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Russia

Steady first-half growth; recovery in fixed capital investment yet to occur. Industrial output in January-June increased 5 % y-o-y. Among the categories of industrial output, mining and mineral extraction (including oil and gas production) increased nearly 3 % y-o-y, while manufacturing was up 8 %. Electricity, gas and water supply remained at roughly 2010 levels.

Production of crude oil and coal each rose about 1 %, and natural gas production grew 5 %. Growth in crude oil production is limited by the fact that production capacity is stretched to the limit. Gas production volumes, in contrast, are currently limited by demand.

Production of machinery and equipment climbed 12 %, electrical and electronic equipment production 7 % and transport vehicles 35 %. Some of the brisk growth was due to the low comparison point a year ago. The flagship for growth was unquestionably passenger cars, which saw an increase in production of 77 % y-o-y. The recovery in production of passenger cars was supported by Russia's incentive programme to get drivers to turn in their old cars, as well as the substantial 2009 hike in duties on imported cars (a move that for all practical purposes has ended imports of used cars to Russia).

Construction, however, remained in slow recovery mode. In the first half, construction activity was up just 1 % from the 1H10, while apartment construction declined 4 %. It was the third year in a row for decrease in apartment production.

The trend in fixed capital investment in the wake of the recession has been halting and slower than expected. In the second quarter of this year, fixed capital investment returned to growth after falling in the first quarter. For the first half, fixed capital investment was up 3 % y-o-y.

Consumption has long been a more significant driver of domestic demand than fixed capital investment. Retail sales increased 5 % in the first half. Consumer demand has been lifted by gains in real wages, although they haven't been as big as before the recession, when real wages grew more than 10 % a year. In June, real wages were up 4 % y-o-y. According to Rosstat the average monthly wage in June was 24,601 rubles or €620.

Since the recession's bottom, unemployment has recovered steadily. June's unemployment rate was 6.1 %, which was the lowest since August 2008.

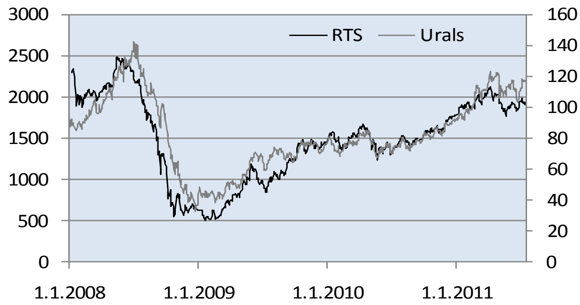
Inflation rate showed little change in first half. Consumer price inflation remained at a brisk 9.5 % in the first half. For June, 12-month inflation slowed to 9.4 %. Food prices were up 12.5 % y-o-y in June, while non-food goods rose 6.6 % and services 8.8 %. Costs related to housing such as rents, power and heating continued to increase rapidly (11.1 %).

Inflation has been slowing this month, mainly due to calmer global trends in food prices and food prices' seasonal decrease.

Russian stock market closely tracking global economic trends. Prices on Moscow's RTS exchange in the first six months of the year reflected trends on other world's stock exchanges, although RTS price swings were sharper.

Share prices in Russia have traditionally been driven by world market prices for oil. Russian share prices climbed steadily from early 2009 to peak in April 2011, when Urals-grade crude oil briefly surpassed $120 a barrel. Since then share prices have declined as on the other world's exchanges. The declines reflect concerns over trends in the global economy.

RTS index (left scale) and Urals oil price, $/bbl (right scale)



Sources: RTS, Bloomberg

Sberbank expands operations into Central and Eastern Europe. Russia's largest bank, majority state-owned Sberbank, made a landmark deal last week with the Austrian Volksbank to purchase its Volksbank International (VBI) unit. The sales agreement should be signed this month, and the deal should be closed before the end of the year.

The deal covers VBI's nearly 400 sales offices in eight countries in Central and Eastern Europe. VBI mainly provides retail banking services to households and small and medium-sized companies. The parent Volksbank was among the eight banks failing the European Banking Authority's stress tests last week. Volksbank will use money from the VBI sale to bolster its own capital adequacy.

Sberbank CEO German Gref said the deal represents Sberbank's first step in a strategy to penetrate international markets. The bank plans that by 2014 it will generate 5–7 % of its profits from operations in Central and Eastern Europe and CIS countries. Sberbank is also planning to expand operations gradually into the Chinese and Indian markets. Sberbank currently has subsidiaries in Kazakhstan, Ukraine and Belarus, as well as a branch office in India.

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China

Tighter monetary stance reflected in lower import growth in the first half. Growth in imports saw its biggest slowdown in 20 months in June as it slowed to 19 % y-o-y (28 % y-o-y in May). The value of imports in 1H11 was $829 billion. Growth for the first half overall was 28 %, reflecting high commodity prices at the start of the year.

To help importers, China lowered import duties on 33 commodities from the start of July. Most of the duty reductions apply to energy, raw materials and textiles. Duties on gasoline and fuel oil were cut to 1 %, while duties on diesel and jet fuel were eliminated altogether.

Export growth also slowed slightly in June, but exports were still up 18 % y-o-y. For the first six months of the year, the value of exports was $874 billion (up 24 % y-o-y). Exports to developing countries remained strong, while growth in exports to the United States and the EU region continued to slow. Due to weaker exports and domestic demand, China's trade surplus expanded in June to $22 billion, up from $13 billion in May. In the first half, the trade surplus shrank 18 % y-o-y to $45 billion.

China's trade partners are less than sanguine about China's imposition of export quotas on certain metals. On July 5, the WTO sided with the US, EU and Mexico in their 2009 complaint that certain Chinese raw material export quotas were invalid. The complaint pertained to e.g. bauxite, magnesium and zinc, all products where China is the world's leading producer. The WTO ruling increases pressure on China to relax restrictions on high-tech rare earth metals. China has so far responded with a decision to double export quotas for some rare earth metals for the second half of 2011. The higher quotas, however, are somewhat illusory as the list of metal compounds subject to export quotas was lengthened in May.

China-North Korea bilateral trade increased by nearly a third in 2010. The value of China-North Korea trade reached $3.5 billion last year. Cooling relations between North and South Korea helped enhance China's role in foreign trade with the otherwise isolated North Korea. South Korea last year imposed trade sanctions on its northern counterpart after North Korea sank a naval ship and directed artillery fire on Yeonpyeong Island. With the imposition of sanctions, Korean bilateral trade was down in 2010 about 15 % to $1.7 billion.

There are many reasons for the limitations on North Korea opportunities to engage in foreign trade. One reality is simply the country's low production levels and government solvency. The UN has banned the selling of luxury goods and arms to North Korea, and the US and Japan have in practice imposed complete trade bans on North Korea. In April, the United States blacklisted the North Korean DongBang bank for facilitating arms trade between North Korea and Iran.

China is also bound by the UN sanctions on North Korea. According to official figures, China's imports from North Korea consist largely of coal and iron ore. China exports to North Korea much of its needed raw materials, energy and manufactured products. According to newspaper reports, Chinese firms have also financed North Korean infrastructure projects such as bridges and harbours. Hunger remains a problem in North Korea. In June, the UN launched a programme to feed starving Koreans.

In June, bilateral cooperation with China and North Korea deepened with the establishment of three special economic zones in North Korea. China's official press briefing said that mutual understanding had been achieved for creating special economic zones in the Rajin-Sonbong (Rason) region and on Hwanggumpyong and Wi Hwan islands. The special economic zones are located along North Korea's northern border near China. North and South Korea are already engaged in industrial cooperation in the Kaesong special economic zone near the demilitarized zone.

Chinese foreign travel on the rise. China's National Bureau of Statistics reports 57 million Chinese travelled abroad in 2010. The number of travellers rose by about a fifth from 2009. The most recent available breakdown of travel by country destination is available for 2009, when 85 % of Chinese foreign travel was bound for countries in Asia. The biggest destinations were Hong Kong and Macau, which accounted for 70 % of Chinese foreign travel. The other top-five destinations were Japan (3 %), Korea (3 %) and Taiwan (2 %). Taiwan opened up to Mainland travellers in 2008.

A recent report by the Boston Consulting Group (BCG) shows that Chinese tourists are younger than their American counterparts and prefer to travel with friends rather than family. The Chinese tend to use travel bureaus to book their trips and arrange visas. According to BCG, half of the spending of Chinese tourists abroad goes to buying goods. Western travellers in contrast, spend most of their money on meals and hotels.

Chinese "shop till you drop" behaviour reflects in part the prominence of gift-giving in Chinese society. According to some Chinese sources, shopping is one of the main reasons for foreign travel. The Chinese purchase considerable amounts of luxury goods from Hong Kong and Macau. Luxury items are considerably cheaper than on the mainland where prices are subject to high import duties. In France and the United Kingdom, for example, Chinese tourists have become an important purchaser group of luxury products. In recent weeks, the Chinese media have reported on government plans to lower import taxes on luxury items.

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