stiff competition has forced a drop in retail prices. Although the market share of domestic car brands in China continues to decline, foreign carmakers must partner extensively with Chinese firms to operate in China. As a result, relatively few fully assembled new cars are imported to China. In 2003, officials designated the auto industry as a pillar of the Chinese economy. The goal is to create a robust car industry with a few major international car companies.

Russia

New support for a struggling production sector. In December, the government designated 295 top-tier Russian firms critical to economic development. The list of companies eligible for special public support includes large or regionally significant enterprises in nearly all branches of industry. In February, the government approved the principles for a system of loan guarantees for these critical firms. The loan guarantee system also covers about 1,200 firms in the defence sector.

Companies are eligible for state guarantees for loans that they use to finance production or capital investment. The loan guarantees in the defence sector cover 70 % of the loan, while firms in other fields get guarantee coverage of up to 50 %. The 2009 budget sets aside 300 billion roubles (€6.5 billion) in guarantee funds, of which 100 billion roubles will go to the defence sector. State development bank VEB will act as the guarantee intermediary.

The government is also planning new measures to support oil production, most notably construction of East Siberian infrastructure financed with public money to develop oil exploration and production. Oil produced by the newly opened fields would be temporarily exempted from export tariffs. Oil refining capacity will be boosted by state guarantees for loans for capital investment in refineries.

Russia begins LNG production. President Medvedev and Japan's prime minister Aso last week inaugurated a liquefied natural gas (LNG) facility within the Sakhalin II project. LNG production is a new field for Gazprom, which is gradually increasing its offshore gas production. Traditionally Gazprom exports gas from onshore fields through land-based pipelines, but liquefaction of gas allows it the possibility to use more flexible sea transport.

Under the Sakhalin II production-sharing agreement signed in 1994, the project operator is the Sakhalin Energy Investment Company (SEIC), a consortium of Shell, Mitsubishi and Mitsui. In 2006, Gazprom assumed a majority stake in SEIC (50 % + 1 share) after the consortium was accused of violating environmental protection laws. Shell, Mitsui and Mitsubishi became minority shareholders in the venture.

Regular LNG shipping from Sakhalin II will begin in March. Production will reach 6 million tons this year. The plant's ultimate capacity, 9.6 million tons a year, should be reached next year. The plant's entire output capacity has been sold for the next 20 years: 65 % of production will go to Japan, 20 % to North America and the rest to South Korea. Sakhalin's full capacity represents about 5 % of current global LNG production.

The planned development of the Shtokman oil and gas field in the Barents Sea will significantly boost Gazprom's

production. Construction of an LNG plant and shipping harbour to serve the production of the offshore Shtokman field are planned for the Kola peninsula.

LNG has steadily increased its share of the global gas market. As of 2006, LNG accounted for nearly 25 % of the global market. Gazprom's goal is to become the world's third largest LNG producer.

Exxon, in contrast, reports ongoing troubles with exports from its Sakhalin I oil and gas project. An affiliate of Exxon operates the project under the auspices of an international consortium, consisting of a group of international companies and Russia's state-owned Rosneft. Exxon claims Gazprom wants to buy gas for itself rather than let Exxon export it to China. Sakhalin I began oil and gas production in 2005.

Rising unemployment worries Russians. Rosstat's January unemployment figure, based on ILO methodology, climbed by 300,000 people to over 6.1 million. This put Russia's unemployment rate at 8.1 %, higher than in the US (7.6 %) or Finland (7 %). According to Russia's ministry of health and social development, another half million people had received notice of redundancy. According to newspaper reports, the state administration is also considering cutting workers.

Less than a third of Russia's unemployed are officially registered as seeking work. This is due in part to Russia's stinginess with unemployment benefits. Even with the latest benefit hike at the beginning of the year, the maximum monthly unemployment benefit is just 4,900 roubles (a bit over €100). The latest available Rosstat figures (summer 2008) on the minimum subsistence income for a working-age person was over 5,000 roubles.

Unemployment has risen sharply in areas (e.g. Chelyabinsk and Sverdlovsk) where the labour pool is dependent on a few large metal producers or carmakers. President Medvedev showed his disappointment with regional-level efforts to deal with burgeoning unemployment by firing four regional governors last week.

In addition to firings, many firms have resorted to layoffs, shorter work hours and delayed or cut wage payments. According to a recent Levada Centre survey, 30 % of Russians experienced delayed wage payments or wage cuts at their workplace in December. Despite the hardships, keeping your job is important for Russians. Larger firms typically provide their employees with a range of valuable social services.

The rise in unemployment has led to large reductions in foreign worker quotas. In addition to the foreigners with work permits, Russia has millions of illegal foreign workers from former Soviet republics. The decline in workers' remittances from abroad may have huge impacts in their home countries. The World Bank estimates the workers' remittances from abroad account e.g. 45 % of GDP in Tajikistan and 38 % of GDP in Moldova.

China

China and the US to broaden their dialogue agenda.

New US Secretary of State Hillary Clinton took her first official trip abroad last week, visiting Japan, Indonesia, Korea and China. The trip was seen as a signal that the Obama administration plans to give relations with Asia greater emphasis. In China, Clinton stressed the economic interdependence of the two nations and the US desire to continue in some form the minister-level biannual “strategic dialogue” initiated by former treasury secretary Henry Paulson in 2006. Clinton suggested that weak economic conditions in the US are likely to dominate discussions with China. She hoped China would continue to buy US government debt and avoided the hot-button issue of China’s exchange-rate policy.

Paulson’s economic strategic dialogue has proven so successful that president Obama’s cabinet wants to see the meetings continue in some form. The US is proposing to add security and other policy issues to the mix. During the Bush administration, the treasury department led China relations. Now the roles may be divided among treasury secretary Timothy Geithner, Clinton, and possibly other officials. The scope of cooperation is still unclear and the matter will be discussed next week during the visit of Chinese foreign minister Yang Jiechi to Washington DC.

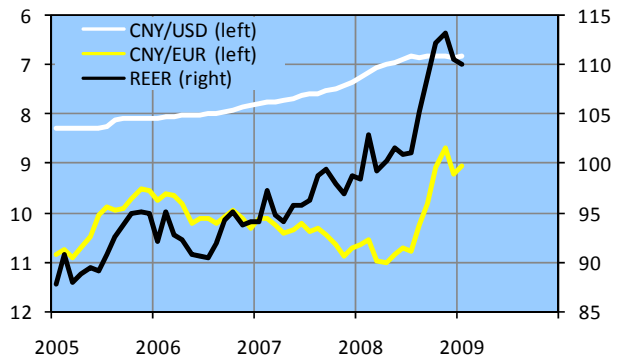
Exchange rate policy remains a touchy subject for the new administration. On one hand, the Democrats have been highly critical of China’s exchange rate policy, with Geithner going so far last January as to accuse China of manipulating its exchange rate. On the other hand, it is unlikely the treasury department will actually declare China manipulates its currency in its next semiannual report to the US Congress in April. If the report did accuse China of exchange rate manipulation, it would open the possibility of imposing import tariffs on Chinese goods – a move China would not take lightly. During Paulson’s era as treasury secretary, he said that the issue of yuan appreciation was inextricably linked to broader reforms of China’s financial markets. The view allowed the Bush administration to hold back on charges of currency manipulation. It is expected, that the new administration’s exchange rate policies are likely to closely resemble those of its predecessor.

Yuan stable against the dollar, strengthening against other major currencies. As the downturn in the world economy gained steam last summer, China’s government abandoned its policy of gradual yuan appreciation against the US dollar. Although the yuan-dollar exchange rate has remained quite stable in recent months, the yuan has gained sharply against the euro, as the euro has declined

against the dollar. Since the delinking of the yuan’s dollar peg in July 2005, the Chinese currency, measured in nominal terms, has gained 21 % against the dollar and 13 % against the euro.

Valuable insights into the development of the yuan’s exchange rate are provided by the real effective exchange rate, which describes average trend of price competitiveness of Chinese producers relative to their trade partners. The yuan’s real effective exchange rate, which is based on the trade-weighted exchange rates of its partners and inflation differences, has strengthened since 2005. This, in turn, has dragged down China’s price competitiveness. Real exchange rate appreciation is a typical feature of countries with rapid economic growth and rising productivity. China’s high inflation and the decline of the euro have contributed to the yuan’s gains in the second half of 2008. The real exchange rate is now 23 % above its level just before the July 2005 exchange rate policy reform.

Yuan-dollar-, yuan-euro exchange rates (inverted scale); real effective exchange rate (rise indicates yuan appreciation)



Sources: Reuters, BIS

Support measures improve outlook for steel industry.

China’s latest stimulus measures include increased spending on infrastructure, subsidies for the shipbuilding industry, measures to boost car demand, and several measures to reinvigorate China’s construction sector – the country’s largest steel consumer.

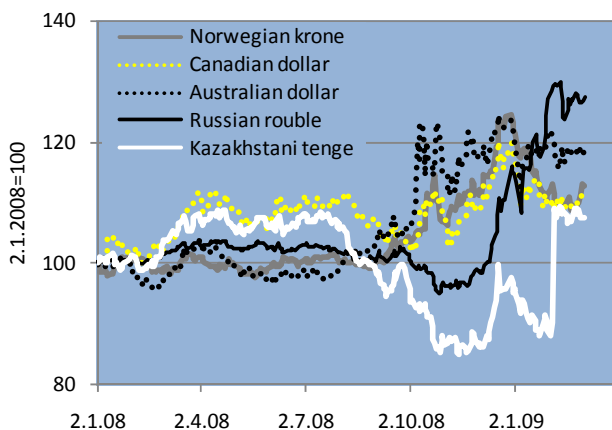
China last year produced 500 million tons of steel, or about 40 % of global output. The steel industry has been in trouble due to high commodity prices and falling demand. In the fourth quarter of 2008, the steel industry posted losses of nearly 50 billion yuan (€5.5 billion). For all last year, however, the industry enjoyed profits of 85 billion yuan.

Russia

Rouble exchange rate hit harder than currencies of many other raw material exporters. With crude oil prices down over 70 % from record highs and even more dramatic changes in prices of some other commodities, many countries that depend on export earnings from just one or two raw materials have experienced sharp drops in their exchange rates in recent months. Some commodity producers such as Australia and Norway have simply let their exchange rates slide. Others, including Russia, have fought valiant, but ill-fated, battles to prop up their currencies. Kazakhstan capitulated with a devaluation of its currency early last month.

Even with the Central Bank of Russia's market operations, the Russian rouble lost substantially more value than the Norwegian krone or the Kazakhstan tenge, even if both countries, like Russia, generate most of their export earnings from energy. The rouble's weaker exchange rate appears to acknowledge that Russian inflation is also considerably higher than Norway's. In recent weeks, the external value of the rouble appears to have stabilised and the CBR has not had to intervene much in the currency markets.

Euro-equivalent rates for currencies of raw material exporting countries, Jan. 2, 2008=100 (rising trend indicates weakening exchange rate)



Source: European Central Bank

Russia's currency reserves no longer hemorrhaging. Russia's foreign currency reserves as of end-February stood at \$384 billion, some \$4 billion less than at the end of January. Before the February's staunching of reserve depletion, Russia's reserves had contracted at an average rate of \$35 billion a month since August 2008 as the CBR defended the rouble.

The slowdown in reserve depletion has been accompanied by a stabilisation of the rouble's exchange rate. Relative to one unit of the dollar-euro currency basket, the rouble's value fluctuated between 39 and 41 roubles in February. On Friday (Mar. 6), the exchange rate was 40.11 roubles per currency-basket unit. At the end of January, the CBR lifted the upper trading limit to 41 roubles per unit.

Prosecutor General's office investigating possible abuses at Russia's state investment company. The Russian Venture Company (RVC) was established in 2006 to further the emergence of venture capital investment in novel technologies and high-tech production. RVC's initial capital endowment was 30 billion roubles (€860 million) taken from the federal budget. The money is to be invested via private asset management companies in technology start-ups.

A report by the Prosecutor General's office issued in December 2008, however, lists serious deficiencies in RVC operations. Only a small fraction of the assets have been invested, and of those, some have gone to ventures outside the contemplated scope of the fund. Most RVC assets still sit in bank accounts, providing the company with a steady cash flow that it has been free to spend as it wishes. The Prosecutor General's office called on RVC to explain the disproportionately large administrative costs, including the generous CEO pay and compensation of three board members (two are non-Russian).

The economic development ministry, which oversees RVC's operations, announced it had responded to the situation by drawing up an operating strategy for RVC, including criteria for evaluating the company's performance. The ministry will take measures to increase the efficiency of the use of funds, cut administrative costs and increase oversight of the private fund management companies. The ministry, however, pointed out in its announcement to the Prosecutor General's office that venture capital investment is not geared to short-term profits.

Russia created several new state development organisations besides RVC during the recent boom years. They include, among others, an investment fund that partners with the private sector in large projects, an information technology fund and the Russian nanotechnology fund. Scientific and technical advancement of small companies is supported by another fund and there are a number of regional and branch-specific development funds.

RVC's problems seem to be typical for many of Russia's nascent state investment funds. The problems go beyond fraud and abuse to the more profound difficulties of functioning in an environment that lacks institutions, experience and expertise, as well as suitable investment targets. The report of the Prosecutor General's office also suggests that its own investigators are unfamiliar with how venture capital funds operate.

China

Outlook for Chinese manufacturers continues to weaken. China's Purchasing Managers' Index (PMI) remained below the critical 50 % mark in February. The PMI, assembled by China's Federation of Logistics & Purchasing (CFLP), rose from a 45.3 % reading in January to 49 % last month. Even with the improvement, it was the fifth month in a row that Chinese firms faced a poor business outlook. The 11 subindexes in the PMI range from company order books to output and inventory levels. A PMI value below 50 indicates the majority of managers surveyed perceive business conditions in the current month as worse than in the previous month.

CFLP has published the PMI since 2005. Typically, the strongest PMI figures of the year are in the two months following the Chinese New Year holidays (in January this year). February's resurgence of PMI figures may reflect hopes of a second round of stimulus from the government. On Thursday (Feb. 5), however, Chinese premier Wen Jiabao announced to the People's Congress that no further stimulus spending was currently needed.

World Bank examines China's progress under current five-year plan. A recent World Bank report finds China has made good progress towards a number of goals set in the country's 11th five-year plan (2006–2010). Economic growth has exceeded expectations and China has succeeded in improving living conditions in the countryside, education and health care. However, achievements have been mixed in the environmental protection arena. Air and water pollution are on the decline, water use is more efficient and forest areas have expanded. Yet the goal of energy efficiency has only been achieved in a few sectors. The country still faces major environmental challenges.

The World Bank noted that China has made little progress in adjusting its growth strategy away from industrial and investment-driven growth to growth led by domestic consumption of goods and services. Moreover, factors underlying the economic growth model persist, e.g. underpricing of production factors (energy, capital). If China fails to adopt a new growth model, it will find energy efficiency gains elusive and ever-widening earning disparities between the city and the countryside. The World Bank said domestic consumption needs to be supported by public spending on social needs such as health care and education. A stronger currency and financial sector reforms would shift production to the economy's "closed sector," which includes services, as well as encourage production of small and mid-sized firms.

Further deterioration of the world economy since the report was released in December 2008 has reduced

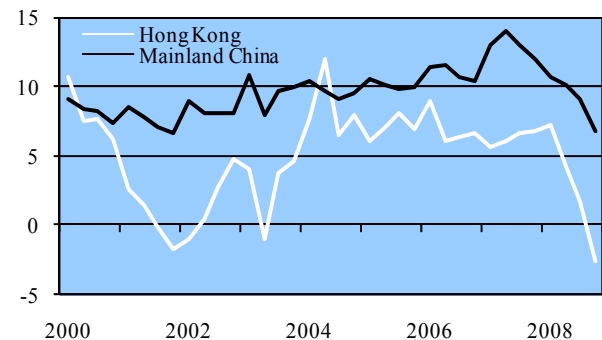
China's export prospects. The current crisis as such does not make adoption of the new growth model easier as increased unemployment and lower wage growth have cut into domestic demand. Nevertheless, the crisis illustrates the timeliness of a new growth strategy; foreign demand has dried up, making the role of domestic demand all the more critical.

Recession grips Hong Kong SAR. Hong Kong's overall economic output was down in 4Q08 for the third consecutive quarter. The fall in the fourth quarter was 2.5 % y-o-y. Hong Kong's GDP grew 2.5 % overall in 2008, down from GDP growth of above 6 % in 2007. The unemployment rate ticked up slightly, although at the start of this year it was still just 4.5 %.

All GDP demand components, excluding public consumption, shrank in 4Q08. Private consumption fell over 3 % y-o-y, while investment dropped over 17 % y-o-y. The slump in private consumption reflects the negative wealth effect due to lower asset prices. The contraction of imports and exports to and from mainland China was echoed in Hong Kong, where re-export activity slid nearly 12 % y-o-y in December. Hong Kong's total goods exports fell nearly 13 % y-o-y in December, while goods imports were down 17 % y-o-y. On-year growth in services exports from the seven-million-resident SAR was nearly stagnant in 4Q08.

The downturn has helped bring down consumer price inflation to around 3 %. Hong Kong inflation was running above 6 % in mid-2008. As Hong Kong monetary policy is based on a dollar peg and a currency board, it tracks US monetary policy (i.e. near-zero interest rates). Hong Kong fiscal policy focuses on providing economic stimulus through investment in infrastructure. The spending is expected to keep public finances in the red in coming years. Hong Kong officials expect economic growth to decrease 2–3 % this year with on-year inflation hovering around 1.5 %.

Quarterly change in real GDP for Hong Kong and mainland China, % y-o-y



Sources: Statistics bureaus of Hong Kong and mainland China

Russia

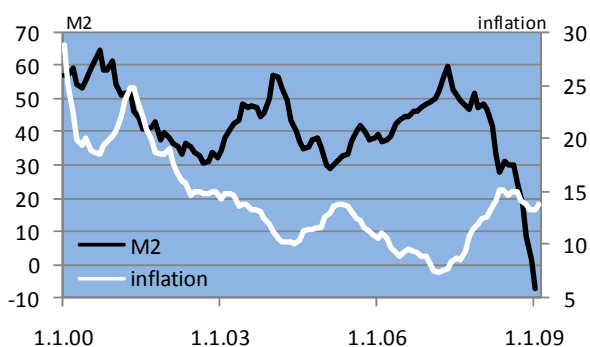
Inflation remains high amidst economic slowdown.

Consumer prices rose 1.7 % m-o-m in February, led by a 1.9 % increase in the price of food. Inflation for both food and non-food goods accelerated from January. In contrast, the rise in prices of services slowed sharply in February as some administrative price hikes were implemented at the start of the year.

Consumer prices overall were up 13.9 % y-o-y in February. Inflation remained high and even accelerated slightly from January. February food prices climbed 16 % y-o-y, while prices for services were up 17 %.

Money supply growth, a determinant of inflation, has slowed significantly over the past year as liquidity in financial markets dried up. In comparison, the broad money supply (M2) was expanding at a rate above 48 % y-o-y in January 2008 and grew 27 % overall last year. In January 2009, M2 contracted at a rate of 7 % y-o-y. M2 encompasses all cash in circulation in Russia and the stock of rouble deposits. While the decline of the total deposit stock that started last autumn is no longer occurring, depositors continue to move out of roubles into foreign currencies. As a result, foreign currency deposits accounted for over a third of the entire deposit stock as of end-January. M2 is expected to increase only 20–25 % this year. Eventually, this lower expansion of the money supply should feed through as lower inflation. The government's inflation estimate for 2009 is 13–14 %.

Inflation and money supply growth, %



Sources: Rosstat and Central Bank of Russia

Russia raises oil export duty. Russia increased the export duty from \$100.90 per ton in February to \$115.30 per ton at the start of the month. The export duty is now revised monthly based on the average world market price for Urals blend. The bimonthly duty-setting scheme was abandoned at the end of last year and replaced with a month-to-month scheme that better tracks changes in world oil prices. The average price of Urals blend used for the current duty was based on the January 15–February 14 period.

While export duties on oil products have until recently been adjusted downwards to reflect world market prices, prices for oil products remain high in Russia. The Federal Anti-monopoly Service (FAS) has started new investigations into anti-trust violations by Rosneft, Lukoil, Gazprom Neft and TNK-BP. The FAS claims that these companies have exploited their control of the entire production and distribution chain by charging consumers excessive prices. The oil companies dispute the claim. FAS last autumn issued fines of 1–1.5 billion roubles to oil firms for cartel abuses.

Russia's economic troubles reflected in lower Finnish exports. The value of Finnish exports to Russia slid more than 10 % y-o-y in the final two months of 2008, due largely to a drop in exports of machinery and equipment. For all of 2008, however, Finnish exports to Russia rose 13 % to a value of more than €7.6 billion. Russia, which accounted for nearly 12 % of Finnish exports, became Finland's largest export market. Nearly a fifth of Finland's exports to Russia, however, consisted of passenger cars not manufactured in Finland. Passenger cars also represented half of the export growth. Russia is an important export market e.g. for Finnish foodstuffs and textiles as about a fifth of these products' exports was destined to Russia last year. The bulk of the production of these goods, however, is consumed in Finland's domestic market.

The value of Finnish imports from Russia in 2008 reached €10.1 billion, an on-year increase of 21 %. With an over 16 % share, Russia last year was Finland's largest import provider. The value of imports, however, contracted sharply in November–December. This largely reflected the collapse in world commodity prices as imports consist largely of oil and other raw materials.

The slide in Russian demand has also been seen in transit cargoes passing through Finland to Russia. For 4Q08, the volume of road transit shipments fell 14 % y-o-y, due largely to a decline in shipments of passenger cars. Some 40 % of all car imports to Russia passed through Finland last year. For 2008 overall, both the volume and value of transit shipments increased slightly. The value of transit shipment was estimated at €31 billion, or about a sixth of Russia's total €200 billion in goods imports.

Russia's evaporating demand, the faltering rouble and hikes in import duties have hurt this year's outlook for Finnish exporters and transshipping to Russia. According to preliminary data, Finnish exports to Russia contracted in January to about half of the January 2008 level. Transit shipments were also down substantially. A January survey by the Finnish-Russian Chamber of Commerce found that every third firm expected their Russian exports to decline in the following six months.

China

Deflation hits Chinese consumer prices. China last month experienced consumer price deflation for the first time since 2002, with consumer prices falling 1.6 % y-o-y. Producer prices, which already went into decline last December, were down 4.5 % y-o-y in February. Changes in food prices tend to drive Chinese consumer prices. Food prices were down nearly 2 % y-o-y in February. The drop in consumer prices tracked developments in the real economy, where economic growth has slowed below its potential and reduced cost pressures. The loss of foreign export markets has created overcapacity that has added to the downward pressure on prices. A survey of property prices in 70 major cities found an average decline in housing prices of more than 1 % y-o-y in February. Over the longer term, inflation is expected to return as the stimulus package kicks in to increase bank lending and grow the money supply.

China's last bout with deflation, a product of the Asia financial crisis, lasted from 1998 to 2002. Then the deflation was explained by large productivity gains, the drop in duties as a result of WTO membership, and appreciation of the yuan's trade-weighted exchange rate, which lowered import prices. In the same vein, the yuan's nominal trade-weighted exchange rate increased sharply and inflation slowed in the second half of 2008.

The effects of deflation are considered more deleterious to the macroeconomy than inflation. Despite growth in real wages, consumer demand can collapse if consumers expect a sustained decline in prices. In addition, investment demand may suffer from high real interest rates. Deflationary episodes become particularly dangerous when the key monetary policy rates approach zero while real interest rates stay positive. In February 2008, the real interest rate on a one-year loan was -1.2 %. In February 2009, it was 6.9 %. Even so, China still has room to manoeuvre in its interest rate policy should it find it necessary to further relax its monetary stance.

January-February figures show no sign of an economic turnaround. China's National Bureau of Statistics reports that the decline in industrial output growth that started in the second half of 2008 continued in January and February. In real terms, growth was just 3.8 % y-o-y, which is far below the rates of 16–17 % ordinarily seen in previous years. In January-February, industrial output growth was boosted by a surge in construction material production supported by the government's stimulus package.

Growth in fixed capital investment remains brisk. In January-February, fixed investment in urban areas increased 27 % y-o-y in nominal terms. This growth was led

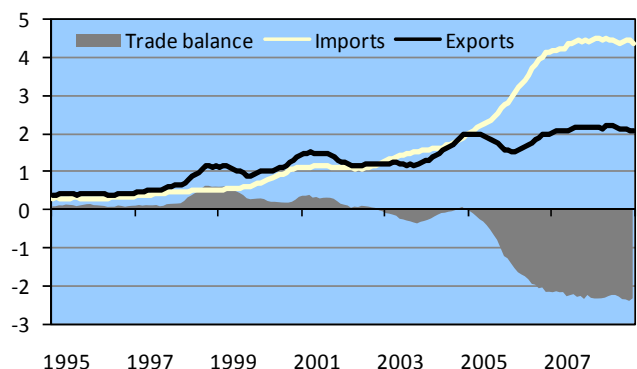
by state-owned enterprises. On the other hand, demand for exports collapsed in February with exports down 27 % y-o-y. China has not been able to support other Asian economies through trade as its imports have also fallen considerably. China's foreign trade surplus was only \$5 billion in February, down from \$39 billion in January. Officials hope to boost exports e.g. by eliminating export tariffs and increasing VAT rebates to exporters. Despite the high hopes of exporters, the government has been unwilling to devalue the yuan as demand in export markets has fallen.

Finland-China trade declined in 2008. Customs Finland reports the value of exports to China amounted to €2.1 billion in 2008, a 5 % drop from 2007. China accounted for 3.1 % of Finnish exports, making it Finland's tenth largest export destination. Based on the figures for the first half of 2008, two-thirds of Finnish exports to China consisted of machinery and equipment, with the rest largely made up of metals, pulp and paper. The drop in the value of exports was largely due to a drop in sales of phone equipment and lower metal prices.

The value of Finland's imports from China last year was €4.4 billion, a decline of 2 % from 2007. China accounted for 7.0 % of Finland's total imports last year, making it Finland's fourth largest source of imports. Two-thirds of Chinese imports to Finland consisted of phones, office equipment and other electrical devices. Clothing and footwear accounted for a bit over 10 % of imports in January-July. Lower phone sales were the main reason for the decline in imports.

Hong Kong's figures are not included in the above-mentioned data, but the special administrative region's share of Finland's foreign trade is miniscule. Finnish exports to Hong Kong last year accounted for 0.4 % of Finland's total exports and 0.1 % of imports.

Finland-China trade, € billion (12-month moving sum)



Source: Customs Finland

Russia

Falling apartment prices in Russia. Rosstat reports that housing prices went into decline in 4Q08 relative to the previous quarter. It was the first drop in housing prices since 2002 when housing price data first began to be collected. The average Russian apartment in 4Q08 was selling at about 55,000 roubles (\$2,000) per square metre, although prices vary widely depending on location and type of apartment. The average price was just over 80,000 roubles per m² in St. Petersburg and just under 140,000 roubles in Moscow.

Real estate agents say the slide in prices has continued since the start of the year. In Moscow, rouble-denominated prices fell at a rate of 1–2 % a month during January and February. Measured in dollar terms, the price drop has been more precipitous as the rouble has weakened. Many housing deals in Russia are denominated in dollars.

Currency-denominated housing loans account for about a fifth of banks' total housing loan stock (not counting Moscow, where over 60 % of the loan stock is in foreign currency). Russia's stock of housing loans is small. At the start of 2009, the loan stock amounted to just 1.2 trillion roubles, or 3 % of GDP. About 500,000 housing loans have been granted by banks, i.e. less than 1 % of households have a housing loan.

At the beginning of 2009, the default rate on housing loans was around 1 %. Many expect the share to increase significantly, however. Some apartment buyers paid construction firms cash up front for apartments yet to be built. The projects are now on hold as construction firms struggle with financial problems.

Medvedev prioritises the fight against corruption. Under a presidential decree issued last week, the state administration would be reformed by 2013 as part of new anti-corruption efforts. The goal is to increase the efficiency of public administration through the use of modern personnel management techniques and better organization of administrative functions. Opportunities for corruption would be reduced e.g. through implementation of a performance-based compensation system and income and asset disclosure requirements for holders of official posts. The measures follow earlier reforms such as setting general criteria for appointment to official posts designed to bring transparency to the process.

President Medvedev said corruption problems have worsened as the country wrestles with its current economic stresses. He requested that his cabinet quickly draft proposals to alter the anti-corruption law already passed by the Duma but not enacted yet to give it more teeth.

By several measures, corruption in Russia has recently been on the increase. A January survey of the VTsIOM

research institute found that 41 % of Russians consider corruption and bureaucracy to be among Russia's most serious problems. In January 2008, the same survey found only 30 % of Russians held this view.

Nord Stream submits environmental impact report to Finnish officials. Last week, the Nord Stream consortium delivered for comments its environmental impact assessment on its planned gas pipeline to be buried in Baltic seabed. Environmental officials will collate comments on the report, and on the basis of these comments, issue an official statement for consideration when the final approval decision is made. According to the Finnish law, the realisation of the project requires approvals from the Finnish government and Finland's environmental authorities.

The pipeline running from Russia to Germany transits the Baltic seabed in the waters of Finland, Sweden and Denmark. The consortium plans to eventually construct two parallel pipelines with an annual transmission capacity of 55 billion m³. The first pipeline will be ready in 2011 if Nord Stream gets the needed permits from all national authorities to go ahead with construction. Gazprom is the 51 % majority shareholder in the pipeline consortium. The German firms BASF-Wintershall and E.ON Ruhrgas each own 20 % stakes and the Dutch Gasunie 9 %.

Nord Stream says most of the impact on Finnish economic waters will occur during the construction phase (e.g. hazards to sea traffic). Long-term impacts will be seen e.g. on commercial fishing as bottom trawling may be limited for security reasons.

The second major project for gas transmission from Russia to the EU is the joint South Stream project of Gazprom and the Italian ENI. The pipeline is planned to run from Russia across the bottom of the Black Sea to Bulgaria, and then on to Italy or Austria. The South Stream pipeline's annual capacity should be 30 billion m³, with completion set for around 2015.

About 80 % of Russia's current gas exports to Europe travel via Ukraine. The completion of the new projects would give a huge boost to Russia's gas export capacity. In the long run, however, the increase in Russian gas exports will depend more on production growth than pipeline capacity growth. The volume of Russian gas production has only risen about 1 % a year in recent years, in part reflecting moderate growth in demand. Russian gas exports (excluding gas of non-Russian origin) were 195 billion m³ last year.

The third project under planning, the EU-supported Nabucco pipeline run by a consortium led by the Austrian OMV will carry gas from Caspian Sea, e.g. Azerbaijan, gas fields to the EU. Construction is planned to begin in 2011 and would reach full capacity of 31 billion m³ in 2020. The project may, however, be delayed as EU ministers last Monday refused to grant financing.

China

Confidence in rapid economic recovery headlines People's Congress session. China's highest decision-making body, the nearly 3,000-member People's Congress, adjourned its annual convention last Friday (Mar. 13). The nine-day event was shorter than usual and generally upbeat despite poor economic growth figures in January-February. China's leaders said they expected the country to hit its 8 % GDP growth target this year. Premier Wen Jiabao opined that the goal was achievable with the help of the massive stimulus package announced last autumn, and central bank governor Zhou Xiaochuan said he was already seeing signs of economic recovery. Outside observers, however, have recently revised their growth forecasts for China downwards to levels well below the government's target. While no further stimulus measures were declared at the meeting, new capital infusions are not out of the question if economic growth underperforms.

Regular themes of People's Congress meetings included calls for universal access to free primary school education, improvement of the public health care system, money for rural development and fighting corruption. However, there was notably little discussion of development of western China, the environment or energy efficiency. Instead, discussion focused on the new topic of dealing with rising unemployment caused by the economic slowdown. China leaders also said they were ready to expand cooperation with Taiwan as long as it stays consistent with the "One China" principle.

The government will this year devote considerable attention and spending to internal security measures and social stability as several milestones, fuelled in part by frustration with the economic downturn, could trigger social unrest. Last week was the 50th anniversary of the Tibetan uprising. Early summer marks 20 years since the Tiananmen Square protests. In autumn, China celebrates the 60th anniversary of the Chinese Communist Party's ascension to power.

China prepares 2009 budget with large deficit. Government revenues are expected to increase 8 % this year to 6.6 trillion yuan (€760 billion, or 20 % of GDP using the official 8 % growth assumption). Expenditures should rise to about 22 %, leaving the budget 950 billion yuan in the red (2.9 % of GDP). Although the law calls for regional administrations to have balanced budgets, they will be permitted this year to run a total 200 billion yuan deficit. The local governments will issue bonds through the Ministry of Finance to cover the shortfall.

This year's budget proposal is exceptionally complex and itemises only central government revenues and expenditures in any detail. Central government spending is expected to reach about 4.4 trillion yuan, with nearly 2.9 trillion yuan going to various transfers and refunds to

regional administrations. About 77 % of expenditure will occur at the regional level.

Some 730 billion yuan from the central government budget will go to education, health care, and employment programmes that directly benefit citizens. A nearly equivalent amount of budget spending will go to boosting agricultural output and improving rural living conditions. The budget is in line with the stimulus package presented in autumn. The faster-than-expected rise in the above-mentioned spending categories partly reflects the state's willingness to take on debt in hard times. Tax relief estimated at 500 billion yuan is also included.

Figures for realised revenues and expenditures under the 2008 budget were also released. State revenues rose nearly 20 % last year to 6.13 trillion yuan (€700 billion, or 20 % of GDP). Expenditures climbed 26 % to 6.24 trillion yuan (€710 billion). Improved tax revenue performance signalled a broad expansion of the tax base, given that several taxes were reduced or eliminated mid-year. The stimulus package also helped increase funding for agricultural production, affordable housing and subsidies to grain producers. The high tax revenues meant last year's budget deficit was only 180 billion yuan (0.6 % of GDP), about half of what was originally anticipated.

China boosts bank lending to support growth. As part of the economic stimulus and fiscal policy package, lending by China's commercial banks has expanded briskly since December. The volume of new loans hit 1.62 trillion yuan in January and nearly 1.1 trillion yuan in February. The nominal rise in the loan stock in February exceeded 24 % y-o-y. Real growth in lending increased from just over 6 % in April 2008 to nearly 26 % in February 2009.

The rapid expansion of credit has aroused concerns that the stock of non-performing loans will rise, especially if lending goes to sectors already suffering from overcapacity. The damage to bank balance sheets will be amplified if economic growth slows further. The stock of non-performing loans in 4Q08, however, was just 2.5 % of the loan stock of commercial banks.

The rapid expansion in loan growth was reflected in the broad money supply (M2), up 21 % y-o-y in February (M2 increased less than 17 % in 2008 overall). In general, longer term inflation is considered a monetary phenomenon, i.e. inflation depends on central bank policy and thereby on money supply. In the current decade, M2 increases in China, both in nominal and real terms, have had the strongest impact on inflation with a lag of about 18 months. Taking only the current M2 growth into account, inflation can be expected to pick up again in mid-2010. The increase in M2, fuelled by increased bank lending, could also lead to higher prices for shares and other assets. In February, China experienced deflation, with consumer prices down 1.6 % y-o-y. The government has set a 4 % inflation target for this year.

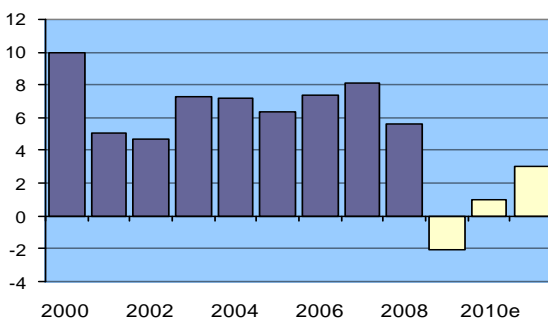
Russia

Latest BOFIT forecast sees modest contraction in Russian GDP this year. Russia's economic outlook has been clouded by the global economic downturn and last year's collapse in oil prices. In our latest [forecast](#), we predict consumption growth will fall on weaker income development and increased unemployment. The tight financial situation and lower corporate profits should sharply reduce investment. While export volumes should decline slightly in response to weaker international demand, the depreciation of the rouble and evaporation of domestic demand is likely to drive down imports significantly.

With the sharp drop in export earnings, Russia will not enjoy the large current account and federal budget surpluses as it has for most of the past decade. On the other hand, as Russian imports seem to have adjusted swiftly, large current account deficits should not present a problem for Russia. However, the federal budget will be deeply in the red this year as the state spends heavily to prop up the public sector. Deficit financing will take a large bite out of reserve savings, which will diminish the government's room to manoeuvre in economic policy in coming years.

BOFIT sees Russian GDP contracting 2 % in 2009, and then returning to low growth in 2010–2011 as the global recovery gets underway. If the downturn in the world economy persists and deepens, or oil prices fall further, the Russian economy could perform well below forecast.

Russian GDP on-year real growth, %



Sources: Rosstat, BOFIT

Weak economic performance in February. Preliminary Rosstat data show that the modest growth in retail sales of previous months turned to a contraction of 2 % y-o-y in February. Consumer demand was hurt by a fall in real wages and increased unemployment. Real wages declined 5 % y-o-y in February and the unemployment rate increased nearly a half percentage point to 8.5 %. It appears that consumption growth was still sustained earlier by

some households using their savings to purchase durable goods on increasing worries over rouble depreciation.

Investment demand weakened further in February, driving down investment 14 % y-o-y and industrial output 13 %. While the contractions in both investment and industrial output were modest compared to January, the collapse of construction activity accelerated in February, falling 21% y-o-y.

Over the past six weeks, several purchasing manager indexes and expectation indicators suggest Russians expect the contraction in production to continue, albeit at a gentler rate than in previous months.

Russian state increasingly cautious about refinancing foreign borrowing of private corporations. First deputy prime minister Igor Shuvalov, who coordinates government crisis measures, said last week that, except in special cases, the government would no longer help private companies pay back their foreign loans. In a change of policy, Shuvalov noted that if firms are unable to service their debts, the government would permit the surrender of shares posted as collateral to foreign creditors. The government's former policy was to avoid the possibility that significant ownership shares of large domestic corporations might fall into foreign hands. Indeed, the CBR at the end of last year loaned money through VEB to big companies to service foreign debt (e.g. \$4.5 billion went to the world's largest aluminium producer Rusal, owned by Oleg Deripaska, and another \$2 billion to mobile phone operator Vimpelkom). The measures were part of the government's crisis package for indebted enterprises, for which \$50 billion of CBR currency reserves were initially set aside. About \$12 billion of the package were actually used before the programme was abandoned in February.

Shuvalov revealed the government's change of heart on loan bail-outs in negotiations with Rusal's foreign financiers. Rusal still owes foreign banks \$7.4 billion and is currently negotiating an extended repayment schedule.

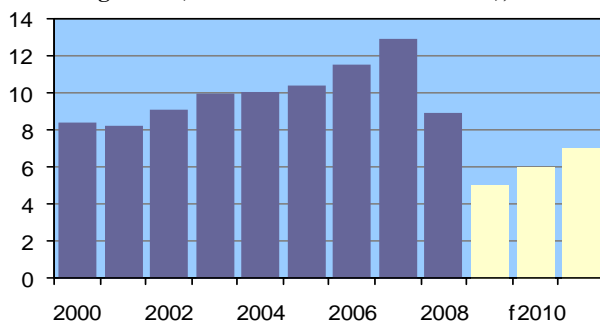
Shares used to secure corporate loans are subject to the law on foreign investments in strategic sectors, which entered into force last year. The foreign investor must get approval from a commission headed by the prime minister if the investor seeks a stake of more than 50 % in a company operating in a strategic branch or more than 10 % in a company operating in a strategic branch in hydrocarbon or other extractive industries.

CBR figures show Russia's foreign debt in September 2008 was about \$540 billion, of which \$42 billion was government and central bank debt, \$198 billion banking sector debt and \$300 billion corporate debt. The bank and corporate debt figures include debt owed by Russia's state-owned banks and enterprises. Russian scheduled debt servicing costs (payments on interest and principal) this year total about \$140 billion.

China

BOFIT sees significant slowing of China's GDP growth in 2009. Our latest [forecast](#) for China predicts real GDP growth will slow this year to 5 %. This is a considerably darker outlook than in our previous three-year forecast published September 2008, and it indicates just how hard China has been affected by the global economic downturn. China faces the difficult task of making up for its lost export demand with increased domestic demand at a time when exporters are more likely to lay off workers and thereby increase unemployment and create pressures that subdue wage growth. The unpromising export picture is also making firms more reluctant to invest. While China potentially could grow faster, we expect the Chinese economy to recover slowly along with Europe and the US in 2010 (6 %) and 2011 (7 %).

Real GDP growth (actual and forecast 2009–2011), %



Sources: China's National Bureau of Statistics and BOFIT

The reduction in net exports should depress economic growth this year. The situation is unique for China's recent history; the contribution of foreign trade to economic growth remained positive even in the wake of the Asian crisis of the late 1990s. Given the loss of export demand, China has moved to support its economy with a massive stimulus package that spends extensively on infrastructure projects. China has extensive opportunities to implement additional stimulus measures – government debt is a mere 20 % of GDP and China's monetary authorities have still considerable room to manoeuvre.

Our latest forecast is subject to the enhanced uncertainty in the global economy, China's evolving response to crisis and the unreliability or lack of coverage of China's statistical data. In addition, China's decision to rapidly expand bank lending under the stimulus package could lead to poor investment decisions and increase in the stock of non-performing loans. Rising unemployment could also increase social unrest. Even with these challenges, China's leadership seems willing to resort to even unconventional meas-

ures to deliver economic growth at a level near the official 8 % target. The current situation highlights China's need to embrace a more consumption-driven growth model.

Mild recovery in share prices continues. Defying the worldwide trend, Shanghai and Shenzhen stock exchanges have enjoyed a modest upward trend since mid-October. The rise has been fed by China's state-owned investment companies purchasing shares and hopes of a quick recovery as the effects of China's stimulus package kick in. Some observers, however, have voiced concerns that the rapid expansion of lending may be boosting share prices as individuals and companies buy shares with borrowed money.

Shanghai and Moscow stock indices



Source: Bloomberg

China's competition authorities deny Coca Cola's bid to purchase juice giant Huiyuan. Last week's decision by the Ministry of Commerce (MoC) sets an important precedent in enforcement of the new anti-monopoly law that entered into force in August 2008. The ruling merely noted that the bid failed to exactly follow the letter of the anti-monopoly law and thereby created a possibility the Coca Cola might use its dominant market position to limit competition or achieve a monopoly position on the juice market. The deal would have given Coca Cola a slightly over 20 % share of China's juice market – a level not generally considered a monopoly position. On the other hand, Coca Cola already controls over 50 % of China's beverage market. Coca Cola offered Huiyuan 12.20 Hong Kong dollars per share. After the ruling, the share price fell to about 5 HK dollars.

The decision has been criticised for the MoC's failure to cite a specific anti-monopoly basis for the decision. As a result the MoC appears to be endorsing protectionism and a willingness to pander to xenophobic sentiments at the possible expense of Chinese companies trying to expand abroad. The decision could make foreign firms more reluctant to invest in Chinese companies. As the global economy has deteriorated, flow of foreign direct investment to China (measured on-year) has fallen five months in a row. Investment was down 25 % y-o-y in the first two months of 2009 and the trend is expected to continue through the first half.

Russia

CBR signals lower interest rates. Central Bank of Russia deputy chairman Alexei Ulyukayev hinted late last week at possible cuts in key interest rates in the second quarter of this year. Ulyukayev said any cut is likely to be modest, but nevertheless provides an important signal to the market about the direction of interest rates. Ulyukayev reiterated finance minister Alexei Kudrin's view that falling inflation this year will justify gradually lower interest rates.

The head of state development bank VEB has expressed the view that the CBR has kept its key rates too high for the current economic circumstances. The CBR hiked its key rates on February 10 in response to rouble depreciation. Since then, the rouble's external value has stabilised, and even appreciated slightly, against the CBR's dollar-euro currency basket. In early February, the rouble had a brush with the CBR's ceiling on rouble depreciation (41 roubles per currency-basket unit), but thereafter appreciated. Over the last two weeks the rouble has hovered at a level just under 39 roubles.

Russia's foreign currency reserves have also increased slightly in recent weeks, and stood at \$388 billion on March 27. The currency reserves have stabilised in the past two months at around \$380–390 billion.

Revised 2009 budget draft emphasises measures to deal with the economic crisis. The government has approved the finance ministry's suggested revised federal budget proposal to replace the budget act passed last November by the Duma. The new budget bill is now headed to the Duma for approval.

The draft budget increases spending in the face of lower projected revenues. Thus, Russia will pass its first deficit budget since 1999. The budget deficit will correspond to 7.4 % of forecast GDP. Revenues are 6.7 trillion roubles (€149 billion) and expenditures 9.7 trillion roubles (€216 billion). Compared to the realised 2008 budget revenues will be nominally down 28 %, while spending will be up 28 %.

The budget assumes the Urals oil price will average \$41 a barrel this year – half the \$95 per barrel assumption used in the original 2009 budget. On-year inflation at year's end is expected to be 13 %.

The structure of spending has changed substantially from the earlier budget. More money will go to abating the economic crisis, whereas corresponding cuts will come especially from investments. The original 2009 budget planned large increases in investment for many branches. Already last year an interim law was enacted to allow the government to decide independently on allocation of economic crisis funds without the need for Duma approval.

Breakdown of 2009 federal budget spending

| | Roubles (billion) | Change from 2008 (%) |
|--|----------------------|-------------------------|
| Public administration | 1,018 | 22 |
| Business | 1,744 | 70 |
| Defence | 1,197 | 15 |
| National security and law enforcement | 1,022 | 22 |
| Social policy | 311 | 6 |
| Education | 395 | 11 |
| Health care | 335 | 21 |
| Culture | 109 | 23 |
| Housing | 90 | 30 |
| Environment | 13 | 27 |
| Transfers to other budgets | 3,458 | 29 |
| Total | 9,692 | 28 |

Source: Ministry of Finance

Some 1.6 trillion roubles (€36 billion) are allocated for dealing with the economic crisis, of which a large share is included under the "business" category. The amount includes 325 billion roubles (€7 billion) to bolster financial markets, the enterprise sector and sustain employment, 300 billion roubles to prop up the banking system and 130 billion roubles for social support. The atomic energy company Rosatom and Russian railways will each receive 50 billion roubles in support.

A large chunk of new funding comes in the form of transfers to regional budgets and off-budget funds, through which a large part of social spending is financed. TV and radio also get more funding, e.g. for socially important programmes and international projects.

Although all major spending categories will see increases in nominal terms from last year, high inflation will erode their real value. Direct spending from the federal budget on education and social policy will thus decline in real terms from last year if inflation remains at the target level of 13 %. Defence spending would rise 2 % in real terms.

The plan is to cover the budget deficit with domestic borrowing and by dipping into the reserve fund, which has been built up with revenues from oil export tariffs. At the end of February, the reserve fund held a total of 4.9 trillion roubles (€109 billion), of which 2.7 trillion roubles (€60 billion) are planned to be used for financing this year's budget deficit. Russia currently has no plans to borrow from international markets to finance its deficit.

Finance minister Kudrin recently declared that the budget stimulus package will be a one-time deal. Russia's financial buffer is too thin to float consecutive stimulus packages of similar magnitude over the coming years.

China

China expands use of the yuan beyond its borders and calls for new global reserve currency. In recent months, China has engaged in currency swaps with Hong Kong, Korea, Belarus, Indonesia, Malaysia and Argentina. In a currency swap, a debt denominated in one currency is exchanged for an equivalent amount of another for a pre-specified period, although their interest rates may differ. In China's case, currency swaps help the Chinese party avoid the exchange rate risk of, say, dollars, while the foreign counterparty gets yuan it can use to purchase Chinese products. Chinese officials claim currency swaps support trade and investment with the counterparty countries.

In December 2008, China decided on trial use of the yuan as a foreign trade settlement currency between the Guangdong province and the Yangtse River Delta economic zone and the Hong Kong and Macao special administrative regions. China further permitted trial use of the yuan in trade between the ASEAN countries and the Guangxi and Yunnan provinces. The initiative boosts the yuan's international profile and more broadly China's presence in international trade. The yuan has yet to become fully convertible, however.

China's central bank governor Zhou Xiaochuan recently proposed creation of a new global reserve currency in a speech posted on the People's Bank of China website. The proposal follows John Maynard Keynes' never-implemented call for creation of a global reserve currency. The new super-sovereign currency would expand IMF special drawing rights (SDR) to include a full range of major currencies. The SDR unit is now composed of the euro, US dollar, yen and sterling. Technically, China can change the composition of its reserves to reflect the proposed currency basket any time it wants.

Creation of a truly new reserve currency is a complicated process that requires launch of a new currency and creation of accompanying institutions. A global reserve currency must also be widely accepted as an instrument of exchange. Any nation (currently the US) whose currency enjoys a reserve currency status is likely to have reservations about such a plan. A special benefit to the issuer of the reserve currency is that it can borrow money on international markets in its own currency and run current account deficits corresponding to the currency reserves held by all other countries.

Underlying China's reserve currency proposal is a concern about preserving the value of its dollar-denominated assets. In January 2009, China was reported to hold about \$700 billion of its reserves in US treasuries.

Increased unemployment among migrant workers and new graduates. According to the government's latest estimates, the number of unemployed migrant workers in China has risen to about 23 million. It has become increasingly difficult for migrant workers to find new work after their existing work contract ends. About 11 million migrants continue to pursue work in cities, but a larger share of those unemployed have chosen to return to their home districts to seek work after being laid off. According to some estimates, as many as two-thirds of those returning to their home districts attempt to start new businesses, but less than 10 % succeed. A big reason these new businesses fail is the lack of access to financing. In response, the government has increased funding available to help small start-ups in rural areas.

The total number of migrant workers is estimated to be about 130 million, with most working in the construction sector, the textile industry or industries focused on export. The remittances by migrant workers are estimated to account for as much as 40 % of rural incomes. Thus, increased unemployment has a direct impact on the disposable incomes of the rural population.

The problems of employment do not only affect migrant workers, but also recent graduates who find it increasingly hard to secure their first job. In June, over 6 million students will complete their studies. Of last year's graduates 1.5 million are still unemployed. The government has implemented various measures to help new graduates find a job. Up to 200,000 of new graduates will be employed as teachers in elementary and middle schools in rural areas. Military recruiters are also sweetening incentives to sign up for the armed services: the government will pay off student loans and those with outstanding service records will be eligible for graduate school without having to take the demanding entrance exams. Small and medium-sized enterprises, in turn, will get tax breaks for employing new graduates. Although entrepreneurship is not popular among Chinese college graduates, those who want to try their hand as entrepreneurs will be subsidised. According to one study, less than 1 % of students start a business upon graduation.

At the end of 2008, China's official unemployment rate was 4.2 %. This figure does not include rural unemployed or migrant workers. Even the actual level of urban unemployment is estimated to be much higher. Although official unemployment is predicted to rise only moderately, real unemployment is expected to surge. Because the migrant rural population and recent graduates are more prone to demonstrate, the government has sought to tailor its employment efforts specifically to assuage these groups. By one estimate, the fiscal stimulus announced last November could produce as many as 20 million new jobs.

Russia

Small banks called on to increase their capital base or leave the market. Under banking law amendments that entered into force last month, currently operating banks must increase their minimum capital to 90 million roubles by the beginning of next year and to 180 million roubles by the beginning of 2012. New banks are subject to the 180-million-rouble minimum when they start operations.

The earlier version of the law required a minimum capital of €5 million as in most EU countries. The large swings in the rouble's exchange rate, however, led decision-makers to set the limit in roubles. At current exchange rates, 180 million roubles equals €4 million. The earlier minimum capital requirement did not apply to banks already in operation.

The reform of capital requirements is part of government measures to deal with the financial crisis. The objective is to strengthen the banking sector in tough times and enhance the effectiveness of banking supervision by clearing the field from very small banks. Finance minister Alexei Kudrin said smaller banks only have marginal significance in the economy. Moreover, these include banks engaged in money laundering, which has increased in the current recession.

Kudrin estimated that about 150 of the approximately 1,000 banks operating in Russia will be unable to meet the new capital requirement by the beginning of next year.

Last year, the Central Bank of Russia cancelled the licenses of 33 banks due to violations. This year already 16 banks have had their licenses pulled.

Risk of growing bank credit losses causes concern.

CBR figures show that in February 3 % of business loans and 4 % of household loans were non-performing. In autumn of 2008, the shares were 1 % and 3 %, respectively.

Finance minister Alexei Kudrin said the share of non-performing loans could actually be as high as 10 % of bank loan stocks given that banks use bookkeeping tricks to hide the true situation. Peter Aven, the head of Russia's largest private bank, Alfa Bank, warned that the share of non-performing loans could reach as much as 15–20 % of the loan stock by the end of this year. Many banks cannot sustain such massive loan losses, while state resources are insufficient to make up such losses for small players.

According to experts, the problem is most acute for banks that are established to serve one company only (so-called pocket banks) or are heavily involved in real estate investment. Such banks are said to constitute a third of all banks operating in Russia.

The CBR takes the view that the risk of credit losses is not that high, despite the growth in losses at the moment. CBR chairman Sergei Ignatyev justifies his more positive outlook with a belief that a turnaround in the economy is

approaching, in part backed by the fact that the oil price has recently remained at levels above \$50 a barrel.

The growth in non-performing loans is expected to cause banks problems meeting their capital requirements. To increase bank capital (and thus keep the allowed share of non-performing loans below the limit), the CBR is considering allowing banks to book a part of their state-issued subordinated loans as tier one capital. Another alternative under discussion to recapitalise banks is that the state issue special bonds to purchase shares in banks through their new share emissions.

As bank lending to companies has fallen precipitously, the CBR at end-March gave banks guidelines that state holding companies and their subsidiaries will be treated as individual entities rather than a single company for the purposes of borrowing. This should increase lending, which is regulated by limiting credit to one borrower to 25 % of bank's total credit portfolio.

The government has also sought to revive lending by offering bank guarantees for corporate loans. The state guarantees can cover up to 70 % of loans taken by firms involved in the defence sector and up to 50 % of loans to companies operating in other sectors that are seen as critical to the national economy. Some 300 billion roubles (about €7 billion) have been set aside under the current budget for such guarantees. So far, this arrangement has not led to increased lending as banks find the system complicated and feel the remaining risks are still too high.

Putin tells Duma about the impact of economic crisis on reforms. Prime minister Vladimir Putin's recent presentation to the Duma followed a constitutional amendment last December at the initiative of president Dmitri Medvedev, making the government annually report on its activities to the Duma.

Putin said that, in spite of proposals from the finance and economy ministries to the contrary, the current economic crisis does not justify postponing the reforms in the social security payment system agreed on last autumn. The current regressive social tax will be replaced next year by separate pension, social and health insurance payments. Hikes in contribution rates, however, have been put off until 2011. The hikes will raise company social contributions from about 26 % at present to 34 % of the wage bill. The reform is needed to deal with an ever-widening deficit in the pension fund. The pension fund deficit is currently covered by transfers from the federal budget and the national welfare fund.

Despite the economic crisis, the government continues to incrementally hike regulated prices. For example, increases in electricity rates will continue as planned as foreign companies that have committed to investing in Russia are basing their investment decisions on an assumption that Russian rates will continue to rise so that they eventually align with international pricing.

China

China wins several lower-profile decisions at last week's G20 summit. While China failed to do little more than generate discussion on two of its most-publicised goals at the G20 summit in London (i.e. an agreement to refrain from protectionist measures and a general commitment to fiscal stimulus policies), it won commitments by G20 members to take actions indirectly beneficial to China. These include expanding IMF resources, a boost in World Bank financing and a pledge to create additional \$250 billion in IMF special drawing rights (SDRs). The first two commitments will help in reviving the global economy, and thereby increase demand for Chinese exports. The increased SDR reserves will give national central banks greater room to manoeuvre and relax monetary policy at the global level.

In addition to these agreed-upon measures, central actors in the global economy in relation to regulation are likely to take China's economic advantage better into account. China promised to increase its contribution to IMF reserves, while receiving a boost in its IMF quota. By providing funds to the IMF, China gets increased say at the Fund. At the meeting, the EU and the United States agreed to relinquish their long-held traditional right to name the heads of the World Bank and the IMF. This change potentially gives China and India a shot at the top slots in both organisations.

China generally views the additional financial market regulation in a positive light, with the reservation that China would not like to see the new regulation weaken its own financial system. China managed to dictate some of the content of a communiqué on G20 plans to eliminate tax havens by successfully managing to have Hong Kong and Macao special administrative regions omitted from the OECD list of tax havens.

Profitability down at China's largest commercial banks. In the fourth quarter of 2008, profits of Bank of China were down nearly 60 % y-o-y and the profits of China Construction Bank fell 30 %. Industrial and Commercial Bank of China (ICBC), China's largest commercial bank (which, like China's other major commercial banks, is mostly state owned) managed to match profitability in 4Q08 with the same quarter a year earlier. For all three banks, profits for 2008 overall were somewhat higher than in 2007. For last year overall, Bank of China's profits were up 14 %, China Construction Bank up 34 % and ICBC up 35 %. Bank of China, the most international of China's commercial banks, has suffered the largest losses in securities tied to subprime mortgages and other foreign investments.

The sale of stakes in China's largest commercial banks to foreign strategic investors three to four years ago occurred in conjunction with large IPOs. Now that the three-year lockup agreements have expired, Royal Bank of Scotland and UBS have divested their stakes in Bank of China. Bank of America also reduced its holdings in China Construction Bank. Two weeks ago, Goldman Sachs announced its intentions to retain a significant share of its current holdings in ICBC.

As part of China's fiscal stimulus package, commercial banks are encouraged to increase lending. For 2009, the government is targeting a 5 trillion yuan increase in the loan stock, of which over half was already achieved in the first two months of the year. At the end of last year, the stock of non-performing loans relative to all commercial bank loans was 2.5 %. The ratio of non-performing loans contracted in the first two months of this year to 2.2 %. Large-scale borrowing, however, is ultimately feared to increase non-performing loans, especially if economic growth slows further.

Industrial firms expect a tough year. Official figures show profits of industrial firms with annual net sales exceeding 5 million yuan rose 5 % y-o-y during the first eleven months of 2008. In contrast, the financial statements of several of the listed companies show profitability was down significantly last year. Moreover, losses of companies reporting losses nearly tripled last year.

Indeed, many large industrial firms expect no improvement in the situation this year. Chinese steel giant Baosteel predicts its sales revenues will fall by more than a quarter. The large aluminium producer Chalco issued a profit warning for the first quarter and expects weak demand to prevail for the rest of the year. Logistics companies and coal producers see a very difficult year ahead, and the construction sector is suffering from falling housing prices. On the other hand, telecom companies and carmakers are cautiously hopeful for better times ahead as they are counting on domestic demand to hold up as a result of the government's huge stimulus package. Changes in profitability can influence the fixed asset investment decisions of Chinese companies as much of this investment is financed out of pocket.

According to the latest purchasing manager survey released by the China Federation of Logistics and Purchasing (CFLP), 52 % of respondents at industrial firms reported that the business outlook for March improved from February. The index usually reaches its highest (i.e. most optimistic) values in the springtime. A second index, the CLSA purchasing manager index, indicated that the outlook for industrial firms continued to weaken in March.

Russia

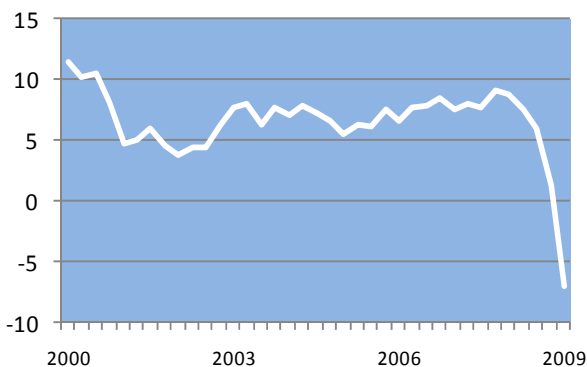
Klepach estimates GDP contracted 7 % y-o-y in first quarter. When giving the preliminary estimate, deputy economy minister Andrei Klepach qualified the figure by noting it was worse than what the ministry was expecting. According to Rosstat's performance index for seven core economic sectors (a good indicator of GDP growth), output on average was down 12 % y-o-y in the first two months of the year.

Rosstat also just released its official quarterly GDP growth figures for 2008. They indicate GDP growth slowed rapidly from nearly 9 % in the first quarter to about 1 % in the fourth quarter. For all of last year, GDP increased 5.6 %.

The current government forecast expects GDP to shrink 2.2 % in 2009 and that the economy will return to growth by the end of the year. This view assumes the stimulus measures included in the new version of 2009 budget currently under discussion in the Duma will be implemented. Without the support measures, the government says GDP could contract as much as 4–5 % this year.

Many forecasters have grown increasingly pessimistic about the outlook for the Russian economy. The World Bank's latest forecast sees Russian GDP contracting 4.5 % this year. The OECD's newest prediction anticipates a drop of 5.6 %.

GDP (percentage change from four quarters previous)



Sources: Rosstat, MinEco estimate

Current account surplus shows significant drop in first quarter. According to preliminary figures released by the Central Bank of Russia, the current account surplus fell to \$11 billion, down from \$38 billion a year earlier. The trade surplus amounted to \$22 billion (\$50 billion in 1Q08). The decline was driven by a 45 % y-o-y drop in the value of

goods exports, which reflected the massive drop in the average price of Urals-grade crude oil in the first quarter of 2009 to just \$44 per barrel – a level less than half of the average price in the first quarter of 2008. The value of goods imports plunged 36 % as Russian struggled with harsher economic conditions and a weakened rouble.

The financial account deficit in the balance-of-payments figures for the first quarter climbed to \$30 billion (\$26 billion in 1Q08). A deficit in the financial account means that more financial assets are flowing out of the country than are flowing in. Factors driving growth in the financial account deficit include the decline in foreign borrowing and a trend among individuals to shift their savings out of roubles and into other currencies.

Although the CBR's foreign currency reserves shrank \$31 billion in the first quarter, the haemorrhaging appears to have been staunched in recent weeks. On April 10, Russia's foreign currency reserves stood at \$384 billion.

Facing capital outflows and rouble depreciation, the CBR burned through \$40 billion in January in its efforts to prop up the value of the rouble. In February, the market interventions all but stopped as the rouble ceased to decline against its dollar-euro currency basket. Since March, the rouble has appreciated slightly against its currency basket.

Russia's foreign debt declines. Preliminary Central Bank of Russia figure shows Russia's gross foreign debt as of end-March stood at \$454 billion. At the beginning of 2009, the foreign debt stock amounted to \$485 billion. At its peak, Russia's foreign debt reached \$542 billion at the end of September 2008. The largest share of the debt by far was held by the private sector. As of end-March 2009, the foreign debt of banks stood at \$148 billion and other enterprises \$275 billion. Public sector debt amounted to just \$31 billion.

The foreign debt burden of banks has sharply contracted, declining \$50 billion from September 2008. Over the same time the foreign debts of the rest of the enterprise sector contracted \$26 billion. Banks and companies have been forced to pay down their debts or renegotiate payment schedules as they have lost access to refinancing from international financial markets due to tighter lending requirements.

CBR data show that foreign debt (principal and interest) coming due this year will amount to \$140 billion. About half will come due in the first six months of 2009.

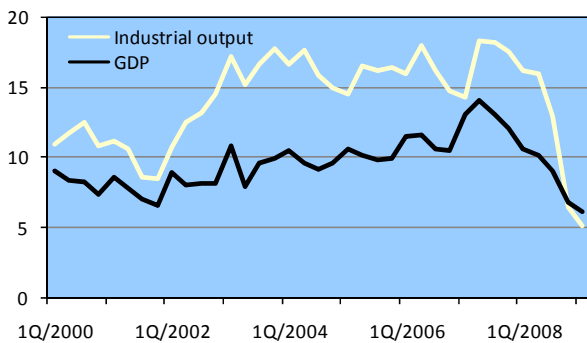
Russia's foreign debt is relatively small by international standards. The public sector debt represents only about 2 % of GDP and the debt of the corporate sector and banks is about 25 % of GDP. The central bank's foreign currency reserves at the moment are sufficient to cover some 85 % of Russia's foreign debt.

China

GDP growth slowed in the first quarter. The National Bureau of Statistics reports GDP grew 6.1 % y-o-y in the first quarter of 2009, down slightly from growth of 6.8 % posted in the fourth quarter of 2008. Economic growth was pulled down by industrial output growth of 5.3 % y-o-y. Industrial activity accounts for nearly half of China's GDP. Output of services rose in the first quarter 7.3 % and agricultural production 3.5 %. Figures show industrial output revived in March to over 8 % y-o-y (growth was below 4 % in January-February).

The differences among industrial branches are quite large, with production of export-focused foreign-owned corporations experiencing drop of more than 1 % in output in the first quarter of the year. Regional variation in growth was also quite stark. On-year industrial output growth in coastal regions where industry is geared to exports fell to below 4 % in January-March. Western China, in contrast, saw output growth of almost 12 % y-o-y. These high growth figures have aroused a certain amount of scepticism in light of the fact that China's industrial electricity consumption overall fell over 8 % in the first quarter. Another oddity was that industrial output growth figure dipped substantially below GDP growth for the first time in the current decade (see chart).

Real growth in GDP and industrial output, %



Source: National Bureau of Statistics

With fading export demand, the sustaining of China's economic growth increasingly depends on domestic demand, which has been actively supported by the central government and local administrations. Retail sales rose nearly 16 % in real terms in the first quarter, or slightly more than last year's average. Real investment growth accelerated to about 30 % y-o-y. As with industrial output, fixed asset investment grew fastest in the western parts of the country.

March consumer prices were down 1.2 % y-o-y (1.6 % in February). Money supply (M2) growth last month ac-

celerated to 26 % y-o-y. The amount of yuan loans from banks (1,890 billion yuan, or \$277 billion) was six times higher than the amount granted in March 2008. The situation is quite bizarre: rapid slowing in inflation makes real interest rates on loans fairly high, yet borrowing is skyrocketing. There appears to be no need at the moment for further relaxation of China's monetary and fiscal stance.

Further contraction in exports and imports in March. China's exports in terms of value contracted 17 % y-o-y in March, while the value of imports declined 25 %. March's plunge in export growth was slightly less dramatic than in February, and the contraction in imports nearly matched February in percentage terms. As a result, the overall trade surplus for the month climbed to just over \$18 billion. The ongoing economic crisis has yet to inflict any significant reduction in China's trade surpluses. The first quarter surplus this year was substantially larger than first-quarter surpluses in recent years. Measured in dollar terms, exports and imports in March were clearly higher than in February, with the value of exports rising nearly 40 % m-o-m. Nevertheless, the value of both exports and imports were below their January levels.

In March, China boosted again value-added-tax rebates for nearly 4,000 export products, including textiles, clothing and steel. Although the government uses tax refunds as a means to support export firms in these stressful times, they cannot substitute for the prevailing weak demand in China's export markets. Thus, despite official proclamations that the government's 8 % GDP growth target is achievable, it seems highly unlikely that growth will significantly accelerate from the current 6 % on-year growth until the global economy generally and China's main export markets in particular begin to recover. Exports to the European Union, China's most important trading partner, contracted 20 % y-o-y in March. The rapid decline in imports has also denied countries in the region that export to China any significant stimulus.

Shanghai stock exchange rolls out own board for growth enterprises. The Growth Enterprise Board (GEB) will open May 1. The recently released listing norms call for GEB applicants to have net assets of over 20 million yuan (€2.2 million) and an operating history of at least three years. After the IPO, the firm's share capital must reach at least 30 million yuan (€3.3 million).

Introduction of the GEB was well timed for small and medium-sized enterprises, which have seen access to credit tighten. About a third of the 200 firms waiting for listing will be included in the GEB. The GEB is expected to attract risk-taking investors seeking higher returns. In summer 2004, the Shenzhen stock exchange introduced its own SME list, which currently includes just under 300 firms.

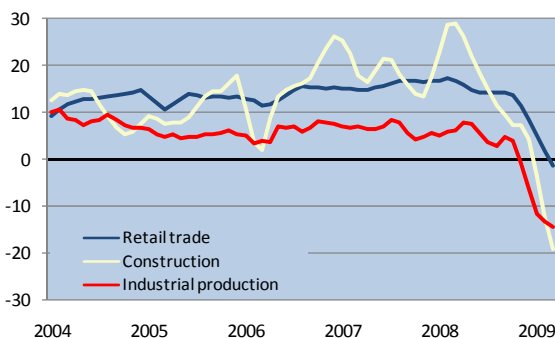
Russia

Economic slide continued in March. Investment and output continued their steady steep decline in March. According to Rosstat preliminary figures, investment contracted 15 % y-o-y in March, industrial output was down 14 % y-o-y and there was a 20 % drop in construction activity. The first quarter rates of decline overall matched roughly the March figures.

The industrial branches hit hardest were those producing investment goods or durable goods, i.e. machinery and equipment, transport vehicles and construction materials. At the same time, the food industry was buoyed by improved price competitiveness from rouble depreciation. In recent months, food, beverages and tobacco have accounted for a growing share of retail sales. In addition, the reduction in output of oil products has contracted less on average. Crude oil production on-year rose slightly in March.

Retail sales, a good indicator of consumer trends, contracted 4 % y-o-y in March as incomes fell and unemployment rose. The first quarter saw a 1 % drop from a year earlier. Preliminary figures indicate that average nominal wage growth continued to slow significantly in March. As the inflation remained at 14 %, the average real wage was 6 % smaller than a year earlier. Under the ILO methodology, the unemployment rate reached 9.5 % in March. During the past six months, the number of unemployed increased by 2.6 million persons and now stands at 7.1 million persons.

Monthly change in core production sectors, % y-o-y (3-month moving average)



Source: Rosstat

Wage arrears and barter trade have re-emerged after a decade's hiatus as companies struggle with the tight liquidity situation. Wage arrears nearly doubled in the first quarter of 2009, affecting a half-million workers by end-March. Wage arrears last reached this level in late 2005.

Barter, which was used extensively in the 1990s, has also come back into fashion in the business community as money has become tight. Nevertheless, barter trade is estimated to represent just 2 % of the value of sales of Russian industry at the moment. It reached nearly 60 % at its peak in the late 1990s. The revived popularity of barter, however, threatens to promote tax evasion schemes such as under-pricing of goods in company accounts. A return to extensive reliance on barter would weaken the financial sector and constitute a step backwards in development of Russia's market economy.

More gas pipeline options than ever. Russian gas exports in 2008 were little changed from the 2007 level of about 195 billion cubic metres. However, gas production and exports have been declining in recent months. In 1Q09, production contracted 15 %. Gas export levels in January 2009 fell to less than half of the level a year earlier, due in part to a shutdown in gas deliveries caused by the Ukraine gas crisis. Gazprom expects the volume of exports to contract nearly 20 % in 2009.

An EU-Ukraine agreement signed at the end of March on modernisation of the Ukraine gas network has caused substantial consternation in Russia, which feels excluded on a matter essential to its trade advantage. The agreement is expected to feed Russia's plans to build pipelines that bypass Ukraine altogether (e.g. the Nord Stream pipeline running under the Baltic Sea to Germany and the South Stream under the Black Sea to Bulgaria).

Ukraine president Viktor Yushchenko visited Azerbaijan at the beginning of April. During his visit, the Azeri and Ukrainian leaders discussed e.g. a planned gas pipeline (White Stream) running from Azerbaijan via Georgia to Ukraine. This pipeline would offer Ukraine import routes independent of Russia.

Turkmenistan is planning its own domestic gas pipeline (Vostok-Zapad) from its massive fields in the east of the country to the shore of the Caspian Sea, where the pipeline could be hooked up with a planned pipeline running from Kazakhstan to Russia (Pre-Caspian). In several scenarios under discussion, the Vostok-Zapad pipeline could, much to Russia's chagrin, transmit gas across the floor of the Caspian Sea to the EU-supported Nabucco pipeline.

Russia and Turkmenistan have engaged in a bitter war of words after the April 9 shutdown of a gas pipeline running from Turkmenistan to Russia (Central Asia-Center). The pipeline is Turkmenistan's only gas export route and Turkmeni officials accused Gazprom of sabotaging the pipeline and disrupting the country's gas exports. Gazprom annually purchases about 60 billion m³ of gas from Turkmenistan. A pipeline break a year ago would have caused Gazprom substantial delivery problems, but at current demand levels Gazprom can easily make up the loss of Turkmeni gas with its own domestic production.

China

United States still claims yuan undervalued, but backs off on accusing China of currency manipulation. A major source of friction in US-China relations in recent years has been a perception that China holds down the external value of the yuan and deliberately drags its heels in adjusting its exchange rate policy. At his January confirmation hearing for the treasury secretary post, Timothy Geithner said the Barack Obama's administration was convinced China manipulates its exchange rate, and thus US law would permit imposition of retaliatory hikes in import tariffs. However, in the treasury department's semi-annual report to Congress on the global economy and exchange rate trends released mid-April, the new administration continued Bush administration policies and refrained from accusing China of using foreign exchange policy to boost current account surpluses or create unfair competitive advantage for its exporters.

According to the treasury department report, China in recent years has added flexibility to its exchange rate policies and Chinese officials in January reiterated their commitment to increase the elasticity in the yuan's exchange rate to reflect market conditions. The report also noted that China is widening yuan convertibility, evidenced by a recent decision to give export-focused companies located in China's coastal provinces the opportunity to use the yuan on a trial basis in foreign trade with Hong Kong and Macao. The treasury department stressed that during the worsening of the global financial crisis the yuan's nominal exchange rate against the US dollar has strengthened a bit while the exchange rates of the most other currencies fell sharply against the dollar. Taking inflation differences into account, the yuan's real effective (trade-weighted) exchange rate appreciated 17 % between end-June 2008 and end-February 2009. Moreover, the report found that growth of China's currency reserves has slowed and that the country has implemented a major economic stimulus package. Although the treasury department refrained from accusing China of unfair exchange rate manipulation, it still considers the yuan to be undervalued.

While many in the US Congress and American business community still condemn China for manipulating the yuan's exchange rate, the Obama administration's decision to back off was expected. This decision comports with the policy of the Bush administration, which possibly even helped reform-minded leaders in China push through change. The current policy apparently commits both parties to gradual reforms in China. The Obama administration has also decided to continue the institution of strategic dialogue meetings held twice a year, which was initially proposed by former treasury secretary Henry Paulson. Early this month,

the US announced that secretary of state Hillary Clinton would join Geithner at the talks. The Chinese side of the discussions is led by state counsellor Dai Bingguo and deputy prime minister Wang Qishan. The parties will meet for the first time this summer in the US when the expanded agenda for discussion will be tried for the first time.

IMF trims China forecast, gives darker outlook for Russia. The International Monetary Fund this week cut its forecast for Chinese 2009 growth from its previous 6.7 % forecast in January to 6.5 %. The new figure closely matches China's reported growth rate for first quarter output, but is still well below the government's official target of 8 % GDP growth for 2009. Nevertheless, China's growth remains impressive by international standards, thanks in part to large government stimulus. The IMF forecasts relatively modest GDP growth of 7.5 % in 2010. The acceleration of growth is based on the IMF's assumption that the global economy will start to recover gradually and that China will continue to practice expansive monetary and fiscal policies. The lower growth is expected to drive inflation down this year to near zero (0.1 %). Inflation would then pick up slightly next year to 0.7 %. The IMF expects China's 2009 current account surplus to reach 10.3 % of GDP.

For Asia overall, the IMF outlook sees substantial downside risks to growth. For example, the current forecast would prove over-optimistic if exports continue to fall or access to finance remains tight due to a postponed recovery of the world economy. Thus, the IMF is encouraging all Asian countries to shift their growth emphasis from exports and investment to domestic consumption. For China, in particular, the IMF sees further room to support household consumption. The Fund notes that lower inflation has increased real interest rates, making further monetary easing possible. Several observers and Chinese officials, however, consider monetary policy relaxation unnecessary as borrowing has increased rapidly in recent months.

The IMF expects the Russian economy to contract by 6 % this year, a substantial downward revision from the 0.7 % contraction predicted in January. The Russian economy is expected to return to growth next year with tepid growth of 0.5 % y-o-y. Inflation this year is expected to reach 13 %. The ratio of Russia's current account surplus to GDP is forecasted to fall to 0.5 % this year.

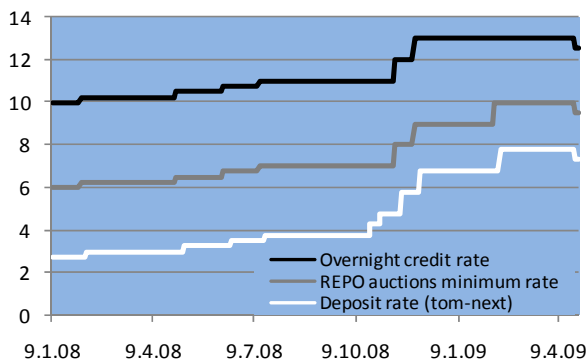
The IMF observed that CIS countries have been hit by a triple whammy: a financial crisis, contracting export demand and a huge drop in energy prices. The rapid growth of Russia's foreign-currency debt, partly due to the weakening of the rouble's external value, is feared to lower domestic investment and increase unemployment. The risk of credit losses will grow and Russia should brace for a wave of non-performing loans by bolstering bank balance sheets now.

Russia

Central Bank of Russia lowers interest rates. Last Friday (Apr. 24), Russia's central bank lowered its key interest rates by 0.5 percentage points. Presently, the refinancing and overnight lending rates stand at 12.5 %. The CBR's benchmark deposit rates were adjusted down to 7.25 – 7.75 %.

The decision to cut interest rates reinforced the CBR's earlier message to the markets that rates will be lowered in the second quarter as inflation begins to cool and the external value of the rouble stabilises. Central bank deputy chairman Alexei Ulyukayev observed earlier that, while rate cuts at this point would necessarily be rather small, they are nevertheless useful in signalling to the markets that benchmark rates are switched to a downward trend.

Trends for some benchmark CBR rates in 2008-2009



Source: Central Bank of Russia

The central bank raised some of its rates last time on February 10 as part of effort to put the brakes on a fall in the rouble exchange rate. While the rouble has depreciated significantly against the CBR's dollar-euro currency basket since autumn 2008, it has stabilised in past weeks. It has recovered to just above 38 roubles per currency-basket unit after getting close to the central bank's ceiling of 41 roubles in early February. In the last two months, the price of Urals-grade crude oil has climbed from just over \$40 a barrel to nearly \$50 a barrel.

The CBR also announced plans to incrementally raise reserve requirements of banks. The first hike from 0.5 % to 1 % will occur at the beginning of May. Thereafter, the reserve requirement will be raised by a half percentage point every month until August, when it will reach 2.5 %. The CBR lowered the minimum reserve requirement temporarily to exceptionally low levels in autumn 2008 in response to the loss of liquidity created by the global financial crisis.

Russia's main stock index, the RTS, welcomed the CBR's rate cut announcement. The RTS has risen over 50 % from its January-February lows to levels above 800 points in the past weeks.

Although Russia labour productivity is rising quickly, it remains far behind international leaders. According to preliminary data released by the Conference Board, labour productivity in Russia grew 6 % last year, a rate that closely matched its average throughout the 2000s. With the exception of China, Russia outperformed other emerging markets surveyed – last year and over the decade. The Conference Board expects productivity growth in Russia to slow sharply this year, while productivity growth is should accelerate slightly in China and Brazil.

According to a new study from the international consultancy McKinsey, growth in labour productivity accounted for two-thirds of gains in Russian per capita GDP during the past decade. Growth in the labour supply accounted for the remaining third. Much of the rapid growth in labour productivity, however, has been based on increased capacity utilization rather than new investment. The report notes that this path to growth was already exhausted before the international financial crisis struck. Moreover, the labour force is now shrinking.

The McKinsey report concludes that in order to sustain future growth, Russia needs a substantially higher investment ratio to replace outdated production facilities. Indeed, antiquated production stock and inefficient business processes are seen as the crucial stumbling blocks that are keeping Russian labour productivity to an average level just 26 % that of the United States. The report proposes a number of ways for Russia to boost productivity, including increasing competition and labour mobility. Measures to streamline business processes include increased focus on project management, development of financial markets and reduction of economic regulation and bureaucracy.

Labour productivity in Russia by key sector

| Sector | Productivity, % of US level |
|--------------------------|-----------------------------|
| Electric power | 15 |
| Residential construction | 21 |
| Retail banking | 23 |
| Retail | 31 |
| Steel | 33 |
| Average | 26 |

Source: McKinsey Global Institute

China

2008 balance-of-payments figures show continuing rise in China's current account surplus. The State Administration of Foreign Exchange (SAFE) last week released its balance-of-payments figures for 2008. The new numbers show China's current account surplus climbed 15 % from the previous year to \$426 billion. Last year's surplus corresponded to slightly less than 10 % of GDP (11 % of GDP in 2007). China's goods trade surplus amounted to \$361 billion, while the service account remained slightly in deficit. Currency also flowed into China through income and current transfers.

China's combined capital and financial account surplus contracted over 70 % from 2007 to about \$19 billion. The net flow of foreign direct investment into China amounted to \$148 billion (\$138 billion in 2007), which corresponded to just over 3 % of GDP. FDI outflows from China tripled from 2007 to more than \$53 billion.

Growth in China's foreign currency reserves slowed at the end of 2008. On December 31, China's currency reserves stood at \$1,946 billion, an amount equal to 44 % of Chinese GDP. As of end-March, foreign currency reserves were valued at \$1,954 billion.

Main balance-of-payments categories and foreign currency reserves, US\$ billion

| | 2006 | 2007 | 2008 |
|---------------------------|-------|-------|-------|
| Current account | 250 | 372 | 426 |
| Capital account | 4 | 3 | 3 |
| Financial account | 6 | 70 | 16 |
| Net errors and omissions | -12 | 16 | -26 |
| Reserve increase for year | 247 | 462 | 418 |
| Total reserves (Dec.31) | 1,066 | 1,528 | 1,946 |

Source: SAFE

As many as 30 million migrant workers now out of work. At the end of January, the official estimate for the number of unemployed migrant workers was about 23 million. Last week, the deputy head of the Chinese State Council's Development & Research Center said the actual amount is now about 30 % higher. Estimates of the size of the pool of migrant workers also vary. The government recently increased its estimate from 130 million people to about 225 million, of which 13 % are thought to be jobless at the moment. Some 14 million migrant workers who recently lost their jobs have apparently decided to remain in their rural home districts after returning home to celebrate this year's Chinese New Year holiday rather than struggle to find new work in the cities.

China's official unemployment rate, which does not count unemployed country-dwellers, is still a relatively modest 4.3 %. The official unemployment rate, however, has been rising since the fourth quarter of 2008 with the slowdown in economic growth and factory closings. The government still says it wants to keep the official unemployment rate below 4.6 % in 2009 and has targeted the creation of 9 million new jobs by the end of the year. In the first three months of this year, an estimated 2.7 million new jobs have been created, about 12 % less than in the same period in 2008. Even so, the current rate of job creation is more than 50 % higher than the rate of job creation 4Q08. China's official unemployment numbers are generally considered unreliable; some estimates put China's unemployment rate in recent months at around 10 %.

Labour market disputes (e.g. due to unpaid wages) are on the increase. Almost 100,000 civil claims were filed in the first quarter, a nearly 60 % jump from 1Q08.

Slow-but-sure progress in economic integration of Southeast and East Asia. Spurred by the Asian financial meltdown in the late 1990s and current crisis, efforts at economic integration of the ASEAN+3 nations (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam + China, Japan and Korea) have proceeded in small steps. This year, the countries have increased the size of the common reserve fund created under the Chiang Mai Initiative from \$80 billion to \$120 billion. While the group agreed last year to continue development of bond markets in the region, talks on establishing a common Asian currency have not moved on.

China has good economic relations with countries in Southeast Asia. This week the country announced plans to grant \$10 billion for development of infrastructure between ASEAN countries and China, as well as \$15 billion for other joint cooperation projects. Since China eliminated barriers to trade with ASEAN members in the summer of 2005 under a free-trade agreement, exports of Chinese products to the region have boomed. China's imports from the region have grown, too, albeit much more slowly. China-Japan relations have also been on the mend.

China-Taiwan relations have improved a lot since the election of Ma Ying-jeou last year as Taiwan's president. China and Taiwan last week agreed to ease requirements for entry to the financial sector, increase cooperation in law enforcement, and double the number of scheduled flights between Taiwan and the mainland. Talks on agriculture and fishing are scheduled for this autumn.

Despite the thaw in China-Taiwan relations, the region is still dogged by territorial disputes in e.g. the South and East China Seas, and many countries are suspicious of China's ultimate agenda as it continues to increase its regional dominance. The conflicts among countries in the last century are still fresh in memory for some.

Russia

Inflation declined in April to 13.2 % y-o-y. In earlier months, the consumer price rise was still accelerating despite the faltering economy.

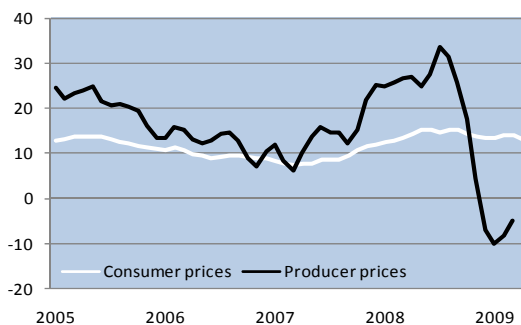
Rapid inflation in the early part of the year was largely driven by devaluation of the rouble. The economy ministry estimates that imports account for 35 % of processed foods and 55 % of other finished goods. In addition, the share of imported ingredients in domestic food production is around 15–20 %, and the share of imported inputs in production of non-food goods is even higher. Russian protectionist trade policies such as tariff hikes have further increased prices of imported products.

The burst in inflation early this year also came from annual hikes in regulated prices for services (e.g. municipal utility rates). The economy ministry estimates regulated rates were hiked 15 % at the beginning of this year, a larger increase than in previous years. Nevertheless, the realised hikes were smaller than initially planned and some were postponed until later in the year.

Measured year-to-year, producer prices began to slide at the end of last year. In March, they were down 5 % y-o-y. Producer prices are highly sensitive to global commodity prices. Measured month-to-month, however, producer prices started to increase in February and March.

Inflationary pressures have been subdued by a decrease in the broad money supply (M2). At the start of April, M2 was down 10 % y-o-y. The money supply level appears to have stabilised over the last two months.

12-month change in consumer and producer prices, %



Source: Rosstat

Russia's inflation rate is still substantially higher than inflation rates of its main trading partners. This difference and the nominal exchange rate combine to determine the real exchange rate which reflects the price competitiveness of Russian products against comparable foreign products. If Russia's nominal exchange rate remains unchanged, the country's higher inflation relative to others tends to erode the price competitiveness of Russian products.

In March, the rouble's nominal effective (trade-weighted) exchange rate was down 14 % from December 2008, while the real effective exchange rate was down 10 %. On the other hand, the rouble's foreign-trade-weighted exchange rate has depreciated less than the rouble's exchange rate relative to the euro or the dollar because many of the currencies used in determining the rouble's effective exchange rate have also depreciated.

Government works to make life easier for small and medium-sized businesses. Under a new law enacted last year and implemented May 1, companies now have some protection against intrusive government inspections. Officials are now limited to making routine inspections of small and medium-sized enterprises (SMEs) once every three years and can only initiate special investigations with permission of the Prosecutor General's office.

Other measures to help small business include a law implemented last year aimed at making it easier for SMEs to purchase the operating facilities they currently occupy under a lease. In hot real estate markets, SMEs with choice business locations often found it difficult to avoid eviction. To improve access of SMEs to finance, the government has included 30 billion roubles (€690 million) in its stimulus package to fund loans to small businesses.

A survey made at the end of 2008 by Opora, an organisation that lobbies on behalf of SMEs, found that SMEs were most distressed over the inability to find competent employees and lack of access to finance. Other worries included the unfair practices of larger competitors, difficulties in finding commercial space, and capricious behaviour of the authorities. The survey was made before the impacts of the current recession were felt.

Moscow's NISIPP institute, which studies entrepreneurship, found that the situation of SMEs has been deteriorating since late 2008, due in part to increased official pressure on firms, e.g. from tax authorities. SMEs have increasingly found themselves competing head-to-head with large private firms, state-owned companies and businesses run by municipalities, because the poor economy forces struggling large businesses to encroach on the traditional spheres of small business activity such as providing services and retail. This has put SMEs at their greatest disadvantage since the period before the 1998 financial crisis, when the rouble's collapse provided small entrepreneurs with rich opportunities to capture business from their larger competitors.

Rosstat's company classification scheme was revised at the start of 2008. Although it still differs somewhat from the EU system, both define SMEs as companies with fewer than 250 employees.

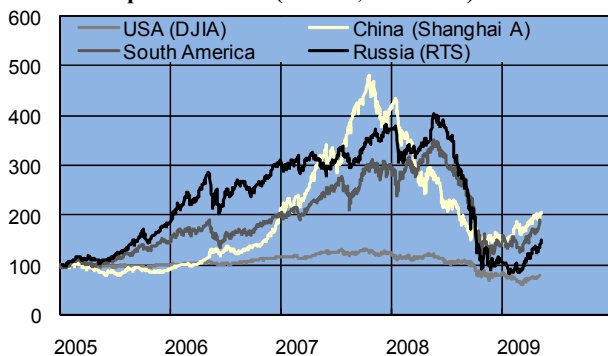
Russia's SME sector has been slow to emerge compared to most transition countries, due in part to the pitfalls of its business environment. Russia's approximately 2.4 million SMEs employ over 10 million people.

China

Share prices on Shanghai stock exchange up 40 % from start of the year. Share prices in China were recently lifted on reports that industrial output and investment growth accelerated in March. Two April purchasing managers indices released this week give tentative support to this trend. The PMI of the China Federation of Logistics & Purchasing, which is compiled from survey data by the NBS, indicated ongoing improvement for industrial producers in April. However, the PMI figure for China released by the Hong Kong brokerage CLSA only suggested a stabilisation of the situation; i.e. no change in the industrial situation from March to April.

China has outperformed other major markets since the start of the year. While it is true China's economic growth remains robust relative to most countries, some pundits are concerned that shares may already be overpriced. The recovery in Chinese share prices began earlier than anywhere else, due in part to an explosion in bank lending as part of China's stimulus package that may have funnelled money into the stock markets. At the moment, the price-to-earnings ratio of an average Shanghai A-share is 22. The P/E for a Shenzhen share is 33. The average P/E for shares listed on the Hong Kong stock exchange was a much more reasonable 12 at the start of this week.

Stock index performances (Dec. 31, 2004=100)



Source: Bloomberg

Part of China's stock market volatility can be attributed to growing pains. Following a disastrous performance in 2008, interest in owning shares has re-emerged. In the early months of 2009, investors were much more active in opening new share trading accounts than at the same time last year. China's financial institutions are also becoming more sophisticated. Late April news reports said foreign firms would be granted permission to list on the Shanghai stock exchange on a trial basis, including permission to trade in

yuan-priced shares. The experiment is part of plans to make Shanghai an international financial hub.

Labour productivity gains remain strong. The Conference Board estimated in January that labour productivity in China rose 7.7 % last year. While the increase was substantially off the 2000s average of 10.5 % per year, the Board said it expects labour productivity to grow about 9 % y-o-y this year as China's labour pool shrinks and remaining employees produce more. The government, however, is highly focused on preserving jobs, so decreases in the number of workers may be less than the Conference Board's projection.

In the 1990s, China's labour productivity gains averaged about 6 % a year, which was quite respectable in historical and international comparisons. But China's productivity growth has been in a class of its own in recent years. A large part of these gains have been achieved through capital investment and increases in the value-added component. Movement of labour from lower value-added industries to industries with higher value-added should sustain these productivity gains for years. Productivity in China is measured in terms of GDP per worker instead of GDP per hour worked as in most developed economies. This alternate approach somewhat overstates productivity gains when work-time increases faster than production.

China arms imports lower than at any time in the past decade. The Stockholm International Peace Research Institute (SIPRI) estimates China's arms imports last year contracted to their lowest level since 1998. China imported 15 % less arms than in 2007. The fall in imports reflects Chinese efforts to increase domestic arms production. The shift has been particularly felt by Russia, which provides nearly all China's imported arms and weapons systems. The Russians have become increasingly wary about selling arms to China as the Chinese have turned to producing knock-off versions of the Russian products that it sells to other countries such as Pakistan and many states in Africa. China is still a big arms buyer by international standards. Last year, only South Korea, India and Algeria bought more weapons from foreign suppliers.

SIPRI reports China's weapon's exports last year remained around the average for the 2000s. The world's largest arms exporters are still the US and Russia. China is the world's ninth largest arms exporter. China's arms exports are only a third of its weapons imports.

China defence spending has grown at an average rate of 16 % a year during the current decade. Slightly over 6 % of this year's budget is dedicated to defence expenditures. The budget provides for pay increases for soldiers and low-ranking officers of as much as 50 % and wage hikes for higher-ranking officers of 20–30 %. About 2.3 million people serve full-time in the People's Liberation Army.

Russia

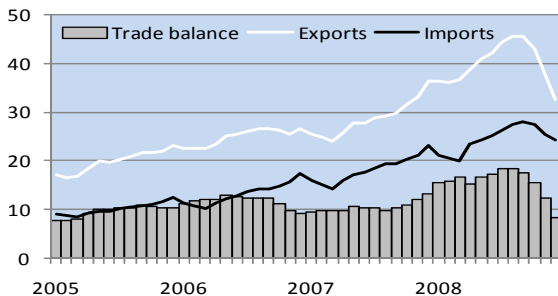
China now Russia's largest trading partner. Measured on-year, the value of Russian exports fell by nearly half both in the first quarter and in March. In dollar terms, imports shrank nearly 40 % y-o-y in 1Q09. The rate of decline in imports was still accelerating slightly in March. Nevertheless, Russia still posted a trade surplus in 1Q09 of about half the size four quarters previous.

Although lower oil price levels have decreased the overall share of energy products in total Russian exports, exported oil, oil products and natural gas still represented 60 % of the entire value of Russian exports in the first quarter. In volume terms, Russian crude oil exports remained at nearly the same level as a year ago. For the year, the export volume of oil products was up 10 % and natural gas down by over 50 %.

The largest decline in imports in the first quarter was registered in the categories of machinery & equipment, transport vehicles, and mineral products. They fell by around half in value terms over a year ago. The number of passenger cars imported in the first quarter was just a third of the amounts imported in 1Q08. The smallest contractions measured by value were registered in imports of textiles (down 8 %) and foodstuffs (down 18 %).

Russian customs figures for 1Q09 show China's share of Russian trade was nearly 9 %, surpassing both Germany and the Netherlands to become Russia's largest trading partner. Chinese exports to Russia consisted largely of consumer goods, the demand which contracted less than investment goods. EU countries, on the other hand, accounted for a smaller share of Russian imports as Russia mainly imports investment goods from the EU.

Monthly value of Russian goods trade, US\$ billion (3-month moving average)



Source: Central Bank of Russia

The shift was also evident in Finnish exports to Russia and transshipments of third-country goods through Finland. Customs Finland reports the value of Finnish exports to Russia in the first two months of the year were slightly more than half of what they were a year earlier. Prelimi-

nary figures suggest this trend continued in March. In 1Q09, the volume of transit cargo moving through Finnish ports was also down by nearly half from a year ago.

Economic crisis tests stability of Russian regions. Industrial output fell last year in 24 of Russia's 83 regions. In 1Q09, industrial output shrank in 67 regions, with industrial output down over 30 % y-o-y in seven regions.

Russia's regional development minister Viktor Basargin estimates that in many regions nearly 70 % of budgeted tax income for the first quarter was not received. Under Russian law, a region can be placed under federal administration when the region's arrears on debt servicing exceed 30 % of the region's tax revenues and other income streams. While this legal remedy has never been applied, the possibility of invoking it is now under discussion at the regional development ministry.

Officials expect the current drop in incomes will have profound social consequences. The government has been discussing a variety of possible subsidies. In addition to transfers from the federal budget, regions also receive employment subsidies. This year 43 billion roubles (about €1 billion) in employment subsidies have been set aside.

Construction declined an average of nearly 20 % in January-March. Construction was down 33 % in the City of St. Petersburg and over 36 % in the Siberian federal district.

Indicators for federal regional districts in 1Q09, % y-o-y

| | Industrial output | Investment* | Retail sales | Construction | Unemployment |
|------------|-------------------|-------------|--------------|--------------|--------------|
| All Russia | -14.3 | -10.4 | -1.1 | -19.3 | 9.5 |
| Central | -23.9 | -7.8 | -1.7 | -15.5 | 6.6 |
| North-West | -19.5 | -7.9 | -3.9 | -27.9 | 7.5 |
| South | -31.5 | -4.5 | 5.0 | -10.3 | 12.0 |
| Volga | -22.4 | -23.6 | -1.0 | -33.3 | 10.5 |
| Urals | -8.7 | -7.2 | 3.6 | -17.4 | 10.3 |
| Siberian | -17.9 | -13.8 | -5.8 | -36.2 | 11.8 |
| Far East | -6.6 | 2.4 | 0.5 | -22.3 | 10.3 |

Source: Rosstat

* January-February 2009

While 1Q09 retail sales overall were down just 1 % y-o-y, they were off 5 % in Moscow and St. Petersburg. Higher prices lifted retail sales in many regions.

Regional differences in Russian incomes are substantial. Real incomes contracted 3 % on average in January-March. The sharpest drop was in the Nenets autonomous okrug, where incomes declined by a third in January-February. In St. Petersburg, real incomes fell 21 %.

Wage arrears have increased in all regions, with the Central, Volga and Urals federal districts hardest hit. In these districts, over 25 % of the population is involved in the metals and oil industries, and the machine-building, chemicals and textile industries are also big employers.

The lowest unemployment rates in the first quarter were registered in Russia's largest cities. Unemployment was still below 4 % in Moscow and St. Petersburg.

China

April indicators for economic recovery remain mixed.

The entire world has been watching China's key economic indicators in recent months for signs of a recovery that might pull Asia's economies back to a path of growth. Unfortunately, last month's figures suggest the long-anticipated turning point has yet to be reached, leaving the markets to ponder a raft of mixed signals.

Industrial output grew 7.3 % y-o-y in April. Growth was well below the March figure, which was likely boosted by inventory build-up. Export sector output declined 14 % y-o-y in April, while iron and steel production geared for the domestic market saw only minor decreases. As in recent months, electricity production continued to be lower than previous year reflecting the slight decline in electricity demand since the start of the year. Highest output gains were posted by the transport equipment industry (up 10 %) and the textile industry (up 8 %). The shuttering of excess plant capacity and reduction of inventories appears to be taking longer than anticipated. Some of the more optimistic forecasts of improved Chinese growth have been cut back; the more tuned expectation is that China will not return to high growth until the fourth quarter of this year.

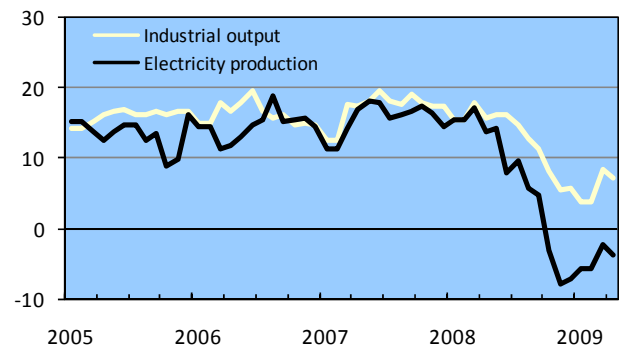
China's exports were also down more than expected in April, plummeting 23 % y-o-y in dollar terms. Although exports on-year contracted more sharply in April than in March (-17 %), seasonally adjusted April exports were up nearly 7 % from March. The revival in exports was clearest in the textile industry and other labour-intensive branches involved with production of consumer goods. At the same time China's imports decreased 23 % (down 25 % in March). The trade surplus contracted both on-year and on-month.

Chinese exports to its three top trading partners are down considerably. Exports to the United States declined 15 % y-o-y in the first quarter and 18 % in April. Imports from the US fell 18 % in the first quarter and 16 % in April. Moreover, China's trade surplus with the US shrank considerably in the first four months of this year. Exports to the EU have been on the decline for the past six months, while exports to Japan started to decline at the start of the year. Exports to the EU were down 23 % in the first quarter and 28 % in April. The respective figures for Japan were -17 % and -24 %. China's imports from the EU also were off 15 % y-o-y in the first quarter and down 17 % in April. Imports from Japan declined 30 % in the first quarter and 24 % in April.

China had good news in April with respect to retail sales and fixed capital investment. April retail sales climbed about 15 % y-o-y in real terms. The sharpest rise

was in rural areas, where the government has implemented a number of stimulus measures. The stimulus also helped boost fixed investment over 30 % y-o-y in real terms in January-April. In the same period, the volume of new investment projects increased 45 %. The central government and regional administrations accounted for the lion's share of this new investment, while the level of private investment remained quite marginal.

Industrial output and electricity production, % change y-o-y



Source: China National Bureau of Statistics

Consumer prices decline 1.5 % in April. The current deflationary episode persisted in April with consumer prices falling slightly relative to March. Part of the on-year decline should be attributed to unusually high figures in April 2008, when prices were still climbing briskly (8.5 % y-o-y). Now prices fell across the board. April producer prices were down 6.6 % y-o-y. On the other hand, it appears that the risk of a serious deflationary episode will be avoided as the broad money supply (M2) expanded 26 % y-o-y in April. After skyrocketing in the first quarter, the growth of bank lending stock slowed to below 600 billion yuan (€64 billion) in April, i.e. less than half the level of previous months.

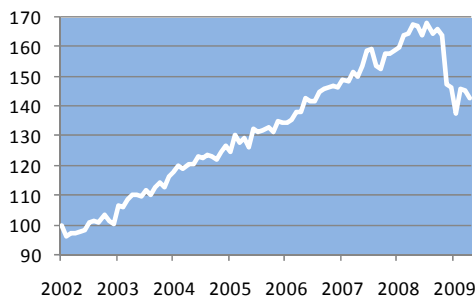
Sharp slowdown in cargo transportation growth. As China's economic growth has slowed, its interior freight transportation growth has also declined. The National Bureau of Statistics reports that freight volumes in the first quarter of 2009 increased 4 % y-o-y, a level well below the 10 % average of recent years. Growth has been down since November 2008. In terms of kilometres shipped, freight volumes declined nearly 10 % in the first quarter of the year. Rail and ship freight volumes have declined in the first part of this year, while road transport growth has slowed down only by a few percentage points. Three-quarters of freight in China is transported by road. While large seasonal fluctuations are typical for freight volumes, anecdotal evidence suggests a slight revival in freight transportation.

Russia

Russian industrial output continues to decline. April production was down by nearly 17 % from a year earlier. Manufacturing output declined over 25 % y-o-y, mineral extraction industries were off 2 %, and supply of electricity, natural gas and water fell 3 %. One of the largest drops occurred in passenger car production, which plummeted 56 % and had large repercussions for companies serving the car industry. While food production generally declined, production of meat and cheese was up over 10 %. Oil production rose 2 %, but gas production fell 24 %.

Seasonally adjusted industrial output in April contracted slightly from March. Russia's ministry of economic development and trade predicts output will begin to revive by the end of this year. Thus, the overall contraction in industrial output for the year would exceed 10 %.

Seasonally adjusted industrial output (Jan. 2002 = 100)



Sources: Rosstat, seasonal adjustments by BOFIT

CBR lowers rates for the second time in a month. Last week (May 14), the Central Bank of Russia lowered its key rates by 0.25–0.5 percentage points. The overnight credit rate is currently 12 % and deposit rates 6.75–7.25 %. The one-day minimum repo auction interest rate is 9 %. The CBR previously lowered its key rates on April 24, 2009. Although market rates rose somewhat early this week, the general trend has been downwards. The one-day Moscow Interbank Actual Credit Rate (MIACR), for example, held below 7 % all last week.

CBR monetary policy applies an interest rate corridor within which markets rates should move. The band ceiling is the overnight credit rate and the floor is the CBR deposit rate. The minimum repo auction interest typically tracks the middle of the band.

The CBR reports that falling inflation and a stabilising, and possibly even appreciating, rouble will allow it to gradually reduce key rates. Over the past month, the rouble appreciated from 38 roubles to just over 37 roubles against one unit of the CBR's currency basket. During that

time the price of Urals oil rose from \$50 a barrel to around \$55.

According to CBR's First Deputy Chairman Alexey Ulyukaev, in April capital outflow from Russia amounted to \$2 billion, the smallest monthly figure since the autumn of 2008.

Proposed customs policy programme favours domestic producers. The draft proposal on 2010–2012 customs policy emphasises measures to mitigate the impacts of the global financial crisis in the near term and the use of customs policy to move towards the long-term goals of diversifying Russia's production structure and increasing the level of value-added in Russian products. The government plans to take up the programme this month.

The draft calls for lowering or eliminating import duties on raw materials and production goods, while duties on finished goods would be increased in categories that compete directly with domestic producers. The proposed programme expects the average customs duty to decline from 11.5 % last year to 10.5–11 % in the three coming years. Export duties would be eliminated for most products with the exception of energy products, raw timber and scrap metal.

Customs policy will be selective and depend on the competitiveness of production sectors. The impact of protective duties would be felt most in branches that are potentially competitive with imports such as cars, agricultural machinery, as well as meat and dairy products. Higher customs duties would also be applied in less competitive but socially important (e.g. pharmaceuticals) or labour-intensive industries (e.g. textiles and footwear) against imports. Import duties on other products where Russian manufacturers compete poorly (e.g. household appliances, electronics) would basically have a fiscal significance only.

The operations of the Federal Customs Service (FCS) will be modernised by e.g. computerising customs transactions and simplifying customs documents. The programme also considers the planned establishment next year of a Russia-Belarus-Kazakhstan customs union. In the event the customs union is created before Russia joins the WTO, negotiations should be started on the accession of the whole customs union under the same conditions as Russia.

The programme makes no mention of a recent FCS statement that surprised Finnish and Russian companies involved in road transshipment of high-value cargo from third countries going to Russia. The FCS wants container cargo brought directly to Russian ports or sent via transit country rail systems. Russia has long sought to reach independence in handling imported foreign goods, but the ongoing lack of adequate infrastructure has made this goal difficult to realise. Today only 4 % of cargo containers passing through Finland to Russia are transported by rail.

China

Financial snags in roll-out of stimulus package. While inspections by China's National Audit Office (NAO) on implementation of stimulus measures at the local level have not turned up any major instances of fraud, waste or abuse, it was found that some local administrations and state-owned companies are struggling to meet their commitments. Regarding local projects, the central government has committed to provide less than a third of project funding out of the massive 4 trillion yuan (€430 billion) stimulus package. The NAO observed that some local administrations and state enterprises are having trouble coming up with their share of the funding, and this, in turn, is postponing the start and implementation of projects.

Of the 335 capital investment projects examined by the NAO, local governments and state firms had put together less than half of their financial commitments at the end of March, when the central administration had already disbursed nearly all of its scheduled commitment for investment projects. Some local officials were found to have taken the central government money and used it e.g. to pay off old debts or reinvested the money in higher-yield instruments. There were no cases of outright embezzlement, but local officials often provided overly optimistic schedules for investment projects.

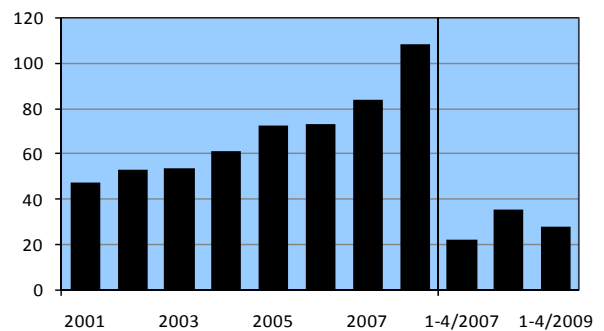
When the financing of the stimulus package was announced last autumn, the troubles facing local administrations, which are required to balance their budgets, were anticipated. The central government has, however, been somewhat lenient on local administrations, permitting them to go into debt by 200 billion yuan this year. It is possible that hastily green-lighted investment projects may end up unprofitable later. This may have diminished the enthusiasm of state-owned enterprises to participate in such projects.

FDI down sharply in first four months of 2009. Foreign direct investment inflows into China declined 21 % y-o-y during January-April. The \$6 billion FDI inflow for the month of April translated into a decrease of 23 % y-o-y. Although the contraction from the start of the year appears dramatic, it actually represents a return to more typical levels. FDI inflows were massive in 2008, reaching \$108 billion for the year. In the first four months of this year, investments are actually beating the same period in 2007.

More tellingly, the number of projects under implementation has declined each year over the past four years. On the other hand, the average size of a project was growing until the start of this year. Nominally, foreign investment in China is relatively small, representing a mere 7 % of total investment annually. Hong Kong is the largest provider of FDI (about 46 %), and its relative contribution has

increased sharply as other countries (including tax havens) have pulled back from investment in China. Combined EU and US investments represent less than 10 % of total foreign investment at the moment.

Total FDI inflows into China, US\$ billion



Source: China's Ministry of Commerce

China's major energy projects in Russia and Central Asia move ahead. In February, China and Russia penned an agreement under which China's state development bank will lend \$25 billion to several large Russian companies involved in oil production and distribution in exchange for a commitment to supply oil from fields in East Siberia. The agreement is a shot in the arm for the long-planned East Siberia-Pacific Ocean (ESPO) oil pipeline and its branch pipeline running to China. The 2,700 km first stage of the ESPO pipeline runs from Tayshet in the Irkutsk region to Skovorodino on the north bank of the Amur River. It is expected to become operational before the end of this year. News stories last month claimed that construction of the oil pipeline running from Skovorodino to China had broken ground and that oil could be flowing to China as soon as next year. The agreement states that the new pipeline will carry 15 million tons of oil a year to China over the next 20 years.

In April, China's state-owned energy giant CNPC acquired a majority stake in MangistauMunaiGas (MMG), an energy company in Kazakhstan. As part of the deal, China will extend a \$10 billion credit to Kazakhstan. India's ONGC and Russia's Gazprom Neft also aspired to owning control in MMG. Chinese firms continue to increase their presence in Kazakhstan's energy sector.

Under an earlier contract, China will import substantial amounts of natural gas from Turkmenistan, and construction work for that project is underway. Some observers see the project activity as an indication that China is shifting its energy supply emphasis from Africa to Central Asia.

China made also deals this spring with Brazil and Venezuela that extend credit in exchange for later oil deliveries. Last year, the oil reserves of China's largest state-owned oil companies were depleted 4-6 %. The latest agreements are intended to make up for falling reserves.

Russia

Economic contraction continued in April. Preliminary Rosstat figures indicate fixed capital investment shrank 16 % y-o-y in April, slightly more than in March which was also reflected in similar development of industrial output. Contraction continued to slow in the construction sector, but construction was still down 16 % y-o-y. Housing construction, on the other hand, has grown a bit in recent months compared to a year earlier. Barometer indexes for industrial firms revealed a general expectation that the decline in output will slow further.

The decline in retail sales accelerated in April with the sales down 5 % y-o-y in volume terms. Consumer activity has continued to deteriorate as unemployment has risen and real wages have fallen. Official April unemployment exceeded 10 %, while the average wage declined 3 % in real terms. The slide in real wages slowed a bit, however, as inflation moderated and nominal wages rose slightly faster than last month.

The economy ministry estimates that Russian GDP contracted 9.8 % y-o-y in the January-April period. The m-o-m rate of contraction, however, slowed in April.

Change in budget policy needed to deal with prolonged recession. In his speech last Monday (May 25) president Dmitri Medvedev outlined state fiscal policy guidelines for the drafting of the 2010 federal budget. He emphasised macroeconomic stability as a precondition for sustained economic growth and called for a cautious approach to spending that should not be based on optimistic revenue projections.

The 2009 budget is the first federal budget to show a deficit since 1999. This year's deficit will reach at least 7 % of GDP, reflecting a substantial drop in tax revenues and additional spending to stimulate the economy.

Strict fiscal discipline will be needed for the government to meet its goal of gradually reducing the budget deficit in coming years. The current plan is to reduce the deficit to 5 % of GDP in 2010 and 3 % in 2011. Deficit reduction will require a fundamental revision of budget structure and a shift in the spending focus. Medvedev said that the state must not compromise on social programmes, but seek to make such spending more effective by e.g. shifting spending decisions to the regional level.

Because the Russian economy is dependent on the global business cycle, Medvedev called for awareness of potentially large fluctuations in tax revenues and the need to continue accruing surpluses to reserve funds during good times.

The president's policy speech is seen as bolstering the strict budgetary position of finance minister Alexei Kudrin.

Russia's largest teleoperators declared "strategic enterprises." In May, the Federal Anti-monopoly Service (FAS) classified Russia's largest teleoperators (Megafon, MTS and Vimpelcom) as companies with dominant market positions. Last March, MTS had a 34 % share of Russia's mobile phone subscribers, Vimpelcom 26 % and Megafon 23 %.

Under Russian competition law, telecom firms with dominant market positions are defined as strategic enterprises. This classification automatically invokes special rules on foreign ownership. A foreign investor seeking to acquire over 50 % of a strategic enterprise must receive permission from the Russian's cabinet's special commission to monitor foreign investment. If the foreign investor is controlled by a foreign state, permission must be sought already at the 25 % level. Any foreign investor holding a stake larger than 5 % in a strategic enterprise must report its ownership to the commission.

The Finnish-Swedish TeliaSonera currently owns almost 36 % of Megafon. Norway's state-majority-owned Telenor (54 %) holds a nearly 30 % stake in Vimpelcom. With the change in the Russian operators' status, these foreign investors must report their holdings to the commission, but are not required to seek permission for their current holdings.

Alfa, the largest Russian owner in Vimpelcom, has long been embroiled in a dispute with Telenor over how Vimpelcom should be run. In March an Omsk city appeals court seized 27 % of Vimpelcom shares owned by Telenor. The shares could be sold off in a forced sale to cover \$1.7 billion in damages Telenor caused to Vimpelcom under a derivative shareholder suit.

EU-Russia summit ends with little to show. EU and Russian leaders gathered late last week in Khabarovsk on the shores of the Amur River to discuss an agenda topped by energy security issues.

Russia-EU relations have been touchy this year following the Ukraine gas crisis in January, an EU decision in March to support the repair and maintenance of Ukraine's gas grid, and the official inauguration early this month of the EU's new "Eastern Partnership" programme to strengthen ties with several former Soviet states outside the EU in Eastern Europe and the Caucasus region.

No meeting of minds on key issues was achieved during the summit. Medvedev noted that Russia would not ratify the Energy Charter and offered to replace it with a new agreement. Medvedev also stated that Russia should not be blamed for the interruption of gas deliveries to Europe, and suggested the EU help Ukraine finance its gas imports and the storage of gas in order to avoid supply cuts.

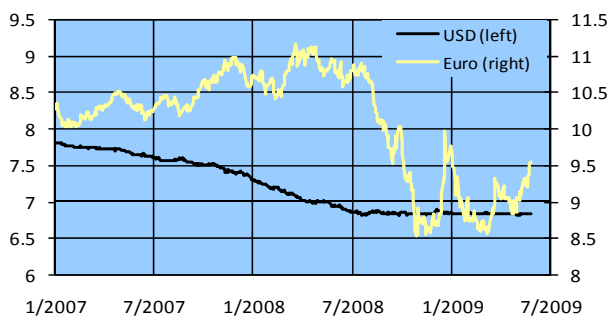
China

Yuan's international role continues to expand. In the midst of last week's visit of Brazilian president Luiz Inácio Lula da Silva to China, China and Brazil discussed the possible use of the yuan and real in bilateral trade – a step that would expand the international use of the yuan to a new level. However, as the yuan is still not freely convertible, its use in foreign trade would require special arrangements. Following a policy of small steps, China has gradually expanded the use of the yuan outside mainland China under special arrangements on a trial basis.

In December 2008, the People's Bank of China signed a bilateral currency swap accord with South Korea's central bank. The arrangement provides Korean companies with a possibility to borrow in yuan for their China operations. China also made currency swap deals this spring with four other countries and Hong Kong. The total value of the swap agreements is 650 billion yuan (€68 billion). Bilateral currency swaps provide liquidity to China's trading partners and promote trade and investments between partner countries. At the same time the swap deals will increase an interest to use the yuan in international business.

Chinese officials last month granted permission to companies operating in the Yangtze River Delta and the southern Guangdong province to use the yuan in commerce with Hong Kong and Macao. A similar experiment in wider use of the yuan is also underway in the Yunnan and Guangxi provinces in southwest China in trade with ASEAN countries. Acceptance of the yuan in Hong Kong and Macao has become widespread and the Chinese currency is used as a means of payment alongside the local currencies. Indeed, it already seems that it would be very difficult to reverse these experiments and developments. In the bigger picture, international use of the yuan will put pressure on the Chinese government to relax currency controls.

Dollar-yuan and euro-yuan exchange rates



Source: Reuters

While interest in the Chinese currency has created appreciation pressure, the PBoC has held the external value of the yuan stable relative to the US dollar since last summer. As a result, the euro-yuan rate has taken the brunt of exchange rate volatility.

EU-China summit focuses on trade and environmental issues. President of the European Commission Jose Manuel Barroso and the current EU president, Czech president Vaclav Klaus, hosted a Chinese delegation led by premier Wen Jiabao last week in Prague. EU-China summits have been held annually since 1998, except last year, when China cancelled the event at the last minute after French president Nicolas Sarkozy, then EU president, met with Tibet's exiled spiritual leader, the Dalai Lama.

Themes headlining last week's agenda related to trade and the environment. Both parties emphasised the significance of open and fair trade in recovery from the global recession. The EU and China penned an agreement on scientific and technology partnership, development of clean energy technologies and increased cooperation among small and medium-sized enterprises.

Discussion also touched on ways to deal with climate change. While the EU would like to see China commit to a substantial reduction of CO₂ emissions by 2020, China wants the developed countries to take full responsibility for their historical legacy of emissions. China also requested that the EU grant it market-economy status, a move that would ease import of Chinese products to the EU. The EU, however, said it was not ready to grant market-economy status just yet. China also asked for a lifting of the EU's 20-year ban on weapons exports to China. China views status as a market economy and the lifting of the weapons exports ban as important symbolic issues.

EU-China trade has skyrocketed in recent years. After the US, Russia and Switzerland, China is the now the EU's fourth largest export destination. The EU is China's most important export market. Due to the economic crisis, China's exports to the EU zone have contracted, however. For January-April, exports were down 24 % y-o-y.

China expected weather global financial crisis in good shape. A global competitiveness study from Switzerland's International Institute for Management Development (IMD) reveals that China's international competitiveness puts it 18th among countries best poised to ride out the current global recession and improve competitiveness over the near term. China's ranking was lifted largely by the fact that its economic prospects are better than most countries surveyed in coming years. The study was based on a questionnaire distributed to companies in 57 countries. IMD found that Denmark was in best shape to weather the global crisis. Finland ranked 9th and Russia brought up the rear in 51st position.

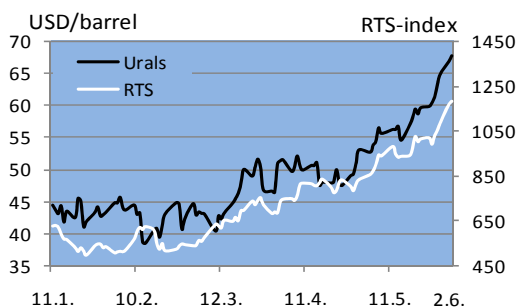
Russia

Russian shares and commodities prices up. The Russian RTS index climbed over 30 % in May. In comparison, the S&P 500, which follows the share prices of the largest US corporations, strengthened 5 % and the corresponding European DJ Euro Stoxx 50 index just 1 %. Since recovering from its January lows, the RTS has risen 130 %. Even so, it is still off its all time high reached last summer by about 50 %. The average daily trading volume in May of companies listed in the RTS index and the Moscow stock exchange's broader MICEX was \$2 billion, somewhat below the \$2.2 billion daily average last summer. Share prices on Russian stock exchanges are generally very volatile.

At the beginning of June, the world market price for Urals-grade crude oil was almost \$68 a barrel, up from less than \$50 a barrel in April. In addition, world prices for copper and nickel recovered to levels not seen since October 2008. May gainers on the Russian stock exchanges were energy companies, while Russia's largest bank Sberbank also fared well. Shares of companies in the construction sector and retail sales continued to tank. Shares of energy companies rose despite relatively weak first quarter performances. The profits of state-owned Rosneft in the first quarter fell 20 % y-o-y to \$2.1 billion. Lukoil's 1Q09 profits (\$0.9 billion) were down 70 % from a year earlier.

In addition to higher oil prices, Russian share prices have been buoyed by expectations of rouble appreciation. In May, the average exchange rate of the rouble against a unit of the euro-dollar currency basket was 37.1, a significant strengthening from the 38.3 average of April.

RTS index and price of Urals oil from January 2009



Sources: RTS, Bloomberg

Corruption remains a serious problem for Russia.

Federal supreme court head Vyacheslav Lebedev said in his annual report on the activities of the court that corruption appears most prevalent in the interior ministry (e.g. state police), and the fields of health care, education, tax inspection and fire safety inspection. Most corruption

involves small bribes, and only about 7 % of cases involve large sums of money or organised activity.

Justice minister Alexander Kononov complained that the current anti-corruption campaign has yet to produce any decisive results. Kononov blamed inadequate legislation that allows abuse, incompetent public sector employees and the underdevelopment of civil society.

While the number of incidents of corruption coming to the attention of officials continues to grow, the general figures fail to tell the full story. High-level corruption is rarely exposed. Chief prosecutor Yuri Chaika said the problem is that most incidents of corruption are investigated at the lowest levels of administration.

Chaika noted that corruption is most common in organisations involved in state-funded projects or in the granting of special permits for business activities. The most dangerous areas for corruption are along the country's borders, where illegal activities include smuggling and financing of terrorism. In the view of the chief prosecutor, operations of border officials currently suffer from a lack of sufficient effective oversight.

The anti-corruption campaign was launched last year at the initiative of president Dmitri Medvedev. While the campaign has resulted in e.g. approval of a separate anti-corruption law and amendments to other laws, experts say the public largely considers the campaign as symbolic. Concrete measures include a programme this year to equip police cars with dashboard cameras and a requirement that officers in uniform wear name badges. Starting next year, police officers must give their employer a report on their sources of income.

The most recent Corruption Perception Index (CPI) from Transparency International, which surveys the extent of corruption globally, ranked Russia as the 33rd most corrupt country among its 180 countries surveyed. In terms of corruption, Russia was on par with Bangladesh, Kenya and Syria.

Finnish and Russian prime ministers met in Helsinki to discuss bilateral and multilateral economic issues.

The latest twice-a-year meeting of prime ministers produced no breakthroughs on bilateral issues between Finland and Russia. Finnish concerns included Russian export tariffs on raw timber and possible Russian restrictions on container traffic moving through Finland to Russia. Prime Minister Vladimir Putin said that the wood tariffs were meant to encourage foreign investment in Russia's forest industry.

Putin emphasised the significance of the Nord Stream gas pipeline for Europe's energy future. Finnish environmental authorities are currently studying the potential impacts of the planned pipeline. Putin repeated president Medvedev's proposal made at the recent Russia-EU summit that would require the EU participate in resolving the Ukraine gas issue.

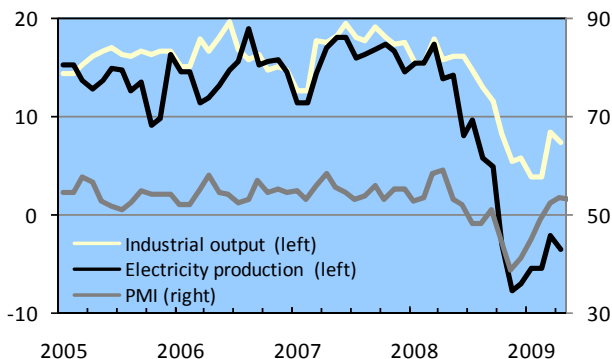
China

China's purchasing manager indexes suggest cautious optimism. The May purchasing managers' index (PMI) published by the China Federation of Logistics and Purchasing (CFLP) climbed for a third month in a row, and showed a clear majority (53 %) of firms experienced a better month in May than in April. The CFLP's positive index reading was backed up by the PMI published by the brokerage firm CLSA. It, too, held above the critical 50 % mark for the second month in a row. The CLSA's reading for May (51.2 %) was the highest since July 2008. Both indexes approached their long-term averages.

The development of sub-indexes within the CFLP survey is interesting from the standpoint of economic development. Industrial production and order books grew relative to the previous month, while inventories of finished goods shrank. At the same time, also inventories of production inputs contracted and orders for inputs increased. Overall, the PMI sub-index trends signalled a general message that inventories are declining, production is rising, and order books are gradually on the increase. Both imports and new export orders were close to April levels, suggesting that foreign trade is no longer contracting.

The positive PMI reading was somewhat contradicted by the latest figures for electrical power generation and oil consumption, both of which have contracted slightly from 2008. Converting the PMI production sub-index to its on-year equivalent indicates that the production this spring was down considerably from spring 2008. In this respect, the PMI is in line with electricity and oil consumption.

On-year growth in industrial output and electricity production, %; CFLP purchasing manager index



Sources: NBS and CFLP

Economy and climate issues dominate Geithner's visit to China. US treasury secretary Timothy Geithner made his first official visit to China this week, meeting with

China's top leadership, including president Hu Jintao. The visit was a prelude to the next "strategic dialogue" meeting in July in Washington DC. In addition to extensive discussion of economic matters, the delegations focused on climate change issues. The preparations affect the upcoming Copenhagen climate summit at the end of this year, where the next phase of the Kyoto protocol will be decided.

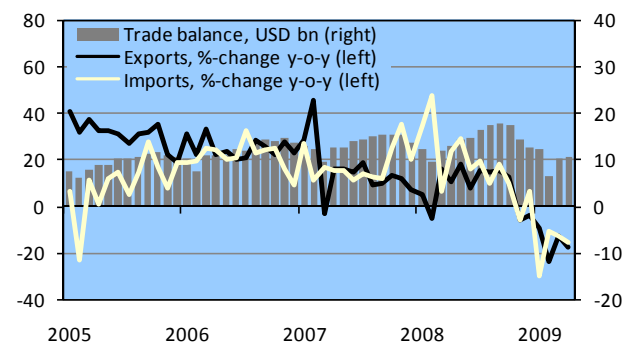
As the international financial crisis continues, the Chinese have become increasingly concerned about United States' growing debt. The Chinese fear that further borrowing by the world's largest debtor will give US policymakers incentive to inflate away part of the country's debt and thereby diminish the real value of dollar-denominated debt held by the Chinese. Geithner gave assurances that the US fully intends to keep inflation at bay. China has the world's largest currency reserves (nearly \$2 trillion), about 60 % of which is assumed to be invested in dollar assets.

As recently as January, Geithner was a harsh critic of China's exchange rate policy. During his meetings this week, however, the subject was scarcely mentioned. Geithner's June 1 address to Peking University simply expressed hope that China would shift to a more flexible exchange rate policy. Since July 2008, the People's Bank of China has held the yuan's nominal exchange rate stable against the dollar. The yuan's real (trade-weighted) exchange rate stands at the level of last summer.

Geithner repeated the US wish that China further open its markets to foreign investment and avoid protectionist measures. Chinese officials have recently been giving foreign firms harsher scrutiny. A survey of members of the US-China Chamber of Commerce (Amcham China) found a perception that protectionism is on the rise and that getting permits has become more difficult in recent years. Bureaucracy, unclear regulations and inconsistent interpretation of rules continue to plague companies.

While China keeps running large trade surpluses with the US, the recent US recession has slightly reduced China's trade surplus. In January-April, Chinese exports to the US contracted 16 % y-o-y.

Monthly change in China-US trade, %



Source: China Customs

Russia

13th St. Petersburg Economic Forum focuses on finance and business during economic crisis. Politicians, researchers and major business leaders from around the world gathered on June 4–6 in St. Petersburg to discuss the current state of the global economy and Russia's role in it. Nearly 30 panel and roundtable discussions dealt with topics ranging from social and national security policies during an economic crisis and government measures to deal with the crisis to financial market issues and logistics. A Finnish-arranged panel considered energy efficiency.

At the same time, Russia also sponsored the first World Grain Forum. Discussion centred on grain prices, biofuels, food safety and food technology. Russia announced plans to substantially grow its contribution to the international grain market over the next 15 years. The goal is to eventually export 50 million tons of grain a year, an ambitious goal given that Russian grain exports last growing season are estimated at 18–19 million tons following a bumper harvest. Russia, Ukraine and Kazakhstan discussed establishment of a joint grain pool to improve their competitive position on international markets.

In the course of the economic forum, a number of trade and finance deals were signed. The Russian investment bank VTB Capital and Germany's Deutsche Bank announced the establishment of an investment fund for the Moscow and St. Petersburg real estate markets. Partners in the venture include the Finnish pension insurance companies Etera and Ilmarinen, as well as the Finnish construction company SRV Group that will be the main contractor in the projects. Current fund assets exceed €100 million. The plan is to ultimately raise the level of assets to around €300 million.

Russia's WTO membership was among the hottest topics at the forum. Prior to Putin's bombshell this week (see item below), EU representatives were optimistic about Russian WTO membership, and Russia was promising to speed up implementation of WTO technical requirements.

Putin announcement throws Russia's WTO membership goals into doubt. At the Eurasian Economic Community summit in Moscow on Tuesday (June 9), prime minister Vladimir Putin announced that Russia, Belarus and Kazakhstan were inaugurating a customs union next year.

Putin said the countries end their individual WTO accession talks and will seek membership jointly as a single trading bloc. Membership negotiations would start anew next year, led by Russia from the customs union side.

News of the suspension of WTO talks came as a surprise. At the St. Petersburg Economic Forum a few days earlier, economic development minister Elvira Nabiullina

and Russia's lead WTO negotiator Maxim Medvedkov said they expected Russia to complete its membership negotiations this year. This expectation was echoed by EU trade commissioner Catherine Ashton. Different signals came from Anatoly Chubais, presently the head of state-owned Rusnano, who doubted the timetable and said that Russia is actively seeking alternative arrangements. According to Chubais, one of the alternatives could be the three-member customs union.

No change in CBR monetary policy. The Central Bank of Russia lowered its key rates on June 5 by 0.5 percentage point. The rate cut was the third since mid-April, when the CBR began cutting rates. Both the refinancing rate and the overnight credit rate are now 11.5 % and the 7-day repo auction minimum rate stands at 9 %.

Until April, the CBR incrementally hiked its key steering rates to stifle inflationary pressure and support the value of the rouble. Lately inflation has begun to subside falling from 13.2 % y-o-y in April to 12.3 % in May.

The rouble has strengthened recently along with rising global crude oil prices. As of Friday (June 12), one euro bought 43.35 roubles and one dollar 30.91 roubles. The rouble last traded at these levels in January 2009. The rouble reached its weakest point in February, when it traded at 46.84 roubles to the euro and 36.43 roubles to the dollar.

President Medvedev announced last week that he was recommending a third term for CBR chairman Sergei Ignatyev. The appointment process is based on a president's motion to the Duma, which can approve a candidate for up to three consecutive terms.

Ignatyev is credited with the swift response that helped contain the spread of effects from the global financial meltdown last autumn. The CBR was quick in implementing e.g. a system where the CBR extended unsecured loans to banks to deal with the tight liquidity situation.

According to finance minister Alexei Kudrin, Ignatyev was the father of the controlled devaluation policy launched last November. Under the pressure of falling crude oil prices and declining export earnings the CBR devalued the rouble gradually by about a third over a three-month period, after which the rouble's value stabilized. Ignatyev has been criticised for the stepwise devaluation as it gave banks and other large enterprises an opportunity to prepare for the rouble's depreciation and shift money out of rouble assets – including money they had received as part of the CBR's crisis financing – into other currencies, thereby increasing the amount of currency flowing out of the country. The possibility to prepare for the change, however, made it easier for banks, businesses and households to adjust to the lower exchange rate regime.

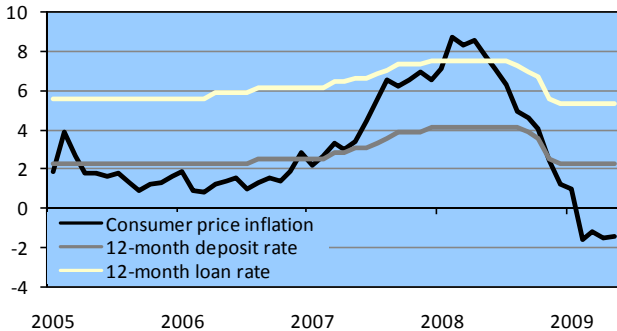
In recent weeks, Russia's currency reserves have risen again. On June 5, they stood at \$410 billion, or about two-thirds of the all-time peak reached in August 2008.

China

Deflation continues in May. Consumer prices declined 1.4 % y-o-y in May. Prices have fallen each month from March 2008, with the exception of the Chinese New Year this January, when prices traditionally spike. Meat prices have fallen furthest, and are now returning to conventional levels from their peak in 2007, when e.g. swine ailments reduced pork supplies and raised prices. Today's lower consumer prices partly reflect oversupply. As exports have faltered, producers have found themselves fighting over domestic market share. The problems of oversupply and the drop in international commodity prices impact Chinese producer prices, which continued to slide in May (down 7 % y-o-y).

Although consumer prices were down on-year for the fourth month in a row, the threat of a serious deflation episode is not expected to materialise. China's money supply has expanded rapidly this year, strengthening the expectation of increased inflationary pressure over the near term. Moreover, the People's Bank of China does not seem overly concerned about current price trends, since it has not adjusted its monetary stance this year.

On-year change in consumer prices and key 12-month reference rates, %



Sources: National Bureau of Statistics and PBoC

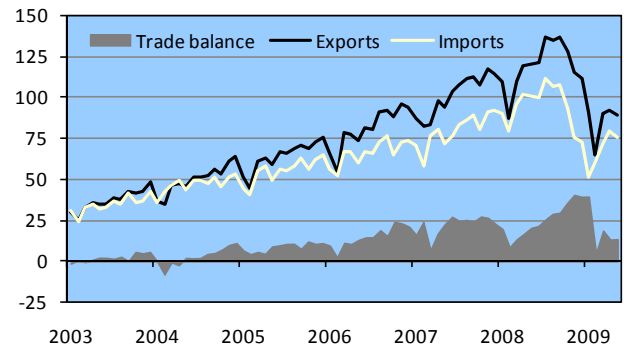
China increases VAT rebates to support exporters. The government announced a further hike in value-added-tax refunds two days before the release of China's May foreign trade figures, which showed exports were still in a nosedive (down 26 % y-o-y). As earlier, the new round of tax refunds was directed at industries that have suffered most from the global economic downturn (e.g. electronics, steel, machine-building and toy manufacturing). The latest series of VAT refunds apply to over 600 categories of goods. The new tax schedule applies retroactively from June 1. In practice, certain production branches now qualify for a full refund on their VAT payments for exported goods.

China last boosted VAT refunds on export goods in April. In all, the government has increased tax refunds to exporters seven times since August 2008. China has also attempted to support its flagging export industries by preventing yuan appreciation against the dollar.

In the first quarter of this year, China's tax revenues fell by over 10 % y-o-y due to the reduced taxes and a smaller tax base.

China has agreed with the ten ASEAN member states on establishment of a free-trade area, within which customs duties would be eliminated from all products from the start of 2010. Last year, 8 % of Chinese exports and 10 % of Chinese imports went to ASEAN countries. China already has seven free-trade agreements in force and is in the process of negotiating another 14 free-trade agreements. When implemented, 31 countries would be covered under free-trade agreements with China.

Chinese foreign trade, US\$ billion



Source: China Customs

State merges two airlines. The merger of state-majority-owned China Eastern Airlines (CEA) and Shanghai Airlines is now underway. Under the merger plan, Shanghai Airlines will operate as a CEA subsidiary. Both companies have made losses in recent years, forcing the government to directly subsidise them. Last year the two airlines posted total losses of 16.5 billion yuan (€1.6 billion). The new company will control about half of Shanghai air traffic, which officials hope will provide sufficient competitiveness to make the new airline profitable. The new airline will have a fleet of about 300 planes, and will operate more than 600 routes.

Officials have tried in recent years to encourage mergers in several sectors in order to create economies of scale sufficient to overcome fierce market competition. Large mergers, however, have been rare in China. One reason is believed to be opposition from regional governments. State-dictated mergers, however, could become more common if lower economic growth continues and company losses persist.

Russia

IMF Article IV mission remarks lay out the implications of lower growth for Russia's future. In its concluding statement on the 2009 Article IV consultation, the IMF said Russia's future development could be clouded by a slow rise in commodity prices for years to come. Moreover, the Fund experts noted that global deleveraging as a result of the financial meltdown will mean diminished capital flows to emerging economies like Russia.

The IMF praised Russia for its timely response to the global economic downturn and its fiscally prudent policies of recent years. While Russia's reserve cushion, amassed from years of large budget surpluses, is instrumental in covering near-term budget deficits, the Fund notes that the international downturn has revealed severe deficiencies in Russia's economic policies that led to strong linkage to world business cycles and overdependence on foreign financing.

The IMF was particularly concerned about the rise in the stock of non-performing loans held by Russia's banking sector. The Central Bank of Russia, it pointed out, needs to effectively appraise the capital adequacy of banks. For this the CBR needs increased supervision powers. It is crucial for the CBR to develop a comprehensive strategy to recapitalise viable banks.

The IMF warned of the dangers Russia faces if it relies on stimulus measures beyond an appropriate amount of countercyclical fiscal relaxation. The government has approved a budget deficit of 7 % of GDP for 2009. Cutting expenditure from such high spending levels to balance the budget may be very difficult in coming years. In addition, the IMF emphasised the importance of using stimulus measures in a targeted fashion.

Fixed capital investment declined 16 % y-o-y in the first quarter. The value of fixed capital investment in January-March was 1.3 trillion roubles (about €30 billion). The value of investment shrank substantially in certain branches (e.g. down 22 % in the food industry, 34 % in the chemicals industry and 39 % for railways).

Investment in social fields declined, too. Investment in education contracted 19 % y-o-y, while investment in health care was down 7 %.

Investment growth was highest in the fields of pipeline transmission (47 %), mining of metallic ores (36 %), the financial sector (35 %), research activity (35 %) and pulp and paper production (17 %).

Investment in oil refining capacity climbed 78 %, while investment in oil drilling and production of other energy commodities fell 12 %.

Some 26 % of investment went to transportation infrastructure and telecommunications, 21 % to oil drilling and other forms of mineral extractions and 19 % to manufacturing.

A substantial share of fixed capital investment, 41 %, continued to be financed by out-of-pocket by companies, a decline of five percentage points from a year earlier.

In addition, company raised 18 % of their financing from other organisations and 13 % from budget funds. About a third of this budget funding came from the federal budget. The combined share of domestic and foreign bank loans was 13 %. The share of loans from foreign banks was 4 %. The share of financing raised through IPOs fell from around 2 % to below 1 %.

The share of foreign investment grew to nearly 7 % of total fixed capital investment.

Finland's exports to Russia decline, especially in re-exports and transit freight businesses. The latest figures from Customs Finland show that the value of Finnish exports to Russia plummeted by 47 % y-o-y during the first quarter of 2009. While the contraction affected all main product categories, the largest drops were seen in transport vehicles (73 %), electrical equipment and devices (59 %) and printed matter (53 %). The drop in vehicle exports largely reflected a collapse in passenger car imports to Russia transiting through Finland as re-exports. There was also a significant decline in the value of cellular phones in the electrical machinery and device category as fewer phones produced in third countries passed through Finland as re-exports.

Finland's top export category was chemical substances and products, down just 5 %. This category includes the booming business of pharmaceutical exports.

The value of Finnish imports from Russia decreased 42 % during the first quarter. The value of wood imports declined 71 % and crude oil was off by 47 %.

In recent years, Finland's three largest trade partners (Germany, Sweden and Russia) have held fairly similar market shares. Last year, Russia, with a 12 % share, topped the list for the first time as Finland's largest export destination. The shares of Sweden and Germany were both around 10 %. Russia's share of growth was lifted somewhat artificially by a 55 % increase in the value of automobile exports that consist mainly of re-exports.

In 1Q09, Finland's largest export market was Germany (11 %), followed by Sweden (10 %) and Russia (9 %). The leading sources of imports were Germany and Russia, each with 14 % shares. Sweden's share was 10 %.

Road-transit freight moving through Finland in the first quarter fell 47 % in volume terms and 44 % in value terms. The largest drop occurred in transit shipping of passenger cars, down 75 %.

China

May economic performance reinforces growth prognoses. After a feeble April performance, China's economy showed signs that economic growth was no longer slowing in May, and through public sector stimulus measures it may even be accelerating. Real on-year growth in industrial output accelerated in May to 8.9 % (from 7.3 % in April). Both of China's purchasing manager indexes (CFLP and CLSA) indicated the situation in May improved from April for most manufacturers. Car manufacturing in May was up 29 % y-o-y, while electricity production was still down almost 3 %.

Nominal growth of 15 % y-o-y in retail sales suggests household income development is still rather healthy. Fixed capital investment, which is the main supporter of the demand side at the moment, grew by a third in nominal terms in the January-May period. Investment in capital-intensive infrastructure suggests that the government's 4-trillion-yuan (\$585 billion) stimulus package announced late last year has been central in fuelling the recent capital investment boom. However, May also brought indications of recovery in the real estate market, signalling a possible widening in the base for investment demand.

China's economic growth is being fed by bank lending on a massive scale. The amount of new loans issued in May doubled from a year earlier and the broad money supply (M2) was up 25 % y-o-y. Even so, money growth has not prevented deflation yet; in May consumer prices were down 1.4 % y-o-y and producer prices down by 7 %.

China's economic growth now relies on domestic demand, as there are no signs of revival in foreign trade. The value of China's exports and imports in May was down some 25 % from a year ago. Over the past few months, however, it appears the value of exports has stabilised at the \$90-billion level and imports at around \$75–80 billion. The trade surpluses posted in April and May were distinctly smaller than a year ago.

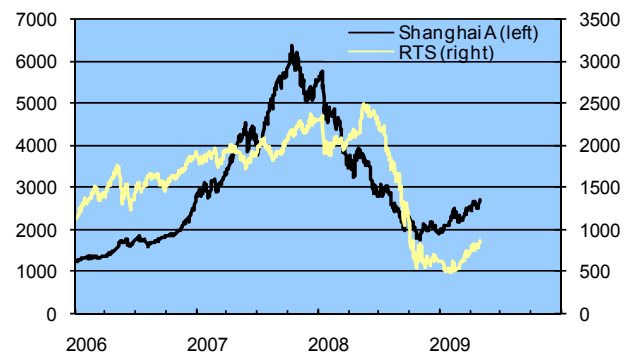
China's relatively strong domestic economic growth suggests a stabilising situation, although there are several disconcerting aspects to these trends over the medium-term. In particular, strong credit growth has increased the risk of non-performing loans to banks, as well as the danger of an asset price bubble and general inflationary pressures. Robust growth in fixed capital investment will only further increase China's already huge ratio of investment to GDP at a time when the economy would rather need to boost the share of private consumption.

Share prices continue to soar. The Shanghai A-share index has risen 50 % since the start of the year, which places the Chinese bourse among the world's best per-

forming exchanges this year. The rise in China's share prices began already last November, when the economic downturn was at its nadir and the government announced its massive stimulus package. The stimulus has likely supported the rise in share prices as it flooded with cash an economy having few investment alternatives. The index of China's number-two bourse, the Shenzhen stock exchange, is up over 60 % from the start of the year.

Shanghai's dollar-denominated B-share index tightly tracks A-share prices. Although the B-share market was initially created for foreign investors, the market was opened in 2001 to domestic investors. Moreover, the long-running conversion of non-tradable shares in state-owned enterprises to tradable shares is now on its final leg. All listed companies are participating in the overhaul, so the share of market-tradable shares continues to increase and all non-tradable shares should be fully converted by 2011.

Shanghai A and Moscow RTS indexes



Source: Bloomberg

BRIC countries gather. The presidents of world's largest emerging economies, the BRIC (Brazil, Russia, India and China) countries, met jointly for the first time this week in Russia in the city of Yekaterinburg 1,700 km east of Moscow.

The international economic downturn dominated the discussion, and the countries hoped that developing economies would assume greater roles in core global institutions. In particular, the countries expressed a desire to see a reallocation of UN powers. The resolutions from the meeting were of a general nature. The next BRIC meeting will take place next year in Brazil. In addition, the countries will have a chance to talk at the G20 meeting in September.

The contribution of the BRIC countries to the global economy has grown rapidly. In 2008, their combined share of world GDP was about 15 % – double their contribution a decade earlier. Growth among the BRICs continues to be led by China, which now has a GDP value that nearly equals the combined GDP of the other three countries. Nearly half of the world lives in a BRIC country.

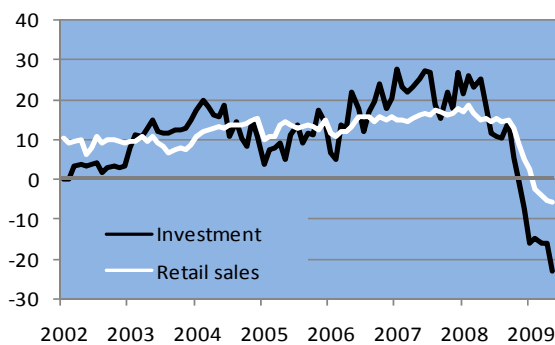
Russia

Economic retrenching goes on. While May industrial output contracted 17 % y-o-y, seasonally adjusted figures show that in May output fell only slightly from April.

The collapse in fixed capital investment continued in May, with investment down 23 % y-o-y. For the first five months of 2009, investment was down 18 % y-o-y.

Consumption is falling more slowly than capital investment. Retail sales, a good indicator of consumption, declined 6 % y-o-y in May and 2 % y-o-y for the first five months of the year. Real disposable incomes shrank about 1 % and real wages 3 %. The average nominal monthly wage in May was 18,200 roubles (€420).

12-month change in fixed investment and retail sales, %



Source: Rosstat

Rosstat's revised figures indicate GDP shrank 9.8 % y-o-y in the first quarter. The World Bank's Global Monitoring Report, released at the start of the week, forecasts Russian GDP will contract by 7.9 % this year.

Russia tightens regulation of securities markets. At the St. Petersburg Economic Forum at the start of June, president Dmitri Medvedev said that Russia will strive to make Moscow a centre of international finance. The plan, which has long been on the agenda, is part of the development strategy for financial markets approved in January. Russia's financial markets still suffer from many shortcomings, so creating a coherent legislative framework is seen as a first step in increasing participation of international investors in Russian securities markets.

The Duma passed an amended in the criminal code concerning insider trading in February. The revision increases punishments significantly – manipulation of share prices can now result in up to seven years in prison rather than a fine as earlier. Other new felony-level crimes in the law include falsification of share register information. The Duma is currently considering further legislation on in-

sider trading and share price manipulation (e.g. clarifying the definition of an insider). The Duma is presently looking at a bill on creation of a central share depository, but progress on the matter has been slow.

At end-April, president Medvedev signed into law a new securities act that permits trading in foreign securities on Russian exchanges. Listing requires approval from the Federal Financial Markets Service (FFMS), the agency charged with supervision of Russian securities markets. Observers note that foreign-registered Russian companies and companies domiciled in CIS countries are particularly interested in listing in Russia.

A goal of the development strategy for financial markets is to make Russian stock exchanges the main market place for shares of Russian companies. At the start of June, the FFMS presented a draft law to reduce the maximum share of stocks of Russian companies sold on foreign exchanges from 30 % to 25 %. The maximum share for companies operating in strategic sectors would be cut to 5 % from the current 25 %. Russian companies could only hold share emissions abroad after listing in Russia.

Share investment would be encouraged by protecting investor assets against broker insolvencies with a special claims fund. Proposed legislation on the claims fund should be presented to the government this month.

Russia, Belarus and Kazakhstan tell the WTO that they are breaking off membership talks. The renegade trio unofficially announced their plans last week at a get-together of several dozen WTO members in Geneva. It is still unclear as to how and when WTO membership negotiations would resume or the details of how the planned customs union would handle negotiations. Russia has nearly completed its WTO membership negotiations, having resolved 95 % of issues. The largest remaining questions concern tariffs on wood exports and agricultural subsidies, among others. Kazakhstan, in contrast, has only completed talks on 30 % of the membership topics, and Belarus a mere 10 %.

It is widely believed that creation of a customs union will impede Russia's WTO membership. The technical challenges could be daunting as the WTO has never had to deal with membership application of a customs union. In addition, Russia, Belarus and Kazakhstan are at very different points in their membership talks and have distinctly different foreign trade structures. Reconciliation among the three as to common goals will in itself be challenging.

Some observers see Russia's sudden withdrawal from bilateral negotiations as an indication of diminished enthusiasm for WTO membership. First deputy prime minister Igor Shuvalov said Tuesday (June 23) that Russia's withdrawal was a response to numerous US and EU demands on Russian membership made without corresponding indications that compliance would lead to membership.

China

World Bank raises China's growth outlook. In its latest forecast, the World Bank estimates the Chinese economy will grow 7.2 % this year, up from its March forecast of 6.5 %. The World Bank expects China's GDP growth to reach 7.7 % next year. In its just-released *Global Monitoring Report*, the World Bank stated that there were limits on the impacts of a stimulus package and given that China is now strongly integrated into the world economy its development depends on global recovery. As a result, further stimulus measures were not recommended this year; the budget deficit is already rising faster than expected eroding opportunities for further stimulus actions next year. Moreover, the cost-effectiveness and benefits of public projects are limited. China is also seen as facing similar risks associated with its massive credit expansion as it can lead to ultimately unprofitable or misdirected investments.

The World Bank reiterated its view that domestic demand should drive growth in the future so China's government must do more to encourage demand on the part of private consumers. While domestic consumer demand has held up even as income growth has slowed and consumer confidence weakened, it is likely that consumer demand in the countryside will gradually fade as remittances fall because of a persisting poor situation for migrant workers. There is already some evidence of growth in savings.

The report found that recent profits of Chinese companies are smaller than in previous years. Companies have large amounts of unused capacity and prices are falling globally and in China. Declining profits, overcapacity, downward price pressure and economic uncertainty have dampened the willingness of companies to invest.

The report's authors consider premature recent claims that the Chinese economy is firmly on the road to permanent recovery. They paid particular attention to the government's limited possibilities for substituting public demand for poor export demand and weak private investments. If the world economy does not revive soon, China will be unable to sustain growth levels much higher from others.

The World Bank estimates the government's stimulus measures this year will add about one percentage point to China's GDP growth. Next year, however, growth is expected to accelerate less than in other countries as the effects of the stimulus wear off. Industry still faces accommodation pressures, which will also reduce growth next year. Weaker export demand in the coming decade could cut China's annual GDP growth by as much as two percentage points. The World Bank considers the risk of deflation minimal.

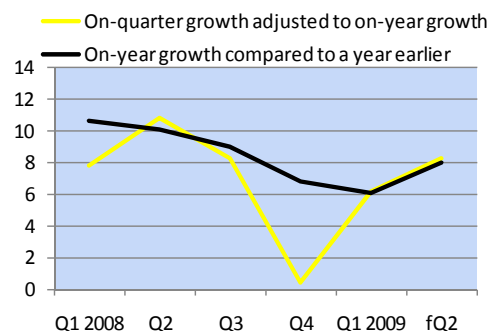
Number of Chinese living in poverty expected to fall despite the world financial crisis. The World Bank's annual *Global Monitoring Report* also considers poverty and development trends. Using the current definition of poverty (disposable income of \$1.25 a day), the number of China's poor fell from 683 million in 1990 (60 % of the population) to 208 million in 2005 (16 % of the population). This success at poverty reduction has made China one of the few countries in the world where poverty has been cut both in absolute and relative terms. The World Bank notes that the current financial crisis and higher food prices have clouded the overall positive outlook concerning global poverty developments. Even so, the World Bank expects the number of China's poor to fall to about 60 million by 2015.

China released new quarterly GDP figures. This week the National Bureau of Statistics website posted an article by researcher Tonxin Guo that for the first time presented information in an official forum on China's quarter-on-quarter GDP developments. Although the article was attributed solely to Guo and dealt only with quarterly figures for 2008 and 2009, the announcement has fuelled hopes that the NBS is on the verge of regularly releasing statistics on quarter-to-quarter changes in GDP. By some estimates, the NBS could start releasing quarterly GDP data from the start of next year.

The reform is welcome as reliable assessment of quarterly trends is still not possible. Moreover, on-quarter calculations of various investment banks and forecasting bodies give conflicting views of current trends.

Even if the reliability of the new statistical data will be challenged, it nevertheless offers a superior base for economic monitoring and research. The new quarterly figures provide a sharper view of the Chinese economy, especially in the rapidly changing conditions. The just-released data suggest that the recent trend diverges decisively from the picture given by currently available figures. The new figures show China's GDP grew a mere 0.1 % q-o-q in the last quarter of 2008, which works out to growth of 0.4 % y-o-y. This is much less than figures reported earlier.

12-month change in GDP growth, %



Source: China National Bureau of Statistics

Russia

Declining capital investment diminished GDP. Russian GDP contracted by nearly 10 % y-o-y in the first quarter of 2009. In comparison, Russian GDP increased 9 % in the first quarter of 2008. The contraction this year was largely due to a substantial decline in fixed capital formation. Fixed investment was down 16 % y-o-y. Inventories also declined substantially, which seems to have added rather significantly to GDP contraction. The inventory component in Russia's balance of resources and expenditure has been relatively large and rising for several years now. Last year it corresponded to nearly 4 % of GDP.

Total consumption contracted in the first quarter of 2009 by 2 % y-o-y. Household consumption was down 3 % y-o-y, while public consumption increased over 1 %. Consumption as a share of GDP rose sharply to over 80 %.

Net exports grew by nearly a fifth for the first time in years. Imports contracted in real terms substantially faster than exports, when in earlier years it grew substantially faster than exports. Exports contracted in the first quarter by nearly 15 % y-o-y, while imports shrank 34 %.

Russia officially launches talks on OECD membership. On June 24, economy minister Elvira Nabiullina submitted a memo to the OECD that lays the foundations for reviewing Russia's preparedness for membership. The OECD launched a new round of expansion in 2007, when it invited Chile, Israel, Slovenia, Russia and Estonia to enter into membership talks. Russia initially petitioned for OECD membership in the mid-1990s.

The OECD currently has 30 members. The main requirements for membership are commitments to democracy and a market economy. The OECD acts as an expert organisation and works through dozens of committees in which member-country representatives meet to exchange information and agree on common procedures and rules. Committee topics cover the full range of administrative fields from economic policy, statistics and regional development to health care, fishing, pension systems and culture.

In membership talks, each OECD committee respectively studies the practices in the candidate country and on the basis of its findings, votes on whether the country should be recommended for membership. OECD members must commit e.g. to uphold the OECD's more than 200 standards and rules.

OECD Secretary General Angel Gurría stated that by starting the membership talks Russia has affirmed its commitment to economic reforms based on internationally accepted rules.

FDI to Russia contracted sharply in 2008. The Central Bank of Russia reports that the stock of foreign direct investment fell by more than half during 2008, ending the year at just \$214 billion. The shrinking of Russia's FDI stock reflected significant downward valuation changes. Valuation changes decreased the value of the FDI stock by \$350 billion, while the net inflow of investments was \$70 billion.

The value of the stock of portfolio investment in Russia shrank also substantially. Portfolio investments lost more than \$220 billion due to valuation changes and the net outflow of securities investment reached nearly \$30 billion. The stock of portfolio investment was \$111 billion at the end of 2008.

The share of direct investment in total foreign investment was 28 % last year, or eleven percentage points less than in 2007. The share of portfolio investment declined to 15 %. The bulk of foreign investment, however, comprised other investment, mainly various forms of credit.

The CBR does not release a breakdown of the foreign investment stock by country or by sector. Rosstat does release a breakdown analysis, but due to the fact that Rosstat and CBR use different methodologies in preparing statistical data on foreign investment, their reported figures are different. Rosstat figures put the stock of foreign direct investment in Russia in 2008 at \$122 billion.

According to Rosstat figures, more than a fifth of FDI inflows last year went to manufacturing, most notably the processed food industries. Mining and mineral extraction industries, as well as the real estate business, also received FDI shares approaching 20 %. Nearly a third of investments went to Moscow, while some 5 % went to St. Petersburg.

Top providers of FDI to Russia in 2008, % share of FDI stock

| | |
|----------------|------|
| Cyprus | 33.3 |
| Netherlands | 29.4 |
| Germany | 5.9 |
| Virgin Islands | 4.5 |
| Great Britain | 3.8 |
| United States | 2.6 |
| Austria | 2.0 |
| Finland | 1.7 |

Source: Rosstat

The stock of Russian FDI abroad also contracted last year by nearly half to \$203 billion. The decline in Russia's foreign investment stock also reflected valuation changes. The net outflow of Russia's foreign direct investment was \$53 billion.

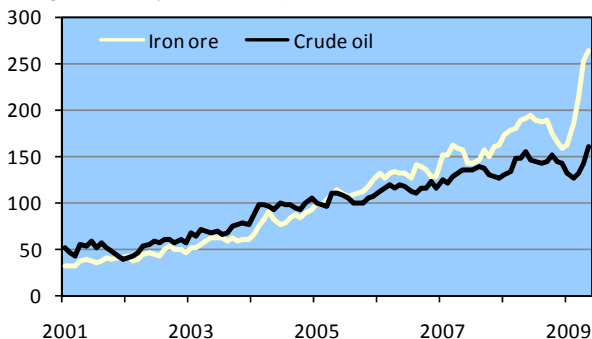
China

June PMI figures suggest outlook for manufacturers keeps improving. China's official manufacturing purchasing manager index (PMI), released by China's Federation of Logistics & Purchasing (CFLP), posted a June value of 53.2, or about the same slightly optimistic number as in May. A PMI value above 50 indicates that a majority of industrial firms see better business prospects in the current month than in the previous month. The official PMI has now held above the critical 50-point mark for the fourth month in a row. The June sub-index for export order-book volumes also climbed above the 50-point mark to 51.4, but was still well below values posted in recent years. Exporters face a slower recovery than domestic producers. Also the sub-index for imports (49.9), remains below values of recent years, while the other sub-indices no longer indicate special stresses on industrial producers.

The PMI released by the Hong Kong brokerage CLSA also indicated that China's economy continued to bounce back for the third month in a row.

China's appetite for commodities driven by desire to build up inventories. Although the volume of Chinese imports overall is still down 6 % from last year (and down 25 % in value terms), import volumes have rebounded sharply in recent months due largely to a massive increase in commodity imports. Crude oil import volumes now exceed last year's level and iron ore imports are up about a third from last year (see chart). Imports of pure aluminium and copper have skyrocketed from previous years.

Import volumes of crude oil and iron ore (3-month moving average, January 2005 = 100)



Sources: CEIC, BOFIT

The growth in imports of metallic ores and refined metals has been driven in part from of a revival in construction activity as a result of the government's stimulus package. Increased construction, in turn, has helped steel-

makers recover from last year's production collapse. Car-makers are also driving metal demand. In May, China produced about 600,000 passenger cars, a third more than in May 2008.

Higher output, however, does not fully explain the increase. Companies appear to be taking advantage of a slump in global commodity prices to replenish depleted raw material inventories; energy prices are about half of last year's peak and metal prices are off 40 % from their recent highs. There is also evidence that certain commodities are cheaper abroad right now than in China. For example, China's own iron ore production is still well below the level of a year ago.

China's building up of strategic commodity reserves is affecting global demand for crude oil and metals. Its recent aggressive purchasing of pure aluminium and copper may be related to the build up.

Western countries chafe at China's economic and trade policies. As the global economic downturn persists, countries are finding it easier to accuse others of indulging in protectionism. China, in particular, has become a popular target for such vitriol. At the beginning of June, China's top ministries underscored the fact that, wherever possible, the government's massive stimulus spending should go to domestic providers of goods and services. The order invokes a 2002 law under which state offices are required to favour Chinese goods suppliers and service providers. Earlier, however, enforcement of the law was quite lax. China has yet to ratify the WTO's government procurement agreement, which states that members must assure equal treatment of domestic and foreign firms in competitive bidding for public procurement.

The EU and the United States last week took the unusual step of filing a joint complaint with the WTO for consultation on Chinese export restrictions on certain commodities (e.g. bauxite, coke, magnesium and zinc) on the grounds that these restrictions violate China's WTO commitments. The EU and the US claim that export restrictions distort prices in the world market and confer an unfair competitive advantage on Chinese companies. Complaints to the WTO typically deal with restrictions on imports. Under the WTO consultation rules for disputes, the parties have two months to negotiate and work out a solution. If they fail to reach an accord, the dispute can be submitted to a panel set by the WTO for resolution.

The WTO must also deal with a claim filed by the US last December charging that loan terms, public subsidies and other benefits granted to China's domestic firms violate China's WTO obligations. There is also pending a claim filed in March 2008 that China has imposed barriers to entry on foreign providers of financial information services.

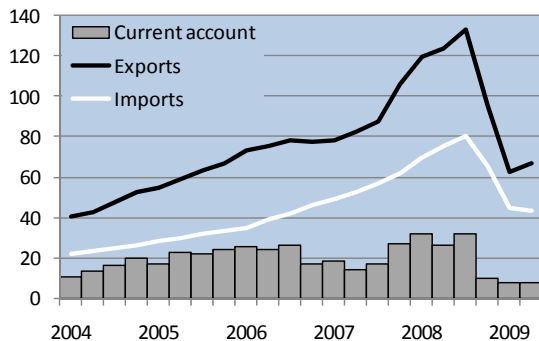
Russia

Current account surplus keeps shrinking in second quarter; financial account shows surplus. Preliminary balance-of-payments figures released by the Central Bank of Russia show that the country's current account surplus fell to \$8 billion in the second quarter and \$17 billion for the first half of the year. For the January-June period, the surplus contracted to about a quarter from a year earlier, mostly as a result of lower oil prices.

Goods valued at \$126 billion were exported in the first half, while goods worth \$82 billion were imported. Exports contracted 47 % y-o-y and imports 39 % y-o-y. Compared to 1Q09, the value of seasonally adjusted exports grew slightly in the second quarter, but imports still continued to contract slightly.

The services balance remained in deficit in the first half of 2009. Both exports and imports of services declined about 25 % y-o-y in the first half. The value of exported services was \$19 billion and imported services \$27 billion. Payments of loan interest and dividends abroad dropped 40 % y-o-y to \$30 billion.

Russian exports, imports and current account surpluses, US\$ billion (quarterly, seasonally adjusted)



Sources: Central Bank of Russia, BOFIT

The financial account in 2Q09 showed a surplus (\$7 billion) for the first time since summer 2008. For 1H09, the financial account showed a deficit of \$25 billion. The banking sector continued to show a net outflow of foreign investment in the second quarter due largely to the fact that banks paid down foreign debt faster than they borrowed from abroad. The non-financial sector, in contrast, was net exporter of capital in all investment categories. Looking at Russian investment abroad, banks pulled back and showed net repatriation of their foreign receivables, while other firms invested more abroad than they repatriated.

Russia's foreign currency reserves increased by \$21 billion in 2Q09, standing at \$413 billion at the start of July.

Rouble strengthened in the second quarter. After two quarters of depreciation, the rouble bounced back in 2Q09 with an appreciation of more than 5 % q-o-q in nominal terms against the US dollar and more than 1 % against the euro. The rouble's strengthening was slightly more in real terms due to Russia's persistently high inflation. Although the rise in prices has slowed in recent months, Russian on-year inflation still ran at 12 % in June. In comparison, the US has experienced deflation in recent months and inflation has fallen to around zero in the eurozone.

The rouble's real effective (trade-weighted) exchange rate appreciated nearly five 5 % q-o-q in the second quarter. Real exchange rate appreciation erodes the price competitiveness of Russian products relative to foreign products. In June, however, the exchange rate was still 3 % lower than a year earlier, at the same level as in end-2007.

Foreign debt of Russian firms increased slightly in the second quarter. According to preliminary CBR figures, Russia's foreign debt at the end of June was \$475 billion, up from \$450 billion at end-March. At its peak in September 2008, Russia's foreign debt reached \$542 billion.

Banks had foreign debts of \$142 billion at the end of June and non-bank firms \$294 billion. Banks have reduced their outstanding foreign debt by 14 % since the start of the year, while the debt burden of other firms has risen 4 %. Observers note that the growth in other firms' indebtedness is to a large degree due to exchange rate fluctuations and new debt acquired by few energy companies.

The public sector's share of foreign debt is below 10 %. Majority-state-held banks and enterprises, however, accounted for nearly a third of private sector debt.

The CBR reports that a total of \$128 billion in foreign debt servicing and scheduled payment of principal will come due this year. Russia's foreign debt corresponds to just a third of GDP, which is quite modest by international standards.

President Obama makes his first visit to Russia. The discussion between the presidents of Russia and the US focused on security issues. Problems facing firms doing business in the other's country were also discussed in context of the visit. Obama and Medvedev agreed to form a presidential commission that will include a working group on bilateral economic issues. The group will be led by Russian economic development minister Elvira Nabiullina and US trade secretary Gary Locke. Its main purpose will be to promote investment in high-tech and small and medium-sized enterprises.

China

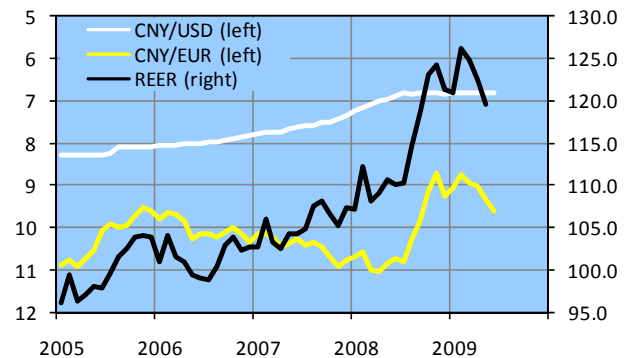
China extends yuan use in international trade. Last spring the government announced that Shanghai and a number of export-oriented cities in the Guangdong province could use the yuan on a trial basis as a settlement currency in trade. Yuan-denominated trade is allowed with Hong Kong, Macao and ASEAN countries and the discussion has extended to including other countries. This week, the first yuan-based settlement took place between Hong Kong and mainland China. Chinese banks have been eagerly making bank-to-bank agreements, especially with banks operating in Hong Kong, on use of the yuan currency accounts. China's tax officials have also announced that they are developing a scheme to make yuan-valued export trade eligible for tax refunds.

Reasons for expanding the use of the yuan include decreasing dependence on the US dollar and reducing risks and costs associated with currency trading. For small exporters operating just outside the Chinese border, the costs of converting currency substantially reduces their profit margins, so the opportunity to use yuan has been popular. Moreover, China continues to voice concern over the dollar's dominance as the world's reserve currency at a time when the US is practicing loose monetary and fiscal policies. The biggest fear is that the dollar could lose value and diminish China's vast holdings of dollar assets. This year the People's Bank of China has signed some 650 billion yuan (€68 billion) in currency swap contracts with e.g. Argentina, Belarus, Hong Kong, Indonesia, Malaysia and South Korea. The significance of the contracts so far is largely symbolic, and over the short-term no significant changes in dollar use, especially in light of China's huge dollar reserves, are expected.

China's long-term goal is to expand the use of the yuan in trade, allow its external value to be set by the market, and even establish the yuan as an international reserve currency. The road to this goal will be long, however, as many crucial elements are missing in China's financial framework, including liquid securities markets, free movement of capital and an independent central bank. The current measures are seen as small steps in this direction.

The popularity of broader international use of the yuan has been further fuelled by expectations of yuan appreciation once the deepest phase of the current economic slump has passed. In practice, China's central bank reimposed its dollar peg of the yuan a year ago, when the effects of the financial crisis in the US began to spread. Since that time, the yuan's real effective (trade-weighted) exchange rate (REER) has risen slightly, mainly on dollar strengthening.

Dollar-yuan, euro-yuan exchange rates (inverted scale) and real effective exchange rate; rising trend indicates yuan appreciation



Sources: Reuters and BIS

Banks remained eager to lend in June. China's banking sector has so far weathered the international financial crisis practically unscathed, thanks in part to capital controls set by officials that restrict bank operations in international markets. In total, Chinese banks have only had to write down a few billion dollars in losses from sub-prime-based securities. Indirectly, Chinese banks are, however, in the midst of a domestic economic crisis as bank lending has exploded due to the government's massive economic stimulus package. China's loan stock increased nearly 30 % y-o-y in the first half of 2009.

The lending boom is feared to increase poor investment decisions, which in turn will eventually contribute to an increase in the stock of non-performing loans. The rapid rise in lending has recently ignited a discussion on whether a tighter monetary stance should be implemented. For the time being, however, the PBoC has merely been monitoring the situation. No changes e.g. in interest rates or reserve requirements have been announced this year.

Overall, China's banking sector is in fairly good shape. Rapid economic growth has supported soaring bank profitability in recent years. Last year, even as lower economic growth depressed bank profits generally, China's largest banks posted profits 10–40 % higher than a year earlier.

Bank earnings are largely supported by the margin between lending and borrowing. Commercial banks are not allowed to freely set interest rates. Instead, their offered rates on loans must be at least 90 % of the reference rate and deposit rates no more than 10 % above than the reference rate. At the moment, the reference rate on one-year loans is 5.31 % and the on-year deposit rate is 2.25 %. Elimination of interest-rate restrictions have been discussed, but for the time being officials have been reluctant to act on the matter.

Russia

Central Bank of Russia lowers rates. Effective from the start of this week, the CBR cut its key steering rates by a half percentage point. The refinancing rate presently stands at 11 %. The interest rate reduction was the fourth since the central bank began cutting rates in late April.

The CBR felt the latest rate cuts were justified by an apparent cooling of inflation and stabilisation of currency markets. Inflation levelled off to a month-on-month rate of 0.6 % in May and June. The on-year inflation rate slowed to 11.9 % in June. The rouble's external value held rather steady throughout last month. The Central Bank also noted that it had minimal need for intervention in the currency market in June.

The rate cuts are hoped to revive bank lending and reduce the cost of credit. The CBR noted that bank lending rates continue to remain high despite earlier cuts. In May, the average interest rate on rouble-denominated corporate loans of less than a year was 15.9 %.

Economy ministry says slow recovery of Russian economy is underway. The latest forecast from Russia's economy ministry estimates GDP contraction ended in the second quarter and that very modest on-quarter GDP growth will be posted in 3Q09. Ministry estimates that on-year GDP contracted 10 % in the first half of this year and will shrink 8.5 % for all of 2009.

The ministry sees the strongest support for recovery in the facts that inventory adjustment should no longer occur and the moderate revival of export demand. Consumer demand is also expected to show an inkling of growth in the second half of this year. Fixed investment, in contrast, will continue to contract for the rest of the year, declining overall more than 20 % y-o-y. Net exports are expected to have a positive contribution on growth this year since exports are predicted to contract just 7 %, when imports shrink by a third.

The economy ministry's forecast for the years 2010–2012 considers two basic scenarios. Both work from the assumption that the average price of Urals-grade crude oil will rise from \$55 dollar a barrel in 2010 to \$57 in 2012. The main difference between the forecast scenarios lies in the extent of government stimulus and support measures.

Under the conservative forecast, the economy recovers sluggishly because of the government's more limited efforts to revive the economy. This is reflected in the lower federal budget deficit, reaching 5.5 % of GDP in 2010, and then shrinks to 2 % of GDP in 2012. In the more optimistic forecast, the economy grows somewhat faster and annual federal budget deficits are on average one percentage

point bigger than in the conservative scenario. In both forecasts, real GDP in 2012 remains below the 2008 level.

The risks to economic development mentioned in the forecast include another oil price drop, ineffectiveness of public sector stimulus measures and an increase in stock of non-performing loans.

Recent forecasts of Russian real GDP growth, % y-o-y

| | 2009 | 2010 | 2011 | 2012 |
|---------------------------|------|------|------|------|
| Russian economy ministry: | | | | |
| Conservative | -8.5 | 0.1 | 1.5 | 3.2 |
| Optimistic | | 1.0 | 2.6 | 3.8 |
| World Bank | -7.5 | 2.5 | 3.0 | - |
| OECD | -6.8 | 3.7 | - | - |
| IMF | -6.5 | 1.5 | - | - |

Drinking habits killing Russia. A study on Russian drinking patterns published in mid-June claims that alcohol either directly or indirectly causes a quarter of all deaths in Russia. The estimated world average for alcohol-caused death is about 4 %. The research was commissioned by the Public Chamber, an advisory body that brings together experts from the Russian government and public associations.

The study finds that much of the recent decline in Russia's population can be attributed to premature deaths caused by alcohol use. During the 2000s, Russia has experienced a net loss of population on the order of 600,000 people a year. Falling population has meant, among other things, a decrease in the labour supply.

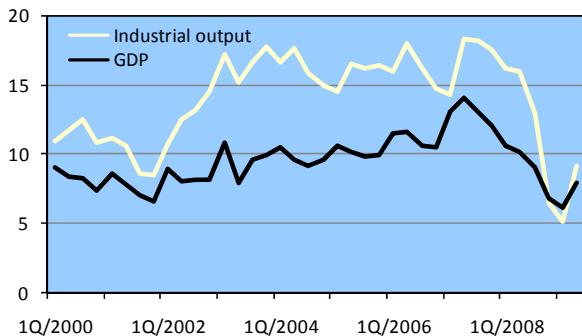
Russia's relatively low birth rate is a factor in population loss, but the overwhelming cause is high mortality rates among working-aged men. The life expectancy of a Russian man is just 61 years, which is lower than in e.g. Bangladesh, Yemen or Tajikistan. The expected lifespan of the average western European man is 77 years. Death rates for males aged 15 to 30 are 3.5 times higher than for similar aged Russian women. Only 42 % of Russian men now aged 24 years can expect to see their 60th birthday.

Alcohol consumption has reached an all-time high in Russia. The World Health Organization (WHO) estimates the average Russian consumed over 15 litres of ethyl alcohol in 2002. The issue is most problematic from the public health perspective; Russians tend to consume a large share of their alcohol in the form of distilled spirits. Over 80 % of Russian teenagers consume alcohol to some extent and a third of teens drink daily. Experimentation with drinking in Russia is occurring at ever younger ages. In the 1980s, Russians typically had their first drinking experience at the age of 17. Today it is about 14. The study estimated the annual cost of alcohol abuse to Russian society equals about 4 % of GDP.

China

China's stimulus package seems to be getting results – economic growth recovers. On Thursday (July 16), the National Bureau of Statistics released its second-quarter economic figures. The latest data suggest China could be the first large economy in the world to emerge from the global economic crisis. The massive economic stimulus package announced last November showed clear indications of working its way through the economy in the 2Q09. Real GDP growth bounced back from 6.1 % y-o-y in the first quarter to 7.9 % y-o-y in the second quarter. The NBS report added that rapid economic growth has largely been sustained by the service sector in the absence of earlier growth engines of recent years, manufacturing and construction. Industrial output and construction have also manifested green shoots of recovery in recent months compared to the situation at the start of the year. Last January, China set a GDP growth target of 8 % for 2009. Once dismissed by observers as optimistic, it now appears China will hit its growth target for 2009.

Growth of real GDP and industrial output, %-change y-o-y



Source: China National Bureau of Statistics

The international economic crisis, which led to a collapse in demand for Chinese exports, has increased the importance of domestic demand in sustaining China's economic success. Retail sales, a rough measure of consumer demand, posted strong growth in the first half of the year. In real terms, trade climbed nearly 17 % y-o-y. The impacts of the economic stimulus are most apparent in investment demand, with fixed capital investment in 1H09 soaring 34 % y-o-y in nominal terms. Much of the growth came from state-sponsored investment. For example, investment to improve the rail system was up 130 % y-o-y, develop the social security safety net 71 % and upgrade road infrastructure 55 %. Private companies, on the other hand, have yet to show signs of a pickup in spending on capital investment.

The slide in consumer prices continued in June, with prices down 1.7 % y-o-y. Although prices were lower in June than in May, it is expected that the current deflationary episode will not last long. The expansion of the money supply (M2 up 28 % y-o-y in June) is expected to increase pressure for higher prices. On the other hand, deflation could be prolonged by falling producer prices. Low world commodity prices dragged down producer prices by 6 % y-o-y in June.

China's export industry appears to have a pulse. The value of China's exports (without seasonal adjustment) contracted 21 % y-o-y in June. Even so, exports grew on a seasonally adjusted basis 4.5 % m-o-m in June. Similarly, the value of China's imports in June was down 13 % y-o-y, but up about 2 % from May. China's overall trade surplus for June was still large (\$8.2 billion), but considerably smaller than some of the record months in recent years. The recovery in imports is foreshadowed by the ending of inventory reductions and the recovery in industrial production and exports. A significant share of China's imports consists of raw materials or intermediate products that are used in production of finished export goods. The NBS reported industrial output grew nearly 11 % y-o-y in June.

China has moved to support evaporating exports. The first measure was to stop yuan appreciation nearly a year ago when clouds began to gather. The government then moved to boost price competitiveness of companies by increasing tax refunds for export products.

Chinese trade delegation visits Finland. An over 200-person trade delegation led by China's deputy trade minister Gao Hucheng met with the heads of Finnish enterprises and government leaders last week to put together trade deals worth about €1.5 billion. The major Finnish firms Nokia, Kone and Metso announced substantial trade deals with the Chinese. While Nokia did not specify the value of its deal, Metso reported it had made a €260 million contract to supply paper machines to China. Most of the deal-signings had been agreed earlier. The Chinese trade delegation's visit to Finland was part of a larger European tour that also hit Italy, Portugal and Sweden.

Despite WTO membership, China is still using a variety of measures that complicate things for foreign companies operating in China. A new report out of Finland's foreign ministry suggests that Finnish firms still encounter considerable direct and indirect barriers to trade in Chinese markets. Finnish firms note frequent problems with customs practices, as well as technical barriers that include difficulties in getting certifications, tax problems and struggles for work permits. China last year was Finland's tenth largest export market. With the collapse of various other export markets, China's significance as an export destination has risen a couple notches.

Russia

Economy may have bottomed in the second quarter.

The economic trend in the first half of this year was characterised by a sharp across-the-board drop in the first quarter and a substantial lessening in the rate of decline in the second quarter. The economic downturn appears to have hit some sort of bottom, at least for the moment. Indeed, a few preliminary figures for June offered cautious evidence of a return to positive growth.

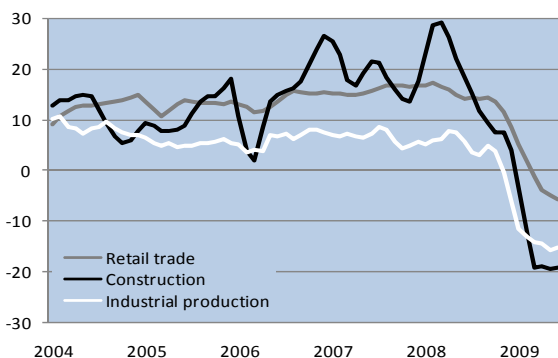
The global economic meltdown has hit capital investment in Russia particularly hard. Fixed capital investment fell 18 % y-o-y in the first half. Investment demand was dampened by uncertainty and a weak economy, as well as reduced corporate cash flows and tight credit markets.

The low levels of investment were also reflected in construction and industrial output figures. In January-June, construction contracted 19 % y-o-y and industrial output 15 %. The fall in industrial output was driven by a 30–40 % collapse in production of investment goods such as machinery, transport vehicles and construction equipment. On the brighter side, in addition to more positive development in oil production and refining, production of consumer goods such as processed foods showed little decline. On a month-to-month basis, many consumer branches have posted slight growth in recent months.

Consumer demand has been affected by low wage growth, rising unemployment and the drying up of credit. Retail sales, an indicator of consumption development, contracted 3 % y-o-y in 1H09, the same amount as real wages. On a seasonally adjusted basis, June retail sales were nearly identical to May's performance.

The earlier rise in unemployment appeared to slack off in June, and the unemployment rate held below 9 %. Russia's official June number of unemployed was 6.3 million persons. In addition, some 1.2 million people worked shorter hours and another 1.2 million were on at least partly unpaid leave.

On-year changes in output, % (3-month moving average)



Source: Rosstat

First-half federal budget deficit smaller than expected.

The federal budget posted a deficit of 754 billion roubles (€17 billion) in the first six months of 2009. The red ink corresponded to 4 % of estimated GDP for the period.

Higher-than-budgeted crude oil prices boosted the federal budget energy tax income in the first half (the average price of Urals crude in 1H09 was \$51 a barrel). However, the larger-than-expected slide in GDP curbed value-added tax revenues, bringing budget revenues overall close to plan. On the other hand, realised budget expenditures lagged. The main spending of budgeted funds in Russia traditionally takes place in the second half of the year. This year, however, spending was supposed to take place sooner as part of government efforts to stoke domestic demand through early release of regular budget funds and implementation of the stimulus package.

In the first five months of 2009, regional budgets in general posted modest surpluses. As regional tax revenues were reduced, in particular due to the fall in income tax revenue, various transfers and assistance from the federal budget became the largest sources of funding to regional budgets. Regions are virtually prevented from funding their budget expenditures with borrowed money as the federal administration sets strict rules for regional borrowing.

Total tax revenues accruing to the federal budget and regional budgets in January-May were down 32 % y-o-y. The fall in tax revenues reflected the economic slump, as well as last year's cuts in the corporate income tax and mineral extraction fees, and the increase in the number of small firms qualifying for lower tax rates.

Acting on a request from government, the finance ministry is currently studying ways to increase tax income next year. Proposals include a hike in the mineral extraction fee on natural gas producers (i.e. Gazprom), higher stamp taxes and bigger excise taxes on alcohol and tobacco.

Mandatory social contribution arrangement set to change next year.

On July 17, the Duma approved a bill once again dividing the unified social tax into three parts: a pension insurance contribution, a social security contribution and a health insurance contribution. The change was driven in part by a gaping and ever-growing deficit in the pension fund.

The actual overall increase in employee contributions will not start until January 2011 payments. The hike mostly affects pension contributions and health insurance. After the hike, the pension insurance contribution is 26 % of gross pay, the social security payment 2.9 % and the health insurance payment 5.1 %. The combined contribution will rise to 34 % at that time. The current unified social tax rate is 26 %. The government has promised to compensate companies for the increase.

China

China's foreign currency reserves continue to grow.

China's world-beating foreign currency reserves exceeded \$2.1 trillion at the end of June. Currency reserve growth this year has slowed to about half the decade average, when China's reserves doubled roughly every two years. While large trade surpluses have been the main contributor to growth in reserves in recent years, investment flows into China have also exceeded investment flows abroad.

Because the majority of China's foreign currency reserves are invested in dollar-denominated financial assets, the Chinese have repeatedly expressed concern about the decline in the dollar's value and the risk of further devaluation. To protect the value of their investments, the Chinese have demanded that the US rein in its budget deficit and keep inflation in check. At the moment, the US dollar, and particularly US treasuries, remain the paramount investment instrument globally. On the other hand, China, as the largest holder of US debt, well understands that it would be counter-productive to dump dollar investments as it would only reduce their value. Meanwhile, the Chinese government can spread risk and gradually wean itself off of dollar-dependence by purchasing an ever-larger share of non-dollar securities.

Income continues to rise in real terms in both the countryside and cities.

In the first half of 2009, disposable income climbed 11 % y-o-y. Urban-dwellers on average took home 1,610 yuan (€170) a month. In the countryside, the pace of growth in cash income was slightly lower, 8 % y-o-y, with the average monthly income rising to 450 yuan (€47). The pace of income growth has slowed in both cities and the countryside. The importance of income transfers has increased rapidly both for city people and rural residents and they account for an ever-larger share of disposable income. Income transfers were up 16 % y-o-y in cities and 31 % in the countryside.

As China has become richer, state spending on income supports has also risen. This year's budget sets aside 54 billion yuan (€5.7 billion) for income supports, an increase of nearly 50 % from 2008. At the end of last year, some 23 million city-dwellers and nearly 43 million people in the countryside received income supports.

China's official figures only indicate a modest increase in unemployment due to the global economic turmoil. But China's unemployment figures are notoriously inaccurate; the bulk of unemployed persons never make it into the statistics. Several reports have noted that college graduates have been struggling to find jobs. However, the Ministry of Education claimed recently that about 70 % of graduates have found a job. The claim has met with wide scepti-

cism as the claimed rate would be higher than last year when the economy was still booming. Based on the findings of some surveys, it appears only about 40 % of this year's graduates have found jobs.

The rise in unemployment and the weakened economy have caused a massive increase in the number of labour disputes reaching the courts. Part of the increased litigiousness has been spurred by the new labour act introduced at the start of the year. The law grants workers new entitlements and has increased awareness among workers about defending their interests. The number of labour disputes in mainland China overall rose 30 % in 1H09. Much of the action has been centred in provinces geared to export industries. The actual number of labour disputes is likely greater than reported in official media.

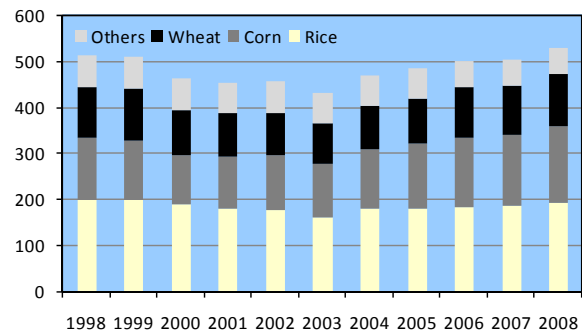
Summer harvest of key crops improves over last summer.

The National Bureau of Statistics reports that the summer harvest of key staple crops (beans, corn, potatoes, rice and wheat) was up 2 % from last year to 120 million metric tons. Much of the growth reflected an increase in the area of land under cultivation. China's summer harvest accounts for about a quarter of the country's harvest.

Harvest of critical food crops has risen steadily since 2003. Before that, the dual trends of falling agricultural prices and high potential profits from erecting industrial plants or residential housing on farmland, led to a collapse in the area of land under cultivation. To get farming back on track, Beijing tightened the rules to assure productive land was dedicated to farming. With the new rules and techniques that increased yields, harvests have risen each year since 2003. Also the price development of agricultural products has been favorable for producers.

China considers agricultural self-sufficiency a top goal. China is a net exporter of some food products and imports small quantities of agricultural products relative to domestic production. The main exceptions are soybeans and vegetable oil, which China imports in vast amounts.

Key staple crop production, millions of metric tons



Source: NBS

Russia

Russia's shrinking car market. Sales of new cars fell 49 % y-o-y in the first half of 2009 according to the Moscow office of the Association of European Businesses. In June the drop was 56 % y-o-y. Auditing giant PriceWaterhouseCoopers recently estimated that in the 1H09 about 390,000 Russian-made cars and 345,000 new imports were sold. 44 % fewer Ladas were sold in the first half of the year than a year earlier. Hyundai, Mitsubishi, Volvo, Dodge, Jeep, Saab, Chrysler and Alfa Romeo's sales numbers all plummeted over 60 %. Volkswagen (up 4 %) and Hummer (up 104 %), however, bucked the general trend.

According to Rosstat, the number of cars built in Russia declined 60 % y-o-y in the first half of this year. In the first quarter, car imports declined 67 % overall, and imports of used cars were down 96 %.

The state helps out domestic car producers by imposing duties on imports, which were again raised at the start of the year. In July, Russian customs started phytosanitary inspections of imported used cars with a view to preventing pest insects from entering the country.

The state has initiated a financing scheme to help buyers purchase cars built or assembled in Russia. The arrangement gives consumers a possibility to get a car loan, of which the state pays two-thirds interest. To be eligible for the programme, the price of the vehicle may not exceed 600,000 roubles (about €14,000). Rosstat reports that the average price of a new Russian car was 236,000 roubles in June. The average price of a foreign car assembled in Russia was 443,000 roubles. Some 6 billion roubles (€140 million) have been set aside for the three-year interest subsidy programme.

Shrinking demand has forced Eastern Europe's largest carmaker, Russia's Avtovaz, to halt production for August. Avtovaz, which employs 110,000 people, also plans to cut back to 20-hour weeks between September 2009 and February 2010. Avtovaz brands include Lada and Niva.

Housing construction down slightly, sharp growth in housing loan defaults. Nearly 234,000 new apartments were built in Russia in the first half of the year. The volume of housing construction roughly matched the production in 1H08 and was 3 % higher than in 1H07. In June, however, apartment construction was down over 14 % from a year earlier. The most apartments (12 %) were built in the Moscow region. The City of Moscow's share of finished apartments was 6 % and St. Petersburg 4 %.

It is not just builders who no longer have access to cheap credit; housing demand has also shrivelled as loans have become hard to come by. The CBR reports that in June, 82 % fewer rouble-denominated loans were issued

compared to June 2008. The number of new housing loans denominated in foreign currencies sank 91 %.

The value of non-performing rouble housing loans rose in June by 82 % y-o-y to 13 billion roubles (about €300 million), or 1.4 % of the rouble-denominated loan stock. The stock of non-performing foreign currency housing loans reached 10 billion roubles last month – an amount that equals about 4.3 % of the foreign currency housing loan stock.

The average rouble price of a Moscow apartment in June was down 21 % from the October 2008 peak, when the average price of housing reached €4,400 a square metre, according to the market research group IRN. The average price of a square metre of Moscow housing is currently 126,000 roubles (about €2,900).

Across-the-board pension increases next year. Last weekend, president Dmitri Medvedev signed into law two acts that increase pensions from the start of next year. In addition to a 10 % hike, pensioners will get an extra one per cent boost for every year they worked during the Soviet era. Thus, the arrangement benefits the eldest people most. The new laws also state that when a pension is smaller than the official subsistence minimum, the difference must be made up with social security funds.

The hike affects some 37 million pensioners. Pensioners over 70 will see the biggest pension boost (about 1,700 roubles extra). The average monthly pension next year will rise to 7,800 roubles. This spring, the average was 5,100 roubles (about €115). The average pension last year exceeded the subsistence minimum by 15 %.

The impact of the hikes on the living standards will be reduced by annual increases in municipal services rates e.g. rental housing, energy and water. The annual rise in prices is designed to gradually raise prices to the point where they match production costs.

Under the newest policy direction, pensions in Russia should continue to be raised as long as the pensions of people who entered working life during the Soviet era correspond at least to 2.5 times the subsistence minimum. For those currently in the workforce, there is a push to support the ILO's minimum recommended pension, which corresponds to 40 % of wage. At present the average pension corresponds to only about a quarter of the average wage.

Pensions have risen about 13 % a year in real terms throughout the 2000s, but from a very low starting point. Pensions have, however, significantly lagged soaring real wage growth. At their relative peak in 2000, pensions reached 33 % of the average wage.

In recent years, the amount of funds collected for the pension fund through social contributions has failed to keep up with the ineluctable rise in disbursements. The gap has been funded with money from the federal budget.

China

IMF advises China to improve its social safety net. A report on the IMF's recent Article IV consultations with China suggests that the country has weathered the global economic downturn in good shape. The IMF gave high marks to Chinese officials for moving swiftly to implement stimulus measures late last year when the economic crisis was deepening rapidly.

Despite China's favourable economic trends, the IMF stressed that China needs to continue with its economic reform programmes in order to put its economic growth on a more sustainable basis. The IMF reiterated the importance of putting good systems for health care, pension security and education in place. Improvements in social security would help reduce the need for Chinese to save for old age, children's education and unexpected health concerns, which in turn would help shift China's growth paradigm away from exports and investment to growth driven by consumer demand.

The IMF typically performs an Article IV consultation and publishes a related report every year with key member countries. The last Article IV report for China was published in 2006. After that, the IMF and China spent a couple of years for agreeing on what should be included in the report.

New share bubble in the offing? China's share prices have skyrocketed in the past eight months. Since the start of the year, the Shanghai A-share index has climbed 90 % and the Shenzhen index has more than doubled. The share price spike has increasingly begun to resemble the last bubble, which burst at the end of 2007 (see graph). Just as in the 2007 heyday, millions of new share investment accounts have been opened in recent months. Also, the fact that share prices started to rise in the very depths of economic crisis at the end of last year suggests a bubble being formed.

Officials are warning banks in particular of the bubble, as borrowed money has apparently been used to purchase shares. According to one official estimate, a fifth of new lending this year has been used to buy shares. Although borrowed money was also used to fuel the last bubble, that bubble collapse had little impact on China's macroeconomy. The impact of this latest bubble has yet to be seen.

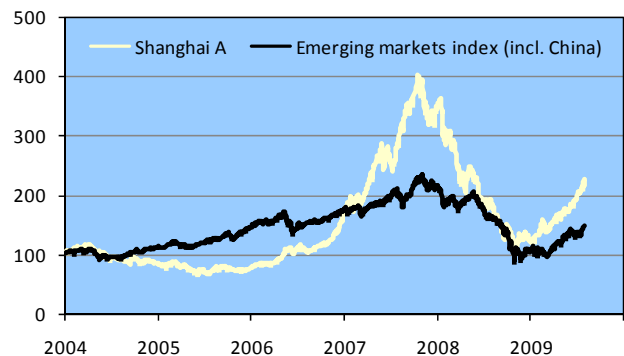
Part of the Chinese craze to own shares is driven by the lack of opportunities to invest anywhere else. Often, a Chinese investor's sole alternative to buying shares is deposit account at the bank. In addition, private firms seeking to boost earnings have ploughed their assets into shares instead of investment, as the long-term outlook for many sectors is still cloudy.

IPOs were halted last September, when government wanted to support falling share prices by limiting the supply of new shares. In July, officials renewed permission to stage IPOs. Even with the listing ban, the volume of publicly traded shares has risen this year as restrictions on trade of state companies' shares have expired.

Immediately after the IPO ban was lifted, Shanghai saw world's biggest IPO in over a year, when China State Construction raised 50 billion yuan (€5.2 billion) from the market. More big stock issuances are planned: China's number-four bank, Agricultural Bank of China, is planning an IPO. At the moment it is still not known whether the bank plans to list exclusively in Shanghai, Hong Kong or on both exchanges. Since Shenzhen bourse listings recommenced, about a hundred new technology firms have expressed interest joining the new technology list of the exchange. Trading on this new list is expected to get underway before the end of this year.

Nearly 900 firms are listed on the Shanghai bourse and under 800 on the Shenzhen. Although there is little difference in the number of firms listed, the aggregate market capitalisation of companies listed on the Shanghai exchange is nearly four times larger than that on the Shenzhen stock market.

Shanghai A-share index and MSCI emerging markets index, Jan. 1, 2004=100



Sources: Bloomberg and Morgan Stanley

US-China strategic dialog continues. Another high-level dialogue was arranged this week in Washington DC. The agenda at the Obama administration's first strategic dialog was modified to include strategic issues other than the economy, too. This week's meeting saw exchanges on such topics as the international financial crisis, the North Korea situation and environmental issues. China again expressed concerns over the rising indebtedness of the US and the possible repercussions of mounting debt on the value of Chinese investments. China is the largest holder of US debt. Although the trade imbalance between the two countries has shrunk slightly this year, China continues to post its largest surpluses with the US.

Russia

Cabinet approves 2010 federal budget guidelines. Next year's proposed budget would have expenditures of 9.8 trillion roubles (€220 billion) and revenues of 6.6 trillion roubles (€150 billion), which would produce a deficit equivalent to 7.5 % of GDP. Nominally, spending and revenues roughly match the 2009 budget, but with inflation factored in represents a drop of some 10 % in real terms.

Next year's budget calculations assume Urals-grade crude oil will average \$55 a barrel and GDP will grow by 1 %. Inflation is expected to moderate slightly to 10 % by the end of next year, and the rouble should weaken to an average exchange rate next year of 34.50 roubles to the dollar. The current exchange rate is slightly above 31 roubles to the dollar.

The largest share of federal spending will go to pensions and other social sector outlays. Some 2.5 billion roubles will be used to cover the pension fund shortfall, as well as 3.6 billion roubles for other social sector spending, 0.3 billion roubles for state debt servicing and 3.4 billion roubles for all other spending. The social sector is one of the few budget categories to receive increased funding next year. E.g. covering the pension fund deficit will require 33 % more budget funding compared with this year.

Less funding will go next year particularly to public investments such as road construction and rural development. Public support to enterprises will be reduced in all areas except high-tech branches. Spending on health care, education and defence will remain largely at the same nominal level as this year (i.e. fall in real terms).

The deficit will be financed in part from the reserve fund, which is to be phased out at the end of next year, and in part from the national welfare fund. The state also plans to raise about 570 billion roubles (\$18 billion) from international finance markets and a matching amount from the domestic market.

Ministries have now begun to draft their individual budgets under the proposed guidelines. The government's final budget draft is scheduled to be ready in autumn.

Russian oil output levels in 1H09 largely unchanged from last year. Production in the Sakhalin region even rose sharply, while production in mature Siberian fields declined nearly 1 %. The Khanty-Mansi and Yamal-Nenets autonomous regions continue to be Russia's leading oil production areas, but many of the large oil fields there have already peaked. Investment in development of new fields has lagged in recent years due to e.g. harsh taxation and political risk. Moreover, most of Russia's unexploited hydrocarbon resources are very difficult to access.

The sharp decline in oil prices and the global economic downturn have reduced oil companies' investments. Russia has tried to blunt the impacts of the economic crisis on oil companies with reductions in mineral extraction fees and export duties. Special tax breaks are also being considered for companies that bring new oil fields on stream. While rouble depreciation has helped soften the impact of lower oil prices on producers, the lack of access to financing may warm Russians to the notion of foreign investment, which in turn could lead to more effective development of new oil fields. Among Russia's largest oil companies, production was boosted in 1H09 by increases at the partly foreign-owned Lukoil and TNK-BP, while production at state-owned Rosneft and Surgutneftegaz fell slightly. The four companies together account for two-thirds of Russia's oil production.

Russia's economy ministry and international organisations in the energy field forecast that Russian oil output in 2009 will remain at the 2008 level and then decline 1–2 % next year. While there is great potential to raise production over the longer term, there are also many challenges to bringing new fields on stream.

About half of crude oil production is presently exported and about half refined domestically. Preliminary energy ministry figures show that the volume of crude oil exports rose in January–July by 1 % y-o-y. Russia's economy ministry estimates that oil exports will grow 1 % this year and stabilise or contract about 1 % a year in 2010–2012.

Sharp declines in natural gas production and gas exports. With Gazprom's output declining, Russia's overall natural gas production was off by a fifth from 2008 in the first half of the current year. Oil companies and independent gas producers, however, made up part of the deficit by boosting their output 3 %. Gazprom accounts for 80 % of Russian gas production.

Demand for gas has been reduced by weakness in Russia's domestic and export markets. Domestic gas consumption was estimated to have fallen 7 % y-o-y in the first half of 2009, while the volume of gas exports declined as much as 40 %. The sharp drop was due in part to the gas dispute between Russia and Ukraine at the start of the year. Preliminary data show exports began to recover in July. About 23 % of gas production was exported, of which about a fifth went to CIS members and the rest largely to the EU and Turkey. In addition to its own production, Russia sells Central Asian gas, mainly to CIS states. Media reports assert that Gazprom exported over 80 billion m³ of gas in the first half. About a fifth of that gas came from Central Asia, where production is contracting at roughly the same rate as Gazprom's.

Russia's economy ministry forecasts gas production this year will contract by 12 % and gas exports by 17 %, before recovering in coming years. Under ministry's economic scenarios, the average rise in output during 2010–2012 will be 2–4 % and export growth 5–7 %.

China

Stimulus costs to state higher than originally expected.

Last March, China budgeted for a 950 billion yuan deficit (about €100 billion or 3 % of GDP). The budget estimate forecast that state revenues will rise 8 % this year. Based on Ministry of Finance figures, the deficit for 2009 will be larger than expected due to a drop in state revenues of 2.4 % y-o-y in the first half of this year. The largest decline was seen in taxes collected from enterprises. Growth in spending also slightly outpaced original budget estimates.

China typically releases the majority of state funding in second half of the year, with a particularly large spike in December (typically three times higher than in average months). The heavy December spending is driven by the release of year-end subsidies. On the revenue side, the situation is the reverse. The tax take in recent years has been somewhat higher in the first six months than in the second half of that year.

In isolation, a larger-than-expected budget deficit is a fairly minor concern for China, which has a very modest government debt level by international standards (about 18 % of GDP). Moreover, state debt has been issued domestically. In July the finance ministry found it hard to attract buyer interest due to the low yields on its bonds. After the ministry responded by raising yields, issuing of bonds has progressed smoothly.

China's local administrations have had problems implementing projects mandated under the stimulus package as local administrations must provide funds for projects. The possibilities for local administrations to raise capital for stimulus projects are quite modest, however, as the law requires them to have balanced budgets. To help, the central administration this year takes the unusual step of issuing 200 billion yuan (€20 billion) in bonds to support cash-strapped local administrations. Even so, the funds are insufficient given the magnitude of the stimulus, which, by some reports, has forced local administrators to circumvent the budget rules by making enterprises under their control foot the bill.

The increased delegation of public roles to off budget in the local level have made it even more difficult to monitor the already opaque use of public finances – even for central administrators in Beijing.

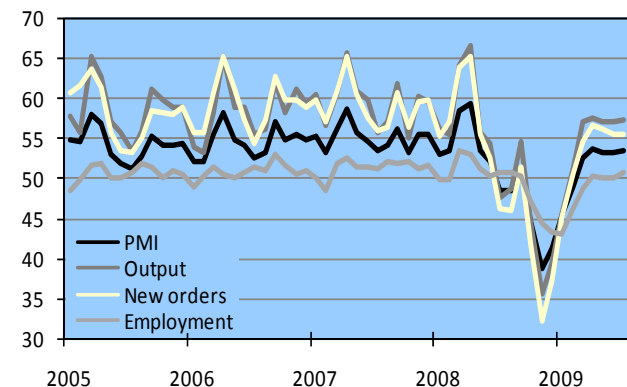
China's purchasing manager index suggests rising optimism among manufacturers. After some bleak months last autumn and winter, the official purchasing managers' index in manufacturing (China Federation of Logistics & Purchasing PMI) has remained at a level of

about 53 points since March. In July, the PMI reading was 53.3. An index value above 50 indicates that the majority of industrial firms perceive an improvement from the previous month. A narrower PMI reading published by Hong Kong-based investment bank CLSA also returned to its highest level in a year last month (52.8). The CLSA's PMI value has held above the critical 50-point mark for four consecutive months now, which is well in line with the official CFLP index.

The CFLP PMI is composed of five sub-indexes: new orders (30 % weighting), output (25 %), employment (20 %), supplier delivery times (15 %) and stocks of major inputs (10 %). In addition, the CFLP reports separate indexes for imports and exports, which are not included in the PMI. The CFLP PMI, its sub-indexes and related indexes have remained remarkably stable over the past five months (see chart). For example, the output sub-index has remained at a value of 57 for the past five months, which is quite distinct from its performance in recent years and relative to other economic figures. Accordingly, output has been rising month-on-month since March, and the change from the previous month has been sharper than the average of the entire four-and-a-half-year history of the PMI. After a sharp drop late last year, the recovery of output growth has been remarkably strong.

Output and new orders (index value 56), as well as new export orders (52), increased in July, while inventories of finished goods fell. With the exception of a brief period in spring 2008, inventories have been shrinking for much of the past five years. There was a mild increase in employment in July (51). Increased output also lifted purchasing of manufacturing inputs (56), even if imports of inputs continued to shrink (49). The growth in project activity and recovery of commodity markets have driven up input prices (60).

PMI index (CFLP) and three major sub-indexes



Source: CFLP

Russia

CBR again lowers refinancing rate. Effective last Monday (Aug. 10), the Central Bank of Russia dropped its benchmark refinancing rate a quarter of a percentage point to 10.75 %. The CBR also lowered the rates used in its financial market operations by 0.25 percentage point. Among its key rates, the overnight repo rate now stands at 7.75 % and the deposit rate 5.5 %.

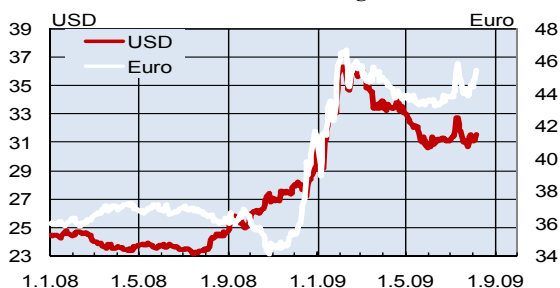
Following the cut, the CBR explained that, despite four consecutive rate cuts this spring and summer, there have been few signs of recovery in Russia's credit markets. The rate cut was smaller than the earlier cuts, however, as persistent high inflation has limited the central bank's room for response. Consumer price inflation remained at 12 % y-o-y in July, matching the rate of the two previous months. The CBR expects inflation to cool in coming months as demand remains weak and the amount of money in circulation has contracted. The broad money supply (M2) fell since September 2008, but turned to growth in February. M2 is still about 8 % smaller than a year ago.

Many analysts doubt rate cuts can have much effect on boosting bank lending. Rather, they say, the move slightly weakens the rouble's exchange rate.

Since February this year, the CBR has refrained from major interventions in the currency markets, due to its long-range commitment to shifting gradually away from monetary policy based on exchange rate steering to a policy based mainly on inflation targeting. In its press release on interest rate reductions, the CBR noted that the shift implies that businesses should be prepared for possible wide exchange rate fluctuations also in the future.

Despite increased daily volatility in the rouble's exchange rate, its value relative to its euro-dollar currency basket has remained within the band set by the CBR in January. Rouble depreciation picked up a bit this week, and some reports claim the CBR jumped in to purchase roubles to prop it up. The depreciation may have been a reaction to public demands for a devaluation and a weaker-than-expected second quarter GDP figure.

Rouble-euro, rouble-dollar exchange rates



Source: Central Bank of Russia

According to preliminary Rosstat estimates, GDP contracted 10.9 % y-o-y in the second quarter, or slightly more than the 9.8 % contraction in the first quarter.

Russia's foreign currency and gold reserves, which had been growing since March, declined by \$10 billion in July. The total value of Russia's foreign currency reserves stood at \$402 billion as of end-July, the same level as in summer 2007.

Gazprom and gas supplies to Europe. Last week, Turkey granted permission to Gazprom and the Italian Eni to begin seismic studies in Turkey's territorial waters in November. The sea-bottom corridor is part of the route of the proposed South Stream gas pipeline, which would traverse the Black Sea from Russia to Western Europe, and would reduce the amount of gas moving through Ukraine. About 80 % of Russian gas going to Europe travels via Ukraine.

The proposed South Stream pipeline would be operational in 2015 and would have an annual transmission capacity of 63 billion m³, an amount roughly equal to a third of Russia's 2008 gas exports. In exchange, Russia agreed to supply crude oil for Turkey's planned oil pipeline that would run from the Black Sea to the Mediterranean Sea. Russia was previously reluctant to support the project, and the latest offer is seen as a concession from Russia to secure Turkish participation in South Stream.

Turkey's strategic location has made it a focal point in the discussion of possible energy routes to Europe. In July, the EU and Turkey agreed on Turkey's participation in the Nabucco pipeline project, which the EU promotes. The Nabucco pipeline would transmit gas from the Caucasus region, Central Asia and the Middle East via Turkey to Europe. Its purpose is to reduce EU dependence on Russian gas, and it is seen as direct competitor of South Stream. Nabucco's gas suppliers have yet to be identified, however. Possible suppliers include Azerbaijan, which is expected to sharply increase its gas production in coming years, and Turkmenistan.

Last week, the EU and international financial institutions reached an agreement with Ukraine to assure uninterrupted gas supplies to Europe. The international financial institutions will lend money to the Ukraine to help it pay off its outstanding gas bills owed to Russia and to buy enough gas to replenish its gas storages for the coming winter. The first tranche of the loan (\$300 million) will be provided by the EBRD. In coming tranches, other international financial institutions are slated to put in an additional \$1.4 billion. In response, Ukraine has to modernise its energy sector, and e.g. raise its domestic gas prices to a level that allows it to pay its gas bills to Russia. Ukraine also has to increase the transparency of its hazy gas sales and transmission arrangements. In June, prime minister Putin warned the EU of possible cuts in the natural gas supplies unless Ukraine pays its gas bills on time.

China

Commercial banks set to pull back on lending. The People's Bank of China is pressuring the country's four giant (predominantly state-owned) banks to reduce lending in the second half. Among the large banks, China Construction Bank (CCB) announced plans to grant just 200 billion yuan (€20 billion) in new loans in the second half. CCB issued 700 billion yuan in new loans in 1H09. As recently as two weeks ago, the PBoC was still claiming it had no plans to impose direct limits on lending, but instead it would conduct market-based fine-tuning operations.

Regulatory limits on bank lending issued by officials have been a routine aspect of monetary policy in China. Banks were earlier given lending quotas at the start of the year, which bank regulators then monitored rather closely. This year's lending plan originally targeted growth in the loan stock of 5 trillion yuan (€500 billion, 16 % of the total loan stock). Because the state stimulus encouraged commercial banks to lend vigorously, however, the 2009 target was surpassed by 50 % already by June, when the loan stock growth reached 7.4 trillion yuan.

This exceptional expansion of the money supply has yet to drive up prices, however. July consumer prices were down 1.8 % y-o-y. Moreover, despite directives to banks to put brakes on lending, the central bank continues to maintain a moderately loose monetary stance. While it appears the PBoC has yet to get permission from the country's leaders to raise interest rates or reserve requirements, it has recently raised yields on its own bonds – traditionally an indicator that an increase in reference rates was in the wings. There have been no changes in reference rates or reserve requirements for banks since December 2008.

Positive economic figures for July. Industrial output climbed nearly 11 % y-o-y in real terms in July. Growth was on par with June, but still far below the pace of growth in recent years. Growth was registered in all 39 industrial branches tracked by the government. Of these, growth in 16 branches accelerated from June, while growth slowed slightly in other branches. Electrical power generation (a proxy for industrial output), which had been sliding since October 2008, has been rising since June. Electricity production was up 4 % y-o-y in July.

The value of China's exports contracted 23 % y-o-y in July, while the value of imports was off 15 %. The trade surplus was \$10.6 billion in July. On a seasonally adjusted month-to-month basis, the value of exports rose 5 % and imports nearly 4 %. Seasonally adjusted figures for both exports and imports have been rising since May, when National Bureau of Statistics (NBS) started to release them.

In January-July, fixed capital investment rose 32 % y-o-y in nominal terms, suggesting a slight cooling in growth in July. Nearly half of capital investment was made by state-owned enterprises (up 40 % y-o-y). Reduced lending growth in the second half of the year is expected to depress growth in fixed capital investment.

July retail sales of consumer goods were up 15 % y-o-y in nominal terms. On-year real growth also was slightly faster (up about 17 % y-o-y in July) than in previous years. Demand for cars and construction goods were distinctly invigorated by government stimulus measures.

Consumer prices fell 1.8 % y-o-y. Evidence of deflation was apparent across the board, as prices in six of eight major goods categories declined. Moreover, prices in the tobacco and alcohol category were partly boosted by an increase in the tax on tobacco products. July producer prices slid 8 % y-o-y and 0.5 % m-o-m. International commodity prices are much lower than a year ago and this is now reflected in producer prices. The current deflationary episode in consumer prices, however, is expected to end within the next six months.

China has consolidated release dates for economic data. Starting this month, the NBS publishes all main monthly economic indicators on the eleventh day of the month. Previously, monthly figures were released on several days.

Asian countries hold the bulk of foreign currency reserves. China's foreign currency reserves amounted to \$2.1 trillion as of end-June, or nearly 20% more than a year earlier. Despite the global economic downturn, China's foreign currency reserves swelled 2 % in June. China alone now holds nearly a third of the world's total currency reserves. China's role as a capital supplier is further augmented by Taiwan and Hong Kong, which together hold about \$530 billion in reserves. Among the top ten countries holding foreign currency reserves, only three are non-Asian (Russia, Brazil and the Euro system). About two-thirds of foreign currency reserves are held by Asian governments.

Foreign currency reserve rankings as of end-June 2009 (without gold)

| | US\$ bn | 12-month change, % | Share, % |
|-------------|---------|--------------------|----------|
| China | 2,132 | 17.8 | 30.1 |
| Japan | 989 | 1.5 | 14.0 |
| Russia | 402 | -0.9 | 5.7 |
| Taiwan | 321 | 10.4 | 4.5 |
| India | 257 | -13.5 | 3.6 |
| South Korea | 238 | -4.0 | 3.4 |
| Hong Kong | 207 | 31.3 | 2.9 |
| Brazil | 198 | 7.1 | 2.8 |
| Euro system | 192 | -11.1 | 2.7 |
| Others | 2,137 | -3.0 | 30.2 |
| Total | 7,072 | 4.2 | 100.0 |

Source: Bloomberg

Russia

Foreign trade picked up in June. The value of Russia's goods exports in the first half of the year was \$126 billion and the value of goods imports was \$82 billion. Exports contracted nearly 50 % y-o-y and imports were down 40 %. Russia still showed trade surplus, although it declined by half from 1H08. Month-on-month the value of goods exports and imports rose slightly in June.

Even with oil prices far off their highs of summer 2008, energy products accounted for two-thirds of the value of exports in the first half. Metals also retained a 12 % share of the value of exports. On the import side, there were sharp contractions in imports of investment goods and consumer durables. The drop in imports of consumer goods, however, was smaller. The value of imports of machinery, equipment and transportation vehicles shrank by more than 50 % y-o-y in January-June, whereas foodstuff imports were down by some 20 %. The share of foodstuffs in imports increased to 19 %.

Foodstuffs have recently been a hot topic in the debate over Russian trade policies. In June, officials banned imports of Belarus milk powder on the grounds that it failed to meet Russian packing regulations. Last week, milk products from three Lithuanian companies were banned for hygienic violations. The milk product dispute coincided with Russia's increased border inspections of Lithuanian lorries, which the Russians claim is necessary to discourage smuggling.

Russia, Belarus and Kazakhstan formed a negotiating team for their collective WTO membership talks as a customs union at a meeting last week in Moscow. Russia's chief WTO negotiator Maxim Medvedkov was designated to head up the negotiating team. Deputy prime minister Igor Shuvalov said that, while the three countries aspired to join the WTO at the same time and under the same conditions, alternative arrangements could be accepted with the agreement of leaders of all the three countries.

Summertime blues for Russian stocks. Russia's main share price indexes, the MICEX and RTS, both declined over 13 % in the past, even as stocks on other global exchanges were on the rise. The largest falls were registered for shares of oil and gas companies, which have the largest weightings in Russia's share indexes. The share prices of Gazprom and Lukoil have fallen nearly 20 % over the past three months.

In August market sentiment was further depressed by weak second quarter GDP data, rumours of rouble devaluation and the major accident at the Sayano-Shushenskaya hydropower station in Southern Siberia, which drove down the shares of RusHydro, the plant's owner. Hopes of recovery of the global economy have helped revive prices of metal producers. Shares of steel-maker Severstal rose about 12 % during the summer.

Corporate bond issues revived in June. A total of 205 billion roubles (about €4.6 billion) in new corporate bonds were issued, raising the aggregate sum for corporate bonds issued in the first half to 262 billion roubles. The largest borrowers were the state oil pipeline operator Transneft and state-owned VTB Bank.

Construction of Ust-Luga container terminal will be delayed. National Container Company (NCC), which has been building a container terminal at the Ust-Luga multi-purpose port on the southern shore of the Gulf of Finland near the Estonian border, announced this week it was for the time being suspending construction as one of the two owners of the company had pulled out from the project. Construction of the terminal commenced in 2007 and the first phase of the project was set, according to recent information, to be completed next year.

NCC owns 80 % of the Ust-Luga container terminal project; the remaining 20 % is held by the German logistics group Eurogate. NCC itself is owned in equal shares by the Russian Far East Shipping Company (FESCO) and First Quantum, a Russian, but UK-registered, company. On August 6, FESCO announced that construction of the container terminal was not justified under current economic conditions due to a massive drop in container traffic.

The Ust-Luga container terminal project, scheduled for completion in 2019, would be the largest container handling facility in the former Soviet Union area. The project's total investment is \$800 million, of which \$160 million has so far been spent. The container terminal is intended to reduce the dependence of Russian foreign trade on road and rail transport from ports in the Baltics and Finland and to ease the crush at St. Petersburg's container terminal by handling cargoes going to Moscow and elsewhere in the country.

Ust-Luga will also become an important oil port. In June, the second phase of the Baltic Pipeline System (BPS-2) broke ground. The BPS carries crude oil from Western Siberia and the Urals to the shores of the Gulf of Finland. The first BPS pipeline, built in 2001 and brought to full capacity in 2006, ends near Vyborg at the Primorski Harbour, presently Russia's largest oil harbour. The BPS-2 pipeline will terminate in Ust-Luga. The pipeline's annual capacity will reach 30 million tons in 2012 and 50 million tons in 2013. BPS-2 will reduce Russia's dependence on the Druzhba oil pipeline, which runs through Belarus.

State-owned Zarubezhneft is building a terminal at Ust-Luga for transshipment of oil products. This development would make Ust-Luga the most important oil product harbour in the Gulf of Finland. Most products will come via pipeline from the Kirish refinery, which will get more crude oil feed when BPS-2 is ready. An LPG terminal is also under construction at Ust-Luga. Coal and timber terminals, among others, are already operational.

China

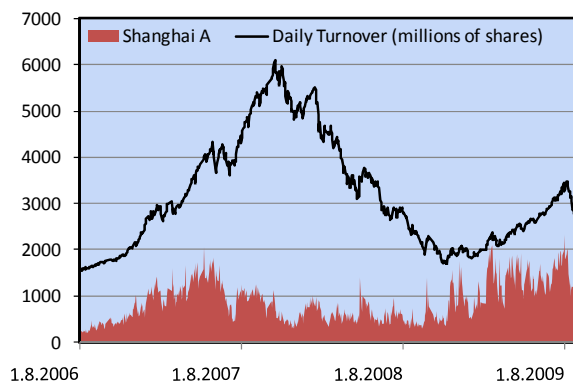
Inflows of foreign direct investment in China declined significantly in July. Foreign direct investment inflow in China has been falling since late 2008. The drop in July was the largest in nearly six years with FDI for the month falling to just \$5 billion, or 35 % less than in July 2008. Direct investment in the first seven months of the year reached almost \$50 billion; investment inflows shrank about 20 % y-o-y.

Some of the currency inflows into China in the first half of the year appear to have been speculative in nature. China's foreign currency reserves climbed in 1H09 about \$220 billion, with FDI and goods trade accounting for about half. The rest can be attributed to exchange rate fluctuations, normal credit transactions and speculative money flows.

Speculative money is believed to be pouring into China's stock markets and real estate. This might have driven the recent rise in apartment prices in Beijing and Shanghai. At the beginning of the month, the Shanghai stock exchange was up 100 % from its low at the end of last year.

In recent days, however, about 20 % has been trimmed from share prices as the increase in bank lending has slowed down significantly. In addition, the volume of share trading has fallen by about half since the beginning of August. China's stock markets now appear to be taking a breather and have yet to establish a clear direction.

3-year chart for Shanghai stock exchange



Source: Bloomberg

China continues to buy US treasuries. The United States' Department of the Treasury reports that the net value of government bonds held by China at the end of June fell to under \$780 billion. Compared to May, the amount of treasuries held by China fell 3 % – the largest drop in nearly nine years.

Monthly figures released by the US treasury department on purchases and sales of treasuries do not take into account China's indirect purchases made e.g. via London brokers or in secondary markets. The statistics are usually revised, however, after an annual survey in which most UK-reported treasury purchases are reattributed to China. When China's estimated treasury purchases via the UK are included, it appears China actually increased its treasury holdings in June.

The US treasury department's official figures show China holds about 20 % of US treasuries, although the true share is larger. In any case, China is indisputably the largest holder of US debt. China does not release the composition of its foreign currency reserves.

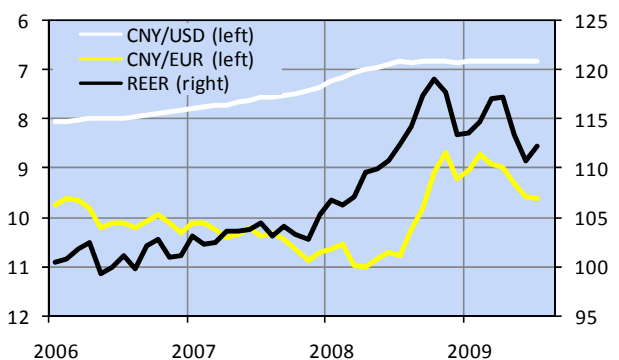
China has repeatedly expressed worries over depreciation of its dollar-denominated investments that could result if the US government continues to pursue aggressive stimulus policies. If the United States succumbs to the temptation of inflating away its debts, it will reduce purchasing power of the dollar and hence Chinese dollar-denominated investments.

China continues to hold the yuan's exchange rate stable against the dollar.

The external value of the Chinese currency has slavishly tracked the dollar since July 2008. At the same time, the real effective (trade-weighted) exchange rate (REER), which takes into account fluctuations in the yuan's value relative to the currencies of China's most important trading partners and differences in inflation rates, has been all over the map. The REER, which seems to reflect movements in the euro-yuan exchange rate and inflation differences in general, is now at about the same level it was a year ago.

Although China's exchange rate policies have dogged US-China relations for years, they have been put on the back burner since the international financial crisis hit.

Dollar-yuan, euro-yuan exchange rates (inverted scale); real effective exchange rate (up trend indicates yuan appreciation)



Sources: CEIC, Bloomberg

Russia

Russian economy no longer contracting. Preliminary seasonally adjusted figures from the economy ministry indicate GDP rose 0.5 % m-o-m in July. The economy returned to growth in June, when on-month growth was also about 0.5 %. The economy ministry estimates the GDP contraction over the past 12 months still exceeded 9 % in July.

The economy ministry found that seasonally adjusted industrial output rose 1 % on-month in July, the third straight month of growth gains. The ministry's assessment found that investment is no longer contracting and construction activity declined only slightly from the previous month. The volume of July retail sales and real wages also remained essentially unchanged from June levels.

Preliminary Rosstat data show industrial output was down 11 % y-o-y in July. In the same period, investment declined 19 %, construction 18 %, the volume of retail sales 8 % and real wages 6 %.

The official number of unemployed in July was unchanged from June. July unemployment rate remained at 8.3 %.

Financial crisis has been hard on Russia's forest industries. The output of Russia's forest industries has contracted at about the same rate as the manufacturing sector generally. In 1H09, wood processing industry's production dropped nearly 30 % y-o-y, reflecting, among other things, a collapse in demand for lumber by the construction industry. The pulp and paper industries, which focus more on consumer products, saw their output fall 16 %. Logging activity declined roughly by the same amount.

In addition to the economic downturn, logging companies have been struggling with implementation of the new forests act. Both experts in the field and companies have criticised the new law for favouring big corporations over small and medium-sized enterprises. Critics also point out that only a few of the 200-or-so large investment projects approved by the industry and trade ministry are actually being realised. Weak export demand for timber has not been helped by hikes in export duties on raw timber exports. In 1H09, Russia exported about half the amount of raw timber it exported in 1H08.

Finland imported 2 million cubic metres of raw timber from Russia in 1H09, about half the amount it imported in 1H08. In the first five months of 2009, 60 % of Finland's raw timber imports came from Russia (80 % in 2006).

A Finnish forestry company, Koskisen Oy, this summer saw its mill project make it onto the government's list of priority status projects. Under the new forests act, companies that seek to invest at least 300 million roubles in a

forest project may be eligible for priority investment status, which confers the right to lease forest lands at reduced rent and avoid the competitive bidding process.

Rosstat figures for 2008 and the first half of 2009 indicate that most foreign investment in Russia's forest sector came from Finland. Taking into account the relative size of its economy, the total stock of Finland's FDI in Russia is the largest of any country with the exception of financial intermediary states like Cyprus, the Netherlands and the Virgin Islands (a significant part of the investment flowing through these countries is likely of Russian origin).

At meetings over the summer, the presidents and various ministers of Russia and Finland discussed issues related to the forest sector, especially hikes on raw timber export tariffs. The subject will be discussed again at a forest-policy summit in St. Petersburg in October.

Situation steady in the banking sector. Central Bank of Russia figures show household deposits increased during the first half of the year by nearly 10 % in nominal terms, or slightly less than in 1H08. Real growth in deposits (i.e. taking into consideration the period's inflation) was some 2 %. Deposit rates have risen somewhat since the start of the year, and in June the average deposit interest rate was 9.5 %. The real interest rate on deposits is still negative, however, as annual inflation is running at around 12 %.

The trend for deposits suggests no major change in confidence in the banking sector. The share of deposits to the banking sector's assets rose from 52 % in January to 56 % in June. The share of central bank funding, which was 12 % in January, fell to 7 % in June, indicating that banks are not struggling with liquidity problems.

As of end-June, the loan stock was at the same level as at the start of the year as banks focused on preserving solvency rather than boosting lending. In nominal terms, the stock of loans to households contracted 8 % during the first half. The stock of loans to corporations grew 3 % in nominal terms, with most of the increase attributable to renegotiated terms for existing loans. Following the decline in the CBR refinancing rate, the average interest rate on loans has dropped from 17.4 % in January to 14.7 % in June. As a rule, only state-owned banks lend money at these rates and only to companies with the highest creditworthiness.

The reluctance of banks to lend reflects both fears that lending in uncertain conditions could result in an increase in the stock of non-performing loans and banks' lack of access to long-term financing. The growth in non-performing loans has slowed, however, since April. At the end of June, the share of non-performing loans in the stock of corporate loans was under 5 % and below 6 % in the stock of household loans. As the figures are based on Russian accounting standards, however, only the belated payment tranches of a loan are treated as being in default.

China

First-half balance-of-payments figures show a reduced current account surplus. China's current account surplus fell by 32 % y-o-y in the first six months of this year to \$130 billion. The current account surplus for 1H09 equalled 6.3 % of GDP for the period (down from 10.4 % of GDP in 1H08). The smaller surplus comports with evidence of lower foreign demand and consequently a smaller goods trade surplus. The \$186 billion increase in China's foreign currency reserves was less than 1H08.

The financial account surplus shrank further in 1H09. Foreign direct investment inflows into China have dwindled significantly from last year's record level. Direct investment inflows into China were about \$21 billion higher than Chinese investment abroad. The net inflow was down nearly 50 % from the 1H08. The drop may reflect an increased preference of Chinese to invest abroad. The initial balance-of-payments data do not elaborate direct investment inflows and outflows to make clear what is happening.

Net errors and omissions, the balance-of-payments category often used as a rough indication of speculative capital flows, was larger in 1H09 than in the first half in recent years. The yuan's year-long stability against the US dollar may have again raised speculation about yuan appreciation in the future.

Balance of payments and currency reserves, US\$ billion

| January-June | 2007 | 2008 | 2009 |
|-------------------------------|-------|-------|-------|
| Current account | 163 | 192 | 130 |
| Capital account | 1 | 2 | 1 |
| Financial account | 89 | 70 | 32 |
| Net errors and omissions | 13 | 17 | 23 |
| Increase in currency reserves | 266 | 281 | 186 |
| Reserves on June 30 | 1,333 | 1,809 | 2,132 |

Source: SAFE

Broad-based growth in China's imports. Since the collapse at the end of last year, China's imports have revived rapidly. The monthly value of imports measured in dollars matched the early 2006 level in January and February, but exceeded the end 2007 level already in June and July.

Countries that supply oil and other commodities to China have benefited directly from China's recovery. In July, the value of imports from Latin America, led by Brazil and Chile, surpassed again the US. The value of China's July imports from Africa was roughly the same as the value of imports from Australia (\$4 billion). July imports from Australia exceeded the record set in 2008. China's monthly imports from Russia (\$2 billion in July) have recovered to a level close to the 2008 average. Trade

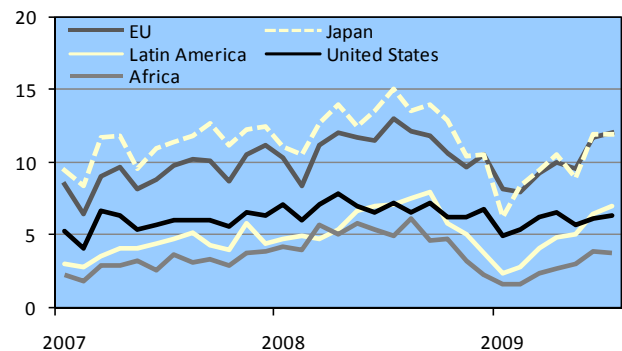
with commodity producers has been boosted by higher import volumes and world commodity prices that have been on the rise since the start of the year.

The recovery of Chinese imports, however, does not only affect commodity producers; imports from the EU and Japan have also risen rapidly in recent months. July imports from Germany returned to their pre-crisis level of a year ago. Imports from the United States, which did not decline as sharply as in other key markets, have shown a less dramatic rebound in recent months.

An interesting question in the current situation is how much of the recent rapid growth in China's imports has been driven by companies replenishing inventories (and the state replenishing national strategic raw material reserves). The front-weighted stimulus package has revived the economy and imports and boosted demand for commodities and investment goods. If the pull from these factors fades, the sharp on-month spike in imports may level off. The development in commodity prices can of course change the picture.

China's imports may thus return to pre-crisis levels. The next question becomes whether China will be able to truly compensate for the export difficulties of other countries and lift the global economy out of recession.

China's imports by region, US\$ billion



Source: CEIC

Hong Kong and Taiwan benefitting from China's economic recovery. The bottom of the economic recession for Hong Kong's 5 million residents and Taiwan's 22 million residents appears to have been reached. Hong Kong's economy experienced a 3 % q-o-q increase in the second quarter; Taiwan's economy grew 5 % q-o-q.

Economic growth has been largely supported by recoveries in domestic demand. While Hong Kong and Taiwan have been swept along by China's growth, the direct impacts of increased foreign trade are substantially smaller than those of higher domestic demand. The economic downturn at the start of the year was so severe that GDP in both areas is still expected to contract about 4 % for the year.

Russia

Economic development varies significantly across Russian regions. Regions with the strongest economic performances in the first half of the year were those involved with mineral extraction industries. Regions that performed poorest were those involved with manufacturing. Russian industrial output (including the production of mineral extraction industries) contracted 14 % y-o-y in the first seven months of the year. Production rose, however, 35 % in the Nenets autonomous area in the Arkhangelsk region, 27 % in the Sakhalin region and 15 % in the Amur region. Output in all these regions is based on oil, gas, and metals. E.g. the Volga region's industrial zones such as Nizhny Novgorod, Samara and Ulyanovsk saw industrial output decline about 30 %. Industrial output was down 28 % in Moscow and 24 % in St. Petersburg. Output in the Leningrad region, however, slid just 9 %.

Nationally, the average monthly per capita income in June was 17,600 roubles (€380). Per capita income was highest in Moscow and in oil producing regions such as Nenets and Hanti-Mansi (33,000–46,000 roubles). The next highest incomes (20,000–26,000 roubles) were in e.g. St. Petersburg and the Sakhalin, Komi and Murmansk regions. The poorest regions (incomes below 10,000 roubles a month) were found in the Caucasus, but there are a few of them also in Siberia, the Volga region and even near Moscow. The income differences, however, are narrowed to some extent as living costs in poorer regions are lower than in richer regions.

In real terms, average Russian incomes overall were up 3 % y-o-y in June. In Moscow, real incomes rose 11 %, while in St. Petersburg they fell 5 %.

Russia has approximately 400 one-company towns. In June, prime minister Vladimir Putin asked his cabinet to draw up criteria for *monocities* (towns largely dependent on a single industry or activity) in order to evaluate the need to provide federal support. Under the proposal prepared last month under the direction of the regions ministry, classification as a one-company town could be made by either of two criteria: 1) at least a quarter of the local labour force works for one company or a group of technologically integrated companies, or 2) the production of one company or group of related companies constitutes at least half of all production in a given locality.

About half of Russia's 400 one-company towns meeting the official definition do not presently require financial injections. This group consists of towns where the main employer is a nuclear power plant, a hydropower plant, an oil or gas producer or an export company. Academic cities and closed cities also do not need special subsidies.

The finance ministry reports that next year's budget will dedicate about 10 billion roubles (€220 million) to

support monocities. Experts warn that if the allocation is not well planned, the subsidies will perversely incentivise the preservation of inefficient production structures.

Russia's tough economic times reflected in trade with Finland. In the first half of 2009, the value of Finnish exports to Russia was about €2 billion and imports from Russia about €3 billion. The value of exports and imports declined in 1H09 by nearly half from the same period a year earlier. The seasonally adjusted export figure for June, however, rose slightly from May. The value of imports kept sliding.

The share of mineral products in imports has even increased, exceeding 80 % in January-June. The sharpest drop was seen in Finland's metal imports from Russia, the value of which was less than 20 % of the level in 1H08.

1H09 car exports from Finland fell dramatically (down nearly 80 % from 1H08). In reality, cars going to Russia are re-exports; they are imported from third countries to a Finnish port and then transported by road onward into Russia. Cars represented less than 10 % of Finland's exports to Russia in 1H09, down from over 20 % in 1H08. The smallest contractions in exports were in chemical products (down 10 %) and foodstuffs (down 30 %). Finland's main export products to Russia remained machinery and equipment, accounting for about a third of exports. Machinery and equipment exports contracted over 50 % y-o-y in 1H09. The domination of investment goods and consumer durables in Finnish exports to Russia partly explains the fact that Finnish exports to Russia have contracted faster than Russian total imports as demand for these goods has fallen most in Russia. In euro terms, the value of Russia's total imports in 1H09 fell 30 % y-o-y.

The drop in transit freight passing through Finland into Russia closely tracked Finland's exports to Russia in the first half of the year. Road transit freight was down about 50 % from 1H08 both in terms of value and volume. The biggest decline in transit freight was seen in car transfers, which declined both in value and volume terms by nearly 80 % y-o-y.

The value of tax-free purchases by Russian tourists in Finland was €80 million in the January-August period, down 4 % from the same period in 2008. The economic downturn has impaired Russian tourism in Finland, which often combines tourism with shopping. In 1H09, Russians had 5 % fewer overnight stays in Finland than in 1H08. Even so, Russian tourism in Finland was not down as much as Russia's foreign tourism generally.

Russian shopping expeditions to Finland may be endangered by a proposal from Russian customs this summer that the maximum amount of tax-free goods a person can bring back would be reduced from the current level of 65,000 roubles to 20,000 roubles (just over €400). According to Russian customs, the reduction will prevent import of goods intended for commercial resale under the guise of personal imports.

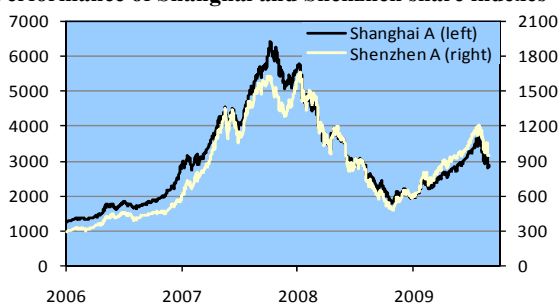
China

Share prices plunge in response to tighter lending. The yuan-denominated Shanghai and Shenzhen A-share indexes declined around 7 % on Monday (Aug. 31). Share prices were dragged down by the retreat in commercial bank lending and notifications from banks that lending will be more restricted in the second half of the year as banks work to improve the quality of their loan portfolios. The explosion in borrowing in the first half is expected to leave a legacy of more non-performing loans in the future.

Share indexes shed about 20 % of their value last month as the market corrected from an unrelenting rise that began late last year. Even with the pull-back, the Shanghai A index is up nearly 60 % from November 2008. Some of the money handed out by commercial banks in their recent lending spree has ended up in investments in stocks or apartments, rather than as pure investment in the real economy as intended by the stimulus programme.

China's stock markets, which were established in the 1990s, continue to display the high volatility typical of emerging markets. Only a tiny share of traded shares is available to foreign investors. Interest in China's stock markets continues to grow, however, as China is expected to lead the world out of recession and even pull along other economies. Trends in China's stock markets, however, only partly reflect broader macroeconomic trends. Share prices tend to react strongly to government policy shifts and even rumours of proposed policy changes.

Performance of Shanghai and Shenzhen share indexes



Source: Bloomberg

Outlook for manufacturers continues to improve. The official purchasing managers index (PMI), which is released by the China Federation of Logistics & Purchasing, saw improvement in the manufacturing sector continue in August. The index value rose from 53.3 in July to 54 and August was the sixth month in a row the reading was above 50. An index value above 50 signals the majority of firms see the situation of the current month as improved from the previous month. The sub-index categories with large gains

in August were domestic order books and industrial output. Export orders and imports have picked up in recent months.

China's other PMI, which is released by the investment bank HSBC, also showed improvement in the manufacturing sector in August.

China's significance for Finnish trade on the rise. While Customs Finland reports that in the first half of the year the value of Finland's imports from China declined 17 % from 1H08 to €1.7 billion, it was still much better than Finland's overall drop of 35 % in imports. China's share of total imports has now reached more than 8 %, placing China as Finland's fourth largest supplier after Germany, Russia and Sweden. Finnish exports to China (€1.0 billion) shrank just 9 % in the first half, compared to an overall drop of 36 % in Finnish exports. China, with nearly 5 % of Finnish exports, is Finland's seventh largest export destination.

Chinese statistics show Finland imported €1.4 billion worth of goods from China and exported €1.3 billion in goods to China.

Some 64 % of Finland's imports from China fall into the machinery and equipment category. For some product groups, the Chinese share is substantial. For example, China accounts for 44 % of telephone and radio device imports, and a third of office equipment come from China. Miscellaneous industrial goods account for 26 % of Finland's imports from China and nearly half of those imports consist of clothing. Clothing imports from China rose in January-June.

Over two-thirds of Finnish exports to China consist of power-generation, industrial, and electrical machinery and equipment. Exports of some of these products increased strongly in the first half. Other important export groups include base metals, iron goods, pulp, and to a lesser extent paper and cardboard. Although about a quarter of Finland's pulp exports go to China, Finland's exports are not particularly dependent on the Chinese market. In the important subcategories of industrial machinery and equipment, China accounts at most (special machinery for various branches) for 15 % of Finland's total exports.

In 1H09, Hong Kong accounted for a 0.1 % share of Finland's total imports and Taiwan 0.7 %. Hong Kong accounted for 0.6 % of Finnish exports and Taiwan 0.5 %.

A recent report from Finland's foreign ministry on barriers to trade confronting Finnish companies found that, after Russia, Finnish firms have their biggest problems dealing with trade barriers in China. Of all reported trade barriers, 11 % involved China (Russia 42 %). The biggest obstacles were technical barriers to trade and theft of intellectual property. Companies complained about direct counterfeit and knock-off products, as well as the reluctance of Chinese authorities to enforce IP rights. Product certification and China's idiosyncratic standardization rules made it difficult for companies to operate in the Chinese market.

Russia

Launch of massive Vankor oil and gas deposit boosts Russian oil output in August. Preliminary figures from Russia's energy ministry show crude oil production in the first eight months of the year rose 0.4 % y-o-y. August production growth accelerated to 1 % y-o-y. The growth acceleration in August is mainly due to the beginning of commercial production at Rosneft's Vankor oil and gas fields in the Krasnoyarsk region of Eastern Siberia.

Vankor is one of Russia's largest new oil and gas fields. Current oil production is about 130,000 barrels a day, but it should reach 220,000 barrels by the end of the year. Annual peak production of around 500,000 barrels a day is estimated to be reached in 2014. Last year, Russia's total daily production averaged about 10 million barrels.

Oil pumped from the Vankor fields is shipped to the pipeline network operated by the state-owned monopoly Transneft. Eventually, Vankor oil should serve as an important source for the Asian, and especially Chinese markets. It will be pumped through the Eastern Siberia Pacific Ocean (ESPO) pipeline currently under construction. Starting in 2011, China should be receiving 300,000 barrels of Vankor oil a day. There are also plans to pipe Vankor crude to the Gulf of Finland. In June, Transneft began construction of the BTS-2 pipeline, which will reach to the Ust-Luga port near St. Petersburg. The pipeline should be completed by 2012.

Besides Vankor, oil production is growing mainly in the new fields of Sakhalin area, whereas the largest older fields have already passed their peak production. Hence the government has strived for encouraging oil sector investment with e.g. tax breaks for the oil originating in the new fields of Eastern Siberia. Russia's economy ministry reports that investment in oil production rose in nominal terms 24 % y-o-y in January-July.

Russia's metal exports to China increased in 1H09. The value of Russian exports to China in the first half of the year was \$7 billion and the value of imports from China was \$9 billion. The value of exports contracted about a third from a year ago and the value of imports was off 40 %. China was Russia's top supplier of import goods, with a 13 % share. China took 6 % of Russian exports.

About half of Russia's exports to China are classed as mineral products. The share of wood and paper was nearly 20 %, and about 80 % of Russia's raw timber exports went to China. Other exports to China consisted largely of chemical and metal industry products. The value of metal exports rose nearly 23 % y-o-y in 1H09. The volume of steel exports nearly doubled.

Nearly half of Russia's imports from China consisted of machinery, equipment and vehicles. However, the value

of imports fell 50 % y-o-y in 1H09. Textiles and leather goods represented over a fifth of imports and their value fell nearly 10 %. Half of textiles and leather goods imported to Russia came from China.

A recent issue in Russian and Chinese trade relations has been the incidents at Moscow's giant Cherkizovsky outdoor market. In late June, Russian officials shut down the market on the pretext of health and public safety violations. The market provided work for thousands of Chinese traders. Some were deported as illegal immigrants, and officials confiscated goods worth billions of dollars from traders working at the market. At the end of July, a delegation led by China's deputy trade minister visited Moscow to discuss the fate of the Chinese traders. While China's trade ministry expressed support for Russia's crackdown on smuggling and criminality, it noted the obstacles Chinese traders face (e.g. difficulties with Russia's customs authorities) persist in making business in Russia. The Chinese said it would take time to implement changes in trade practices. The historic Izmailovsky market in Moscow was also shut down this summer and police raided the Sevastopol market. Russia's interior ministry characterised the raid as a successful closing down of a major smuggling channel for Chinese goods.

The shut-downs of outdoor markets have been seen as support for Russia's domestic textile producers and footwear manufacturers. Russia's ministry for industry and trade estimates that nearly half of clothes and shoes supplied in Russia are produced or imported by using gray schemes. According to Rosstat about half of clothes and shoes for sale in Russia are bought at market squares. Many Russians also use outdoor markets to sell goods, especially clothes and shoes, they have personally brought into Russia from China under personal duty-free quotas. In the first half of the year, the number of Russian tourist trips to China slipped to less than a half of a year earlier, due in part to stricter rules on personal duty-free imports in Russian Far East.

Russia slips badly in WEF competitiveness rankings.

Among the 133 countries surveyed in the World Economic Forum's latest *Global Competitiveness Report 2009*, Russia dropped from 51st place last year to 63rd this year. Russia was the sole BRIC country to lose relative competitiveness in international markets.

Russia's strengths were the large size of its markets and macroeconomic stability (which, however, reflected the possible transitory high world prices for crude oil). Russia's most notable weaknesses were structural problems such as government inefficiency (ranking 110), lack of judicial independence (116), weak property rights (119), as well as favouritism of government officials in dealing with the private sector. In addition, private sector activities were hobbled by poor ethical behaviour of firms (112).

China

China moves ahead with plans to increase yuan use in international settlements. This week, China's finance ministry announced plans to offer investors in Hong Kong yuan-denominated sovereign bonds worth 6 billion yuan (€600 million) at the end of this month. The bond issue will be the first issuance of yuan sovereigns outside mainland China. The issue is directed to private individuals and institutional investors. Although the amount is relatively small, the decision indicates a commitment on the part of the Chinese government to continue on the path to widen the regional and international use of yuan and further develop China's financial markets.

The *South China Morning Post* reports that the People's Bank of China (PBoC) is establishing a new department to oversee and handle issues related to international use of the yuan. The unit reflects a desire of officials to better track the impacts of measures to lift currency controls this year and prepare for possible further steps in liberalisation of yuan use.

In the past 12 months, the Chinese government has broadened the use of yuan in international settlements. Companies in Shanghai and the Pearl River Delta are permitted to use the yuan as settlement currency in trade with companies in Hong Kong, Macao, ASEAN countries (and possibly certain African countries). The PBoC has also made a total of 650 billion yuan (€65 billion) in currency swap agreements with a number of Asian countries, Argentina and Belarus in its efforts to give the yuan a higher international profile. China's big banks earlier issued their own yuan-denominated bonds in Hong Kong.

Despite China's rapid progress in promoting yuan use, the Chinese currency still has a way to go before it becomes a fully convertible international currency. The ongoing integration of China's currency and financial markets into the global economy, however, is undeniable. For example, China plans to open its stock markets further to foreign investors in the near future – a trend that clearly demonstrates the pressure to eliminate currency controls.

Reliance on green energy technologies on the rise. Although the relative share of electrical power generated by renewable energy systems is still small in China, the country has made remarkable progress in adopting new approaches in recent years. The amount of wind-generated electricity quadrupled between 2006 and 2008, and today China has the world's fourth largest wind power generation capacity after the US, Germany and Spain. Large dam projects have also helped double hydropower generation since 2002. Solar power use has increased dramatically along with incentives such as direct subsidies to e.g. build-

ing owners who install solar panels on their buildings. Moreover, China is planning to construct one of the world's largest solar fields in Inner Mongolia.

The introduction of renewable power technologies has not been without difficulties. Despite state support for construction of wind farms, companies that operate the electricity grid have little incentive bring wind farms, which are often located in remote areas, onto the grid. By some estimates, as much as 20 % of wind power currently generated in China is still off-grid and capacity utilisation of wind farms has been lower than expected. There have also been problems with hydropower projects as China struggles with droughts and uncertainty over the long-term environmental impacts of huge dams.

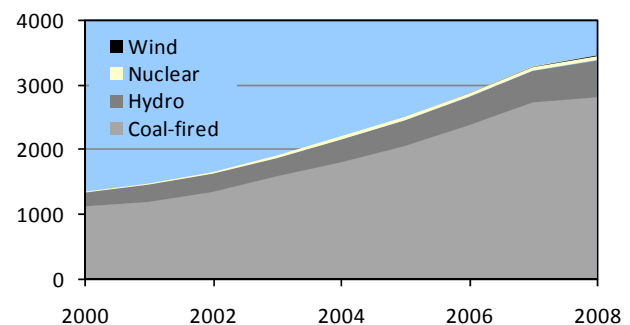
Despite the rapid rise of sustainable energy systems, they still generate a small share of China's total electricity (see chart). Hydropower accounts for 16 % of electrical power generation, and wind just 0.4 %. Coal, in contrast is the basis of more than 80 % of China's power generation. China's goal is to raise the share of electricity generated by renewable systems to over 20 % by 2020.

China is the world's largest emitter of carbon dioxide. A substantial amount of these emissions are generated by coal-burning power plants. China's future energy production will continue to rely heavily on coal-fired power plants and China has not committed to Kyoto treaty emission targets. International climate talks will continue in December at the Climate Summit in Copenhagen.

China's CO₂ emissions should fall slightly as the country makes gains in energy efficiency and its worst-polluting coal-fired power plants are shut down. A target of the current five-year plan (2006–2010) is to reduce energy consumption by 20 % relative to China's per capita GDP. Although progress towards this decrease has been achieved, it appears unlikely that the target will be met.

Although the state has passed an energy saving law and launched a raft of energy-saving programs, heavy regulation of electricity prices erodes the incentive to be energy efficient. Moreover, there has not been political enthusiasm for deregulation of energy prices.

Electrical power generation in China, TWh



Source: NBS

Russia

Sberbank to take a stake in Opel. Last week, General Motors approved the sale of the majority stake in Opel to a Canadian-Russian investor consortium (Magna International and Sberbank). Magna and Sberbank will jointly purchase a 55 % stake in Opel for €500 million. The deal includes GM's plant in St. Petersburg and GM's distribution network in Russia. Finalisation of the deal is expected to take place over the next few months.

The majority stake in Sberbank, Russia's largest bank, is held by the Central Bank of Russia. Sberbank, in turn, also owns subsidiary banks in Ukraine and Kazakhstan. Sberbank has never previously had extensive holdings in the car manufacturing branch.

Under the deal, Sberbank is allowed to sell its stake in Opel to either state development bank VEB or the GAZ car plant, owned by billionaire Oleg Deripaska. Deripaska was once an owner of Magna, but had to sell his stake when the financial crisis hit. Many Deripaska companies are now struggling to service foreign debt and have received extensive government support to stay afloat.

GAZ will act as the technical partner of Magna and Sberbank, and should participate in the production of Opel vehicles in Russia. Russia is expected to become one of the main markets for Opel, and Magna says it plans to invest €170 million in Opel's Russian manufacturing capacity in near term.

Government approves Energy Strategy 2030. On August 27, the Russian government approved its long-discussed national energy strategy through 2030. The latest strategy is a follow-on to the 2020 energy strategy approved in 2003. The content is largely aspirational and mentions few concrete measures. Although the final version of the energy strategy has yet to be released, newspaper reports suggest there are no significant changes from the draft version published last spring.

The strategy emphasises national energy security, energy savings, environmental protection and effective use of budget resources. Energy security considers both the reliability of the domestic energy infrastructure (production, transmission, and distribution grids), as well as increasing the effectiveness and diversity of energy export channels. Russia is presently almost entirely dependent on CIS and EU markets. Under the strategy, about 20 % of gas exports and 25 % of oil exports will flow to growing Asian markets by 2030. Asia accounts today for no Russian gas sales and only 6 % of Russian oil sales.

The strategy foresees low growth in oil, gas and coal production. The goal for domestic energy consumption is to adopt strong energy-saving measures and reduce reliance on natural gas as the fuel for generation of electricity and heating. Hence the exports volumes of coal, crude oil and oil products are not expected to rise significantly over

the next two decades. Gas exports, however, are expected to climb 45 % from current levels by 2030 – an average volume increase of about 2 % a year. The strategy reaffirms earlier agreed measures to be implemented as part of the deregulation of Russia's electricity markets.

Medvedev orders review of state corporations. Last month, president Dmitri Medvedev tasked the Prosecutor General's Office with investigation of how effectively the transferred assets of seven recently created state corporations are being used, and to determine whether there is justification for preserving the state corporation model as an organisational format.

Most of the state corporations under scrutiny were formed in 2007. They include nuclear power monopoly Rosatom; state development bank VEB; the Deposit Insurance Agency; the Housing and Municipal Services Development Fund; the Rosnano high-tech investment fund; Olimpstroï, the constructor for the Sochi Olympics; and technology conglomerate Rostekhnologii. Each corporation is based on a separate legislative act and is not subject to general laws governing state-owned enterprises (SOEs) and organisations. As a result, oversight of these entities has been weaker than other SOEs, even while they have received substantial budget funding and state property. Concerns have been raised by the upper-house Federation Council, the Federal Agency for State Property Management and the Prosecutor General's Office. For example, Olimpstroï and the Housing and Municipal Services Development Fund have been criticised for inefficient use of funds.

Rostekhnologii, which has its roots in arms exporter Rosoboronexport, has rapidly strengthened its position in the Russian manufacturing sector. The corporation was established to develop and commercialise Russia's high-tech innovations as these goals were thought best achieved with a state-owned giant. About 400 companies have been shifted to Rostekhnologii ownership. Over half operate in the defence sector. Firms in other branches include car-makers AvtoVAZ and KamAZ, as well as six local airlines separated from Aeroflot. These airlines will now be merged as a new national airline Rosavia. All companies under the Rostekhnologii umbrella will eventually be grouped into some 30 holding companies. The economy ministry says tens of billions of dollars in assets have already been shifted to Rostekhnologii. It took months from the officials to agree on the state assets to be shifted to Rostekhnologii, as the finance ministry and Federal Antimonopoly Service in particular wanted to limit the amount transferred. Recently, the corporation has expanded e.g. to the pharmaceutical industry and is said to be planning to increase its stake in AvtoVAZ.

The prosecutor general will submit his report to the president in November. It is possible that the state corporation format will be abandoned altogether and replaced by traditional structures (state organisation, SOE or fund).

China

China retaliates against US tariffs on Chinese tires.

Pressured by a complaint from United Steelworkers union, president Barack Obama's cabinet last week decided to go ahead with imposition of an additional 35 % tariff on car tires imported from China to the United States. The US said the move was justified as a response to the harm suffered by domestic tire producers and the loss of jobs caused by a tripling in tire imports from China over the last five years. It was the first significant trade intervention in Obama's term, and set off criticism domestically and in China.

The hike in US import tariffs was seen as a concession by Obama to American factory workers and fulfilment of a campaign promise. Defenders of the decision argue that China has long avoided playing by the rules of an open trading system, and that this was above all manifested in China's efforts to deliberately keep the yuan artificially undervalued. Opponents believe that the decision will ultimately do more harm than good for US businesses. In the view of critics, the increased tariffs fail to protect jobs in America as tires can simply be imported from other low-cost countries to substitute for tires produced in China. Moreover, all large American tire-makers have production in China, so they do not see it in their interest to erect barriers to trade. A looming fear is that punitive tariffs on tires will encourage producers in other industries to also demand for safeguard measures.

China reacted strongly to the US move, claiming that the decision to punish Chinese tire-makers violates US commitments on limiting the spread of protectionist measures. The Chinese government also announced it was immediately launching an investigation into whether imported American car parts and chicken products are subsidised in ways that might justify imposition of anti-dumping tariffs. Although China denied its actions were related to the US decision to hike tariffs on tires, the response was received as the trade policy countermeasure.

Increased risk of rising protectionism is seen as one of the major long-term threats stemming from the global financial crisis. Trade conflicts could seriously harm recovery of the global economy. Moreover, the recent protectionist moves are likely to dampen the mood at the upcoming G20 meeting in Pittsburgh next week, as well president Obama's slated visit to China in November.

Slowing rate of prices declines in China. Although consumer prices were still down 1.2 % y-o-y in August, they rose on month from July (up 0.5 % m-o-m). It was the first time since January that a rise in consumer prices was registered. When the effects from changes in food and energy

prices are factored out, consumer prices fell 1.6 % y-o-y. The slowing of on-year price declines and the on-month rise in prices in August confirms the view that this present deflationary episode will be transitory.

The increase in the broad money supply (M2) has been exceptionally rapid (up August 28 % y-o-y). Traditionally, the rate of M2 growth in China has been a fairly reliable indicator of future trends in consumer price inflation. The pursuit of relaxed monetary policies is also feared to cause a bubble in share and asset prices. For the moment, China's government has avoided significant tightening of its monetary stance, preferring to concentrate on measures that assure robust economic growth.

At the World Economic Forum last week in Dalian, Chinese premier Wen Jiabao promised China will remain committed to fiscal and monetary policies geared to providing economic stimulus. He noted, however, that his officials would also prepare for emerging inflation.

Favourable real economic trends continued in August.

China's National Bureau of Statistics reports real growth in industrial output accelerates in August to above 12 % y-o-y (from just under 11 % in July). In particular, production levels of industrial products related to construction such as cement and steel have been on the rise in recent months. Manufacturing of computers and plastic products has also increased rapidly. Production of refrigerators (for which purchasers have been receiving government-sponsored rebates) is up significantly.

Rising economic demand is further reflected in higher fixed capital investment in January-August. Supported by state stimulus measures, real capital investment was up on year by over a third. There were no signs, however, of increased enthusiasm for private firms to invest.

NBS figures show retail sales rose 17 % y-o-y in real terms in August. Chinese retail sales figures are considered unreliable, as they are not comprehensive and include a certain amount wholesale activity. Nevertheless, the outlook for a rapid growth in retail sales is supported by the rise in real incomes, which, according to the NBS, has remained strong despite the setbacks to the economy. Again, there is skepticism about official income statistics, as Chinese business surveys suggest people are clearly more dissatisfied than earlier about their income levels. Official figures also indicate an increase in the unemployment rate.

China's goods exports in August amounted to \$104 billion, 23 % less than in August 2008. August imports were \$88 billion, a drop of 17 % y-o-y. Despite a dramatic rebound in m-o-m figures of Chinese exports and imports since the end of last year, the rate of recovery slowed considerably in August.

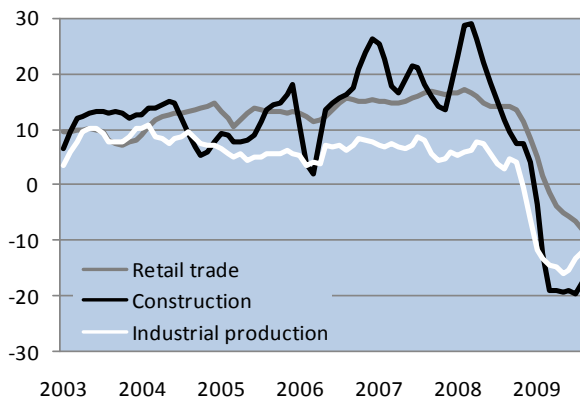
Russia

Poor economic performance in August. Preliminary data from Rosstat show that fixed capital investment in August declined still by nearly a fifth compared to twelve months earlier. The economy ministry estimates that investment also fell on month if seasonal variations are not taken into account. The ministry added that in August also construction contracted on month and that industrial output remained at about the July level. Construction was down 15 % y-o-y, while industrial output was off 13 %.

There were no visible signs of a recovery in consumer demand last month. The volume of retail sales in August was nearly 10 % below August 2008. Retail sales and real wages remained at the same level as in July according to the seasonally adjusted calculations of the economy ministry. Official unemployment continued to hover just above 8 % in August.

The economy ministry reports Russian GDP contracted 10.5 % y-o-y in August. GDP was about the same level as in July. The ministry expects GDP to return to on-quarter growth in the third quarter.

On-year output growth, % (3-month moving average)



Source: Rosstat

No growth in prices in August. Month-on-month inflation ground to zero in August, after averaging around 0.6 % in previous months. Consumer price inflation slowed to 11.6 % y-o-y.

The slowdown in inflation was led by the usual seasonal drop in prices of fruits and vegetables. Prices of non-food goods and services continued to climb, but at lower rates than previously.

All main components in the consumer price index (food, non-food goods and services) had relatively similar impacts on inflation trends in the first eight months of the year. The rise in the price of services largely reflected the regular annual hikes in regulated prices at the start of the year. The rise in food prices slowed somewhat from last year, while price growth of non-food goods was clearly higher than in 2008. In recent months, prices of non-food goods have been the largest driver of inflation.

The drop in the inflation rate in August allowed the Central Bank of Russia to lower its refinancing rate and other key rates by 0.25 percentage point on September 15. Since April, when the CBR started lowering the rate, it has reduced the refinancing rate by a total of 2.5 percentage points. The refinancing rate currently stands at 10.5 %.

A CBR press release accompanying the rate-cut decision noted that the central bank saw positive signs in the credit markets in August. The release also stated that if the global demand of energy products remains low there could be seen increased volatility in oil prices and the rouble's exchange rate.

After appreciating in the second quarter, the rouble lost ground slightly in July and August. According to preliminary data, the rouble's nominal effective (trade-weighted) exchange rate in August was nearly a fifth weaker than in August 2008, while its real effective exchange rate was about 6 % weaker.

Economic growth of recent years has not increased income disparity in Russia. The latest Rosstat data indicates that Russia's Gini coefficient stood at 0.42 at the end of 2008. The Gini coefficient, which provides a rough indication of income disparities within a society, has been practically unchanged for Russia since 2006. At the time of the collapse of the Soviet Union in 1991, Russia's Gini coefficient was about 0.27, or the current level of Finland. Russia's Gini coefficient soared to 0.40 by 2000 and has changed only a little since then. The Gini coefficient posits a spectrum of possible wealth disparity in a society between zero (completely equal wealth distribution among households) to one (a single household controls all wealth in the society).

By international comparison, Russia's wealth distribution is more inequitable than in any EU country, but still more egalitarian than the United States (0.45 in 2007), China (0.47 in 2007) and most countries in Latin America (for example, Brazil had a Gini coefficient of 0.57 in 2005). On the other hand, income disparities seem to be narrower in other CIS countries than in Russia. For example, the Gini coefficient for Ukraine in 2006 was 0.31.

China

Annual communist party meeting ends with little to show. The Central Committee of the Communist Party of China (CPC) wound up its four-day meeting last Friday (Sept. 18). The meeting brought together almost 400 members and alternate members of the Central Committee for the largest annual CPC body meeting. Its members are selected at the National Party Congress, which is held every five years. In the annual meeting, party members discuss and largely decide the future of the party and the country including key appointments.

This year's meeting ended without any major public declarations, however. Chinese media said topics under discussion at the closed-door meeting included a proposal to require that high-level public officials declare the value of their personal property as well as that of their close relatives. In the public statement following the meeting, the Central Committee repeated a number of familiar themes – striving to sustain stable economic growth, increasing democracy within the party and a strong commitment to fighting corruption. No concrete measures were mentioned.

The meeting ended without the announcement of any major appointments despite general anticipation ahead of the meeting that vice president Xi Jinping would be elevated to deputy chairman of the influential military commission – a signal in the past that an individual was on the path to being elected as China's next president. Both current president Hu Jintao and his predecessor Jiang Zemin were appointed to the prestigious military commission before they became president. Most observers, however, think Xi still remains on track to be China's next president.

Asian Development Bank raises its outlook for developing economies in Asia. In its latest report on 44 emerging Asian countries, the Asian Development Bank (ADB) found that countries in the region had weathered the global financial crisis better than its early forecast last March had predicted. The September survey of the Manila-based ADB expects that the region will achieve overall economic growth of 3.9 % this year, i.e. half a percentage point higher than its March forecast. Developing Asian countries now represent for about a quarter of the world's economic output if adjusted for purchasing power.

The report credited China's large, well-timed stimulus measures for the economic success of developing Asia in the midst of the global financial crisis. China accounts for nearly half of the total production in ADB's reported countries and 38 % of the total population covered by the survey. ADB expects China's economic growth this year to reach 8 %, or a one percentage point higher performance than forecast in the spring. More robust economic growth

than in the March forecast is also anticipated for the other economic giants in the region, India and Indonesia, which, because of their relatively closed economies, were largely spared the ravages of the global financial crisis. In contrast, most of the open, export-oriented economies in the region continue to suffer from crisis effects.

While price pressures in the region are still fairly modest, they are expected to increase next year. ADB believes that consumer prices in China will fall about 0.5 % this year, but rise about 3 % next year.

Forecast and realised on-year GDP growth of largest developing economies in Asia, %; ADB September 2009 forecast (March 2009 forecast in parentheses)

| | 2008 | f2009 | f2010 |
|------------------------------|------|-------------|-----------|
| China | 9.0 | 8.2 (7.0) | 8.9 (8.0) |
| India | 6.7 | 6.0 (5.0) | 7.0 (6.5) |
| South Korea | 2.2 | -2.0 (-3.0) | 4.0 (4.0) |
| Indonesia | 6.1 | 4.3 (3.6) | 5.4 (5.0) |
| Taiwan | 0.1 | -4.9 (-4.0) | 2.4 (2.4) |
| All emerging Asian economies | 6.1 | 3.9 (3.4) | 6.4 (6.0) |

Source: ADB

China promises to limit carbon dioxide emissions at UN conference on climate change. In his address to the UN general assembly, Chinese president Hu Jintao declared his country was committed to cut China's carbon dioxide intensity (emissions relative to gross domestic product) from a 2005 level by 2020. The statement was significant as China was still in 2005 the second largest carbon dioxide emitter at that time after the United States. China's CO₂ emissions in 2005 were about 5.5 million kilotons or 1.04 kilograms per unit of GDP, an intensity level of slightly more than twice that of the United States. China, however, did not commit to a specific target for reduction of carbon dioxide intensity. Although emissions intensity will fall, China's emissions in absolute terms will continue to rise as production rises and people buy more cars.

China is likely to ultimately commit to specific CO₂ emissions targets, but for the time being president Hu Jintao appears to be shying away from specific numbers in order to retain a negotiating edge going into the Copenhagen Climate Summit held in December. China earlier committed to a specific target for reducing energy intensity (units of energy used per unit of production) in its most recent five-year plan. The plan called for a 20 % reduction from 2005 levels by 2010. In addition, China has targeted an increase in the share of energy produced by non-fossil fuels (i.e. renewable energy sources such as wind and hydro, as well as nuclear) to 15 % by 2010 under the current five-year plan. Coal today remains China's main fuel source by a large margin.

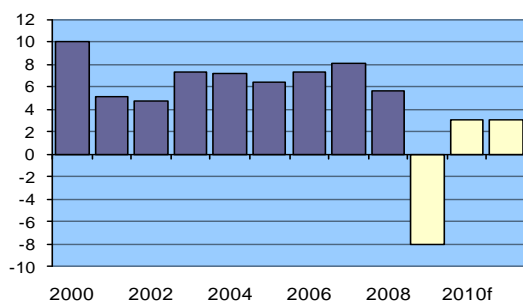
Russia

Latest BOFIT forecast sees Russian economy returning to modest growth this year. The seizing-up of international financial markets and collapse of oil prices last year traumatized the Russian economy, but it now appears the worst is already passed. Towards the end of the year, the economy is expected to recover and even post modest quarterly growth, thanks to gradual recoveries in consumer and export demand. Stabilisation of income and employment trends, higher oil prices and public sector support should assist the modest recovery of consumer demand. Capital investment will remain depressed longer, as demand uncertainties still prevail and access to financing is more difficult.

Russian GDP is still expected to contract 8 % y-o-y this year, reflecting the economy's feeble first-half performance. However, positive growth around 3 % p.a. should return in the next two years. Due to the strong contraction in output, GDP is not expected to recover to its pre-crisis level over the next years. The import trend, which follows GDP, is expected to fall sharply this year. In 2010–2011, however, imports are forecast to bounce back faster than GDP and the economy's propensity to import gradually returns to the pre-crisis level.

Russia's economic performance in the coming years will depend largely on the recovery of the world economy, which will impact Russia's export prices and demand. Household consumption trends add to this uncertainty, especially if income development falters and unemployment begins to rise again. Moreover, an on-going credit drought on financial markets could dampen economic recovery. There is also a risk that Russian growth will slow down in longer term, as the financial crisis may restrict capital investment vital for Russia's future economic development. ([BOFIT forecast for Russia 2009-2011](#))

Real annual GDP growth (includes 2009-2011 forecast), %



Sources: Rosstat, BOFIT Russia Forecast

CBR to continue steering rouble exchange rate in coming years. On Wednesday (Sept. 30), the Central Bank of Russia submitted to the Duma a draft of its monetary policy programme extending through 2012. The programme

repeats the CBR's long-held goal of reducing direct involvement in steering the rouble's exchange rate and gradually shifting exclusively to inflation targeting.

In announcing the programme, CBR chairman Sergey Ignatyev noted, however, that the CBR will have to continue to intervene in the markets to prevent large swings in the rouble's external value for the foreseeable future because the Russian economy remains so extensively dependent on world commodity prices.

On Wednesday, the CBR again lowered its refinancing and other key rates by 0.25–0.75 percentage points. The central bank justified the cuts in light of a moderating inflation outlook, as well as persisting high borrowing costs in the real sector and a need to enhance credit growth. After the cut, the refinancing rate stood at 10 %. 12-month inflation was 11 % in mid-September.

Problems from international economic crisis begin to affect Russia's insurance sector. The Federal Service for Insurance Supervision reports that growth in Russia's insurance industry came to a halt in the first half of 2009 after several years of brisk growth. Russia's insurance sector is still relatively small and undeveloped. Insurance premiums collected in 2008 only amounted to about 2 % of GDP, compared to a European average above 7 %.

Insurance premiums paid in during the first half of 2009 amounted to 225 billion roubles (about €5 billion), or 9 % less than in 1H08. Claims paid out, in contrast, increased 30 %, a faster pace than before. In the first half of 2009, insurance companies paid out nearly 110 billion roubles on claims. The number of insurance companies continued to fall in the first half, and stood at 743 as of end-June (830 at end-June 2008).

Struggling insurance companies have reduced claim settlements and postponed payments. This behaviour has led to a dramatic rise in the court cases brought by policyholders against their own insurers. Some 15,700 suits were filed in the 1H09, or more than double the number of such filings in 1H08. At the same time, insurance fraud has also increased.

Russia's largest insurance company, Rosgosstrakh, is mostly owned by CEO Danil Khatshaturov (the Russian state holds a 25 %-plus-four-share stake). The company was listed as a strategic company, which implies that state holding can only be reduced with special permission. Because Rosgosstrakh now needs more capital to retain its financial solidity, president Medvedev in September approved the removal of Rosgosstrakh from the list of strategic companies allowing it to raise capital by issuing new shares. The state will retain a "golden share" that gives it veto rights in all important company decisions. On Wednesday, the Rosgosstrakh shareholder meeting voted to go ahead with the share issuance. If the issuance proceeds as planned, Russian state's ownership stake would fall to about 13 %.

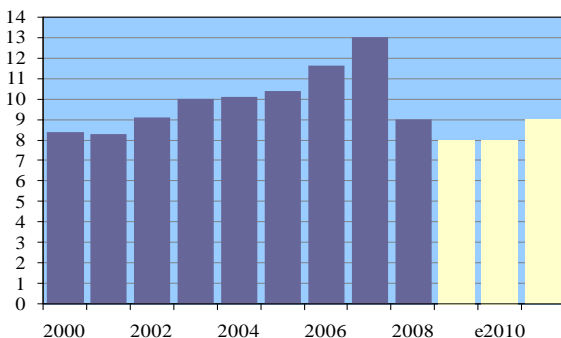
China

Latest BOFIT forecast sees robust growth for Chinese economy in 2009–2011. Although GDP growth slowed in the second half of 2008 and early 2009, official figures suggest the slowdown has been less intense and shorter-lived than we forecast six months ago. With China now on the recovery track, our latest forecast sees GDP growth averaging around 8 % pa in 2009–2010 and around 9 % pa in 2011 ([BOFIT Forecast for China 2009-2011](#)).

Chinese growth at the moment is largely supported by public investment under the government's stimulus package. Private consumption, which plays a relatively small role in the Chinese economy compared to most countries, also looks healthy in terms of retail sales. The impact of the global downturn is most clearly evidenced in foreign trade; export volumes this year are expected to hold well below last year's level. Strong domestic demand, however, has prevented a drastic decline in imports, and the recovery in imports should be fairly swift. The contribution of net exports to GDP growth could be negative during the forecast period, something rarely seen in the last decade.

China's successful stimulus comes with inherent policy risks. A huge increase in bank lending has ignited price pressures in the stock and the real estate market. Although there are no signs yet that this inflationary pressure is spreading to other parts of the economy, the possibility cannot be ruled out and will grow more likely if the stimulus programme is extended. For the policy-maker, the choices are difficult. On one hand, preventing higher unemployment levels is needed to assure social stability. On the other hand, policy-makers face a backlash if the massive savings of households are eaten up by inflation. While policy-makers are presently emphasising measures to stimulate growth and employment, the time is fast approaching when loose credit must end. This trade-off imposes limits on economic growth in the forecast period.

Real annual GDP growth (includes 2009–2011 forecast), %



Sources: China National Bureau of Statistics, BOFIT

On Thursday (Oct. 1), the People's Republic of China celebrated its 60-year anniversary. After three decades of market reforms, China has emerged as a major world economy. It can no longer rely on exports and investment to drive growth, but rather needs to promote growth driven by domestic consumption. Ironically, current stimulus measures have merely reinforced the traditional emphasis on investment. China's investment rate (investment to GDP) is now approaching an eye-popping 44 %.

G20 gathering ends with little to show. China wanted to discuss four topics going into the last week's G20 meeting in Pittsburgh: agreeing on measures to promote recovery of the global economy, creation of a common development strategy to tackle social and economic problems of developing and least-developed countries, reforming international financial institutions, and opposing protectionism. In practice, the agenda only took up the last two issues.

Despite the lack of action, the G20 has effectively replaced the G8 as a forum for dealing with important world economic issues. The G20 reflects the emerging power of Asia. Unlike the G8, which included Japan as its sole Asian member, the G20 also includes China, India, Korea, Indonesia and Australia. G20 members together account for about 85 % of world GDP.

The G20 gathering passed a resolution on renewal of the IMF and supported increased voting shares for developing economies at IMF meetings. Currently, the EU has a voting share of one third, the US 17 % and the remainder is shared among other members. However the US in practice has a veto power, since any decision requires an 85 % supermajority to pass. The EU has a larger voting share and more seats on the IMF board than its economic size. The G20 agreement on the IMF will likely force the EU to surrender some of its voting share to developing countries.

CIC investing heavily in natural resource companies.

China's sovereign wealth fund, China Investment Corporation (CIC), spent \$850 million last week for a 14.5 % stake in the Hong Kong-based commodities trader Noble Group and loaned nearly \$2 billion to a struggling Indonesian coal producer (PT Bumi Resources). This week, the CIC picked up an 11 % stake in Kazakhstan's number-2 energy company for nearly \$1 billion. In July, CIC acquired a 17 % stake in the Canadian-registered mining company Teck Resources for \$1.5 billion. Analysts see China's interest in natural resources as reflecting concerns over access to raw material supplies in the future.

The CIC was established in 2007 with \$200 billion from China's currency reserves. Its mission is to improve the overall return on currency reserve assets.

Other Chinese state companies are also investing heavily in natural resources. News reports this week claimed state oil company Sinopec plans to invest \$30 billion in development of Nigerian oil fields.

Russia

Government tightens budget policy. Late last month, the government submitted its proposed 2010 federal budget to the Duma. The budget calculations cautiously assume the price of Urals crude will average \$58 per barrel (currently just under \$70), giving the government room to manoeuvre on economic policy if the price is higher. The economic scenario used to prepare the budget foresees GDP growing 1.6 % next year and inflation at a level of 9–10 % at year's end.

Projected budget revenues are 7.0 trillion roubles (€160 billion) and expenditures of 9.9 trillion roubles (€225 billion). Revenues would correspond to 16 % of projected 2010 GDP, while expenditures would be 23 % of GDP. The budget deficit would reach €65 billion, almost 7 % of projected GDP.

Public sector revenues overall (federal and regional budgets, as well as pension, health insurance and social funds) would come in next year at 13.6 trillion roubles (31 % of GDP) against expenditures of 17.0 trillion roubles (39 % of GDP). The resulting deficit would be about 8 % of GDP.

Nominally, federal budget revenues climb 4 % next year. In real terms, however, revenues will be 6 % lower than this year. A factor affecting the revenue is the social insurance reform that will be launched at the start of next year, cutting into insurance premia revenues.

Budget spending falls in 2010 nearly 1 % in nominal terms and 10 % in real terms. The only real growth in the main spending categories occurs in general public administration, where spending rises 12 %. The growth reflects e.g. higher servicing costs for public debt and spending on international cooperation. The smallest spending declines will be seen in defence (real change -6 %), law enforcement and national security (-4 %), transfers of social support to regional budgets and social funds (-5 %), as well as social security (-10 %). The largest cuts affect business-related spending, which will plunge 34 % as a result of e.g. reduced public investment.

The considerable spending cuts partly reflect a pull-back from the increased spending this year created by the government's stimulus package. Under the government's 2011 and 2012 budget framework, spending in 2011 would fall to 19.5 % of GDP and the following year to just 18 %, the same level as in 2008. 2009 federal budget expenditures are now expected to come in at around 25.5 % of GDP.

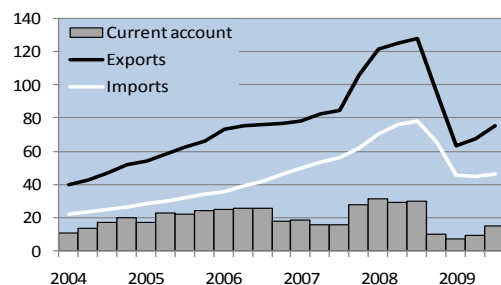
Next year's federal budget foresees a 2.9 trillion rouble deficit, of which 2.2 trillion roubles will be covered with funds earlier set aside in national reserve funds collected from high energy tax income. The remaining 700 billion roubles (€16 billion) will be borrowed, with about half raised from the sale of bonds on the domestic market and

the rest from international markets. The remaining 2.8 trillion roubles (€63 billion) in reserve funds will be held to cover future budget deficits.

Current account remains in surplus in third quarter; financial account shows deficit. Preliminary balance-of-payments figures show the value of Russian goods exports in January-September was \$206 billion and the value of goods imports \$132 billion. Although the value of exports and imports in 3Q09 was still more than 40 % below 3Q08, both exports and imports were up from the second quarter (seasonally adjusted). Russia's current account surplus was \$32 billion in the first nine months of the year, about a third of the same period in 2008. The rebound in oil prices, however, meant that the lion's share of the surplus was generated in the third quarter.

The financial account deficit in January-September was \$46 billion (roughly in balance in the same period in 2008). An increase in foreign direct investment and foreign debt in 3Q09 lifted the net inflow of capital from abroad to \$15 billion. The net outflow of Russian capital was \$40 billion, of which the banking sector shipped out \$24 billion. Russia's gold and currency reserves fell by \$12 billion in the third quarter and stood at \$413 billion at end-September.

Russian goods trade and current account balances, quarterly, US\$ billion (seasonally adjusted)



Sources: Central Bank of Russia, BOFIT

Russia's foreign debt up slightly in the third quarter.

Preliminary CBR figures indicate Russia's foreign debt stood at \$487 billion at end-September, or more than \$10 billion more than at the end of June. Foreign debt of banks declined to \$138 billion, while foreign debt of non-bank firms rose to \$303 billion. Government foreign debt remained unchanged at \$30 billion. Russia has a relatively low debt burden; total foreign debt to GDP is 40 % and government foreign debt only about 3 %.

Russia's net financial position has remained clearly positive. At the beginning of the year, Russia's foreign debt was \$480 billion against foreign obligations to Russia of about \$800 billion. The public sector's net position was positive and the corporate sector's negative. When capital investment and derivatives are included, the value of Russian liabilities to foreign creditors exceeded \$750 billion, while assets amounted to about \$1 trillion.

China

IMF raises its forecast for Chinese growth and warns of potential risks. The IMF's latest World Economic Outlook (WEO) released last week provides fresh economic forecasts for this year and 2010. The IMF lifted its 2009 GDP growth prognosis for China by a percentage point from its July forecast to 8.5 % and now expects GDP growth to reach 9 % next year. The Fund also sees consumer price inflation hovering around zero both this year and next year (-0.1 % in 2009 and 0.6 % in 2010). China's current account surplus is projected to climb from below 8 % of GDP this year to 8.6 % of GDP in 2010, suggesting that the global financial crisis will not significantly lower China's surpluses.

The improved performance of the Chinese and other Asian economies reflects expansionary monetary and fiscal policies in the region, acceleration in industrial output after inventory adjustments and recovery of financial markets. However, worsening labour market situation in China could impede growth in domestic demand. Overcapacity could also depress demand for investment goods elsewhere in Asia. China's demand for imports so far supports export-driven economies such as Korea and Indonesia.

The IMF offered a number of caveats on risks facing the Chinese economy. The recent boom in lending, for example, could generate an asset bubble, along with over-investment and degradation of bank loan portfolios. Moreover, a return to the era of spectacular export-driven growth seems unlikely anytime soon. Thus, the Fund continues to encourage China and Asia generally to rebalance their growth strategies towards domestic consumption and away from external sources.

The 2009 outlooks for Russia and other CIS countries were revised downwards slightly from July, while leaving basically unchanged the projections for next year. Russia's economy will begin to pull out of its deep recession only next year (GDP is expected to shrink 7.5 % in 2009), helped by expansive fiscal policy, higher commodity prices and a pick-up in growth among developed nations. The big challenge facing Russia is to provide well-targeted fiscal measures in a manner that does not leave the country saddled with recurring budget deficits.

IMF forecasts for GDP growth in 2009 and 2010, %
(figures in parentheses are from the July forecast)

| | 2009 | 2010 |
|---------------|-------------|-----------|
| China | 8.5 (7.5) | 9.0 (8.5) |
| Russia | -7.5 (-6.5) | 1.5 (1.5) |
| CIS countries | -6.7 (-5.8) | 2.1 (2.0) |
| India | 5.4 (5.4) | 6.4 (6.5) |

Sources: IMF, WEO

September PMI reading suggests growing optimism among manufacturers. China's official purchasing manager index, the China Federation of Logistics and Purchasing PMI, climbed to a reading of 54.3 in September. It was the seventh month in a row that surveyed Chinese manufacturers felt conditions had improved from the previous month. The positive reading is in line with data on industrial output and GDP. The PMI provided an early sign of the acceleration in industrial output last spring as the worst effects from the international financial crisis began to recede in China. Moreover, it identified the low point in economic conditions when the PMI fell to around 40 points at the end of last year.

Among the sector-specific sub-indexes, the highest reading in terms of the output index was measured for transport equipment. The export outlook for paper products was also quite strong. The latest reading of China's other purchasing manager index, the HSBC PMI, reinforced the sentiment of improving business conditions for China's industrial firms.

China surpasses US as world's biggest CO₂ emitter.

The International Energy Agency (IEA) reports that China's carbon dioxide emissions exceeded 6 billion tons in 2007, an amount that represented over 20 % of total CO₂ emissions globally. Although China's CO₂ emissions nearly tripled between 1990 and 2007, GDP increased even faster, causing emissions as a share of GDP to fall by about half.

In contrast, Russia's carbon dioxide emissions were 1.6 billion tons in 2007, a decline of 27 % from 1990. In the same period, Russia's CO₂ emissions relative to GDP dropped 31 %.

Despite the rapid rise, Chinese CO₂ emissions per capita were only 42 % of the OECD average in 2007. Russian per capita CO₂ emissions were roughly on par with the OECD average.

About 77 % of China's energy is produced by burning coal, and coal-fired power generation accounts for nearly all of Chinese CO₂ emissions growth in the 1990–2007 period. In terms of absolute production capacity, China produces more energy from renewable sources than any other country in the world (151 GW in 2007). Moreover, China has set as a goal for 2020 to produce 15 % of its energy from renewable sources. Production of solar panels and wind turbines are among China's fastest growing export industries.

The IEA estimates that by 2030, China's CO₂ emissions will double from their 2007 level, but expects Russian emissions to increase only about 24 % above the 2007 level. Russia has a special problem with CO₂ emissions released in conjunction with oil production as well as other greenhouse gases, particularly methane.

Russia

Government plans additional bailout measures for struggling AvtoVAZ. AvtoVAZ, Russia's largest car-maker and producer of the legendary Lada cars, reported on Monday (Oct. 12) a first-half loss of 19 billion roubles (€435 million) and a 50 % drop in sales from 1H08.

AvtoVAZ's main owners are state corporation Rostekhnologii (25.1 % shareholding), investment bank Troika Dialog (24.8 %) and the French Renault (25 %). Renault purchased its stake in 2007. So far this year, the Russian government has pumped 25 billion roubles (€570 million) in zero-interest loans into AvtoVAZ. Exacerbation of the firm's fiscal deterioration caused prime minister Vladimir Putin early this month to demand that Renault either participate in the bailout or accept a reduced stake in the company.

As a part of additional financing, Renault agreed to begin joint production of cars with AvtoVAZ in 2012. For that it would provide AvtoVAZ with advanced production technology to assist in the modernisation of the company. Renault's contribution would amount to 75 % of the project costs.

AvtoVAZ says it still needs at least 70 billion roubles (€1.6 billion) in funding this year just to keep going. Of that, 40 billion roubles (€915 million) would go to servicing debt. The government is currently seeking solutions for covering the financial needs of the company.

AvtoVAZ biggest problems are poor competitiveness of its products, an out-dated production organisation, as well as lousy management and associated side effects. In fact, an emergency infusion of money will not solve these problems, but only support a creaking production structure. The AvtoVAZ operation in Tolyatti employs more than 100,000 people. AvtoVAZ announced plans late last month to lay off nearly 28,000 people. Such massive layoffs are, however, considered politically unacceptable.

In addition to financial support, Russia supports domestic carmakers with heavy import tariffs. The government decided in early October to continue for at least nine months the hike in tariffs on imported cars introduced at the start of 2009.

Telenor and Altimo set to launch joint venture. Last week, one of the longest-running corporate struggles in Russia appeared to approach resolution as Norwegian telecom Telenor and Altimo, a member of the Russian consortium Alfa Group, agreed to merge VimpelCom and Kyivstar, two mobile phone network operators that they own in Russia and Ukraine. Telenor and Altimo have battled for control of the companies for several years. Last summer, a Siberian court froze trading in shares of Telenor-owned VimpelCom. The company created under

the merger, VimpelCom Ltd, is registered in Bermuda and has its head office in the Netherlands. Telenor and Altimo both hold nearly 40 % stakes in the new company.

This particular battle for corporate control has been closely followed internationally as it is seen as a test case for foreign investor treatment in Russia. For the most part, analysts see the final solution as fair to both parties.

Alfa Group owner Mikhail Fridman last year joined up with an alliance of Russian business magnates in a struggle to wrest control of the board of TNK-BP from British Petroleum. The parties eventually agree to continue with 50-50 split in voting control, but the board composition was changed and its British chairman given the boot. A new board chairman has yet to be selected. Fridman last spring became interim CEO of TNK-BP.

Putin's visit to China focused on natural resources and regional development. The international financial crisis has warmed relations between China and Russia. Along with other large emerging economies, the two have been critical of the disproportionate role that the US plays in the global economy. They have sought to increase the role of the developing world in international institutions such as the IMF and in arenas such as currency markets. There was surprisingly little progress on one of the most anticipated issues – Russian gas exports to China. Gazprom and CNPC failed to reach a deal on gas pricing, even after several years of hashing.

The parties penned economic agreements consisting largely of Chinese loans and other financing to Russian banks and firms. Russian state banks VEB and VTB received a total of over \$1 billion in credits for e.g. financing imports from China and construction projects. China has lately granted financing to support its exports to a number of countries in South America and Asia, as well as Belarus. In addition, the Russian metal producer Petropavlovsk is set to receive Chinese financing for development of Russian iron ore deposits near the Chinese border.

Russia's massive natural resources play a huge role in economic cooperation with China, even if Russia has become increasingly dissatisfied with its role as a raw-material supplier in its trade with China. China, on the other hand, seeks to secure raw materials to sustain economic growth. The economic crisis has increased Russia's interest in attracting foreign investment, especially for development of natural resources in remote areas in the Far East and Siberia.

Russia and China have agreed on an economic cooperation programme for 2009–2018 for the Russian Far East and Eastern Siberia as well as Northeast China. The countries will work on raw-material and wood processing projects in Russia. In China, manufacturing of machinery and vehicles, as well as trade and logistics are areas to be developed jointly. The programme implementation remains unclear, however.

China

China and Russia discuss energy cooperation. During the course of prime minister Putin's visit to Beijing this week, plans for several long-running projects in the energy sector were again on the agenda. It was e.g. agreed that the oil pipeline from Skovorodino in Russia to Daqing in China, which is currently under construction, will be completed next year so that oil transmission can begin in 2011. Rosneft and China National Petroleum Corporation agreed on construction of an oil refinery in Tianjin.

A 2006 agreement on construction of two natural gas pipelines running from Russia to China was reaffirmed at the meeting. The latest revised plan calls for completion of the pipelines in 2014–2015, although significant uncertainty still remains. Start of construction work has been delayed because the parties have been unable to agree on the contract price for gas.

According to Chinese newspapers, other projects under discussion included the continued cooperation on construction of nuclear power plants. Russia and China earlier cooperated on construction of the Tianwan nuclear power plant.

China is also involved in energy cooperation with countries in Central Asia. A gas pipeline running from Turkmenistan to China should be completed by the end of this year. The pipeline's initial transport capacity will be just 5 billion cubic metres a year, but it is planned to increase incrementally to a level of 30 billion m³ a year by 2013. The oil pipeline from Kazakhstan to Xinjiang in China was completed in summer 2006. The pipeline was extended to the Caspian Sea last summer and currently has a transmission capacity of 10 million tons of oil per year.

China's growing energy needs. China was the world's second biggest energy user last year after the United States. The third and fourth largest energy consumers were the EU and Russia. Figures from British Petroleum show China accounted for an 18 % share of global energy consumption in 2008. China's most important energy source remained coal (70 %), with China accounting for 46 % of the total world consumption. China satisfied 19 % of its energy needs with oil, and accounted for 10 % of world consumption (making China the world's second biggest consumer of oil after the United States). China's heavy reliance on coal recently made it the world's largest carbon dioxide and sulphur dioxide emitter.

The easiest way for China to reduce air pollution would be to replace coal with cleaner energy sources. For example, natural gas produces 45 % less CO₂ emissions than coal, practically no SO₂, and lower NO_x emissions. Natural gas satisfies just 4 % of China's energy consumption at the moment.

New trade figures signal revival in foreign trade.

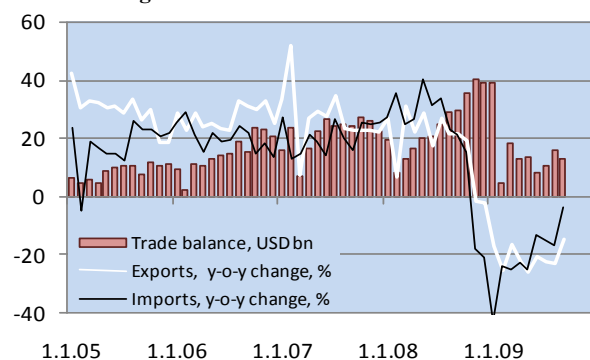
Month-on-month, China's exports and imports rose sharply in September. The short-term trend in the country's foreign trade is interesting to anyone surveying the global economy for signs of reviving growth and increased trade activity. Particularly informative are the seasonally adjusted on-month changes in imports and exports, where the impacts of regular monthly changes in foreign trade are removed. In September, the value of Chinese exports rose more than 6 % and imports over 8 % m-o-m. In August, the comparable rates of growth were clearly lower (exports up just over 3 % and imports up 1 %).

Year-on-year, exports and imports continued to contract, just not as fast as before. In dollar terms, the value of exports declined 15 % y-o-y in September, compared to a drop of 23 % in August. The value of imports fell 4 %. The trade surplus contracted to \$13 billion as imports increased (the August trade surplus was below \$16 billion).

Figures on September foreign trade volumes have yet to be released. The August figures, however, confirm the view that growth in domestic demand and investment is propping up China's imports. The volume of imports grew on-year for the third consecutive month (June to August), with growth in August climbing to 4 % y-o-y. The volume of exports, on the other hand, has fallen steadily since last November (down 16 % in August). The freight volumes at Chinese ports collapsed late last year and early this year in the wake of the global economic slowdown. Freight shipments at ports recovered in the spring, and since May have been well above the levels at the start of the year.

The value of China's exports to the EU in September contracted 17 % y-o-y. Exports to Japan shrank 9 % and exports to the US were down 14 % (corresponding figures for August: -27 %, -20 % and -22 %, respectively). China's imports from advanced economies have picked up. The value of imports from the EU climbed nearly 8 % y-o-y in September. The value of imports from the US and Japan fell slightly.

China's foreign trade



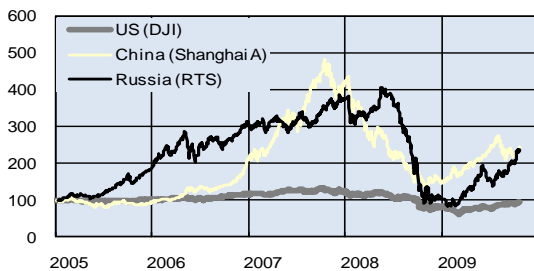
Source: China Customs

Russia

Russian stock market up, rouble exchange rate strengthens. Even with a dip this summer, share prices tracked by the Moscow Stock Exchange's RTS index have solidly recovered since the start of the year, when the index began to claw its way back from lows in the wake of the 2008 financial meltdown.

The rising trend reflects the return of liquidity to international financial markets, which has lifted share prices in Russia and other emerging markets. Russian share prices have further buoyed by higher crude oil prices and rouble appreciation.

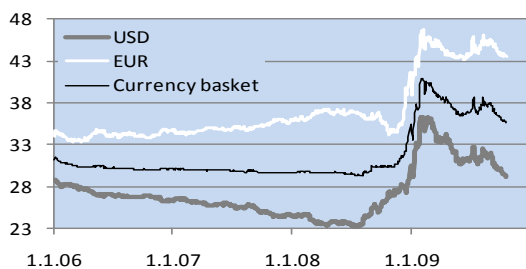
Comparative performances of Russia, China and US benchmark share indexes (Jan. 1, 2005 = 100)



Source: Bloomberg

The CBR embarked last November on a controlled devaluation of the rouble. Since the operation ended in February, the rouble has rallied about 12 % against its euro-dollar currency basket. On Friday (Oct. 23), the exchange rate stood at 29.09 roubles to the dollar and 43.57 roubles to the euro.

Rouble rate vis-à-vis euro, dollar and currency basket



Source: Central Bank of Russia

Economic crisis subdues Russian inflation. Consumer prices rose still 0.6 % m-o-m in June and July, but were unchanged in August and September. Consumer price inflation was just 10.7 % y-o-y in September, the smallest 12-month change since October 2007.

12-month change in consumer prices, %



Source: Rosstat

Russia reverts to solo approach in WTO talks. Last week Russia, Belarus and Kazakhstan for the first time negotiated with WTO in Geneva their accession as a customs union. After the negotiations, however, the three countries announced they were abandoning their efforts to enter the WTO as a customs union. They will now continue accession talks separately, while still trying to coordinate accession schedules and membership conditions (particularly with regard to import duties). The move should speed up negotiations for Russia and Kazakhstan, which both have largely resolved their membership issues. Belarus, in contrast, must still hold talks on many issues.

Until last summer, the three countries had been negotiating their entries separately, but prime minister Vladimir Putin confused the situation with his announcement that the countries intended to enter the WTO together as a customs union. President Dmitri Medvedev then backed off a bit from the plan in July. It now appears the initiative is dead.

The different approaches may result from the fact that WTO membership remains a controversial topic for Russians, and even more so since the economic crisis hit. WTO membership was officially embraced by Russia's political leaders in the early 2000s, but has always had its detractors from across the political and business spectrum. As negotiations dragged on for years, WTO membership gradually lost its sheen. Trade policy discussion today is more concerned with protecting domestic industries than gaining global market share. Russia's talks have been near the finish line for several years, so technically Russia could wrap up its WTO talks in short order. The biggest issues outstanding are export tariffs on raw timber and agricultural subsidies.

A proposed hike in the export tariff on raw timber may again be put off a year on the recommendation of a foreign trade policy commission led by first deputy prime minister Mikhail Zubkov. Initially, the plan was to raise the export tax introduced in 2008 from €15 per cubic metre of raw timber to €50 at the start of 2009. Due to the economic crisis, the hike was delayed. Russia's political leaders appear unanimous at the moment on implementing the hike, despite opposition from various actors involved in the forest industries sector.

China

China's GDP growth accelerated in third quarter. Real GDP climbed 8.9 % y-o-y in the July-September period, up from 7.9 % growth in the second quarter. In addition to China's characteristic growth in industrial output, growth in the service sector was also robust. In the first nine months of the year, economic output rose 7.7 % y-o-y, suggesting that the government's target of 8 % GDP growth for 2009 – once considered ambitious – will now be met.

Growth in industrial output also picked up with production rising nearly 14 % y-o-y in real terms in September (industrial output growth was just over 12 % y-o-y in August). However, profitability of industrial enterprises contracted in the first eight months of the year compared to the same period a year earlier due to the global financial crisis. Real growth in retail sales remained steady in the third quarter. Growth in the first nine months of the year was 17 % y-o-y.

Demand-side growth this year has been sustained largely by fixed asset investment. The growth in capital investment is a consequence of the fiscal stimulus' focus on improving infrastructure. In the first nine months of the year, fixed asset investment climbed over 33 % y-o-y in nominal terms, and growth in spending was equally as fast in the countryside as in cities. A current challenge for policymakers is to encourage private sector investment in addition to the current strong increase in public investment. Recent recovery in investment in the real estate sector may suggest private investment is reviving.

Strongest growth in both fixed asset investment and industrial production has been experienced in China's economically less developed western regions. This suggests that the government's fiscal stimulus policies have largely succeeded, at least in the short run, in reducing China's regional economic disparities.

Deflationary episode appears to be ending. The acceleration of economic growth and huge expansion of bank lending seem to have decreased deflationary pressures. There are now signs inflation is re-emerging.

Although consumer prices in September were still 0.8 % lower than a year earlier, prices rose month-on-month in both August and September.

Producer prices in September were still 7.0 % lower than a year earlier, however, but fell slightly less than the 7.9 % y-o-y registered in August. China does not release month-on-month changes for producer prices, but other indicators for industrial prices suggest prices have been relatively stable for several months now.

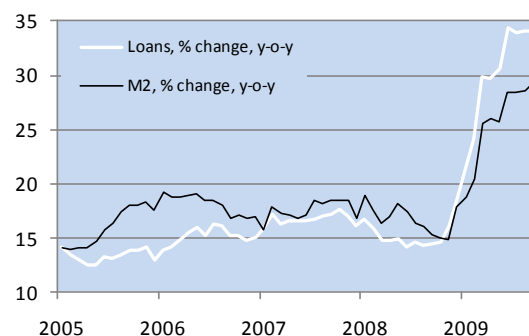
Volume of new bank lending continues to expand rapidly. Banks granted new yuan-denominated loans worth a total of 517 billion (€50 billion) in September – a higher level of lending than in July or August. Bank lending has grown at a rate above 30 % y-o-y since May. The rapid growth in lending has been driven by economic stimulus package, which instructed state-owned commercial banks to take a leading role in promoting infrastructure investment. Lending to households, however, has also expanded rapidly.

Driven by the rise in bank lending, the broad money supply (M2) grew more than 29 % y-o-y in September. This figure was closely matched by growth in bank deposits (28 % y-o-y). The People's Bank of China has set a target of 17 % M2 growth for 2009.

The significance of increased bank lending in supporting economic growth largely reflects the heavy emphasis on banking in the Chinese financial system. Studies show the two most significant sources of finance for fixed asset investment of Chinese firms are bank loans or self-fund-raising. Self-fund-raising includes the use of off-budget funding from local governments, retained earnings, increases in equity capital (in the case of exchange-listed companies), as well as the strategy favoured by small entrepreneurs – borrowing money from friends and relatives. The reliance on self-fund-raising is quite common among small and medium-sized enterprises, which, as a rule, have limited access to bank loans compared to big firms.

Measured in terms of Tier 1 capital, Asia's four largest banks are based in China. They are the largely state-owned commercial banks created during economic reforms, when state bank functions from the era of the command economy were divvied up among the new entities. Industrial and Commercial Bank of China ranks first in Asia in terms of Tier 1 capital and is the world's eighth largest bank. India's largest bank, the State Bank of India, is Asia's 11th largest bank and 64th in world rankings.

Growth in bank lending and broad money supply (M2), % y-o-y



Source: People's Bank of China

Russia

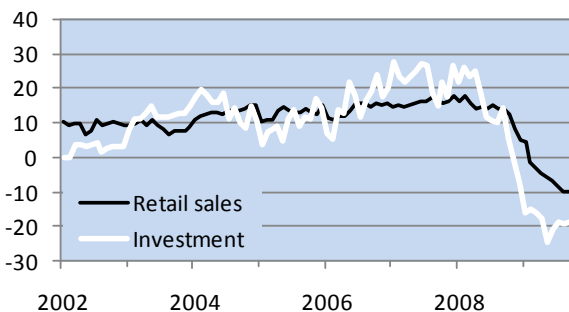
No definite signs of economic recovery yet. Preliminary figures from Russia's economy ministry show the on-year contraction in GDP slowed in September to a loss of 8.6 % y-o-y. In August, the Russian economy was still contracting 10.5 % y-o-y. Seasonally adjusted GDP, however, has grown slightly on-month since June. The drivers of growth are largely in the agriculture and manufacturing sectors.

Rosstat says that industrial output in September was down 10 % y-o-y. Construction fell 18 %, freight transport 6 % and retail sales 10 %. According to the economy ministry's seasonally adjusted figures, industrial output returned to on-month growth in June, even as economic contraction continued in other sectors.

Agricultural output in September was up 7 % y-o-y thanks to such factors as a bumper grain harvest.

The on-year decline in fixed capital investment slowed somewhat, even if the decline was still substantial. In September, fixed investment was down 19 % from a year earlier. The economy ministry noted that the seasonally adjusted contraction in fixed investment came to a halt in September.

12-month change in fixed investment and retail sales, %



Source: Rosstat

The drop in real disposable incomes continued in September both on month and on year. Real incomes in September were down 5 % from a year earlier. This was most apparent in retail sales, which showed their weakest performance since 2000. Consumers shifted to purchasing cheaper goods, and the relative share of consumer spending on food is again increasing. Food currently represents 49 % of the consumer shopping basket.

The unemployment rate has been fairly stable lately. Under ILO methodology, the unemployment rate has hovered around 8 % since early summer. Officials expect the employment situation to deteriorate further during the coming winter and hitting bottom sometime in the first half of 2010.

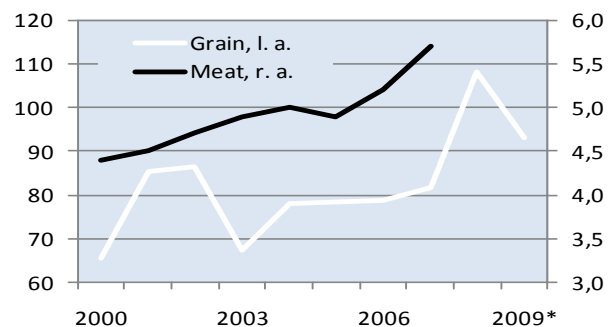
Good grain harvest this year. The agriculture ministry estimates the 2009 grain harvest will reach 93 million tons, making it the second largest harvest in this decade (although 15 million tons short of last year's record harvest).

The agriculture ministry said the grain harvest was surprisingly large given the dry summer, and, in fact, a grain glut appears to be driving grain prices down. The state last year purchased 8 million tons of grain from farmers to support market prices. Grain deliveries have yet to begin and the government has not started making its grain purchases for the year.

The trend to larger harvests has made Russia a major grain exporter, surpassed only by the US, Canada and the EU. Yelena Skrynnik, agriculture minister since January, reports that domestic grain consumption is presently about 77 million tons. Russia exported 23 million tons of grain in 2008 and this year hopes to export about 19 million tons. Moreover, Russia intends to eventually increase grain exports to a level around 50 million tons a year. Increased grain production will require more efficient production, an increase in the area of land under cultivation, and modernisation of equipment for handling and storage of grain (including a lack of silos for grain drying and storage, and inadequate transport equipment). Even with these challenges solved, harbour capacity is inadequate to deal with a big increase in grain export volumes.

Total production of beef, pork and poultry rose 7 % y-o-y in the first nine months of the year, while milk production remained at the 2008 level. Russia has long attempted to increase domestic meat production and reduce meat imports. The numbers of pigs, sheep and poultry kept in Russia has been on the rise in recent years. In 2008, the stock of these animals was larger than at the start of the 2000s. On the other hand, Russian cattle production remains in decline. Last year, the amount of cattle in Russia was 28 % lower than in 2000. The long term aim of Russia's agriculture policy is to increase food self-sufficiency. Meat production has received special attention as Russia was only 60 % self-sufficient in meat supply in 2008. Russia is 80 % self-sufficient in milk production, 58 % in sugar, 84 % in vegetables and 40 % in fruit.

Grain and meat production, millions of metric tons



Source: Rosstat

China

China's competitiveness improves as REER declines.

China's officials have kept the value of the yuan stable against the dollar since July 2008. Non-deliverable forwards contracts traded outside China already show an expectation of yuan appreciation against the dollar. On Wednesday (Oct. 28), the one-year forward price was below 6.7 yuan to the dollar, while the yuan's spot rate was 6.8 to the dollar. Several observers speculate that China will let the yuan to strengthen against the dollar as soon as recoveries in its main export markets take root. Over the past year, the yuan has lost value against several major currencies, including the euro, the British pound and the Australian dollar.

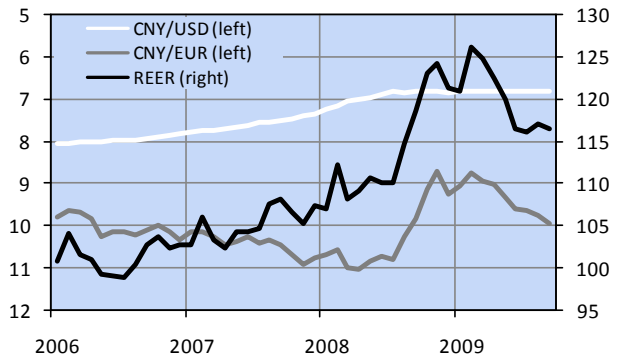
Due to the de facto peg to the US dollar, the yuan's nominal effective (trade-weighted) exchange rate, or NEER, has tracked the dollar's decline against other major currencies in recent months. The NEER has declined almost 9 % since March. In the same period, the real effective exchange rate (REER), which takes into account fluctuations in price and cost levels, has sunk nearly 8 %. Even with the deflationary episode of recent months, the decline in the effective exchange rate increases inflationary pressures by raising import prices. China's REER now stands at about the level of spring 2002. Economic theory says the REER of a developing economy should rise over the long run as it has the possibility to make relatively larger productivity gains and may sustain higher inflation rates than developed economies.

Effective exchange rates offer a broader picture of the impacts of exchange rate fluctuations on the economy than bilateral exchange rates. The REER is applied for measuring competitiveness. Effective exchange rates can also be used to estimate the impact of external shocks and to measure overall monetary conditions. Studies have evaluated the impacts of changes in the yuan's REER on China's trade surpluses with different trading partners. The impact is generally found to be small, however, due in part to the fact that a large chunk of China's imports are re-exported once assembly or finishing work is completed in China. As a result, exchange rate appreciation does not increase imports to the expected extent.

As the structure of a country's foreign trade is important in calculating the effective exchange rate, the currency composition must be adjusted from time to time to reflect the importance of individual trading partners. For example, the Bank of International Settlements (BIS) calculations of the yuan's broad effective exchange rate show a gradual decrease in the relative importance of trade with Japan between 1995 and 2005, while the importance of

trade increased for e.g. the UK, the US, Taiwan and the euro area.

Dollar-yuan, euro-yuan rates (inverted scale); yuan real effective exchange rate (rising trend shows yuan appreciation)



Sources: BIS, Reuters, Bank of Finland

Chinese share markets struggle to find direction. Since the market retreat in August, Chinese share prices have regained some ground. Between January 1 and October 28, share prices rose about 70 %. The total market capitalisation of companies listed on the Shanghai and Shenzhen stock exchanges is currently almost \$3.2 trillion (65 % of estimated GDP). The average price-to-earnings (P/E) ratio for companies included on the Shanghai A-share index currently stands at 26, up from 15 at the start of the year. The average P/E ratio of companies included in the Shenzhen stock exchange's A-share index has soared to 40, while the average P/E ratio for companies traded on the Hong Kong bourse is 17.

The uncertainty in China's stock markets partly reflects the fact that China's policy-makers are at a crossroads. On one hand, the acceleration in economic growth and re-emergence of inflationary pressures are signals that it may be time to tighten monetary policy – a move that throws cold water on share prices, and if the stimulus is withdrawn, it could kill off lending and depress asset prices. On the other hand, China's stock markets are still young, so trends in stock prices are influenced by a variety of factors related to reforms and development of the markets.

The development of Chinese stock markets has been impressive. The enthusiasm for investing in shares as a personal savings strategy remains strong – at least when measured by the rate at which new share accounts are being opened. So far this year, the number of new share accounts has increased by some 13 million to 137 million. Another sign of market evolution is the increase in tradable shares on the market; tradable shares now represent about 60 % of all total market capitalisation. A year ago, just a third of the total market capitalisation came from tradable shares.

Russia

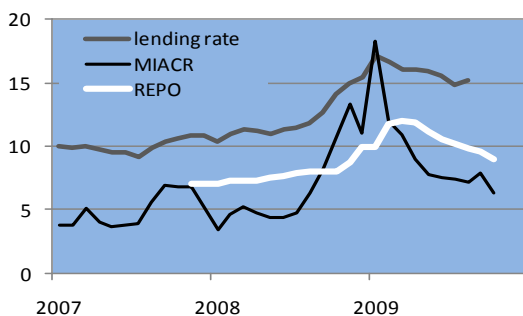
Central bank lowers interest rates for the eighth time this year. The Central Bank of Russia lowered its steering rates a half percentage point, effective October 30. One-day and seven-day fixed rate repos fell to 8.5 %, while the one-year repo went to 9.25 %. In a repo auction, one of the CBR's most important monetary policy tools, credit is granted against marketable securities. During the tight liquidity episode this year, the CBR started to accept a widened range of collateral securities and even provides credit to banks in exchange for non-marketable securities. Rates for credits up to 90 days involving non-marketable securities fell to 8.5 %, while the one-year rate went to 9.5 %. In addition to these instruments the CBR uses a wide variety of other instruments in its monetary operations.

The refinancing rate was dropped to 9.5 %. Despite its prominence, the refinancing rate only has administrative significance and is not used in central bank financing. A number of official payments and interest rates are tied by law to the refi rate. On October 29, CBR first deputy chairman Alexei Ulyukayev said that the central bank used too many different types of financial instruments with too many different maturities, so the CBR will try to reduce their number and thereby increase the transparency of its market operations. Ulyukayev further noted that any changes were likely to take place gradually.

The CBR justified its latest rate cut with the same arguments as earlier: slowing inflation and the need to provide support to domestic producers through easier access to financing. Despite earlier cuts in rates, banks have yet to show any increased enthusiasm for lending.

On-month inflation was zero in October, the third month in a row, which lowered the figure for 12-month inflation from 10.7 % in September to 9.7 % in October.

Average commercial bank lending rate, 7-day interbank rate (MIACR) and 7-day repo rate, % p.a.



Source: Central Bank of Russia

Russia has begun to attract short-term foreign investment again as its interest rates are higher than in many

countries. The growth in foreign currency flowing into Russia has caused the rouble to appreciate and forced the CBR into the market to buy up foreign currency to curb rouble appreciation. The CBR lowered rates with a view also to limit the on-shoring of short-term investment and preventing increased risk in the stock and forex markets.

CBR market operations increased the central bank's gold and foreign currency reserves to \$429 billion on October 23, the highest level this year.

Official report shows Russia deployed a diverse range of measures to help its finance sector. A recent report by the Russian government and central bank to the Duma shows the government moved swiftly when the international financial crisis hit last autumn.

The first support measures were already implemented in September 2008, when the finance ministry began to auction available budget funds as short-term deposits to banks to help them through a period of acute illiquidity.

In contrast to standard international practice, the central bank began to auction non-collateralised loans in October 2008. The CBR gave nearly 220 of Russia's larger banks the opportunity to participate. The stock of non-collateralised credits peaked in February 2009. The loans were initially offered for six months, but now the loan time has been extended up to a year. The CBR plans to phase out such lending as soon as the economy revives.

To help the interbank market, the central bank agreed with 18 largest commercial banks that it would cover up to 90 % of credit losses incurred on interbank loans. The popularity of the program has grown steadily; as of September, 370 banks had loans guaranteed by the CBR. The program is slated to end in December, but the CBR has proposed to the Duma a one-year extension. Under the program, the CBR has reimbursed one credit default.

In October 2008, 420 billion roubles (€10 billion) in oil tax revenues from the national welfare fund were invested in state development bank VEB. VEB, in turn, put 40 % of the money in domestic shares to support the stock market and invested the rest in commercial banks as 10-year capital loans to bolster bank capital adequacy and assure that banks resume lending. VEB has also received money directly from the federal budget for the same purpose. The state has also capitalised VEB.

In February 2009, the government decided that the state would guarantee loans to companies it regarded as important to the macroeconomy. 300 billion roubles were set aside in this year's budget for this purpose, with 200 billion roubles earmarked for civilian industries and 100 billion roubles for defence industries. So far, guarantees totalling about 220 billion roubles have been granted to over 80 firms. The system will be continued next year, but will be used to support investment projects rather than fund company operating costs as this year.

Next year's measures to support the finance sector will be specified as work on the budget proceeds in the Duma.

China

World Bank expects Chinese economic growth to accelerate slightly in 2010. The World Bank's latest *Quarterly Update* projects China's GDP will grow 8.4 % in real terms this year and 8.7 % in 2010. The World Bank lifted its economic growth forecast for 2009 by more than a percentage point from its July update. The new World Bank figure closely matches the IMF's projection for Chinese growth released at the beginning of October.

The World Bank update suggested China's massive stimulus package succeeded in increasing domestic investment demand to such an extent that it largely offset the loss of global trade. The World Bank expects the impacts of the stimulus to attenuate next year and the pace of investment growth to decline to more normal levels. Growth in domestic consumer demand will remain strong throughout 2010. The report also indicated that the global economy will only recover slowly, so China's export surpluses will remain approximately unchanged in 2010 from 2009.

The World Bank notes that broad money supply (M2) has expanded rapidly this year, a situation that typically foreshadows a pickup in consumer price inflation. Despite the M2 growth, however, the report only expects consumer price inflation to reach 2 % next year. Due to the global financial crisis, prices continue to be restrained by overcapacity in China and elsewhere.

In the medium-term, the World Bank update sees China's biggest challenge as rebalancing the economy by shifting emphasis from investment and exports to consumption and services. The report encouraged China to increase the use of measures to stimulate domestic consumption and the role of the service sector in the economy.

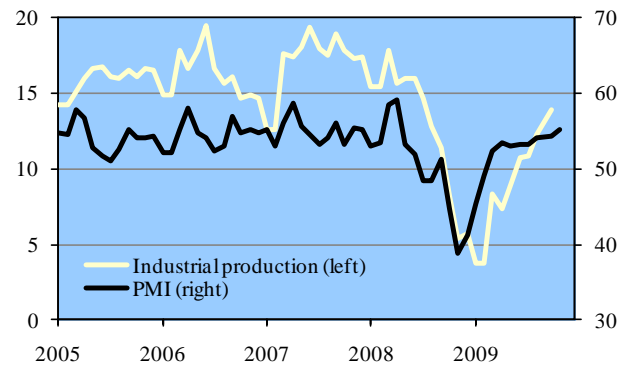
Purchasing manager index suggests economic recovery underway, but problems also mounting. China's official index of manufacturing purchasing managers (PMI), published by the China Federation of Logistics and Purchasing, showed a distinct jump in optimism from September to October. As the chart opposite shows, the PMI tracked the steady deterioration in economic conditions from October 2008 to February 2009. Since then, all PMI readings have been above 50, indicating improving industrial business conditions. The optimistic readings are backed by rising industrial output figures, which also suggest an economic resurgence.

While many indicators point to higher economic growth for China, the situation is somewhat precarious. Rapid growth in bank lending has fuelled higher prices in the real estate markets. According to some reports, supervisory officials suspect many real estate developers are

over-extended financially. Thus, a drop in real estate prices could lead to an increase in the stock of non-performing loans.

A number of branches in the industrial sector have long suffered from overcapacity, and recently these concerns have worsened. Steel prices, for example, have fallen since their August peak, and steelmakers now expect lower profitability to extend through the fourth quarter due to overcapacity problems.

CFLP purchasing manager index and on-year change in industrial output, %



Sources: CFLP, CEIC

Household incomes continue to rise. In the third quarter of the year, the nominal average disposable income was 1,440 yuan (€143) in cities and 480 yuan (€47) in the countryside. The disposable incomes of urban-dwellers rose 9 % y-o-y in nominal terms, or more than five percentage points less than in 3Q08. Given that inflation has slowed (and even turned to deflation), urban real incomes are currently rising at about 10 % a year, which is actually somewhat faster than last year. The rate of income growth is similar in rural areas. A quarterly survey of urban households recently found that average real wages are rising faster than last year.

Despite a drop in economic growth and rising unemployment, wages and disposable household income continue to climb at a surprisingly steady pace. Although the official figures for unemployment have only risen modestly, the degraded situation of migrant workers from the countryside has caused concern. Migrant workers, which provide a labour reserve for cities and act to smooth peaks in labour demand, have been forced to compromise on their wages. The National Bureau of Statistics has been accused of manipulating the income data to whitewash the situation. On the other hand, China's wage and income statistics do not include most migrant workers and the data on migrant worker employment are generally inconclusive.

Russia

Slowdown in construction sector continues. Rosstat figures show the volume of construction production declined 18 % y-o-y in January-September. The pace of fall in September was about the same as earlier in the year.

Even with the on-going slowdown overall, there are huge variations regionally and by the type of construction. The volume of residential housing completed in January-September was down less than 1 % from the same period in 2008. The main reason was that construction of detached houses and summer houses increased 6 % y-o-y. Their share of total completed residential housing was 55 %. Growth was concentrated in some of Russia's wealthiest areas such as the Moscow and Leningrad regions. In the Moscow region, 20 % more residential housing was completed than a year earlier. In the Leningrad region, the increase was 29 %. The enthusiasm for this type of construction reflects lower land prices and cheaper construction materials in the midst of recession.

The outlook for other types of housing construction is not yet bright. In the city of St. Petersburg, for example, new construction starts were down 16 % y-o-y in January-September. The drop was 3 % in the city of Moscow.

Analysts report demand in Moscow for new housing revived a bit this autumn, even though the amount of completed housing deals in October was still down 67 % from the pre-crisis level. The decline in housing prices continues. Prices fell 9 % in Moscow and 17 % in St. Petersburg from the start of the year. Moreover, buyers have benefited little from the price slide as their real disposable incomes have fallen accordingly while interest rates on housing loans have increased and access to loans has become more difficult.

Banks still not lending, larger firms turn to bond issues to raise money. The Central Bank of Russia reports that the stock of corporate borrowing rose by 200 billion roubles (€4.5 billion) in January-September, a nominal rise of 2 %, i.e. the loan stock contracted in real terms. As in other countries, banks in Russia are cautious about lending due to high credit risk exposure. Russian banks are no longer experiencing liquidity problems, however, and household deposits have risen nearly 14 % since the start of the year, i.e. about the same amount as a year earlier.

With the financial crisis, the significance of bond issues as a source of finance for large corporations has increased in both Russia and elsewhere. In the first nine months of 2009, Russian firms issued rouble-denominated bonds worth 650 billion roubles (€15 billion), up from 470 billion roubles in bonds in all of 2008. State railways corporation RZD and state oil pipeline operator Transneft have been the largest bond issuers this year. To date, issuers

have had no problem finding investors, but the situation could change when the Russian state begins to issue bonds to cover federal budget deficits next year.

Russian firms issued \$9.4 billion in international bonds during the first nine months of the year – 15 % of all corporate bonds issued on international markets in the period.

Nord Stream pipeline project moves ahead. Last Thursday (Nov. 5), Nord Stream, the natural gas pipeline project of Gazprom and three European energy companies, received tentative go-aheads from the Finnish and Swedish governments to run the pipeline through their economic zones. The Danish government granted permission in October. From Finland's perspective, construction work still needs a permit from the Western Finland Environmental Centre under Finland's Water Act. Permits from German and Russian officials are also outstanding. Nord Stream's twin pipelines will be buried in the Baltic seabed, running 1,220 kilometres from Portovaya Bay near Vyborg to Lubmini in the Greifswald region of Germany. The pipelines will eventually have a transmission capacity of 55 billion cubic metres a year. The company's goal is to have the first pipeline, with a capacity of 27 billion cubic metres a year, ready in 2011.

Gazprom is also planning a South Stream gas pipeline project with the Italian ENI. The pipeline would traverse the bottom of the Black Sea from the Krasnodar region of Russia to Varna, Bulgaria. The plan calls for branching the pipeline in Bulgaria; the northern branch would extend to Austria and southern branch to Italy via Greece. South Stream has a planned annual capacity of 63 billion cubic metres a year. While a project schedule has yet to be set, prime ministers Vladimir Putin and Silvio Berlusconi agreed to accelerate the project at their meeting in St. Petersburg at the end of October.

Gazprom gas supplies to EU clients in recent years have averaged around 150 billion cubic metres a year, i.e. about 25 % of EU total natural gas consumption. About 80 % of Gazprom's gas supplies to Europe is transmitted by pipeline via Ukraine. In the first eight months of this year, however, Russian gas exports were down about 30 % y-o-y. The drop in gas supplies reflects both diminished demand and the current relatively high price of piped Russian gas. The price of gas transmitted by pipeline is based on long-term supply contracts tied to oil prices. The price of liquefied natural gas (LNG), in contrast, is determined by the spot market. At the moment, LNG from other countries is cheaper than Russian gas and has eaten into Gazprom's market share in Europe.

Gazprom controls Russia's pipeline grid and has the sole right to export gas from Russia. Other gas producers (independent gas producers and oil companies that produce natural gas as a byproduct) must ship their gas via Gazprom pipelines.

China

China raises fuel prices. China's National Development and Reform Commission hiked prices of gasoline and diesel by 480 yuan (€47) per ton in all provinces of China. The price hikes went into effect on Tuesday (Nov. 10). The current ex-refinery wholesale price of gasoline is 7,100 yuan (€695) a ton, a nearly 7 % increase from the older price. The average wholesale ex-refinery price of diesel fuel rose to 6,360 yuan (€622) a ton, and on Tuesday the price of diesel was about 8 % higher than earlier. China's regulated retail fuel prices vary from city to city, and prices are affected by such factors as transport distance. In Beijing, the current retail price of 90-octane gasoline is 5.98 yuan (€0.58) per litre.

The timing and extent of the Chinese fuel price adjustment was determined on the basis of the pricing scheme introduced at the start of this year. Under the new scheme, adjustment of retail prices must be considered whenever the world market price of crude oil shifts more than 4 % during 22 consecutive workdays. This year prices were raised four times and lowered three times. With this eighth adjustment, November on-year consumer price inflation is expected to increase by about 0.12 percentage point.

The price hike is designed to protect the profit margins of Chinese oil refiners when the price of crude oil rises. Following the hike, share prices for Chinese oil refiners rose on both the Hong Kong and Shanghai stock exchanges. China notes the purpose of price regulation is to secure fuel supplies. The higher prices should also encourage consumers to conserve energy.

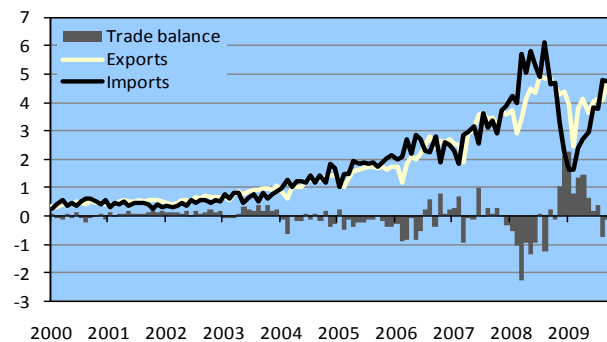
China promises more cheap loans to African countries as it builds trade relations. Every three years since 2000, China and African states meet. The latest get-together, which included representatives from nearly 50 African states, was held last weekend in Egypt. At the meeting, China's premier Wen Jiabao promised the continent ten billion dollars in preferential loans over the next three years. China also committed to technical assistance, mainly in the areas of agriculture and construction. China promised to forgive old loans to the poorest and most heavily indebted countries and remove import tariffs on products from the poorest countries. At the previous Sino-African summit in 2006, China granted \$5 billion in cheap loans.

Africa's share of China's foreign trade is relatively small and concentrated among a few countries. Most Chinese imports from Africa are raw materials. The value of Chinese exports to Africa last year was \$50 billion (3 % of total exports). About 40 % went to Egypt, South Africa and Nigeria. China's imports from Africa last year totalled \$55

billion (5 % of total imports). Angola accounted for nearly 40 % of imports and South Africa, Sudan, Congo and Libya together accounted for another 40 %.

Although Chinese imports from Africa were hard hit when the financial crisis hit last year, exports to Africa suffered a bit less. The global collapse of commodity prices last autumn underlies the decline in the value of imports. Since spring, China has boosted its commodity import volumes and commodity prices have begun to recover. China's imports from Africa have bounced back accordingly and China is again beginning to run a net trade deficit with its African trading partners.

China-Africa trade, US\$ billion



Source: China Customs

Chinese foreign direct investment in Africa, while modest, has increased rapidly in recent years. China's trade ministry reports that Chinese FDI in Africa last year amounted to \$5.5 billion, or 10 % of Chinese overseas FDI. Of this amount, nearly \$5 billion came from the acquisition of a 20 % stake in the South African Standard Bank by ICBC, China's largest commercial bank. Outside South Africa, Chinese investment has focused on oil-producing countries: Algeria, Nigeria and Sudan. China is also planning a \$7-billion investment in bauxite mines in Guinea. The FDI figures from China's trade ministry do not fully distinguish among countries. For example, it is known that Angola has enjoyed Chinese investments.

Problems have emerged as Chinese activity in Africa has increased. The international community has characterised China's engagement as neo-imperialist and has been particularly critical of its cooperation with political pariahs like Sudan. Moreover, African partners are often disappointed in Chinese companies, which bring in a large share of their workforce from China rather than hiring locals. On the other hand, local operating practices and those of Chinese firms can differ radically. Even the Chinese workers that have been shipped out to Africa find themselves disappointed by promises of their Chinese employers. In 2008, the Chinese media reported a number of cases where Chinese workers in Africa held protests against their Chinese employers.

Russia

Experts say bottom of recession probably past in Russia. The latest World Bank forecast sees Russian GDP contracting 8.7 % this year and returning to 3.2 % growth next year. The economic recovery is predicated on revivals of the global economy and international financial markets, as well as a relatively high crude oil price. On the other hand, growth is limited by Russia's weak domestic demand and tight domestic credit markets. The World Bank pointed out that its forecast is subject to risks from international uncertainties.

Similar growth expectations appear in the latest Russia forecast from the European Bank for Reconstruction and Development's *EBRD Transition Report*. The OECD's fresh *Economic Outlook* puts 2010 growth at almost 5 %. The Russian economy ministry is also preparing a revised economic forecast. Deputy economy minister Andrei Klepach said he now expects GDP to rise next year 3–3.5 % if the oil price stays at or above \$60–70 a barrel. BOFIT's September forecast sees Russian GDP growth reaching 3 % next year.

Rosstat preliminary figures find GDP growth in the third quarter down about 9 % from 3Q08. The rate of decline, however, slowed from earlier quarters; the Russia economy contracted 10 % y-o-y in the first quarter and 11 % in the second quarter. In the third quarter, GDP rose 14 % q-o-q, although seasonally adjusted growth was estimated at about 1 %.

Rosstat's latest figures also show, however, that industrial output contracted 11 % y-o-y in October. This suggests the recovery remains shaky as the contraction in industrial output actually accelerated slightly last month.

Medvedev's state-of-the-nation speech once again stresses need to move ahead with reforms. President Medvedev covered a wide range of current governmental and social issues in his state-of-the-nation speech to the Russian parliament last Thursday (Nov. 12). He repeated his earlier calls for strengthening democracy, development of the judicial system, as well as modernisation and increased operational efficiency in the public and private sectors. The twin pillars of Russia's future economy involve creation of an environment that fosters innovation and advancement of technology. High technology will be promoted through state-backed initiatives, especially in the pharmaceuticals industry, energy production, and information and space technology.

Medvedev said he wanted to limit the role of the state in the economy. As a concrete measure, he mentioned phasing out the special status granted to large state corporations created during the Putin presidency in 2007. He

also called for revising the organisational format of these companies.

Early last week, the Prosecutor General's office submitted its report on state corporation performance to president Medvedev (see [BOFIT Weekly 38/2009](#)). Of the seven corporations, only one (nuclear power monopoly Rosatom) escaped criticism. Others earned warnings for e.g. weak governance, misappropriation of assets and bid-rigging.

Medvedev chief economic policy advisor Arkady Dvorkovich announced that state development bank VEB, high-tech investment fund Rusnano and the Rostekhnologii consortium will be converted to state-owned share corporations next year. The Housing and Municipal Services Development Fund will be phased out in 2012 and Olimpstroj, the company overseeing construction projects for the 2014 Sochi Olympics, will be wound down after its mission is completed. Rosatom and the Deposit Insurance Agency will retain their current organisational formats due to their special missions.

Russian car industry staggered by GM's decision to scrub Opel sale. At the beginning of November, General Motors overturned its September decision to sell a 55 % stake in Opel for €500 million to a consortium consisting of Canadian car parts manufacturer Magna and Sberbank, Russia's largest state-majority bank (see [BOFIT Weekly 38/2009](#)). Magna is a global leader in parts supply for the car industry. In 2007, Russian oligarch Oleg Deripaska, whose holdings include GAZ, Russia's second-largest carmaker, acquired an 18 % stake in Magna. Thereafter, Magna participated in modernisation of GAZ production facilities. A year ago, however, Deripaska had to sell off his stake in Magna after he ran into money problems.

The cancellation of the deal was especially disappointing for Russia, which hoped to modernise its domestic car industry with state-of-the-art technology from Opel. Russia apparently also envisaged the deal helping to attain the strategic goal of reorganising the country's struggling car industry as a whole. Not only GAZ, but other firms such as the country's largest carmaker AvtoVAZ, could have produced Opels.

Before GM announced it was cancelling the sale, Magna and Sberbank prepared a detailed reorganisation plan for Opel. At the moment, Magna is in talks with GM on how it will be compensated for the money and resources used. According to newspaper reports, Magna could claim as much as €100 million in reliance damages. Sberbank is also considering claiming compensation. Chairman German Gref said, if needed, the bank was ready to go to court to recover its costs. The Russian government has no plans at the moment to get involved in the matter, although prime minister Putin publicly decried the scrubbing of the sale. GM claims it did not break any commitments to its partners.

China

Industrial output rose in October. Chinese industrial output increased 16 % y-o-y last month. Compared to September, the pace of growth accelerated slightly and appears to be returning to pre-crisis levels. In November 2008, industrial output growth was just 8 %.

Fixed capital investment rose 33 % y-o-y in nominal terms in the first ten months of the year. Closer inspection of the headline figure for fixed investment reveals a change in its structure. Construction investment was rising at just 3 % y-o-y early in the year, down from 31 % for all of 2008. By the end of October, growth in construction investment had accelerated to about 16 % y-o-y. Fixed investment by state-owned enterprises rose at nearly 40 % in the first ten months of the year. The central government response to the fallout from global economic crisis was in full swing by the start of 2009 with growth in fixed capital investment rising to 40 %. By October, however, central government fixed investment growth had subsided to 19 %. Fixed investment by regional governments only accelerated significantly in the second quarter of 2009, and growth in January-October was 35 % y-o-y. As a result, most investment growth is still driven by central and regional governments or investment by state enterprises.

Retail sales in October were up in nominal terms 16 % y-o-y. While this was a bit less than in October 2008, it was higher relative to September. Retail sales increased about 17 % y-o-y in real terms. Consumer price inflation was down 0.5 % y-o-y in October, but the decline in prices has decelerated. Household assets were boosted by a 4 % y-o-y rise in housing prices in October. Producer prices continued to fall (down 6 % y-o-y), although the rate of decline was considerably less than in previous months.

Obama visit to China matches expectations. US president Barack Obama arrived in China on Sunday (Nov. 15) as part of his eight-country tour of Asia. During his first official visit to China, Obama met with president Hu Jintao and premier Wen Jiabao.

The meeting agenda covered trade policy, China's exchange rate policy, mutual goals at the upcoming Copenhagen climate summit, as well as discussions on North Korea, Afghanistan and Iran. Obama reiterated the US wish for greater flexibility in the yuan's exchange rate. He also emphasized the importance of respecting human rights and uncensored internet access. Despite disagreements between the parties on many issues, especially in the area of trade policy, both parties were polite and congenial in public, keeping their comments on major issues at a general level.

In talks on specific economic issues, the *South China Morning Post* reports discussions included the possibility of increasing investment of Chinese banks in small and medium-sized American banks. If permitted, such investment would represent a shift from current reserved US policy.

International pressure for yuan appreciation continues to increase. After China officially ended its dollar peg of the yuan in summer 2005, the yuan was allowed to appreciate about 20 % against the dollar. Since the global meltdown hit in summer 2008, however, Chinese officials have held the yuan's exchange rate at US\$ 1 = 6.8 yuan. As the dollar depreciation this year proceeded, the yuan's exchange rate dropped in relation to other currencies even as the Chinese economy enjoyed more robust growth than the rest of the world.

Although president Obama kept his public comments modest on the need for a shift in Chinese exchange rate policy during his visit, the closed discussions with his hosts may have been more heated. Within the United States demands for yuan appreciation are increasingly shrill. For example, Nobel economist Paul Krugman has raised the issue several times recently in his column in the *New York Times*, bluntly accusing China of manipulating its currency at the expense of other low-income countries and demanding that the US take action to deal with the problem.

Other Asian countries have also begun to criticise China's "beggar-thy-neighbour" exchange rate policy. At last week's Asia-Pacific Economic Cooperation (APEC) summit, finance ministers called for market-based exchange rate regimes. The declaration was a direct reference to China as many of the 21 APEC members are currently struggling with over-appreciation of their currencies and looked on helplessly as the yuan has depreciated along with the dollar. Other large developing countries in the G20, particularly Brazil and Russia, would also like to see a stronger yuan as it would take appreciation pressure off their currencies. The IMF has publicly called for China to let its currency appreciate.

China's decision-makers until recently stressed the importance of a stable exchange rate as a reason for refusing to let the yuan appreciate. Now, however, current circumstances increasingly call for a flexible exchange rate regime rather than a peg as it would facilitate better control over monetary policy and promote development and improved functioning of China's financial markets. New language used in the third quarter monetary policy report of the People's Bank of China may suggest a shift in exchange rate policy is already underway.

Based on current prices of yuan forward contracts (NDF), markets expect the yuan to appreciate 3–4 % against the dollar next year.

Russia

Duma approves 2010 federal budget. Total revenues and spending of the budget approved by the Duma last Friday (Nov. 20) were identical to the budget proposal submitted by the government to the Duma in September (see [BOFIT Weekly 41/2009](#)). The spending emphasis, however, was shifted somewhat according to government's own proposal. The most significant change was a reduction in crisis support provided to banks; capital credits available were cut from 250 billion roubles to 100 billion roubles after banks showed only mild interest in the credits as the terms compelled them to increase lending at a time when they are largely averse to lending.

Some 125 billion roubles of the resulting savings will be transferred to a crisis fund that the government can allocate from if necessary without first getting permission from the Duma. The remaining 25 billion roubles will be spent. Some 10.5 billion roubles will be used to conduct the census, which the government last summer announced to postpone in order to cut expenditure. A harsh backlash from experts forced the government to abandon its decision.

Total federal budget revenues next year will amount to 7 trillion roubles (€163 billion) and expenditures 9.9 trillion roubles (€231 billion). The deficit amounts to 6.8 % of GDP. The budget calculations assume an average price of \$58 a barrel for Urals crude, real GDP growth of 1.6 % in 2010 and 8 % inflation. The exchange rate is expected to average 33.9 roubles to the dollar next year.

The assumptions about the crude oil price and GDP growth appear somewhat conservative in the current light. The aim of the cautious approach is to keep spending in check.

Budget spending next year declines in real terms in nearly all budget categories.

Federal budget expenditures 2009 and 2010 (RUB billion, nominal percentage change from previous year)

| | 2009 | | 2010 | |
|---------------------------------------|--------|----|--------|-----|
| | RUB bn | % | RUB bn | % |
| Public administration | 959 | 14 | 1,187 | 24 |
| Business | 1,846 | 80 | 1,347 | -27 |
| Defence | 1,212 | 16 | 1,253 | 3 |
| National security and law enforcement | 1,006 | 20 | 1,062 | 6 |
| Social policy | 331 | 13 | 329 | -1 |
| Education | 413 | 16 | 399 | -3 |
| Health care | 348 | 25 | 333 | -4 |
| Culture | 115 | 29 | 108 | -6 |
| Housing | 143 | 10 | 138 | -3 |
| Environment | 13 | 30 | 12 | -8 |
| Transfers to other budgets | 3,545 | 33 | 3,719 | 5 |
| Total | 9,931 | 31 | 9,887 | 0 |

Source: Ministry of Finance

CBR contemplates new measures to limit inflows of foreign currency into the country. The Central Bank of Russia and the government are concerned about the instability caused by a surge in short-term speculative capital into the country. Most worrisome is the possibility that Russian firms and banks would again begin to borrow from abroad on a massive scale.

CBR deputy chairman Alexei Ulyukayev said last week that the central bank could begin to limit loan taking by applying above-average reserve requirements on foreign borrowings and limiting the size of open foreign currency positions. The government could start monitoring the foreign borrowing of state enterprises. The central bank, however, has no plans to get involved with direct regulation of capital movements.

The growing influx of foreign currency into Russia has fuelled rouble appreciation. The CBR intervened in the market to limit the appreciation with purchases of \$16 billion in foreign currency in October and \$6 billion in the first half of November. As of mid-November, the CBR's foreign currency reserves had increased to \$442 billion.

Last Thursday (Nov 19), Ulyukayev announced the CBR had imposed a new, narrower fluctuation band on the rouble relative to its dollar-euro currency basket. The CBR intervenes to keep the rouble within this band. The new ceiling and floor of the band are 35 and 38 roubles. The band can be changed as the situation demands. The wider fluctuation band, imposed last January, also stays in force. It has limits of 26 and 41 roubles.

On November 25, the CBR again lowered its refinancing rates by 0.5 percentage point. The minimum rate of the CBR's most important financial instrument, a one-day repo credit, now stands at 6.25 %. The change is intended to promote recovery of the credit markets and reduce differences between foreign and domestic interest rates in order to relieve appreciation pressures on the rouble.

Russia declares its interest to join WTO as soon as possible at EU-Russia summit in Stockholm on November 18. So far it has been unclear how Russia plans to join the WTO as it simultaneously continues work on a customs union with Kazakhstan and Belarus, which is expected to impede Russia's WTO accession. President Medvedev announced that Russia will choose the fastest track to membership – with or without its fellow customs union members. Medvedev stated that creation of the three-country customs union has put pressure on the EU to push for Russia's membership.

From the EU's standpoint, one of the top summit issues was European energy security. Just before the Stockholm meeting, Russia and the EU signed a document that committed the parties to give adequate warning ahead of any possible interruptions in oil, gas or electricity supplies. In particular, the agreement is important in securing information on gas flows via Ukraine to Europe.

China

Several branches suffering from overcapacity. Many of China's industrial branches that have traditionally suffered overcapacity problems, particularly cement and steel production, continue to do so. Officials this week announced a suspension on construction of cement plants. The government earlier this autumn declared no new steel smelter projects would be approved during the next two years. Officials report overcapacity persists in many other industries too, including aluminium, glass, silicon, wind turbines and shipbuilding. A recent report by the European Union Chamber of Commerce in China notes significant overcapacity exists also in chemicals production and oil refining.

Although China has struggled for years to restrict investment in branches plagued by overcapacity, the measures applied have largely failed as the problems keep recurring in the same branches where official measures are applied. Overcapacity, by definition, constitutes a waste of economic resources, but the resulting low prices also improve international price competitiveness of Chinese products.

China-Taiwan relations continue to improve. Relations have thawed rapidly since Taiwan's current president Ma Ying-jeou took office in May 2008. The rapprochement continued this month on a number of fronts. This week, for example, the Taiwanese government announced it was abandoning claims to territorial waters surrounding its two outmost islands in the South China Sea between China and Taiwan. The islands, Kinmen and Matsu, which lie just a few kilometers off the mainland, remain under Taiwanese control.

In November, Taiwanese universities announced plans to allow mainland Chinese to study in Taiwan. Although the plan still needs parliamentary approval, the operation is expected to begin already next year. The Taiwanese have long been allowed to study in universities in mainland China.

China and Taiwan this month signed memoranda of understandings, which are designed to open up operations of financial institutions and insurance agencies in both areas. The agreements focus on increasing official cooperation and are non-binding. Moreover, a number of significant restrictions will remain in place. While the agreements represent a major opening, they are viewed carefully, especially in Taiwan. The relatively small domestic actors in Taiwan's banking sector fear mainland China's giant state-owned banks will occupy the field.

The two regions are expected to sign the wide-ranging Economic Cooperation Framework Agreement next year. While the details of the agreement have yet to be released,

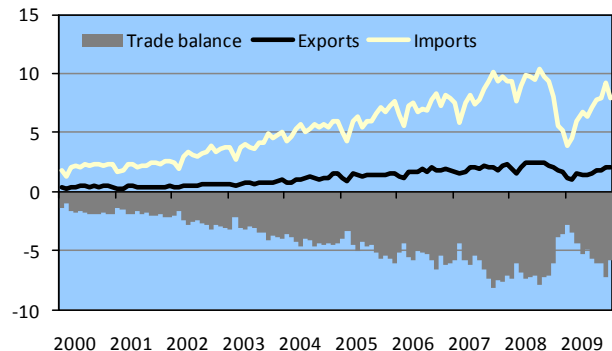
president Ma has said it will be designed to free up trade in goods and services, as well as promote capital flows.

Despite political opposition and limits on direct interaction, China and Taiwan have been economically tied to each other for decades. At the end of 2007, Taiwanese firms ranked fifth as providers of foreign direct investment to mainland China (after Hong Kong, the Virgin Islands, Japan and the United States). The possibilities for mainland Chinese to make direct investments in Taiwan remain modest, but the situation has improved this year.

After a 60-year break, direct air travel routes were established between Taiwan and the mainland last year. Previously, anyone flying between the two areas had to travel via a third country, usually Hong Kong. Sea travel between Taiwan and mainland China is also on the rise and mainland Chinese tourists have now better possibilities to visit the island.

Taiwan's export-driven economy suffered disproportionately when the international financial meltdown hit. However, the economy began to recover last spring as Taiwan's exports to China took off. China, by far, is Taiwan's main trading partner. About a quarter of Taiwan's exports go to mainland China and 13 % of imports come from the mainland. Last year, 9 % of mainland China's imports came from Taiwan and 2 % of exports went to Taiwan.

China's trade in goods with Taiwan, US\$ billion



Source: China Customs

China country risk barely changed in Euromoney rankings. The September *Euromoney* survey of country risk raised China's ranking one notch from spring. Of the 186 countries surveyed, China ranked 45. The country risk comparison has been published every spring and autumn since 1996, when China ranked 40th. Country risk is determined by looking at political risk, economic performance, the country's indebtedness, its creditworthiness and access of companies to financing.

In the most recent survey, Norway has the lowest country risk, with Finland in sixth place and Hong Kong at 22nd. Russia's ranking fell seven places to 56.

Russia

Russian federal finances better than anticipated. Federal budget tax revenues in 2009 have exceeded forecast largely due to the rebound in world oil prices. The 2009 budget assumed a Urals price of \$41 a barrel, when in fact its price has averaged close to \$60 a barrel.

Another, though less significant, factor affecting budget revenues has been improvement in tax collection. Tax inspectors have increased scrutiny of e.g. “one-day businesses” created to avoid taxes. The tax crack-down has also raised an outcry from firms over heavy-handed treatment from tax authorities.

The finance ministry has revised its estimate for the federal budget deficit this year to about 7 % of GDP, down from its original forecast for a deficit exceeding 8 % of GDP. Russia’s borrowing needs are reduced by the improved budget situation and generally brighter economic outlook. In summer, the government was still planning to issue \$18 billion in sovereign debt internationally next year. The borrowing needs now appear to be half that amount.

The federal budget consistently ran surpluses throughout the 2000s until this year.

Finnish exports to Russia continue to contract. In the first nine months of the year, the value of Russian exports to Finland amounted to €2.9 billion (9 % of Finland’s total exports in the period). Exports declined 49 % compared to a year earlier. The value of Finnish imports from Russia in January-September amounted to €5 billion, or 16 % of total imports. The value of imports fell 38 % y-o-y. Finnish exports to Russia continued to contract faster than Finland’s total exports, which were down 36 % y-o-y.

Russia’s imports from Finland in January-September slid more than Russian imports overall (down 43 % in the period). Finland has been losing market share slightly in Russia for the past few years. In the first nine months of 2009, Finland accounted for 2.4 % of Russian imports, down from 3 % in 2006.

With the rise in oil prices over the 2000s, Russia has climbed to the top three of Finland’s largest trading partners. The other top partners are Germany and Sweden.

As usual, machinery and equipment was the most important Finnish goods export category with 41 % in January-September. Paper products accounted for 9 % of goods exports to Russia.

Some 77 % of Finland’s imports from Russia were mineral products (mostly crude oil). Chemical products accounted for 6 % of imports, other raw materials (including sawn wood and timber) 5 % and iron and steel 8 %.

The lion’s share of imports from Russia are either unprocessed or only slightly processed goods.

The value of forest industry products imported from Russia fell over 60 % y-o-y in the period, bringing Russia’s share in Finnish forest industry products imports down to 24 %. In major part, the decrease was due to Russia’s decision to increase export tariffs on raw timber to €15/m³ in spring 2008 and plans to increase the tariffs ultimately to €50 /m³. In October, prime minister Putin said the planned hikes could be postponed until the end of 2012.

Road freight transport to Russia via Finland declined 55 % y-o-y both in volume and value terms in the first nine months of the year. In 3Q09, road freight transport was down 63 % y-o-y. The biggest drop was registered in transit shipping of cars, which was off 88 % y-o-y.

The Russian government this year has continued to pursue protectionist foreign trade policies. During January-September, the government approved about 30 increases in import duties. The increased tariffs apply to imports of e.g. cars, farm machinery and ferrous metals.

Russia-Belarus-Kazakhstan customs union enters into force January 1, 2010. The presidents of the three countries met in Minsk last Friday (Nov. 27) to sign documents establishing a customs union. The agreement calls for a six-month adjustment period to synchronise tariffs within the customs union. Most tariffs will match current Russian customs duties, so the other two member countries will adjust their customs rates to those of Russia.

Kazakhstan has the biggest adjustment ahead as it must raise tariffs on about 5,000 goods. One of the toughest issues for Kazakhstan will be hiking import tariffs on passenger cars. Russia has relatively high import tariffs on foreign cars to protect its domestic carmakers. Russia also has high export tariffs on crude oil – a major source of federal tax revenues. In contrast, Kazakhstan collects no tariffs on oil exports. There was no agreement on these tariffs at the meeting, rather the member countries agreed they will be discussed at a supranational commission of the member countries. Kazakhstan and Belarus expect the customs union to significantly accelerate their economic growth, which should compensate for any negative impacts from higher tariffs.

Meeting observers Kyrgyzstan and Tajikistan announced their interest in customs union membership, although no timetable for membership was discussed.

President Medvedev announced that an EU-type common economic zone – and even a common currency – will eventually evolve out of the customs union. There are plans to establish the common economic area in 2012. Belarus and Kazakhstan are eager to form a common economic area, while Russia favours a more relaxed pace.

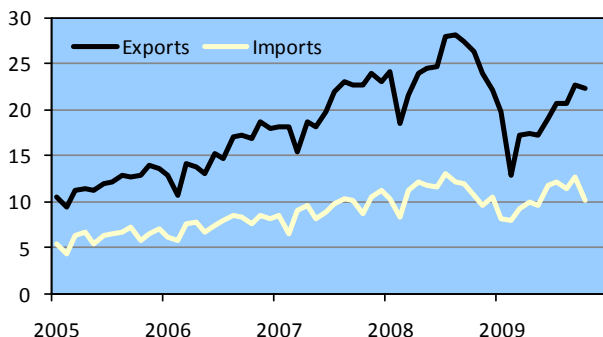
China

China rejects EU arguments for a stronger yuan. At Monday's (Nov. 30) EU-China summit in Nanjing, EU leaders failed to get understanding from their Chinese colleagues regarding European concerns over China's exchange rate policy. Chinese negotiators noted that, given the turbulence of the global economy, yuan stability is their top concern rather than any other aspects of foreign exchange policy. Indeed, China felt EU exchange rate worries were misplaced; their biggest concern at the moment should be the rise of protectionist sentiments. Just two weeks ago, US president Barack Obama departed Beijing with little to show from his first official visit to China. With the Copenhagen climate summit just around the corner, climate change was also a major theme at the EU-China talks.

For more than a year, China has pegged yuan to the dollar (at a rate of 6.83 yuan to the dollar), which has resulted in additional problems in Europe as the dollar has weakened. The yuan-euro rate peaked in mid-February at 8.6 yuan to the euro. Thereafter, the yuan rigidly tracked the dollar's decline of 16 % against the euro. The current yuan-euro rate is about 10.3. China stands alone in defending its fixed exchange rate policy. The vast majority of experts and international institutions note that both China and the rest of the global economy would benefit from allowing greater flexibility in the yuan's exchange rate.

The EU is China's most important trading partner, accounting for a fifth of China's entire exports and 13 % of total imports. Chinese figures show January-October exports to the EU sank 23 % y-o-y, while imports from the EU were down 9 % y-o-y. China's trade surplus fell in January-October to \$87 billion, down from \$134 billion in the same period a year earlier.

Monthly values of China's trade with the EU, US\$ billion



Sources: China Customs, CEIC

EU figures show China's share of EU foreign trade has risen this year as exports to China and imports from China have fallen less than foreign trade generally. In 1H09, China

accounted for 7 % of EU's external exports (6 % in 1H08) and 17 % (14 %) of EU's imports from outside the block.

The EU presently has three complaints against Chinese trade practices pending with the WTO. The cases involve imports of car parts to China, restrictions on companies operating in China that provide financial information, and various limits on exports of raw materials from China. China has filed a counterclaim against the EU accusing the EU of antidumping practices that harm sales of steel fasteners made in China.

Weak start for Shenzhen technology list. Prices of companies listed on the Shenzhen stock exchange's new technology list ChiNext have performed worse than the Shenzhen A-share index overall since it was inaugurated at the end of October. The Shenzhen A index is up about 15 % since end-October, while the technology list has gained just 5 %. Prices on the Shanghai exchange, China's major bourse, have also outperformed the ChiNext list.

The ChiNext was designed to improve access of small innovation-focused firms to finance. Only 28 companies were approved for the list, although the amount is expected to rise. The Shenzhen launched a list of 50 small and medium-sized companies in 2004, which currently has over 300 firms. Although the SME list has been lately scarcely mentioned in the Chinese media, the share prices on the list have put in good performances in recent months.

China's stock markets are relatively undeveloped. As investors lack reliable information about listed companies, China's stock markets often defy trends in the general economy, swinging violently in reaction to rumours and perceived official intentions. For example, despite the strong economic growth share prices nose-dived in the second half of 2007 after officials moved to dampen corporate investment. In November 2008, even as China's economic prospects darkened with the international finance crisis, stock prices shot up on the announcement of a massive stimulus package. Share prices plunged in August 2009 on news officials were planning a monetary tightening and commercial banks were reducing lending.

Shanghai and Moscow exchanges, 2006-2009



Source: Bloomberg

Russia

The 2010 privatisation plan to include stakes in important enterprises. Late last month, the government put its stamp of approval on next year's privatisation plan, which calls for reduction in state ownership share in some 450 companies. In addition, nearly 60 other properties will be put on sale. The sales include shares in some fairly large state companies that should be quite interesting to investors.

The 2010 plan signals a distinct policy shift from recent years, when privatisation activity was modest and mostly involved divestment of companies that attracted little investor interest. As a result, only a small share of companies listed for privatisation in a given year actually got sold.

The 2010 plan includes sale of a 25.1 % stake in regional power producer TGK-5, a spin-off from last year's breakup of electricity monopoly UES; all of Mosmetrostroi, the company in charge of construction of the Moscow metro system; and 13 % of Rosgosstrakh, the country's largest insurance company. Also up for sale are stakes in several shipping companies, harbours and airports, including Sovkomflot, Russia's largest tanker shipping company; the massive Novorossiyski port on the Black Sea; as well as the Novosibirsk and Yekaterinburg airports. Planned divestures in northwestern Russia include part of the Murmansk shipping company and port, as well as the North-Western Shipping Company based in St. Petersburg.

The list includes more than two dozen firms classed as strategic, i.e. companies whose state ownership can only be reduced with presidential approval. The government is currently finalising the list of proposed strategic privatisations for approval by president Medvedev.

Following prime minister Putin's lead, several cabinet members over the past twelve months have argued for increased privatisation sales. One motive for selling state assets at this time is to fund the federal budget deficit. If sold as planned, the 2010 privatisation offerings would generate 72 billion roubles (€1.6 billion) for the state coffers. Some 700 billion roubles of the federal budget's 2,900-billion-rouble deficit would come from debt financing and privatisation sales.

Another goal of privatisation is reducing the role of state ownership in the economy. Finance minister Alexei Kudrin said the aim is to reduce the level of participation of federal and regional administrations in the enterprise sector to around 30 % in the coming years. The state-participation level has been on the rise in recent years, reaching about 50 %, when the state stepped in with fi-

ancing support to state enterprise in the midst of the financial crisis.

This year's privatisation plan assumes sales income of 12 billion roubles (€0.3 billion). Actual figures are not known yet.

Limits imposed on scope of official inspections. Companies operating in Russia are subject to highly invasive official inspections and getting needed permits can be a drag on operations.

This autumn, chief prosecutor Yuri Chaika reported on official malfeasance during company inspections to a closed cabinet session. At the meeting, prime minister Putin noted that inspections have become lucrative activity for official agencies and associated organisations. Inspection responsibilities are often delegated to these associated unofficial organisations that may charge whatever they feel the traffic will bear. Such organisations work, among others, for the natural resources ministry, the social affairs and health ministry, Russian customs and the federal tax service. Industry ministry information shows e.g. that while the cost of a permit to establish a bakery is 1,300 roubles (€30), the cost of the fire inspection certificate needed to operate is 600,000 roubles (€13,000).

To rectify the situation, a government decree specifying which inspections by federal officials are subject to a fee went into force on December 8. Previously, in addition to the government, ministries and even government agencies could decide whether clients need to pay for an inspection. Now inspection fees cannot be collected unless they are listed in the decree or the fee is otherwise specified by law, and all fees must be reasonable. The decree states that inspections can only be performed by official federal organs. The list includes 19 types of inspections related to e.g. environmental protection, drug registration, as well as animal and plant diseases.

The government also made other decisions this autumn aimed at keeping inspectors off the backs of businesses. Starting next year, officials are only allowed to perform an inspection after it has been presented to and approved by the Prosecutor General's Office. Russian customs submitted its inspection plan for next year to the Prosecutor General's Office last month. The prosecutor's office found that 90 % of the planned customs inspections violated statute. Among the main reasons for rejection of planned customs inspections were inspection frequencies higher than the once every third year maximum set by law, and planned inspection periods longer than the three-month limit permitted under the law.

The Duma is currently dealing with a bill giving guiding principles and standards to providers of public services. The legislation is expected to reach the president's desk for signing before the end of the year.

China

China's leaders set out 2010 economic policies. China's top leadership convened last week for their annual working seminar to consider next year's economic strategy. According to the information released immediately following the meeting, the government is not planning any large changes in fiscal or monetary policy, but will continue to provide stimulus and maintain a loose fiscal stance to sustain stable economic growth.

Two notable take-aways from the meeting were commitments to increase the role of private consumer demand as a driver of economic growth and provide increased support to urban development. The details of the decisions reached at the meeting will, as usual, be worked out later.

The government's stimulative policies have reached a dilemma. Although the government has not indicated changes in its monetary and fiscal stance, it must come to grips with a range of serious issues. For example, the government must deal with industrial overcapacity, which has been increasing. Worries over a real estate bubble have also materialised. In China's biggest cities, the rise in housing prices accelerated in November to 5.7 % y-o-y, up from 3.9 % y-o-y in October. In response, the government this week eliminated tax breaks for homebuyers and proposed cuts in subsidies to consumers for purchases of cars and home electronics.

Plant overcapacity and runaway real estate markets highlight the intractability of the problems facing the government. It can hardly take on problems caused by excessive bank lending case by case, and must instead consider the far more wide-reaching measures of tightening monetary and fiscal policy. Even so, the decision to stick with an expansive fiscal and monetary stance suggests that government is still worried about the economic outlook despite GDP growth exceeding 8 %.

The government's desire to stabilise economic growth by making the economy more consumer-driven and reduce income disparities underlie the working seminar decisions to promote consumer demand and urbanisation. The income disparity between China's urban residents and rural populace is among the largest in the world. Thus, urbanisation and opportunities to move labour to high-productivity jobs, as well as increased availability of services are seen as the key to sustained economic development and social stability. Direct subsidies to the countryside have also been increased. The government could soon abolish the domicile permit system (*hukou*) instituted back in the late 1950s, which prevents rural denizens from moving to town and enjoying the same entitlements as their city brethren.

Commercial banks could be hit with big losses on stimulus lending. When China's leaders decided to move ahead with a massive stimulus package in November 2008, commercial banks were given a major role in distributing the stimulus financing. Banks so far this year have granted loans at a much higher rate than in recent years. As of end-October, the loan stock was up 30 % from the beginning of the year. As a result of hasty loan approvals, many stimulus-financed projects may eventually be proven economically non-viable, causing some borrowers to default. This problem has yet to show up in official Chinese statistics, which show that the stock of non-performing loans (NPLs) held by banks and its ratio to total lending declined this year (the NPL ratio was 1.7 % at end-September).

Officials are nevertheless bracing for trouble. Rapid growth in lending has eaten into bank capital, so China's bank regulator (CBRC) has demanded clarification from the country's five biggest banks on how they plan to increase their capital reserves next year. The CBRC announced an increase in the capital adequacy ratio for commercial banks by one percentage point to 11 % at the start of the next year. It also this autumn investigated whether construction firms are overburdened with debt. The fear is that builders have over-borrowed and could face huge debt-servicing difficulties if real estate prices slump. Problems could get out of hand for banks rather quickly as Chinese companies commonly take bullet loans, where only interest is paid during the life of the loan and the principal is paid back in full when the loan matures.

Payment troubles among private individuals are also increasing. The central bank has warned banks that payment defaults by credit-card holders are already increasing rapidly and hurt banks even if the credit-card business is still quite small. Officials would also like to see banks transfer money lent for home purchases directly to seller in order to prevent the borrower from using the money in some other way. There is a concern that money lent for housing loans, as well as many other types of loans, has been used for speculation in stock markets and elsewhere.

China's banking sector is rather well prepared to deal with an increase in NPLs. The four largest state commercial banks have been bailed out by the state in recent years, so most of their old non-performing loans have been taken off their books. Moreover, three of the four large banks have already held IPOs, and number-four Agricultural Bank of China hopes to list on the stock exchange as soon as next year. Even with the IPOs, the state has retained majority stakes in the big banks, and effectively most of the banking sector remains under state control. With the state increasing its stake in large banks this year, any serious bank difficulties are likely to end up quickly in the government's lap. On the other hand, continued robust economic growth will lay the ground for bank growth and profitability, as well as removal of non-performing asset from bank balance sheets.

Russia

Russia set to increase minimum capital requirements for banks next year. Banks operating in Russia have until the end of March 2010 to increase their charter capital to at least 90 million roubles (€2 million). This minimum requirement, which already applies to new banks, will now be extended to all established banks. The Central Bank of Russia reports that currently 82 banks have charter capital of under 90 million roubles.

The minimum capital requirement will further increase to 180 million roubles at the beginning of 2012. Last week, finance minister Alexei Kudrin announced that he considers it necessary that the minimum capital requirements be raised incrementally over the next five years until they reach one billion roubles (€22 million). The higher capital requirement is expected to reduce substantially the number of banks in Russia and improve the CBR's ability to supervise the banking sector. The minimum capital requirement for EU banks is €5 million.

Largely due to withdrawal of bank licenses after central bank inspections, the number of banks in Russia has been falling in recent years. Notably, even in the face of a difficult operating environment, the risk of widespread bank failures has not materialised. As of end-September, 1,074 banks operated in Russia, down from 1,136 banks at the start of the year.

Although Russia has many banks, the banking sector is quite concentrated. The combined assets of Russia's five largest banks accounted for about 50 % of the banking sector's total assets in September. The 20 largest banks together had about a 70 % share and the 50 largest banks over 80 %. The top 50 banks form the operational core of Russia's banking sector and provide most financing.

Russia's ten largest banks in 2009

| | % share of bank sector total assets | Largest shareholder |
|----------------|-------------------------------------|------------------------|
| Sberbank | 24 | CBR |
| VTB | 8 | Russian state |
| Gazprombank | 5 | Gazprom |
| Rosselkhozbank | 3 | Russian state |
| Bank Moskv | 3 | City of Moscow |
| Alfa-Bank | 3 | Russian investor group |
| UniCredit Bank | 2 | Italian bank |
| Raiffeisenbank | 2 | Austrian bank |
| VTB-24 | 2 | Russian state |
| Rosbank | 2 | French bank (SocGen) |

Sources: Central Bank of Russia and OECD

The Russia state has a distinctively large (and recently increasing) footprint in the banking sector. The increased state involvement in the sector reflects in part the merger

of some troubled banks with state-owned banks and the use of state banks to distribute financial assistance as part of the government's stimulus package. The share of direct and indirect state participation in the banking sector, measured in terms of total assets, had reached 56 % as of summer 2009, up from 36 % in 2001. The significance of foreign banks also continues to grow. Foreign banks now account for nearly 20 % of the Russian banking sector's total assets.

Global economic downturn reduces FDI flows into Russia. Preliminary figures from the Central Bank of Russia show the value of foreign direct investment into Russia during January-September 2009 was \$30 billion, or 44 % less than in the same period a year earlier. (The figures do not include investments in the financial sector.) FDI inflows to Russia reached \$73 billion in 2008.

Rosstat figures provide insight into the structure of FDI. Rosstat uses slightly different rules than the central bank in collecting data on FDI, so its overall figures are not fully comparable with CBR figures, which follow international standards. Rosstat reports that the largest share of FDI inflows during the first nine months of the year went to manufacturing (28 % of investment), mining and mineral extraction (22 %), as well as trade and real estate (17 % each). FDI is also geographically quite concentrated. Some 52 % of FDI is destined for the City of Moscow and the Moscow region, in part because most nationally operating companies have their headquarters in Moscow. The next largest destinations for FDI were the City of St. Petersburg (9 %), followed by the Sakhalin (8 %) and Kaluga (3.5 %) regions. The Sakhalin region boasts extensive oil and gas deposits; the Kaluga region includes an industrial zone on the outskirts of Moscow.

Rosstat reports the biggest foreign direct investment flows into Russia in the January-September period came from Cyprus, Germany and the Netherlands, which together accounted for 48 % of FDI. Cyprus, in particular, is an important off-shore banking centre for Russia and is used to recycle Russian capital and circumvent taxes.

Finland accounted for nearly a 6 % share of FDI inflows to Russia. The presence of Finnish investment is particularly strong in Northwest Russia. In January-September, some 40 % of FDI registered in St. Petersburg was of Finnish origin. Bank of Finland figures show the stock of Finnish investment in Russia stood at €2.5 billion as of end-2008.

Foreign direct investment flows into Russia, which were barely a trickle a decade ago, have increased briskly throughout the 2000s. According to UNCTAD figures, Russia's FDI stock amounted to \$214 billion at the end of 2008. The stock corresponded to 12 % of the Russian GDP, placing the country in between e.g. Brazil (19 %) and China (9 %). The FDI stocks of developed countries averaged 25 % of GDP in 2008.

China

Broad-based economic recovery continues. China's National Bureau of Statistics reports November industrial output rose 19 % y-o-y in real terms. On-year growth accelerated sharply from the previous month (16 % in October). Industrial output also increased more than 1 % m-o-m. Recoveries in the domestic economy and the global economy helped boost industrial growth.

Retail sales, an indicator of domestic consumer demand trends, rose about 15 % y-o-y in real terms last month, although November retail sales were down slightly month-to-month. Official figures for retail sales are notoriously suspect, because measuring is difficult as companies in the retail sector tend to be small and street selling is common in China. Moreover, official figures include a certain amount of wholesale business.

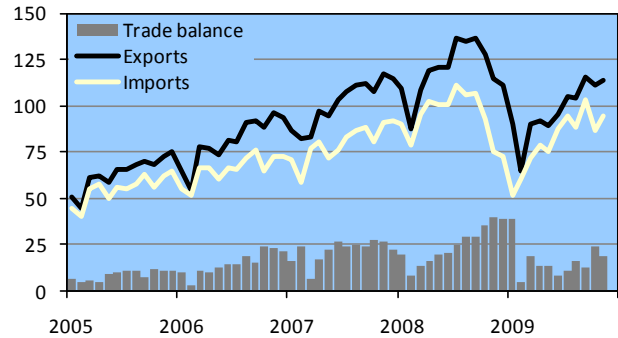
The soaring growth in fixed capital investment this year has been largely supported by the government's massive stimulus package. Although the pace of investment growth remained high, it has slowed a bit in recent months from September's peak. On a positive note, official figures suggest private firms are gradually increasing their investment in capital assets; in the first half of the year, capital investment was largely state-driven.

Steadier growth in Chinese exports and imports in October and November. The value of imports in November was approximately \$95 billion. The seasonally adjusted value of imports has remained at this level for the last three months. On-year growth was 26 %, reflecting the collapse in China's external trade last year. Although the value of imports is still 10 % below pre-crisis levels, import volumes are already higher than in the final months of 2008. The revival of imports to China has mainly come from raw material markets. Several investment banks this week raised their forecasts on iron ore contract prices next year to reflect a huge jump in Chinese demand.

The value of China's exports climbed to \$114 billion in November. Over the past couple months, however, the seasonally adjusted value of exports has remained flat. Exports were in a tailspin in November 2008, so the current level shows a return to roughly the same level as December 2008, but still well below pre-crisis peaks. The trends in Chinese exports over the last two months, however, indicate a slow and halting recovery of international markets.

China's trade surplus for the first eleven months of the year was about \$180 billion. While the surplus is still impressive, it was nearly \$80 billion less than in the same period a year earlier.

Chinese foreign trade, US\$ billion

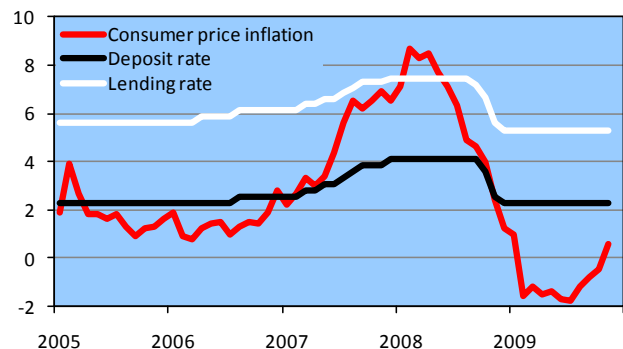


Source: China Customs

Consumer prices on the rise. Consumer prices rose 0.6 % y-o-y in November. It was the first month since January that prices showed an on-year rise. Clothing prices and housing costs, in particular, have risen in recent months. Food prices were also up on-month in November. Producer prices, on the other hand, continued to decline, down 2 % y-o-y in November.

At the end of November, the broad money supply (M2) was up 30 % y-o-y. The central bank has let the money supply expand rapidly to support the economic recovery. Central bank's annual M2 growth target has been around 16 % in recent years. While there is a fear loose monetary policy could at some point send prices through the roof, price inflation remains quite modest for the time being. The statistical evidence suggests that an acceleration in money supply expansion is followed by an acceleration in inflation approximately 18 months later. While a tighter monetary stance has been discussed for months, officials have yet to implement any significant measures.

On-year consumer price inflation and 12-month reference rates, %



Sources: PBoC and NBS

Russia

Duma approves law on retail trade. The aim of the law is to protect consumers e.g. by limiting the extent to which retailers could saturate a particular market. Progress with the bill, under preparation since 2004, has been slow due to sharp differences in opinions of retailers and producers. At the final stage, conflicting views emerged also between the presidential administration and government experts. In November, Russia's leading liberal economists asked the Duma to reject the bill, which they claimed limited freedom of enterprise and contract rights. The presidential administration also complained the bill overreached.

On December 18, the Duma approved a version of the bill closely matching the government proposal. The law's key clauses were the most controversial. One allows the government to regulate prices of basic goods for a maximum of 90 days if the price of the product increased over 30 % in the 30 days before price controls were imposed. Another clause prohibits a retail chain from expanding its activities if its share in a given region or district already exceeds 25 % of total retail sales. A third limits discounts from wholesalers to retailers to no more than 10 % of the purchase value.

The law needs to be approved by the upper-house Federation Council and signed by the president to become effective. Both events are expected to occur before the end of this year. The law will enter into force on February 1, 2010.

Duma takes up bill on technical standards. Late last week, president Dmitri Medvedev submitted a bill proposal to the Duma, whereby Russia can adopt foreign technical standards to replace out-of-date Russian standards. The standards impose mandatory rules on manufacturers regarding products and production methods.

The goal of the bill is to speed up reform of standards inherited from the Soviet era. The old regulations have perpetuated inefficient production approaches in Russia, allowing poor quality products, unsafe and unhealthy working conditions, and creating obstacles to adopting new technologies. Reform of technical standards has been going on since 2003, but it has progressed extremely slowly.

According to the bill, technical standards of members of the Russia-Belarus-Kazakhstan customs union as well as EU directives can be adopted in Russia.

Changes in special economic zones. President Medvedev announced in October that the federal agency in charge of special economic zones (RosOEZ) will be phased out and its activities placed under the economic development ministry. The change was motivated by a need to improve

SEZ administration. Both president Medvedev and economic development minister Elvira Nabiullina have berated the ineffectiveness of SEZs on numerous occasions. The General Prosecutor charged in September 2008 that budget funds going to SEZs were being wasted. In addition, the report revealed that a number of tourism SEZs had not registered a single investor.

Despite the criticism, there is still support for special economic zones. This autumn, the economic development ministry proposed to the cabinet the establishment of two new SEZs in the Ulyanovsk and Khabarovsk regions. The 2010 federal budget includes nearly 5 billion roubles (€110 million) for SEZ infrastructure projects.

An amendment passed by the Duma this month also seeks to promote development of special economic zones. Under the old law, companies wanting to operate in an industrial SEZ were required to invest a minimum of €10 million. Under the new law, the minimum initial investment falls to €3 million. Similarly, the minimum initial investment in a port SEZ declines from €100 million to €10 million.

In addition, the amendment expanded the scope of regions to act. For example, a port SEZ is allowed to engage in shipbuilding; earlier port activities largely were construed as logistics services. Research and innovation SEZs are allowed to expand their scope of operations from product development to production. Here the goal is to promote e.g. production of car parts to provide carmakers in the St. Petersburg region.

Throughout the past year, the federal government has waffled on SEZ relations with sub-governmental levels. For example, the Lipetsk region attempted to establish its own SEZ governed by regional regulations only to have the Duma quash the attempt. However, president Medvedev and economy minister Nabiullina have stated that regions should be delegated greater authority on SEZ issues.

The SEZ law entered into force in 2005. Under the law, companies operating in an SEZ are eligible for concessions such as lower customs duties, lower labour costs and taxes, as well as favourable treatment from officials. SEZs fall into three categories: technology-focused research and innovation areas (St. Petersburg, Dubna, Zelenograd okrug and Tomsk oblast SEZs), industrial zones (Lipetsk oblast and Republic of Tatarstan SEZs), as well as tourism zones (Krasnodar, Stavropol, Altai okrug, Kaliningrad and Irkutsk oblast and Buryat and Altai republic SEZs). In addition, there are three port SEZs, four casino SEZs and two old SEZs inherited from the 1990s.

RosOEZ reports that a total of 181 firms operated in special economic zones in May 2009. Of them 139 are situated in research and innovation SEZs. Only 18 firms were registered in tourism SEZs. Total investment in SEZs amounted to about €5 billion. SEZs in Russia employed a total of 8,000 people.

China

Copenhagen climate conference fails to produce binding treaty. The conference got off to a rocky start three weeks ago with China and the United States declaring summit goals very different from EU aspirations. As the summit proceeded, it became clear the rift between developing nations, which are exempt from the Kyoto treaty, and developed nations, was becoming harder to bridge. China went into the meeting backed by the G-77 group of developing nations, whose members staged for example walkout during the UN-sponsored conference. Even though many developed countries understand and are willing to lighten the burden of dealing with climate change on developing countries, the US, for example, challenged China's claim it should be classed as a developing country even when it was willing to forego funding and let it go to needier nations.

China repeated its argument that it was largely not responsible for historical greenhouse gas emissions. International Energy Agency data, however, show Chinese emissions from energy production during 1971-2007 amounted to about 90 gigatons of CO₂, roughly half of US CO₂ energy-related emissions during that time and 20 % more than the EU's cumulative contribution. On the other hand, the observation period is too short to reflect long-term impacts of CO₂ emissions and does not include e.g. car exhaust, so the IAE figure portrays China in an overly dark light. Furthermore, China's emissions viewed on a per capita emissions basis, are far lower than in many other countries (see [BOFIT Focus/Opinion 10/2009](#)).

A number of crucial issues were, however, resolved at Copenhagen that should move forward the process of getting a binding agreement next year in Mexico. Japan promised to provide over €10 billion in assistance to developing nations by 2012, which was more than the €7.2 billion promised by the EU. Japan's funding, however, came with a caveat that a politically binding climate agreement has to be in place. The US, Australia, Japan, France, Norway and the UK together promised to kick in €2.4 billion for protection of rainforests in developing countries and curtailing the loss of forests. The UN estimates that realistically developing countries need some €70 billion a year to fight climate change.

In the wake of the summit, China has said it was generally satisfied with the non-binding memorandum produced at the end of the summit.

China increases its grip on Central Asian energy supplies. A natural gas pipeline running from Turkmenistan through Uzbekistan and Kazakhstan to China opened last week. It is the first gas pipeline running to China. The

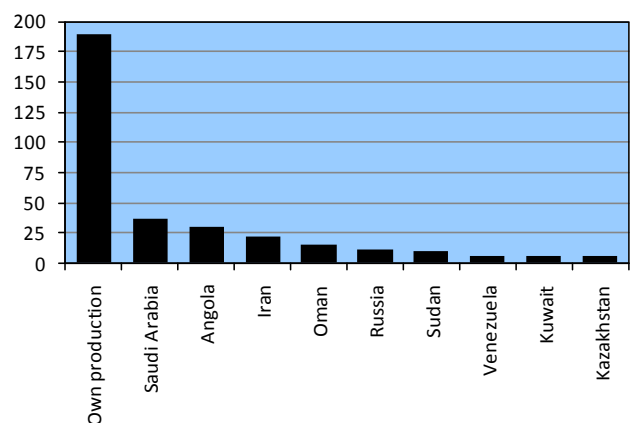
pipeline is about 7,000 kilometres long, of which about 5,000 km is within China's borders. China expects to receive about 5 billion cubic metres of gas from Turkmenistan next year and the amount should rise to 30 billion m³ by 2013, making Turkmenistan China's largest gas supplier by far. The pipeline grid is also joined to gas fields in Kazakhstan, which has promised to supply China with 10 billion m³ of gas a year. Kazakhstan's deliveries are set to begin in 2011.

Observers doubt Turkmenistan can meet its future supply commitments, as the country has promised prospective buyers more gas than it currently produces. It has committed to supply China with 30 billion m³ a year, or half of Turkmenistan's entire 2008 production. Given that Turkmenistan itself consumes 20 billion m³ of gas each year and the absence of major investment projects that might bring production up to levels needed to meet Turkmenistan's commitments, customer disappointments could lie ahead.

China consumes about 80 billion m³ of natural gas each year, making it the world's seventh largest gas consumer. Gas currently supplies slightly over 4 % of China's energy needs, but that share is growing rapidly. The lion's share of gas is produced by domestic gas fields. A small amount of liquefied natural gas (LNG) is brought in by ship (about 5 % of the gas consumed). China gets most of its LNG from Australia and it is constructing more LNG terminals to support increasing LNG imports.

China's growing energy needs have allowed Central Asian energy producers to diversify their export markets, which, until recently were dominated by Russia. The countries have eagerly grabbed the new opportunity. China made its first oil pipeline deal with Kazakhstan in 1997 and oil began to flow to China at the end of 2005. China has granted billions of dollars in loans to countries in Central Asia to develop their energy resources and invested in energy companies operating in the region.

China's crude oil sources in 2008, millions of tons



Sources: National Bureau of Statistics, COMTRADE

Central Bank of Russia / Exchange rates 2009

http://www.cbr.ru/eng/currency_base/dynamics.aspx

| date | USD | Euro |
|-------------|------------|-------------|
| 1.1.2009 | 29.3916 | 41.4275 |
| 12.1.2009 | 30.5331 | 41.1311 |
| 13.1.2009 | 30.9981 | 41.5282 |
| 14.1.2009 | 31.2226 | 41.4105 |
| 15.1.2009 | 31.5616 | 41.9706 |
| 16.1.2009 | 32.2135 | 42.3833 |
| 17.1.2009 | 32.5747 | 43.08 |
| 20.1.2009 | 32.9085 | 43.7815 |
| 21.1.2009 | 33.4154 | 43.3331 |
| 22.1.2009 | 32.643 | 42.1454 |
| 23.1.2009 | 32.7991 | 42.6454 |
| 24.1.2009 | 32.8926 | 42.3986 |
| 27.1.2009 | 32.9018 | 42.4861 |
| 28.1.2009 | 32.9979 | 43.7123 |
| 29.1.2009 | 33.2155 | 44.0305 |
| 30.1.2009 | 34.6847 | 45.3398 |
| 31.1.2009 | 35.4146 | 45.6636 |
| 3.2.2009 | 36.1767 | 46.0457 |
| 4.2.2009 | 36.129 | 46.3896 |
| 5.2.2009 | 36.0135 | 46.8392 |
| 6.2.2009 | 36.3095 | 46.5924 |
| 7.2.2009 | 36.3798 | 46.4788 |
| 10.2.2009 | 36.1258 | 46.5951 |
| 11.2.2009 | 35.9285 | 46.3621 |
| 12.2.2009 | 35.8323 | 46.3312 |
| 13.2.2009 | 34.8003 | 44.9655 |
| 14.2.2009 | 34.5578 | 44.6107 |
| 17.2.2009 | 34.7797 | 44.3476 |
| 18.2.2009 | 35.6345 | 44.9957 |
| 19.2.2009 | 36.4267 | 45.9741 |
| 20.2.2009 | 36.091 | 45.4422 |
| 21.2.2009 | 36.076 | 45.4089 |
| 25.2.2009 | 36.0254 | 45.9108 |
| 26.2.2009 | 35.7442 | 45.967 |
| 27.2.2009 | 35.7223 | 45.428 |
| 28.2.2009 | 35.7205 | 45.3543 |
| 3.3.2009 | 36.1644 | 45.5201 |
| 4.3.2009 | 36.2054 | 45.8071 |
| 5.3.2009 | 36.2284 | 45.3543 |
| 6.3.2009 | 35.8899 | 45.2572 |
| 7.3.2009 | 35.7374 | 45.3686 |
| 11.3.2009 | 35.4534 | 45.0365 |
| 12.3.2009 | 35.1164 | 44.4258 |
| 13.3.2009 | 35.2944 | 45.0674 |

Central Bank of Russia / Exchange rates 2009

http://www.cbr.ru/eng/currency_base/dynamics.aspx

| date | USD | Euro |
|-------------|------------|-------------|
| 14.3.2009 | 34.8316 | 44.9258 |
| 17.3.2009 | 34.8388 | 45.1894 |
| 18.3.2009 | 34.5318 | 44.8603 |
| 19.3.2009 | 34.4203 | 44.8083 |
| 20.3.2009 | 33.8222 | 45.5416 |
| 21.3.2009 | 33.423 | 45.7695 |
| 24.3.2009 | 33.3034 | 45.6323 |
| 25.3.2009 | 33.2726 | 45.2674 |
| 26.3.2009 | 33.7268 | 45.3963 |
| 27.3.2009 | 33.4668 | 45.4446 |
| 28.3.2009 | 33.4133 | 45.3151 |
| 31.3.2009 | 34.0134 | 44.9419 |
| 1.4.2009 | 33.9032 | 44.8946 |
| 2.4.2009 | 33.9456 | 44.7912 |
| 3.4.2009 | 33.7636 | 44.8684 |
| 4.4.2009 | 33.4095 | 44.8523 |
| 7.4.2009 | 33.1743 | 44.9412 |
| 8.4.2009 | 33.384 | 44.6578 |
| 9.4.2009 | 33.7781 | 44.4993 |
| 10.4.2009 | 33.5334 | 44.586 |
| 11.4.2009 | 33.6309 | 44.1607 |
| 14.4.2009 | 33.4863 | 44.1986 |
| 15.4.2009 | 33.3887 | 44.447 |
| 16.4.2009 | 33.4507 | 44.2653 |
| 17.4.2009 | 33.4184 | 44.0555 |
| 18.4.2009 | 33.4677 | 43.8226 |
| 21.4.2009 | 33.5371 | 43.5613 |
| 22.4.2009 | 34.1043 | 44.0764 |
| 23.4.2009 | 34.0597 | 44.0392 |
| 24.4.2009 | 33.7848 | 44.0216 |
| 25.4.2009 | 33.4187 | 44.0392 |
| 28.4.2009 | 33.3904 | 43.8783 |
| 29.4.2009 | 33.5533 | 43.6596 |
| 30.4.2009 | 33.2491 | 43.8389 |
| 1.5.2009 | 32.974 | 43.9939 |
| 5.5.2009 | 32.9672 | 43.8727 |
| 6.5.2009 | 32.8146 | 43.8501 |
| 7.5.2009 | 32.8883 | 43.725 |
| 8.5.2009 | 32.7915 | 43.5406 |
| 9.5.2009 | 32.5534 | 43.6574 |
| 13.5.2009 | 32.2817 | 43.9709 |
| 14.5.2009 | 31.9841 | 43.7798 |
| 15.5.2009 | 32.1677 | 43.6258 |
| 16.5.2009 | 32.0797 | 43.6124 |

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| date | USD | Euro |
|-------------|------------|-------------|
| 19.5.2009 | 32.2919 | 43.4714 |
| 20.5.2009 | 31.9498 | 43.3303 |
| 21.5.2009 | 31.8009 | 43.246 |
| 22.5.2009 | 31.4586 | 43.3562 |
| 23.5.2009 | 31.1998 | 43.4644 |
| 26.5.2009 | 31.0516 | 43.4909 |
| 27.5.2009 | 31.1465 | 43.4712 |
| 28.5.2009 | 31.1846 | 43.4963 |
| 29.5.2009 | 31.3259 | 43.3269 |
| 30.5.2009 | 30.9843 | 43.378 |
| 2.6.2009 | 30.7441 | 43.4875 |
| 3.6.2009 | 30.7321 | 43.4152 |
| 4.6.2009 | 30.5131 | 43.649 |
| 5.6.2009 | 30.8767 | 43.8542 |
| 6.6.2009 | 30.6919 | 43.6009 |
| 9.6.2009 | 31.0751 | 43.328 |
| 10.6.2009 | 31.2637 | 43.4909 |
| 11.6.2009 | 30.9277 | 43.5895 |
| 12.6.2009 | 30.9124 | 43.3546 |
| 16.6.2009 | 31.1548 | 43.2958 |
| 17.6.2009 | 31.3185 | 43.3511 |
| 18.6.2009 | 31.1297 | 43.2796 |
| 19.6.2009 | 31.0998 | 43.434 |
| 20.6.2009 | 31.1541 | 43.3914 |
| 23.6.2009 | 31.2408 | 43.3216 |
| 24.6.2009 | 31.5765 | 43.7556 |
| 25.6.2009 | 31.1365 | 43.9274 |
| 26.6.2009 | 31.2037 | 43.5728 |
| 27.6.2009 | 31.1184 | 43.6965 |
| 30.6.2009 | 31.2904 | 43.8191 |
| 1.7.2009 | 31.0385 | 43.8512 |
| 2.7.2009 | 31.1904 | 43.8069 |
| 3.7.2009 | 31.1252 | 43.9052 |
| 4.7.2009 | 31.2481 | 43.7942 |
| 7.7.2009 | 31.4143 | 43.8481 |
| 8.7.2009 | 31.4695 | 43.8559 |
| 9.7.2009 | 31.7819 | 44.1387 |
| 10.7.2009 | 31.8878 | 44.407 |
| 11.7.2009 | 32.0353 | 44.6732 |
| 14.7.2009 | 33.0597 | 46.0059 |
| 15.7.2009 | 32.5072 | 45.4873 |
| 16.7.2009 | 32.047 | 44.994 |
| 17.7.2009 | 31.6943 | 44.6066 |
| 18.7.2009 | 31.7837 | 44.8023 |

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| date | USD | Euro |
|-------------|------------|-------------|
| 21.7.2009 | 31.3733 | 44.4466 |
| 22.7.2009 | 31.1791 | 44.2743 |
| 23.7.2009 | 31.0785 | 44.1159 |
| 24.7.2009 | 31.076 | 44.2771 |
| 25.7.2009 | 31.1372 | 44.1712 |
| 28.7.2009 | 30.7457 | 43.8249 |
| 29.7.2009 | 30.6431 | 43.7675 |
| 30.7.2009 | 31.4162 | 44.4351 |
| 31.7.2009 | 31.7555 | 44.6927 |
| 1.8.2009 | 31.1533 | 43.9978 |
| 4.8.2009 | 31.2424 | 44.4642 |
| 5.8.2009 | 31.0484 | 44.7097 |
| 6.8.2009 | 31.1326 | 44.778 |
| 7.8.2009 | 31.1814 | 44.9168 |
| 8.8.2009 | 31.5473 | 45.2893 |
| 11.8.2009 | 31.6503 | 44.9498 |
| 12.8.2009 | 31.7477 | 44.9389 |
| 13.8.2009 | 32.6926 | 46.1718 |
| 14.8.2009 | 32.1457 | 45.8108 |
| 15.8.2009 | 31.7226 | 45.2618 |
| 18.8.2009 | 32.2874 | 45.635 |
| 19.8.2009 | 31.9187 | 45.0884 |
| 20.8.2009 | 31.9191 | 45.0123 |
| 21.8.2009 | 31.6011 | 44.9842 |
| 22.8.2009 | 31.9443 | 45.4663 |
| 25.8.2009 | 31.5544 | 45.1512 |
| 26.8.2009 | 31.5437 | 45.0476 |
| 27.8.2009 | 31.4007 | 44.9407 |
| 28.8.2009 | 31.6405 | 45.0782 |
| 29.8.2009 | 31.5687 | 45.3011 |
| 1.9.2009 | 31.8397 | 45.4321 |
| 2.9.2009 | 31.7743 | 45.6501 |
| 3.9.2009 | 31.973 | 45.488 |
| 4.9.2009 | 31.7679 | 45.3932 |
| 5.9.2009 | 31.6062 | 45.1084 |
| 8.9.2009 | 31.4298 | 45.0672 |
| 9.9.2009 | 31.3754 | 45.1084 |
| 10.9.2009 | 31.1452 | 45.1512 |
| 11.9.2009 | 30.8851 | 45.0212 |
| 12.9.2009 | 30.7246 | 44.8886 |
| 15.9.2009 | 30.8617 | 44.8575 |
| 16.9.2009 | 30.9895 | 45.3036 |
| 17.9.2009 | 30.6067 | 44.9612 |
| 18.9.2009 | 30.3881 | 44.8133 |

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| date | USD | Euro |
|-------------|------------|-------------|
| 19.9.2009 | 30.3744 | 44.6807 |
| 22.9.2009 | 30.3711 | 44.5271 |
| 23.9.2009 | 30.2385 | 44.5625 |
| 24.9.2009 | 30.0004 | 44.3946 |
| 25.9.2009 | 30.0678 | 44.362 |
| 26.9.2009 | 30.137 | 44.2562 |
| 29.9.2009 | 30.1985 | 44.1291 |
| 30.9.2009 | 30.0922 | 44.0068 |
| 1.10.2009 | 30.0087 | 43.8877 |
| 2.10.2009 | 30.0621 | 43.8245 |
| 3.10.2009 | 30.124 | 43.8154 |
| 6.10.2009 | 30.0785 | 44.0259 |
| 7.10.2009 | 29.8322 | 43.9667 |
| 8.10.2009 | 29.7819 | 43.8211 |
| 9.10.2009 | 29.6396 | 43.751 |
| 10.10.2009 | 29.609 | 43.6052 |
| 13.10.2009 | 29.5945 | 43.5069 |
| 14.10.2009 | 29.5043 | 43.6133 |
| 15.10.2009 | 29.4651 | 43.8647 |
| 16.10.2009 | 29.3206 | 43.846 |
| 17.10.2009 | 29.3281 | 43.7429 |
| 20.10.2009 | 29.3553 | 43.7453 |
| 21.10.2009 | 29.1911 | 43.7166 |
| 22.10.2009 | 29.1641 | 43.6003 |
| 23.10.2009 | 29.0858 | 43.5705 |
| 24.10.2009 | 29.0003 | 43.5353 |
| 27.10.2009 | 28.9403 | 43.5002 |
| 28.10.2009 | 29.0184 | 43.2606 |
| 29.10.2009 | 29.1749 | 43.2489 |
| 30.10.2009 | 29.3441 | 43.218 |
| 31.10.2009 | 29.0488 | 43.0678 |
| 3.11.2009 | 29.1944 | 43.0588 |
| 4.11.2009 | 29.2337 | 43.1606 |
| 6.11.2009 | 29.133 | 43.1897 |
| 7.11.2009 | 29.0156 | 43.1578 |
| 10.11.2009 | 28.8497 | 43.1476 |
| 11.11.2009 | 28.7391 | 43.0742 |
| 12.11.2009 | 28.7007 | 43.0424 |
| 13.11.2009 | 28.6701 | 42.9134 |
| 14.11.2009 | 28.8345 | 42.8971 |
| 17.11.2009 | 28.6705 | 42.9541 |
| 18.11.2009 | 28.6768 | 42.8948 |
| 19.11.2009 | 28.7163 | 42.7844 |
| 20.11.2009 | 28.7459 | 42.7998 |

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| date | USD | Euro |
|-------------|------------|-------------|
| 21.11.2009 | 28.8554 | 43.0407 |
| 24.11.2009 | 28.7986 | 43.0856 |
| 25.11.2009 | 28.8481 | 42.9981 |
| 26.11.2009 | 28.7909 | 43.1921 |
| 27.11.2009 | 28.8751 | 43.5523 |
| 28.11.2009 | 29.8179 | 44.3571 |
| 1.12.2009 | 29.0687 | 43.7658 |
| 2.12.2009 | 29.1771 | 43.8736 |
| 3.12.2009 | 29.056 | 43.8252 |
| 4.12.2009 | 29.2427 | 44.1945 |
| 5.12.2009 | 29.1979 | 44.0275 |
| 8.12.2009 | 29.5221 | 43.8905 |
| 9.12.2009 | 30.1839 | 44.7174 |
| 10.12.2009 | 30.7562 | 45.2608 |
| 11.12.2009 | 30.6268 | 45.0735 |
| 12.12.2009 | 30.2107 | 44.4913 |
| 15.12.2009 | 30.0481 | 44.0806 |
| 16.12.2009 | 30.0678 | 43.9441 |
| 17.12.2009 | 30.1978 | 43.9016 |
| 18.12.2009 | 30.4392 | 43.8568 |
| 19.12.2009 | 30.7187 | 44.1766 |
| 22.12.2009 | 30.5529 | 43.7854 |
| 23.12.2009 | 30.4439 | 43.5744 |
| 24.12.2009 | 30.5007 | 43.4848 |
| 25.12.2009 | 29.9292 | 42.9903 |
| 26.12.2009 | 29.4266 | 42.3566 |
| 29.12.2009 | 29.5952 | 42.5638 |
| 30.12.2009 | 29.8491 | 43.0096 |
| 31.12.2009 | 30.2442 | 43.3883 |