

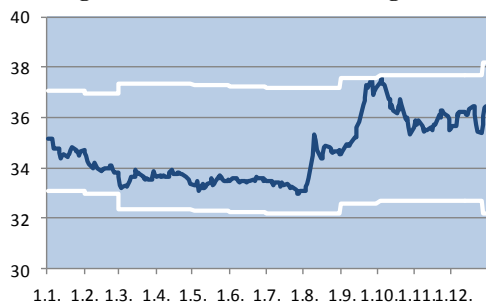
## Russia

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

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

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

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



Sources: Bloomberg, CBR

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

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

The state corporations created out of Vladimir Putin's National Champions Initiative include the conglomerate Rostekhnologii with origins in the arms industry, development bank VEB, and Olimpstroj, which is responsible for

construction related to the 2014 Sochi Olympics. The new state corporations have been allowed to act quite independently; their activities are not monitored as closely as other state-owned enterprises. Also other state-owned large companies have been established during the past few years, such as OSK (United Shipbuilding Corporation) and OAK (United Aviation Corporation). They merged firms functioning in the same branch in the hope of creating large companies that are both innovative and capable of competing in the international arena.

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

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

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

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

The ambitions of Moscow's administrators for the expansion area include construction of a world-class financial centre and a science and innovation cluster around the Skolkovo innovation centre. Federal and city administration functions could also be moved to the new area. The area should promote creation of as many as a million new jobs and bring house for two million Moscow residents. The plans would require construction of over 100 million m<sup>2</sup> of floorspace and significant improvements in transport infrastructure. No specific plans or timetables for the development have yet been released.

## China

### China prepares for selection of new leadership duo.

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

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

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

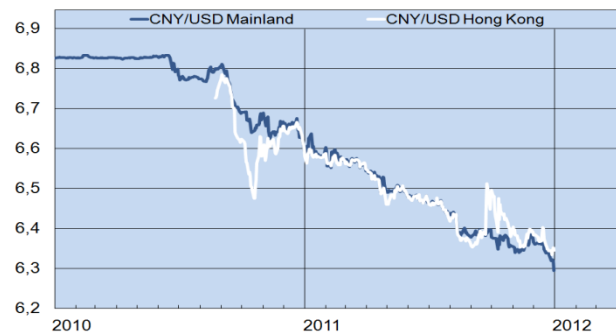
As of end-November, the nominal effective (trade-weighted) exchange rate had risen nearly 4 % from January. The real effective exchange rate was up nearly 5 %.

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

Increased uncertainty around yuan's exchange rate can be seen in changes in forex flows. Smaller trade surpluses

and euro depreciation reduced China's foreign currency reserves as measured in US dollars in September. The trend and forecast for the yuan exchange rate suggest net capital inflows to China were small in the fourth quarter with little change expected. In September, China's gold and foreign currency reserves stood at \$3.217 trillion.

### Dollar-yuan exchange rate in mainland China and Hong Kong

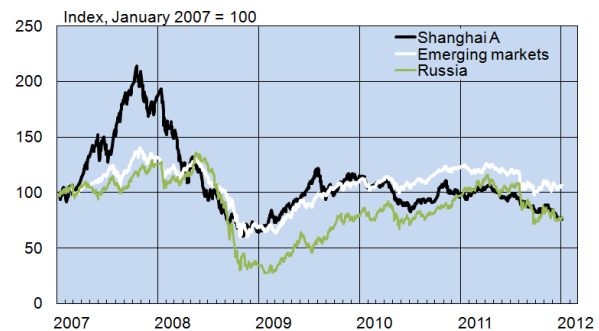


Source: Reuters

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

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

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



Source: Bloomberg