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Yearbook 2005



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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 headlines 2005

7.1.2005 BOFIT Weekly – Russia headlines 1/2005

- Putin consolidated political power in 2004.
- Slow progress in structural reform of Russian economy in 2004.
- New legislation entering into force at the start of 2005.
- Russia to build pipeline to Sea of Japan.

14.1.2005 BOFIT Weekly – Russia headlines 2/2005

- Russian inflation rate exceeds 2004 forecast.
- Current account surplus and outflow of private capital higher than expected in first three quarters of 2004.
- Government sets meat import quotas for 2005.
- Operating environment for small firms improves slightly.

21.1.2005 BOFIT Weekly – Russia headlines 3/2005

- Rouble exchange rate drops in 4Q04.
- Stabilisation fund reaches 3 % of GDP at end-2004.
- Russia's reform of social benefits in trouble.

28.1.2005 BOFIT Weekly – Russia headlines 4/2005

- Russian economic growth expected to slow this year.
- Industrial output growth declined towards the end of 2004.
- Audit Chamber's assessment of 1993–2003 privatisation outcomes awaits Duma discussion.

4.2.2005 BOFIT Weekly – Russia headlines 5/2005

- Unexpectedly high GDP growth figure for 2004.
- Russia pays off the last of its IMF debts.
- Third major agency upgrades Russia's creditworthiness.
- Public debate on Russian economic policies heats up.

11.2.2005 BOFIT Weekly – Russia headlines 6/2005

- Russian inflation picks up.
- Russian central bank makes shift in foreign exchange policy official.
- Yuganskneftegaz deal raises questions.
- State prosecutor says Russian corruption has reached troubling proportions.
- Strong demand for new cars in Russia.
- Fradkov government survives Duma no-confidence vote.

18.2.2005 BOFIT Weekly – Russia headlines 7/2005

- Russian foreign trade soars in 2004.
- Road freight transit via Finland to Russia increased last year.
- Natural resources ministry plans to exclude foreigners from auctions of strategic mineral deposits.
- Land decisions postponed.

25.2.2005 BOFIT Weekly – Russia headlines 8/2005

- Russian industrial output grew faster than expected in 2004.
- CBR relaxes currency controls.
- Government considers problems in tax administration.
- IMF mission asks Russia to ease policies to restrain rouble's appreciation.
- Russia's WTO membership talks could be completed during this year.

4.3.2005 BOFIT Weekly – Russia headlines 9/2005

- Loose fiscal policy threatens Russian budget balance.
- Russian oil production rose in 2004.
- Widening income disparity between rich and poor.

11.3.2005 BOFIT Weekly – Russia headlines 10/2005

- Russian inflation remained high in February.
- Growth in core production slowed in January.
- Rapid increase in foreign investment continues.
- New housing code enters into force.

18.3.2005 BOFIT Weekly – Russia headlines 11/2005

- Russia rapidly paying down public foreign debt.
- String of federal budget surpluses unbroken in 2004.
- Russia has over two dozen billionaires in 2005.
- Putin fires an elected governor.

24.3.2005 BOFIT Weekly – Russia headlines 12/2005

- Growth of construction and transport slows in January-February.
- More euro emphasis in rouble currency basket.
- Government approves new draft of act on mineral and hydrocarbon use.
- Duma to consider new forest code.
- Russian government plans new special economic zones.

1.4.2005 BOFIT Weekly – Russia headlines 13/2005

- Two-thirds of Russian banks now covered by deposit insurance.
- Construction growth slows.
- Support for Putin drops, cabinet's popularity rises.
- Finland: Russia now third main trading partner, China seventh.

8.4.2005 BOFIT Weekly – Russia headlines 14/2005

- Russia's current account surplus rises to 10 % of GDP in 2004.
- Russian inflation exceeding government target.
- Rouble strengthens in real terms.
- Foreign borrowing by companies and banks continues to rise.

15.4.2005 BOFIT Weekly – Russia headlines 15/2005

- Government accepts medium-range economic forecast.
- Russian investment climate hurt again.
- Putin signs Public Chamber bill.
- Euromoney and Institutional Investor publish country risk rankings.

22.4.2005 BOFIT Weekly – Russia headlines 16/2005

- Slowdown in Russian industrial output growth.
- Distinctly lower growth in oil output.
- Russian IPOs enliven capital markets.
- Gazprom and Germany's BASF sign deal on construction of Baltic Sea gas pipeline.
- New regional unions in the works.

29.4.2005 BOFIT Weekly – Russia headlines 17/2005

- Putin's state-of-the-nation speech stresses importance of strengthening state.
- Growth in real incomes slows.
- Progress in Russia's WTO talks.
- Forests bill receives severe criticism.

6.5.2005 BOFIT Weekly – Russia headlines 18/2005

- Industrial producer prices continue to rise.
- Growth in retail sales remains strong.
- Russia has sixth largest foreign currency reserves.
- Administrative reform stumbles along; number of bureaucrats actually increased last year.

13.5.2005 BOFIT Weekly – Russia headlines 19/2005

- Russian inflation remained high in April.
- EU and Russia agree on broad based cooperation.
- Russia mobile phone connections approach the 100-million mark.
- Government approves transportation strategy extending through 2020.

20.5.2005 BOFIT Weekly – Russia headlines 20/2005

- Russia agrees on early retirement of part of Paris Club debt.
- Russia's trade surplus swells.
- CBR increases euro component in currency basket.
- Russia and Estonia sign border treaty.
- CIS countries enjoy strong economic growth, but huge disparities in living standards persist.

27.5.2005 BOFIT Weekly – Russia headlines 21/2005

- FDI inflows to Russia soar 30 % in the first quarter.
- Deposit insurance scheme gradually put in place.
- New banking strategy approved.
- Gazprom and Rosneft call off merger plans.
- Duma to be elected exclusively from party lists.
- Duma ratifies China border agreement.
- Baku–Tbilisi–Ceyhan oil pipeline comes on stream.

3.6.2005 BOFIT Weekly – Russia headlines 22/2005

- Growth slows in Russia's core production sectors.
- Higher transit freight volumes, lower value cargoes.
- Putin delivers annual budget speech to parliament.
- Khodorkovsky gets nine-year sentence.

10.6.2005 BOFIT Weekly – Russia headlines 23/2005

- Inflation subsides a bit in May.
- Rouble's real appreciation continues.
- No big changes in stocks.
- Putin comes down hard on UES management for blackouts and progress in company structuring.
- Finland now Russia's eighth largest trading partner.

17.6.2005 BOFIT Weekly – Russia headlines 24/2005

- Russian GDP growth slowed in the first quarter.
- Share of long-term deposits up.
- Law on credit history enters into force.
- Listing boom continues.
- Russia tightens economic cooperation with China.

23.6.2005 BOFIT Weekly – Russia headlines 25/2005

- Growth in Russian industrial output slowed significantly in May.
- Growth in investment continues to slow.
- Duma approves supplemental budget.
- CBR releases data on composition of foreign currency reserves.

1.7.2005 BOFIT Weekly – Russia headlines 26/2005

- Growth slows in Russia's core production sectors.
- IMF mission expresses concern about Russia's loosening fiscal discipline.
- Reform of Russia's justice system has proceeded more slowly than in other transition countries.
- A brief summary of spring legislation.
- No surprises at Gazprom shareholders' meeting.
- Russia balks at ratification of border treaty with Estonia.

8.7.2005 BOFIT Weekly – Russia headlines 27/2005

- June inflation slowed slightly.
- Russia's current account surplus reached 14 % of GDP in the first quarter.
- Basic Element gets green light on purchase of Silovye Mashiny.
- Russia still hopes to get WTO membership in December.
- Finnish firms confronting the most trade barriers in Russia.

15.7.2005 BOFIT Weekly – Russia headlines 28/2005

- Russia uses a third of stabilisation fund to pay down Paris Club debt.
- Russia prepares for its G8 presidency.
- Gazprom takes aim at Sibneft.
- Russian Duma approves legislation on special economic zones and election act.
- Russian defence spending around 3 % of GDP in recent years.

22.7.2005 BOFIT Weekly – Russia headlines 29/2005

- Industrial output growth accelerated in June.
- Economy ministry publishes 2006 privatisation plan.
- Russian markets attract giant carmakers.
- Concentration of Finnish exports to Russia by enterprises closely resembles the overall structure of Finnish exports.

29.7.2005 BOFIT Weekly – Russia headlines 30/2005

- Growth in Russia's core production sectors picked up in June.
- Stabilisation fund assets to be invested in securities of G8 countries.
- CBR pulls license of bank admitted to deposit insurance scheme.
- Standard & Poor's holds Russia's credit rating steady.
- Surging corruption plagues Russian business.

5.8.2005 BOFIT Weekly – Russia headlines 31/2005

- Euro's weighting in currency basket increased.
- Average Russian wage €250 a month.
- Summer boom in Russian financial markets.
- Russia's tiny, but growing, insurance sector.
- Russian government approves space program guidelines for 2006–2015.
- Putin visits Finland.

12.8.2005 BOFIT Weekly – Russia headlines 32/2005

- Russian inflation slowed further in July.
- Fitch raises Russia's credit rating.
- Rise in producer prices decelerated slightly.
- Growth in oil output slows, export earnings surge.
- Russia to establish investment fund for public-private projects.

19.8.2005 BOFIT Weekly – Russia headlines 33/2005

- Russian foreign trade expanded rapidly in first half.
- Investment on the rise.
- Government disappointed by recent pace of economic growth.
- Government submits bill on tax amnesty of undeclared income.
- Growth in natural gas production lags.

26.8.2005 BOFIT Weekly – Russia headlines 34/2005

- Growth of core production sectors in Russia accelerates in July.
- Government considers 2006 budget.
- Russia completed early payment on Paris Club debt.
- Government agrees on Svyazinvest privatisation.
- Survey reveals insights into challenges facing small and mid-sized businesses.

2.9.2005 BOFIT Weekly – Russia headlines 35/2005

- Domestic oil prices soar in Russia.
- Rouble continues to strengthen.
- Russia posts record-low unemployment.
- Alarm over Russian demographic trends.
- CIS and CES summits in Kazan.

9.9.2005 BOFIT Weekly – Russia headlines 36/2005

- Russian consumer prices fell slightly in August.
- Record budget surplus posted in 1H05.
- Bilateral trade between Finland and Russia intensifies.
- Finland's role as freight transit corridor to Russia increases.
- Credit bureaus launch operations.
- Putin displays surprising interest in welfare issues.

16.9.2005 BOFIT Weekly – Russia headlines 37/2005

- Russian GDP growth accelerates slightly.
- Central bank plans changes in monetary and exchange rate policies.
- Duma convenes its autumn session.
- Rosneftegaz takes huge loan.
- Russia and Germany agree on gas pipeline.
- Russia and China move up in UN living standard rankings.

23.9.2005 BOFIT Weekly – Russia headlines 38/2005

- Russian industrial output growth slowed in August.
- Oil companies assent to freeze on retail gasoline prices until year's end.
- World Bank survey finds improvement in Russian business climate; Fraser survey gives harsher view.
- Gazprom takes huge loan to purchase Sibneft.
- Putin now responsible for appointments of nearly a third of regional governors.

30.9.2005 BOFIT Weekly – Russia headlines 39/2005

- Russia's GDP growth accelerates slightly.
- One fifth of banks excluded from new deposit insurance scheme.
- Local administration reform postponed.
- Gazprom buys Sibneft.
- Telecoms lead in transparency.

7.10.2005 BOFIT Weekly – Russia headlines 40/2005

- Russia's current account surplus continues to grow.
- Share prices continue to soar.
- Finnish FDI to Russia up sharply in 2004.
- Corporate profits in January-July up 41 % y-o-y.
- Russia's grain harvest generally on track.

14.10.2005 BOFIT Weekly – Russia headlines 41/2005

- Russian consumer prices up in September.
- Vneshtorgbank acquires CBR's Russian bank holdings abroad.
- Finance minister Kudrin declares Russia will not join the WTO on disadvantageous terms.
- Government dispute over proposed VAT reduction.
- EU and Russia agree on visa flexibility and readmission of illegal border-crossers.
- Russia drops five places in international competitiveness comparison.

21.10.2005 BOFIT Weekly – Russia headlines 42/2005

- Russian industrial output growth revives slightly.
- Higher oil export tariffs.
- Russia outlines its positions with international financial institutions at G20 meeting.
- Krasnoyarsk krai regional merger set for start of 2007.
- Corruption on the increase in Russia.

28.10.2005 BOFIT Weekly – Russia headlines 43/2005

- Russian economic output recovers.
- Moody's upgrades Russia's creditworthiness.
- Government releases list of strategic deposits.
- Putin establishes Coordination Council.
- LUKoil profits rise fastest among Russia's largest companies.

4.11.2005 BOFIT Weekly – Russia headlines 44/2005

- Moscow oblast posts highest industrial output growth.
- S&P bank governance survey finds Russian banks lacking.
- Government adopts administrative reform concept for 2006–2008.

11.11.2005 BOFIT Weekly – Russia headlines 45/2005

- Russian inflation still exceeds government's target.
- Government supports housing construction.
- Moscow's housing shortage gets worse.
- Russian-speakers on the decline.

18.11.2005 BOFIT Weekly – Russia headlines 46/2005

- Growth in Russian foreign trade remains brisk.
- Rouble appreciation slows.
- CBR currency reserves up by a third this year.
- Russia's private sector takes on foreign debt.
- President Putin reshuffles his cabinet.

25.11.2005 BOFIT Weekly – Russia headlines 47/2005

- Russia's total economic output continues to revive.
- CBR sticks with current monetary policy.
- Foreign investment down slightly in January-September.
- Cabinet shake-up continues.

2.12.2005 BOFIT Weekly – Russia headlines 48/2005

- Russia's economy ministry announces winning hosts of six special economic zones.
- State increases corporate ownership.
- St. Petersburg surpasses Moscow in investment attractiveness.

9.12.2005 BOFIT Weekly – Russia headlines 49/2005

- Russian inflation slowed in late autumn.
- Russia becomes Finland's largest trading partner.
- Flow of transit freight moving through Finland to Russia continues to increase.
- Russian firms borrowing like never before.

16.12.2005 BOFIT Weekly – Russia headlines 50/2005

- Russian GDP growth accelerated in the third quarter.
- Duma approves 2006 federal budget proposal.
- Duma accepts CBR's 2006 monetary policy program.
- Duma and Federation Council approve direct foreign ownership of Gazprom shares.

23.12.2005 BOFIT Weekly – Russia headlines 51/2005

- Retail sales and construction continue to drive Russian economic output.
- Euro's weight in CBR currency basket increased further.
- Russia's WTO accession pushed back to mid-2006 at the earliest.
- Russia to hike gas prices for Ukraine.

30.12.2005 BOFIT Weekly – Russia headlines 52/2005

- Central bank lowers interest rates.
- Parliament approves greater oversight of non-governmental organisations.
- Business environment for small firms worsened in 2004.
- Duma opens spring session on January 10.

BOFIT Weekly – China headlines 2005

7.1.2005 BOFIT Weekly – China headlines 1/2005

- China's foreign debt continues to increase.
- Tighter linkage of electricity and coal prices.
- Yuan bank cards now work abroad.
- Share markets await new issues.

14.1.2005 BOFIT Weekly – China headlines 2/2005

- China's foreign trade boomed in 2004.
- Chinese population passes the 1.3 billion mark.
- Growth in insurance payments slows.
- VAT rebate reform gets system working again.

21.1.2005 BOFIT Weekly – China headlines 3/2005

- Central bank lays out monetary policy goals for 2005.
- FDI continued to rise in 2004.
- Banks reduced their stocks of non-performing loans last year.

28.1.2005 BOFIT Weekly – China headlines 4/2005

- Strong economic growth in China sustained throughout 2004.
- Growth in fixed investment slowed slightly in 2004.
- Inflation rate continued to decline in December.
- Manufacturing growth remained brisk in 2004.

4.2.2005 BOFIT Weekly – China headlines 5/2005

- The blossoming of China-Japan trade.
- Household incomes grew rapidly last year.
- China's 2004 grain harvest beats forecasts.
- Major census seeks to determine reliability of Chinese economic data.

11.2.2005 BOFIT Weekly – China headlines 6/2005

- Profitability of Chinese state-owned enterprises bolstered by economic expansion.
- Rising Chinese direct investment abroad.
- Export growth strong in January.

18.2.2005 BOFIT Weekly – China headlines 7/2005

- China not yet ready to abandon current exchange rate regime.
- Record US trade deficit with China in 2004.
- Middle East remains main source of oil imports.

25.2.2005 BOFIT Weekly – China headlines 8/2005

- Inflation slows in January.
- Industrial output growth decelerates in January.
- Rapid FDI growth continues.
- Money supply growth slowed further in January.

4.3.2005 BOFIT Weekly – China headlines 9/2005

- Current account surplus booms in 2004, capital inflows reach record level.
- People's Congress gathers in Beijing.
- China to liberalise capital flows this year.

11.3.2005 BOFIT Weekly – China headlines 10/2005

- Chinese officials set 8 % GDP growth target for this year.
- NPC to approve 2004 budget report and 2005 budget estimate.
- NBS criticises statistical methodologies of regional administrations.
- Price of iron ore imports rises dramatically.

18.3.2005 BOFIT Weekly – China headlines 11/2005

- Food prices boost Chinese inflation in February.
- Annual Congress session adjourns.
- Foreign trade surplus surges in February.
- Industrial production enjoyed robust growth in January-February.

24.3.2005 BOFIT Weekly – China headlines 12/2005

- Lower growth in fixed investment.
- Retail sales continue to rise.
- Growth in FDI slows.
- Central bank cuts interest rates for excess reserves of commercial banks.
- Central bank raises interest rates on housing loans.

1.4.2005 BOFIT Weekly – China headlines 13/2005

- China's short-term foreign debt up in 2004.
- As expected, end of quota system boosts Chinese textile exports.
- Stock prices hit six-year low.
- China raises gasoline prices.

8.4.2005 BOFIT Weekly – China headlines 14/2005

- Scandals plague China's largest banks.
- Increased barriers to Chinese exports.
- Grain imports grew rapidly in January-February.
- Revised electricity pricing mechanism.

15.4.2005 BOFIT Weekly – China headlines 15/2005

- China posts foreign trade surplus in first quarter.
- China and India affirm cooperation.
- Tax revenue growth on target in first quarter.
- China's first private airline takes to the skies.

22.4.2005 BOFIT Weekly – China headlines 16/2005

- Rapid economic growth continues in China.
- Higher food and housing prices lift inflation.
- China and Australia begin talks on free-trade area.
- Chill on China-Japan relations.

29.4.2005 BOFIT Weekly – China headlines 17/2005

- Growth in fixed investments in China continued strong in first quarter.
- Industrial output growth surges on.
- Foreign exchange reserves up further in 2004.
- Foreign exchange reserves used to bolster balance sheets of state-owned ICBC.
- Growth of money supply and credit on track.

6.5.2005 BOFIT Weekly – China headlines 18/2005

- China prepares to sell state shares in listed companies.
- Higher electricity rates.
- Steady growth in wages and retail sales.
- EU launches investigations into imported clothing and textile products.

13.5.2005 BOFIT Weekly – China headlines 19/2005

- Real estate prices in China continued to rise in the first quarter.
- Taiwan opposition leaders visit Mainland China.
- Hong Kong and Macao special administrative regions benefit from growth in the global economy and China.

20.5.2005 BOFIT Weekly – China headlines 20/2005

- Chinese inflation slowed sharply in April; stable money supply growth.
- FDI falls in April.
- Robust growth in foreign trade continues.
- EU and US reinstate import quotas on Chinese textile and clothing products.

27.5.2005 BOFIT Weekly – China headlines 21/2005

- Rapid rise of Chinese industrial output continues.
- Rise in producer prices remains brisk.
- Investment shows no sign of slowing.
- Incremental freeing up of capital movements.
- China upgrades its rail system.

3.6.2005 BOFIT Weekly – China headlines 22/2005

- China cancels export tariffs on textiles and clothing.
- Tighter monitoring of foreign trade payments.
- Central Asia's increasing role in China's energy strategy.
- China became world's fourth most popular tourist destination last year.
- Hong Kong GDP growth remains strong.

10.6.2005 BOFIT Weekly – China headlines 23/2005

- China's foreign debt continues to grow.
- Stock markets continue to slide.
- Banking sector's non-performing loan stock unchanged, bank profitability up.
- Outlook good for summer grain crops.
- Electrical power capacity lags demand.

17.6.2005 BOFIT Weekly – China headlines 24/2005

- EU and China agree on textile trade limits.
- Export growth drives trade surplus in May.
- Chinese inflation unchanged in May.
- Steady growth in retail sales.

23.6.2005 BOFIT Weekly – China headlines 25/2005

- Chinese industrial output growth remains strong.
- Little change in FDI inflows.
- Chinese investment growth shows no signs of slowing.
- Income disparities of urbanites continue to widen.
- Bank of America buys stake in China Construction Bank.

1.7.2005 BOFIT Weekly – China headlines 26/2005

- Stock market reform shifts into high gear.
- Liberalisation of China-ASEAN trade begins.
- CNOOC moves to boost oil reserves.
- China and Russia establish a new cooperation body.

8.7.2005 BOFIT Weekly – China headlines 27/2005

- China's president signs political communiqué with Russia; Kazakhstan promises China more energy.
- Steel production enjoys red hot growth.
- China to begin building up strategic oil reserves at the end of this year.
- Local governments spending more on keeping city commercial banks afloat.

15.7.2005 BOFIT Weekly – China headlines 28/2005

- China releases draft of new property laws.
- Rapid increase in exports.
- China and the United States discuss market access and trade problems.
- China rolls out purchasing manager index.

22.7.2005 BOFIT Weekly – China headlines 29/2005

- China revalues yuan, shifts to currency basket.
- Chinese economic growth remains robust.
- Growth in China's currency reserves accelerated at the start of the year.
- Inflation declined in June.
- Standard & Poor's lifts China's credit rating.

29.7.2005 BOFIT Weekly – China headlines 30/2005

- China's new exchange rate regime.
- Household incomes rising rapidly.
- Industrial output growth remains brisk.
- Opposition to CNOOC's bid for Unocal increases.

5.8.2005 BOFIT Weekly – China headlines 31/2005

- China relaxes currency controls further.
- Steel industry reforms.
- Competition in China's auto sector heats up.
- CNOOC abandons its bid for Unocal.

12.8.2005 BOFIT Weekly – China headlines 32/2005

- China's central bank governor reveals more about currency basket.
- China's largest bank transfers non-performing loans to asset management firms.
- Electrical power shortages continue.
- Pension system problems.

19.8.2005 BOFIT Weekly – China headlines 33/2005

- Slow rise in Chinese consumer prices.
- Investment growth remains brisk.
- Trade surplus continues to swell.
- Steady increase in exports raises industrial output.
- Broad money supply growth accelerated in July.

26.8.2005 BOFIT Weekly – China headlines 34/2005

- Fuel shortages in southern China.
- State share reform extended to all listed companies.
- Investor group acquires stake in Bank of China.
- CNPC to acquire PetroKazakhstan.

2.9.2005 BOFIT Weekly – China headlines 35/2005

- Chinese central bank raises rates on foreign currency deposits.
- Rapid rise in corporate profitability continues.
- No resolution to textile trade talks.
- Hong Kong economy continues to boom.

9.9.2005 BOFIT Weekly – China headlines 36/2005

- Chinese and EU leaders meet in Beijing.
- China and EU resolve dispute over clothing and textile quotas.
- European firms satisfied with China's development.
- Government continues to bail out stock brokers.

16.9.2005 BOFIT Weekly – China headlines 37/2005

- Slowdown in Chinese consumer price rise continued in August.
- Money supply growth accelerated this summer.
- Foreign trade surplus continues to balloon.
- IMF recommends increased flexibility in China's exchange rate.
- Macao's economic growth slows slightly.

23.9.2005 BOFIT Weekly – China headlines 38/2005

- OECD report anticipates continued strong economic growth for China.
- Rapid growth in fixed investment.
- Lower foreign direct investment in China.
- Foreign owners now have stakes in three of China's four large state banks.

30.9.2005 BOFIT Weekly – China headlines 39/2005

- China's exchange rate reform proceeds.
- Rapid growth in industrial output.
- Steady rise in domestic consumption.
- China drops in WEF competitiveness survey.

7.10.2005 BOFIT Weekly – China headlines 40/2005

- Chinese auditors give negative assessment of use of public funds in 2004.
- Creditworthiness of banks on the rise.
- Strong growth in China's transport sector.
- Fraser Institute: China climbs economic freedom index.

14.10.2005 BOFIT Weekly – China headlines 41/2005

- China rolls out latest five-year plan.
- Foreign trade growth shows no sign of slowing.
- Slower growth in China's foreign debt.
- Rapid growth in Chinese tax receipts.
- ADB and IFC get permission to issue yuan bonds.

21.10.2005 BOFIT Weekly – China headlines 42/2005

- Investment and exports continue to drive Chinese economic growth.
- Fitch upgrades China's creditworthiness on strong balance of payments, robust economic development and banking system improvements.
- China Construction Bank IPO rocks Hong Kong bourse.

28.10.2005 BOFIT Weekly – China headlines 43/2005

- Chinese inflation slowed in September.
- Retail sales growth holds steady.
- Robust industrial output continues.
- FDI inflows remain steady.

4.11.2005 BOFIT Weekly – China headlines 44/2005

- Chinese current account surplus widened further in January-June.
- Investment growth remains rapid.
- China raises non-taxable income ceiling.
- Rapid incomes growth continues.

11.11.2005 BOFIT Weekly – China headlines 45/2005

- Good early summer grain harvests in China.
- China introduces new measures of unemployment.
- US and China agree on textile trade.
- Central bank publishes report on stability of financial system.
- Limiting of foreign ownership in Chinese bank sector discussed.

18.11.2005 BOFIT Weekly – China headlines 46/2005

- Chinese consumer price inflation accelerated slightly in October.
- Foreign trade surplus continues to grow.
- Stock market reforms continue.
- OECD assesses Chinese agriculture policy.

25.11.2005 BOFIT Weekly – China headlines 47/2005

- No slowing in fixed investment in China.
- Industrial profits and rapid production growth continues.
- President Bush visits China.
- Finland running trade deficit with China this year.

2.12.2005 BOFIT Weekly – China headlines 48/2005

- Third quarter growth figures for Hong Kong and Macao.
- Further liberalisation of China–Hong Kong trade.
- Easier to use yuan in Hong Kong.
- China ratifies UN anti-corruption convention.

9.12.2005 BOFIT Weekly – China headlines 49/2005

- China further opens its banking sector to foreign investors.
- Census of Chinese economy completed.
- Excess production of steel and aluminium; copper supplies inadequate to meet demand.

16.12.2005 BOFIT Weekly – China headlines 50/2005

- China considering radical upward revision of GDP.
- Despite rapid money supply growth, consumer price inflation remained low in November.
- Eerie consistency in industrial output growth.
- Export growth cooled in November.
- China meeting its WTO commitments for 2005.

23.12.2005 BOFIT Weekly – China headlines 51/2005

- Chinese GDP revised upwards by 17 %!
- Rapid investment growth continues.
- 2005 monetary policy and financial market highlights.

30.12.2005 BOFIT Weekly – China headlines 52/2005

- Chinese investment abroad continues to increase.
- Pension scheme revised.
- Industry profitability keeps climbing.
- China closes factories and limits investments.



Russia

Putin consolidated political power in 2004. Based on a presidential initiative, president Vladimir **Putin** gained the power to select *gubernatorial nominees*, which means in practice the president now chooses regional governors. Moreover, the *Political Parties Act* was also amended to curtail the political significance of minor parties. Under the revised law, a party must by the end of 2005 have at least 50,000 members and at least 500 member organisations located in more than a half of Russia's 89 regions to have standing in elections. Finally, the Duma approved the first reading of the president's proposed amendment to annul the one-deputy districts and require all 450 Duma deputies be selected from national party lists. This will in effect exclude from the Duma practically all liberal opposition deputies currently chosen from one-deputy districts.

Slow progress in structural reform of Russian economy in 2004. Reform of energy giant UES stalled last summer when the government shelved the company's long-planned partial privatisation. After years of halting reform of natural gas monopoly Gazprom, the company's new expanded role in Russia's energy sector may further hinder its reform (*BOFIT Weekly 29/2004*). The banking sector's mini-crisis last summer and the actual re-nationalisation of the Yukos oil company at the end of 2004 indicate that the fundamentals of the Russian economy are still weak in part and that the economic operating environment remains unstable.

The massive administrative reform launched last spring has seriously hampered the everyday functioning of ministries and agencies. The reform is set to continue, although it does not appear to be meeting its goals of clarifying structures of public administration or lines of responsibility. This year's theme is reform of regional administration.

Contrary to expectations, important pieces of legislation failed to materialise last year. They include the Subsoil Code (which the Duma rejected in October) and the Forest and Water Codes. Work on them should continue this year.

New legislation entering into force at the start of 2005. The impact of the legislative changes is most apparent in the social sector. From the start of this year, 15 million citizens have begun to receive monetary compensation out of the federal budget in lieu of public services earlier provided to them at no charge. The compensation partly covers the purchase of the previously free services. In addition, beneficiaries may use certain "basic services" (e.g. medications, spa treatments and public transport) worth a set amount of money. The benefit packages for some beneficiary groups are now determined at the regional level and financed out of regional budgets.

Due to changes to the regressive *unified social tax*, employers will make smaller contributions to pension insurance, health insurance and social funds. For the start of the year, the top social tax rate has been lowered to 26 %. The new housing law, part of the larger *housing legislation package*, also entered into force, launching the gradual implementation of a large-scale housing sector reform.

Also now in force is a *minimum wage increase* from 600 roubles a month to 720 roubles (19 euro). Hikes also apply to e.g. state sector wages, social payments and student stipends.

The new year brought revisions in the tax code with the introduction of land and water taxes. New principles on budget and tax allocation at the local, regional and federal levels also came into effect. The new principles are intended to more clearly delineate the responsibilities and duties at various administrative levels.

Russia to build pipeline to Sea of Japan. On New Year's Eve, the government announced its decision to construct an oil pipeline stretching over 4,000 kilometres from Taishet in eastern Siberia to Nakhodka on the Sea of Japan. State pipeline operator Transneft will construct the pipeline. While the construction costs are difficult to pin down, they will likely exceed €15 billion. Some of the project is planned to be privately financed and the Japanese have declared interest in participating in the financing. The government has asked Transneft to submit a detailed pipeline construction proposal by early May. The planned capacity of the pipeline is about 1.6 million barrels a day, or nearly a third of Russia's current oil exports.

With Transneft's pipeline grid pushed to full capacity, the pipeline decision was eagerly awaited. Without the new pipeline, Russia has almost no possibility to substantially increase capacity from its current level. The pipeline to the Sea of Japan also shortens the distance for Siberian oil to reach US and Japanese markets. All of Russia's major export routes currently go via Europe. The government's decision was a disappointment to China, which has lobbied for the shorter alternative pipeline to Daqing, China. Plans for that pipeline are now on hold.

Planned expansions of Transneft export pipeline grid 2003–2020, volumes in millions of barrels per day

Transneft export pipelines	03	05	10	15	20
To Primorsk terminal (BPS)	0.6	1.2	1.2	1.2	1.2
To Baltic and Polish terminals	0.1	0.3	0.3	0.3	0.3
Ukraine-Europe (Druzhba)	1.3	1.3	1.3	1.3	1.3
Black Sea grid	1.3	1.3	1.3	1.3	1.3
Caspian Sea grid	0.4	0.6	1.3	1.3	1.3
Taishet to Nakhodka			0.6	1.0	1.6
Western Siberia to Murmansk				1.0	1.6
Total	3.7	4.7	6.1	7.5	8.7

Source: Russian Ministry of Industry and Energy



China

China's foreign debt continues to increase. The State Agency for Foreign Exchange (SAFE) reports China's foreign debt at the end of September 2004 was \$223 billion, a 15.3 % increase from the end of 2003. Short-term debt was about 45 % of the total.

Fast economic growth and state measures to dampen domestic lending encouraged foreign borrowing. Capital flows into China were also boosted by high domestic interest rates relative to international levels and expectations of a yuan revaluation. In relative terms, China's foreign debt remains quite modest – only 16 % of 2003 GDP or 43 % of the nation's foreign currency reserves as of end-September 2004. Public debt accounts for about a quarter of foreign debt.

Tighter linkage of electricity and coal prices. In December, the Chinese government approved a plan to better correlate trends in electricity prices with those of coal prices. Under the plan, the price of electricity will be adjusted when the price of coal changes at least 5 % within a six-month period. The reform is expected to enter into force in the first half of this year. Since the coal price rose in the last seven months of 2004, the new policy is expected to bring large hikes in electricity prices in the near term. The price charged for electricity supplied to farms, housing and fertilizer production will also be raised, but using a different mechanism.

In recent years, increases in state-regulated electricity prices have failed to keep up with rising coal prices as electricity demand has grown. Coal producers also remain reluctant to sell coal to electrical power producers, who are allowed to buy coal at prices well below market. Estimates put the difference between the market price for coal and the price allowed for electrical power producers at 26 % for 2003 and this gap further widened last year. Profitability at many power plants has suffered as their profit margins have been hurt by higher coal prices and an increasing shortage of coal supplies. The reform is intended to increase the market mechanism function throughout the energy sector. Problems are nevertheless expected this year, when the excessive demand for coal and the subsequent price hike is expected to continue. The main bottleneck is coal transport capacity, which the government seeks to rapidly increase.

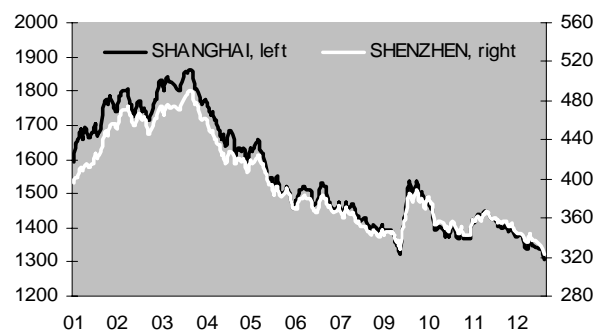
Yuan bank cards now work abroad. China's central bank, the People's Bank of China, has announced it will allow holders of bank cards issued by Mainland Chinese banks participating in the national payments system to use their bank cards abroad. The new arrangement goes into effect on Monday (Jan. 10) and allows card use in

Thailand, South Korea and Singapore. As of end-2004, 75 Chinese banks participated in the national payments system. Earlier, it was impossible to use a yuan-based bank card outside China's borders. Under the new rules, each card will carry a daily debit limit of 5,000 yuan (450 euro). Hong Kong and Macao began to accept Mainland China bank cards last year. Foreign banks operating in Mainland China are not allowed to issue yuan-denominated bank cards.

Share markets await new issues. At the beginning of January revised regulations on new share issues entered into force. After a three-month hiatus, new share issues are again expected to appear on the markets (see *BOFIT Weekly 49/2004*). Under the new regulations, the listing prices of initial public offerings for companies to be listed will be determined by inquiries to institutional investors. This group of institutional investors comprises investment funds, investment banks, investment fund companies, as well as foreign investors and foreign insurance companies approved by China's Securities Regulatory Commission (CSRC). The CSRC posts its list of approved institutional investors on its website. To get a valid appraisal, the listing company must send out a pricing enquiry to at least 20 institutional investors and at least 50 investors when it plans to issue more than 400 million shares.

The revised rules are intended to assure that newly listed share prices reflect the market. Unfortunately, the new rules also give institutional investors the possibility to manipulate listing prices. The conflict of interest arises because institutional investors are also permitted to subscribe to the very shares they appraise. Small private investors, on the other hand, are not permitted to participate in the pricing of new listings. Small investors do not seem too impressed by the new rules as the Shanghai and Shenzhen bourses both continued their declines. Most shares traded on stock exchanges are owned by small investors.

A-share indices for Shanghai and Shenzhen exchanges



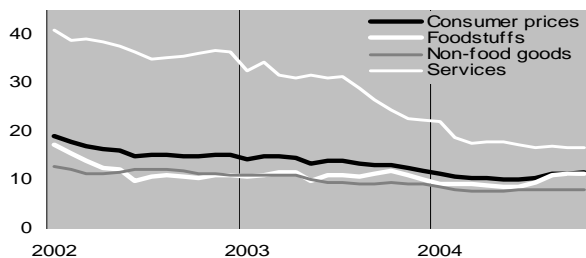
Sources: Shanghai and Shenzhen exchanges

Russia

Russian inflation rate exceeds 2004 forecast. Russian consumer prices rose 11.7 % last year, substantially more than the government's 8–10 % target range. A major factor driving inflation was the acceleration in the rise in food prices since late summer to 12.3 % y-o-y. The spikes in meat prices (up 17 %) and grain products (20 %) were particularly substantial. Prices of non-food goods rose an average of 7.4 %, led by gasoline prices which climbed 31 %. The on-year rise in prices of services remained brisk (17.7 %), where housing (24 %) and daycare (22 %) were the fastest rising items.

Unlike in earlier years, inflation hardly slowed in 2004. The high inflation was sustained in part by an unanticipated massive inflow of foreign currency into Russia as a result of high world oil prices. Many observers consider optimistic the Russian government's announced inflation target of around 8 % for this year.

12-month changes in Russian consumer prices since 2002, %



Source: State Statistics Service

Current account surplus and outflow of private capital higher than expected in first three quarters of 2004.

Balance-of-payments data released by the Central Bank of Russia for January-September 2004 show a current account surplus of nearly \$41 billion, or nearly 10 % of GDP (compared to less than 9 % in the same period in 2003). Measured in dollars, Russian export earnings on exports of goods and services swelled by nearly a third in January-September from the same period in 2003. Imports of goods and services grew about 25 %. Measured against a basket of currencies of Russia's main trading partners, which gives a better idea of the actual development of Russian foreign trade, the value of exports grew less than 25 % and imports less than 20 %.

The net outflow of private capital in January-September was \$17 billion or 4 % of GDP (compared to 1 % of GDP in January-September 2003). Of this, the unrecorded net capital outflow (errors and emissions item in the balance of payments) was \$7 billion, or slightly more than last year. The enterprise sector recorded a net capital outflow of over \$4 billion – a reversal of the net capital flow direction from the previous year. This was due above all to a capital out-

flow of nearly \$19 billion bolstered by fictitious import transactions and securities trades, while company borrowing from abroad fell to under \$10 billion. FDI inflows to Russia fell to \$6 billion, while Russian direct investment abroad declined to just under \$6 billion.

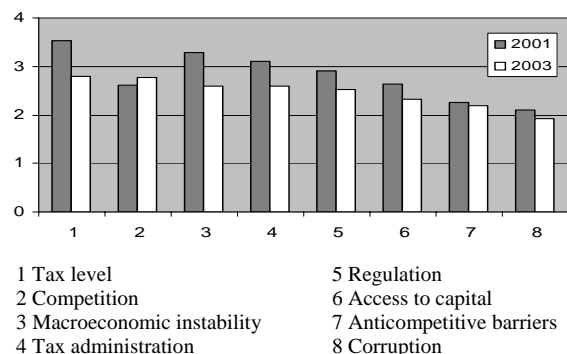
Government sets meat import quotas for 2005. The EU will get 80 % of the total beef import quota of 457,500 tonnes (an increase of 2 % from last year) and half of the 467,400-tonne pork quota (+4 %). About a fifth of the 1,050,000-tonne poultry quota (+5 %) will go to EU exporters. The value of annual EU meat imports to Russia is currently about €1.3 billion.

Russia has agreed with the main WTO members that it will keep its protectionist quota system in place until 2009. The use of quotas last year gave a boost to Russia's domestic poultry industry, but also induced a rapid rise in meat prices. After a long dispute, EU countries agreed to Russian demands to move to a single veterinary certificate for all imported meats of EU origin.

Operating environment for small firms improves slightly.

The latest survey of the regulatory burden on small business by the Moscow-based Centre for Economic and Financial Research (CEFIR) reveals that the regulatory burden was somewhat eased in 2003 compared to the previous two years. For example, the number of official inspection visits fell and registration of new companies became easier. Tax administration was also considered to have been simplified, perhaps due in part to new legislation governing small businesses. The most common barrier to entrepreneurship was tough competition, which actually suggests a gradual improvement in the business climate. There was virtually no change in the effects of corruption and criminality. Lack of access to financing was also seen as a major problem for small businesses. CEFIR interviewed 1,600 businesses in 19 regions. The State Statistics Service showed that 953,000 small businesses operated in Russia at the beginning of October 2004 and that these companies employed 13 % of the labour force. Small firms contributed 13 % of GDP in 2003.

Perceived regulatory burden on small enterprises in 2001 and 2003 (1 = not a problem, 5 = threatens firm's existence)



Source: CEFIR

China

China's foreign trade boomed in 2004. Total foreign trade reached \$1,150 billion (€880bn) in 2004, a 36 % increase from 2003. Exports grew 35 % y-o-y, while imports climbed 36 %. China recorded a trade surplus of \$32 billion at the end of 2004, up from \$25.5 billion in 2003. The European Union became China's largest trading partner, followed by the United States and Japan. Among China's largest trading partners, Canada led the growth in bilateral trade with a 55 % increase.

Exports of electromechanical products soared 42 % y-o-y and constituted 55 % of all exports. In contrast, growth in traditional Chinese exports, such as clothing and shoes, slowed to less than 20 %. Imports of finished industrial products constituted almost 40 % of total imports. Although growth was still a robust 31 % y-o-y, it slowed 8 percentage points from 2003. In contrast, imports of raw materials such as crude oil and iron ore rose by over 60 % y-o-y. Growth was 14 percentage points higher than in 2003.

Chinese population passes the 1.3 billion mark. Without the one-child-per-family policy introduced in the late 1970s, China's population would have surpassed the 1.3-billion mark already in 2000 instead of this month. People over 60 now constitute 11 % of the population and it will rise to 28 % of the population by 2040 due to the policy. Sometime in the 2050s, China's population will begin to decline. The rapid aging of China's population has created new pressures to secure adequate incomes for the elderly. Because most rural residents are even not in the pension system, they face the risk of burdening their only child with having to provide income for themselves, their parents and grandparents. Although urban residents are in the pension system, it is clearly inadequate. The situation is skewed by the disproportionate ratio of male births to female births. Only 100 girls are born for every 120 boys. The effects of long-term preference for boys will already begin to emerge within the next five years. To balance the situation, the government criminalised gender-based abortions from the start of this year. Moreover, although China is the world's most populous country, labour shortages have begun to appear, especially in coastal regions (see *BOFIT Weekly 46/2004*).

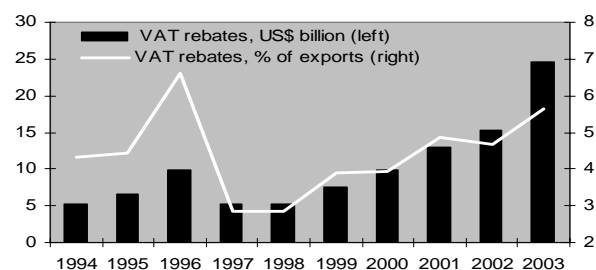
Growth in insurance payments slows. China's Insurance Regulatory Commission (CIRC) reports insurance premia collected rose 11.3 % last year to around CNY 430 billion (€9bn). Insurance payments rose 27 % in 2003 and 45 % in 2002. The largest growth (25 %) was posted in property insurance payments, which was driven by rapid growth in fixed investments and brisk car sales in the early part of last year. This year CIRC plans to focus on improving the cor-

porate governance in insurance companies and develop China's health insurance system. Although the growth in insurance payments has slowed, it has not dampened the growth of insurance companies. The assets of Chinese insurance companies at the end of 2004 totalled nearly CNY 1,200 billion (€110bn), or 30 % more than a year earlier. According to CIRC, the profitability of insurance companies improved last year. A new CIRC rule that went into effect at the start of the year could, however, affect insurance company profitability. Under the new rule, insurance companies must deposit 0.5–1.0 % of the insurance premia collections in a national fund. The purpose of the fund is to secure the rights of policyholders in the event their insurance company goes bankrupt.

VAT rebate reform gets system working again. China introduced VAT rebates for exported goods in 1985 to boost its export sector. Over the past decade, annual export growth has averaged nearly 20 %. Unfortunately, rapid export growth and increased rebates, together with the fiscal decentralisation in 1994, strained the central government's ability to keep up with its growing spending commitments. In some cases, the state's VAT rebate arrears were as late as two years. To fix the problem, the central government began to reform the VAT rebate regime in 2003 (see *BOFIT Weekly 1/2004*). Last year a total of CNY 200 billion (€18 billion) in arrears were paid off, achieving the main objective of the reform. VAT rebates in 2004 are likely to match the level of 2003.

The VAT rates are typically 17 %, 13 % for different goods, and 6 % for small companies. The amount of VAT rebates on exported goods will depend on the rebate rates designated by the government. For example, the rebate rate of 17 % indicates a full return of VAT payments to the exporting company. However the effective rebate rate (the ratio of rebates to total exports) has generally remained below 6 %. Although the government vowed to reduce the overall level of VAT rebate rates, the change announced in December actually hiked the rate for information technology exports from 13 % to the highest possible percentage bracket of 17 %. The move suggests the government is still using the VAT rebate system to support the main export sectors and its industrial policy.

VAT export rebates, 1994–2003



Source: State Administration of Taxation

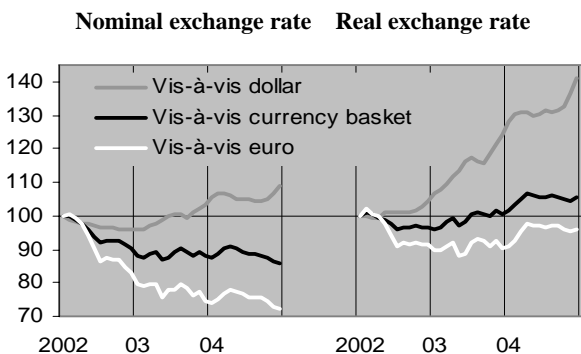
Russia

Rouble exchange rate drops in 4Q04. The rouble's nominal exchange rate climbed nearly 5 % against the flagging dollar in international markets in the last three months of 2004. It fell, however, 4–5 % in relation to the euro and 2.5 % vis-à-vis a basket of the currencies of Russia's trading partners. Thus, the rouble's real exchange rate, which is based on the nominal exchange rate development, inflation differences between countries and reflects development of cost levels and price competitiveness, shot up against the dollar while falling slightly against the euro and currency basket.

The rouble's nominal exchange rate weakened, although preliminary figures indicate that the current account surplus and net inflow of private capital from abroad in the last quarter of 2004 were both huge. The Central Bank of Russia continued its battle against appreciation pressure on the rouble through interventions in the forex markets. This increased the CBR's foreign currency reserves by \$27 billion in the fourth quarter and its currency reserves stood at \$125 billion at the end of the year.

During the past three years, the rouble's nominal exchange rate in relation to the currency basket has declined 15 % and the real exchange rate has gained 7 %, mostly in early 2004. Some analysts see this as evidence that Russia has already weaned itself from a strong peg to the US dollar. In the past three years, the nominal value of the rouble has risen 8 % against the dollar and the real exchange rate over 40 %. Relative to the euro, however, the rouble has fallen nearly 30 % in nominal terms and 2 % in real terms.

Rouble's average exchange rate, January 2002–December 2004



Source: Russian Central Bank

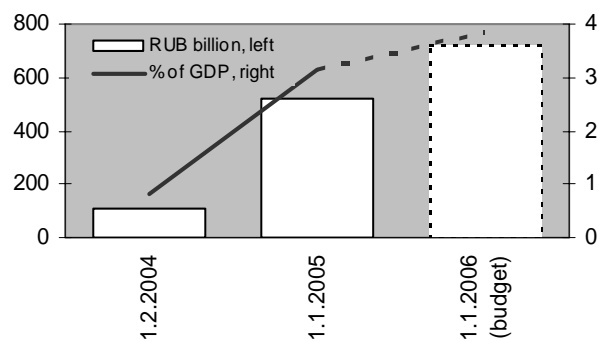
Stabilisation fund reaches 3 % of GDP at end-2004. At the stabilisation fund's inception in February 2004, its assets stood at RUB 106 billion. It was initially funded

with the transfer of assets in the state reserve fund and the 2003 budget surplus. High oil prices helped fill the fund much faster than anticipated. The finance ministry reports that fund assets at the end of last year totalled RUB 522 billion (over €14bn).

Part of the excess in the fund above RUB 500 billion will go this year to prepay foreign debt and funding the state pension fund's shortfall. The Russian government is currently in discussions with the Paris Club of creditors on accelerating the paying off of foreign debts.

The government's 2005 budget assumption is that RUB 390 billion will be added to the fund this year. By January 1, 2006 the value of the fund should reach RUB 720 billion (about €20bn or nearly 4 % of GDP).

Stabilisation fund growth, 2004–2005



Source: Ministry of Finance

Russia's reform of social benefits in trouble. Although the social benefit reform passed by the Duma quickly last summer heads in the right direction in principle, it was not particularly well thought out. The changes, which went into force at the start of this year, replaced free services provided to the populace with monetary compensation. Some of the responsibility for providing such services was assigned to regions, many of which are not technically prepared to implement them. Moreover, many regional budgets simply lack the money to finance the costs of the new arrangements.

After more than two weeks of widespread protests, the president and cabinet found themselves forced to retreat somewhat on these reforms. The most debated change – elimination of free public transportation for pensioners and war veterans – will now be replaced by subsidised transport passes. Furthermore, the annual pension increase, originally scheduled for April, will be moved up a month and the amount of the increase doubled. These measures will be funded out of the federal budget.

China

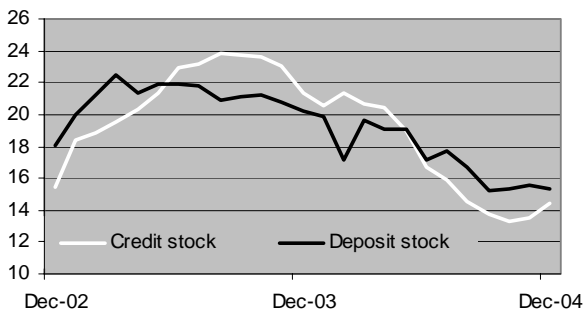
Central bank lays out monetary policy goals for 2005.

The total loan stock grew 14 % in 2004, well under the central bank's target ceiling of 16 %. Most new loans to households issued last year (over a quarter of all new loans) were for mortgages or cars. China's four major state-owned banks held 65 % of the total loan stock, with the next twelve shareholding banks trailing far behind with a combined share of just 15 %. The deposit stock grew 15 % in 2004, and about half of the deposit stock consisted of household deposits. Money supply (M2) increased 15 % in 2004 or two percentage points below of the central bank's target.

The central bank listed its main objectives for the current year at the beginning of this month. It will continue its tight monetary policy and target growth rates for credit and money supply at 14 % and 15 %, respectively. The central bank vowed to increase the role of indirect instruments in monetary policy (e.g. open market operations and reserve requirements). The central bank currently relies heavily on direct instruments (e.g. interest rate controls, credit ceilings and directed lending). The central bank will also emphasise the balancing of international payments by encouraging capital outflows, especially Chinese foreign direct investment abroad.

At the end of 2004, China's foreign reserves rose to \$610 billion (€470bn), an increase of \$210 billion from 2003. The current account surplus and FDI amounted to around \$100 billion, approximately the same level as in 2003. The rest (\$110bn) was accumulated through financial accounts, partly on the expectation of a yuan revaluation.

Growth of credit and deposit stocks, % change y-o-y



Source: People's Bank of China

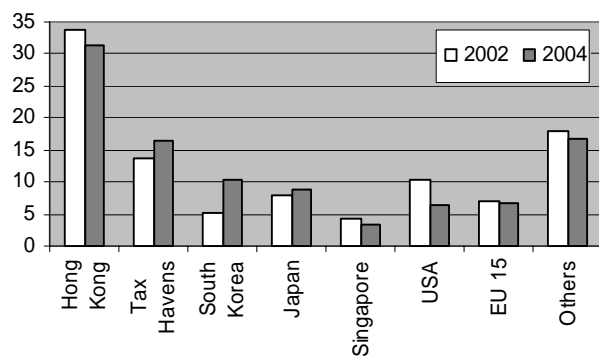
FDI continued to rise in 2004. Foreign direct investment in Mainland China rose 13 % y-o-y last year and totalled over \$60 billion, making China the second largest recipient of FDI after the United States. However, given China's size, the investments are not particularly impressive for an emerging country. China's Ministry of Commerce said investment was particularly strong in high-tech fields such

as manufacture of electronic devices. Investments in research centres also expanded vigorously, while government measures effectively constrained investment in overheated industries such as cement and aluminium. China last year granted operating licences to over 43,000 new companies with foreign participation. The number of such firms rose 6 % from 2003 to nearly 510,000.

Nearly a third of foreign direct investment in China came from Hong Kong. Tax havens provided another 16 %, while South Korea accounted for 10 %. Investment continued to focus mainly on eastern China, but there was also strong growth in investment directed towards central and northeastern regions. FDI in western China remained modest and were virtually unchanged from a year earlier.

Chinese investments abroad (excluding the financial sector) amounted to \$1.8 billion during January-November 2004. About half of that amount went to investments in South America. Some 55 % went to the mining industry. The state has encouraged domestic industries to invest abroad since 2003.

Sources of foreign direct investment by country, % share



Source: NBS and Ministry of Commerce

Banks reduced their stocks of non-performing loans last year. China's Banking Regulatory Commission reports that the ratio of non-performing loans to total lending of the country's four largest state-owned bank's and the twelve leading shareholding banks fell last year 4.6 percentage points to 13.2 %. Banks succeeded in reducing their stocks of non-performing loans by CNY 400 billion (€37bn) so that the value of outstanding non-performing loans at the end of 2004 was just CNY 1,720 billion. The stock of non-performing loans held by the four large state-owned banks fell by CNY 350 billion to CNY 1,580 billion and their non-performing loans ratio fell 4.8 percentage points to 15.6 %. China wants to reduce the amount of non-performing loans to prepare the banking sector for increased competition when it opens to foreign banks at the start of 2007. The reduction of non-performing loans has been largely achieved through the transfer of such loans to state-run asset management companies (see *BOFIT Weekly 41/2004*).

Russia

Russian economic growth expected to slow this year.

The economy ministry's December forecast anticipated GDP growth this year in the range of 4.7–6.1 %. In the earlier forecast from August, the economy ministry was still estimating a 6.3 % growth for 2005. Economic growth is particularly dependent on world oil prices. The higher end of the growth forecast range assumes a price of \$35 a barrel for Urals-grade crude oil and that the government will actively pursue policies to stimulate economic growth. The pessimistic scenario uses an oil price assumption of \$31 a barrel. The average price of Urals crude in 2004 was \$34.50 a barrel. Preliminary economy ministry figures suggest that GDP growth last year was 6.9 %.

The consensus forecast for the Russian economy in 2005, based on an average of the outlooks of 20 investment banks, was still 6.0 % in November. The average fell this month to 5.5 %.

Various GDP growth forecasts for 2005

Economy ministry (12/2004)	4.7–6.1 %
OECD (11/2004)	5.5 %
EBRD (11/2004)	6.0 %
IMF (09/2004)	6.6 %
IET (12/2004)	3.8–6.0 %
Average of six Russian investment banks ¹⁾	5.4 %

¹⁾ Troika, MNB, RenCap, UFG, Aton and Uralsib (01/2005)

Industrial output growth declined towards the end of 2004.

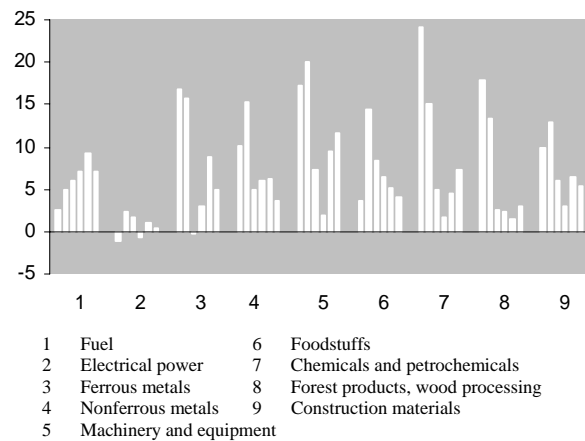
The industrial output slowed down in the fourth quarter and averaged at 6.1 % for the entire year. In the first nine months of 2004, industrial output growth was 6.5 % y-o-y. For October–December, industrial output growth slowed to a pace of 4.8 % y-o-y.

The fastest growing industrial branches in 2004 were glass and ceramics (16 %), and machine-building and metal fabrication (12 %). In the machine-building and metal fabrication segment, the fastest growing industries were manufacture of machine tools (24 %) and rail cars (23 %). The growth in rail car production was largely driven by Russia's increased shipment of crude oil by rail. In contrast, production of steel pipe used in construction of oil and gas pipelines contracted 2 %. Automobile production grew 10 % y-o-y.

Fuel production overall rose 7 %, with production of crude oil up 9 %, coal 1 % and natural gas 2 %. Despite the rapid increase in crude oil output, oil refining grew just 3 %. Other industrial segments enjoying robust growth included chemicals and petrochemicals (7 %), construction materials (5 %), ferrous metallurgy (5 %) and the food

industry (4 %). While the food industry witness a decline in grain products (down 5 %), beer production was up 12 %. Forest products and wood processing grew 3 % y-o-y. Production fell in four industrial branches, including light industry (down 7.5 %).

On-year change in output of major industrial segments, 1999–2004, %



Source: State Statistics Service

Audit Chamber's assessment of 1993–2003 privatisation outcomes awaits Duma discussion.

A review of Russia's privatisation experience, originally scheduled for Duma consideration in July 2004, was shifted to spring 2005. The assessment was launched about a year ago at the behest of president Vladimir Putin and focused on the legal correctness of 140 large privatisation sales. The report aroused concern in the corporate sector as it was even feared to lead to re-nationalisation of privatised assets.

Sergei Stepashin, chairman of Russia's Audit Chamber, stressed that the chief goal of the report was to examine earlier privatisations in order to avoid similar mistakes in the future. The report states that although privatisation efforts managed to raise the share of private enterprises to 60 % of all Russian companies by the end of the 1990s, they failed to create broad ownership bases, improve efficiency or attract sufficient resources to make needed investment. Moreover, the study found that, throughout the 1990s, the state lacked a consistent privatisation policy, which resulted in conflicting and deficient laws, as well as a lack of oversight. On the other hand, neither has the government been able to promote efficiency in companies in which it still holds substantial stakes.

In its conclusions and recommendations for further action, the report emphasises that deficiencies in legislation do not justify unwinding old privatisation sales. However, research on privatisation sales needs to continue and violators of laws in the state administration and the enterprise sector need to be brought to justice.

China

Strong economic growth in China sustained throughout 2004. The expected slowing of growth towards the end of the year never materialised. Instead, real annual growth accelerated slightly from the third quarter to 9.5 % in the final quarter. Overall growth for 2004 was also 9.5 %.

A surprise motor of growth at the end of last year was agriculture. Crop yields for maize, rice, beans, wheat and potato beat all estimates, rising 9 % from 2003. Much of last year's harvest was booked in fourth quarter statistics and thus had a strong impact on fourth quarter growth. Production of other crops also rose and growth in the agriculture-dominated primary sector accelerated to 6 % in 2004. Growth in the service sector also picked up from 2003, and remained fairly stable throughout the year. The value-added of the sector was up 8 % y-o-y. Growth was strong in both sales and the transportation sector. On the other hand, growth slowed slightly to 11 % in the Chinese economy's secondary sector, which includes e.g. manufacturing and construction.

China's official demand-side statistics of the national accounts for last year will not be released until next autumn, but preliminary figures indicate fixed investment growth was 26 % y-o-y. Although investment growth slowed substantially from the first quarter, it overall nearly matched 2003 for the year. Retail sales, up 10 % in constant prices, suggest a strong increase in private consumption. Public consumption is also expected to increase. Despite the rapid increase in tax revenues, the budget deficit is expected to remain at nearly last year's level. The high export growth (36 %) that continued throughout 2004 contributed substantially to economic growth as well.

Growth in fixed investment slowed slightly in 2004.

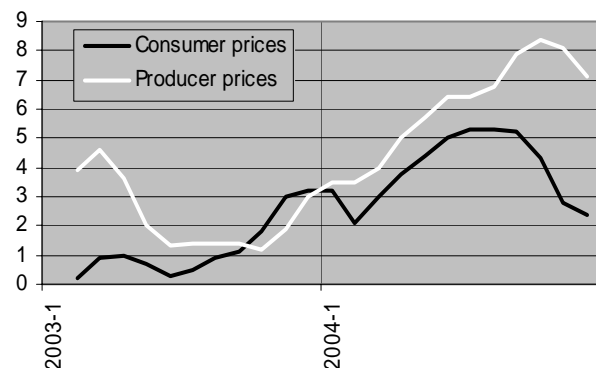
Fixed investment last year increased 26 % y-o-y. The growth rate slowed 2 percentage points from 2003. Investment growth exceeded 40 % in the first quarter of 2004, but from the second quarter onwards the government imposed measures to restrain growth in overheated sectors of the economy. Fixed investments totalled CNY 7,000 billion (€650bn). Investment in urban areas grew nearly 28 %, while investment rose over 17 % in the countryside. Nearly 84 % of investments were directed towards urban areas.

Investments in primary industry grew 20 % y-o-y, secondary 38 % and services nearly 22 %. Growth in investment in the primary sector (mainly agriculture) accelerated substantially from 2003, while investment

growth slowed in the secondary sector (e.g. manufacturing and construction) and services. Investment growth slowed considerably in some of the formerly fastest-growing production branches such as the metal and mineral extraction industries. Investment in energy production continued to accelerate. Fixed investment in eastern China grew 26 %, central China 33 % and western China 29 %. This year, growth in fixed investment is expected to slow further.

Inflation rate continued to decline in December. Consumer prices in December were 2.4 % higher than a year earlier. Thus, the inflation rate was lower than in November, when prices rose 2.8 % y-o-y. The slowdown in inflation was due mainly to the lower rate of increase in food prices. In 2004, consumer prices rose on average 3.9 % (i.e. substantially faster than in 2003, when the on-year increase was just 1.2 %).

Consumer and producer prices, 12-month change, %



Source: National Bureau of Statistics

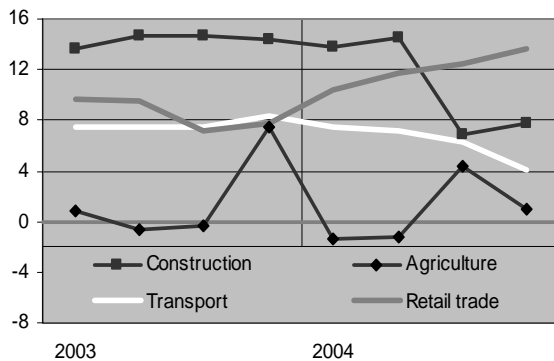
Manufacturing growth remained brisk in 2004. Last year, output rose 17 % y-o-y, a slight slowing from 2003. Heavy industry grew over 18 % y-o-y, while light industry was up nearly 15 %. Coal and energy production rose about 15 %, pig iron and steel about 24 %, and computers, air conditioning equipment and mobile phones 29–43 %. China produced 5.2 million motor vehicles, or 14 % more than in 2003. The manufacturing sector made profits totalling CNY 1,130 billion (€105bn), a 38 % increase from a year earlier. The ratio of sales to production was 98.1 %, a slight improvement from China's earlier figures. Companies with annual sales over CNY 5 million are included in the industrial production figures.

Russia

Unexpectedly high GDP growth figure for 2004. Many observers were surprised by preliminary data from the State Statistical Service showing Russian GDP grew 7.1 % last year. Only two weeks earlier, the economy ministry estimated that 2004 GDP growth was 6.9 %. GDP grew 7.3 % in 2003.

The combined index of five base sectors of the economy (used as a proxy for GDP) showed production grew 6.6 % last year. Overall, growth in base sectors slowed substantially in the last six months of the year. Higher growth was only seen in retail sales and agriculture. Retail sales have continued to grow rapidly since 2000; last year they were up 12 % y-o-y. Agricultural output rose just 1.6 %, while industrial output rose 6 % and construction 10 %. Housing construction was the fastest growing branch of the construction sector. Freight transport volumes increased 6 % overall, with rail freight rising 8 % and pipeline transmission volumes up 6 %. Sea freight, on the other hand, plummeted 30 %. Rail shipments of crude oil and oil products increased just 2 % y-o-y.

Quarterly change in base sector output growth, % change from previous year



Source: State Statistics Service

Russia pays off the last of its IMF debts. Finance minister Alexei **Kudrin** announced Tuesday (Feb. 1) that Russia had paid off its remaining \$3.3 billion in IMF debt as part of an accelerated debt retirement schedule. The final tranche would have come due in 2008. Russia became an IMF member in 1991, the same year it used its first standby credit. Russia's IMF borrowing peaked at \$19.5 billion in crisis-ridden 1998.

In recent years, Russia has been able to prepay its foreign debt thanks to its prodigious oil export earnings. Last year it launched talks on accelerating retirement of Soviet-

era debts owed to Paris Club members. There was no progress, however, in reaching an agreement as the creditor countries had low enthusiasm for Russia's proposed 10 % discount for accelerated payback of the debt. Russia owes Paris Club members approximately \$44 billion.

At the end of last year, the CBR's foreign currency and gold reserves exceeded for the first time Russia's public foreign debt (total public foreign debt stood at \$113 billion at end-September). In January, the CBR's foreign currency reserves stood at \$119 billion.

Third major agency upgrades Russia's creditworthiness. On Monday (Jan. 31), international credit rating agency Standard & Poor's lifted its rating on Russian long-term foreign currency sovereigns from speculative to its lowest investment-grade rating. The other two main international credit rating agencies have already raised Russian sovereigns to investment grade (Moody's in October 2003 and Fitch in November 2004). The conferring of an investment-grade rating opens the door to large institutional investors, who are restricted by their fund rules. It also means that the Russian state and Russian firms can borrow at lower cost on international markets.

Standard & Poor's based its decision to upgrade on improvements in Russia's economic situation and its ability to service its debts. Debt servicing ability has been enhanced by the federal budget and current account surpluses, the central bank's huge foreign currency reserves and recent reductions in the foreign debt stock. The agency concluded that Russia's financial position is now so stable that it compensates for increased uncertainty caused by recent shifts in economic policy and a slowdown in economic reform.

Public debate on Russian economic policies heats up. The Russian economy's strong dependence on commodity exports and low investment growth have forced the country to consider new directions in economic policy. The debate pits the majority of the leading politicians seeking a stronger state role against critics advocating greater liberalisation of current economic policy.

President Vladimir **Putin**, commenting on the government's failed efforts to diversify the economy, is offering new measures such as establishing high-tech zones. Prime minister Mikhail **Fradkov** proposes lowering the value-added tax to 13 % from 18 % to stimulate the economy, a measure that finance minister Alexei **Kudrin** strongly opposes.

Economy minister German **Gref** observes that increasing the state's role in business life undermines the growth performance of the economy. Anatoly **Chubais**, CEO of electricity monopoly UES, feels that the investment climate has been damaged by capricious tax treatment and the unpredictability of government actions.

China

The blossoming of China-Japan trade. Japanese foreign trade figures show China continues to increase its role as a major player in world trade. China (including Hong Kong) last year surpassed the US as Japan's largest trading partner. Bilateral trade has risen on soaring domestic demand in China and the decision by Japanese companies to assemble products in China for third-country markets. Some estimates claim 25–33 % of Japan's export to China ends up in the United States. As an indicator of this new trend in the world economy, nine of Japan's large corporations have established some 200 new enterprises in China since 2001. Japan's finance ministry reports that the share of Japanese companies' foreign direct investment going to China rose from about 2 % in 2000 to nearly 15 % in the first half of 2004.

China's customs figures for 2004 show Chinese exports rose 35 %, while imports climbed 36 %. Thanks to this brisk growth, China surpassed Japan as the world's third largest trading country (after the US and Germany). China's largest trading partners are the EU, the US and Japan – each with about 15 % shares. Chinese data show Japan accounted for nearly 10 % of the over \$60 billion in FDI inflows into China in 2004.

Household incomes grew rapidly last year. Per capita real incomes in 2004 rose at the highest rate in seven years. Real disposable incomes in urban areas climbed nearly 8 % y-o-y, while an average monthly income was 785 yuan (73 euro). In rural areas, real cash incomes grew 7 % and averaged 240 yuan (22 euro) per person per month. The growth of rural real incomes, however, slowed sharply in the last quarter of 2004, due in part to a slowing rise in prices for agricultural products. Nevertheless, the Chinese government remains committed to raising the incomes of farm dwellers to reduce the income disparity between the countryside and cities.

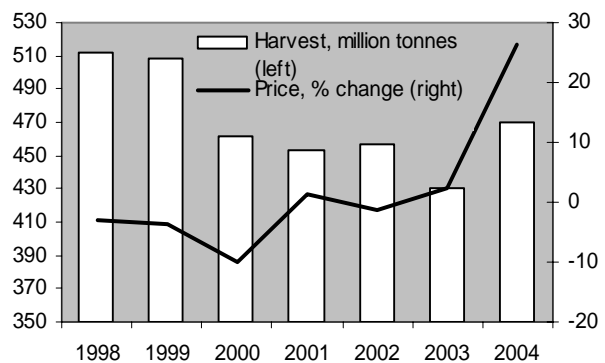
The rapid growth in incomes has accelerated retail sales of consumer goods, which grew over 10 % in real terms last year. Growth was one percentage point higher than in 2003. Particularly high growth was registered in sales of oil products (46 %), communications equipment (42 %) and motor vehicles (23 %). Brisk growth in retail sales is also expected this year.

China's 2004 grain harvest beats forecasts. A total of 470 million tonnes of grain was harvested last year, an increase of 9 % from 2003. Preliminary figures released in December estimated the 2004 grain harvest would reach only about 455 million tonnes, or roughly the government's target for last year (see *BOFIT Weekly* 52/2004). The higher crop yields reflect several factors,

including favourable weather conditions, more land under cultivation, better use of farmland and the incentive of sharply higher grain prices. The National Bureau of Statistics harvest figures include rice, wheat, beans, maize and certain root vegetables.

Annual harvests fell about 80 million tonnes during the period 1999–2003, so last year China began to directly subsidise grain production. In 2005, China will continue to develop its agricultural sector. The government says grain production will be made more efficient through such measures as further tax relief to farmers, subsidies for production of certain crops, support for better plant varieties and mechanisation of farm operations. In addition, land classified as farmland can no longer be used for any purpose other than agriculture.

Grain production and grain prices, 1998–2004



Source: National Bureau of Statistics

Major census seeks to determine reliability of Chinese economic data. Collection of the national economic census data began at the turn of the year and is expected to be completed by the end of March. The economic census covers China's "secondary sector" (e.g. construction, manufacturing and mining), the "tertiary" service sector and production and operational units of public administration (including private entrepreneurs). The census seeks to determine the number and capacity of production units, employee numbers, the economic situation for each unit, as well as their consumption of raw materials and energy. The detailed data collected will be used to establish the accuracy of statistical data and make improvements in economic policy.

The results will be published in September. Nearly 10 million people are participating in the census as interviewers or statisticians. To assure reliable census responses, collected data cannot be introduced as evidence in a court proceeding. China, which has never before attempted such a wide-ranging economic census, now will conduct an economic census every five years.

Russia

Russian inflation picks up. January consumer prices were 12.6 % higher than a year earlier. While the Russian CPI typically jumps at the beginning of the year due to scheduled hikes in administratively set prices for services, this year's increases have been particularly sharp. During January, prices rose 2.6 %, the fastest increase since early 2002. Housing and municipal services showed the largest January increase, 19 %. Next came daycare (9 %), passenger transport (4 %) and cultural services (3 %). Food prices in January rose just 1.4 % and other goods 0.4 %.

The government has declared it will strive to reduce the 12-month inflation rate to 8.5 % by December. The chances of actually meeting that target, however, seem slim, due in part to the government's recent failure on social security reform and subsequent commitment to spend more money.

Russian central bank makes shift in foreign exchange policy official. The Central Bank of Russia abandoned the dollar targeting in rouble's managed float. From now on the external value of the rouble will target a dollar-euro currency basket, consisting of 0.1 euro and 0.9 U.S. dollars. At current exchange rates, the euro has a weighting of 12–13 % in the currency basket. The CBR said the share of the euro will be gradually increased to better reflect the euro's increasing role in Russian foreign trade.

The CBR noted that the introduction of the currency basket is intended to reduce volatility in the rouble's external value. Analysts point out that Russia actually abandoned its strong peg to the US dollar last year, so the CBR's announcement is merely official acknowledgment of a policy already in place.

Yuganskneftegaz deal raises questions. It emerged early this year that state oil company Rosneft was behind the Baikal Finance Group, which purchased Yukos core production unit Yuganskneftegaz in a forced sale in December. Yukos' decision to petition a US federal district court for bankruptcy caused western companies to shy away from the auction and kept western banks from financing the acquisition. Rosneft's financing plan raised discussion in the Duma after some members of opposition claimed that Yuganskneftegaz has been transferred to Rosneft without actual payment of the \$9.3 billion sale price. At the start of this week, prime minister Mikhail **Fradkov** told the Duma that the state had received \$7.6 billion of the agreed sale price, although the auction conditions specified a 20-day delivery for the full amount. Rosneft purportedly raised a \$6 billion loan from a consortium of Chinese banks to cover most of the purchase price. According to press information, the loan is a down payment

for Rosneft's long-term commitment to deliver oil to China. The Chinese, however, deny any involvement in the financing arrangement.

Chinese oil company CNPC announced it was in talks to acquire a 20 % stake in Yuganskneftegaz, which produces 11 % of Russian oil. The Indian ONGC has also expressed interest in the company. Early this week, Yukos' main owner Menatep served the Russian Federation with a claim for expropriating its investment and demanded over \$28 billion in damages. Menatep also demanded that Rosneft immediately pay back its \$900 million loan to Yuganskneftegaz.

State prosecutor says Russian corruption has reached troubling proportions. Prosecutor general Vladimir **Ustinov** expressed his concerns in his annual report to the Federation Council at the end of last month. Ustinov reported that the number of corruption crimes in Russia increased 20 % last year, compared to an overall crime increase of 5 %. Ustinov encouraged the legislators, consistent with the UN Convention against Corruption that Russia signed in December 2003, restore such measures as confiscation of property as punishment for corruption crimes. Ustinov said the Duma should harmonise Russian legislation with UN and European Council conventions, because corruption is a serious obstacle to economic growth. Last year, the Duma accepted the first reading of an anti-corruption bill.

Strong demand for new cars in Russia. Recent growth in demand for new cars has focused particularly on foreign makes. Sales of domestically built vehicles in 2004 rose 12 %. Russia produced 103,000 cars in 2004 and imported 350,000 new cars. Imports of foreign cars grew 80 % y-o-y. Car importers foresee even better sales this year with imports exceeding 500,000 cars.

Fradkov government survives Duma no-confidence vote. Wednesday's (Feb. 9) no-confidence vote in the Duma only found support among 112 deputies. However, even fewer deputies, just 20, were willing to vote against the motion. Constitutionally, passage of a no-confidence vote requires 226 votes, or a simple majority of all Duma deputies. An interesting aspect of vote was the decision by most United Russia deputies (over 300 legislators) to abstain.

In the view of opposition leaders, Fradkov's eleven-month-old government has failed to make headway in its cornerstone economic reforms and thoroughly botched the recent transmutation of social benefits into monetary compensation. Two days before the vote, president Vladimir **Putin** publicly criticised finance minister Alexei **Kudrin** on the clumsy implementation of the benefits reform.

China

Profitability of Chinese state-owned enterprises bolstered by economic expansion. The State-owned Assets Supervision and Administration Commission (SASAC) reports that the net sales of some 470 large state-owned enterprises rose 25 % overall in 2004. Total profits of these enterprises surged over 50 % (a 22 percentage-point increase from 2003). The improved performance was not evenly distributed among sectors, however. Extractive industries (oil, petrochemicals and mining), power utilities and transportation accounted for much of increase in profits, while profitability actually declined about 15 % in the automobile and electronics industries. The overall brisk growth in these large state-owned enterprises reflected last year's robust economic development. Some enterprises, however, began to experience cash flow problems as bank credit tightened during the course of the year. Moreover, inventories of finished products overall rose 27 % last year in large state-owned enterprises, 10 percentage points higher than in 2003. Automobile inventories were up by 35 % y-o-y. It is dubious that state-owned enterprises will repeat their good performance this year in the face of lower economic growth and ongoing monetary tightening.

The profitability of state-owned enterprises was partly enhanced by the closing of insolvent companies. While over 3,000 state-supported enterprises had been wound down as of summer 2004, China continues to support many unprofitable state businesses. At the beginning of February, the State Council made a decision in principle to phase out subsidies to poor performing state-owned companies. While no schedule for winding down these businesses has yet been announced, supports have already been withdrawn from state-owned companies located in Beijing, Shanghai and three coastal provinces. China is also preparing rules for management buyouts of small and medium-sized state companies.

Rising Chinese direct investment abroad. Chinese foreign direct investment (excluding the financial sector) outflows reached \$3.6 billion in 2004, up 27 % from 2003. The number of Chinese enterprises abroad also grew briskly (63 % y-o-y). Over half of China's FDI outflows went to mining projects, while about a quarter went to the service sector. From a geographic perspective, almost half of Chinese FDI ended up in Latin America, while over a third went to Asia (with Hong Kong the largest recipient). Europe's share (mainly Germany and Russia) last year was less than 10 %.

To achieve a balance in its international payments position and reduce revaluation pressure on the yuan, the

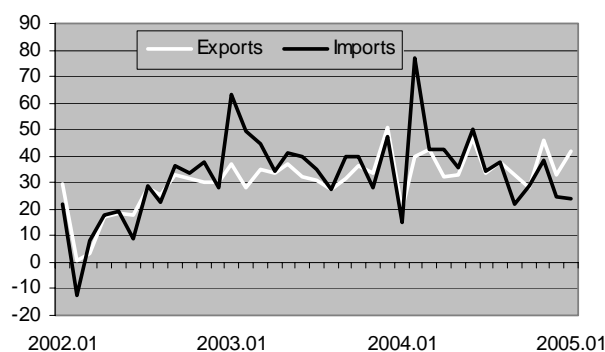
monetary authority introduced began to encourage capital outflows in 2003. In December, Lenovo, a domestic PC manufacturer, announced it was acquiring IBM's PC manufacturing business for \$1.8 billion. Earlier this year, the State Administration of Foreign Exchange (SAFE) approved the Ping An insurance company's \$1.8 billion portfolio investment abroad. Despite the rapid growth, controls on capital outflows continued to restrain Chinese FDI to a relatively low level. China attracted \$60 billion in FDI last year, which was approximately a tenth of last year's \$612 billion in global FDI flows as estimated by the United Nations Conference on Trade and Development (UNCTAD).

Export growth strong in January. Exports amounted to \$51 billion in January, an increase of 42 % from a year earlier. Imports overall climbed 24 % to \$44 billion, and the trade surplus was nearly \$7 billion. Exports of state-owned enterprises grew 22 % y-o-y and imports 11 %. Exports of companies with foreign participation rose over 42 % y-o-y, while imports through such companies were up 30 %.

The EU became China's largest trading partner last year. In January, trade with the EU continued its brisk growth (36 %) with the value of mutual trade climbing to \$16 billion. Trade with the US grew nearly as fast (31 %) and was valued at \$14 billion.

Part of the January foreign trade surplus was due to a 24 % y-o-y reduction in crude oil imports. The last time a 12-month decline in crude oil imports was recorded was summer 2002. The slump in oil imports in January reflected record oil imports in December, which built up reserves.

12-month change of Chinese exports and imports, %



Source: Ministry of Commerce

Russia

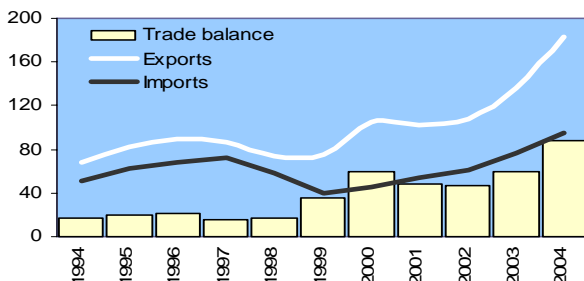
Russian foreign trade soars in 2004. High world prices for minerals, and oil in particular, boosted Russia's foreign trade surplus last year. According to Central Bank of Russia figures, the value of exports reached \$183 billion, while the value of imports was \$95 billion. The trade surplus was a record \$88 billion.

Export earnings were up 35 % y-o-y. Exports to non-CIS countries climbed 33 % and 42 % to CIS countries. Preliminary balance-of-payments figures indicate that earnings from crude oil exports rose 48 % and oil products 33 % in 2004. Natural gas exports were up 12 % in value terms. The Federal Statistics Service reports 57 % of exports were fuel and energy (including 32 % crude oil), and 17 % metals and metal products.

Imports earnings increased 25 % last year. Imports from non-CIS countries grew 23 %, while imports from CIS countries rose 31 %. Federal Statistics Service figures indicate machinery and equipment accounted for 41 % of imports, while foods and agricultural products represented 18 %. The State Customs Committee reports that Russia's largest trading partners in 2004 were Germany, Belarus and Ukraine. Finland ranked as Russia's tenth largest trading partner. The value of Finnish-Russian trade climbed 32 %.

Last year's foreign trade growth was robust, even after the 10 % drop in the US dollar (in which Russian trade is reported) against the euro is factored out. The explosion in export earnings boosted the current account surplus, which according to preliminary data reached \$57 billion last year, an amount equivalent to 10 % of GDP. This huge current account surplus has put strong appreciation pressure on the rouble.

Russian foreign trade, 1994–2004, US\$ billion

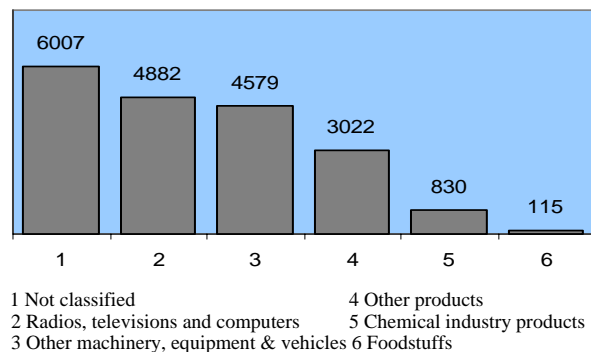


Source: Central Bank of Russia

Road freight transit via Finland to Russia increased last year. Customs Finland figures show the value of road freight heading east to Russia grew 10 % y-o-y in 2004 (actual tonnage was up 17 %.) The value of transit freight was €19.4 billion, while the volume of freight was slightly

above 2.3 million tonnes. Transport of high-value items continued to decline, however, while bulk freight cargoes remained on the rise. Transit freight moving through Finland to Russia mainly entered Finland via the ports of Kotka, Helsinki and Hanko.

2004 road freight transiting Finland to Russia, €million



Source: Customs Finland

Natural resources ministry plans to exclude foreigners from auctions of strategic mineral deposits. Natural resources minister Yuri **Trutnev** reported to the cabinet on planned amendments to the subterranean resources act, whereby foreign companies would be banned from participation in auctions of rights to mine strategic mineral deposits. Banned companies would include Russian-owned companies registered outside Russia, as well as companies registered in Russia that have over 49 % foreign ownership. The minister said that during the course of this year it would hold 270 auctions, of which six would be closed to foreign participants. Trutnev said the new rules are intended to keep refining operations of minerals and metals from moving abroad.

Land decisions postponed. The Duma decided last week to extend the deadline for renewing leases of agricultural land to comply with current laws to July 1, 2006. If the partners fail to renew their leases by the deadline, the lands will revert to local administrations. Economic minister German **Gref** conceded that the lands of former farm collectives (sovkhoz and kolkhoz) need to be used more effectively than at present, but it be done without stripping current land owners of their rights.

There has also been little progress in the area of sale and lease of lots underlying private enterprises. The main problems are deficiencies in the legislation and the fact that Russia still lacks a land market sufficient to provide price formation. Currently, only 33 % of all land parcels are listed in the consolidated land register. This has added pressure to delay once again the deadline for acquiring land or making lease agreements to January 1, 2007.

China

China not yet ready to abandon current exchange rate regime. China's central bank head and finance minister joined their G-7 counterparts in London at the beginning of the month. China attended its first G7 meeting in an official capacity last October in Washington (*BOFIT Weekly 40/2004*). China's exchange rate policy topped the discussion at both occasions. At the latest meeting, China reiterated its position that it would move towards a more flexible regime when the time is ripe. People's Bank of China governor **Zhou Xiaochuan** later told the media that China's current account was basically in balance, which would indicate that yuan was not seriously undervalued.

The country's basic international payments balance (current account balance plus foreign direct investment) last year amounted to less than 5 % of GDP; the current account surplus was less than 2 % of GDP. Estimates of yuan undervaluation vary from 10 % to 20 % for the real effective exchange rate and run as high as 40 % for the bilateral exchange rate between the yuan and the US dollar. However, most estimates fail to take into account that China is still a transition economy undergoing rapid structural change, and, for example, still heavily regulates prices of agricultural products and critical raw materials. Since such regulatory measures inevitably create distortions in resource allocation, the move to market-based mechanisms may bring higher inflation. Moreover, the current government's goal of increasing rural incomes is also expected to drive wage inflation. Higher domestic inflation under a fixed exchange rate generally leads to real appreciation of the exchange rate.

Other structural changes that could affect exchange rate policy include the slashing of the current preferential tax and land use policies extended to exporters. First, China is a large continental economy in which internal demand should play a major role in economic development. Second, the central government's fiscal position cannot sustain continued subsidies to the export sector as fiscal policy shifts to increasing support for the agricultural sector. Moreover, overall fiscal balance has become a problem. Although official figures put the deficit below 3 % of GDP, contingent liabilities including non-performing loans in the banking sector and an undercapitalised social security system could worsen China's fiscal position dramatically. Assessments of China's exchange rate policy and possible choice of exchange rate regime thus requires a balanced approach that takes into consideration both China's external and internal balances.

The Chinese government's official stand at present implies it is shifting towards a flexible exchange rate regime with full convertibility of the capital account. Recent policy changes also indicate China is moving to liberate capi-

tal flows. The government has made special efforts to encourage outflows from China in order to ease pressures for a yuan revaluation. Experiences in other countries suggest, however, that a more flexible exchange rate regime would help to alleviate problems related to liberalisation of the capital account.

Record US trade deficit with China in 2004. The US trade deficit with China reached \$160 billion (€20 bn) in 2004, a 30 % increase from 2003. The total US trade deficit hit \$620 billion. Last year's bilateral trade deficit with China was the highest ever with any country. China's currency peg is likely to receive greater scrutiny, although factors contributing to the large trade imbalance also include differences in savings rates and an extensive integration of trade within Asia.

Middle East remains main source of oil imports. China imported a total of 120 million tonnes of crude oil last year and imports grew rapidly (up 35 % y-o-y). The five largest oil suppliers were Saudi Arabia (14 % of Chinese oil imports), Oman (14 %), Angola (13 %), Iran (12 %) and Russia (9 %). Imports from Oman grew 76 % y-o-y. China seeks to disperse its oil imports so as to minimise the risk of possible regional disruptions in supply. In addition, the Chinese government is encouraging its domestic oil companies to acquire oil supplies abroad.

In particular, China is strongly pushing efforts to boost oil imports from Russia. After a disappointing setback at the end of last year when Russia decided not to build a pipeline to Daqing, China agreed with Russian state oil company Rosneft on the import of 50 million tonnes of crude oil through 2010. Of that amount, 5 million tonnes are already slated for delivery this year. Previously, Yukos was the main Russian supplier of oil to China.

At the end of January, China also agreed with Venezuela – a country with which it has had little dealings – on oil supplies. Venezuela has contracted to deliver annually 5 million tonnes of crude oil along with major quantities of other petroleum products. In addition, CNPC and Petróleos de Venezuela agreed on forming a joint venture to develop Venezuela's most important oil production area. China is also increasing cooperation with Canada and Kazakhstan. China is pursuing a number of ongoing oil-related claims over islands and offshore areas in the South China Sea and the East China Sea.

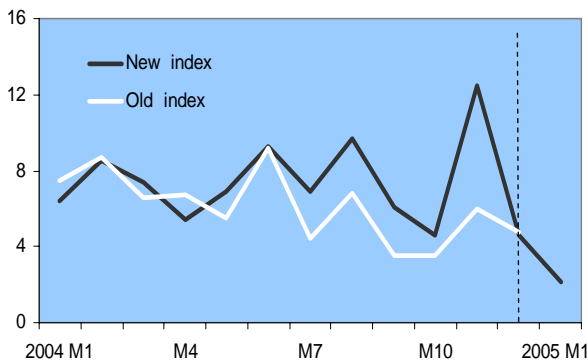
Although China has increased its domestic oil production capacity and last year discovered 800 million tonnes of new oil reserves (and despite the government's energy conservation initiative), consumption is still expected to rise rapidly, driving up demand for imported oil. China embarked last year on building a strategic oil reserve, a project that will continue for years to come. Crude oil imports are expected to grow 20 % this year.

Russia

Russian industrial output grew faster than expected in 2004. When the Federal Statistics Service introduced its revised methodology for calculating industrial output at the beginning of this year, it also revised its output figures for 2004. According to the statistics service, the new methodology complies better with international practices. Under the new regime, industrial output grew 7.3 % y-o-y in 2004 (compared to a preliminary figure of 6.1 %). The adjusted industrial output figure explains the statistics service's preliminary GDP growth figure of 7.1 % for 2004, considered high by observers.

Under the new index, in January 2005 growth was just 2.1 % y-o-y (as against 6.4 % y-o-y in January 2004). The slow growth is partly explained by the lack of January workdays. There were just 15 workdays in January 2005, compared to 19 workdays in January 2004.

Monthly industrial output 2004–2005, % change from 12 months previous



Source: Federal Statistics Service

CBR relaxes currency controls. Under the currency act that entered into force last summer, the Central Bank of Russia can in order to restrict short-term capital movements require that importers and exporters of capital make non-interest-bearing reserve deposits in the central bank. This month, the CBR reduced its reserve deposit requirements, so that, e.g., the three percent deposit requirement on financial capital brought by a non-resident into the country for investment in corporate securities was lowered to 2 %. The change is partly due to the interest rate hike in the US at the beginning of February, which curbs the enthusiasm international investors have for emerging markets.

Most analysts consider the CBR's latest move of minor significance. While the original goal of the restriction was to prevent inflows of speculative capital from abroad, in fact, Russia is currently a net exporter of capital.

Government considers problems in tax administration.

The reform of Russia's tax system was largely completed by the start of this year, so companies in principle should have little reason to fear sudden changes in the system. However, many companies still feel exposed to arbitrary treatment by tax officials, e.g. drawn-out and highly intrusive audits. The current laws also still give the tax authorities huge leeway in deciding what they consider tax evasion. In recent months, a number of large firms, including some operating in the oil and telecom sectors, have been hit with substantial claims for back taxes from the beginning of 2000. Business sector representatives believe that the predictability of business has suffered significantly as a result of actions by tax officials.

To solve some of these problems, the Russian government is considering reducing the independent decision-making authority of local tax officials and establishing special units to deal with taxpayer complaints. Clarification of ambiguities in the tax laws, on the other hand, is a far more difficult task. The government has presented plans for a further reduction in VAT and corporate profit taxes. Most members of the business community would, however, give highest priority to improving the equitable behaviour of tax authorities in lieu of a tax rebate.

IMF mission asks Russia to ease policies to restrain rouble's appreciation.

After last week's visit to Moscow, the IMF mission found in its concluding statement that economic growth had slowed slightly in the second half of 2004 due to events in the oil sector, last summer's banking crisis and a decaying investment climate. Inflation continues to exceed the government target and according to the Fund will persist in the range of 10.5–11 % unless the central bank shifts its policy to allow a stronger exchange rate.

The Fund representatives reminded Russia of the need to maintain a tight fiscal stance, and warned of the temptation of increasing budget expenditures on the basis of robust oil export earnings. The IMF urged Russia to continue building up its stabilisation fund, asking further that stabilisation fund monies be used exclusively to pay off the country's foreign debt. Finally, the Fund pressed for Russia to make speedier progress in its public administration reform to retain investor confidence.

Russia's WTO membership talks could be completed during this year.

At the conclusion of the 26th meeting of the accession working-group Russia's chief negotiator Maxim Medvedkov said that he expects Russia could complete accession talks by the end of this year. The stickiest negotiations presently concern foreign ownership in the telecommunications, banking and insurance sectors. Medvedkov declared that Russia would retain its restrictions in banking and insurance. However, he said Russia might be willing to reconsider issues related to the telecommunications sector and Rostelecom's monopoly. The next round of talks will be held at the end of April.

China

Inflation slows in January. The consumer price index (CPI) rose 1.9 % y-o-y in January. Prices rose faster in rural areas (2.8 % y-o-y) than in the cities (1.4 %). The rise in food prices slowed to 4 % y-o-y in January, and fell below 1 % for prices of non-foods. For 2004, inflation was 3.9 % overall, with food prices up 9.9 % y-o-y.

Producer prices climbed 5.8 % y-o-y in January, led by higher prices (about 11 %) for raw materials, fuel and electrical power. While crude oil prices continued to soar (up 20 % y-o-y), growth was actually 17 percentage points lower than in December. Coal prices, on the other hand, were up 26 % y-o-y, or slightly higher growth than in December. Producer prices increased 6.1 % overall in 2004, dragged up mainly by rising prices for raw materials and energy.

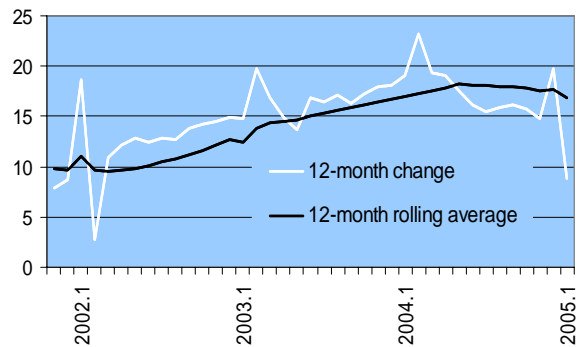
Although figures for on-year consumer and producer price inflation in January suggest a slowing trend, it should be noted that price indices in China are not seasonally adjusted. Chinese New Year fell in January in 2004, while it was in early February this year. Further, the government still aggressively regulates many key product prices.

Industrial output growth decelerates in January.

Production in the manufacturing sector rose 9 % y-o-y in January (here, taking into consideration the seasonal effects of Chinese New Year). The growth rate was the lowest in three years. In 2004, manufacturing output grew 17 % from a year earlier. Manufacturing output in January was equally strong for state-owned enterprises and private companies with foreign participation. Light and heavy industries also grew at roughly the same pace. The January production in heavy industry was however double that of light industry. The production of coal and electrical power grew especially fast in January. Although manufacturing growth slowed in January, exports of industrial products grew briskly (31 % y-o-y).

Although the National Bureau of Statistics released a seasonally adjusted figure for manufacturing, many analysts doubt whether that number actually gives an accurate picture of output growth. The manufacturing output data of the NBS covers all state-owned enterprises, as well as the companies with annual sales exceeding CNY 5 million (€460,000).

Growth in industrial output, % change y-o-y



Source: NBS

Rapid FDI growth continues. Monthly foreign direct investment inflows to China reached \$4 billion in January, an increase of 11 % from a year earlier. A quarter of direct investment came from Hong Kong. Tax havens and Japan also accounted for over 10 % of FDI. Most striking, however, was the 80 % y-o-y increase in European investment. In January, China granted operating licences to 3,500 new companies with foreign capital participation. The number of operating licences for such companies rose over 20 % from a year earlier, bringing the number of companies with foreign participation to over 510,000.

As part of its WTO accession conditions, China eliminated at the start of the year certain restrictions on foreign direct investment (e.g. in the transportation sector). FDI inflows are expected to continue to enjoy brisk growth this year. FDI inflows to China totalled \$60 billion in 2004, an increase of 13 % from 2003.

Money supply growth slowed further in January.

Growth in the broad measure of money supply (M2) slowed to 14 % y-o-y in January. M2 growth was half a percentage point higher in December. M2 grew 15 % overall last year, which was 2 percentage points less than the PBoC's target. The central bank's money-supply growth target this year is 15 %.

Yuan-denominated lending rose 14 % y-o-y in January. Banks provided new loans worth a total of CNY 280 billion in January, bringing the total stock of yuan loans to more than CNY 18 trillion. During the last year as well as in January, growth in lending remained at 14 %, which is also the PBoC's declared target for 2005.

Russia

Loose fiscal policy threatens Russian budget balance.

Based on current liabilities, finance minister Alexei **Kudrin** warns that the 2006 budget will show a deficit of RUB 500 billion (over €13bn), or 2.2 % of GDP. The last time Russia had a federal budget in the red was 1999.

The government has already boosted spending this year in several areas. For example, hundreds of billions of roubles have been dedicated to smoothing things over in the wake of the social benefits reform. In addition, the basic component of work pensions was raised both earlier and to a greater extent than originally planned (it was raised at the beginning of this month from 660 to 900 roubles a month, an increase of over 36 %). Another general increase in pensions is scheduled for the beginning of August. Wages in the “budget sector” were also hiked 20 % in January, and according to the prime minister wages should double by 2008. Military pay was increased an average of 30 % at the beginning of March and judges got a 20 % raise at the beginning of the year (and should get another 80 % at the beginning of July). The minimum monthly wage, which was increased at the beginning of the year to 720 roubles, will go up to 800 roubles at the beginning of September and rise to 1,100 roubles in May 2006. The new housing code that entered into force this week significantly boosts spending on housing subsidies.

Prime minister Mikhail **Fradkov**, in contradiction to policy guidelines set out by the finance and economy ministries, says the government continues to be committed to the president’s goal of doubling GDP over the next ten years. He claims this will require tax cuts to sustain economic growth. The prime minister also argues that for economic reforms to succeed, income levels need to rise substantially. Unhappy with his cabinet mates, Fradkov is seeking to strengthen the role of government apparatus in budget preparation and thus following his predecessor Mikhail **Kasyanov**’s technique of giving high-level bureaucrats various functions within inner circles of the cabinet. Observers note this behaviour contradicts the president’s policy for administrative reform laid out in March 2004, which emphasises ministerial responsibility.

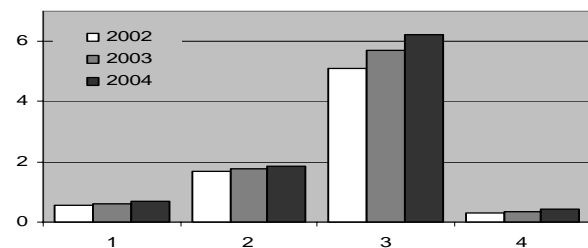
Russian oil production rose in 2004. The Federal Statistics Service reports Russian crude oil production grew 8.6 % last year. Crude oil production (excluding gas condensates) was 443 million tonnes, an average of around 9 million barrels a day. Among Russia’s seven federal districts, the Urals Federal District remains the most important production region (68 % of national output), and, in particular, the Khanty-Mansy Autonomous Region, which in itself accounts for 56 % of all Russian oil production. While the Urals Federal District’s output was still up 9.5 % last year,

many observers see the region’s production capacity ceiling being reached. The fastest growth in production was seen in the Siberian Federal District (18 % a year) and the North-western Federal District (19 %). Production shares in up-and-coming oil production centres, the Siberian and Far Eastern Districts, are still modest (only 5 % of production). The Sakhalin oblast, where many international companies have recently invested heavily and where many new mineral extraction permits have been granted, boasted the highest annual growth (11 %) in the Far Eastern Federal District.

Last year Russia produced 195 million tonnes of refined oil products, a 3 % increase from 2003. Most refined oil products went to domestic consumption. Crude oil exports climbed to 257 million tonnes (an average of 5.2 million barrels a day) or over half of output. Earnings from crude oil exports increased substantially in the second half of 2004 thanks to high international prices and increased export volumes. Crude oil exports rose 15 % last year.

Russia’s economy ministry forecasts crude oil production will rise 5 % in 2005 and 3 % in 2006. Exports are estimated to grow 5–7 % this year and 4–6 % next year.

Russian crude oil output by federal districts, 2002–2004, millions of barrels a day



1. Northwestern and Southern Federal Districts
2. Volga Federal District
3. Urals Federal District
4. Siberian and Far Eastern Federal Districts

Source: Federal Statistics Service

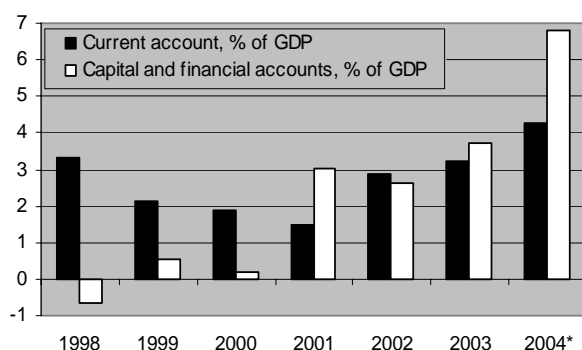
Widening income disparity between rich and poor. The Federal Statistics Service reports that the benefits of rapid economic growth appear to disproportionately benefit the richer segments of Russian society. In 2004, real incomes for the overall population grew slightly over 8 %, while real wage earnings were up nearly 11 %. At the same time, real incomes of people in the top decile grew 12 % a year, while incomes in the bottom decile rose just 6 %. In addition, the real incomes of the poorest of the poor fell substantially. Thus, despite the fact that the share of persons living below the official poverty line fell from 25 % in 2003 to under 18 % in 2004, those living in poverty are now subject to an even harsher experience. At the start of economic reforms in 1991, Russia’s Gini index was 0.26. By 2004, it had risen to 0.4. The Gini index figure describes how evenly incomes are distributed in a society; the lower the figure, the more evenly incomes are distributed.

China

Current account surplus booms in 2004, capital inflows reach record level. According to preliminary figures from the People's Bank of China, last year's current account surplus was \$70 billion (€55bn). The record surplus was about 50 % higher than in 2003. While the central bank has yet to detail the structure of the current account surplus, the trade balance has typically been the most important factor driving the current account. The 2004 surplus on the capital and financial accounts was \$112 billion, which was more than double the 2003 surplus. Over half of the surplus (\$60 billion) represented foreign direct investment in China. Much of the remaining surplus was explained by inflows of speculative capital, which increased in anticipation of a possible yuan revaluation.

For China to hold its exchange rate at the current peg of 8.28 yuan to the dollar, the PBoC must absorb excess foreign currency from the market. As a result of its exchange rate policy, the central bank's foreign currency reserves ballooned from just over \$400 billion at the end of 2003 to \$610 billion at the end of 2004. Moreover, to keep inflation at bay in the face of a growing money supply, the central bank also sopped up about \$80 billion in liquidity last year through its market operations, mainly by selling central bank bills to banks.

Current account and capital and financial accounts balances, % of GDP



*) preliminary estimate

Source: PBoC

People's Congress gathers in Beijing. China's parliament, the National People's Congress (NPC), commences its annual plenary session on March 5. Around 3,000 members of the NPC will gather in Beijing for the next two weeks to decide on new legislation, this year's budgets and approve the government's main proposals on economic and social policy. The meeting will also discuss and vote on a controversial anti-secession law, which would authorise China to use force in the event Taiwan declares formal independence. The meeting will also make official the nomination of **Hu Jintao** as head of the military following the resignation of former president **Jiang Zemin** (see *BOFIT Weekly 39/2004*).

Finance minister **Jin Renqing** will present estimates for state revenues and expenditures in 2005. The government wants to reduce the budget deficit this year to CNY 300 billion (€27bn), or about 2 % of GDP. For its part, the government would diminish overheating pressures on the economy by reducing the amount of bonds issued to finance infrastructure projects from CNY 110 billion last year to about CNY 80 billion this year. The 2004 budget foresaw a deficit at the level of 2003 budget, or CNY 319 billion (2.3 % of GDP). Realised budget figures for 2004 have not yet been published.

China to liberalise capital flows this year. The State Administration of Foreign Exchange (SAFE), which administers currency controls, announced that currency operations on the capital account will be gradually liberalised in the coming year. In conjunction with the liberalisation of the capital account, insurance companies will gain the possibility of investing abroad and Chinese companies will find it easier to make direct investments abroad. Officials also hope to allow international development banks to raise money in China by issuing yuan-denominated bonds.

The Chinese currency, the yuan, is presently convertible on the current account, while capital movements are strictly regulated. As China hopes to make the yuan a fully convertible currency, reducing restrictions on capital flows supports this long-term goal. In the short run, capital outflows will be encouraged to lessen appreciation pressure on the yuan.

Russia

Russian inflation remained high in February. Consumer prices in February were up 12.8 % y-o-y. The substantial acceleration in inflation since the start of the year largely reflects hikes in regulated prices for services. The biggest increases were seen in housing and municipal services (36 %), day-care (30 %) and passenger transport (22 %). The pick-up in inflation has also been driven by a continuing rapid rise in food prices. Food prices were up 12.2 % y-o-y in February, with meat prices (up 23 % y-o-y) exerting a particularly notable effect. Prices of other goods rose on average 7.3 % y-o-y, of which the largest price increase was seen in gasoline (28 %). The government aims to reduce annual inflation to 8.5 % by the end of the year.

Growth in core production slowed in January. Transportation grew 2 % y-o-y, retail sales 10 % and construction 6 %. Although the pace of construction growth was still 13 % y-o-y in January 2004, it subsequently slowed during autumn and winter. Agricultural output fell 0.5 % y-o-y in January, while industrial output grew just 2 %, mainly because there were so few workdays in January. The workday-adjusted figure for industrial output has yet to be released.

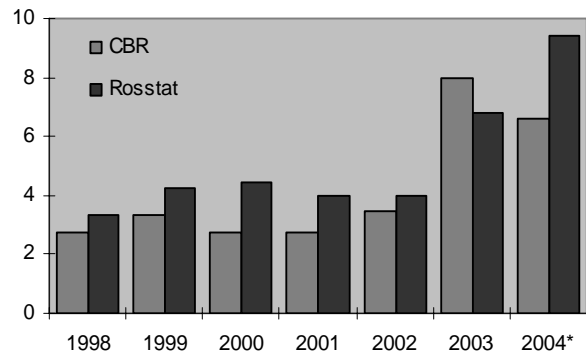
At the beginning of the year the Federal State Statistics Service changed its methodology for calculating and reporting GDP and discontinued the use of its earlier production index of five base sectors of the economy.

Rapid increase in foreign investment continues. The Federal State Statistics Service (Rosstat) reports that foreign investment in Russian enterprises (excluding the finance sector) totalled \$41 billion last year. Of this, foreign direct investment represented \$9.4 billion, a 39 % increase from a year earlier. The figure is 30 % higher than the Central Bank of Russia's preliminary figures for 2004. The CBR and Rosstat calculate their FDI figures differently. Rosstat figures include investment in companies that are either entirely or partly foreign-owned operating in Russia. Foreign owners extended \$1.7 billion in credit to such firms, or 20 % less than a year earlier. Portfolio investment in Russian firms last year amounted to just \$0.3 billion, which was 17 % less than a year earlier.

Half of all investments were made in industry, with about half of that going to the fuel industry. Rosstat also notes that the stock of foreign investment as of end-2004 was \$82 billion, of which \$36 billion was direct investment. The largest foreign investment sources were Luxemburg, Great Britain and Cyprus (with Cyprus still the leading source at 17 % of total foreign investment). Rus-

sian companies invested \$34 billion abroad last year, a 45 % increase over 2003. Leading investment destinations were the US, Cyprus and the British Virgin Islands.

Direct investment into Russia 1998–2004, US\$ billion



Source: Federal State Statistics Service and Central Bank of Russia
* CBR figures for 2004 are based on preliminary data.

New housing code enters into force. The new Housing Code is hoped to bring healthy competition to the Russian housing market and help reduce long queues for housing. Industry and energy minister Viktor **Khrishtenko** said that the state housing queue, which before the Code's approval included 4.5 million families, will be shortened by half through mandating that only low-income citizens or people belonging to special groups can remain in the queue. For years, Russians have been allowed to privatise their state-owned apartment at no cost. To date, 65 % of the housing stock has been transferred into private hands. Under the new Housing Code, however, the practice of no-cost privatisation of apartments will be discontinued at the end of 2006. This year there will be an effort to incorporate the state-owned organisations responsible for building supervision and maintenance. The government also wants to develop new modes of property management; at the end of last year, for example, a law on housing cooperatives was adopted.

According to regional development minister Vladimir **Yakovlev**, the rapid rise in housing costs this year has not been a response to the new code but rather a reflection of the fact that in many regions housing related fees were earlier not raised sufficiently to keep up with actual costs.

A system for housing and real estate loans has also been developed in recent years and amendments to the real estate lending act were made at the end of last year. Observers report there are still many difficulties with lending and huge regional differences.

A large part of Russia's housing is dilapidated. Yakovlev suggests that as much as 70 % of heating, electrical, water and sewage infrastructure needs to be replaced.

China

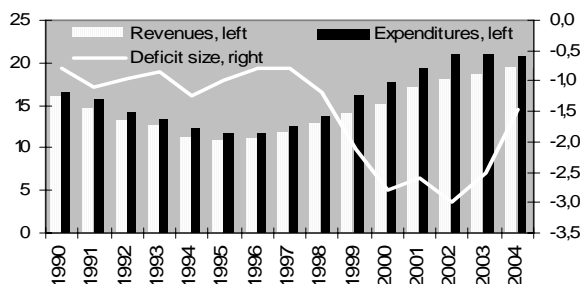
Chinese officials set 8 % GDP growth target for this year. China's National Development and Reform Commission (NDRC) published list of economic development targets for 2005. The annual growth target for real GDP is set at 8 % and the inflation target is 4 %. The on-year growth in foreign trade is anticipated to grow by 15 %, while trade is expected to be more or less in balance. Compared to 2004 levels, household disposable incomes should rise 6 % in urban areas and cash incomes about 5 % in rural areas. Growth in retail sales is expected to hit 13 % y-o-y. The level of registered unemployed in cities should remain above 4 %.

Real GDP grew 9.5 % last year, while inflation was slightly below 4 %. Foreign trade grew 36 % y-o-y and retail sales were up 10 %. Registered unemployed in cities exceeded 4 %.

NPC to approve 2004 budget report and 2005 budget estimate. The report submitted to the National People's Congress meeting by the Ministry of Finance states that the budget deficit (central and regional budgets) contracted last year to CNY 200 billion (€17bn), or 1.5 % of GDP. The 2003 budget deficit was nearly CNY 300 billion, or 2.5 % of GDP. Higher-than-expected growth in fiscal revenues (21 % y-o-y) reduced the budget deficit last year. The 2004 budget report found that CNY 200 billion of fiscal revenues were of a one-time nature. The central government budget deficit last year was 2.3 % of GDP, while the consolidated regional budget figure showed a surplus.

This year's revenue and spending estimates incorporate a commitment to restrain further growth in public spending (see *BOFIT Weekly* 52/2004, 9/2005). The spending emphasis will shift somewhat towards the agricultural sector and public services. Only CNY 14 billion have been reserved to lower the tax burden on rural agriculture. Fiscal revenues are expected to rise 11 % this year.

Revenues, expenditures and budget balance as % of GDP (includes central and regional budgets)



Source: National Bureau of Statistics

NBS criticises statistical methodologies of regional administrations. The head of the National Bureau of Statistics (NBS) slammed regional leaders for fudging their GDP growth figures. Using the regional figures, China's overall GDP growth last year would have been nearly four percentage points higher than the official NBS figure of 9.5 %. The NBS uses direct sampling to calculate GDP to correct for overstated regional figures. The NBS already forbid regional governments from giving out their own GDP figures this year.

Price of iron ore imports rises dramatically. China reached agreement with the Australian Rio Tinto and the Brazilian CVRD on an over 70 % increase in iron ore prices. The Australian BHP Billiton, the world's third largest iron ore producer, had demanded an even greater price increase. Iron ore producers justified the increase by pointing out that the price of iron ore has risen much less than the steel price, i.e. the world price of steel has doubled in the past two years, but the price of iron ore has increased only about 30 %. The Australian and Brazilian companies together produce over half of the world's iron ore.

China imported over 200 million tonnes of iron ore in 2004, a 40 % increase from 2003. Iron ore imports cover about half of China's iron ore needs. While China's own iron ore production growth is expected to grow rapidly this year (over 20 % last year), the production growth will still be insufficient to keep up with the steel industry's growing needs. Thus, iron ore imports will continue to rise this year. Chinese harbours are presently estimated to have enough ore in stock to cover about two months of imports. Steel mills are also said to have about two months supply of iron ore on hand.

At the beginning of March, China introduced a licensing regime for iron ore importers. Although this is expected to significantly reduce the number of iron ore importers, it will have little impact on the amount of iron ore imported.

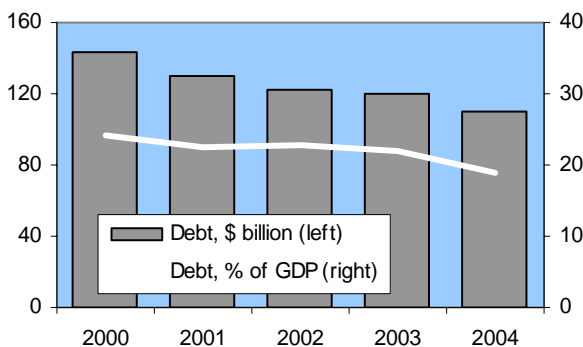
Last year China produced 270 million tonnes of steel, a 23 % increase from 2003. Steel imports fell to 30 million tonnes. China's steel production this year is expected to exceed 300 million tonnes and imports should contract even further. Steel prices should rise, at least in the first half of the year, but not as rapidly as the rise in iron ore prices. China accounts for about a quarter of world steel consumption.

Russia

Russia rapidly paying down public foreign debt. At the beginning of March, Russia's economy ministry published figures on public foreign debt in 2004. As of year's end, the stock of state foreign debt stood at \$111 billion (€1bn), or about 18 % of GDP. The largest creditor was the Paris Club, which is still owed about \$43 billion (€2bn), or about 40 % of Russia's public foreign debt. Eurobond issues amounted to \$35 billion (€2bn), or 32 % of Russia's debt. Russian debt to international financial institutions was nearly \$10 billion (€7bn).

High oil prices have helped boost the current account surplus and build up the Stability Fund. Russia has been keen to negotiate with Paris Club members on an accelerated payment schedule, but has yet to get creditors to agree to e.g. its demand for a discount for early repayment. Russia was particularly eager last year to pay off its Soviet-era trade credits and debts to international institutions.

Russian public foreign debt at year-end



Source: Ministry of Finance, IFS

String of federal budget surpluses unbroken in 2004.

After a decade of deficits in the 1990s, the Russian federal budget has produced surpluses throughout the 2000s. Last year's budget surplus was the largest in recent history (4.4 % of GDP). Although persistently high oil prices are generally attributed as the reason for Russia's ongoing surpluses, it is also worth noting that the country has consistently displayed fiscal restraint in recent years. Last year's budget revenues corresponded to 20.4 % of GDP, while expenditures were just 16.1 % of GDP. Since 2003, revenues as a share of GDP have grown 5 %, while spending in relative terms has fallen 9 %. The budget's largest revenue streams, customs tariffs and fees for natural resource extraction, have grown rapidly in recent years. The share of customs revenues as a proportion of GDP increased 50 % y-o-y, while natural resource extraction fees climbed by more than a third. Revenues from VAT, excise

taxes and the unified social tax all contracted as a result of changes made in 2004.

The three largest spending categories (defence, transfers to regions and social and cultural spending) have all contracted in relation to GDP since 2003. The top spending item in the federal budget earlier were interest payments. Throughout the 2000s, the share of interest payments in expenditures has fallen rapidly and presently only accounts for about 8 % of total spending.

Russia has over two dozen billionaires in 2005. The list of billionaires published by *Forbes* magazine identified 27 Russians with a property at least of a billion dollars. Their collective wealth amounts to about \$91 billion, or 17 % of Russian GDP. According to *Forbes*, Roman **Abramovich**, with a personal property estimated at \$13.3 billion, was Russia's richest man. The Chukotka regional governor is also the largest shareholder in the Sibneft oil company. The *Forbes* list also ranked him as the world's 21st richest person. Last year, Russia's richest man was Mikhail **Khodorkovsky**, the main owner of the Yukos oil company. Due to the collapse of Yukos shares, Khodorkovsky only ranks 15th on the Russian list. For the first time the list also included a woman. Russia's 25th richest person, Yelena **Baturina**, is the wife of Moscow mayor Yuri **Luzhkov**. Her property is valued at \$1.3 billion.

Russia's ten richest in 2005, US\$ billion

Rank	Name	Company	Wealth
1.	Roman Abramovich	Sibneft	13.3
2.	Mikhail Fridman	Alfa Group	7.0
3.	Vladimir Lisin	Novolipetsk MK	7.0
4.	Oleg Deripaska	Basic Element	5.5
5.	Viktor Vekselberg	TNK-BP	5.0
6.	Alexei Mordashov	Severstal Group	4.8
7.	Vladimir Potanin	Norilsk Nickel	4.4
8.	Mikhail Prokhorov	Norilsk Nickel	4.4
9.	Vagit Alekperov	Lukoil	4.3
10.	Viktor Rashnikov	Magnitogorsk MK	3.6

Source: Forbes

Putin fires an elected governor. Vladimir **Loginov**, governor of the Koryak autonomous district in Far East region became the first elected governor to be sacked mid-term. His administration failed to prepare adequately the district for its winter heating needs and caused residents to suffer the ravages of the cold. Recently amended legislation allows the president to remove from office any governor no longer enjoying the president's confidence. Observers note that the Kremlin earlier indicated it would not use its right to fire on governors elected by direct popular vote.



China

Food prices boost Chinese inflation in February. Consumer prices rose by 3.9 % y-o-y in February, up from 1.9 % in January. Prices continued to rise faster in rural areas (4.5 % y-o-y) than in urban areas (3.6 %). February food prices jumped nearly 9 % y-o-y, compared to just 4 % in January. Non-food prices were up 1.4 % y-o-y, compared to 0.8 % in January.

Higher food prices coincided with Chinese New Year, which fell in February this year. Almost all food products saw a pick-up in prices in February. The biggest change was in prices for fresh vegetables, which were up 13 % in February (prices declined 10 % in January). The effect of Chinese New Year was also seen in prices for transportation which increased 9 % (down 6 % in January). Leisure travel prices also rose 7 % (down 8 % in January). For the period January-February, consumer prices were up 2.9 % y-o-y.

February producer prices rose by 5.4 %, or slightly less than in January. Crude oil (up 22 % y-o-y) and coal (up 27 %) continued to drive the rise in producer prices.

Annual Congress session adjourns. The Third Session of the Tenth National People's Congress ended on Monday (Mar. 14). As expected, the Congress endorsed the government's action plan and budget proposal for this year. On the final day of the meeting, the party also approved a controversial anti-secession law that gives China the legal option of using force in the event Taiwan attempts to declare formal independence.

Rural areas were high on the action plan agenda. The government seeks to increase rural incomes this year by eliminating the agriculture tax in 600 counties. Central government transfers of CNY 66 billion (€6bn), an increase of CNY 14 billion from 2004, will be required to cover the costs of the rural tax cuts. Agriculture taxes will be abolished nationally in 2006. This year, the government will continue its direct subsidies to grain production introduced last year. The living and working conditions of rural migrant workers in cities should also improve.

The action plan gives priority to balancing regional development also this year. The government will continue its support via economic policy and funding to western regions. Notably, the number of infrastructure and environmental projects will be increased. In the Northeast region, emphasis will be given to grain production and the trial of a consumption-based VAT system will continue.

The action plan vows to sustain vigorous economic growth this year. In the short-term, emphasis will be paid to economic tightening through prudent fiscal and monetary policies. The continuing move to a market-based economy is to be supported by structural reforms in state-owned enterprises and the financial sector.

Foreign trade surplus surges in February. China's Ministry of Commerce reports that in January-February *imports* rose 8 % y-o-y and declined in February by 5 % from a year earlier to a level of \$40 billion. The February decline was partly a reflection of the high import figure a year earlier. In January-February, imports of primary goods grew 12 % overall. Highest growth was registered in the volume of iron ore imports (24 % y-o-y), and import volumes of soybeans and crude oil decreased (both down around 12 %). Imports of industrial products grew just 7 % y-o-y, and import volumes of cars and steel decreased (60 % and nearly 50 % respectively). In January-February, imports overall grew sluggish as imports for domestic consumption fell nearly 2 % y-o-y, while imports of goods for processing and further exports continued to rise at a nearly 20 % pace.

In January-February, *exports* continued to grow rapidly (37 % y-o-y), amounting to \$95 billion. Exports of finished industrial goods continued to increase briskly (33 % y-o-y). Electromechanical devices continued to dominate Chinese exports with a 54 % share of total exports and growth of 34 % y-o-y in January-February. Exports of clothing and footwear grew just under 30 % y-o-y.

The foreign trade surplus for February was thus \$5 billion. For the first two months of this year, China produced a trade surplus of \$11 billion. China had a trade deficit of \$8 billion in January-February 2004.

In the first two months of the year, the European Union was China's largest trading partner; total trade was valued at about \$30 billion (up 29 % y-o-y). Trade with the US was second at \$27 billion, an increase of 22 % y-o-y. The largest importer and the third largest trading partner in the period was Japan (\$25 billion, 11 % y-o-y).

Industrial production enjoyed robust growth in January-February. The National Bureau of Statistics reports industrial output rose 17 % y-o-y in January-February, about the same rate of growth posted in 2004. The industrial sector overall was up 9 % y-o-y in January. High growth in January-February was seen in metallurgy (up 27 % y-o-y) and electronics production (up 19 %). Electricity production grew 12 % from a year earlier. The NBS did not release its February production figures.



Russia

Growth of construction and transport slows in January-February. Among the five main production sectors of the economy, growth in construction and transport continued to slow in February, while growth of industrial output and retail sales accelerated slightly.

For January-February, the construction sector grew 5.5 % y-o-y; down from 6.2 % growth in January and 10 % last year. The transport sector was up only about 3 % in the first two months of the year, due to significant drop in sea freight. The rate of contraction in agricultural output in January-February was less than 1 % a year, but the output, however, contracted less than a year earlier. Retail sales grew 10.1 %, or about the same pace as at the same time last year. Industrial output climbed 3.9 % y-o-y in the first two months of the year.

More euro emphasis in rouble currency basket. On Monday (Mar. 21), the Central Bank of Russia announced it had doubled the euro's weighting in its currency basket used to steer the rouble's external value. The basket now consists of 0.2 euro and 0.8 dollars, compared to its initial composition of 0.1 euro and 0.9 dollars. The dual-currency basket was officially introduced at the beginning of February as a mechanism for steering the rouble's exchange rate.

The recent change reflects the central bank's goal of incrementally increasing the euro's weighting in the currency basket. The change will reduce fluctuation in the rouble's exchange rate vis-à-vis the euro, while allowing for increased fluctuations against the dollar. The CBR's exchange rate policy is geared to dampening rouble appreciation. Compared to the same period a year ago, in January-February the rouble was 10 % stronger in real terms (i.e. taking inflation into consideration) with respect to the euro and nearly 13 % more valuable with respect to the dollar.

Government approves new draft of act on mineral and hydrocarbon use. Analysts cautiously lauded the legislative proposal, which clarifies mining practices and makes contracting and licensing processes more transparent than earlier. In lieu of permit granting, the draft bill now calls for the federal government and investors to make civil-law contracts on mineral extraction. Each contract will automatically grant use rights along with exploration rights, so that when a new deposit is identified, the investor is not required to participate in a separate auction to gain use rights. Under the new law, exploitation rights would no longer be governed by a web of various administrative regulations. This should significantly clarify operations in the mineral and hydrocarbon extraction sectors.

The draft proposes that a contracting party must be either a Russian citizen or a company registered in Russia. Companies where foreigners hold a majority stake are barred from participating in auctions for rights to work strategic deposits. Natural resources minister Yuri **Trutnev** says the issue of strategic deposits is a minor one. Of the 250 licence auctions planned for this year, only six involve strategic deposits. Trutnev added that current licences would remain valid. The government hopes to submit its draft of the legislation to the Duma during April so that the act can be implemented from the beginning of next year.

Duma to consider new forest code. The new code has been years in preparation and will finally come to the first reading of the Duma next month. The code seeks to increase the overall efficiency of Russia's forestry sector (see *BOFIT Week in Review 8/2004*). Valery **Roshchupkin**, head of the Federal Forest Agency, notes that the current felling rate produces just 170 million cubic metres of wood each year, when the potential volume may be as high as 550 million cubic metres. He claims a big problem is the forest industry's technological backwardness. It is the reason most of Russian wood exports are in the form of raw wood. Moreover, the forest sector still suffers from aging administration at federal and regional levels.

Two-thirds of Russia's land area, nearly 900 million hectares, is forest. That corresponds to a quarter of all the world's forests.

Russian government plans new special economic zones. The government last week approved a draft law on the zones for submission to the Duma in the near future. The main goals of special economic zones are to stimulate economic growth, diversify the structure of the national economy and attract investment. Special economic zones may be created for either production or research and technological activities in a specific area. The zones would retain their special status for up to 20 years. The construction of regional infrastructure will be funded through federal and regional budgets.

Under the draft law, companies operating in special economic zones will enjoy certain customs and tax benefits, which are different for the two types of the zones. The Russian government will determine the business areas of the companies locating in special economic zones. With just a few exceptions, companies will be barred from operating in such fields as mining, metallurgy and production of products subject to excise taxes. Firms locating in industrial economic zones must commit to investing at least €10 million in the zone, of which a million must be invested in the first year.

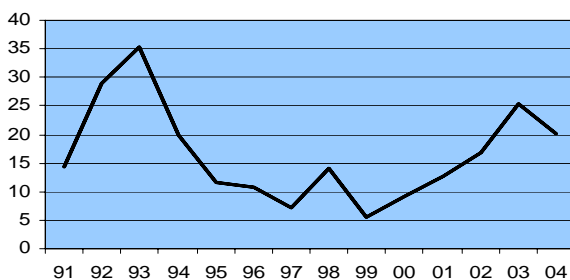
Current special economic zones will be abolished with the exception of the Kaliningrad and Magadan zones.

China

Lower growth in fixed investment. The nominal growth in fixed investment in urban areas in January-February was 25 % y-o-y, down from 53 % a year earlier. Although the National Bureau of Statistics gives only nominal investment figures, it calculates a price index for fixed investment twice a year. Although no index figure was available for January-February, real growth in investment was clearly lower than in the same period a year earlier. The number of new investment projects also declined 3 % y-o-y in the first two months of this year.

Fixed investment in real estate grew nominally 27 % y-o-y in January-February and accounted for about a third of investment in urban areas. Investment increasingly focused on “bottle-neck” industries such as coal (up 150 % y-o-y in nominal terms), and electricity and water production (60 %). The NBS reports nominal growth in fixed investment was 26 % last year, when the investment price index rose 6 %.

Real growth in fixed investments, % y-o-y



Source: National Bureau of Statistics

Retail sales continue to rise. The NBS reports retail sales grew 14 % y-o-y nominally in January-February. In real terms, growth proceeded at a steady 10 % pace. February retail sales were boosted to 16 % y-o-y by Chinese New Year.

Rapid economic growth and strong domestic demand in accordance with government policy have supported growth in the retail sector. Last year’s elimination of barriers to foreign retailers under China’s WTO commitments have also bolstered retail sales. At the People’s Congress earlier this month, Chinese retailers expressed their hopes that the government would grant them tax breaks and loosen land use regulations.

Growth in FDI slows. In January-February, foreign direct investment growth slowed to 8 % y-o-y and investments amounted to \$8 billion. FDI rose by more than 13 % last

year. Part of the FDI figure is believed to be Chinese investment recycled through a third-country. Foreign capital invested in Chinese companies receives substantial benefits (e.g. tax breaks). Chinese FDI outflows also spiked after US officials approved the sale of IBM’s personal computer production to the Chinese Lenovo for \$1.3 billion.

Europe (EU15) led FDI growth in the first two months of this year (43 % y-o-y). Investments in tax havens also climbed, while FDI inflows from Asian countries and the US declined.

Central bank cuts interest rates for excess reserves of commercial banks. The People’s Bank of China lowered its interest rate on deposits of commercial banks exceeding their reserve requirement to 0.99 %. The interest rate on excess reserves was 1.62 % before the change. Nearly all commercial banks are currently subject to a 7.5 % reserve requirement (see *BOFIT Weekly 16/2004*). Excess reserves of commercial banks averaged 4 % of their deposits last year. By year’s end, excess reserves were 5.25 %, due mainly to seasonal fluctuations such as national holidays. The lower rate is expected to reduce the central bank’s interest costs and encourage commercial banks to get a better grasp on their liquidity management.

At the end of February, the growth of broad money (M2) and the loan stock was just under 14 %. Both figures are below the PBoC’s targets for this year (see *BOFIT Weekly 3/2005*).

Central bank raises interest rates on housing loans. From March 17, the PBoC eliminated special conditions on private housing loans. Commercial banks will now grant housing loan under the same conditions as any commercial lending. The old interest rate on housing loans was fixed at 5.3 %. Commercial banks have leeway to discount as much as 10 % from the 6.1 % official reference rate on a five-year commercial loan. Thus, the minimum rate on housing loans is about 5.5 %, or 0.2 percentage points higher than earlier. Commercial banks can now also demand a downpayment equal to 30 % of the loan in areas where real estate prices are booming. Previously, banks could only demand a 20 % downpayment.

Banks have offered private housing loans since the start of 1998. At the end of February, housing loans constituted 10 % of the loan stock of commercial banks. Real estate prices rose 15 % nationally last year. A recent PBoC consumer survey found that over a fifth of households in urban areas are planning to purchase a new apartment within the next three months. The state tries to dampen the overheated housing market with above measures. Unification of commercial interest rates is also part of the ongoing interest rate reform.

Russia

Two-thirds of Russian banks now covered by deposit insurance. Over 800 of Russia's approximately 1,200 banks have passed central bank inspections and been admitted into the new deposit insurance system. Since the government's decision to establish the system at the end of 2003, the Central Bank of Russia has performed inspections of banks wishing to enter the system.

Russia's banking sector has long suffered from a lack of transparency. The CBR often could not even identify actual bank owners and some banks reported inflated net assets. While observers welcome the arrangement as a healthy move for the sector, they add that this initial culling is merely a good start.

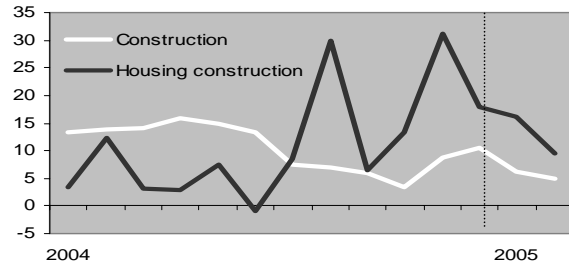
The deposit insurance scheme fully covers deposits of private individuals up to 100,000 roubles (2,800 euro). Before the new system was introduced, only deposits with the state-owned Sberbank savings bank were covered. Officials hope the new arrangement will increase the confidence of average Russians in private banks as well as the competitiveness of private banks with Sberbank, and thereby promote development of the banking sector.

The deposit insurance system covers 98 % of all deposits in Russian banks. Banks that do not meet the system's admission criteria will no longer be allowed to accept deposits.

Construction growth slows. The Federal State Statistics Service (Rosstat) reports that construction growth slowed significantly from the record 14–15 % y-o-y pace set in early summer 2004. The uncertainty in the banking sector in July impacted construction directly; July on-year growth in the sector slowed to below 10 % and did not recover to above the 10 % level until December 2004. Growth in construction averaged 10 % for the year. In the period, accelerated growth only occurred in housing construction. Construction growth has slowed since the start of the year, and was only 5.5 % y-o-y in January-February.

Rosstat put the value of Russian construction output last year at RUB 1,470 billion (€1bn). A large share of construction activity (27 %) was concentrated in the Central Federal District, which includes Moscow. About 70 % of that activity was in the City of Moscow and the Moscow oblast. Construction was also quite active (20 %) in the Urals Federal District. Over 80 % of all construction there occurred in the oil-rich Tyumen oblast. The lowest construction activity was registered in the Siberian and Far Eastern federal districts. Much of the construction in the Far Eastern Federal District was concentrated in the Sakhalin oblast.

Monthly change in Russian construction output, % y-o-y



Source: Rosstat

Support for Putin drops, cabinet's popularity rises.

According to a recent Levada Center poll, approval of president Vladimir **Putin** has fallen during the past twelve months from over 80 % to 66 %. In contrast, prime minister Mikhail **Fradkov**'s one-year-old government was significantly more popular in March 2005 than the preceding government of Mikhail **Kasyanov** a year earlier.

The leading party in March 2005 was Putin's own United Russia, with an approval rating of 36 %. Next were the Communists (22 %), the Liberal Democrats (13 %) and the Motherland party (9 %).

Public sentiment on key posts, March 2004–2005, %

	March '05		March '04	
	support	oppose	support	oppose
President	66	26	81	16
PM	26	59	n.a.	n.a.
Cabinet	31	63	12	70
Duma	35	35	9	77

Source: Levada Center

Finland: Russia now third main trading partner, China seventh. Customs Finland figures show that Russia was the third largest destination for Finnish exports and the second largest source of imports in 2004. Finland ran a substantial trade deficit with Russia. The value of exports to Russia was €4.4 billion in 2004, rising 22 % from the previous year. Imports were worth €3 billion, a 25 % y-o-y increase. Finland last year imported mainly crude oil and wood products from Russia and exported consumer goods.

Finland had a slight trade surplus with China. Finnish exports to China and imports from China were estimated to be worth about €2 billion each. Exports to China grew last year a stunning 53 %, while imports were up 24 %.

If last year's pace of trade growth continues, Russia will surpass Germany this year as Finland's largest trading partner. In China's case, continued growth would move it from Finland's seventh to fourth largest trading partner.

China

China's short-term foreign debt up in 2004. Foreign debt (excluding Hong Kong and Macao) rose 18 % last year. Short-term borrowing represented 46 % of total foreign debt, which is high by international standards. However, half of short-term borrowings last year were in the form of trade credits, compared to just 20 % in 2003. Trade credits are generally seen as less risky than other forms of short-term borrowing. The State Agency for Foreign Exchange (SAFE) earlier expressed concern that companies were using trade financing to postpone payments in anticipation of a yuan revaluation.

Although China's foreign debt has grown in absolute terms, it remains under 14 % measured as the ratio of external debt to GDP. Last year, the ratio of debt to exports of goods and services was 35 %, while the ratio of short-term debt to foreign currency reserves was 17 %. Both ratios are low by international standards. The rapid growth in foreign debt reflects both brisk economic growth and ongoing hopes for a yuan revaluation.

As expected, end of quota system boosts Chinese textile exports. In accordance with WTO rules, import quotas on clothing and textiles were eliminated at the beginning of this year. Industrialised countries have used quotas for 40 years to protect their domestic clothing and textile industries. In the new trade environment, the dollar value of China's clothing and textile exports rose 28 % y-o-y in the first two months of this year. Growth in exports to the US and Europe was particularly strong. In the US market, import volumes of many Chinese products have multiplied, which reflects the fact that China's earlier import quotas were fairly restrictive compared to most of China's competitors.

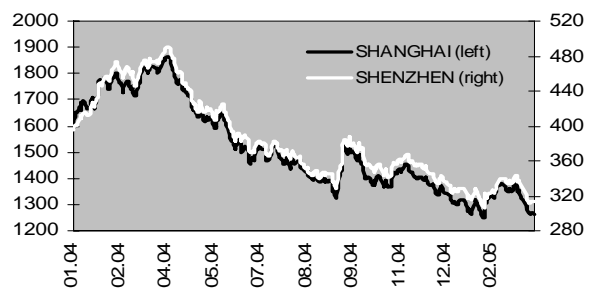
Textile makers in the US and southern Europe are now demanding countermeasures to stem the flood of Chinese imports. In contrast, northern European clothing manufacturers, which anticipated the liberalisation of textile and clothing trade, have already moved much of their production to Asia and now fear repercussion from the imposition of countermeasures. China's association for textile producers reports that companies that are either partly or entirely foreign owned account for about 40 % of Chinese exports of clothing and textiles.

EU trade commissioner Peter **Mandelson** said the EU wants to establish "danger zones" for levels of certain imports. When imports in a certain product category exceed a defined level, the commission would begin an investigation that would include consideration from the consumer's perspective. China has made a small stab at restraining growth of clothing and textile exports by imposing export tariffs (1–3 %) and by proposing minimum

price levels for export goods produced by Chinese-owned firms.

Stock prices hit six-year low. Despite government reform efforts, stock prices have continued to tumble this year. State measures include reduction of the stamp tax in January and clarification in February of share investment regulations issued to insurance companies last autumn (see *BOFIT Weekly 45/2004*). The state would also like to set up a fund for protecting security holders in the event a brokerage goes bankrupt. The authorities have so far refrained from dealing with the larger structural problems in China's stock markets such as inadequate disclosure requirements for new listings and poor corporate governance practices.

Shanghai and Shenzhen exchanges, A-share indices



Sources: Shanghai and Shenzhen bourses

China raises gasoline prices. Last week, China's National Development and Reform Commission (NDRC) lifted wholesale gasoline prices by 8 %. The change was immediately seen in retail prices, which jumped 0.25 yuan a litre. Pump prices for gasoline are now around 3.70 yuan (0.34 euro) per litre. The NDRC, however, left the wholesale price for diesel oil unchanged. China last raised wholesale fuel prices at the end of August (see *BOFIT Weekly 36/2004*).

China regulates retail fuel prices through wholesale prices. Retail fuel prices are allowed to fluctuate 8 % around the wholesale price. The rise in wholesale prices has not kept up with soaring world prices for crude oil. Minor refiners, pinched by rising crude oil prices and rigid wholesale prices for fuel, are in trouble. On the other hand, the profits of Sinopec, China's largest oil refiner, increased over 60 % y-o-y to CNY 36 billion (€3.3bn).

Although growth in car sales in China has not been as rapid as at the beginning of 2004, fuel consumption is expected to climb briskly this year. China hopes to increase its domestic oil refining capacity and improve fuel efficiency. For example, the government has announced that next summer it will introduce stricter fuel consumption standards for all new cars. The state has also purportedly spent years drafting a fuel tax law designed to promote energy conservation.

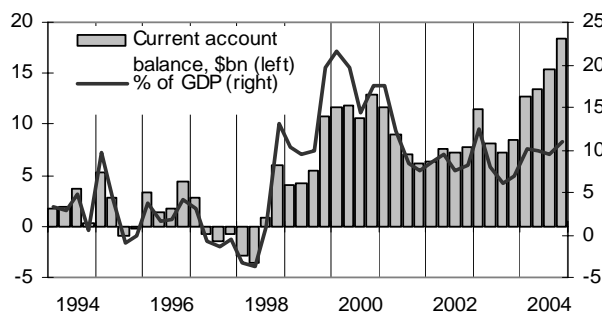
Russia

Russia's current account surplus rises to 10 % of GDP in 2004. Balance-of-payment figures released by the Central Bank of Russia at the end of March show Russia's current account surplus in 2004 amounted to \$60 billion, or about 10 % of GDP. The massive surplus was mainly the result of a record foreign trade surplus of nearly \$74 billion.

The CBR data also showed that foreign direct investment inflows into Russia in 2004 climbed to \$11.7 billion, up 47 % from 2003. On the other hand, FDI outflows from Russia last year decreased by 2 % to \$9.6 billion. Some \$4.7 billion in portfolio investment flowed into the country; the corresponding outflow was \$4.1 billion. The deficit in other capital flows was about \$11 billion, and the net errors and omissions item was about \$6 billion negative (down from \$8 billion negative in 2003).

Russia's foreign currency reserves grew by \$45 billion last year to \$125 billion at year's end. The reserves equalled about 21 % of GDP.

Russia's current account balance, 1994–2004, quarterly



Sources: CBR, Rosstat

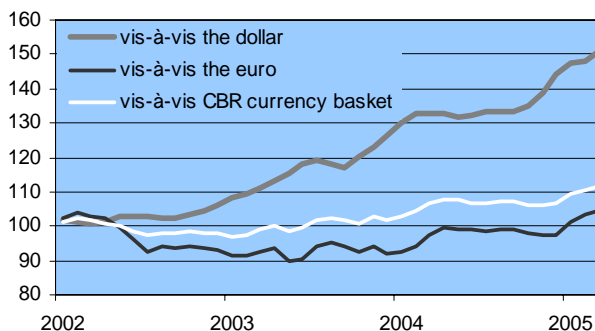
Russian inflation exceeding government target. In March, inflation was 13.3 % y-o-y. For the first quarter, consumer prices climbed 5.3 % from December, a pace well ahead the economy ministry's forecast for 2005 and imperilling the government's target for all of this year of just 8.5 %. The ongoing rapid rise in consumer prices in March prompted finance minister Alexei **Kudrin** to warn that the government is failing at its efforts to rein in inflation.

On the other hand, the rise in prices of services slowed after a burst at the start of the year. While prices for services increased about 25 % y-o-y in January–March, in March they were up only about one per cent.

The rise in food prices accelerated in March to 13 % y-o-y. The rise in prices of other goods was more modest, about 7 % y-o-y.

Rouble strengthens in real terms. In early April, CBR chairman Sergei **Ignatyev** said that the rouble's effective real exchange rate (i.e. real exchange rate weighted for foreign trade shares) strengthened 6.2 % in the first quarter. Already in 2003–2004, Russia's higher inflation relative to its main trading partners led to a 13.4 % appreciation in the real effective exchange rate. Altogether, this adds up to nearly 20 % appreciation. The rouble's strength has weakened Russia's international competitiveness. When calculating the rouble's real effective exchange rate, the CBR give the US a weighting of just 4 %, while euro-zone countries have a combined weighting of 36 %. Since the start of 2003, the rouble has gained 40 % in real terms against the dollar and 14 % against the euro.

Rouble real exchange rate, index, December 2001=100



Source: CBR

Foreign borrowing by companies and banks continues to rise. CBR figures indicate that the gross foreign debt of banks increased last year from \$25 billion to \$33 billion. At the same time, the net foreign indebtedness of the banking sector grew from \$6 billion to over \$11 billion. Foreign loans of banks increased sharply in the fourth quarter of 2004. That figure apparently includes borrowing related to Rosneft's acquisition of Yuganskneftegaz.

Firms also substantially increased their foreign borrowing last year. The gross debt of the enterprise sector at the end of 2004 was nearly \$74 billion, up from just \$55 billion at the end of 2003.

Russia's public sector gross foreign debt as of end-2004 was \$105 billion, which was significantly less than the central bank's gold and foreign currency reserves.



China

Scandals plague China's largest banks. China's four large state-owned commercial banks (Industrial and Commercial Bank of China, Bank of China, China Construction Bank and Agricultural Bank of China) account for over half of loans granted by the banking sector. The latter three banks have recently become embroiled in scandals involving bribes of bank personnel, fraud and shady lending practices. The recent scandals follow earlier abuses detected at the banks and concern both bank branch offices and headquarters. An example of pervasiveness of the corruption problems is seen in the fact that nearly 200 BoC lending decisions made between December 2000 and June 2002 are now under investigation. The banks in question claim they have punished tens of thousands of their employees for taking bribes or granted loans in violation of regulatory guidelines.

In response to the latest wave of scandals, China's Banking Regulatory Commission has promised to launch a special investigation into lending practices, an action that is likely to reveal further instances of malfeasance.

Although the government had hoped to have its first stock market listings of commercial bank shares open to foreign investors this year, the latest revelations about bank governance and internal oversight will complicate the process and depress bank share prices. China is under pressure from its WTO commitments, which call for rapid reform and increased competitiveness of the domestic banking sector ahead of the opening of the Chinese market to foreign banks in the latter part of 2006.

Increased barriers to Chinese exports. The Ministry of Commerce annually publishes a foreign market access report. The latest report finds that last year 57 anti-dumping and other product-specific safeguard investigations were launched against Chinese exporters.

Since 1995, about a seventh of all anti-dumping cases by WTO members have involved Chinese products. The report's purpose is to inform Chinese exporters about foreign trade practices of different countries and the treatment of Chinese foreign investment. China is expected to raise market access issues in its bilateral and multilateral negotiations.

As of end-2004, the US had 59 retaliatory measures in place against Chinese products. The US last year also launched six new investigations into dumping allegations and twelve investigations to safeguard domestic textile and clothing manufacturers. Average US customs tariffs are substantially higher for industries such as textiles and clothing, which are of particular importance for China. The EU launched nine dumping investigations against China last year. Russia last year raised import tariffs on all

Chinese products and banned imports of Chinese meat products from the start of September.

Grain imports grew rapidly in January-February.

According to the figures from the Ministry of Commerce, the value of grain imports (excluding beans and tubers) more than tripled from a year earlier. Wheat constituted more than 70 % of the total grain imports, and its value grew 800 % from the same period last year.

China has begun to see grain shortages due to poor harvests. Factors contributing to the decline in grain production include low state-regulated grain prices and the loss of arable land. However, in 2004 grain production climbed 9 % y-o-y due to favourable weather conditions, increased government support and higher grain prices (see *BOFIT Weekly 5/2005*). Grain prices jumped 26 % in 2004, up from a 2 % gain in 2003. The current level of domestic grain production remains inadequate to meet demand. Grain prices increased 12 % y-o-y in January-February.

The value of imported agricultural products was \$1.5 billion (€1.1 billion) in January-February and its share of total imports was about 2 % during the same period. China's trade of agricultural products was roughly in balance. In February, the Ministry of Commerce began releasing monthly statistics on imports and exports of agricultural products.

Revised electricity pricing mechanism. The new electricity pricing mechanism is based on the state council's reform plan released in 2003. Under the new mechanism, electricity prices will be determined separately at the generation, transmission and sale stages. At the generation stage, the electricity price is based on fixed investment costs and operating costs, which reflect e.g. coal prices (see *BOFIT Weekly 1/2005*).

Power grid operators can include fixed mark-ups set by the state in their rates. The new regime also allows the final sale price to be adjusted according to market conditions, with the exception of electricity prices for the agricultural sector and households. These require approvals from representative councils and can only be modified at fixed intervals. As a result, the industrial and commercial sectors will be most affected by the new mechanism. The new regime continues to rely on administratively set pricing, so it cannot be described as market based.

At the end of 2004, China's installed electricity generation capacity was 13 % greater than a year earlier. Thermal generation (e.g. coal, natural gas) constituted about 75 % of total capacity. Industry accounted for 75 % of total electricity consumption in 2004, an increase of 16 % y-o-y. Urban residents used almost twice as much electricity as rural households. China's electricity shortage this summer is expected to be at least as bad as last summer's 20 million kWh shortfall. Half of the shortage will affect the Eastern region.

Russia

Government accepts medium-range economic forecast.

The government last week approved the economy minister's economic forecast for 2006–2008. The forecast, first presented to the cabinet last December, was sent back to the ministry several times for revision. Prime minister Mikhail **Fradkov** was particularly dissatisfied with the cautiousness of the growth figures, which if realised would jeopardise the president's declared target of doubling GDP in ten years. There are two versions of the approved forecast: a basic forecast that assumes annual growth of 4.5–4.6 % during 2006–2008, and an optimistic version that anticipates 5.9–6.2 % growth in the same period. The forecast versions differ on assumptions for oil prices, investment trends and economic efficiency.

Both predictions assume oil prices will fall significantly in 2006, thereby reducing the nominal value of exports in dollar terms. Both versions also see growth in the volume of oil exports slowing to 1–2 %, which is substantially more pessimistic than earlier forecasts. In presenting the economic outlook, economy minister German **Gref** reminded cabinet members that GDP growth has typically exceeded budget assumptions in recent years, due largely to the rise in oil prices. He also noted that a rapid drop in oil prices also carried certain risks. The purpose of the medium-range forecast is to provide the government with a basis for preparing future budgets.

Key growth figures under the optimistic scenario, %

	2004	2005f	2006f	2007f	2008f
GDP	7.1	6.5	5.9	6.15	6.15
Inflation	11.7	8.5–10	7–8	6–7	4–5.5
Rouble's real effective exchange rate	4.7	8–9	3.2	2.9	2
Nominal value of exports (US\$)	35	16.1	-4.3	4.1	4.1
Urals-grade crude oil (US\$/barrel)	34.4	39	34	33	33.5

Source: Ministry of Economic Development and Trade

Russian investment climate hurt again. The Russian-British oil venture TNK-BP announced the Russian tax authorities had slapped it with a €770 million bill for 2001 back taxes. The company had already been hit in December with a claim for €10 million in tax arrears for 2000–2003. TNK-BP says the claims are baseless. The September 2003 merger of British Petroleum's Russia operations with Tyumen Oil and SIDANCO resulted in TNK-BP. The new oil giant was thought to enjoy special insulation from the whims of tax officials because the merger had been blessed by Russia's top leadership.

This week, Russia's competition authorities also rejected the German Siemens' attempt to acquire a nearly 75 % share in the Russian turbine manufacturer Silovye Mashiny. The merger would have given the merged company a monopoly position in the manufacture of power technology. The deal, which had been under consideration since last summer, encountered opposition in the Duma, because Silovye Mashiny also serves Russia's critical defence technology sector. Even so, the market was expecting that the deal would go through as it had the support of both economy minister German **Gref** and finance minister Alexei **Kudrin**.

Putin signs Public Chamber bill. The Public Chamber Act, the result of a presidential initiative, creates an advisory body on national civil issues that focuses on protection of the interests, rights and freedoms of citizens. The Public Chamber will comprise 126 members. One-third of them will be named by the president, another third by national citizens' organisations and the rest by regional unions. Political parties are barred from nominating candidates and persons serving as members of parliament, ministers or holding public office are not allowed to be members of the Chamber. The Public Chamber is to be funded out of the federal budget. The act enters into force at the beginning of July.

Euromoney and Institutional Investor publish country risk rankings. *Euromoney's* March 2005 survey covered 185 countries, while *Institutional Investor's* considered 173 countries. Country risk is seen as an indicator of a country's creditworthiness. Compared to March 2004, *Russia's* rankings climbed in both surveys even if the quality of Russian credit is expected to fall.

China fell six places in the *Euromoney* rankings from a year ago, but moved up a notch in the *Institutional Investor* rankings. Although *China's* ranking was up in the *Institutional Investor* survey, a growing number of respondents (25 %, up from 9 % in 2004) expressed fears that slowing Chinese economic growth could affect the global economy.

Country risk rankings for March 2005, September 2004 and March 2004

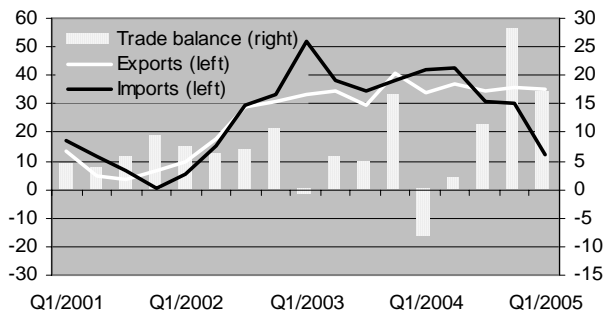
	<i>Euromoney</i>			<i>Institutional Investor</i>		
	3/05	9/04	3/04	3/05	9/04	3/04
Taiwan	24	25	26	24	25	25
Hong Kong	26	26	25	26	26	26
China	51	50	45	37	38	38
Russia	61	64	66	58	58	59
Bulgaria	63	61	63	60	60	60
Romania	65	66	68	65	67	69
Ukraine	83	85	93	82	80	86
Belarus	132	139	134	134	134	134

China

China posts foreign trade surplus in first quarter. Foreign trade (excl. services) surged 23 % y-o-y in the first quarter of 2005. Export growth continued its steady upward trend in the first quarter (up 35 % y-o-y), while import growth slowed to 12 %. Import volumes of some commodities such as steel and crude oil declined. The lower growth in imports not only reflected last year's high growth figure for the same period (42 % y-o-y) but also a slowing in investment growth. The slowing growth in imports in the first quarter was reflected in the \$17 billion (€13bn) foreign trade surplus. In 1Q04, China ran an \$8 billion trade deficit. The European Union remained China's largest trading partner (15 % of foreign trade). The southern Guangdong province accounted for nearly 30 % of all China's trade.

Electromechanical devices constituted over half of total exports in the first quarter, while exports of clothing and textiles represented 14 %. Exports of electromechanical devices rose over 30 % y-o-y in the period, which clothing and textile exports rose 16 %. Both the US and the EU are currently considering anti-dumping measures to curb imports of Chinese clothing and textiles, because China's exports of some textile products have increased dramatically since the global quota system was abolished at the start of this year.

Import and export growth (% y-o-y); trade balance (US\$bn)



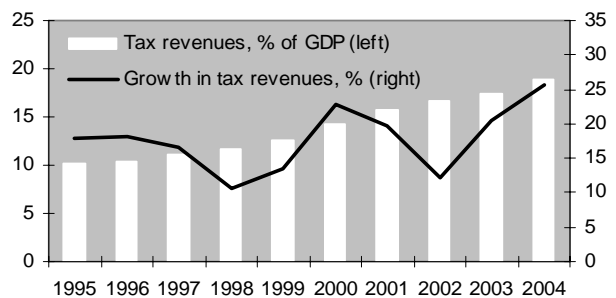
Source: Customs General Administration

China and India affirm cooperation. During his India visit earlier this week, Chinese premier **Wen Jiabao** met with Indian prime minister **Manmohan Singh**. The two leaders agreed the principles of solving the decades old border disputes. They also resolved to double bilateral trade to \$30 billion by 2010. While China-India trade has blossomed, it still only constitutes a minuscule share of China's total foreign trade (see *BOFIT Weekly 53/2004*). The highlights of the joint statement release also included

liberalisation of air traffic and increased cooperation in securing energy supplies. The countries will continue to look into reducing trade barriers. Wen also indicated support for increasing India's role in the UN.

Tax revenue growth on target in first quarter. Tax revenues rose 20 % in the first quarter from the same period a year earlier. Nearly 60 % of the increase in tax revenues came from the value-added, consumption and business tax categories. The rest of the increase reflected higher collections of personal income taxes and profit taxes on foreign enterprises. The eastern region contributed over 70 % of total tax revenues. Growth in tax revenues was the highest in the western region in the first quarter.

Tax revenues to GDP and annual growth in tax revenues



Source: State Administration of Taxation

China's first private airline takes to the skies. Two-plane, one-route Okay Airways has launched its operations as a charter carrier. Last summer, the Civil Aviation Administration of China (CAAC) gave its initial approval to the establishment of four privately owned commercial airlines (see *BOFIT Weekly 28/2004*). The three other airline applicants have yet to receive permission to start flying. Several other companies have also petitioned the CAAC for initial permission to establish airlines.

Domestic air travel in China is still closed to foreign (including Hong Kong and Macao) operators and is dominated by China's three state-owned airlines (Air China, China Southern and China Eastern). Okay Airways and the three other companies seeking licences all claim to be budget carriers, even though price competition is limited in China. Although China has incrementally freed up pricing of air fares, the state continues to strictly regulate landing fees, route charges and the price of aviation fuel.

China's civil aviation sector has boomed in recent years. Passenger numbers in 2004 were up nearly 40 % from 2003 and air companies made over CNY 6 billion (€550 million) in profits. Air travel is expected to grow at a rate of at least 10 % a year over the next three years.

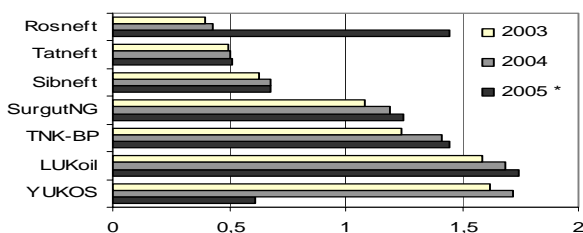
Russia

Slowdown in Russian industrial output growth. Industrial output in the first quarter rose just 3.9 % from a year earlier. Mineral extraction industries, as well as production of electricity, gas and water had growth of just 2.5 %. Manufacturing, on the other hand, was up 5.3 % y-o-y. The pace of industrial output growth slowed from last year's growth rate of nearly 7 %. The slowdown can be attributed to several reasons, including a sharp rise in production costs in recent years, real appreciation of the rouble and capacity constraints in certain fields.

Distinctly lower growth in oil output. On-year growth in Russian crude oil production in the first quarter was only about 4 %, compared to 8.6 % in 1Q04. In the first three months of the year, crude oil production averaged 9.3 million barrels a day. The slowing in production growth was expected, however. For example, the economy ministry's 2005 forecast assumes oil output will rise by only 1–2 %.

Despite lower growth in crude oil production volumes, oil export earnings soared in the first quarter. Preliminary balance-of-payments figures suggest export earnings climbed 56 % y-o-y, mainly due to the rapid rise in oil prices. Pipeline monopoly Transneft reports oil exports were up about 10 % y-o-y in the first quarter. Two-thirds of Russia's crude oil exports go via Transneft pipelines.

Daily output averages of large Russian oil companies, 2003–2005, million bdp.



* January-March

Sources: Renaissance Capital, Troika Dialog

Russian IPOs enliven capital markets. Russian companies are increasingly capable of raising money from capital markets through share listings (IPO) and this year is expected to be the busiest listing year ever. The RTS and MICEX exchanges in Moscow saw twelve new listings in 2004 and already this year have had nine new listings, the largest of which being the €151 million initial public offering of soft beverage maker Lebedyansk EKZ. Perhaps the most noteworthy aspect of the newly listed companies is that they come from sectors traditionally under-represented on Russia's exchanges. They are involved in such branches as food processing, real estate and retail activities.

Even with renewed interest in IPOs, the RTS and MICEX have been losing out to foreign bourses in the competition for new listings, due in part to Russia's arcane regulations and small trading volumes. Five Russian companies are presently listed on the London Stock Exchange and another seven on the New York Stock Exchange. The latest listing abroad was the Sistema conglomerate. Its holdings include the majority stake in the MTS telecom. Sistema's listing on the LSE's main list in February raised \$1.56 billion in new capital, an all-time record for a Russian IPO.

Russia's largest retail chain, Pyatyorochka, is set for its London IPO. The listing is expected to raise at least one billion dollars.

Aluminium producer SUAL, in contrast, just announced it was scrubbing its LSE plans. According to SUAL CEO, current government policies frown on the notion that a strategic raw material producer might wind up in foreign hands.

Gazprom and Germany's BASF sign deal on construction of Baltic Sea gas pipeline. The proposed North-European Gas Pipeline under the Baltic Sea would annually ship up to 30 billion cubic metres of natural gas to Central Europe. Gazprom already supplies about 20 % of Europe's gas demand (Gazprom's supplies to Europe reached 157bn m³ last year). In addition, Gazprom and BASF have agreed to jointly develop the Yuzhno Russkoye gas field, where production is expected to come on stream in 2007. Development of the Zapolyaroye field in the Yamal-Nenets autonomous okrug remains Gazprom's top development project. Zapolyaroye has estimated gas reserves of 3,300 billion cubic metres.

Due to a price dispute, Turkmenistan shut down gas deliveries to Russia at the beginning of this year, motivating Gazprom CEO Alexei Miller to renegotiate terms with Turkmenistan president Saparmurat Niyazov to end the embargo. Turkmenistan has the second-largest gas deposits in Central Asia, and the region's only fields developed to the production stage. With Gazprom's old fields peaking, Turkmenistan gas is hoped to make up the difference until Gazprom get new fields on stream.

New regional unions in the works. Residents of the sparsely populated but resource-rich Taimyr and Evenkia regions voted last Sunday (Apr. 17) by a clear majority to merge their autonomous regions with the larger, industrially more advanced Krasnoyarsk region. The boundaries of the reformed region will show up on the map from the start of 2007.

In addition to the earlier merger in Perm region, another half dozen regional merger proposals are presently under consideration. Russia's 89 administrative regions are quite diverse both in terms of status and degree of development and the Kremlin strongly supports reducing their number.

China

Rapid economic growth continues in China. In real terms, overall GDP growth roared along at 9.5 % y-o-y in the first quarter – a rate well above the government’s target of 8 % for this year. In other words, the pace of growth continues to match the 2004 level. Growth held steady in the main economic sectors, with industry and construction seeing the highest output growth (both up around 11 % y-o-y). Agriculture and other primary sector production increased 5 %, while output in the services sector was up 8 %.

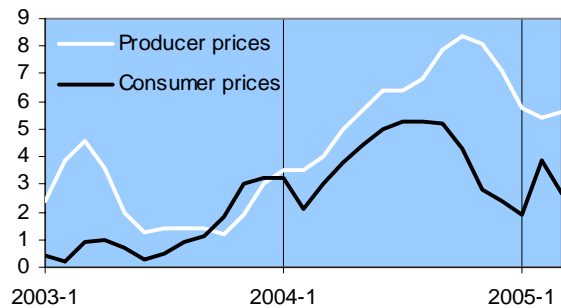
The focus of growth shifted somewhat from capital investment to the export demand and domestic consumption. Export of goods in the first quarter grew 35 %, while growth in imports slowed to 12 %. As a result, China’s trade surplus swelled to \$17 billion; a sharp contrast to 1Q04’s \$8 billion trade deficit. Preliminary figures suggest that the growth in domestic consumption has accelerated; measured in fixed prices, retail sales climbed 12 % y-o-y in the first quarter.

Even eclipsed by other trends, investment growth remains fairly brisk. In fixed prices, investments grew 21 % y-o-y in the first quarter and growth slowed only slightly from 2004. Nevertheless, government efforts to restrain investment growth appear to be taking effect in certain industrial branches. For example, the level of investment in metal industries has essentially stabilised at its 2004 level. Meanwhile, investment in “bottleneck” sectors such as energy and transportation has taken off. Nevertheless, a recent National Bureau of Statistics’ quarterly report warned that the total volume of investments was still too high from the perspective of sustainable growth.

Higher food and housing prices lift inflation. Consumer prices rose 2.8 % y-o-y in the first quarter. Food prices climbed fastest (6.1 % y-o-y), followed by a 5.6 % rise in housing-related prices (which include rents, home decor and renovation costs, and utilities). Like elsewhere, property prices are not included in the consumer price index. The weights in the consumption basket used in calculating the CPI are adjusted according to household consumption from the previous year. Last year, for example, 34 % of consumer spending went to food and about 14 % went to housing. Other important items in the consumer basket include tobacco and alcohol products (14 %), telecommunications and transport services (9 %) and clothing (9 %).

Producer prices rose 5.6 % y-o-y in the first quarter. The rise in producer prices was driven by increases in prices for raw materials, fuel and electrical power of over 10 % y-o-y.

On-year change in consumer and producer prices, %



Source: National Bureau of Statistics

China and Australia begin talks on free-trade area. A joint study suggested that both countries would benefit substantially from a free-trade area. China, however, insisted it would only go ahead with the plan after Australia granted it full market economy status. On Monday (Apr. 18), Australia granted China market economy status. The parties have yet to announce a timetable for their talks. Australia accounts for about 2 % of China’s foreign trade, and the trade turnover between two countries increased 50 % last year. China mainly imports raw materials from Australia (particularly iron ore) and exports electromechanical devices.

China is also negotiating free-trade areas with Chile, New Zealand and Saudi Arabia. China and ASEAN, which have already agreed to setting up a free-trade area, will begin implementation in July (see *BOFIT Weekly* 49/2004). China has been granted full market economy status by about 40 countries, including New Zealand, ASEAN countries, South Africa, Brazil, Russia and Chile.

Chill on China-Japan relations. Anti-Japan demonstrations flared in China this month, following the introduction in Japan of a new history textbook. The Chinese feel that the revised text gives a biased view of Japan’s actions in the Second World War. Demonstrators vandalised Japanese diplomatic missions and facilities of Japanese companies operating in China. A meeting of the foreign ministers of both countries last weekend produced little to calm the situation.

Tensions were further heightened by disputes over rights to natural gas deposits in the East China Sea. Both countries plan to begin exploratory drilling in the area this year. Japan also needs China’s blessing if it is to gain a permanent seat on the UN Security Council. The deterioration of relations with China are partly to blame for the recent drop in Japanese share prices. The leaders of China and Japan will meet at the Asia-Africa summit on Saturday.



Russia

Putin's state-of-the-nation speech stresses importance of strengthening state. After making reference to his economic initiatives from last year's state-of-the-nation speech, Russia's president focused on issues related to the state, security and civil society development.

Putin said Russia, in aiming to *strengthen the federation*, needs forward-looking policies that at their core strive for greater efficiency, promote respect by civil servants for the rule of law and improve the quality of public services. He expected mergers of regions would strengthen national unity and increase efficiency. Putin also noted the need for further liberalisation of private entrepreneurship, and emphasised the importance of private investment, including foreign investment. He said legislation should clearly specify the fields where foreign capital is barred. With changes in the law, he added that it should be possible to encourage domestic investors to repatriate their money from abroad. He criticised heavy-handed actions of tax and customs officials and encouraged them to consider the state's larger interests and the dangers of overly burdensome treatment of companies.

Creation of effective judicial and political institutions featured strongly in the speech. Putin said Russia needs to make its own choices; it must decide for itself how it will guarantee freedom and realise the principles of democracy. The fight against terrorism will continue. CIS cooperation will remain a priority, but Russia is also prepared to increase its cooperation with all nations in solving global problems.

According to Putin, citizens enjoy a right to objective information. He reiterated that the soon-to-be-formed Public Chamber (see *BOFIT Weekly 15/2005*) would help assure citizens' access to unbiased information and suggested that the Chamber could establish a freedom-of-speech commission comprised of experts. The president also mentioned the demographic challenge from Russia's low birth and high morbidity rates, poor health care and lagging "budget sector" wages.

Growth in real incomes slows. The average real wage increased 7.4 % y-o-y in the first three months of this year. Even so, the pace of growth was lower than in 1Q04 when the average real wage rose 10 %. Preliminary Rosstat data indicate that the average monthly wage in March 2005 was 7,850 roubles (218 euro). Wage levels varied widely among occupations. In agriculture, wages were well below the average, while in the mining and oil industries wages were up to triple the average.

Real disposable incomes were up just 3.1 % in the first quarter, eroded in part by sharply higher housing costs and prices for administratively regulated services.

Progress in Russia's WTO talks. At the accession working group's 27th meeting last weekend, Russia finalised talks on bilateral trade of goods with 29 counterparties, including the EU. Together, the 29 counterparties account for nearly 90 % of Russian imports. The EU and Russia also reached agreement on Siberian over flight fees. Economy minister German **Gref** said Russia is aiming at completing its membership negotiations before the WTO minister conference in Hong Kong this December.

Major unresolved issues centre around protection of intellectual rights and provision of financial services (particularly restrictions imposed on foreign banks operating in Russia). Subsidies for meat product exports and aircraft production are other central issues in the bilateral talks between Russia and the US. Questions relating to agricultural subsidies remain to be subject to talks with main agricultural producers. Open questions facing the multilateral talks include barriers to foreign trade imposed by other restrictions than customs tariffs and Russia's demands for transition periods.

Forests bill receives severe criticism. Prior to reaching the Duma in its current form, the proposed forests act has been through at least a half dozen drafts over the past two years. The Duma last week approved the economy ministry's submitted draft in its first reading by a vote of 323–99, despite that many forest industry experts, NGOs – and even some of the forest industry's main players – consider the bill poorly drafted. Much of the discontent has arisen from the inclusion in the bill of private forest ownership. Critics say that approving the act in its current form will result in a major redistribution of forest ownership. Instead of rational forest policy, critics fear large monopolist forest owners would be able to stifle smaller entrepreneurs and threaten public rights to access to forests.

Opponents of the legislation also note deficiencies in establishing a system for supervising and monitoring forest use, as well as overly vague references to the division of rights and responsibilities between the centre and regions. Additionally, they accuse the government of being preoccupied with attracting investment to the forest sector and increasing budget revenues. The cabinet responded that Russia has no time to waste in creating a functional forest policy in order to apply standard business practices to forest ownership and use.

The draft bill still forbids foreign ownership of forest and restricts leases to no more than one year at a time. Russian residents would be able to lease forest lands for up to 99 years at a time.



China

Growth in fixed investments in China continued strong in first quarter. Fixed investment in urban areas soared 21 % in real term from a year earlier, with particularly brisk investment in “bottleneck” sectors. Investment in coal production grew over 80 % y-o-y; investment in electricity, fuel and water production were up 44 %, and railways witnessed explosive expansion in investment of over 300 %. Despite government measures to curb growth, investment in the building sector still slightly exceeded the average pace of investment growth. On the other hand, investments in metal production remained about the same as in 1Q04.

Foreign direct investment in China grew 9.5 % y-o-y in the first quarter, down from 13 % last year. Highest growth (13 % y-o-y) was seen in FDI inflows from Europe. Investment from the US fell sharply.

Industrial output growth surges on. First-quarter industrial output growth (16 % y-o-y) nearly matched last year’s blistering 17 % pace. March industrial output was up 15 % from a year earlier. Investment-driven production of goods saw steep increases. For example, steel production was up over 20 % y-o-y and manufacture of electrical power generation equipment nearly 30 %. Electricity production also rose 13 % in the period.

Foreign exchange reserves up further in 2004. The State Administration of Foreign Exchange (SAFE) has released its balance-of-payments statistics for last year. The figures put China’s foreign exchange reserves at \$610 billion (€470bn) at the end of 2004, up from \$403 billion at the end of 2003. In 2003, \$45 billion of currency reserves was used in the bail-outs of China’s two largest state-owned banks (see *BOFIT Weekly 2/2004*).

The current account surplus represented a third of the increase in foreign exchange reserves last year. The surplus in goods trade grew 32 % y-o-y, while the service deficit widened by 13 %. Current transfers (mainly private remittances from abroad) were up 30 % y-o-y. The bulk of the increase in foreign exchange reserves in 2004 came, however, from surpluses in the financial accounts, which include FDI.

Last year’s heavy foreign currency inflow was largely driven by the expectation of a yuan revaluation. Short-term external borrowing also grew briskly last year until the authorities intervened (see *BOFIT Weekly 24/2004*). The 300 % increase in prepayments to Chinese exporters in 2004 suggests that export companies

turned to trade credits as a means of reducing currency risks and speculation on a possible currency revaluation. This year, SAFE issued new trade credit rules designed to prevent such credit abuses. The net errors and omissions item, which is widely seen as an indicator of the scale of illegal foreign currency flows, was positive and rose by 47 % y-o-y. Net errors and omissions also accounted for more than 10 % of the increase in foreign exchange reserves.

Foreign exchange reserves used to bolster balance sheets of state-owned ICBC. Industrial and Commercial Bank of China (ICBC) has received \$15 billion (€12bn) from foreign exchange reserves. The bank’s recapitalisation strategy departs significantly from the approach for Bank of China (BoC) and China Construction Bank (CCB) in 2003 (see *BOFIT Weekly 2/2004*). Back then the Ministry of Finance wrote off non-performing loans (NPLs) against its entire shareholder equity before SAFE released \$45 billion in foreign exchange reserves and the ownership and administration of CCB and BoC were moved from the MoF to the central bank (although the ministry retained representatives on the board of directors).

In the recapitalization of ICBC, the MoF uses less than \$10 billion (€7.5bn) from its shareholders’ equity as the NPL reserve, and retains a 50 % stake in the bank. ICBC’s core capital adequacy ratio is expected to reach 6 % after the recapitalisation. Through timely issues of additional subordinated loans, the capital adequacy ratio should exceed the required 8 % minimum already this year. Thus, while the amount of NPLs remains large, the new arrangement makes it possible to identify and punish credit abuses.

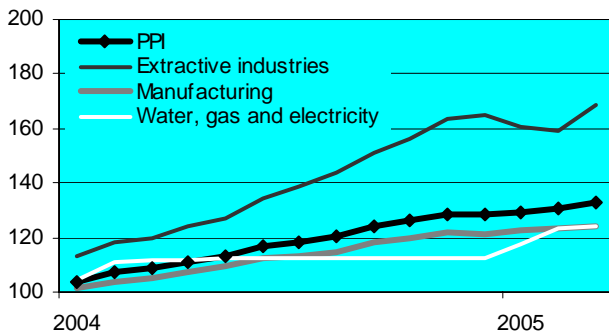
ICBC is the largest commercial bank in China. Its assets constitute over a third of total assets of four state-owned commercial banks. As of end 2004, 19 % of ICBC’s loans were non-performing. In contrast, the NPL ratios of BoC and CCB were 5 % and 4 %, respectively, and their capital adequacy ratios both well exceeded the mandatory 8 % minimum.

Growth of money supply and credit on track. As of end-March, broad money (M2) was up 14 % y-o-y. The bank sector loan stock was 13 % larger than at the end of March 2004. The growth of both money and credit was slightly below central bank targets. In January-March, the volume of new yuan-denominated loans granted was down 12 % from a year earlier.

Russia

Industrial producer prices continue to rise. Industrial producer prices were up in March 19.4 % y-o-y. Producer prices rose nearly 2.5 % for the month and 4.3 % since the start of the year. Highest increases were recorded in extractive industries where the producer prices increased 30 % y-o-y. Within extractive industries, the sharpest increase was in the mining industry, where the on-year rise in prices was over 40 %. Manufacturing producer prices in March climbed 18 % y-o-y. Within manufacturing, the fastest rise was seen in producer prices for coke and oil products (over 50 % y-o-y). March producer prices for electricity, natural gas and water were up 13 % y-o-y. During 2004 industrial producer prices increased 29 %.

Key producer price indices (December 2003 = 100)



Source: Rosstat

Growth in retail sales remains strong. The Federal Statistics Service (Rosstat) reports that *retail sales* in constant prices in the first quarter of this year grew 9.6 % from 1Q04. Retail was the only major segment of the economy that continued to enjoy almost the same robust growth level as last year. For January-March 2005, *industrial production* grew 3.9 % y-o-y, down from around 7 % in the same period a year earlier. Growth in the *construction* sector began to decelerate in the second half of 2004 and slowed further to a pace of just 5.3 % y-o-y in the first three months of this year. Construction growth topped 10 % a year ago. *Freight transport* was up just 2.7 % in the first quarter. Rail freight increased 2 %, pipeline transmission volumes 3 % and road transport 9 %. Sea freight actually fell. *Agricultural output* remained at the same level as last year.

Russia has sixth largest foreign currency reserves. Last month, Russia's foreign currency reserves surpassed \$141 billion. From April 2004, the central bank's gold and foreign currency reserves swelled nearly 70 %. From the start of this year, the reserves were up over 13 %, or about \$17 billion. Russia's foreign currency holdings now exceed the

central government's entire foreign debt, which has resulted e.g. in an upgrading of Russia's credit rating on sovereign debt to investment grade. Only Japan, China, Taiwan, Korea and Singapore have larger foreign exchange reserves. Japan and China are in a class apart with reserves of \$840 billion and \$610 billion, respectively (as of January 1, 2005). Finland has foreign exchange reserves of just under \$12 billion.

Administrative reform stumbles along; number of bureaucrats actually increased last year. Rosstat reports Russia had just over 1.3 million state and local bureaucrats at the end of last year – an increase of nearly 14,000 from the previous year. The highest staffing growth (9.5 %) took place in courts and prosecutors' offices. The central government bureaucracy ended 2004 with about 620,000 personnel, regional administrations some 220,000 and local governments a total of 470,000. Thus, the number of bureaucrats has increased by 310,000, or more than a third, since 1994. At the same time, Russia's public sector share of GDP has fallen continuously.

For years, one of the central goals in administrative reform has been reducing the number of bureaucrats. The most recent attempt at slashing the bureaucracy was made by president Vladimir **Putin** in his decree in March 2004, whereby Russia adopted a three-tier administrative approach, comprising ministerial, institutional and office administration levels. Despite the good intent, the number of administrative bodies and bureaucrats has not been reduced under the latest reforms and many of the required reforms were still being implemented at various government agencies at the start of this year. Some observers claim that shrinking the number of ministries has consolidated more power with the finance ministry. Further, a reduction in the number of deputy ministers complicates daily operations at the remaining ministries. Under the municipal reform, the number of districts will be almost tripled to about 30,000, which in turn is likely to create a boom in the number of local bureaucrats.

To increase bureaucratic efficiency, the president has proposed that the cabinet adopt a "budget framework," whereby the state budget will always be planned in three-year periods. As the same time, a share of administrative finances would become discretionary, and funding would be based on the relative performance of the administrative entity.

China

China prepares to sell state shares in listed companies.

China's Security Supervision Commission (CSRC) last month released regulations on the stock market sale of currently non-traded state shares in listed companies. Such shares constitute about 70 % of total outstanding shares of China's listed companies. As it becomes gradually possible to trade these shares and the large state stakes are broken up, small investors are expected to gain better opportunities to influence company activities. Moreover, listing would force the state to pay greater attention to price movements on the stock exchanges and corporate governance practices of listed companies are expected to improve. Worries about the impending sell-off have long depressed Chinese stock prices. Investors fear the devastation that a dramatic increase in supply would have on share prices. On the other hand, observers note that China's stock markets are still relatively small – the ratio of all listed shares to GDP is below 10 %, which is low even among emerging economies.

Chinese authorities have responded to investor concerns by requiring a one-year freeze on trading once the shares are listed. Starting twelve months after the listing, up to 5 % of the shares in a particular listed company may be traded. After 24 months, 10 % of the shares will be tradable.

The sale of state-owned shares will initially be limited to just a few companies determined by the CSRC. Minority shareholders also have to give their blessing before sales of state shares can begin.

Higher electricity rates. At the beginning of May, the average price of electricity rose 0.03 yuan per kilowatt, or about 5 %. The rate hikes were heftier for commercial and industrial sectors and milder for households. Electricity rates for rural sector were left untouched. Higher rates have been awaited since the introduction of the new electricity pricing mechanism (see *BOFIT Weekly 14/2005*). Since much of China's electrical power is generated in coal-fired plants, the new pricing mechanism gives greater weight to fluctuations in coal prices. However, as the price of coal sold to power producers is still regulated, coal producers cannot pass on higher costs beyond 8 % a year. When the market price of coal rose over 40 % last year, coal producers found it quite unprofitable to sell coal to electricity producers. Coal shortages, transport problems and dilapidated plant conditions cause many power plants now to operate below capacity.

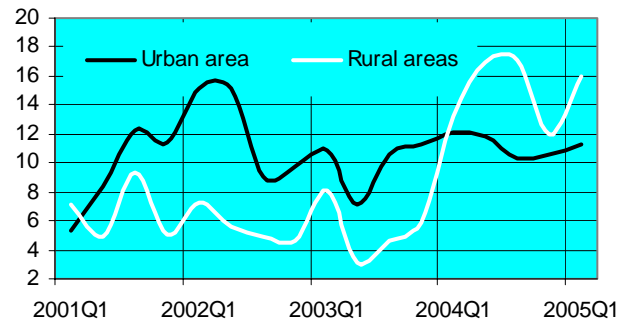
While the current price hike has been kept fairly modest in order not to spike inflation, the National Development and Reform Commission (NDRC) has introduced seasonal and peak time electricity rates in anticipation of an electricity shortage this summer. Moreover, from the start of this month, the NDRC has reduced export rebate rates for steel products and coal, as well as abolished ex-

port rebates for a range of energy-intensive raw material products. Tariffs on coal imports were also lowered at the beginning of April.

Steady growth in wages and retail sales. In the first quarter, per capita real disposable incomes in urban areas rose 9 % y-o-y, while real cash income in rural areas rose 12 %. Urban dwellers had average disposable incomes of 1,000 yuan (90 euro) a month, or three times more than rural residents.

The increase in incomes was reflected in growth of retail sales in the first quarter of over 10 % from a year earlier. Highest growth was seen in the value of sales of fuel, meat and home entertainment equipment.

Per capita nominal income growth in urban and rural areas, % y-o-y



Source: National Bureau of Statistics

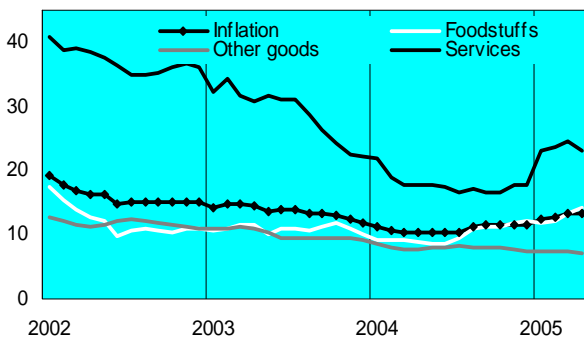
EU launches investigations into imported clothing and textile products. Amounts of certain clothing and textile products from Mainland China imported to EU countries in the first quarter exceeded the "danger zone" level imposed by the EU. The investigations focus on nine products, including mens' trousers (an increase of over 400 % y-o-y) and knit sweaters (over 500 %). The EU wants to complete its investigations within two months. On the basis of its findings, the Commission will decide on whether to invoke protectionist measures in the EU. Under WTO commitments, protectionist measures for clothing and textile products can be used until the end of 2008. While the investigations are still in progress, the EU plans to hold talks with Chinese officials to find a solution that satisfies both sides. EU trade commissioner Peter **Mendelson** had earlier expressed hope that China would voluntarily limit its clothing and textile exports. China's Ministry of Commerce opposes the use of protectionist measures.

The rapid growth in imports of Chinese clothing and textile products has sharply diminished imports from elsewhere outside the EU in several product categories. Further, unit prices in nearly all clothing and textile categories clearly fell in the first quarter compared to a year earlier. Last year, 22 % of clothing and textile imports into the EU came from China. The US is also considering measures to limit clothing and textile imports from China.

Russia

Russian inflation remained high in April. On-year inflation was 13.4 % in April. Despite the government's inflation target for this year of 8.5 %, consumer prices have already risen 6.5 % since the start of the year. After spiking in January, growth in prices for *services* slowed; the month-to-month increase in April was less than a percentage point. Nevertheless, prices for services are up sharply from a year ago (about 23 % y-o-y). The rise in prices of *foodstuffs* continued brisk in April and on-year inflation was 14 %. The rise in prices of *other goods* was a more modest 7 % y-o-y.

Running 12-month change in consumer prices, 2002–2005, %



Source: Rosstat

EU and Russia agree on broad based cooperation. At the EU-Russia summit in Moscow on May 10, EU and Russian representatives signed a partnership agreement on four common spaces. The agreement provides a roadmap for creation of a *common economic space*, *common space of freedom, security and justice*, *common space of external security*, and *common space of research and education*, including cultural aspects.

In the economic arena, the conditions for growing the economy and diversifying trade will be created through e.g. harmonisation of trade and industry regulations, eliminating obstacles to market access and measures to encourage investment. Special attention will be given to protection of intellectual property rights, competition and agriculture.

In other spheres attention will focus on e.g. taking action against organised crime, increasing educational exchanges, fighting terrorism and non-proliferation of weapons of mass destruction. One important topic of interest to Russia, visa-free travel, was not addressed in the agreement.

Russia mobile phone connections approach the 100-million mark. Brisk growth in the number of connections at the start of the year to nearly 90 million put Russia on track to break the 100-million barrier by the end of this year. The number of connections increased 104 % in 2004 and an additional 15 % in the first quarter of this year. The number of connections has increased eleven-fold since 2002. Penetration is now 61 % (i.e. 61 connections per 100 persons) nationally and 111 % in the Moscow region. Many of these connections have never been activated as Russians typically sign up for connections from several operators, so analysts say that the penetration figures are misleading. The largest mobile phone network operators are MTS (market share 36 %), Vimpelcom (34 %) and Megafon (18 %).

Russians last year bought \$4.5 billion worth of mobile phone handsets. The value of handset sales grew nearly 90 % and reflected a developing taste for up-market models with more features. In the first quarter of 2005, the value of mobile phone handset sales was \$1.1 billion. The greatest sales expectations are for handsets in the inexpensive-to-moderate price range as growth of mobile phone use accelerates in areas outside the major cities.

Government approves transportation strategy extending through 2020. In its statement last week, the government claimed that its transportation strategy was nearly finalised. The statement noted that Russia faces big administrative, financial and structural challenges in developing its national transportation infrastructure. The present transportation grid serves neither the needs of the national economy and domestic travel nor does it provide adequately for freight transport between Asia and Europe (a business of potentially great value to Russia).

The strategy is designed to support development of various sectors of society (the economy, the social sector, national defence and the environment). In the strategy's first phase, which runs to 2010, the goal is to complete the modernisation of key transportation systems started in 2002. This program focuses on eliminating bottlenecks, improving critical infrastructure and preserving wide state regulation. Transport minister Igor **Levitin** said that implementation of the initial phase of the transportation strategy requires funding equivalent to at least 4 % of GDP. In practice, this would mean a tripling of investments in the sector from the present level.

The second phase of the strategy focuses on developing transportation markets, environmental protection, privatisation and the overall reduction of state regulation, while taking into account the state and national defence needs. The second phase would also allow for "public-private partnerships," in which major construction projects would be funded by private investors, who would then be entitled to the revenues from the project for a specified period.



China

Real estate prices continued to rise in the first quarter.

Officials report prices increased on average 10 % y-o-y in the first quarter. The rise in prices was three percentage points higher than in 4Q04. Residential housing prices climbed 11 % y-o-y, with Shanghai leading the way with a 20 % y-o-y jump. Land leasing costs nationally were up an average of 8 % y-o-y (China does not allow private ownership of land). Land leases for residential development were 10 % more costly in the first quarter, up from a 2 % gain in the previous quarter. In the prosperous port city of Dalian in Northern China, land leasing costs rose over 50 % y-o-y in the first quarter.

Soaring land leasing costs partly reflect government efforts to rein in real estate development through restricting land supplies. The government earlier hiked interest rates on mortgage loans and tightened bank credit for real estate development. Further regulations were issued this week to restrain runaway real estate prices. Under the new regulations, developers must return possession of the land to the authorities if they fail to break ground within two years. More significantly, taxes will be levied from next month onwards on capital gains from residential housing sales if the owner sells within two years. Moreover, ownership registration will only be possible after construction is completed.

Despite surging property and land prices, other housing-related costs remained virtually unchanged in the first quarter. Rents were up just 2 % y-o-y, while building maintenance fees declined. The rents and building maintenance fees are included in the calculation of the consumer price index. Since 1997, the National Development and Reform Commission and the National Bureau of Statistics have compiled quarterly real estate statistics for 35 major cities. This survey will be expanded from July to cover 70 cities and the housing price index will be published on a monthly basis.

Taiwan opposition leaders visit Mainland China. The recent visit was meant to mend strained relations between Taiwan and the mainland. **Lien** Chan of Taiwan's leading opposition Nationalist Party (Kuomintang) and **Song** Chuyu of the People First Party both spent over a week in Mainland China. Their visit included meetings with Chinese president **Hu** Jintao in Beijing. Ending the current hostility and encouraging a peaceful solution to the current impasse headed the agenda, but trade was also discussed. China agreed to reduce tariffs on Taiwan agricultural imports, as well as promote bilateral travel and transportation. Of course, implementation of agreement will require the blessing of Taiwan's ruling pro-independence Democratic Progress Party. Mainland China was Taiwan's second

largest trading partner last year after Japan. Statistics from both China and Taiwan show that trade between the two rose by over a third last year. Even so, there are still no official direct transportation routes between Mainland China and Taiwan.

Hong Kong and Macao special administrative regions benefit from growth in the global economy and China.

Hong Kong's real GDP growth accelerated from the previous years' modest growth to an 8 % pace in 2004. In Macao, on-year GDP growth climbed above the 10 % level already in 2002-03, and last year growth surpassed 28 %! Total output in Mainland China grew 9.5 % last year. Despite strong growth, inflation has remained relatively modest. In March, the on-year rise in consumer prices was 0.8 % in Hong Kong, 3.7 % in Macao and 2.8 % in China. A healthy economy has helped Hong Kong balance its public finances. Macao's public sector, which is practically debt free, has operated in surplus for years.

Hong Kong (1997) and Macao (1999) joined China as special administrative regions. Both the size and structure of their economies are distinctly different from the mainland. Services dominate economic activity in these special economic regions. They constitute nearly 90 % of Hong Kong's total output, and the major service branches are retail sales and restaurants (27 % of GDP), as well as financial and insurance services (22 %). In Macao, the service sector accounts for over 90 %. In particular, the gaming industry has developed fast and currently accounts for over a third of GDP.

Both special administrative regions have open economies and thus are at the mercy of developments in Mainland China and the world economy. The value of goods and services exports in Hong Kong was almost double GDP. In Macao, the value of exports nearly matched the value of GDP. For Mainland China, the comparable ratio was below 40 %.

Macao's banking and financial system is closely bound to Hong Kong. In addition to the local currency, the pataca, the Hong Kong dollar is in wide circulation in Macao. The pataca is pegged to the Hong Kong dollar, which in turn is pegged to the US dollar.

Beijing's political relations with Macao have been less strained than relations between Beijing and Hong Kong.

China, Hong Kong and Macao, 2004

	China	Hong Kong	Macao
Population, million	1,300	6.8	0.44
Per capita GDP, USD	1,300	23,900	22,500
Currency	USD 1 = CNY 8.28	USD 1 = HKD 7.80	USD 1 = MOP 8.03

Sources: Statistics Bureaus, BOFIT

Russia

Russia agrees on early retirement of part of Paris Club debt. Russia agreed with Paris Club creditors last Sunday (May 15) to pay €12 billion of its nearly €32 billion debt on an accelerated schedule by August 20. Finance minister Alexei **Kudrin** said Russia would use oil export earnings collected in the stabilisation fund, which stood at RUB 858 billion (€4bn) at the beginning of May. Mr. Kudrin, on purpose to hold down inflation, has been a fierce proponent of using the money from the stabilisation fund to pay down debt rather than fund ongoing budget needs. Thanks to the early repayment, Russia will save billions of euros in debt-servicing costs by 2020. Sergei **Storchak**, who is in charge of debt matters at the finance ministry, said 65 % of the record repayment would be paid in euros, 22 % in dollars and the remainder in other currencies of creditor countries.

Russia's trade surplus swells. The Central Bank of Russia reports that Russia's trade surplus in the first quarter grew 37 % y-o-y to \$28 billion. The total value of exports was \$53 billion, an increase of 41 % from the same period a year earlier. Some 87 % of exports went to non-CIS countries, up a couple of percentage points from previous years. Crude oil constituted 35 % of exports in the first quarter, followed by natural gas at 15 % and oil products at 11 %. Even with high world oil prices, the value of exports in all product categories increased roughly the same amount. The value of imports was \$25 billion, an increase of 24 % from a year earlier. Nearly 20 % of imports came from CIS countries.

Russia's quarterly foreign trade figures for 2002–2005, US\$ billion



Source: CBR

CBR increases euro component in currency basket. On Monday (May 16), the CBR made a widely anticipated adjustment in the weighting of its dollar-euro currency

basket, which it uses to guide the rouble's market value. The euro's weight was increased to 0.3 and the dollar's weight lowered to 0.7. The move reflects the euro's increasing importance in Russian foreign trade. In March, the euro constituted 22 % of foreign currency purchases by private individuals. The euro also accounted for half of foreign currency imports by Russian banks. In comparison, it constituted only about 2 % of currency exports.

Russia and Estonia sign border treaty. After years of delay, the treaty on common state borders was signed by the foreign ministers of both countries on Wednesday (May 18). After regaining its independence, Estonia sought to restore the borders agreed under the 1920 Treaty of Tartu. The final agreement, however, recognises Estonia's borders from the Soviet era. The agreement still requires the approval of both countries' parliaments.

CIS countries enjoy strong economic growth, but huge disparities in living standards persist. Economic growth was brisk in CIS countries in 2004. The strong growth was driven by traditional export products, reflecting high world market prices for raw materials and strong domestic demand. Although growth is expected to flatten this year, it will nevertheless remain robust. The CIS countries with the largest populations (Russia, Ukraine and Kazakhstan) all produced current account surpluses, while the smaller CIS countries ran deficits. While inflation has slowed substantially in CIS countries in recent years, the monetary and fiscal policies should remain tight to fight inflation further. The differences in living standards vary tremendously among countries. Russia had the highest average monthly wage in 2004 and Tajikistan had the lowest – less than 10 % of the Russian average wage.

Key figures for CIS countries in 2004¹⁾

Country	GDP, % ²⁾	Infl. rate, % ²⁾	Current account balance, % of GDP	Budget surplus/deficit, % of GDP ³⁾	Avg. monthly wage, US\$
Armenia	10.1	7	-5.8	-1.4	79
Azerbaijan	10.1	7	-27.3	1.3	98
Georgia	8.5	6	-7.5	-	-
Kazakhstan	9.4	7	2.3	-0.5	207
Kyrgyzstan	6.0	4	-3.0	1.0	52
Moldova	7.0	12	-7.1	-0.3	90
Tajikistan	10.6	7	-3.9	-0.3	22
Belarus	11.0	18	-3.0	1.6	162
Russia	7.1	12	10.2	5.8	237
Ukraine	12.1	9	11.0	-0.8	111

1) Figures for Turkmenistan and Uzbekistan were either incomplete or unavailable.

2) Percentage change from 2003.

3) Consolidated budgets, January-September 2004.

Sources: World Economic Outlook 2004, CIS Bureau of Statistics

China

Chinese inflation slowed sharply in April; stable money supply growth. April's consumer prices were up only by 1.8 % y-o-y – the smallest 12-month inflation figure in a year-and-a-half. The CPI's loss of steam reflected the lower rise in food prices (3.1 % y-o-y). In the first quarter, food prices climbed at an annual rate above 6 %. Prices for clothing and transport continued to fall in April, while residential housing maintenance fees started to climb. Hikes in electricity rates this month are expected to revive May inflation (see *BOFIT Weekly 18/2005*). The government has set a 4 % inflation target for this year.

The broad money supply measure (M2) was up 14.1 % y-o-y at the end of April, matching the previous month's pace. Credit growth slowed slightly from March to 12.5 % y-o-y. The growth of both broad money and credit were somewhat below central bank targets (see *BOFIT Weekly 3/2005*).

FDI falls in April. Foreign direct investment inflows fell to \$4 billion last month, contracting nearly 16 % y-o-y (and despite a government downward revision of its figures for the first half of last year). In the first four months of 2005, investments grew just 2.2 % y-o-y and amounted to \$17.5 billion. According to the new revised figures, foreign direct investment shrank 4 % in January-April 2004 from the same period in 2003. FDI inflows in the first four months of this year were also less than in the same period in 2003.

Hong Kong remained the leading source of FDI inflows (nearly \$5 billion) in the first four months of this year, although the inflows from Hong Kong also shrank slightly from a year earlier. The fast growing sources of FDI were tax havens and the EU.

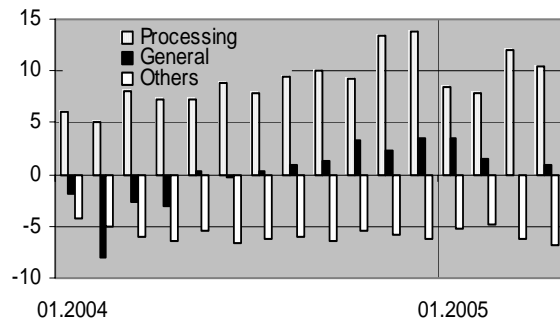
Robust growth in foreign trade continues. Exports of goods grew 32 % y-o-y in April, continuing strong performances last year and in the first quarter (about 35 % in both periods). Imports grew by 16 % in April, which was slightly higher than in the first quarter. After declining 2 % in the first quarter, the volume of crude oil imports increased 23 % y-o-y in April. The volume of coal imports also grew rapidly (50 % y-o-y) last month.

Steel imports, in contrast, plummeted nearly 40 % y-o-y in April. Following last year's massive build-up in steel production capacity in China, lower domestic demand has forced steel producers to increase exports of steel products. In the first quarter, steel exports jumped 220 % y-o-y.

China recorded a goods trade surplus of \$5 billion in April, or a bit less than in March. From January to April, the goods trade was \$21 billion in surplus, compared to an \$11 billion deficit during the same period last year. Processing goods trade (e.g. completing manufacture of prod-

ucts from imported components) accounted for nearly half of all goods trade and the lion's share of the trade surplus.

Balance of goods trade by categories, US\$ billion



Source: Ministry of Commerce

EU and US reinstate import quotas on Chinese textile and clothing products. Following a 160 % volume increase in Chinese imports of T-shirts and a 50 % leap in flax yarn in the first quarter, the European Union says it will invoke safeguard measures. The US also wants to impose safeguard measures on some of the fastest-growing categories of clothing imports: cotton and synthetic shirts, blouses and trousers, as well as underwear and cotton yarn. If formal consultation to solve the disputes starts in May, annual growth in imports of above-mentioned products to the EU and the US will be limited to 7.5 % in the consultation period of 90 days. The base period will be from March 2004 to the end of February this year. If consultations fail to yield satisfactory results, the quotas will remain in place through 2005. According to WTO rules, safeguard measures are allowed during the transition period, which ends at the end of 2008. In addition, findings of investigations on other textile products are expected soon.

Calls for safeguard measures in the US and Europe started well before the global textile quota system ended under WTO agreements at the beginning of this year. China opposes the EU and US measures, which it feels are a bit rushed, given that only three months has passed since the new regime was introduced. China's custom figures show exports of textiles and clothing grew 19 % y-o-y in the first quarter. Growth was six percentage points lower than in the first quarter of 2004. Chinese textile makers employ about 18 million people. Over a third of textile exports are produced by enterprises with foreign capital participation.

China voluntarily imposed export tariffs on textile exports at the start of this year. On Thursday, the country announced it would further raise export tariffs on 74 textile products by an average of 400 %. The hike obliges Chinese textile manufacturers to pay as much as 1-yuan-per-unit on their exports. Women's cotton overcoats will be subject to a 4-yuan-per-piece export tariff, an increase of over 1,200 %.



Russia

FDI inflows to Russia soar 30 % in the first quarter.

Rosstat reports that foreign direct investment in Russia climbed to \$1.9 billion in the first quarter of 2005, a 30 % increase over the same period a year earlier. Foreign investment overall fell a couple per cent, however, mainly due to a large decline in foreign borrowing.

The leading sources of foreign investment remained the same: Cyprus, Luxembourg and the Netherlands. Half of investment went to raw material production and processing industries. The wholesale and retail sector, which accounted for over 22 % of total investment, surpassed the processing industries in attracting investment. The stock of foreign investment capital in Russia at the end of the first quarter was estimated at \$85 billion, or less than 15 % of GDP. Over half of this was in various forms of credit, and nearly all the remainder was FDI. Portfolio investment only accounts for a tiny fraction of total investment.

Deposit insurance scheme gradually put in place. Over 800 of Russia's more than 1,200 banks have already been approved entry into the deposit insurance scheme. Under the deposit insurance act from December 2003, banks taking deposits from the general public must participate in the deposit insurance scheme. Under the law, deposits with insured banks are covered from the day the Deposit Insurance Agency adds the bank to its register. Deposits up to 100,000 roubles (2,800 euro) per account are covered in full. In the event a bank outside the deposit insurance scheme becomes insolvent, the CBR will ensure deposits of up to the same 100,000 roubles (enacted Jul. 29, 2004).

At the beginning of 2005, nearly all deposits of the general public fell below the 100,000-rouble ceiling. DIA head Alexander **Turbanov** said that the assets of the deposit insurance fund are currently approaching RUB 6 billion and should reach RUB 15 billion by year's end. Turbanov would like to see the fund's value rise in the next five years to a level corresponding to about 5 % of deposits. According to Turbanov, the system has already increased depositors' confidence in banks and improved the position of private commercial banks, which must compete against giant state-owned Sberbank, which controls about 60 % of the entire deposit market.

New banking strategy approved. After long preparation, the government and the central bank on April 5 approved a banking sector development strategy extending through 2008. Its objectives are to improve supervision and risk management of credit institutions and to increase competition and create a level field for competition in the banking sector. Banking legislation will be revised to meet international standards.

Particular attention will be paid to shifting credit institutions to international accounting practices, deterring terrorist financing and money laundering, and increasing transparency of bank operations. Increased capital requirements, a reduction in the maturity mismatch and increased protection of creditor rights are considered key measures to improving the risk management and competitiveness of credit institutions.

The CBR will retain its majority stake in Sberbank and study the possibility of transferring its ownership of Russian banks abroad to Vneshtorgbank. The state, which will remain deeply involved in Vneshtorgbank administration, also wants to boost Vnesheconombank's role in servicing state foreign debt.

Gazprom and Rosneft call off merger plans. The merger agreed last September between world's largest natural gas producer Gazprom and state-owned oil company Rosneft was cancelled last week. The decision ended six months of attempts to reach a deal that would have increased the state's stake in Gazprom above 50 % in advance of open trading in Gazprom shares. To acquire a majority stake, the state will now purchase another 10.7 % of Gazprom shares at a current market value of about \$7 billion. The state now plans to buy shares from a Gazprom subsidiary.

Duma to be elected exclusively from party lists. On May 18, president **Putin** signed a new Duma election act into law. All 450 Duma deputies will proportionally represent their constituencies and be elected from nationwide party lists. Winner-take-all districts will be eliminated. Under the new law that enters into force in December 2006, candidates can only stand for officially registered political parties. The first Duma election subject to the new rules is scheduled for December 2007. The new law, introduced at the behest of the president, is expected to further weaken the position of the opposition in the Duma.

Duma ratifies China border agreement. The Duma ratified a supplementary agreement signed by Russia and China last October that affects the confluence area of the Amur and Ussuri rivers. The agreement supplements the original border agreement signed by both states at the beginning of 1991.

Baku-Tbilisi-Ceyhan oil pipeline comes on stream. Inauguration ceremonies were held in Baku on May 25 for the new pipeline (with an annual capacity of 85 million tonnes) running from Azerbaijan through Georgia to the southern coast of Turkey. The new pipeline creates for the Caspian and Caucasian states a straight route to world markets bypassing Russia and Iran. Observers said that the presence of Kazakhstan president Nursultan **Nazarbayev** at the opening ceremony shows the level of interest in the new pipeline among states in the region.



China

Rapid rise of Chinese industrial output continues.

Industrial output in fixed prices was up 16.0 % y-o-y in April and 16.2 % in the first four months of the year. April output was driven largely by exports, as 30 % more industrial products were exported than in April 2004.

Strong development in the energy sector increased electricity production in January-April 13 % y-o-y. Growth in the production of electrical generators also continued very brisk. Production of steel was up 25 % and steel products 23 % in the first part of the year (growth in both categories matched last year's pace). Aluminium output growth accelerated slightly to 22 % y-o-y despite restrictive measures. Export growth was particularly robust for electronics and the clothing and textile industries. The volume of mobile phones and portable computers produced in the first four months of this year doubled compared January-April 2004. Clothing production climbed 20 %. Growth in the car industry returned in April, with car production rising 7 % y-o-y. Car production was up 0.8 % y-o-y in January-April.

Rise in producer prices remains brisk. April producer prices rose 5.8 % y-o-y (5.6 % in March). The rise in producer prices was mainly driven by prices for raw materials, fuel, and electricity, which all increased about 10 % y-o-y. The price of crude oil in April was up 37 % y-o-y and the price of coal 26 % y-o-y.

Investment shows no sign of slowing. Fixed investments nominally grew nearly 26 % y-o-y in January-April. Although state-led companies accounted for about half of investment, the growth of investment in publicly held companies (9 %) was clearly lower than in the private sector.

In addition to investment in railway construction (up 78 %), investments grew especially fast in coal production (69 %), as well as production and distribution of electricity, gas and water (38 %). The government has encouraged investment in the energy sector, as China is expected to face severe power shortages this summer. However, the bulk of new capacity will not be commissioned until the end of this year.

Incremental freeing up of capital movements. On Monday (May 23), the State Agency for Foreign Exchange (SAFE) made it easier for Chinese companies to set up operation abroad by raising the aggregate foreign currency allotment for such foreign investment from

about \$3 billion to around \$5 billion. Investment possibilities will also be broadened from companies in 24 counties to the entire country. Provincial authorities have been given the authority to issue permits on investments of less than \$10 million (from less than \$3 million earlier).

Given China's large foreign currency reserves and massive capital inflows, an increase in the quota of capital outflows by a few billion dollars appears to be a fairly modest move. Nevertheless, it indicates Chinese officials are sticking to their promise of cautiously lifting restrictions on capital movements (see *BOFIT Weekly 9/2005*).

China upgrades its rail system. China's railways are presently constrained by freight transport capacity, a problem that particularly affects transport of raw materials. The railways ministry says that only about a third of the potential demand for rail freight is presently served. To improve the situation, China will this year invest CNY 100 billion (€10bn) in railway construction, or more than double what it spent last year. The goal is to refurbish 2,000 kilometres of track and build over 1,000 km of new track. Under the current five-year plan, the railways ministry plans to build 10,000 km of new track by 2010. To fund this giant infrastructure challenge, the ministry is seeking to increase the amount of private capital invested in railway construction. China's first rail project with private capital participation, a coal freight line, is already expected to be completed this year. Private capital represents about a third of the total investment in that project. The ministry also announced this spring that railway construction projects will be opened up to foreign investors.

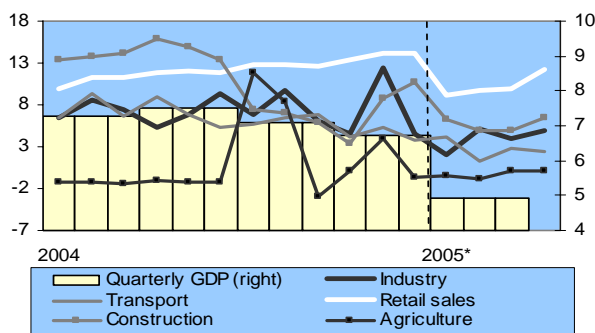
Rail freight volume in the first quarter of 2005 was 640 million tonnes. Rail freight transport was up 8 % y-o-y in 1Q05, compared to over 11 % in the same period a year earlier. The number of rail passengers in the first quarter remained at about 300 million, about the same as in 1Q04. The peaks in Chinese rail passenger travel occur during the week-long national holidays (Chinese New Year in late January or early February, International Labour Day on May 1 and National Day on October 1). During the recent Chinese New Year holidays nearly 150 million passengers travelled by rail, which was about half of all passenger travel in the first quarter. Rail freight transport abroad has also improved with the opening this spring of a rail route from China to Germany via Russia.

Russia

Growth slows in Russia's core production sectors. Output in the transport and construction sectors grew much more slowly in the January-April period than a year earlier. *Transportation services* in the first four months of the year were up 2.7 % y-o-y, compared to 7.8 % in the same period in 2004. *Construction* grew 5.6 % y-o-y in the period, down from 14.4 % in 2004. *Industrial output* rose only 4.2 %, compared to 6.9 % a year earlier. Slowing growth in the transport sector and industrial output reflected in part the slowdown in the growth of crude oil output. Other major segments of the industrial sector remained at levels similar to previous years. *Agricultural output* decreased by 0.2 % y-o-y in January-April. *Retail sales* were up 10.3 % in the first four months of the year.

The outlook for decelerating growth in core production sectors has been incorporated into this year's GDP forecast. At the start of this week, Russia's economy ministry lowered its forecast for GDP growth from 6.5 % to 5.8 % after revising the growth forecast upwards just a month earlier. The economy ministry currently estimates that GDP growth was only 4.9 % in the first quarter, a substantial decline from the 7.3 % growth posted in 1Q04.

Monthly on-year growth by core production sectors, 2004–2005, %



Source: Rosstat

Higher transit freight volumes, lower value cargoes.

Figures from Customs Finland indicate that the volume of road freight moving through Finland to Russia increased 4 % y-o-y in the first quarter of 2005 to 550,000 tonnes. At the same time, however, the value of road-freighted transit cargoes fell 5 % to €1.6 billion. Finland has traditionally been an important point of entry for high-value goods into Russia, while bulk goods have traditionally moved through Baltic ports or by road directly from central Europe. At the beginning of the year, the volume of machinery and equipment via Finland fell, while the volume of passenger cars shipped to Russia increased nearly 60 % y-o-y, caus-

ing the overall increase in transit freight. Finland compiles separate statistics for rail transit freight.

Putin delivers annual budget speech to parliament. In his address on the budget last week to the federal assembly, the president stated that, while Russia had achieved economic stability, inflation was too high. He noted that money in the Stabilisation Fund should be used next year exclusively for paying down foreign debt, despite government intentions to use some money to cover running budget expenditures and investments. Putin also mentioned that lowering the value-added tax was still on agenda, even though observers say the move contradicts the government's earlier decision to leave the tax untouched for the next three years.

Putin proposed that a real estate tax be immediately adopted, that the inheritance tax be eliminated altogether, and that, starting from 2007, the state budget would only require three readings in the Duma instead of the current four. The president also mentioned the need for more specific rules for carrying out corporate tax audits.

Observers say the president's speech was in contradiction to the official inflation target and the government's declared economic policies. Specifically, commentators remarked on the president's push for substantial hikes in federal pensions and wages for workers in the budget sector, public officials and military personnel was incompatible with efforts to lower inflation. Moreover, the government's decision to increase the budget from the beginning of next year, while reducing the share of oil revenues flowing into the Stabilisation Fund in itself will be sufficient to increase inflation.

Khodorkovsky gets nine-year sentence. On Tuesday (May 31), after a one-and-a-half year legal process, the founder of Yukos oil company Mikhail **Khodorkovsky** and his business partner Platon **Lebedev**, each received nine-year sentences for convictions on charges that included fraud and tax evasion. The two were also ordered to pay the Russian state nearly €500 million in back taxes and penalties. The sentence raised criticism in Russia and abroad.

The Prosecutor General's Office also announced it would be filing further charges against the men. The Yukos trial is seen as part of a larger struggle between president Vladimir **Putin** and Russia's oligarchs. Observers say that the ongoing trials have eroded confidence in Russia's investment climate and that this is reflected e.g. in the slowdown in oil production growth.

Yukos, hit hard by tax claims (about €23 billion), has countersued to have the forced sale of Yuganskneftegaz cancelled. Yukos charges that state-owned Rosneft acquired its core production unit Yuganskneftegaz on the cheap and demands reimbursement of €3 billion for unjust enrichment.



China

China cancels export tariffs on textiles and clothing.

In response to the EU and the US decisions to go ahead with protectionist measures, China decided to scrap its customs tariffs for exports of 81 categories of textiles and clothing. Just two weeks ago, China had raised export tariffs retroactively from the start of this year, forcing textile and clothing exporters to come up with additional customs charges on their exports for January through May. China still hopes that the trade dispute with the EU and the US can be resolved through further negotiation. China figures the protectionist measures envisioned by the EU and the US will cost China over \$2 billion worth of exports and a loss of over 300,000 jobs. Moreover, the rapid rule changes are causing havoc among companies involved in textile- and clothing-related businesses.

Tighter monitoring of foreign trade payments. The State Administration of Foreign Exchange (SAFE) issued new procedures on review of trade-related payments received from abroad. The new rules require that payments exceeding US\$200,000 must first be deposited in a separate currency account in China. The rule covers payments falling into three categories: export prepayments, payments from transit trade and inadequately documented export payments. Once the state approves the payment, the funds are released to the payee. The change is a response to last year's increased abuses of trade credits and other payment channels (see *BOFIT Weekly 17/2005*). Foreign currency inflows brought to China are speculating on the possible yuan revaluation. Indeed, rampant speculative currency inflows may already contribute to economic overheating. The yuan is fully convertible on the current account payments.

The change in regulations is part of the government's effort to stem forex inflows and encourage currency outflows. Last month, SAFE relaxed its regulations on Chinese investments abroad. Earlier in April, SAFE fixed this year's aggregate short-term external borrowing quota for banks operating in China at \$60 billion.

Central Asia's increasing role in China's energy strategy. At the end of May, the national oil companies of China and Uzbekistan signed a \$600-million agreement on development of 23 oil deposits in Uzbekistan. Already last year, China agreed with Kazakhstan on construction of a new oil pipeline to western China. The pipeline is expected to come on stream in December of this year with an initial capacity of 200,000 barrels a day. That capacity should double in coming years.

China continues to actively seek out new energy suppliers to secure its economic growth and reduce the current dependence on Middle Eastern oil. Outside Central Asia, Chinese companies this year alone have also made new initiatives to arrange for oil deliveries from Venezuela and Canada.

The International Energy Agency (IEA) reports that overall demand for Chinese crude oil in the first quarter was about 6.5 million barrels a day and that growth in demand (5 %) has significantly slowed from the first half of last year (19 %). China's domestic oil production increased in the first quarter to 3.6 million barrels a day, which is about 5 % more than a year earlier. The rise in China's dependence on imported oil has been fast; over 40 % of China's oil demand is now met with imported oil.

China became world's fourth most popular tourist destination last year. Figures released by the World Tourism Organisation reveal that the number of tourists visiting China last year surpassed Italy, and made China the top destination after France, Spain and the United States. China had over 40 million visitors in 2004, a 27 % jump from the previous year. Tourism to Mainland China recovered strongly from 2003, when tourism was hurt by the SARS epidemic. According to the World Tourism Organization, tourism to Hong Kong was also up 40 % y-o-y, with 22 million visitors, or about three times Hong Kong's population.

Strong economic growth has increased foreign travel of Mainland Chinese in recent years. Chinese officials say that in 2004 about 23 million Mainland Chinese took trips abroad. Mainland Chinese were previously only permitted to visit Taiwan for work or study, but a May decision by Chinese officials has now relaxed travel to Taiwan.

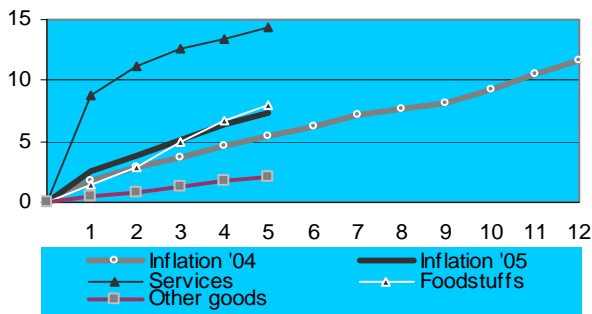
Hong Kong GDP growth remains strong. Hong Kong's census and statistics department reports that GDP grew 6 % y-o-y in real terms in the first quarter. Rapid economic growth in Mainland China has supported Hong Kong's economic growth and helped exports climb 9 % y-o-y in real terms. Private consumption continued along a robust growth path (nearly 5 % y-o-y in real terms). Meanwhile, the growth in consumer prices remained a quite modest at just 0.4 %.

The original CEPA agreement (Closer Economic Partnership Arrangement) between Mainland China and Hong Kong entered into force at the beginning of 2004. The agreement is believed to have increased trade between the Mainland and Hong Kong. The extended version of the agreement adopted at the beginning of this year is seen as having a further positive contribution to trade.

Russia

Inflation subsides a bit in May. On-year inflation was 13.7 % in May. The month-to-month change in consumer prices was lower in May (0.8 %) than in previous months. With consumer prices up 7.3 % already in the first five months of the year, the government's inflation target for 2005 of 8.5–10 % appears increasingly threatened. To meet the government target of 10 %, on-month inflation would have to average just 0.3 % for the rest of this year. The on-year increase in *food prices* accelerated to 15.1 % in May, while inflation in *services* slowed to 22.4 %. The price rise for *other goods* was 6.8 % y-o-y.

Rise in Russian consumer prices since the start of the year, %



Source: Rosstat

Rouble's real appreciation continues. The Central Bank of Russia reports that the effective real exchange rate (foreign-trade-weighted and inflation-adjusted) of the rouble strengthened 7.4 % in the first five months of the year and was up 6.3 % from the same period a year earlier. Given the current rate of appreciation, it now seems likely that the rouble will overshoot the government's appreciation target of 8–9 % announced as part of its April economic forecast for 2005.

At the start of the week, CBR deputy chairman Alexei Ulyukayev admitted he now expects the effective real exchange rate to strengthen as much as 10 % this year. The appreciation will eat into Russia's international competitiveness. Since the start of the year, the rouble has gained in real terms 11.3 % against the euro and 4.1 % against the dollar.

No big changes in stocks. Russia's RTS index rose 18.5 % from the start of the year to a peak of 720 in early April. Since then the index has been in modest retreat, standing at 673 at the start of this month. RTS-listed firms with the heaviest weightings remain Lukoil (33 % of the RTS's capitalisation), Surgutneftegaz (17 %), Sberbank (10 %) and Norilsk Nickel (9 %). The Yukos affair no

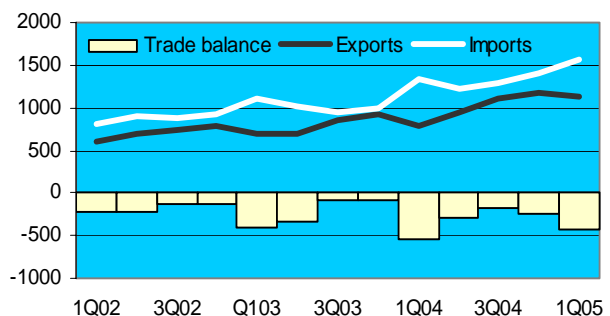
longer drives swings in the RTS index as the Yukos weighting in the index has fallen to only 0.5 %. Russian shares are also traded on Moscow's MICEX currency exchange.

Putin comes down hard on UES management for blackouts and progress in company structuring. At a recent meeting of the national security council, president Vladimir Putin minced few words in his condemnation of power grid monopoly UES for the widespread blackouts at the end of May that affected Moscow and its surroundings. The president charged that UES management has chosen short-term profits over prudent investment and maintenance, despite the utility's healthy financial position. Putin noted that the electrical monopoly not only has to reform in accordance with market principles, but that the reforms must also be geared to benefit Russian society as a whole. The president also called for an investigation of UES's tax records. Tax officials earlier this year presented UES with a claim of RUB 3.7 billion (over €100 million) for 2001 back taxes. Under its agreed reform program, the restructuring of UES should be completed by 2007.

Finland now Russia's eighth largest trading partner. Russian customs figures show that Finland surpassed the US and Switzerland in the first quarter to become Russia's eighth most significant trading partner. Finland accounted for 3.6 % of Russian trade. In the first quarter of 2004, Finland ranked seventh, but then lost ground towards the end the year, falling to tenth position.

Between 2002 and 2004, Finnish exports to Russia grew more slowly than Russia's total imports. However, this trend reversed in the first quarter of 2005. Russian imports overall rose 25 %, while, according to Customs Finland, Finnish exports to Russia rose 32 % and imports from Russia were up 18 %. Russia edged out Sweden during the first quarter of this year to become Finland's second-largest trading partner.

Finland's trade with Russia 2002–2005, €million



Source: Customs Finland

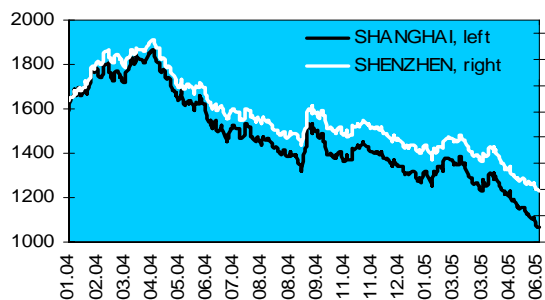
China

China's foreign debt continues to grow. As of end-March, China's foreign debt stock was \$230 billion, up 15 % from a year earlier. The share of short-term debt recently reached nearly 50 % of all foreign borrowing. The state and state-owned banks accounted for over half of the external debt stock as of end-March. China's foreign debt is modest by international standards and considerably less than the central bank's foreign currency reserves, which stood at \$660 billion as of end-March.

Stock markets continue to slide. The value of China's stock indices plunged to an eight-year low last week. Stock indices have dropped almost 15 % since the beginning of May, when the regulatory body (China Stock Regulatory Commission) released its detailed plan for selling off state stakes in listed firms. While the divestiture is believed necessary to long-term stock market development, the authorities have had to move ahead cautiously to minimise the impact on the market (see *BOFIT Weekly 18/2005*). In any case, the reform will fail without associated improvements in investor protection.

According to a central bank survey in the second quarter, less than 6 % of urban residents said they were willing to invest in the stock market, a five-percentage-point drop from the same period in 2004. About 17 % of urban residents prefer government bonds as a means of saving. 20 % of those asked said they planned to buy an apartment during the current quarter.

Shanghai and Shenzhen stock exchanges, A-share indices



Sources: Shanghai and Shenzhen bourses

Banking sector's non-performing loan stock unchanged, bank profitability up. The China Banking Regulatory Commission reports that the stock of non-performing loans (NPLs) held by commercial banks operating in China stood at just over CNY 1,800 billion (€170bn) at the end of March, almost exactly the same level as at the end of 2004. However, due to increased lending, the ratio of NPLs to the total loan stock fell to 12.4 %. Although recent bank-

specific figures are unavailable, NPL portfolios are known to vary radically from bank to bank. For example, as of May 2004, China Construction Bank had the smallest NPL portfolio (3.5 % of all loans) of any of the four large state-owned banks. Agricultural Bank of China, where the reforms only now are getting under way, had the worst NPL problems (27 % of all loans). The National Audit Office launched an assessment of the bank's accounts last month and should have its report ready by November.

Profitability of China's banking sector in 2004 doubled from 2003 to CNY 90 billion (€9bn). Over two-thirds of profits went to the four large state-owned banks. In 2003, the large banks were running losses, in part due to NPL write-offs. Chinese banks traditionally make most of their money on the margin between lending and borrowing rates.

Outlook good for summer grain crops. The Ministry of Agriculture reports the harvest of summer grains will be better than last summer's if weather conditions remain good next week. The ministry claims the good summer harvest has been influenced by several factors, including higher state subsidies to farmers, fair weather and increased land area under cultivation. Last month, the government also asked local officials to increase support to farmers. During the spring, farmers received technical support, particularly in fertiliser use. Summer grains account for about a fifth of China's entire grain harvest.

In April, grain prices were just 6 % higher than a year earlier, far less than last year's 26 % jump. The government has forbidden any price hike, until sales of summer grain start, to avoid acceleration in grain prices. Food items constitute about a third of China's consumer price index.

Electrical power capacity lags demand. China's electrical power shortage worsened in January-April as the growth in electricity production was outpaced by galloping growth in demand. Officials estimate that the gap will only begin to close in the autumn, when new production capacity finally comes on line. As a result, the power shortage this summer is expected to be more severe than last summer. Provinces expecting to be hardest hit have already prepared plans to limit commercial power consumption during periods of peak demand. Chinese power consumption rises sharply when people turn on their air conditioners.

To secure adequate energy supplies, China has established a top-level energy task force to develop a national energy strategy and energy policies. The group's first task will be to assure that coal-fired plants are adequately supplied with fuel. In addition, China is negotiating with Russia's grid operator UES on electricity imports. Electrical power trade between the two countries is nonexistent at the moment and interconnection of national grids will take years.

Russia

Russian GDP growth slowed in the first quarter. At the start of this week, Rosstat reported new GDP figures showing GDP up 5.2 % y-o-y in the first quarter. GDP grew 7.6 % in the same period last year, and 7.2 % for all of 2004. The deceleration in GDP growth in the first quarter largely reflected the slowdown in growth of industrial production, although growth also declined in other key production areas. The economy ministry forecasts GDP will rise 5.8 % this year.

Share of long-term deposits up. In the first quarter of this year, the value of bank deposits by private persons climbed to RUB 1,605 billion (€45bn) and was up 30 % from 1Q04. The value of foreign-currency deposits grew 20 % y-o-y to RUB 539 billion (€15bn). The value of rouble and currency deposits now corresponds to about 12 % of GDP. The broad measure of money supply (M2 aggregate) was up 31 % y-o-y at the end of March.

A positive aspect of the recent development is that the share of long-term deposits (over one year) has been increasing. Long-term rouble and foreign currency deposits substantially outpaced deposits under a year in the first quarter. Long-term deposits now represent 57 % of all deposits, a 12 percentage-point increase from a year ago. The average interest paid on rouble deposits in the first quarter was 5.6 %. Given that 12-month inflation in May was 13.7 %, the real interest rate on deposits is clearly negative. An average deposit account in Russia holds about 700 euro.

Law on credit history enters into force. Under the new credit history act, all banks must provide the credit information of its customers to at least one credit bureau. Credit bureaus in turn sell the collected credit history data base on to banks and other lending agencies. Banks can determine which bureau is holding customer information interesting to them from a register maintained by the Central Bank of Russia. The act, which entered into force on June 1, is hoped to improve the ability of banks to evaluate the creditworthiness of their customers. The chairman of the Duma's bank and financial market committee, Vladislav **Reznik**, said that the law will reduce risk on credit markets and should increase borrowing. Bankers expect interest rates on consumer loans to fall as credit risk declines.

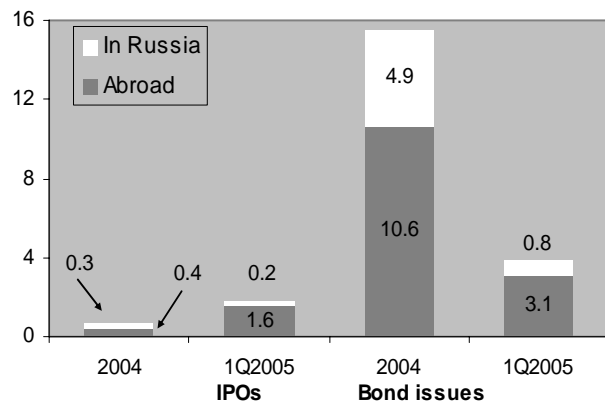
Russia's largest lender, Sberbank, announced last week that it was establishing its own credit information bureau. The announcement came as a disappointment to the credit bureaus already operating on the market. Cooperation with Sberbank, which holds 51 % of Russian consumer loans,

was seen as an attractive business opportunity by credit bureaus.

Listing boom continues. Russian initial public offerings this year have already raised \$2.4 billion in new capital on the London Stock Exchange. For example, last week's IPO by Russian communications firm Rambler Media raised \$40 million (about €33 million) in new capital for the company. The company is registered on the Isle of Jersey; under Russian law, companies domiciled in Russia must first list on a domestic exchange before issuing shares abroad. Two weeks ago, steel company Evrazholding also listed on the London exchange.

The increasingly common phenomenon of Russian companies seeking capital on foreign exchanges has led Russian financial market officials to prepare amendments to listing laws. These are designed to promote companies' listing on domestic bourses and aim at developing Russia's securities markets. The monthly volume of Russian equity trading is approximately \$25 billion, but only a third of such trade takes place on Russian exchanges. According to critics, Russia should preferably develop its financial institutions (e.g. pension and investment funds) and insurance industry in order to increase the volume and capitalisation of domestic bourses.

IPOs and bond issues by Russian firms, US\$ billion



Source: MICEX

Russia tightens economic cooperation with China.

Eight preliminary agreements were signed at the second Russia-China investment forum held last week in St. Petersburg. The total value of the projects amounted to about \$1.5 billion. The largest investment agreement is between the City of St. Petersburg and Shanghai International Investments for construction of a huge residential development worth about \$1.3 billion. Other memoranda concerned the investment in the forest industry and agriculture.

China

EU and China agree on textile trade limits. EU trade commissioner Peter **Mandelson** and China's minister of commerce **Bo Xilai** agreed on June 10, 2005, that China would limit growth in the volume of its exports of textile products to the EU to between 8.0–12.5 % annually. The agreement covers ten product groups (including T-shirts, linens, mens' trousers, pullovers and blouses) and will remain in force from now to the end of 2007. Initial calculations of imports levels will be determined from the 12-month figures for imports at the end of February or end of March 2005. The EU also promised to refrain from invoking possible safeguard measures under its WTO agreements in 2008 and for other textile products.

The deal puts an end to the dispute between China and the EU that had smouldered for months. The fight started with the surge in textile exports from China after the quota system imposed by industrial countries for 40 years was abandoned under the WTO agreement. Despite ten-years notice about the coming changes, textile makers in the southern countries of the EU still pushed for restrictions on textile imports, because they had failed to adjust to the new circumstances. Finland's textile industry, in contrast, spent the past decade transferring production to Asia, and thus opposes to the reimposition of restrictions. In any case, the new arrangement assures China of better terms than if the EU had unilaterally implemented safeguard measures on imports permitted under the WTO agreement (and which would have limited annual import growth to 7.5 %).

Under current agreements, all restrictions on textile trade will be lifted after 2008.

Export growth drives trade surplus in May. Growth of Chinese exports during the early part of this year remained essentially unchanged from last year. Goods exports in January-May were up 33 % y-o-y. Growth in imports, on the other hand retreated to 15 %, well down from the 36 % growth last year. Thanks to the rapid growth in exports and slowing growth in imports, the trade surplus exceeded \$30 billion (compared to a \$9 billion deficit in the same period a year earlier). The trend set in earlier months continued unchanged in May, as exports grew 30 % y-o-y and imports rose just 16 %. The trade surplus for May was \$9 billion, up from \$2 billion in May 2004.

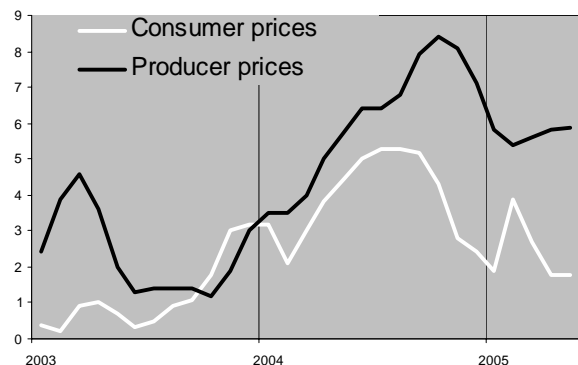
The share of electromechanical devices in total exports in May was 58 %. The pace of growth in electro-mechanical device exports (34 % y-o-y) remained at the same level as at the start of the year. For example, exports of computers and peripheral devices climbed 32 %, while exports of mobile phones and related spare parts were up 39 % from the same period a year earlier.

On the import side, the volume of crude oil imports in January-May was 52 million tonnes, or 5 % more than a year earlier. Imports of oil products fell 21 %. Increased domestic production this year has reduced the need for import of e.g. steel and refined copper to China.

Chinese inflation unchanged in May. Consumer prices in May were up 1.8 % y-o-y. The rise in food prices continued to slow in May, increasing just 2.8 % y-o-y. Prices for housing services remained unchanged. Despite hikes in May, the on-year change in rates for household water supply, electricity and fuel actually fell slightly. The central bank recently lowered its inflation target for this year to 3 %.

May producer prices were up 5.9 % y-o-y. Higher producer prices were driven mainly by higher prices for raw materials, fuels and electricity, which were up about 10 % y-o-y. The on-year rise in crude oil prices accelerated to 43 %.

On-year change in consumer and producer prices, %



Source: NBS

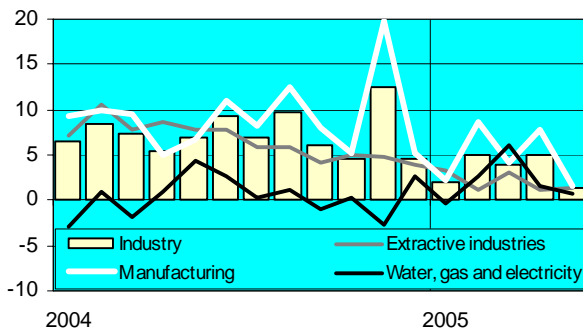
Steady growth in retail sales. The nominal value of May retail sales rose 13 % y-o-y, matching growth in April and the pace set in the first quarter. Sales of oil products climbed 45 % y-o-y. May retail sales in urban areas were up 14 % y-o-y, while rural areas saw an increase of 11 % y-o-y.

Russia

Growth in Russian industrial output slowed significantly in May. Industrial output grew at a rate of 3.6 % y-o-y in January-May, compared to 6.9 % in the same period in 2004. Industrial output fell 6.4 % on month from April to May; on-year growth in May was just 1.4 %. Industrial output growth in May is traditionally slightly lower than in most months due to the large number of public holidays. However, considering that in May 2005 there were 20 workdays compared to 18 last year, the slowdown was quite a bit more than expected. For example, Bloomberg's consensus forecast of major investment banks for May predicted on-year growth of 5.1 %.

For the period January-May, *extractive industries* increased 1.9 % y-o-y, *manufacturing* 4.9 % and *water, electricity and natural gas* 2.1 %. Among the extractive industries, the lower growth in oil production was particularly sharp. Oil output was up 3.2 % y-o-y in the first five months of the year. Natural gas production grew 1.2 % and coal production rose 2.9 %. There was also a substantial slowdown in manufacturing growth.

12-month change in industrial output, key components 2004–2005, %



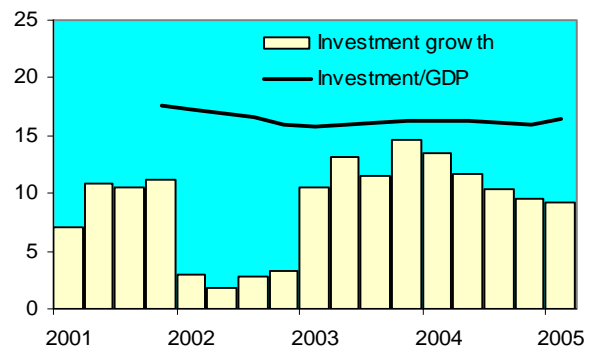
Source: Rosstat

Growth in investment continues to slow. The deceleration in investment growth that began in the first quarter of last year continues. Rosstat reports that in 1Q05 investments in fixed capital grew 9.2 % compared to the first quarter of 2004. In the first quarter of this year, the value of capital investment was RUB 410 billion (about €1.5bn). The investment slowdown is seen as a major drag on industrial output.

The distribution of investment reaching various industrial fields has not changed, however. The greatest share of investment continues to go to metal industries, followed

by the oil and coal industry and the car and transport industries. Housing construction represented an 8 % share of investment and other construction nearly 50 %. Devices and technology represented 36 % of fixed investments.

Annual growth in fixed investments and its share of GDP four-quarter moving average, %



Source: Rosstat

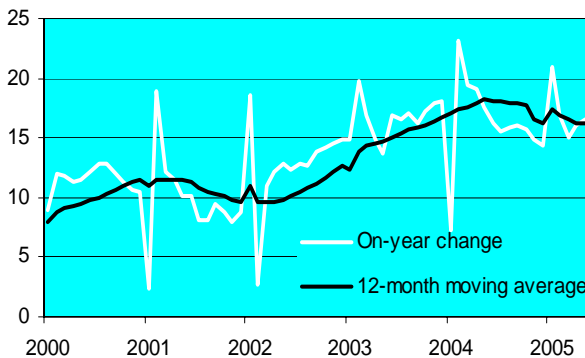
Duma approves supplemental budget. This year's supplemental budget was approved with large majority votes in three consecutive readings. Under the supplemental budget, 2005 budget revenues will grow by 8 % (RUB 272 billion) and spending by 11 % (RUB 348 billion), which will bring down the surplus forecast for the 2005 budget from 1.5 % to under 1 % of GDP. Several factors have conspired to boost federal budget revenues this year, including high energy prices (which have increased tax revenues), as well as the collection of back taxes from several oil companies and the forced sale of Yuganskneftegaz. The higher spending will fund increases in pensions, budget sector wages and stipends.

CBR releases data on composition of foreign currency reserves. At a Monday press conference, Central Bank of Russia deputy chairman Alexei Ulyukayev commented on the composition of the central bank's foreign currency and gold reserves. According to the bank's investment directive the foreign currency reserve should contain 65 % dollars, 30 % euros and 5 % sterling. In addition, the directive specifies that the bank's gold holdings should constitute 4 % of the total value of the reserves. Ulyukayev noted that the directive allowed a certain amount of room for discretion. According to CBR statistics, the value of gold reserves in dollar terms presently constitutes about 2.5 % of the total value of the foreign currency reserves. The foreign currency reserve has grown 18 % since the start of the year and as of June 1 exceeded \$147 billion.

China

Chinese industrial output growth remains strong. May industrial output grew 17 % y-o-y in fixed prices. Rapid growth in many raw-material sectors continued. Thus, growth in steel products, for example, accelerated and was in May up on average 36 % y-o-y. Output of clothing industry was up 18 %. For the period January-May, industrial output climbed 16 % y-o-y.

Industrial output, 12-month change, %



Source: NBS

Little change in FDI inflows. Foreign direct investments in China totalled \$22 billion for the period January-May, which was about the same as in the first five months of 2004. However, slightly fewer foreign companies were established compared to the 2004 period.

Chinese investment growth shows no signs of slowing. The National Bureau of Statistics reports that fixed investments in urban areas during January-May soared an estimated 26 % y-o-y. Investment was particularly strong in “bottleneck” industries, with investment in coal production up 83 %, rail construction 58 %, as well as production and distribution of electricity, fuel and water up 34 %.

Although growth of investment has slowed somewhat from the beginning of 2004, it has still well outpaced the government’s 16 % target for 2005. For just over a year the government has sought to rein in investment growth by tightening lending and limiting the supply of land. The government has also moved to curb the appetite for building new export capacity for energy- and raw-material-intensive industries by eliminating tax incentives (steel) and applying new export taxes (aluminium).

Income disparities of urbanites continue to widen. The rising income differences between rural residents and urban dwellers, as well as between inland and coastal populations have, until recently, been mainly the concerns of decision-makers and researchers. Even less discussed have been the increasing income disparities within city populations. A just-released NBS survey finds that the top quintile of urban earners average 5.3 times the incomes of those in the bottom quintile. In 2002, by comparison, those in the highest earner bracket made 5.1 times those in the lowest. In several cities, those in the top 20 % earned on average as much as eleven times that of the bottom 20 %. Figures from the Ministry of Labour and Social Security show the richest tenth of households control 45 % of the city population’s assets, while the poorest 10 % control only about one per cent. The urban poor usually fall into three groups: old and ill people without relatives, unemployed and migrant workers.

Bank of America buys stake in China Construction Bank. The Chinese state sold a 9 % stake in the country’s third largest bank, China Construction Bank (CCB), to US-based Bank of America (BoA) for an agreed price of \$2.5 billion. Bank of America also committed to subscribe to \$500 million worth of shares later this year in conjunction with CCB’s initial public offering. BoA also negotiated option to increase its stake in CCB to 19.9 % by the end of 2010. The new owner will get a seat on the CCB board and bring 50 of its own experts to the bank. The sale represents the largest acquisition by a foreign bank of a stake in a Chinese bank, as well as the first case of foreign participation in any of China’s four large state-owned banks (which until now have been entirely in state hands).

CCB is believed to be in the best shape of China’s four large state-owned banks. The Chinese state injected the bank with \$22.5 million of new capital at the end of 2003. The bank’s most recent annual report also reveals that the bank was granted \$1.9 billion in tax breaks in 2004. The CCB has restructured itself by halving the number of branches to 14,400 and by reducing the number of employees by a fifth to about 330,000 persons. The share of non-performing loans of all bank lending at the end of last year was under 4 %. The bank’s capital adequacy ratio exceeded 11 %, which was well above the demanded 8 % minimum. Recent revelations of embezzlement and bribery at several banks suggest poor corporate governance remains a serious problem.

CCB is preparing for a foreign listing (evidently on the Hong Kong bourse) towards the end of this year. The first Chinese bank listing on a foreign exchange was the country’s fifth largest bank, Bank of Communications. Trading of Bank of Communications shares began on June 23 on the Hong Kong stock exchange.



Russia

Growth slows in Russia's core production sectors. On-year growth in four of the five core production sectors was lower in January-May compared to the same period in 2004. *Construction* grew 5.3 % y-o-y in the first five months of the year (compared to 14.5 % in the same period in 2004). On-year growth in *industrial production* was down to 3.6 % (6.9 %). *Retail sales* grew 11 % (11.4 %) and *transport* was up just 2.8 % (7.8 %). Only growth in *agricultural production* was higher than a year earlier, rising 0.1 % y-o-y in January-May (-1.3 %). The economy ministry estimates that GDP growth was 5.4 % y-o-y in the first five months of the year.

IMF mission expresses concern about Russia's loosening fiscal discipline. The concluding statement of the IMF mission as part of its Article IV consultation in Moscow in early June reflected concern about the Russian government's planned increases in budget spending. The Fund noted that the higher spending will add to inflationary pressures, and worse, is directed towards permanent costs (such as wages and pensions) rather than funding the inevitable costs of structural reform. The concluding statement stressed that Russia needs to concentrate on creating conditions for continued long-term economic development. Special attention should be paid to improving the investment climate and reforming the education and health care systems.

The Fund observed that monetary policy needs to focus on restraining inflation. Under the current situation, the rouble's nominal exchange rate should be allowed to strengthen so that the central bank can concentrate on hitting its inflation target.

Reform of Russia's justice system has proceeded more slowly than in other transition countries. A recent World Bank report compared the functionality of justice systems and enforcement of court rulings in Central and Eastern Europe, as well as countries in the CIS region. Among the most substantial improvements in Russia's justice system were mentioned the introduction of computer technology into court proceedings, which has given judges better access to information about new legislation and recent rulings. The report noted, however, that Russia still needs to improve judicial independence and the trust of average citizens in the legal system. To improve the transparency of the justice system and increase efficiency, the report suggested among others publication of judicial rulings and higher pay for people working in the justice system.

A brief summary of spring legislation. Without doubt, the major legislative accomplishment of the spring session

was the Duma election law, which enters into force in December 2006. Under the new law, all Duma representatives in the next parliamentary election will be chosen from nation wide party lists. The Duma and Federation Council also approved reduction in the number of business activities requiring licences as well as cuts in inheritance and gift taxes.

The Duma approved second readings of an amendment to the election act forbidding election alliances, refinements to the foreign currency act, and amendments to the Land Code concerning lot acquisition procedures.

First reading approvals included a new forests code, a waters code, measures to develop taxation of small entrepreneurs, an act on special economic areas, an act on the Kaliningrad special economic area, as well as the reduction in the statute of limitations on disputed privatisation deals from ten years to three years in the Civil Code.

Observers consider the delayed bill on public-private partnerships to be one of the most difficult challenges facing legislators. Such partnerships would be beneficial for projects for e.g. development of electrical power and telecommunications grids, rail and road infrastructure, as well as municipal technical services.

No surprises at Gazprom shareholders' meeting. At last week's meeting presidential chief of staff and Gazprom's board chairman Dmitri **Medvedev** announced that the Russian government had signed all the necessary documents for transferring 10.7 % of Gazprom shares from Gazprom subsidiaries to state ownership for a price of €5.8 billion (see *BOFIT Weekly 21/2005*). The shares will go to the state today (July 1). The arrangement lifts state ownership in Gazprom above the 50 % mark. This allows the trade in Gazprom shares to be opened up to foreign investors, who currently only can purchase pricier Gazprom ADRs. Before the liberalisation can be completed, however, certain legislative amendments are required. No schedule for the changes has yet been announced.

According to analysts, the liberalisation of Gazprom shares should put them among the most traded shares in developing markets. The liberalisation will increase the stock of freely tradable Gazprom shares thirteen-fold and will greatly increase the weighting of Gazprom shares in the main share indices for Russia and developing markets.

Russia balks at ratification of border treaty with Estonia. Russia's foreign ministry submitted an official diplomatic complaint to Estonia that stated Russia was annulling the border treaty foreign minister Sergei **Lavrov** signed on May 18, 2005. When the Estonian parliament ratified the border treaty on June 20, it added its own preamble that included language referring to the 1920 Tartu Peace Treaty and the loss of Estonia's independence that was unacceptable for Russia. The annulment means Russia is no longer bound to the border treaty.

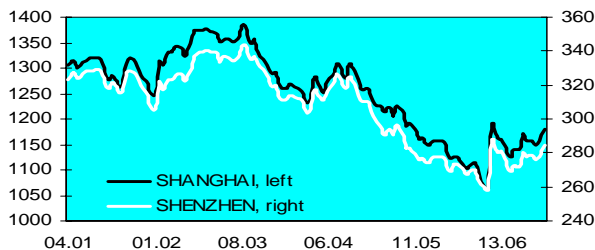
China

Stock market reform shifts into high gear. China's securities regulatory commission (CSRC) last week announced a second batch of state-owned companies to sell their shares on the market. The CSRC launched the reform in May with the list of four small firms. There are currently already 46 firms on the list, including Baosteel, one of the world's largest steelmakers. Officials reiterated that the divesting of state shares is at the centre of the current stock market reform strategy.

Earlier this month, the Ministry of Finance issued new regulations exempting divestment transactions from stamp taxes and income taxes. Moreover, the amount of dividends from listed companies subject to capital income tax was reduced to 50 %. The central bank also announced in June that it was considering refinancing deals for two investment banks with liquidity problems.

These measures suggest the government is actively pushing ahead with stock market reforms. Success of the reforms, however, will greatly depend on the quality of listed firms and protection of investor interests – challenges that remain substantially more daunting than simply selling off state shares.

Shanghai and Shenzhen bourses, A-share indices



Source: CSRC

Liberalisation of China-ASEAN trade begins. Last winter, China and the Association of South-East Asian Nations agreed to move incrementally to a free trade regime. The parties affirmed the agreement last week. Tariffs on over 7,000 products will begin to fall from July 20. By 2010, trade between China and ASEAN founding members (Brunei, Philippines, Indonesia, Malaysia, Singapore and Thailand) should be tariff-free for all products. For other ASEAN members (Cambodia, Laos, Myanmar and Vietnam), the free-trade regime will be implemented by 2015. ASEAN last year granted China market-economy status, which China demanded as a precondition for starting talks on establishing the free-trade area.

Foreign trade between China and ASEAN countries amounted to \$110 billion in 2004, which corresponded to

about 10 % of China's total foreign trade. China has long run a trade deficit with ASEAN, and last year the deficit reached \$20 billion. China's top imports from ASEAN countries are raw materials, components and semi-manufactures. China mainly exports machinery and equipment to the region.

CNOOC moves to boost oil reserves. China's number-three oil company, state-owned CNOOC, submitted an unsolicited tender offer of nearly \$20 billion for the purchase of US-based Unocal. If the deal goes through, it would be ten times larger than any foreign acquisition by a Chinese company to date (the current record is the sale of IBM's laptop computer business to Lenovo). Unocal has proven reserves totalling 1.75 billion barrels, 56 % of which is located in Asia (mainly Thailand and Indonesia). The acquisition of Unocal would double CNOOC's production and increase its reserves by 80 %.

US-based Chevron earlier submitted a slightly lower bid for Unocal. Thus, Unocal's board must now consider both bids, and any deal will have to be approved by US authorities. Moreover, even if CNOOC's bid is accepted, the US congress may seek to block the acquisition.

Chinese oil companies have made substantial investments abroad in oil production capacity in recent years. The big push has come from China's largest oil company CNPC (PetroChina's parent company), which has a total of over 8 billion barrels in reserves, with interests in oil fields in North Africa, Central Asia and South America.

China and Russia establish a new cooperation body.

Chairman of the Standing Committee of the National People's Congress, **Wu Bangguo**, and chairman of the Russian Duma Boris **Gryzlov** agreed during latter's China visit in mid-June, that the countries' parliaments would increase cooperation and establish a cooperation committee to meet once a year. During the visit, the Chinese emphasised recent achievements in bilateral cooperation such as the recent ratification of a permanent border treaty between the two countries, as well as increased cooperation in the spheres of security and energy. China also thanked Russia for its political support on Taiwan, Tibet and human rights issues and promised to continue to support Russia's fight against terrorism.

In a press interview, the Gryzlov stressed the importance of developing economic relations with China. Russia is not satisfied with the current structure of bilateral trade, and hopes above all to develop high technology cooperation and exchanges. Issues of China-Russia cooperation will also be aired during Chinese premier **Hu Jintao's** four-day visit to Russia that began Thursday (June 30). Hu will continue on to a meeting in Kazakhstan of the Shanghai Cooperation Organization, which is made up of members from China, Kazakhstan, Kyrgyzstan, Russia, Tajikistan and Uzbekistan.



Russia

June inflation slowed slightly. Russian inflation fell to a 12-month pace of 13.5 % y-o-y in June. Since the start of the year, consumer prices are up 8 %. The rise in prices of *services* slowed after a short burst early this year. Prices for services overall were up 22.4 % y-o-y last month. The rise in prices for *foodstuffs* accelerated in the first half of this year and then slowed slightly in the first five months of this year to 14.9 % y-o-y. Soaring prices for meat, fruits and vegetables have driven food price inflation. The rise in prices for *other goods* slowed during the spring and was 6.4 % y-o-y.

Russia's current account surplus reached 14 % of GDP in the first quarter. The Central Bank of Russia reports that the current account surplus amounted to \$22 billion (€18.5bn) in the first quarter of 2005, which corresponded to about 14 % of GDP. The current account surplus in 1Q05 was 72 % larger than in the same period a year earlier. The services deficit was \$2.5 billion, while the goods surplus climbed to \$26.9 billion. The growth in the current account surplus largely reflects soaring world oil prices and the resulting boost in Russia's export earnings.

Direct investments in Russia grew in the first quarter to \$5.4 billion, compared to \$4.7 billion in 1Q04. Portfolio investment was \$2.2 billion, up from \$1.4 billion a year earlier. Net outflow of private sector capital fell to just \$200 million in the first quarter. A year earlier, capital outflows abroad amounted to \$4.2 billion. The central bank's reserves also swelled by \$14.4 billion in the first quarter. The net errors and omissions item in the balance-of-payments figures was \$4.8 billion negative.

Basic Element gets green light on purchase of Silovye Mashiny. The Federal Anti-Monopoly Service granted at the end of June permission to the Russian company Basic Element, owned by billionaire Oleg **Deripaska**, for acquiring an 80 % stake in Silovye Mashiny. Silovye Mashiny is a Russian manufacturer and supplier of machinery for hydro, thermal, gas and nuclear power plants. Competition officials rejected in April a similar offer from German Siemens (see *BOFIT Weekly 15/2005*), despite the fact that the deal had the blessing of both German and Russian leaders. The competition officials said their decision to block the sale to Siemens was based on the fact that it would give Siemens the dominant market position in power generation equipment. Basic Element operates in the same energy and metal manufacturing fields as Siemens.

Observers believe that the Siemens deal was scrubbed because Silovye Mashiny also produces equipment for the Russian military.

Russia still hopes to get WTO membership in December. At the 28th meeting of the WTO working group in Geneva at the end of June, several member countries expressed concern over the slow progress in talks with Russia. The main issues yet to be resolved concern agricultural subsidies, opening up of Russia's financial sector and protection of intellectual property rights. Economy minister German **Gref** asked the member countries for patience with Russia's difficulties in shifting quickly to a market economy and hoped that Russia would be able to complete its negotiations with the WTO before the December meeting of ministers. Gref also reiterated that Russia will not seek a transition period to implement the agreements on technical barriers to trade and sanitary and phytosanitary measures. Although, several member countries criticise Russia's domestic pricing of energy products below world market, Russia refuses to give up on its dual pricing scheme, as it claims it is not covered under WTO regulations. The working group for Russia's membership will submit its next report on the state of applicant countries in September.

Finnish firms confronting the most trade barriers in Russia. Finland's ministry of foreign affairs released in early July a survey of Finnish firms' perceptions of barriers to foreign trade. Over half of the reported difficulties have been encountered when dealing with Russia. Respondents said they had also encountered problems in the Chinese and US markets.

Russian customs practices provided the biggest obstacles for Finnish companies, which found the slowness of customs clearing and continuous changes in customs practices particularly troublesome. Moreover, Russia's high customs tariffs were seen as a problem in several branches of business. Especially for companies involved in electronics, machinery and metals, trade with Russia is complicated by technical barriers. Firms were also unhappy with the deficiencies in oversight and enforcement of intellectual property rights. From the taxation standpoint, companies in several different branches mentioned problems with recovering their VAT refunds. According to the survey, problems experienced by Finnish firms doing business in Russia result mainly from corruption and inconsistent interpretation of laws and regulations.

Barriers encountered on the Chinese market were quite similar to those met in Russia. The largest problems were high customs tariffs, inconsistent customs practices, technical barriers to trade and poor protection of intellectual property rights.

China

China's president signs political communiqué with Russia; Kazakhstan promises China more energy. In the course of president **Hu Jintao's** official visit to Russia on July 1–2, he and president Vladimir **Putin** emphasised cooperation and signed a joint communiqué on terrorism, UN reform, making the Korean peninsula a nuclear-free zone, as well as securing peace in Central Asia and the Pacific Rim. The statement stressed the importance of a multilateral approach in international politics and condemned the double standard in the fight against terrorism. The media interpreted much of the initial commentary as directed against the US, while the terrorism comments were directed at Great Britain for failing to support Russia's Chechnya policies. Although Russian state oil company Rosneft agreed with China's state oil companies on looking into the possibility of increasing oil exports to China, observers generally felt China made little progress in increasing energy cooperation.

Before attending the G8 meeting in Scotland, Hu continued on from Russia to Kazakhstan to hold talks on establishing a strategic partnership. In addition to political discussions, the countries signed an initial agreement on construction of a railway running from the Caspian Sea to western China to facilitate oil shipments from the Caspian Sea region. The countries also signed a preliminary agreement on construction of a natural gas pipeline running from Kazakhstan to China. Oil production in Kazakhstan grew 15 % y-o-y in 2004 to 60 million metric tons. The central Asian country's huge reserves will make it a major oil producer. The country now needs to open up new export routes for energy. A new oil pipeline running from Kazakhstan to China should be on stream by the end of this year.

Steel production enjoys red hot growth. Domestic production of steel and steel products soared nearly 30 % y-o-y in January-May. Demand for steel, on the other hand, has slowed in key sectors, especially the construction sector, where the government has sought to rein in investment. Chinese steel production this year is expected to approach 350 million tons, while demand is expected to plateau at about 300 million tons. The domestic steel surplus has cut into Chinese imports and several producers outside China have been forced to reduce their production levels. China's steel production capacity should continue to grow, although the government has barred several new steel mill projects.

The rapid growth in the steel surplus has caused concern both in China and internationally. It is feared that Chinese steel exports will explode and disrupt international markets. To prevent China from flooding the world

with cheap steel, the government moved last week to reinstate the value-added tax on high-grade steel that it abolished six years ago, when the tax was eliminated to encourage exports. The VAT on such products will now be 17 %. VAT on poorer quality steel products for export was increased a few months ago.

The rapid growth in Chinese steel consumption has driven up steel prices worldwide in recent years. The rise in prices continued at the start of this year, when the largest iron ore producers collectively hiked prices over 70 % (see *BOFIT Weekly 10/2005*). China's steel surplus and measures to cut back steel exports have strongly depressed prices in China. The price of certain steel products is currently below their production cost.

China to begin building up strategic oil reserves at the end of this year. To secure adequate energy supplies in unusual circumstances, China began two years ago to build strategic oil reserves. According to Chinese sources, construction of storage facilities has progressed to the point where filling of the first storage tanks at the number-one facility in Zhejiang province could begin before year's end. The total capacity of the first Zhejiang facility is 5.2 million metric tons. China's strategic reserves will be located at four sites along the eastern seaboard, with two facilities located in Zhejiang province, one in Liaoning province and one in Shandong province. The goal of the first phase is to build up strategic oil reserves equal to 14 days worth of oil imports. Ultimately, capacity would be increased to the equivalent of 90 days worth of imports. At the moment, China is entirely dependent on the reserves of state-owned oil companies.

In 2004, China's crude oil imports reached 120 million tons, an increase of 35 % over 2003. China also boosted domestic production about 175 million tons (growth over 3 %). Most Chinese oil imports still come from the Middle East, but in recent years China has made strenuous efforts to diversify the sources of its energy imports.

Local governments spending more on keeping city commercial banks afloat. Last year, local administrations granted a total of CNY 23 billion (€2bn) mainly to city commercial banks to cover losses from non-performing loans. Most such banks are owned and operated by local administrations. Last year's pay-out was twice the entire amount of support paid out over the past ten years. At the end of the first quarter of this year, city commercial banks held about CNY 110 billion (€10bn) in non-performing loans, or 12 % of their loan stocks. There are about 110 city commercial banks in China; they represent over 5 % of the net assets of the banking sector.

Russia

Russia uses a third of stabilisation fund to pay down Paris Club debt. On the cusp of June and July, Russia made early repayment on Soviet-era debt owed to Paris Club creditors. The conditions of settlement were agreed in May (see BOFIT Weekly 20/2005). Media reports indicate Russia paid back a total of RUB 430 billion (€12bn), mostly with money from the stabilisation fund. Budget reporting from the finance ministry shows that as of July 1 the stabilisation fund had been drawn down to RUB 618 billion (€18bn). At the start of June, the ministry said the fund held RUB 955 billion (€28bn). Russia's debt to Paris Club creditors before the payment was nearly €32 billion. The fast repayment of debt will save Russia interest expense and should improve the country's creditworthiness. Several international credit rating agencies have also said they are considering raising Russia's investment rating.

Russia prepares for its G8 presidency. Russian president Vladimir **Putin** participated in last week's G8 summit in Gleneagles, Scotland. He signed the joint communiqué, which pledged debt forgiveness for indebted African nations. The communiqué also introduced measures against climate change and underlined the importance of oil and trade in the world economy. On top of its earlier, partially fulfilled, commitment to forgive nearly €9.5 billion in loans, Russia is considering forgiving about €625 million in Soviet-era debt owed by the world's poorest countries. During the meeting, Russia revealed that it would prioritise energy-related issues during its 2006 G8 presidency. Putin added that the role of Russia's energy policy is to support sustainable growth of the global economy. The Russian president also promised to boost Russian oil and gas production. The next G8 summit will be held in St. Petersburg in summer 2006.

Gazprom takes aim at Sibneft. State gas giant Gazprom continues to plan its expansion into the oil business. According to press reports, Gazprom is focused on Sibneft, which is 57 % controlled by billionaire Roman **Abramovich**. All in all Gazprom plans to acquire a 75 % majority stake in the company. Sibneft for its part co-owns Slavneft with TNK-BP. President Putin said the state will stay out of the deal, and that Gazprom operates independently based on its own business judgment. Observers, however, say the move reflects the government's desire to re-nationalise a significant share of the energy sector. Gazprom earlier diversified into electrical power with the purchase of large stakes in RAO UES and Mosenergo. The liberal economy minister German **Gref** opposes Gazprom's expansion strategy.

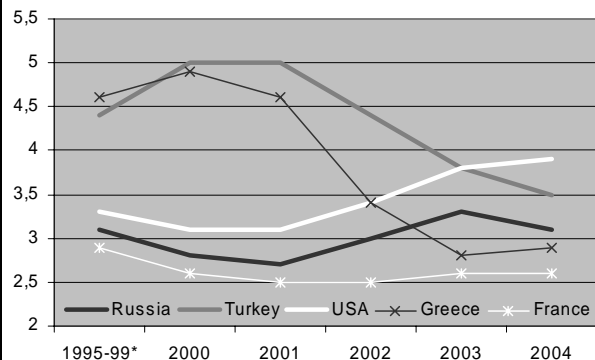
Russian Duma approves legislation on special economic zones and election act. In the beginning of July the Duma accepted in second and third readings a new law on special economic zones. According to the law, such zones would be of two types: industrial and manufacturing or technological innovation zones. Tourism and recreation are also being considered as possible industries that would qualify. Companies operating in special economic areas would be granted tax breaks and enjoy lower customs duties. However, extraction of minerals would be forbidden and production of metals and excisable goods highly restricted in these zones.

At the beginning of July, the Duma also approved the third reading of amendments to the election act. Under the revisions, the threshold for the vote percentage needed by a political party to enter the Duma would be revised from five to seven per cent, and the formation of election alliances to surmount the threshold would be forbidden.

In the past two months the Duma also approved second readings of bills that include an act on developing taxation for small businesses and amendments to the code regulating alcohol production. The Duma's spring session ended last week and it meets again in September.

Russian defence spending around 3 % of GDP in recent years. A NATO survey published in June assessed the defence spending of treaty organisation's 25 members and Russia. In 2004, Russian *defence spending* corresponded to 3.1 % of GDP. The proportionally highest defence spenders were the US (3.9 % of GDP) and Turkey (3.5 %). According to NATO figures, Russia spent \$16.7 billion on defence in 2004. Russia's top defence spending item was *personnel costs* (45 %), compared to 35 % in the US. Russian *equipment costs* consumed 17 % of the defence budget, compared to 25 % for the US. Belgium, Germany, Lithuania and Poland each spent over 70 % of their defence budgets on personnel costs.

Defence spending of a few NATO countries and Russia as a share of GDP 1995–2004, %



Source: NATO
* average



China

China releases draft of new property laws. China's first detailed property law seeks above all to lay out the legal rights that go with buildings and land ownership. The law has been long in drafting and legislators expect final approval next year. The proposed law will be open to public comment until next autumn.

The proposed law holds potentially huge changes particularly for farmers' rights. Currently, farmers can have property under their control seized without compensation if officials decide to exercise eminent domain over the property. The property (typically farmland) is then sold or leased to better payers such as industrial operations or as vacation housing for urbanites. Under the new law, officials would have to pay farmers reasonable compensation for such takings. The draft law also proposes that adjacent spaces (e.g. greenspaces and parking lots) would be shared among residents rather than held by a construction company.

The draft law would also seek to reduce the state's losses in connection with state enterprise privatisations. Under the draft, the state would be entitled to fine or raise charges against a buyer in the event an underpriced transfer of a state-owned firm to private ownership occurs. According to some estimates, the state loses as much as CNY 40 billion (about €4bn) a year when property is transferred to private individuals at low or no cost.

Rapid increase in exports. In the first half of 2005, exports climbed 33 % y-o-y, amounting to \$340 billion. Imports in the same period rose 14 % to \$300 billion. Thus, China showed a foreign trade surplus of \$40 billion in the first six months. The pace of growth in June in both exports and imports matched that of the first half.

In January-June, exports of machinery and equipment rose 33 % y-o-y and their share of total exports was 55 %. Highest growth was posted in steel exports (80 % y-o-y), while highly controversial textile and clothing exports rose slower than the average (23 %). Import growth decelerated as car imports fell over 30 % y-o-y and steel imports declined 26 %. Crude oil imports rose 4 % y-o-y and coal 56 %.

The European Union remained China's largest trading partner, accounting for about 16 % of China's total foreign trade. Next came the United States, Japan and ASEAN members. Growth in EU and US trade is expected to slow as measures to limit imports of textiles and clothing from China begin to take effect. Some of this slowing will be compensated for by increased trade between China and ASEAN countries as the new free-trade zone is gradually implemented.

China and the United States discuss market access and trade problems. The annual session of the joint committee on commerce and trade between the US and China was held Monday (July 11) in Beijing. The US mission was led by secretary of commerce Carlos **Gutierrez**, while the Chinese side was led by vice premier **Wu Yi**. Gutierrez said China promised to implement new measures to rein in product piracy. According to the US, China also promised to consider changes to the draft regulations which aim to ban the use of US software in government offices. Although the US has been wary of Chinese promises to implement trade policy, the Americans found it encouraging that the Chinese government said it would try to switch fully to using only licensed software at all government agencies by the end of this year.

The leaders also discussed – without result – China's rapidly growing textile exports to the US. US textile producers are loudly demanding further restrictions on Chinese imports on top of the quotas imposed in May.

China rolls out purchasing manager index. The June purchasing manager index on manufacturing (PMI) stood at 51.7. The National Bureau of Statistics (NBS) reports that the index, which has been under development and trials for the past three years, dropped in the first six months of 2005, indicating a slowing in output growth.

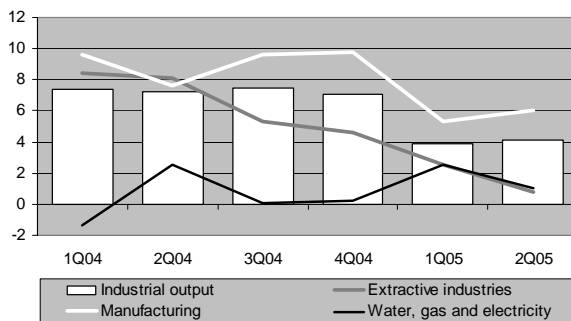
The new index covers 20 industrial activities and is based on the responses of purchasing managers at over 700 companies. Managers are asked to note the volume of new orders, production, the employment situation, price trends and inventories. The largest weighting in the new combined PMI index goes to new orders (30 %), production (25 %) and employment (20 %). A value above 50 indicates optimism about economic conditions in the near future, while a value below 50 normally indicates a gloomy outlook. The PMI index is published monthly and used in two dozen countries, including Russia.

The business confidence index (BCI), another confidence indicator that gauges perceptions of future business in the coming quarter, also suggested a slight slowing in economic growth at the end of June. In the second quarter, the BCI index fell 0.8 % from the previous quarter and 2.8 % from 2Q04. The quarterly published consumer confidence index (CCI) for 2Q05 remained unchanged from the first quarter.

Russia

Industrial output growth accelerated in June. Rosstat reports that on-year growth in industrial output was 6.9 % in June. Growth picked up again after a significant slowing in May, and was the highest since November 2004. In the first half of this year, industrial output rose 4 % compared to the same period a year earlier. June growth in industrial output accelerated most in *manufacturing* to 11 % y-o-y. The on-year rise in industrial output in the first half was 5.6 %. *Extractive* industries in January-June increased 1.4 %. Production of *electrical power, natural gas* and *water* rose 1.8 % y-o-y. Both oil and coal production was up 3 %; natural gas production gained 1 %. Russia's economy ministry recently lowered its forecast for industrial output growth this year from 5.2 % to 4.6 %. This was mostly due to slowing growth in production of crude oil and oil products.

Quarterly industrial output and core components 2004–2005, % change y-o-y



Source: Rosstat

Economy ministry publishes 2006 privatisation plan.

Russia is planning the privatisation of 415 wholly or partly state-owned joint stock companies in 2006. The privatisation programme continues the state's ownership policy reform. Revenues from privatisation sales are expected to raise about RUB 31 billion (€900 million). The state currently owns nearly 8,300 federal state unitary enterprises as well as stakes in over 3,700 joint stock companies. Among these are such operations as bakeries and health spas. In addition to selling off company shares, the state plans to incorporate over thousand federal state unitary enterprises in 2006.

The majority of companies to be privatised under the economy ministry plan operate in the agriculture or food processing sectors. Privatisation will mainly affect companies in the following industries: road transport, defence, heating and energy, construction and chemicals. In addition, some regional airports will be sold as well as stakes

in a few small banks. The ministry's proposal will be presented to government in August.

Russian markets attract giant carmakers. Sales of passenger cars made in Western Europe and Asia have boomed in Russia. Annual growth in this segment reached 80 % in 2004 with sales of new foreign-made cars reaching 280,000, or approximately a fifth of all new car sales. Additionally, over 300,000 second-hand cars were imported last year. In the first half of this year, already 225,000 new passenger cars have been imported to Russia

Last year about a million cars were manufactured in Russia, around 80 % of which were Russian designed. The increase in imports has been hard on Russian carmakers, which have been unable to keep up with rising consumer quality expectations relative to price. Despite resistance from Russian car manufacturers, the industry and energy ministry is preparing a legislative amendment that would eliminate domestic-origin quotas on certain car parts. On the other hand, imports of used cars would be restricted through tougher customs rules. This measure is intended to prevent Russia from becoming a graveyard for old European cars.

The demand for foreign makes assembled in Russia is expected to reach 900,000 by 2010. Automobile industry majors DaimlerChrysler, Toyota and Volkswagen are currently planning to build assembly plants in Russia. Chinese manufacturers are also planning to begin their international expansion by assembling cars in Russia. Renault, Ford, Kia, BMW and Hyundai models are already assembled in Russia; last year sales of these makes reached nearly 130,000.

Concentration of Finnish exports to Russia by enterprises closely resembles the overall structure of Finnish exports.

Statistics Finland figures released this month show that approximately 4,400 Finnish firms were engaged in exporting to Russia in 2004, while about 1,200 were involved in imports. The five leading firms together accounted for a third of Finland's total exports to Russia, and the top 100 accounted for over 70 %. Imports were more concentrated. The five leading companies accounted for fully two-thirds of all Finnish imports from Russia, and top 100 accounted for 97 %. The prominence of various firms was about the same as for Finnish exports generally. In contrast, imports from Russia were clearly more concentrated on fewer enterprises.

About 2,000 Finnish firms were engaged in trade with China in 2004. The five leading firms handled slightly over half of Finland's exports to China, and the top 100 accounted for 93 % of all exports to China. The top five Finnish firms involved in importing from China handled over 40 % of Chinese imports and the top 100 nearly 80 %.

China

China revalues yuan, shifts to currency basket. China yesterday (July 21) abandoned its peg of the yuan to the dollar and shifted to a currency basket. Although the central bank has not reported the composition of the basket, the central bank will permit the yuan's value to fluctuate daily within a narrow 0.3 % trading band. The shift included an immediate 2.1 % revaluation of the yuan against the dollar, putting the yuan's official exchange rate at 8.11. Malaysia's central bank followed China's move immediately, abandoning its own dollar peg.

Chinese economic growth remains robust. In the first half, real total production (GDP) grew 9.5 % y-o-y. Growth exceeded analysts' forecasts and clearly surpassed the government's target of 8-8.5 % growth for the whole year. The allocation of growth by production sectors was unchanged from the first quarter. Industrial production and construction continued to expand fastest (11 % y-o-y), and together accounted for about 60 % of total output. The service sector grew 8 % and had a 30 % share of output. Agriculture and other primary production rose 5 %.

Soaring goods exports (33 % y-o-y) drove growth in the first half. Domestic consumption also remained robust, while retail sales were up 12 % y-o-y in real terms.

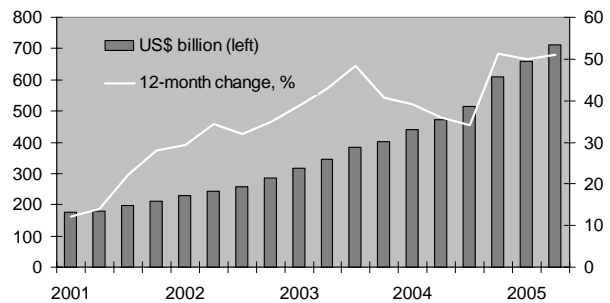
Fixed investments in 1H05 climbed 23 % y-o-y in real terms, which was actually a bit lower than a year earlier. Overall investment growth in the second quarter accelerated from the first quarter, although investments in the real estate sector slowed. Investment in the first half went predominantly to "bottleneck" sectors. Highest growth was registered in coal production (82 % y-o-y) and railway construction (nearly 50 %). In addition, investment in fuel production and electricity, natural gas and water distribution and production grew faster than the average. The figures above indicate that China's already high investment ratio rose further.

Growth in China's currency reserves accelerated at the start of the year. The People's Bank of China reports that its foreign currency reserves as of end-June stood at \$711 billion, up about \$100 billion from the end of last year and about \$240 billion more than twelve months earlier. Growth in the currency reserves during the first half of this year was clearly higher than in 1H04. China's currency reserves are the second largest in the world after Japan.

The rapid growth in currency reserves was driven by sizzling first-half exports (up 33 % from a year earlier) and relatively lower import growth (14 %). As a result, the first half foreign trade surplus swelled to \$40 billion. The value of foreign direct investment was \$29 billion, about 3 %

less than a year ago. Recent capital inflows related to anticipation of the yuan's revaluation have been lower than six months ago.

China's foreign currency reserves, quarterly

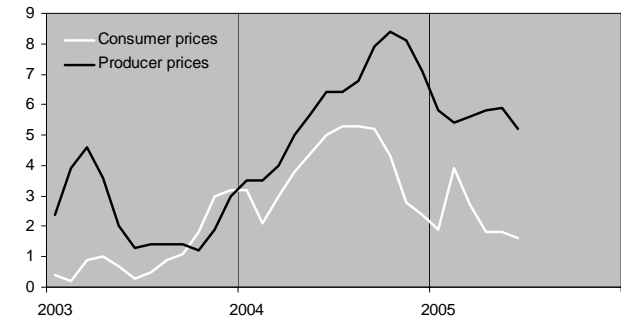


Source: PCoB

Inflation declined in June. Consumer prices in June were up 1.6 % y-o-y, a slight drop from the 1.8 % pace of April and May. Prices for food, housing and cultural services rose outpaced the average, while prices for textiles, home appliances, and transport and telecommunications services declined.

Producer price inflation in June was 5.2 %. Raw material prices in June were up 9 % y-o-y.

12-month change in consumer and producer prices, %



Source: NBS

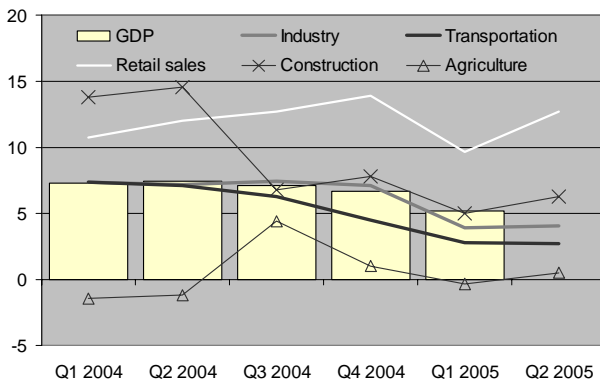
Standard & Poor's lifts China's credit rating. S&P now gives Chinese sovereigns a rating of A- (up from BBB+). The international ratings agency finds the outlook for China's economy positive and sees opportunities for further credit ratings upgrades. S&P said the higher ratings reflect stable economic growth and predictable economic policies. It emphasised achievements in strengthening the banking system and revised lower its estimates of non-performing bank loans at the end of this year to 25-28 % of GDP. S&P observed, however, that current estimates project that central government debt and bank recapitalisation will increase public debt to 44 % of GDP by the end of this year and that this debt ratio threatens to climb rapidly.

Russia

Growth in Russia's core production sectors picked up in June. Rosstat's figures show production growth in core production sectors, while remaining well below the pace of the first half of 2004, accelerated slightly in June. For the first six months of the year, on-year growth in *construction output* was 5.8 % and *industrial output* 4.0 %. *Agricultural output* in the same period was 0.2 %. *Transportation* grew 2.8 %. *Retail sales* led core production sector growth by 11.3 % y-o-y.

Preliminary information from the economy ministry indicates on-year GDP growth in the first five months of the year was 5.4 %. At the beginning of July, Russia's economy ministry raised its outlook for GDP growth this year to 5.9 %.

Quarterly growth of core production sectors 2004–2005, % y-o-y



Source: Rosstat

Stabilisation fund assets to be invested in securities of G8 countries. Russian finance minister Alexei Kudrin announced last week a plan to start investing stabilisation fund assets next year in bonds of G8 countries. Kudrin said that this decision has been taken because of the relative stability of G8 economies. Currently, stabilisation fund assets sit in a central bank account not accruing any interest due to unclarity in legislation on how the assets should be managed.

At the start of July, stabilisation fund assets dropped to RUB 618 billion (approx. €18bn) after at third of total assets were used to pay off debt to Paris Club creditors in June (see *BOFIT Weekly* 28/05).

CBR pulls license of bank admitted to deposit insurance scheme. The CBR last week withdrew the banking license of a bank registered in the deposit insurance scheme. The capital adequacy of the small bank had fallen

below 2 %, the limit that triggers insolvency measures against the bank under Russian legislation. The license withdrawal provoked observers to question the quality of central bank supervisory inspections, given that the bank was entered in the deposit insurance scheme just last March.

The deposit insurance act guarantees individual depositor's savings up to 100,000 roubles. One aim of the deposit insurance act is to increase public trust in Russian banks. The deposit insurance scheme now has 841 participants. The CBR has pulled the licenses of a few small banks not belonging to the scheme this summer. The reasons were low capital adequacy ratios, accounting discrepancies and suspected money laundering.

Standard & Poor's holds Russia's credit rating steady.

Following Russia's ahead-of-schedule payments of Paris Club debt and a massive federal surplus, some analysts have speculated about upgrade in Russia's creditworthiness. Standard & Poor's, however, decided last week to keep Russia's credit rating unchanged. The agency noted the positive developments were offset by persistent political risk, sluggish structural reform and extensive corruption. Moreover, S&P said that despite slowing economic growth, economic policy seems to be headed in a looser direction. Inflation has also exceeded the government's target range. S&P upgraded Russian sovereigns to the lowest invest-grade rating in 2005.

Surging corruption plagues Russian business. A survey released last week by the Russian Indem Foundation finds that the amount of bribes paid in Russia has grown significantly over the last four years reaching an annual €260 billion. Most bribery affects business life. While the number of bribe incidents has fallen, the size of the average bribe has increased ten-fold to an average of €11,000. Most bribes are paid to the branches of executive power. Indem chairman Georgi Satarov says this reflects Russia's imbalance in power sharing and the strict regulation of the national economy. The survey also revealed that the majority of bribes is collected by official inspection agencies and licensing authorities.

For private individuals, the trend has been more positive. The report finds that the willingness of Russians to pay bribes has fallen and that citizens now manage to handle most transactions without bribes. Private individuals are most likely to pay bribes to education and health care officials, although the military's share of bribery has increased dramatically as people have scrambled to avoid military service especially due to the unstable conditions in Chechnya.

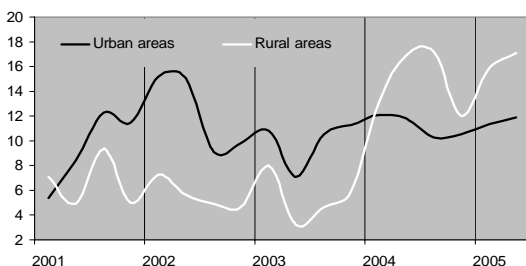
China

China's new exchange rate regime. Last week China abandoned its peg of the renminbi (yuan) to the dollar and shifted to a managed float system with reference to several currencies. Although the People's Bank of China has not reported what currencies are to be used, it will permit the Chinese currency to fluctuate against US dollar daily within a narrow 0.3 % trading band. The shift included an immediate 2.1% revaluation of the renminbi to an official exchange rate of 8.11 to the dollar.

A press release from central bank officials stressed the increased importance of the exchange rate regime in promoting the independence of monetary policy and China's ability to react to shifting economic conditions. While confirming the renminbi's rate is determined in relation to other currencies, the central bank board did not disclose the true currency basket arrangement. Since last week's shift, the renminbi's exchange rate has remained nearly frozen at 8.11 to the dollar. The PBoC appears reluctant to allow major swings in the renminbi's exchange rate, and any shifts in the value of the renminbi to the dollar are expected to be slight in the coming months. The miniscule revaluation has had very little impact on foreign trade. The new arrangement, however, should eventually tolerate large swings in the renminbi's value and open up opportunities for a more flexible exchange rate policy. Malaysia followed China's move immediately last week by also abandoning its dollar peg.

Household incomes rising rapidly. Per capita household incomes in urban areas rose 9.5 % y-o-y in the first half to an average of 900 yuan (90 euro) a month. In the countryside, per capita income growth was even higher (12.5 %), although rural incomes remain paltry – an average of just 200 yuan (20 euro) a month. Because Chinese rural incomes enjoy a year-end boost, only about 40 % of annual incomes are earned in the first half of the year.

Nominal per capita growth in rural and urban household incomes, % y-o-y

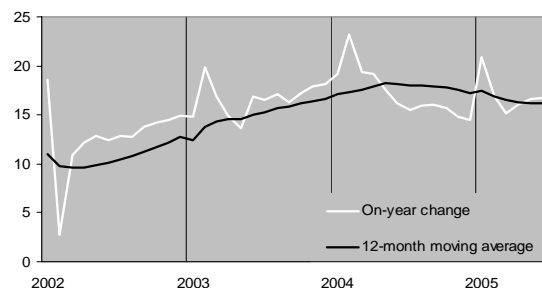


Source: NBS

Industrial output growth remains brisk. Industrial output rose 16.4 % y-o-y in the first half of 2005, showing no signs of slowing. Indeed, industrial growth appears to have accelerated in recent months (16.6 % y-o-y in May and 16.8 % in June). National Bureau of Statistics' figures are based on the performance of private companies with sales exceeding CNY 5 million (about €500,000) and all state-owned enterprises regardless of turnover.

Computer production, up over 60 % y-o-y, led production growth in the first half. Production growth has nearly doubled from last year. Crude oil production was up 5 % y-o-y. Growth in refined oil products slowed to below 10 %. Coal production rose nearly 10 % y-o-y in January-June, which was five percentage points lower than during last year. Production of electrical power generators climbed nearly 50 %, while electricity production grew 13 % y-o-y. Steel production continued to boom (up nearly 30 %), with production growth clearly beating last year's pace. Production of other metals also rose rapidly.

On-year industrial output growth, %



Source: NBS

Opposition to CNOOC's bid for Unocal increases.

China's number-three oil company, state-owned CNOOC, made an unsolicited cash offer of nearly \$20 billion for US-based Unocal at the end of June. Unocal's board, however, decided in early July to recommend Chevron's slightly lower bid to shareholders. CNOOC's bid is problematic as it still requires approval of US officials. Chevron's offer, on the other hand, this week gained the support from the US congress, which decided to postpone its study of CNOOC's offer by nearly two months. Unocal's shareholder meeting is set for August 10, and shareholders are expected to decide on which offer they prefer. However, even if shareholders go with the CNOOC offer, the deal still requires congressional approval. Unocal is a particularly attractive investment for CNOOC because over half of Unocal's proven reserves are located in Asia.



Russia

Euro's weighting in currency basket increased. At the beginning of the week the Central Bank of Russia announced it was altering the composition of the dual-currency basket it uses to steer the external value of the rouble as of August 1st. The euro's weight was increased to 0.35 from an earlier 0.30, while the dollar's weighting fell to 0.65. The currency basket was officially introduced last February with a weighting of 0.1 euro and 0.9 dollar. Thereafter, the euro's weighting has tripled in line with the CBR's goal of bringing greater stability to the rouble's external rate over the short term.

Average Russian wage €250 a month. Rosstat reports that the average Russian monthly wage at the beginning of July was 8,655 roubles, an increase of 22 % from a year earlier. Real wages rose slightly over 8 %. Substantial pay gains have been made in the public sector, where the wage level has traditionally lagged well behind the average wage. Wage trends in high-paying financial services, oil and coal industries also outpaced average wage growth.

The latest wage statistics showed Russian employers at the beginning of July still owed their employees nearly €30 million in wage arrears. Nevertheless, that amount is just half what was owed at the same time a year ago and the arrears problem now affects less than 2 % of the workforce. Less than 10 % of wage arrears are owed by public sector bodies. Of that amount, nearly two-thirds is the responsibility of regional and local administrations.

Summer boom in Russian financial markets. Russia's RTS index reached an all-time high of 794.02 on Thursday (Aug. 4), a 31 % gain for the year. During this week the former peak from April 2004 was already breached twice. The rise in the share prices signals a return of investor confidence in Russia. Analysts argue that Russian markets are undervalued because political uncertainty has kept investors on the sidelines. After a relatively calm period after the conviction of Mikhail **Khodorkovski**, many feel political risk has somewhat abated. Reports that economic growth accelerated in the second quarter also helped boost stock prices. Higher oil prices at the beginning of the week provided the final push to the new RTS record.

Russian companies continue to have initial public offering successes. Russia's second largest gas producer, privately held Novatek, was listed on the London stock exchange in late July. Novatek's IPO generated strong investor interest, easily raising just over €800 million in new capital.

Russia's tiny, but growing, insurance sector. Russia still has a fairly disorganised insurance sector, with about 1,000 insurers and another 45 reinsurers. The capitalisation of the entire sector corresponds to only about 3 % of GDP (compared to, say, 9 % for Finland). Yet the growth of real incomes and personal wealth has begun to be seen in the increase in collected insurance premia, which grew 17 % a year in real terms during 2000–2004. The biggest boost for insurers, however, comes from mandatory automobile insurance, which was part of the new insurance act that entered into force in January 2004. Compulsory car insurance now accounts for 15 % of total premia collections. Voluntary life insurance and property insurance each represent about a quarter of all premia income to insurers.

Russia's insurance market is mostly in the hands of a few: the top fifty insurance companies in 2004 collected 71 % of all insurance premia. Moreover, the state owns a fourth of Russia's largest insurance provider, Rosgosstrakh, which has the only nationwide branch office network. Rosgosstrakh collected over 7 % of total insurance premia in 2004. While the new insurance act allows in principle foreign ownership of insurance providers in Russia, the actual interest of foreign insurers in the Russian market has been modest. Foreign capital currently accounts for under 4 % of the entire sector's capital.

Russian government approves space program guidelines for 2006–2015. The program is designed to secure Russia's basic space technology needs and fund the development of top-quality space technology (including the Clipper shuttle). Russia expects to complete its share of the International Space Station (ISS) and participate in maintenance of the COSPAS/SARSAT emergency system. About RUB 300 billion (\$10–11bn) has been set aside for the decade-long program. While this is less than the US spends annually on its space program, the funding represents a substantial increase in Russian space spending.

Putin visits Finland. President Vladimir **Putin** spent the early part of this week in Finland. At the conclusion of his visit, he and Finland's president Tarja **Halonen** declared that relations between the two countries were excellent. The presidents' discussions included cooperation in high-tech industries, scientific innovation, border security and infrastructure projects. Putin said he would like to see greater Finnish investment in Russia and promised to promote investment protection agreements between Finland and Russia.



China

China relaxes currency controls further. Chinese authorities have continued their step-by-step deregulation of capital flows by again raising the amount of foreign currency a Chinese citizen can purchase for travel purposes. For trips abroad lasting less than six months, travellers can now purchase up to the equivalent of \$5,000 (up from \$3,000 previously). The \$5,000 limit for trips lasting longer than six months set in October 2003 was raised to \$8,000. In addition, procedures for private persons buying foreign currency has been simplified and traveller's possibilities to use credit cards abroad.

The State Administration of Foreign Exchange (SAFE) also raised the limit on the amount of foreign currency that a Chinese company can hold. Under the new rules, a Chinese corporation, bank or other institution can retain 80 % of its foreign currency earnings from foreign trade in its own accounts. Firms previously had to sell at least 50 % of their foreign exchange earnings to designated banks. SAFE hopes the changes will speed up yuan convertibility in foreign exchange markets and give companies greater influence over currency trade matters. The maximum limit for foreign currency holdings has been relaxed several times in recent years, most recently in May 2004.

Steel industry reforms. China, the world's largest steel producer, will reduce the number of small steelmakers through merger with the country's larger steel companies as part of the steel industry reform program launched in June. At the moment, the ten largest steel companies account for 30 % of total steel production; the goal is to raise the figure to 50 % by 2010. The big companies, on the other hand, have little incentive to absorb small steel companies, which tend to be inefficient and state owned (which severely limits any chances of downsizing). Under the new rules, only largest foreign players can invest in China's steel industry, and even then only as minority stakeholders.

The aim of the reform is to restrain growth and gradually improve the efficiency of China's booming steel industry. Steel production is still expected to grow nearly 30 % this year from 2004 and approach a total output level of 350 million tons. The state introduced measures to limit steel industry investment last year to stifle growth, and, in fact, the pace of investment has slowed sharply this year (up only about 20 % y-o-y in the first half of 2005, or 30 percentage points less than in 1H04).

Overcapacity in the steel industry has rapidly reduced imports and increased exports. China became a net steel exporter in the final months of last year. In the first half of

2005, China's steel exports exceeded imports by over 2 million tons (a year earlier China had net imports of about 13 million tons). In the second half of 2005, the surplus is expected to rise further. Foreign steelmakers are worried about China's excess capacity and fear a flood of cheap Chinese steel will cause a crash in world steel prices, particularly prices for low-grade steels.

Competition in China's auto sector heats up. In the first years of 2000s, rapid growth in car sales pushed Chinese carmakers to boost production. Nearly all major international car manufacturers also now have production in China. In 2004 the Chinese government decided to curb car loans, which led to a slowdown in demand growth. At the same time, car production capacity has grown rapidly, so the slide in prices that began last year has continued this year. A rise in raw material prices has further eroded carmakers' profit margins. Chinese carmakers warned that their first-half profits would be just half of what they were in 1H04. China's auto production grew 5 % y-o-y in the first half of 2005.

As competition tightens and production increases, Chinese auto manufacturers are trying to sell more cars abroad. Passenger vehicle exports in 2004 tripled from the previous year. The volume was a modest 9,300 cars, most of which went to developing economies. During 2005, however, an increasing number of Chinese cars will be sent to developed countries. Car imports to China, on the other hand, began to decline in the first half.

CNOOC abandons its bid for Unocal. Blaming an unfavourable US political climate, China's number-three oil company, CNOOC, this week announced it was giving up on efforts to acquire US-based Unocal. CNOOC's bid was widely condemned in the US Congress and a survey this week showed that shareholders were ready to go with the lower, but less risky, bid from US-based Chevron. Unocal shareholders are expected to approve the sale to Chevron at a special shareholders' meeting next week. The markets seemed satisfied with CNOOC's decision to withdraw its offer and the company's share price hit all-time highs on the New York stock exchange.

CNOOC offered nearly \$20 billion for Unocal and the deal would have been the largest foreign direct investment of a Chinese firm to date. In 2003, the Chinese government began to encourage direct investment of Chinese firms abroad. With the exception of Lenovo's recent purchase of IBM's personal computer business, Chinese investments have tended to be small.

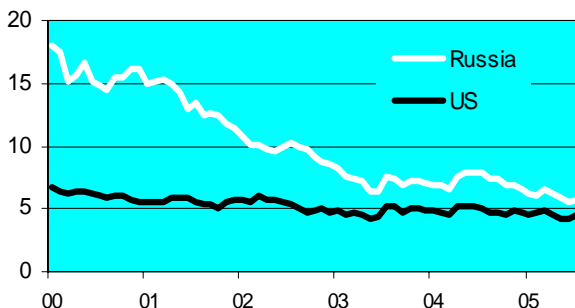
Russia

Russian inflation slowed further in July. Inflation continued to decelerate in July to 13 % y-o-y. Nevertheless, consumer prices have risen 8.5 % since the start of the year, which is already the original floor of the government's target range for the entire year. The economy ministry now expects inflation for 2005 to come in at 10–11 %. The rise in prices for *services* slowed slightly in July to 21.9 % y-o-y. The increase in *food prices* slowed from recent months to 14.1 % y-o-y in July, dampened by a drop in prices for fruits and vegetables, which had rocketed earlier this year. On-year inflation for *other goods* was 6.1 %.

Fitch raises Russia's credit rating. Fitch, one of the top three international credit rating agencies, last week raised its appraisal of Russian sovereigns one notch to BBB. Fitch's rating for Russia now is one step above the minimum investment-grade rating. Fitch said the raise reflected Russia's exemplary macroeconomic situation against the country's persistent structural problems with the economy such as over-dependence on natural resources and an underdeveloped banking sector.

Russia's improved creditworthiness has helped to reduce risk premia on Russian bonds. The spread between Russian government long-term dollar-denominated bonds and US government bonds has been narrowing for years, and has now reached historic lows. The same trend has been repeated for other Russian public sector paper and Russian corporate bonds.

Yields on government bonds (Russia 2018 and US 2020), %, monthly averages



Source: Bloomberg

Rise in producer prices decelerated slightly. Rosstat reports almost no on-month change in producer prices for June, although the on-year rise was still 20 %. Producer prices have slightly outpaced consumer prices, rising 10 %

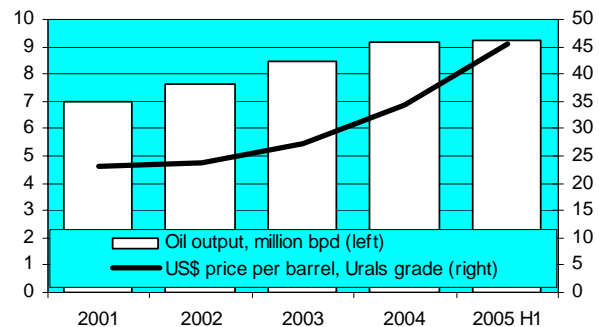
since the start of the year. Prices have climbed particularly fast in extractive industries, and were up 46 % y-o-y in June. Tariffs on industrial freight transport have also increased 20 % during the past 12 months.

Growth in oil output slows, export earnings surge. The economy ministry announced that growth in Russian crude oil output has slowed from last summer's pace of over 10 % y-o-y to just 2.9 % y-o-y in the first half of this year. In June, production was up just 1.4 % y-o-y to 9.4 million barrels a day.

Despite an increase in the volume of crude oil exports of only 0.5 % in the first half of this year, earnings on oil exports soared 50 % y-o-y. During the period, Russia exported \$38 billion worth of oil, which represented 34 % of the total value of exports. The price of Urals-grade crude has increased nearly 60 % over the past twelve months.

With oil output growth declining, economy minister German Gref last week proposed easing off on the progressive export tax rates for crude oil. Gref noted that the current heavy taxation reduces the incentive for oil companies to increase production when oil prices are high. He said the government will review the current export tariff scheme during the autumn.

Average crude oil production and export prices, 2001–2005



Source: Russian economy ministry

Russia to establish investment fund for public-private projects. According to economy minister German Gref's last week announcement the fund will focus on financing nationally significant infrastructure projects. Officials at all levels of government, as well as domestic and foreign-owned companies, are invited to petition for funding. The economy ministry will select worthy projects with the help of foreign consultants, although the final financing decision will rest with a special government commission. The size of the investment fund should grow by about RUB 70 billion (€2bn) yearly within next three years. It will be funded out of oil export revenues and interest savings from early repayment of foreign debt.

China

China's central bank governor reveals more about currency basket. On July 21, the central bank announced it was dropping its dollar peg and henceforth determining the value of the yuan in relation to a basket of unspecified currencies (see *BOFIT Weekly 29-30/2005*). Since the move, however, the yuan has only been allowed to appreciate slightly in relation to the US dollar. Central bank governor **Zhou Xiaochuan** elucidated on Wednesday (Aug. 10) that the basket behind Chinese currency's value reflects the structure of China's foreign trade, foreign debt, foreign direct investment and transfers in the current account. The currency basket emphasises the US dollar, the euro, the Japanese yen and the South Korean won, but also takes into account the values of the Singapore dollar, British pound, Malaysian ringgit, Russian rouble, Australian dollar, Thai baht and the Canadian dollar in determining the yuan's exchange rate. The actual weightings were not revealed and governor Zhou stressed that the yuan is not pegged to the currency basket, but rather takes into account movements in currency rates. The US dollar weighting is generally considered to be the largest in the basket.

China's largest bank transfers non-performing loans to asset management firms. Industrial and Commercial Bank of China (ICBC) sold part of its non-performing loan (NPL) portfolio to four state-owned asset management firms at the end of June. The sale was financed with central bank loans to the asset management firms, which paid 26 % of the CNY 459 billion (€46bn) nominal value of the NPLs. The move extended the reforms of ICBC launched in April, when the bank was recapitalized with \$15 billion of the PBoC's foreign currency reserves (see *BOFIT Weekly 17/2005*).

Thanks mostly to the dumping of the ICBC's loans, the total stock of NPLs held by China's four large state-owned banks dropped dramatically in the second quarter. Banking supervision authorities report that as of end-June, the stock of NPLs was about CNY 1,010 billion (€100bn), down from CNY 1,570 billion at end-April. Moreover, the share of NPLs in the total loan stock fell from 15 % to 10 %. The aggregate stock of NPLs held by smaller banks is substantially less than that of the big banks; it was nearly unchanged between April and June.

Electrical power shortages continue. Despite big increases in power generating capacity and improvements in the transmission grid, many areas continue to suffer power shortages this summer. High temperatures worsen the situation as people turn on their air conditioners. Officials have sought to rein in the growth in power consumption by issuing guidelines on saving electricity and limiting plant and manufacturing operations during hours of peak demand.

In the first half of this year, electricity production was up 13 % y-o-y. Power generation capacity has been increased by 20 million kWh to a total of 460 million kWh. Fastest growth was in hydroelectric power (22 %), as heavy rains and new dam projects raised hydropower's share to 14 % of total production. Although nuclear plants produced 15 % more electricity than a year earlier, they only accounted for slightly above 2 % of total power generation. Most electricity in China is generated by fossil fuels. The government's target this year is to increase production capacity above the 500-million-kWh mark and power shortages are expected to diminish significantly by the end of the year.

Pension system problems. A recent World Bank assessment finds that only 25 % of China's current workforce (fewer than 200 million persons) are entitled to pensions. Of those entitled to pensions, 15 % are civil servants, 30 % are farmers and 55 % are company employees. Although each group nominally has its own pension scheme, more and more civil servants actually belong to the same system as company employees. Participants in the civil service system do not make pension contributions, but after long years of service can still receive up to 90 % of their end-career salary. The arrangement is funded by the government or the working unit. For those who have worked in a company and paid pension contributions for over 15 years, the bulk is financed by the employer but the pension also includes a personal component financed by the worker. Such pensions correspond to about 30 % of the worker's end salary.

All pension schemes also offer the possibility for voluntary pension savings. This month the state extended the rights to operate voluntary pension funds to foreign asset management companies. The government has encouraged voluntary pension schemes because the state system is inadequate to secure the welfare future pensioners. Only about 7 million people were enrolled in voluntary pension savings plans at the end of 2003.

Management of pension savings was transferred in principle from municipalities and cities to the provincial level in 1997. The shift has proceeded slowly and only been fully implemented in four provinces (including Beijing and Shanghai). Pension savings for industrial workers are still managed separately.

China's population will begin to age rapidly as the one-child-per-couple policy introduced in the 1970s starts to take effect. It is forecasted that the share of persons over 60 will rise from the current 11 % to 28 % by 2040. Those outside the pension system have traditionally been supported by their children. The one-child policy, however, has placed a huge burden on only children, who may now be expected to support not only their pensioner parents but possibly their grandparents as well. The current retirement age is 60 for men and usually 50 for women. One possibility would be to increase the retirement age.

Russia

Russian foreign trade expanded rapidly in first half.

The Central Bank of Russia reports that the value of *goods exports* was \$112 billion and *goods imports* \$54 billion for the first half of this year. Exports grew nearly 40 % y-o-y and imports 28 %. The rapid growth in exports largely reflected the rapid rise of prices of energy products and raw materials on world markets. Russian customs figures indicate the EU's share of Russian trade surpassed the 50 % mark in the first half, while the share of CIS countries fell to 13 %. Germany remained Russia's largest trading partner.

Preliminary central bank figures show that *services exports* grew 17 % y-o-y in the first half to \$10.4 billion. *Services imports* increased 14 % and were worth \$16.6 billion.

Investment on the rise. According to preliminary Rosstat figures, investment in fixed capital was nearly RUB 1,250 billion (about \$44bn) in January-June, and showed an increase for the period of 9.4 % y-o-y. Growth in investment accelerated slightly in the second quarter, although it was still off of last year's pace. The economy ministry noted that the slower growth reflects factors including higher borrowing costs and poorly developed financial markets.

Some \$4.5 billion in foreign direct investment flowed into Russia during January-June. That amount represented about a fourth of total foreign investment in the period. While FDI increased 31 % y-o-y, foreign investment overall declined 13 %. Russia's FDI stock as of end-June stood at \$91 billion, about 10 % of fixed investment.

Government disappointed by recent pace of economic growth. Commenting on the Russian economy's performance in the first half, prime minister Mikhail **Fradkov** said he was satisfied with the overall direction of the economy, but conceded the government's goal of doubling GDP would be a daunting task. Cabinet members were disappointed with the slowdown in economic growth. According to economy minister German **Gref**, the slowdown is due mainly to subsiding growth in the oil and gas sectors. The government is also concerned about the decline in investment activity and the slow pace of privatisation.

Mr. Gref also said he was surprised by CBR chairman Sergei **Ignatyev**'s proposed changes in how export tariffs on crude oil and oil products should be set. Ignatyev argues that changing the tariff regime would help control inflation by restraining the rise in domestic gasoline prices. Meanwhile, finance minister Alexei **Kudrin** continues to warn against the dangers of a rapidly appreciating rouble. The government has yet to resolve the conundrum of securing

economic growth while restraining rouble appreciation and subduing inflationary pressures.

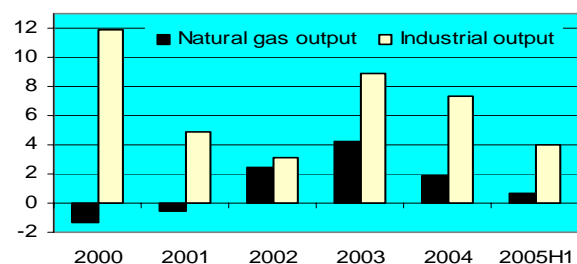
Government submits bill on tax amnesty of undeclared income. Under the proposed legislation, undeclared income of private individuals can be legitimised by paying a 13 % tax on it. The proposed grace period would be the first six months of 2006.

Many analysts feel improving Russia's investment climate would be a more effective way to get Russians to repatriate their capital. The effectiveness of the law is under doubt as it would only be in force for such a short time. Moreover, many feel the amnesty comes at a high price as declared income would have to be deposited in a Russian bank and the tax rate is fairly hefty. The bill still requires Duma approval and the president's signature to become law.

Growth in natural gas production lags. Russian oil and overall industrial production growth continue to outpace growth in natural gas production. Over the past five years, oil production averaged 8.5 % yearly growth and overall industrial production 6.7 %. In the same period, gas production grew a mere 1.3 % per year. Government-regulated prices on the domestic market have diminished the incentive of producers to invest in Russia's outdated gas production and transportation infrastructure. In response, the Russian government now wants to gradually increase prices for domestic industrial users from the current €23 per 1,000 m³ to €30-34 by 2006 and even exceed €60 by 2010.

Gazprom and its subsidiaries account for 86 % of Russian gas production. Factual monopoly position gives Gazprom no incentive to increase its gas production. Moreover, Gazprom has recently diversified into other energy-sector businesses instead of investing adequately in its main business. Russia's independent gas producers and oil companies that produce gas as a by-product produce 14 % of Russian gas. Russia's leading independent gas producer, Novatek, currently accounts for just under 4 % of Russia's gas output. Independents face several barriers to growth, particularly the lack of access to the gas transport infrastructure and thereby export markets.

Annual growth of natural gas and industrial output, %



Source: Rosstat

China

Slow rise in Chinese consumer prices. Consumer prices in July were up just 1.8 % y-o-y. On-year inflation has been fairly steady in recent months. July inflation was driven mainly by a 2.3 % on-year rise in food prices, a nearly 4 % increase in prices for services and higher fuel prices. Prices of other goods remained nearly unchanged or even declined. Back in summer 2004, consumer prices were still rising at more than over 5 % a year, the highest inflation seen in many years. Producer prices, in contrast, rose 5.2 % y-o-y in July 2005.

The rise in consumer prices has been dampened by fierce competition among companies. Overcapacity in certain industries may be adding to competitive pressures. A trade ministry study suggests that in the second half of this year there will be an excess supply of 70 % of the major consumer goods and that there will be no shortages of any key goods. The substantial slowdown in the growth of industrial profitability in the first half of 2005 also indicates tightening competition. By some estimates, higher prices for municipal services (water, electricity, etc.) and fuel, as well as higher state-supported grain prices, should in themselves be sufficient to push up the consumer price index overall in the second half.

Investment growth remains brisk. Fixed investment in July rose nearly 28 % y-o-y, keeping up summer's blistering pace. For the period January-July, investment grew slightly over 27 % y-o-y. The pace of growth was only slightly off that set in the first seven months of 2004 (31 %). Fixed investment growth remained highest in January-July in industry and construction (35 % y-o-y). Investment in the service sector and agriculture were up about 20 %.

Investment in coal production continued to rise rapidly (83 % y-o-y). Investment in municipal services also continued to grow at a 35 % rate, while growth in investment in oil and gas production slipped below 30 %. Investment growth is still running well above the government's declared 16 % growth target for the year.

Trade surplus continues to swell. While China's exports in July climbed 29 % y-o-y, imports were up just 13 % y-o-y. Thus, China's July trade surplus exceeded \$10 billion (compared to less than \$2 billion in July 2004). The surplus for the first seven months of 2005 exceeded \$50 billion (compared to a \$5 billion deficit in the same period in 2004). The trade surplus for January-July reflects the strong export growth (32 % y-o-y) at

a time when import growth slowed to 14 % y-o-y. China continued to run large surpluses with the US and the EU, and trade deficits with several Asian countries.

China's foreign trade balance, US\$ billion



Source: China Customs

Steady increase in exports raises industrial output.

Industrial output grew 16.1 % y-o-y in July and 16.3 % y-o-y in the first seven months of the year. Favourable exporting conditions were a major factor in the rapid growth. Exports of manufactured products rose 30 % y-o-y in January-July. The growth in exports was particularly apparent in certain electrical devices such as computers and in the volume of textiles and clothing produced. Investment in metal industries in the first seven months of this year focused on the steel and aluminium sector (up about 25 % y-o-y). Increased electricity production was reflected in higher output of e.g. coal and crude oil. Automobile manufacturing also rebounded in July; production of passenger vehicles was up 55 % from July 2004.

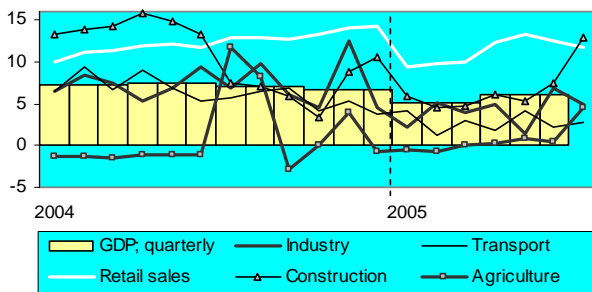
Broad money supply growth accelerated in July.

As of end-July, the broad money supply (M2) was up 16.3 % y-o-y. Growth was 0.6 percentage points higher than in June and exceeded the central bank's M2 growth target of 15 % for 2005. On the other hand, on-year growth of the narrower money supply (M1) slowed to 11 %, despite an 18 % y-o-y increase in the amount of yuan-denominated deposits. On-year lending growth slowed to 13 %, which was slightly below the central bank's target for this year (14 %) and 0.2 percentage points less than in June. July is traditionally a slow month for lending growth.

Russia

Growth of core production sectors in Russia accelerates in July. The growth of the five core production sectors sped up in July after several slow months. Highest growth was recorded for construction and retail sales, which experienced on-year growth of 11.4 % in January-July. Also in the first seven months of the year, transport rose 3 % and agricultural output 1.3 %. Industrial output growth accelerated to 4.1 % in the period.

On-year change in core production sectors, 2004–2005, %



Source: Rosstat

Government considers 2006 budget. The government last week approved a draft of the 2006 budget, which foresees revenues of RUB 5,046 billion (about 21 % of forecast GDP), expenditures of RUB 4,270 billion and a surplus of 3.2 % of GDP. Funding for national security and defence would increase 21 % and constitute 28 % of total budget expenditure. The build-up of the stabilisation fund would continue as would the policy of paying down foreign debt prematurely. Under the budget draft, the stock of state foreign debt would shrink from 12 % of GDP at the end of this year to 9 % of GDP by the end of 2006. The budget assumes an average price of \$40 a barrel for Urals-grade crude oil. Despite growth on the spending side, the draft budget remains in surplus. The finance ministry estimates this year's budget surplus will equal 7 % of GDP.

The government also considered medium-term economic scenarios and raised its economic growth estimate for 2005 to 5.9 %. Under the government's approved "optimistic" scenario, GDP would increase 5.8–6 % per year during 2006–2008. This scenario projects the average price of oil falling to \$36 dollar a barrel by 2008. The government also anticipated only modest growth in oil production: around 3 % in 2005–2006, then slowing to 1.6 % in 2007–2008.

Russia completed early payment on Paris Club debt. As agreed in May, Russia made early payment on over €12 billion of Paris Club debt in July and August. The remain-

ing debt is over €3 billion. Finance minister Alexei Kudrin said Russia would like to continue the early repayment policy next year as paying back debt early saves Russia billions of euros in interest and helps improve the country's credit rating. Payments will continue to be financed out of the stabilisation fund, which had assets of slightly over €20 billion at the beginning of August. The finance ministry expects the fund's value to nearly double by the end of this year.

Government agrees on Svyazinvest privatisation. After years of discussion, the government finally gave the go-ahead for privatisation of Svyazinvest, a holding company that controls the local fixed-line networks and the long-distance monopoly Rostelecom. The 75 % stake is expected to be priced at just over €2 billion. The proposed deal would be the biggest in the history of Russian privatisations. The cabinet's plan requires presidential approval.

The government's 2005 privatisation plan has proceeded slowly; as of end-June, just 8 % of the assets scheduled for divestment this year had been sold. The sales so far have yielded a modest RUB 5.6 billion (€160 million) in budget income.

Survey reveals insights into challenges facing small and mid-sized businesses. OPORA Rossii, the watchdog organisation for the interests of small and medium-sized enterprises (SMEs) in Russia, recently released a survey of its members. Generally, respondents had little flattering to say about the current business environment. The best business environments were found in Yamalo-Nenets autonomous okrug, Bashkortostan republic and the Stavropol oblast. Moscow ranked 78th out of the 80 regions compared.

Frequently changing and extensive regulation remains a problem for entrepreneurs. Small business owners were subject to an average of five separate inspections last year. Six out of ten SMEs said they were unwilling to go to court to resolve civil conflicts. The survey also found that 8.5 % of the revenues of the average firm went to bribing public officials in order to either avoid problems or make current problems go away.

Companies characterised their economic circumstances as "satisfactory," despite a widespread lack of access to financing for investment. Specifically, they classed their circumstances as "sufficient for maintaining business operations, but not growth." Over 60 % of respondents said their capital investments were financed out of company earnings or their own pockets. Only 26 % of respondents said they had ever even applied for a bank loan. SMEs also said they faced a lack of available commercial space and sometimes unreasonably high rents. Surprisingly, a sharp deterioration of the macroeconomic environment was seen as the biggest risk facing small businesses.

China

Fuel shortages in southern China. Shortages of gasoline and diesel fuel have been reported in the southern Guangdong province for several weeks now. The shortages seem largely the result of regulated fuel prices, which have failed to keep up with the rapid rise of crude oil prices on world markets. Although officials have raised fuel prices three times this year, prices are currently only about 15 % higher than at the start of the year. The combination of high crude prices and low regulated fuel prices have made refiners reluctant to sell fuel at all as they are compelled to do it at a loss. Observers estimate that Chinese oil refiners have already suffered about €500 million in losses this year.

Officials, meanwhile, have chosen to blame the shortages on bad weather for holding up shipments by sea. The situation in Guangdong should ease soon as the province's most important fuel supplier, state-owned Sinopec, is increasing supplies to the province.

Observers in Shanghai have also remarked on problems with fuel availability. Officials and key oil sector leaders met last week to discuss about changes to the fuel pricing system. No decisions from the meeting were reported.

State share reform extended to all listed companies.

The conversion of non-tradable state shares into tradable shares has now been extended to all listed companies. The reform started in May with four companies and later was extended to cover 46 companies. There are over 1,300 listed companies at present, and two-thirds of the capital stock is non-tradable state shares. The conversion of state shares into tradable shares still requires investor approval. Many of the companies in the first wave of reform have already approved the change, although investors sometimes disagree among themselves on the conversion mechanism (which they must determine mostly themselves). Typically, holders of tradable shares expect some form of compensation as the increased number of shares is feared to dilute share prices. In mid-August, the largest of the first-wave companies (Baoshan Iron and Steel Co., China's largest steelmaker) approved conversion of its shares. China attempted to convert state shares into tradable shares in 1999 and 2001, but each time was forced to retract the attempt after share prices collapsed.

Investor group acquires stake in Bank of China. Last week (Aug. 18), the Bank of China announced it had reached agreement on the sale of a 10 % stake to a group of investors led by the Royal Bank of Scotland (RBS). The deal was priced at \$3.1 billion. RBS itself will take a 5 % stake in the Bank of China, for which it will pay \$1.6 billion. The other members of the investment group are the

investment bank Merrill Lynch and the Li Ka-Shing Foundation. The deal still requires approval from Chinese officials.

RBS will get one seat on the Bank of China board. Strategic cooperation between RBS and Bank of China will extend to the areas of wealth management services, credit card services, corporate banking and private insurance. The sale also requires that the Bank of China offer its shares to the public in 2006.

The Bank of China is one of China's largest banks, controlling 12 % of lending and 14 % of all deposits. It has over 11,000 branch offices. The sheer size of China's banking market and rapid economic growth make the country attractive to foreign investors. Earlier this year, Bank of America purchased a 9 % stake in China's second largest bank, China Construction Bank. State-owned banks are still burdened with sizable stock of non-performing loans, making investment somewhat risky. Foreign banks, on the other hand, bring to Chinese banking needed technology and administrative skills.

CNPC to acquire PetroKazakhstan. China's largest oil producer, China National Petroleum Corporation (CNPC), has agreed to pay \$4.2 billion for PetroKazakhstan, a Canada-based oil company operating in Kazakhstan. CNPC offered a 20 % premium on the market price of the Canadian company's shares to beat out an offer from India's Oil and Natural Gas Corp. The deal is clearly larger than Lenovo's purchase of IBM's PC business at the end of last year for about \$1.3 billion, which currently represents the largest foreign acquisition by a Chinese company. The PetroKazakhstan deal still requires shareholder approval at an October meeting of shareholders.

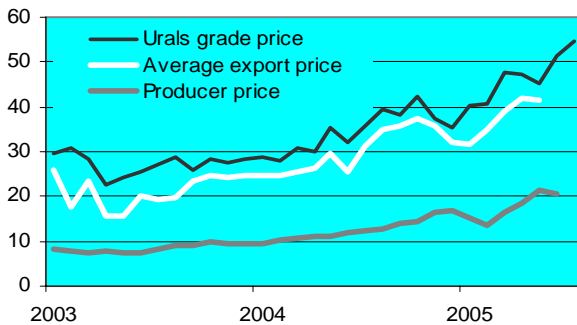
Although the sale price is considered steep and PetroKazakhstan's oil reserves will only increase CNPC's existing reserves a few per cent, the deal well illustrates China's strategic desire to expand its operations and secure access to energy and raw materials. China and Kazakhstan are already involved in several large energy transport projects (rail and pipelines) and the Kazakhstan-China oil pipeline will be completed at the end of this year. PetroKazakhstan's oil fields are located near the Kazakhstan-China oil pipeline.

China is also investing heavily in domestic exploration for oil and natural gas. CNPC announced this week that it and its subsidiaries had identified about 300 million tonnes of new domestic oil deposits in the first part of this year. If the deposits are proven and accessible, they would be roughly sufficient to satisfy China's current oil needs for one year.

Russia

Domestic oil prices soar in Russia. Despite efforts to restrain domestic oil prices by export quotas, prices have risen dramatically since the start of the year and outpaced growth of international oil prices. Last month the domestic price of oil reached an average of \$39 a barrel. Urals-grade crude, meanwhile, averaged nearly \$58 a barrel on international markets. The average export price for Russian oil is slightly lower than the Urals price because Russia still sells crude oil to CIS members at below-market prices. The ratio of domestic producer prices to export prices was about 50 % in June (40 % in June 2004). High oil prices drove up consumer prices. Retail prices for gasoline were up 18 % y-o-y in July.

Trends in Russian crude oil prices 2003–2005, \$ per barrel



Source: Rosstat, BEA

Rouble continues to strengthen. The rouble has strengthened more than anticipated mainly due to the flood of foreign currency into Russia from oil export earnings. The central bank reports that the real effective exchange rate (foreign-trade weighted) climbed 9.2 % in January-July. The rouble has this year gained 15.4 % against the euro and 3.1 % against the dollar. The rouble's real exchange rate recovered to its pre-1998 devaluation level earlier this summer.

The CBR has traditionally limited itself to dollar trading, but it announced last week it would begin euro trading on the MICEX. The CBR says dollar operations will retain priority in implementation of foreign exchange policy.

Russia posts record-low unemployment. Rosstat reports that unemployment hit its lowest level since 1991. Using the ILO methodology, Russia had slightly over five million persons unemployed as of end-July. This number corresponds to an unemployment rate of 6.8 %. The decline in unemployment has continued steadily since the

1998 financial crisis. Notably, falling unemployment at a time when industrial output growth has suffered suggests Russian economy has begun to diversify. Russia's labour force was estimated to be 75 million in July.

According to 2004 figures, 36 % of the Russian workers were employed in the public sector. Of that share, about a quarter were involved in education and another fifth in health care and social services. The largest private-sector employers were in industry (21 %) and retail trade (17 %). About 10 % of workers earned their living from agriculture.

Alarm over Russian demographic trends. Birth rates and average life spans plummeted in Russia after the breakup of the Soviet Union. Even as living standards have recovered in recent years, there has been no change in overall trends. Rosstat reports that Russian women are currently giving birth to an average of just 1.3 children. Infant mortality is also alarmingly high. Figures for 2002 show that 12.4 of every 1,000 children born in Russia died before their first birthday. The average lifespan of a Russian woman in 2003 was 72 years, while men averaged just 59 years. 2002 census figures put Russia's population at slightly over 145 million. Current projections suggest the Russian population will lose a net of 9 million persons by 2015.

CIS and CES summits in Kazan. Turkmenistan's president Saparmurat **Niyazov** did not participate in the CIS summit held August 26 in Kazan. Turkmenistan's leader indicated that his country wished to continue only as a CIS associate member. On the other hand, Russian president Vladimir **Putin** reiterated his belief in the future of the CIS and proposed that a group of experts be formed to study ways to reinvigorate the CIS. Russian foreign minister Sergei **Lavrov** said CIS countries should arrange their relations to be more in accordance with international practices. Observers interpreted the statement as an enticement for former Soviet republics to remain within Russia's sphere of influence. The summit finalised e.g. a memorandum on border cooperation and measures to promote security.

The presidents of countries in the Common Economic Space (CES), which includes Belarus, Kazakhstan, Russia and Ukraine, then met on August 27 for a separate summit. Belarus, Kazakhstan and Russia committed to signing over 40 basic documents on formation of the common economic space by next March. Ukraine wants to consider the signing of each document separately and – in line with its earlier stance – follow a policy against creation of supranational CES bodies. Ukraine explained its policy was dictated by the rules of its constitution and agreements with third-party countries.



China

Chinese central bank raises rates on foreign currency deposits. The People's Bank of China announced on August 22 that it was raising the interest rates it pays on US dollar and Hong Kong dollar denominated deposits. The ceiling on one-year deposits was lifted 0.375 percentage points to 2.0 % for US dollar deposits and to 1.875 % for Hong Kong dollar deposits. Commercial banks operating in China have thus been obliged to use the new ceiling rates since August 23. The rate hike was the third such increase in foreign-currency deposit rates in 2005. The previous hike was implemented in conjunction with the yuan's revaluation on July 21. The ongoing rate hikes are seen as part of China's foreign exchange reforms and efforts to calm speculation of a yuan revaluation.

PBoC figures show the amount of foreign currency deposits fell \$4.8 billion from June to July to \$160 billion. Thanks to the rate hike, foreign firms may now retain a larger share of their earnings as foreign currency. In addition, the incremental rate increases have encouraged Chinese companies to focus more strongly on managing interest-rate and currency risks.

Rapid rise in corporate profitability continues. In first half of 2005, profits of industrial companies were up 20 % y-o-y, which was well off the 40 % pace of on-year growth set in 2004. Growth of profitability this year has been stronger among private companies and listed corporations than for other business formats. Slowing growth suggests profitability has been impacted by stiffer competition, rising prices for raw materials and regulated retail prices. The increase in competition is particularly apparent in the automobile industry, where profits shrank in the first half of this year compared to a year earlier. Higher fuel costs and increased competition have also forced airlines to swallow heavy losses. Fuel costs are said to presently constitute two thirds of airline operating costs.

The outlook for the third quarter is fairly bleak. A survey of publicly traded companies found that 40 % anticipated losses ahead, while another 15 % expected lower profitability.

Higher profitability in the oil sector has been distributed unevenly as oil prices have risen considerably faster than state-regulated fuel prices. The large state-owned oil companies PetroChina and CNOOC are concentrated on oil exploration and production, so their profits have increased rapidly. The refiner Sinopec, on the other hand, has been generally unprofitable in China's regulated environment. The company, however, has had opportunities to make money on its crude oil production and chemical operations. Small refiners with no side businesses have had thus been hit hardest. Refiners have little hope for

improvement in the near term as the government eliminated tax supports on fuel exports for the rest of the year.

No resolution to textile trade talks. China and the European Union continued to negotiate unsuccessfully this week on the fate of Chinese clothing held up in European ports. The massive amounts of Chinese clothing and textiles held up from entering European markets are due to import quotas on clothing retroactively imposed in June. For certain products these quotas have already been filled. The EU would like to see part of the clothing held up in ports released and included under next year's quotas. The Chinese reject this proposal. The hold-up of clothing imports has been most damaging to small clothing retailers as they cannot shift production sites as easily as the large clothing companies. By some estimates, clothing prices in Europe could increase already this autumn if the held-back clothing is not allowed to reach retail outlets.

There are considerable differences on clothing imports from China within Europe. Clothing manufacturers in northern Europe have generally adjusted to the new business environment by shifting production to Asia, while companies in southern Europe have generally resisted adjustment and want protectionist limits on clothing imports.

Textile trade under WTO commitments was liberalised at the beginning of this year. Faced with a flood of Chinese clothing, however, the EU and US decided in May to limit imports. China and the EU reached agreement on limits in June, while the US continue to negotiate on the matter.

Hong Kong economy continues to boom. Real GDP in the Hong Kong special administrative region increased 6.8 % y-o-y in the second quarter of 2005. First-quarter growth was also revised upwards to 6.2 %. Hong Kong's exceptionally open economy enjoyed strong exports in the second quarter in reflection of rapid economic growth in Mainland China and the world economy generally. Goods exports climbed 11 % y-o-y, while growth in exports of services approached 8 %.

The multi-year decline in consumer prices has ended for Hong Kong's seven million inhabitants. During the first seven months of this year, consumer prices increased an average of 0.7 % y-o-y.

The government reports that its GDP growth forecast for this year will remain unchanged at 4.5–5.5 %. Higher oil prices may constitute a threat to economic growth. However, the rapid growth in the first half suggests that GDP growth is likely to come in at the high end of the GDP growth estimate range this year.

Russia

Russian consumer prices fell slightly in August. Rosstat reports an on-month decline in consumer prices of 0.1 % in August – the first such drop in two years. The overall decline in prices was driven by a 13 % drop in prices of fruits and vegetables. On-year inflation, however, was still 12.4 %, which was higher than a year earlier. Since the beginning of this year, prices have risen 8.3 %. Central bank first deputy chairman Alexei Ulyukayev believes that inflation this year will remain within the central bank's target range of 8.5–10 %. He also expects the current decline in consumer prices to continue through September. Russian economists consider the drop in prices merely of a seasonal nature.

On-year inflation in prices of *foodstuffs* slowed in August to 12.8 %; again, a reflection of decline fruit and vegetable prices. Prices of *services* rose at 21.7 % y-o-y, while *other goods* were up 6.2 %.

Record budget surplus posted in 1H05. The rapid rise in raw material prices has swollen Russia's treasury. In the first half of 2005, the federal budget took in revenues of RUB 2,386 billion (€8bn, 26 % of GDP), an amount far above the budget plan. Expenditure, on the other hand, remained close to plan at a modest RUB 1,444 billion (15.6 % of GDP). The overall budget surplus was RUB 942 billion (10.2 % of GDP).

Value-added tax revenues accounted for nearly a third of budget revenues in the first half, about the same as in 1H04. Revenues from customs tariffs and natural resource extraction fees (which mainly are related to raw materials) were substantially higher than last year. Customs revenues accounted for over a quarter of budget revenues and natural resource use fees about 15 %.

Transfers to regional budgets represented over a quarter of spending, a sharp increase in their share of total revenues. The shares of other major spending categories – defence (17 %), social sector (14 %) and security (13 %) – were stable. Debt servicing costs represented 7 % of total expenditures. Their share has fallen substantially in recent years.

Bilateral trade between Finland and Russia intensifies.

Customs Finland reports that Finland's trade with Russia increased 29 % y-o-y in the first half, making Russia Finland's second largest trading partner. Indeed, the level of trade with Russia now nearly matches that of trade with Germany, Finland's largest trading partner. The value of Finnish exports to Russia in the first half was €2.5 billion, which translates into growth of 33 % y-o-y. Imports were valued at €3 billion, an on-year increase of 25 %.

Exports to Russia continued to be dominated by investment and consumer goods. Telephone equipment had a 26 % share. Exports of passenger cars soared 41 % y-o-y in January-June, and accounted for 7 % of total exports. Energy products accounted for about two-thirds of imports. Crude oil imports alone accounted for 39 % of imports from Russia in the first half. Most other imports were raw materials: e.g. iron (7 %), other metals (7 %) and raw wood (9 %).

Finland's role as freight transit corridor to Russia increases.

The value of *road freight* passing through Finland in January-June was €9.3 billion (up 4 % y-o-y), and had a value 3.7 times larger than Finland's own exports to Russia. Automobiles accounted for 23 % of all transit road freight in the first half of 2005. Transit freight of cars has skyrocketed (up 89 % y-o-y). Transit of electrical appliances has also increased dramatically.

Transit rail freight accounted for about 7 % of transit freight moving through Finland to Russia in 1H05. Tonnage, however, was down 4 % y-o-y.

Credit bureaus launch operations. The new act on credit histories introduced in June gave Russian banks until September 1 to make agreements with at least one credit information provider. The new law is designed to make it easier and cheaper for households to get credit by reducing the credit risk exposure of lenders. So far, four credit information providers have been established. Two are subsidiaries of international credit reporting agencies, one is a subsidiary of state-owned Sberbank, and one is owned by a consortium of major private banks. The government hopes that dividing of the market among several credit bureaus will prevent monopolisation of credit history services. On the other hand, problems may ensue from the fact that information on individual and corporate customers with accounts in several banks is held in a variety of registries.

Putin displays surprising interest in welfare issues. On Monday (Sept. 5), president Putin convened the cabinet, parliament and council of state to discuss problems related to health care, education, housing and rural issues. Observers note that the topics of presidential focus – all political sore points – are precisely those where the government has failed worst. The president said that oil revenues earlier committed to investment should now be used to cover running social costs. Putin told his audience to ensure that these social sector measures worth RUB 115 billion (€3.2bn, 0.5 % of GDP) would be implemented without endangering economic balance or accelerating inflation.

China

Chinese and EU leaders meet in Beijing. At the annual EU-China summit in the early part of this week, Britain's prime minister (and rotating EU president) Tony **Blair** and EU Commission president Jose Manuel **Barroso** met with Chinese premier **Wen Jiabao**. The parties signed agreements that included increased cooperation in space and environmental protection, further discussion on the energy and transport sectors, as well as extensions of earlier agreements to the EU's newest members. The parties decided to have more meetings between deputy foreign ministers. EU and Chinese companies penned several deals during the summit. The largest deal was between China's largest air carrier China Southern Airlines and Airbus on a deal that included ten planes worth nearly \$2 billion. The planes would be delivered in 2007–2008.

China and EU resolve dispute over clothing and textile quotas. China and the European Union have finally agreed on the conditions for releasing Chinese clothing and textile imports held up at European ports. Under the deal, half of the blocked clothing and textiles would be released without sanctions. The other half will be included under next year's import quotas for Chinese goods. All of the clothing and textiles sitting in European ports should be released to the EU market by the end of November. The agreement further stipulated that any of China's unused portions of its textile and clothing quotas may be transferred to next year. The lack of an agreement would have increased prices of clothing and textiles in Europe this autumn. Aside from opposition from Lithuania, all other EU members approved the arrangement.

European firms satisfied with China's development. The China unit for the EU Chamber of Commerce has just published a survey of European companies' assessments of the direction of Chinese development. Most surveyed companies felt that China's efforts to meet its WTO commitments had progressed as planned. The survey, however, also found some companies felt that the Chinese were deliberately trying to prevent or delay their commitments by exploiting loopholes in WTO commitments.

EU companies generally praised China's efforts to develop enforcement of intellectual property rights (IPR), which include industrial patent rights and copyrights. Last year China lowered the threshold to bringing civil cases for violations of IPRs. Nevertheless, European companies would like to see better oversight of IPRs, as well as general improvements in the regulatory environment. Copyright violations, for example, increased last year. Most court disputes over IPRs, however, were between Chinese companies.

While China has reduced the state's role in the economy, European companies said that much remains to be done before China can be granted market-economy status. Among other things, China needs to phase out price regulation. The survey respondents also hoped that treatment of foreign and domestic firms would be equal and that China would broadly apply international standards.

Government continues to bail out stock brokers. In recent months, China's central bank had increased its injections of capital support to the troubled stock brokerage sector. At a July seminar arranged by the People's Bank of China, it was reported that the capital injections were mainly directed to brokers via two central bank investment firms. The money is also provided to brokerage firms in the form of low-interest loans from state-owned banks (i.e. China Construction Bank and Industrial and Commercial Bank).

In May, the Chinese credit rating agency Xinhua Far East published a research report on China's securities sector. Tellingly, in a sector with just over 100 companies last year, the 50 top performers collectively posted losses of nearly CNY 5 billion (€500m). Moreover, among the top 50 brokers, 23 needed capital injections of nearly CNY 22 billion (€2.2bn). Some of last year's lousy performance is explained by a general decline in Chinese stocks. Indeed, in the last four years, the total market value has fallen CNY 1,000 billion (€100bn) despite China's booming economic development. Another potential explanation for broker misery is the absence of instruments to help brokerages hedge against risks arising on China's capital markets. Some observers point out that capital injections merely increase moral hazard and suggest that instead the central bank should focus on helping brokers improve their risk management skills and internal control systems. The most recent efforts of the state to improve supervision of domestic brokers and liberalise capital markets may also promote related reforms together with foreign investment in China's local brokers.

Shanghai and Shenzhen bourses, A-share indexes

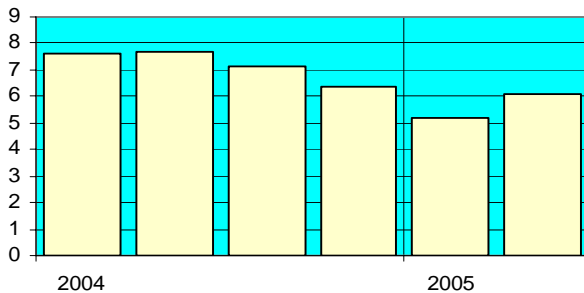


Source: CSRC

Russia

Russian GDP growth accelerates slightly. Rosstat reports GDP rose 6.1 % in the second quarter, a clear increase from 5.2 % in the first quarter. Nevertheless, the overall 5.7 % growth posted in the first half was well below the 7.6 % growth of 1H04. The economy ministry forecasts that GDP will grow 5.9 % for all of 2005 (which means growth needs to accelerate a bit in the coming months). The consensus outlook of major investment banks from July anticipated that economic growth would come in 5.7 % for this year.

Quarterly GDP growth 2004–2005, %, y-o-y



Source: Rosstat

Central bank plans changes in monetary and exchange rate policies. Senior deputy chairman Alexei Ulyukayev said the Central Bank of Russia was considering shifting its monetary policy emphasis towards subduing inflation. Its current policy, which stresses stabilising the nominal exchange rate of the rouble, does not well serve the government's inflation-fighting goals. Russia's abundant export earnings have created strong demand for the rouble. To prevent further rouble strengthening, the CBR has been forced to emit more roubles in order to purchase dollars, exacerbating the problem of excess liquidity.

However, contrary to the above tightening of monetary policy, Ulyukajev noted that the central bank would likely lower the refinancing rate at the end of this year by half a percentage point if the inflation goal of 8.5–10 % is met. The refinancing rate has remained unchanged at 13 % since June 2004. In addition, the central bank is planning to eliminate its requirement that export firms sell 10 % of their foreign currency earnings on domestic currency exchanges.

Duma convenes its autumn session. Prior to adjourning for the summer holidays, the Duma passed legislation that included rules for public-private partnerships and a shortening of the statute of limitations to three years on disputed privatisation sales. The Duma also approved bills on

excise taxes for alcohol, tobacco and fuels, as well as changes in the mineral extraction tax for 2006. Changes in the rules on taxation of small firms were also approved.

The autumn agenda begins in earnest on September 22 when the 2006 budget comes to the floor. Also slated are amendments to the mining act to limit foreigners' access to strategic deposits, as well as the never-ending tinkering with the forest and water codes. The Duma's to-do list includes amendments to the land code concerning pricing of land parcels.

Rosneftegaz takes huge loan. Rosneftegaz, the holding company established several months ago solely as a vehicle for managing the shares of state oil company Rosneft, negotiated last week for a record three-year \$7.5 billion syndicated loan. The lending syndicate comprises four major Western banks. The loan will be secured with 49 % of Rosneft shares. Rosneftegaz will use the financing to complete payment on Gazprom shares it acquired earlier.

After the merger of Rosneft and Gazprom ran into trouble last spring, all of Rosneft's share capital was transferred to the newly created Rosneftegaz corporation, which in turn acquired 10.74 % of Gazprom shares. The arrangement increases the state's stake in Gazprom to above 50 % – a move that allows free trading in Gazprom shares. Rosneft hopes to list its shares next year and use the money raised from the share emission to strengthen its finances and pay off the current loan. Rosneft has been heavily indebted since its purchase of Yukos core production unit, Yuganskneftegaz, early last spring.

Russia and Germany agree on gas pipeline. Russia's Gazprom and its German counterparties Eon and BASF signed a memorandum of understanding on the joint implementation of a natural gas pipeline to run under the Gulf of Finland to Germany. The over 1,200 km gas pipeline will have an annual capacity of 55 billion cubic metres and will cost approximately \$4 billion. The pipeline is scheduled to come on stream in 2010.

Russia and China move up in UN living standard rankings. In this year's *Human Development Report*, the UN Development Programme ranked Russia 62nd in terms of living standards just after Malaysia. The comparison ranked 177 countries in terms of life expectancy, education and income levels in 2003. Russia got a boost in the rankings from its high literacy rate, but was hurt by short life expectancy. The survey noted that Russian living standards have improved slightly over the past decade.

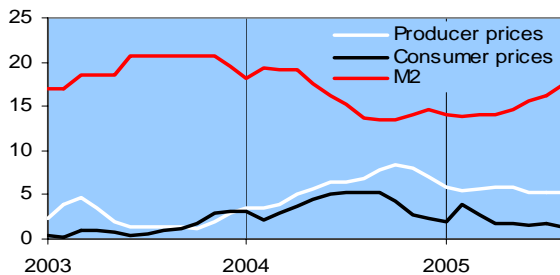
The standard of living in China was among the fastest rising in recent years. China's latest ranking was 85th, following the Philippines. Despite the sluggish pace of reforms in the social sphere, China's climbed in the rankings on the overwhelming strength of its economic expansion.

China

Slowdown in Chinese consumer price rise continued in August. Consumer prices in August were up just 1.3 % from a year earlier – the lowest inflation since September 2003. Inflation was still running at 1.8 % in July. Food prices have been the largest single factor influencing inflation in recent years. Food price inflation slowed considerably in 2004 as a result of good harvests. This year's harvests are also projected to be quite good. Food was just 0.9 % more expensive in August than a year earlier. Inflation has also been dampened by declines in prices for clothing, phone calls, home appliances and cars. Services were up 4 %.

The rise in producer prices, on the other hand, has remained steady throughout this year. Producer prices were up 5.3 % y-o-y in August. Fuel prices have risen sharply. Coal prices were also up strongly from a year earlier.

12-month change in consumer and producer prices, M2, %



Sources: NBS and PBoC

Money supply growth accelerated this summer. The People's Bank of China has set this year's broad money supply target (M2, which includes physical cash in circulation and bank deposits) at 15 %. The money supply increased steadily at a pace slightly under 15 % from summer 2004 to late spring this year, then accelerated this summer. M2 was up 17.3 % y-o-y in August. The recent rapid money supply growth largely reflects China's swelling foreign trade surplus and rising capital imports. The central bank has not completely sterilised the effects of the massive influx of money. China's money market is currently extremely liquid, which has driven down money market rates.

Foreign trade surplus continues to balloon. China posted a foreign trade surplus of \$10 billion in August, pushing the overall trade surplus for this year to \$60 billion. This amount is half again larger than the all-2004 surplus. The surplus for this year is expected to exceed \$100 billion. The expanding trade surplus was mainly the result of slowing import growth, which fell to 15 % y-o-y

in January-August. In the same period, exports climbed at over 30 %. There were signs in August, however, of a pick-up in import growth; imports rose nearly 24 % y-o-y. A slowdown in investment growth is one of the reasons behind the slowing growth in imports.

IMF recommends increased flexibility in China's exchange rate. The IMF executive board concluded its Article IV consultation with China at the beginning of August. The IMF currently expects China's total output to grow 9 % this year, while the average pace of inflation will slow to 3 %. The current account surplus is anticipated to swell to \$114 billion.

The IMF board praised China's government for its macroeconomic policies in dealing with the threat of economic overheating that has emerged in recent years. The Fund sees revived investment growth caused by a banking system awash with liquidity as the largest risk to the Chinese economy at present. Protectionist measures applied by other countries to Chinese goods could also hurt export growth. Finally, China's economic development could be held back by swings in oil prices and a "disorderly unwinding of global current account imbalances."

The IMF board was cautious in its comments on China's exchange rate regime. The board recommended that China increase exchange rate flexibility rather than rely on sequential revaluations. It also encouraged China to use the flexibility built into its new foreign exchange regime to its advantage. Several board members, however, supported incremental and cautious exchange rate moves. Although the IMF still sees administrative regulation as a necessary part of monetary policy, it encouraged China to move towards more active interest rate policies and the use of other market-based mechanisms. The IMF said the government could make its monetary policy more effective by increasing the central bank's operational freedom. The IMF continued to stress the importance of structural reform, especially with regards to the banking sector, state-owned enterprises and the public economy.

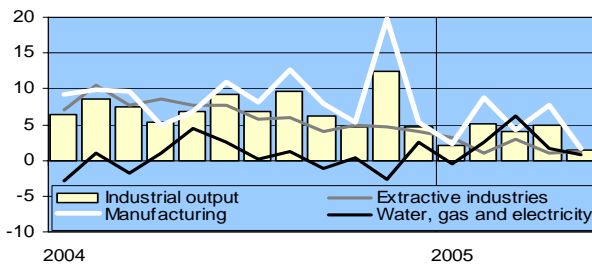
Macao's economic growth slows slightly. Total economic output of the Macao special administrative region grew 8.2 % y-o-y in the second quarter. The first-quarter growth figure was also adjusted upwards to 8.6 %. Investment growth in the second quarter was extremely brisk due to numerous large construction projects. On-year growth in fixed investments exceeded 61 %. At the same time, goods exports were off more than 30 % y-o-y and spending by visitors to Macao (excluding the region's all-important gambling industry) was down nearly 5 % y-o-y in the second quarter. Growth of the Macao economy, which is heavily dependent on its service sector, has slowed considerably from its 2004 pace (28 %). Even so, the current pace is still about the average for the 2000s.

Russia

Russian industrial output growth slowed in August.

On-year growth in industrial output slowed to 3.4 % in August. In the first eight months of 2005, industrial production grew at 3.7 %, or just half of last year's growth pace. Growth in *mineral extraction industries* has slowed this year due to a lower growth in oil output. In January-August, annual growth in mineral extraction industries was just 1.2 %; oil production itself was up 2.2 %. On-year growth in *manufacturing* was also off last year's pace. January-August growth reached 5.7 %, compared to 9 % in the same period in 2004. Manufacturing growth remains driven by the electronics industry and production of industrial machinery and equipment. *Gas, water and electricity* production grew 2.1 % y-o-y in January-August.

Industrial output and its main components 2004–2005, % change y-o-y



Source: Rosstat

Oil companies assent to freeze on retail gasoline prices until year's end.

Early this week, Russia's biggest oil companies agreed to temporarily freeze domestic gasoline prices. Russian energy minister Viktor **Khristenko** denied that the oil companies' decision had any connection to the Russian cabinet's earlier discussions concerning a variety of measures to stem the rise in domestic gasoline prices, which have risen faster than international prices this year. The large oil companies' move to freeze retail gas prices diminishes competition on the gas markets and makes it harder for smaller gasoline distributors to turn a profit as the price freeze does not apply to wholesale gas prices.

World Bank survey finds improvement in Russian business climate; Fraser survey gives harsher view. In the latest annual survey *Doing Business 2006*, Russia ranked 79th out of a field of 155 countries based on 2004 data. The study, co-sponsored by the World Bank and the International Finance Corporation, praised the Russian government for rapid implementation of reforms, which, it noted, had made such activities as starting a company a bit simpler and cheaper. The behaviour of Russian tax offi-

cial, on the other hand, appeared to be more capricious than ever. Licensing practices also came in for harsh criticism. Russia out-ranked other big emerging economies such as China, India and Brazil.

The Canadian Fraser Institute's *Economic Freedom of the World Report* assesses 2003 figures. The report, which examines economic freedom and its impact on world economies, ranked Russia near the bottom at 115th out of 127 countries surveyed. China, India and Brazil all surpassed Russia. Russia got notably low scores (124th) for its financial markets on the basis of such yardsticks as money supply growth, fluctuation and levels of inflation, as well as currency controls. Positive changes from 2002 could be seen in development of property rights, regulation of corporations and lending markets, as well as labour laws.

Gazprom takes huge loan to purchase Sibneft.

News sources report gas giant Gazprom aims to obtain a \$12 billion syndicated loan from six Western banks to purchase Sibneft, Russia's number-five oil company. Gazprom plans to issue bonds as a part of the refinancing package. Sibneft, owned by Roman **Abramovich**, is said to be worth \$11.7 billion. The impending deal has been widely discussed since July, when president Vladimir **Putin** announced Gazprom was in negotiations to acquire Sibneft. The sale plan was evidenced by the record \$2.3 billion dividend pay-out to current shareholders voted for at this month's Sibneft shareholder meeting. If the sale plan goes through, it would be the second large loan taken in a short time by a state company for re-arranging the energy sector. Rosneftgaz last week announced plans to borrow \$7.5 billion to purchase Gazprom shares.

Putin now responsible for appointments of nearly a third of regional governors.

Under legislation that entered into force at the start of this year, it is the president who nominates regional governor candidates. In practice, the president decides governorships, although the nominal formality of presenting the nominee remains with regional parliaments. In the past, governors were selected by direct popular vote. Governors appoint half the representatives in the upper-house Federation Council. The president now also wields the power to dismiss any governor who does not enjoy his confidence. Last March, president Putin dismissed Vladimir **Loginov**, governor of the Koryak autonomous okrug, after the region suffered home heating and hot water shortages last winter.

As of early September, the governors of 27 of Russia's 89 regions had been appointed by the president. Twenty of the appointments went to incumbent governors; only seven governors are actually new to the job. The nomination procedure has won praise for bringing in leaders without ties to regional clans. On the other hand, the lack of connections could impair the new leader's ability to get things done.



China

OECD report anticipates continued strong economic growth for China. The Organization for Economic Cooperation and Development last week released its first economic survey for China. It estimates that real GDP will grow at a rate of 9.0 % this year and accelerate to 9.2 % in 2006. The report predicts that the current account surplus will hit \$100 billion both this year and next year. It sees the private sector making an ever-increasing contribution to the nation's economic growth, noting that the private sector now accounts for over half of China's total production and an even larger share of exports. The OECD reserved special praise for the Chinese government's successful policy choices, which have channelled economic growth to reducing poverty.

The report encouraged China to adopt a more flexible foreign exchange policy in order to simplify implementation of monetary policy and carry on with the foreign exchange reform launched in July. The OECD reminded China that greater efforts to avoid the issuing of non-performing loans are only a start in banking sector reform. In the long run, banking sector governance needs to be developed. The report also advised China to open up and develop its capital markets so that capital could be deployed more efficiently.

Rapid growth in fixed investment. In January-August, nominal growth in urban-area investment exceeded 27 % y-o-y. The pace of investment has remained steady throughout this year. Fixed investment growth apparently accelerated slightly in August. In January-August 2004, investment rose 30 % y-o-y in nominal terms. However, the rise in investment goods prices has decelerated about five percentage points compared to last year and, hence, the pace of real investment growth is still running slightly ahead of last year. The Chinese government has targeted 15 % investment growth for 2005.

Highest fixed investment growth in January-August was registered by the coal industry (82 % y-o-y), producers and distributors of electricity, water and gas (35 %), and in rail construction (39 %). Investments in iron and steel production were off from last year's blistering pace, but still grew a respectable 25 %. Growth in investment in production of other metals continued to boom at nearly 40 % y-o-y.

Lower foreign direct investment in China. Direct investments contracted 3 % y-o-y in the period January-August to \$38 billion. The decline in investment began in

April. By some estimates, the pull-back in investment reflects weaker profitability of foreign companies in China. The negative FDI trend this year remains despite the fact that China revised its figures for last year downwards. Apparently, the total amount of realised direct investment in China last year was closer to \$55 billion than the over \$60 billion earlier touted by officials.

Foreign investment inflows are off 28 % y-o-y from the US and 9 % from Asia. On the other hand, investment from Europe was up 30 % y-o-y, and investment funnelled via tax havens up 29 %. Despite declines in investment from Asia, the region remains by far the largest source of investment for China.

Foreign owners now have stakes in three of China's four large state banks. US-based Goldman Sachs and American Express, and Germany-based Allianz invested \$3 billion in Industrial and Commercial Bank of China (ICBC) at the end of August. In all, they acquired a 10 % stake in state-owned ICBC. Bank of China (BOC) also took on a new large foreign investor at the end of August, when Singapore's state holding company Temasek bought a 10 % stake. The deal includes a commitment from Temasek to invest \$0.5 billion in BOC shares in conjunction with a later listing. In early August, a consortium of the Royal Bank of Scotland, Merrill Lynch and businessman Li Ka-Shing acquired a 10 % stake in BOC. The Bank of America's approximately \$3 billion investment in China Construction Bank in June was followed in July by a \$1 billion investment from Temasek. Foreign investors have also taken positions in some smaller commercial banks. Agricultural Bank of China is now the only large state bank without foreign ownership.

China's robust economic growth offers large opportunities for retail banking, e.g. providing credit cards, loans and insurance. While the sector remains burdened by a huge stock of non-performing loans (over €100 billion as of end-June), poor risk management and a lack of internal controls, foreign investors seem to be counting the fact that the large state banks have such importance for the national economy that their investments are relatively safe. Some observers have also suggested that investment in state-owned banks may be a more cost-effective approach to penetrating China's banking sector than attempting to build independent branch networks.



Russia

Russia's GDP growth accelerates slightly. Rosstat reports that growth in the core production sectors picked up slightly in July and August compared to the first half of the year. The output surge was led by higher growth in *retail sales*. On-year growth in the January-August period was 11.6 %. *Construction* was up 8.0 % in the period. Although construction output growth has accelerated from the first half of the year, it clearly lagged the 12 % growth pace of 2004. *Industrial output* grew 3.7 % in the first eight months of the year, a rate less than half of the growth a year ago. *Transport* was up 2.6 % and *agricultural output* 2.2 % in January-August.

Russia's economy ministry estimates that GDP grew 5.8 % in January-August, or 0.1 percentage points more than during 1H05. The Russian government's GDP growth target for this year is 5.9 %.

One fifth of banks excluded from new deposit insurance scheme. The deposit insurance scheme introduced to protect Russian savers effectively entered into force on September 27, the Central Bank of Russia's deadline for banks to join the system. Of the 1,150 banks that applied for acceptance into the deposit insurance scheme, 927 were admitted. These banks together represent 99 % of all deposits from private persons in Russia. In addition, the deposit insurance agency has drawn up plans to increase the deposit guarantee per depositor from 100,000 roubles to 280,000 roubles over the next two years.

Wide praise has been given to the CBR's decision to apply strict rules in its inspections of applicant banks, which has led to exclusion of weak banks from the scheme. Russians' confidence in insured banks is expected to increase, which will intensify competition in the banking sector. Whereas depositors earlier chose their bank mainly on the basis of reputation, they are now expected to shop around for the most competitive interest rates. A potential downside of the scheme is increased moral hazard, as banks may feel encouraged to take on risk.

Local administration reform postponed. Although local administrative reform was supposed to be launched at the start of 2006, the Duma's has backed off with an amendment to grant regions the possibility to postpone implementation of administrative reforms until 2009. Several Duma deputies felt the amendment was needed, as many of Russia's 89 regions have not yet made adequate preparations for the reform. Even so, several unofficial reports suggest that about half of regions are ready to start implementing reforms already next January. Among other things, the law specifies local administrative tasks and their financing sources.

Gazprom buys Sibneft. The march to concentrate Russia's strategic energy sector in state hands continued this week with Gazprom's September 28 purchase of the majority stake in Sibneft. The €10.8 billion transaction increased Gazprom's stake in Sibneft to over 75 %. The deal constitutes the largest corporate acquisition in Russian history and makes Gazprom Russia's fifth-largest oil producer. The deal is part of Gazprom's declared intention to become one of the world's leading energy companies. In addition to diversifying its production to include production and refining of oil, Gazprom is also getting involved in electrical power generation. Gazprom subsidiary Gazprombank even holds a share in the nuclear power plant constructor Atomstroieksport and is rumoured to be considering the purchase of a company that produces nuclear power plant equipment.

The wisdom of Gazprom's expansion has yet to be evidenced by any increases in productivity or the manifestation of any significant synergies from diversification. Even without proof that its strategy is working, however, Gazprom shares are selling well. The company's share price has risen substantially on both the Moscow and London exchanges. The price of Gazprom American Depository Shares has nearly doubled in the last three months.

Gazprom last week narrowed its list of potential partners in the development of the massive Shtokman gas field to just five candidates: Norsk Hydro and Statoil of Norway, ConocoPhillips and Chevron from the US, and the French Total. Two or three of these will be chosen for the final consortium in which Gazprom will hold the majority (51 %) stake.

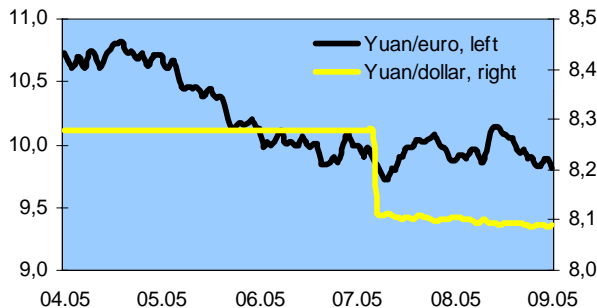
Telecoms lead in transparency. Last week, international credit rating agency Standard & Poor's published its annual survey of the corporate cultures of Russia's 54 largest listed firms. Companies in the telecommunication sector did well: MTS topped the survey, and six of Russia's ten most transparent firms were telecoms. The least transparent firms tended to be in the energy sector.

The S&P survey has in the past four years found steady development of corporate culture in Russia overall. Increasing access to financing through listing on the New York Stock Exchange, with its high regulatory standards, provided one of the strongest motivations for increased transparency. The survey also found Russian companies today provide more comprehensive reporting in English and use the Web more extensively to disseminate corporate information than earlier. They have also shifted to internationally accepted accounting methods. Even so, ownership relations remain obscure and every company surveyed had at least one owner with 25 % voting power. Only half of the companies surveyed had released financial statements in compliance with official requirements ahead of their shareholders' meeting. Only two firms published complete information on board and executive management pay.

China

China's exchange rate reform proceeds. The People's Bank of China announced on September 23 that it was expanding the yuan's fluctuation band from $\pm 1.5\%$ to $\pm 3\%$ in relation to foreign currencies other than the dollar. It left untouched the yuan's $\pm 0.3\%$ allowed daily fluctuation band relative to the PBoC's official average exchange rate for the dollar. Chinese banks may now freely set rates for buying and selling foreign currencies other than dollars and the guidelines on setting dollar exchange rates have been relaxed by broadening the buy-sell spread. Although the central bank announced it was abandoning its dollar peg in July and then allowed the yuan to appreciate slightly, it has held yuan-dollar exchange rate fairly steady since the revaluation. It has never been clear why China wanted to have quite narrow fluctuation band with many currencies at the same time.

Yuan/dollar, yuan/euro rates, April-September 2005



Sources: ECB, Federal Reserve

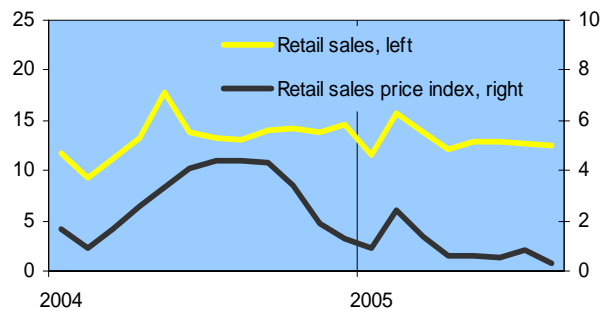
Rapid growth in industrial output. The pace of industrial growth has remained very steady this year, with August industrial output up 16.0 % y-o-y. The January-August figure was 16.3 %. This year's robust production growth has been supported by booming exports and increased domestic consumption. Nevertheless, the industrial output figures do not give a complete picture of production trends as they only include private companies with yearly sales of over CNY 5 million (€500,000) and all state-owned enterprises.

August industrial growth was led by tractor production (80 % y-o-y), paper production (25 %), as well as production of iron, steel and other metals (about 28 %). Although production of passenger vehicles surged 46 % y-o-y in August, the increase was partly a reflection of the fairly low production levels of July-August 2004. In addition, car sales are expected to pick up slightly towards the end of this year. Although car production grew

only about 5 % in the first half, the subsequent spurt in growth lifted the January-August figure to 15 % y-o-y.

Steady rise in domestic consumption. August retail sales growth climbed to 12.5 % y-o-y in nominal terms to slightly over CNY 500 billion (about €50bn). Although nominal growth in the value of sales has slowed slightly this year, inflation has also slowed. Moreover, growth in retail sales in real terms has remained over 10 % for the entire year. August retail sales growth was led by fuels (41 % y-o-y), communications devices (18 %) and clothing (21 %). Sales in food services expanded 16 % y-o-y and accounted for nearly 15 % of total retail sales. A rapid rise in household incomes has helped boost consumption. China's official target for retail growth this year is 13 %.

Value of retail sales and change in price index, % y-o-y



Source: NBS

China drops in WEF competitiveness survey. According to the annual *Global Competitiveness Report* published by the World Economic Forum (WEF), China dropped three places from last year to 49th. In 2002, China ranked 33rd. Part of the decline in rankings, however, merely reflected an increase in the number of countries surveyed. China's ranking in the inflation category fell substantially after its annual inflation rate accelerated to 4 % last year.

The report, which now covers over 100 nations, incorporates several yardsticks to measure the quality of macro economic environment, public institutions and technology. The WEF noted that China's ascendancy into the group of highly competitive nations had been thwarted by the weakness of its public institutions. On the other hand, China's macroeconomic environment now ranks 33rd best in the world.

Finland again topped the list as the world's most competitive country. Taiwan slumped to fifth place, while Hong Kong fell seven places to 27th. Russia lost five places to rank 75th. The WEF did not evaluate Macao's competitiveness.

Russia

Russia's current account surplus continues to grow.

Balance-of-payments figures released by the Central Bank of Russia show that the country's current account surplus climbed to \$45 billion in the first half of the year, an increase of 70 % from 1H04. The current account surplus compares to about 13 % of estimated first-half GDP (approx. \$329bn). The trade surplus exceeded \$58 billion. Goods exports in the period reached \$112 billion, some 60 % of which consisted of oil and gas. The value of goods imports was \$54 billion. Russia's services deficit was about \$6 billion.

Share prices continue to soar. Now in its tenth year, Russia's RTS share index broke through the thousand-point ceiling on September 30. The index continued its upward journey into untested highs this week without the profit taking that typically marks the end of a quarter. On Tuesday (Oct. 4), trading closed with the RTS at 1,045. The RTS is up 71 % for this year; nearly half of the run-up in prices has occurred since August. The RTS' market capitalisation currently exceeds \$57 billion. RTS mainstay *Lukoil* has a weighting of over 16 %. Its share price has risen 42.5 % since early August. Share prices for other oil companies have also rocketed since late summer as world oil prices have climbed. *Tatneft* led the charge with a 73 % increase in the period.

State-dominated *Sberbank* (with a nearly 13 % RTS weighting) has become one of the most popular investment targets outside the energy sector. Its share price has jumped 25 % over the past two months.

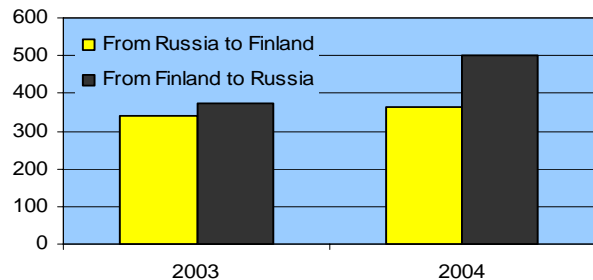
While the sharp increase in share prices largely reflects Russia's strong earnings on oil exports, it also reflects the background trend of foreign investors generally increasing their investments in developing markets. Moreover, although Russia's investment climate has still not cleared enough to ignite foreign direct investment, there is general perception that political risk is waning. The result is that capital inflows into the country go to the purchase of stocks rather than directly to real-economy investments. The federal government's finances are in excellent fiscal shape and short-term currency risk is considered small. In fact, rouble-denominated assets may gain if the central bank lets the rouble to appreciate.

Finnish FDI to Russia up sharply in 2004. Detailed balance-of-payments figures released by the Bank of Finland at the beginning of the week show that the stock of Finnish direct investment in Russia increased 33 % last year to €500 million at year's end. The Finnish central bank reported Finns invested some \$80 million in Russia

in 2004. Due to exchange rate changes, the value of the investment stock added another €45 million.

Russian direct investment in Finland also increased 8 % in 2004. The value of total Russian FDI in Finland at year's end was €370 million. Bank of Finland figures are based on information volunteered by companies, and the data do not include investments made via subsidiaries in third countries.

Total foreign investment stocks 2003–2004, €million



Source: Bank of Finland

Corporate profits in January-July up 41 % y-o-y.

Rosstat reports that in the first seven months of this year Russian firms (excluding banks, insurance companies and agricultural enterprises) earned profits of RUB 1,570 billion (€46bn), an increase of 41 % y-o-y from the same period a year earlier. Profits in 2004 were also up relative to 2003. In particular, energy-sector profits shot up nearly 90 %, which helped boost average firm profitability figures considerably. Above-average growth showings were also posted in retail sales (50 %) and real estate-related services (45 %). Lower profitability relative to 2004 was seen only in the construction sector (down 2 % y-o-y).

Some 62 % of all companies turned a profit in the first seven months of 2005. Nearly all companies in the transport sector and in retail sales made money. On the other hand, nearly half of all companies involved in the distribution of electricity, gas and water operated in the red. Surprisingly, 46 % of companies involved in mineral extractive activities were unprofitable.

Russia's grain harvest generally on track. Rosstat figures show that as of the beginning of September, the net amount of grain harvested (threshed and dried) was nearly 60 million tonnes, a couple per cent higher than at the same point a year ago. Nearly 65 % of sown areas have been harvested. Although grain harvests in the Ural and Siberian federal districts have been hampered by rains, the grain harvest has generally proceeded uneventfully. Russia expects to match the 2004 net grain harvest of 78 million tonnes.

Good grain harvests in the 2000s have helped make Russia a grain exporter. Grain exports are expected to exceed 9 million tonnes in the 2005–2006 harvest period.

China

Chinese auditors give negative assessment of use of public funds in 2004. In its annual inspection, China's National Audit Office (CNAO) identified abuses in all of the 32 ministries and state agencies it audited. Most abuses had to do with improper reporting of expenses, excessive billing of customers, hiding assets or embezzlement. The CNAO found similar abuses when it inspected 55 organisations last year. The CNAO's authority was been expanded in recent years, although the agency's powers to make a significant impact remain limited.

Ministries inspected this year included the Ministry of Foreign Affairs, Ministry of Finance, Ministry of Commerce, and the National Development and Reform Commission (NDRC). For example, the NDRC failed explain the use of CNY 7.5 billion (€750m) in non-dedicated grant money. The Ministry of Commerce left unused over 90 % of its CNY 600 million supplemental budget. The agriculture and education ministries explained loosely afterwards where over CNY 6 billion went. The national tourism office overbilled travel agencies some CNY 6 billion. The national sports administration funnelled an extra CNY 550 million into its partner enterprise.

Chinese estimates reveal that over 4,000 state bureaucrats fled the country in recent years, taking with them about CNY 5 billion (€500m) in state funds.

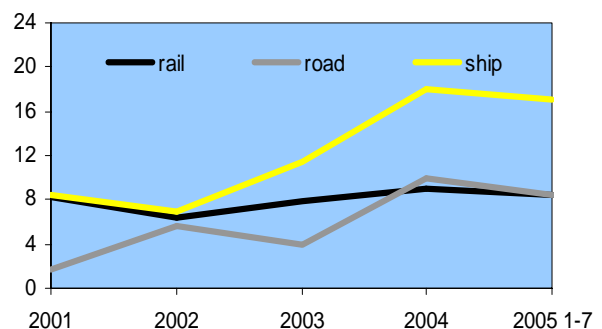
Creditworthiness of banks on the rise. International credit rating agency Standard & Poor's raised its rating one notch on the foreign-currency bonds of five Chinese banks. The upgrade means those banks can now borrow from abroad at lower rates. The five-bank group includes the state-dominated *Bank of China*, *Industrial and Commercial Bank of China* and *China Construction Bank*. The long-term bonds of banks in this group now stand at BBB+ and short-term paper at A-2. S&P reports the risk management processes of Chinese banks have improved substantially along with the quality of bank assets. On the other hand, the banks still receive state support and S&P does not expect the level of subsidies to fall in the medium term even if foreign investors take larger stakes in them. Potential problems identified by S&P include increased difficulty in monitoring the rapidly evolving banking sector and the impact changes in state policy have on the quality of assets. As of end-March, banks held a total of CNY 460 billion (€46bn) in foreign debt, 12 % more than a year earlier.

Strong growth in China's transport sector. Rapidly expanding foreign trade and surging domestic demand have increased freight transport services in recent years.

The volume of transported freight rose 10 % y-o-y in 2004, and growth has stayed on the fast track this year.

Growth in the transport sector has benefited many Chinese companies. For example, the shipping company CO-SCO is now the world's second largest shipping company, with its first-half profits exceeding CNY 10 billion (€1bn). Growing markets have also encouraged nearly all of the large international players in the logistics business to build up networks in China. The situation of foreign companies will improve in December, when China's WTO commitments will permit foreigners 100 % ownership of companies in the logistics field. All international logistics firms in China are currently operated jointly with a Chinese partner. Operations in the transport sector overall has eased in recent years as the state has improved and substantially increased transport routes. China will continue its infrastructure development also in coming years; e.g., the state plans to invest CNY 100 billion in improving the railway grid over the next 15 years.

Growth of freight volumes, % y-o-y



Source: NBS

Fraser Institute: China climbs economic freedom index. In its latest annual *Economic Freedom of the World Report*, Canada's Fraser Institute found that economic freedom in China slightly increased in 2003. However, due to an increase in the number of countries this year to 127, China's overall ranking fell two places to 86th. The report compares size of government, legal structure and protection of property rights, access to sound money, the regulatory environment and international trade. China made its best showing, 38th place, in the international trade category. On the other hand, regulation of China's credit markets gave China the fourth-worst rank in the category (beating out Mozambique, Syria and Myanmar). The Fraser Institute noted that the legal system and protection of property rights in China had improved, that barriers to trade have diminished and that regulations of business operations have eased. The report once again named Hong Kong the world's most open economy (a position it has held since 1980). Taiwan ranked 24th.

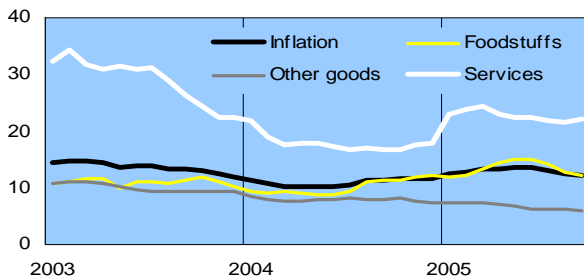
Russia

Russian consumer prices up in September. Inflation in September was 12.2 % y-o-y and 0.3 % m-o-m. After having fallen in August for the first time in two years, consumer prices rose again in September. Consumer prices are up 8.6 % since the start of the year.

Prices for *services* climbed 22 % y-o-y in September, settling into a steady pace after spiking early this year. The rise in *food* prices has also slowed since the start of the year, with prices falling for the second month in a row. On-year inflation of food prices was 12.1 % in September. Prices for *other goods* were up 5.9 % y-o-y, with the biggest increases seen in gasoline prices.

In reaction to the pickup in inflation, the government and CBR have revised their inflation forecast for 2005 upwards to a range of 10–11 %.

12-month change in consumer prices, 2003–2005, %



Source: Rosstat

Vneshtorgbank acquires CBR's Russian bank holdings abroad. The government decided last week to grant Russia's second largest bank, state-owned Vneshtorgbank (VTB), a loan of RUB 37.5 billion (approx. €1.1bn) for the purchase of five Russian banks operating in Europe. The banks located in London, Paris, Frankfurt, Luxembourg and Vienna are a Soviet-era legacy and VTB already held stakes in the banks. RUB 14 billion of the loan will cover share purchases; the remainder will be used to compensate the Central Bank of Russia for its deposits in the five banks to meet local capital adequacy requirements. Once the sale is completed, VTB plans to consolidate the banks under a holding company headquartered in London.

Finance minister Kudrin declares Russia will not join the WTO on disadvantageous terms. Russia to date has completed its bilateral membership talks with 33 WTO members. Negotiations with another 20 countries are currently in progress. The thorniest issues yet to be resolved

are protection of immaterial property rights, access to Russia's financial markets, aircraft import duties, agricultural subsidy levels and domestic pricing of natural gas. Kudrin expects Russia's WTO accession to take place in 2006.

Government dispute over proposed VAT reduction. Russian prime minister Mikhail **Fradkov** has proposed reducing Russia's current 18 % value-added-tax rate to 13 % in 2007. This proposal has been incorporated into the government's 2006-2007 economic policy framework published last week. Fradkov claims lowering taxes and increasing budget expenditures will promote economic growth. This notion has met with stiff opposition from some cabinet members, and in particular, finance minister **Alexei Kudrin** and economy minister **German Gref**. They argue that, far from promoting economic growth, such a move would merely increase inflationary pressures. The fight has accented differences between Fradkov's conservative faction and the cabinet's liberal faction led by Kudrin. The Kudrin faction gained support a couple weeks ago when eleven respected economists warned of negative consequences from a looser fiscal stance.

EU and Russia agree on visa flexibility and readmission of illegal border-crossers. Greater flexibility in visa practices were agreed on at last week's EU-Russia summit in London. On Wednesday (Oct. 12), Schengen countries and Russia affirmed a new arrangement. Official signing of the agreement will take place later this year and the new practices will enter into force in 2006.

After five years of discussion, Russia agreed to readmission of illegal border-crossers – a condition insisted on by the EU. The new arrangement set a single €35 visa fee for citizens of both signatories. Close relatives, students and invalids will be exempt from visa fees, and it will be easier for special groups to get multi-entry visas. Registration procedures will also be simplified.

Russia drops five places in international competitiveness comparison. The World Economic Forum's (WEF) latest annual *Global Competitiveness Report* lowered Russia's last-year ranking among 117 countries five notches to 75th place. The new ranking puts Russia behind Brazil, India and China. The WEF's broad criteria examine countries' prerequisites for economic growth in terms of the management of public finances, macroeconomic conditions, quality of the judicial system, investment in human capital and infrastructure, and technological innovation. Russia fared poorly due to inefficiencies and inequities of its public sector and federal administration. Four newcomers to the list, including neighbours Kazakhstan and Azerbaijan, ranked higher than Russia. Russia, however, scored well for consistent federal budget surpluses.



China

China rolls out latest five-year plan. The central committee of the Chinese Communist Party has approved the blueprints for China's 11th five-year plan (2006–2010). It is the first five-year plan ever to not focus solely on rapid economic growth, but rather seeks to ensure that the welfare of all Chinese citizens will benefit from economic growth. To reduce yawning income disparities, China will give top priority to improving social services, which are still quite rudimentary, especially in the countryside. Moreover, economic growth will increasingly be achieved through efficiency gains and structural improvements such as raising the value-added component of production. The five-year plan also emphasises the importance of environmental protection and efficient energy use, as well as the creation of large international Chinese corporations. Final approval of the new five-year plan will take place at next spring's People's Congress. No substantial changes are expected.

Foreign trade growth shows no sign of slowing. China's goods exports abroad in September rose an estimated 26 % y-o-y. While export growth slowed slightly from August, variations in monthly growth figures are common. On a quarterly basis, export growth this year has continued at a steady pace. For the first three quarters of 2005 the value of exports reached nearly \$550 billion, a 31 % increase from the same period in 2004.

While export growth has outpaced import growth this year, import growth in September jumped to 23 % y-o-y. In January-September, the value of imports was about \$480 billion, or 16 % more than a year ago.

The foreign trade surplus in September was nearly \$8 billion. This surplus was smaller than in previous months, but still well above the September 2004 surplus. China's trade surplus for the period January-September was \$68 billion – a sharp increase from just \$4 billion the first nine months of 2004. A recent commerce ministry report forecasts that the 2005 surplus will reach \$90–100 billion, compared to last year's \$32 billion (1.9 % of GDP). In an interview, central bank governor **Zhou Xiaochuan** said he expects the burgeoning trade surplus to increase friction between China and its trading partners.

Slower growth in China's foreign debt. As of end-June, China's foreign debt was \$266 billion, or 8 % more than at the end of last year. In the same period a year ago, the debt stock climbed 14 %. The lower growth in foreign indebtedness partly reflects the impact of tighter restrictions on

foreign borrowing introduced by officials in spring 2004 to dampen speculation of a yuan revaluation that had caused a flood of money into China.

Some 53 % of China's foreign debt is short-term paper with maturities of less than a year. Chinese banks hold 35 % of the total debt stock, while foreign-owned corporations operating in China have 25 %, foreign banks 19 %, the state 18 % and Chinese firms only 3 %.

In addition to the new debt figures, the state administration for foreign exchange (SAFE) revised its figure for end-2004 debt from \$229 billion to \$248 billion.

Rapid growth in Chinese tax receipts. Chinese tax revenues (excluding tariffs and phased-out agricultural taxes) in January-September soared to over CNY 2,300 billion (€240bn), a 20 % gain from the same period a year earlier. Even so, growth in tax revenues was lower than the 26 % pace posted in 2004. Intermediate taxes (VAT, consumption tax and sales tax) accounted for half of the entire tax take. About a fourth of taxes in the first nine months of this year came from corporate and personal income taxes.

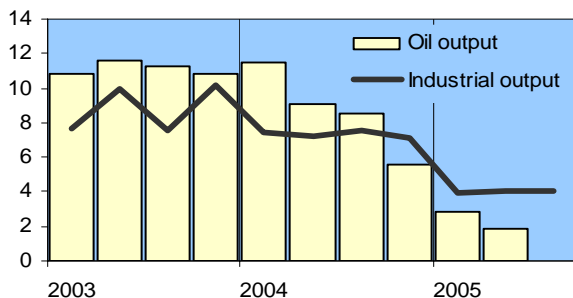
China is currently amending legislation on personal income taxes and is discussing changes that would unify corporate income tax practices. The income tax on domestic corporations is presently 33 % with broad deduction and exemption possibilities, while foreign-owned companies pay 15 % with fewer exemptions. Changes in the consumer tax structure are also in the works.

ADB and IFC get permission to issue yuan bonds. The Asian Development Bank (ADB) and the World Bank's private sector arm, the International Finance Corporation (IFC), have become the first foreign institutions permitted by the People's Bank of China to issue yuan-denominated bonds. Both institutions were granted permission to issue around one billion yuan (€100 million) in ten-year bonds. The institutions began to issue the bonds almost as soon as they received permission, saying they would use the money raised to finance Chinese companies. China is committed to developing its capital markets; the PBoC announced last spring that it would choose one or two foreign investors for a trial bond project. The reform is hoped to increase opportunities for Chinese investors and offer foreign financial institutions access to yuan-based financing. ADB also announced this week that it was investing CNY 600 million (€60m) in the Bank of China.

Russia

Russian industrial output growth revives slightly. On-year growth of *industrial output* in January-September was 4 %. Industrial output growth has slowed substantially this year, reflecting significantly lower production growth in mineral extraction industries. Output in *mineral extraction* industries rose 1 % y-o-y in the January-September period, largely due to lower growth in gas and oil production. Natural gas output contracted 0.1 % y-o-y in the nine-month period, while oil output increased just 2.1 %. Russian industrial output growth is currently driven by *manufacturing*, which climbed 6.1 % y-o-y in January-September. Manufacturing growth was led by production of machinery and equipment at state-owned companies. Production and distribution of *gas, water and electricity* was up 1.9 % y-o-y in the first three quarters.

On-year quarterly growth in industrial and oil output, 2003–2005, %



Source: Rosstat

Higher oil export tariffs. With the recent rise in consumer prices driven partly by higher gasoline prices, Russia's six largest oil refiners promised in September to freeze gasoline prices until the end of the year. The government for its part responded to the inflationary pressure by increasing oil export tariffs in order to increase domestic oil supply. At the beginning of this month, the tariff on exported crude oil was increased from \$140.00 to \$179.90 per tonne. The government also decided to increase tariffs on refined oil products by 25 % at the end of October.

The government is considering a reduction in the mineral extraction tax to encourage higher production levels, as well as the granting of tax deductions to oil companies for oil exploration and the opening of new fields.

Russia outlines its positions with international financial institutions at G20 meeting. At last weekend's G20 gathering of finance ministers and central bank chiefs in Xianghe, China, finance minister Alexei **Kudrin** observed

that Russia's relations to international financial institutions are in a transition period. Having prematurely paid off its outstanding debts to the IMF, Kudrin said Russia is now poised to become a major lender. On the other hand, Russia has so far not made any commitments to increase its share of funding of credits granted by the IMF.

Kudrin also said that Russia had no plans to seek new loans from the World Bank, rather it will finance domestic investment projects itself. The finance minister added that his ministry was drafting a proposal to cover the current shortfall in the national pension fund with stabilisation fund monies generated from oil revenues.

Krasnoyarsk krai regional merger set for early 2007.

The merger plan advanced by the Taimyria and Evenkia autonomous districts calls for merger of those districts with Krasnoyarsk krai.

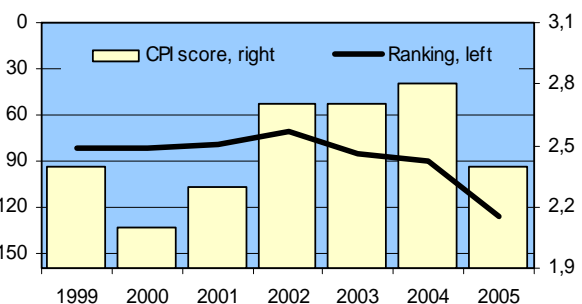
Russia's first regional merger is scheduled to occur in early December, when the old Perm oblast and the Perm-Komi autonomous district are combined to form a new Perm oblast. President Vladimir **Putin** wants to promote administrative efficiency through regional mergers.

Corruption on the increase in Russia.

In its latest annual perceived corruption survey, *Transparency International* found that corruption in *Russia* has increased. Russia's score on the Corruption Perceptions Index (CPI) placed it at 126th out of 159 nations surveyed. It shared its ranking with Albania, Sierra Leone and Nigeria. On the CPI scale of 0–10, the least-corrupt country this year was Iceland with a value of 9.7. Finland and New Zealand shared second place at 9.6. After improvements in its CPI score in 2002, 2003 and 2004, Russia dropped 0.4 points this year to 2.4 – the same CPI value it received in 1999. Yelena **Panfilova**, Head of Transparency International's Moscow bureau, said Russia's decline in the rankings reflects the current administration's low enthusiasm for tackling the corruption problem.

While *China* outranked Russia in the survey, it also fell to share 78th place with Morocco and Sri Lanka. China's CPI value was 3.2, 0.2 points lower than in 2004.

Russian CPI scores and rankings, 1999–2005



Source: Transparency International

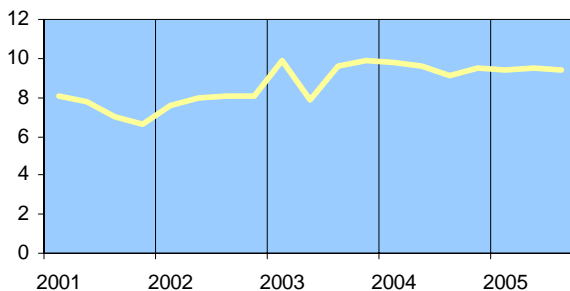
China

Investment and exports continue to drive Chinese economic growth. Steady growth in total economic output continued in the third quarter. Growth came in at 9.4 % y-o-y, matching the pace of growth for the first nine months of this year. Economic growth has remained consistently above 9 % since summer 2003. The latest figures suggest growth at the sectoral level has also been surprisingly stable. Highest growth in the January-September period was recorded in the industrial and construction sectors (11 %). Growth in services accelerated slightly to 8 %, while primary production (mainly agriculture) increased 5 %.

On the demand side, the significance of investment and exports remained large as there seems not to be acceleration in the growth of domestic consumption. During the first three quarters of 2005, fixed investments were up 26 % y-o-y in nominal terms. However, the lack of separate quarterly figures on investment makes it difficult to estimate investment trends.

The rapid expansion of exports combined with a distinct slowing in import growth will significantly boost China's overall trade surplus this year. The surplus in January-September already exceeded 5 % of GDP. Retail sales, which reflect domestic consumption, increased 12 % y-o-y in fixed prices, suggesting consumption has also grown quite steadily throughout this year.

Quarterly GDP growth, %



Source: NBS

Fitch upgrades China's creditworthiness on strong balance of payments, robust economic development and banking system improvements. This week, the international credit rating agency Fitch raised its rating on Chinese long-term foreign-currency borrowing one notch to A, its sixth-highest credit rating. Governments with the similar ratings include the Czech Republic, Greece, Chile and South Korea. The rating for yuan-denominated bor-

rowing was also boosted to A+. Fitch raised its corporate credit ratings for state oil company PetroChina and China's largest banks.

Fitch said the sovereign upgrade was justified by China's extremely strong foreign payments position. At the end of September, China's foreign currency reserves stood at \$770 billion, compared to foreign debt of just \$260 billion by Fitch's estimate. The upgrade also reflected improvements in Chinese bank administration and healthier balance sheets. The China Banking Regulatory Commission (CBRC) put the stock of non-performing loans held by the large state-owned banks as of end-June at 10 % of the total loan stock, down from 16 % at the end of last year. Despite the current favourable economic climate, Fitch warned that a sudden slowdown in growth could have immediate negative impacts on the quality of the credit stock.

Credit ratings agency Moody's has also conferred its sixth-highest rating on Chinese sovereigns, while Standard & Poor's has China one notch lower.

China Construction Bank IPO rocks Hong Kong

bourse. China Construction Bank (CCB) became the first of China's four large state-dominated banks to list internationally. The only Chinese bank listed abroad (Hong Kong) prior to this week's IPO was the mid-sized Bank of Communications. The weeklong subscription period for CCB shares began on Oct. 14. Actual trade in CCB shares will begin next week. The IPO, the world's largest in four years, was for 12 % of the bank's shares. The bulk of shares went to international institutional investors; just 5 % were offered to private investors. The final selling price for the stake came to \$8 billion. Unlike most companies traded on Chinese stock exchanges, CCB has promised to annually pay out about 40 % of its profits as dividends. Investor demand was estimated at \$76 billion, meaning that investors are unlikely to receive the number of shares for which they subscribed. China's largest banks – Industrial and Commercial Bank of China and the Bank of China – plan IPOs in 2006.

The CCB listing evidences the opening up of China's banking sector as well as increasing competition among banks. CCB has actively worked to reduce the share of non-performing loans in its portfolio. Currently, its non-performing loan portfolio is considered to be the smallest of any of the large banks. Earlier this month, Standard & Poor's lifted CCB's credit rating on the basis of improvements in the bank's risk management skills. CCB's semi-annual financial report stated total assets at end-June as more than CNY 4,000 billion (about €400bn). The bank is expected to show a profit this year of more than CNY 40 billion (€4bn).

Russia

Russian economic output recovers. After a slowdown in growth of Russia's core production sectors last spring, growth has bounced back in recent months. Rosstat reports that growth in four of the five core sectors accelerated, while slowing only in the transportation sector. The overall recovery in economic growth continued to be driven by retail sales, which climbed 11.7 % y-o-y in the January-September period. Construction rose 8.3 % y-o-y in the period, industrial output 4.0 %, transportation 2.4 % and agricultural output 2.6 %. Preliminary figures from the economy ministry indicate annual GDP growth was 5.9 % in the first three quarters.

Moody's upgrades Russia's creditworthiness. Moody's lifted one notch its rating for Russia to Baa2. Two years ago, Moody's was the first to take Russian bonds out of the junk category and declare them investment grade. Russia shares Baa2, Moody's next-to-lowest investment-grade rating, with e.g. Tunisia and Mauritania. The boost in Russia's creditworthiness was anticipated as Russia's strong exports earnings from raw materials have significantly improved state finances, while spending has been kept in check and federal debt has been paid down ahead of schedule. According to Moody's assessment, political stability in Russia has increased. Recent additional spending approved in conjunction with the 2006 budget had no impact on the rating agency's decision. The agency believes the Russian economy is now strong enough to withstand even a sharp decline in oil prices.

Moody's noted that any further ratings boost would require that the government make significant efforts to improve the efficiency of public administration, as well restart stalled economic reforms, develop the budgeting system, improve operation of courts and the justice system, fight corruption and reduce inflation.

Government releases list of strategic deposits. On Monday (Oct. 24), the government published a list of five strategic oil, gas, gold and copper deposits closed for foreign participation. The decision to classify a resource as strategic is based on global availability of the resource, the size of the deposit and its geographic location. The list presented was considerably shorter than had been expected. Use of these strategic resources will be governed under the new act on subsoil resources, which is expected to enter into force during the latter part of 2006.

Russia has granted no significant mineral extraction licenses in seven years. The reorganisation of gas and oil industry has provided the state with unprecedented ability to bid for the best licences. However, foreign investors are still welcome to develop remote, hard-to-access oil and

gas deposits. Natural resources minister Yuri **Trutnev** said that the state still wants to restrict participation of foreign investors in development of oil deposits with reserves greater than a billion barrels, natural gas deposits larger than a trillion cubic metres, and deposits with over 10 million tonnes of copper.

Putin establishes Coordination Council. The council's mandate is to coordinate reforms in health care, education, housing and agriculture. President Vladimir **Putin** himself will chair the 41-member council, which includes six key ministers, leaders of the president's administration and a number of regional governors. Observers were surprised to learn that prime minister Mikhail **Fradkov** had not been invited to join the council. The council's status in relation to the national government and whether it can issue binding decisions are as yet unclear.

LUKoil profits rise fastest among Russia's largest companies. This year's rankings of Russia's top 400 companies by Russian business magazine *Expert* was again led by gas giant Gazprom. *Expert*'s survey is based on stated 2004 financial performance. LUKoil's net sales soared 40 % last year, lifting it into second place. Electrical power giant also RAO UES passed Russian Railways (RZD). Troubled oil producer Yukos still held on to the fifth spot as the statements did not yet reflect the forced sale of its core production unit to pay off massive back-tax demands. Observers expect the company to plummet in next year's rankings.

103 of Russia's largest enterprises are domiciled abroad, 116 in Moscow and 23 in St. Petersburg. Over half of the 400 large companies are engaged in industrial activities. Other well-represented sectors included transportation and shipping, telecommunications and banking.

Russia's ten largest companies

Rank 2005	Rank 2004	Company	Net sales (US\$ billion)	Growth, %
1.	1.	Gazprom	33 900	19
2.	3.	LUKoil	28 800	40
3.	4.	RAO UES	23 600	15
4.	2.	RZD	22 900	11
5.	5.	Yukos	22 100	n.a.
6.	6.	TNK-BP	14 300	29
7.	7.	Surgutneftegaz	10 700	30
8.	9.	Sibneft	8 000	21
9.	8.	Sberbank	7 500	13
10.	10.	Norilsk Nickel	6 700	28

Source: Expert

China

Chinese inflation slowed in September. *Consumer prices* in September were up just 0.9 % from a year earlier. Inflation growth declined relative to August, when prices were still 1.3 % higher than a year earlier. The outlook for good crop harvests also dampened the rise in food prices to just 0.3 % y-o-y in September. Prices for services increased an average of 3 % y-o-y. Hard competition pushed down prices of clothing 1.5 % y-o-y and durable goods 0.6 %. Out of services, housing costs rose fastest.

The rise in *producer prices* also slowed in September to 4.5 % y-o-y. In August, prices were up 5.3 %. The largest price increases were seen in energy sector products: the price of crude oil was 33 % higher than a year ago, and oil product prices were also up sharply. Producer prices for coal climbed 22 % y-o-y. On the other hand, the steel industry, which has been one of the major focuses of investment in recent years, experienced a lurching slowdown in the price development of steel products.

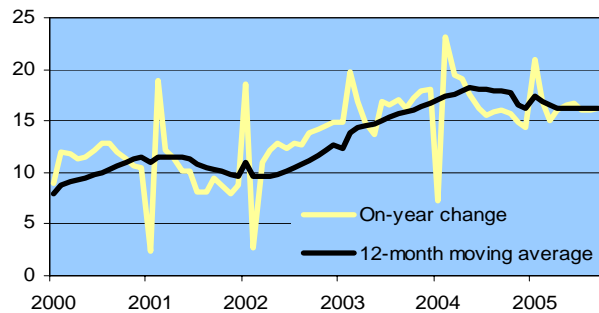
Retail sales growth holds steady. September retail sales in China were up nearly 13 % y-o-y in nominal terms. Growth has held at an even pace throughout the year. In real terms, however, growth in domestic consumption has accelerated slightly as consumer goods inflation slowed in September to just 0.2 % y-o-y. Retail sales in large cities accounted for about two-thirds of all retail trade in January-September. Consumption growth in large cities was also slightly ahead of the national average. As expected, highest growth was seen in fuel sales (up nearly 40 % y-o-y) as well as sales of construction and decoration materials (nearly 30 %). Sales of communication equipment and cosmetics were up 20 % y-o-y. Overall growth in domestic demand has been lower than expected this year.

Robust industrial output continues. Industrial output was up slightly over 16 % y-o-y in September, matching the pace of growth set in the first three quarters of this year. In the January-September period, industrial output accelerated 18 % y-o-y in the private sector, while among state-owned enterprises production was up 11 %. When compiling industrial output figures, Chinese statistical authorities include all state-owned enterprises and private companies with annual net sales greater than CNY 5 million (€500,000).

Although production of passenger cars increased just 5 % in the first half of 2005, revived production in the third quarter pushed the overall figure for the first nine months of this year up to nearly 18 %. The National Bureau of Statistics did not report monthly figures for pas-

senger car output growth. Production growth in the iron and steel industries was strong in the January-September period, up nearly 30 % y-o-y. However, growth in steel output is expected to slow in the fourth quarter as China's largest steel producers decided to cut back on steel production towards the end of the year to sustain steel prices.

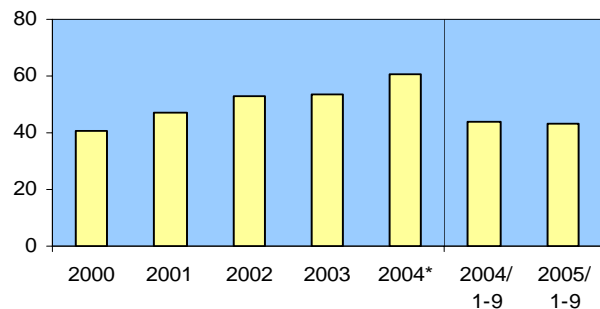
Industrial output, % change y-o-y



Source: NBS

FDI inflows remain steady. In the first nine months of 2005, inflows of foreign direct investment into China shrank 2 % y-o-y, amounting to \$43 billion. The flow of investment into China has been quite steady over the past five years. Although the largest share of investment inflow still originates in Asia, the inflow in January-September shrank nearly 10 % y-o-y. The biggest decline in investments has been those coming from Hong Kong and South Korea. At the same time, investment originating from EU countries and tax havens increased about 30 % y-o-y. The value of FDI in January-September represented about 6 % of the value of domestic capital investment. Contracted foreign investment was up 33 % y-o-y in 2004 and 21 % in the first nine months of the year. The rapid rise in contracted foreign investment raises hope that growth in real-ised investment will also accelerate in coming years.

Foreign direct investment, US\$ billion



* Preliminary figure

Source: Invest in China

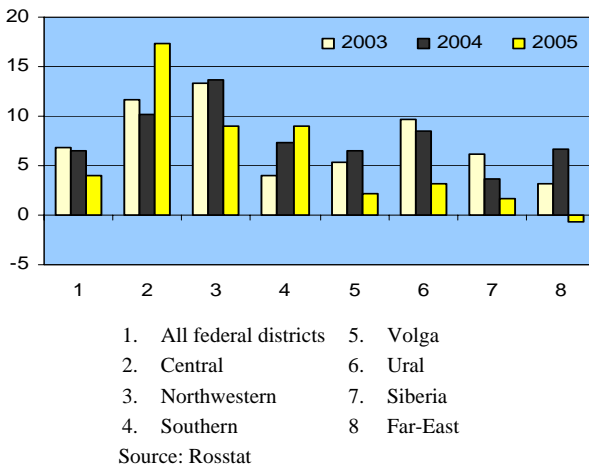
Russia

Moscow oblast posts highest industrial output growth.

Rosstat reports that industrial output in the Moscow oblast soared 36 % y-o-y in the period January-September. Moscow City's 18 % on-year growth was also significantly higher than overall output growth in Russia (4 %). Moscow City and the Moscow oblast contributed 13 % of Russia's total industrial output. Industrial production climbed fastest (17 % y-o-y) in the *Central federal district*, which includes Moscow. The federal district contains about a quarter of all Russian industry.

In the *Northwestern* and *Southern federal districts* industrial output grew 9 % y-o-y in the first nine months of 2005. The Northwestern district accounted for 11 % of Russian industrial output, while the share of the Southern district was 6 %. Output in the *Volga*, *Ural* and *Siberia federal districts* increased just 2–3 %. The Volga and Ural district accounted each for about 20 % of total national output, while the Siberia district contributed about 13 %. Unlike in earlier years, production in the oil-rich Tyumen region of the Ural federal district saw only modest on-year growth in output of 4 % in January-September, dragged down by the mere 2 % growth in production of mineral extraction industries. Several of Russia's largest producing oil fields are located in the Tyumen region. The fields represented 14 % of Russia's entire industrial output in January-September. In the *Far-East federal district*, industrial output fell 1 %. The district contributed 3 % of national industrial output.

On-year industrial output growth in January–September by federal districts, %



S&P bank governance survey finds Russian banks lacking. A Standard & Poor's survey of 30 of Russia's largest banks show that on a scale of 0–100 the average score for Russian banks' transparency and disclosure was

a mere 36. In a similar survey of Russia's 54 largest corporations, the average transparency figure was 50. For the world's top ten banks, the S&P average rating was 81. The survey employed 102 variables, which assessed availability of information on bank ownership, shareholder rights, operations, profitability and disclosure policies. The poor ratings of Russian banks reflect the fact that only five Russian banks are stock-exchange listed. Moreover, most of the largest banks (including Alfa Bank, Rosbank, MDM, Petrocommerce and Uralsib) are part of complicated financial-industrial structures. The survey did not include foreign-owned banks operating in Russia.

The Central Bank of Russia, as the banking supervisory authority, would like to increase public confidence through increased scrutiny of banks' beneficial owners. The CBR wants all banks to migrate over the mid-to-long term to the use of the international IFRS accounting standard in order to increase transparency.

Russia's ten largest Russian-owned banks by total assets; S&P transparency and disclosure survey rankings

Rank	Bank	Assets 1.7.2005 (\$bn)	Ranking (of 30), Transparency rating (max. 100)
1.	Sberbank	97.6	5 th (46)
2.	Vneshtorgbank (VTB)	18.5	1 st (55)
3.	Gazprombank	14.1	19 th (34)
4.	Alfa-Bank	8.2	28 th (23)
5.	Bank of Moscow	7.5	14 th (38)
6.	ROSBANK	5.3	8 th (40)
7.	MDM Bank	4.2	3 rd (51)
8.	Bank Uralsib	3.4	2 nd (32)
9.	International Industrial Bank	2.7	29 th (17)
10.	Bank Petrocommerce	2.3	12 th (39)

Sources: Standard & Poor's, Expert

Government adopts administrative reform concept for 2006–2008.

The government's three-year concept and action plan are intended to revive an essentially stalled administrative reform. Observers were cautiously positive about the concept, but emphasised that success of the reform plan would require strong participation from the business community and NGOs. International comparisons have highlighted the poor quality of Russian administrative practices for several years. The government now wants to focus on improving licensing practices, fighting corruption, mediation and dispute resolution, information systems and extending reforms to the regional level.

The administrative reform, launched in 2003 by presidential decree, aims at reducing the state's role in economic life, trimming layers of bureaucracy, promoting union activity, separating state monitoring and service functions and reforming the division of responsibilities between the central government and regions.

China

Chinese current account surplus widened further in January-June. The State Administration of Foreign Exchange (SAFE) has released its balance-of-payments figures for the first half of 2005. The current account surplus in the period was \$67 billion (8 % of GDP), i.e. \$60 billion more than in the first half of 2004. The surplus reflected a nearly \$54 billion trade surplus and \$12 billion in current transfers. The services deficit was \$4 billion. The discrepancy in the trade surplus reported in the balance-of-payments figures and customs data (approx. \$15 billion for 1H05) is typical for the statistical reporting of China and many other countries.

The financial account surplus was less than \$40 billion, of which \$22 billion came from foreign direct investment. The financial account surplus has fallen since last year and is believed to reflect lower inflows of foreign currency speculating on a yuan revaluation. The "net errors and omissions" figure, which suggests the magnitude and direction of non-recorded foreign currency flows again turned negative, meaning that currency flows out of China exceeded inflows.

The balance-of-payments figures show the central bank's foreign currency reserves added another \$100 billion in the first half of the year, and stood at \$710 billion as of end-June. Foreign currency reserves increased by \$67 billion during the same period last year. Reserve assets have grown rapidly in recent years and are now the world's second largest after Japan.

Key balance-of-payments figures, semi-annual, US\$ billion

	Current account balance	Financial account balance	Net errors & omissions	Change in currency reserves
2004 H1	7.5	66.8	-6.9	67.4
2004 H2	61.2	43.9	33.9	139.0
2005 H1	67.2	38.3	-4.5	101.0

Source: SAFE

Investment growth remains rapid. In the first three quarters of this year, nominal fixed capital investment grew 26 % y-o-y. The growth pace was just 1.6 percentage points lower than a year earlier, and clearly exceeded the government's 16 % growth target for this year. The growth in fixed investment in the January-September period was exceptionally fast in industry and construction (36 %). Investments in primary production, mainly agriculture, grew 19 %, while investment in the service sector was up 23 % y-o-y. By branch, the strong investment growth rates

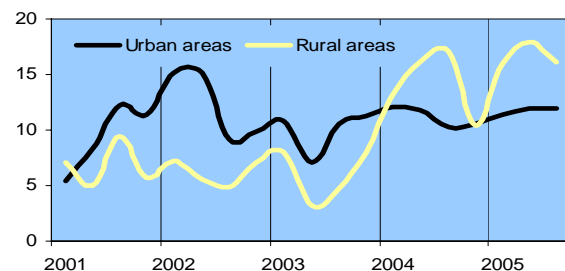
were registered in coal production (77 %), oil and gas production (31 %) and railways (41 %). The rapid pace of investment growth combined with strong exports forms an important engine of Chinese economic growth. The extremely high growth in investment, however, makes questionable the ultimate productivity of new investment.

China raises non-taxable income ceiling. Amendments to the personal income tax law were approved at the end of October and enter into force at the beginning of 2006. Under the changes in the law, the ceiling on tax-exempt monthly personal income rises to 1,600 yuan (160 euro). The progressive tax scale, which ranges from 5 % to 45 %, on amounts exceeding that ceiling was not altered. The previous non-taxed income ceiling, imposed in 1993, was just 800 yuan. The share of individuals earning monthly income above the non-taxable ceiling has grown from 1 % in 1993 to well over 50 % at present.

By raising the ceiling on non-taxed income, China seeks to restrain widening income disparities. The state also wants to tighten supervision of large earners. The Ministry of Finance estimates that raising the ceiling on non-taxed income will halve number of tax payers, and thereby reduce state revenues from income tax by about CNY 20 billion (€2bn). In particular, income tax revenues in poorer regions are expected to drop precipitously. The state intends to increase income transfers to those regions.

Rapid incomes growth continues. Real incomes in urban areas grew 10 % y-o-y and rural incomes 12 % in the first nine months of the year. The rise in rural incomes has accelerated since the start of 2004, although the gap between rural and urban residents remains huge. The average monthly disposable per capita income was 880 yuan (88 euro) in cities and 270 yuan (27 euro) in the countryside. In rural areas, over half of all income was derived from the sale of agricultural products. Thanks to the income tax changes coming into force next year, disposable income in the cities is expected to rise rapidly. On the other hand, rural incomes remain so low that a sizeable share of the population will not be affected by the new income tax law.

Income growth, quarterly, % y-o-y



Source: NBS

Russia

Russian inflation still exceeds government's target.

October 12-month inflation was 11.8 %, slightly down from September. Inflation continued to be sustained by the surging prices for services. The October rise in prices was 21.4 % y-o-y for *services*, 11 % for *foodstuffs* and 6.4 % for *other goods*. It looks like annual inflation will yet again surpass the government's official target. Indeed, in the past ten years, the government has only met its original inflation target once (2003). The government's latest revised inflation target for this year is 11 %, and a further increase in the target value is under consideration. Over half of respondents to a broad survey conducted in July found that Russians were most worried about the rapid rise in consumer prices, ahead of poverty, unemployment and terrorism.

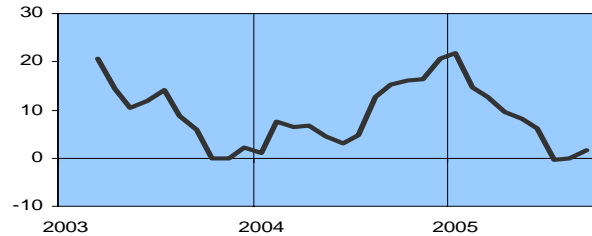
At the end of October, president Vladimir **Putin** joined in the debate and demanded that the government take new measures to protect citizens' real incomes and subdue inflation. Current policy, which concentrates on defending the rouble's nominal value at the expense of higher inflation, is not expected to change.

Government supports housing construction. The Russian government's national housing program seeks to double annual housing output (measured in living-area floorspace) from 40 million m² to 80 million m² by 2010. Improved quality here includes raising the average amount of living space per capita from 20 m² to nearer the EU level (34 m² per person). Over 60 % of the present housing stock is in poor condition and about 10 % requires immediate renovation and repair. The program will focus on support for housing purchases of young families, provide free housing for invalids, expand government guarantees for mortgage loans and increase the capital in the mortgage loan fund by RUB 64 billion (€1.9bn) next year.

Only one family in ten can currently afford their own apartment, even if six of ten families would need to shift to better housing. At the moment, the total demand for new apartments is estimated at 1 billion m². The volume of mortgage lending is expected to rise gradually along with demand for new housing. Some RUB 20 billion in mortgage were granted last year. That amount is expected to rise to RUB 415 billion (approx. €12bn) by 2010.

Implementation of the housing program will be impeded by the current situation where financing is provided by the central government, while zoning is in the hands of local administrations. Construction is monopolised at the regional level, preventing proper market function and price formation. Finally, Russia's undeveloped insurance markets make it difficult to insure risks related to construction.

Russian housing production growth 2003–2005, %, 3-month moving average



Source: Rosstat

Moscow's housing shortage gets worse. The dearth of new apartments in Moscow has hindered the city council plan to demolish nearly a thousand Khrushchev-era five-storey apartment buildings by 2010 and replace them with modern high-rises. The city will finance the construction of the apartment buildings though the city's budget for municipal construction, presently earmarked at about RUB 30 billion (about €880m) a year. The lack of available lots means that the new apartment buildings have to be constructed even higher. Several lots located in different parts of Moscow have been zoned for this "New Ring" project. The total living space in the buildings could amount to as much as 4 million m². Construction should be completed by 2015.

The supply of new apartments in the Russian capital contracted by 25 % since the new housing company act entered into force in April. The rise in housing prices in Moscow actually eased slightly in the first half of this year, despite the new act and lack of available lots to build on. The on-year rise in apartment prices in the downtown area was up just 8 % in January-June, two to four percentage points more than in other parts of the city. Housing downtown in the first half averaged about \$2,600/m², and about \$2,000/m² on average for the city. In St. Petersburg, the second biggest city in Russia, construction has been brisk and the prices of new housing remained flat in the first half of the year. The average price for apartments in St. Petersburg is presently about \$1,000/m².

Russian-speakers on the decline. The government recently approved the "Russian language 2006–2010" program, which seeks to promote proficiency in Russian and strengthen the language's status. The former soviet republics, apart from Russia, today have a population of about 140 million, of which about 100 million are speakers of Russian. In these states, Russian has preserved its status as the official state language only in Belarus. Russian continues to occupy a relatively strong status as an official language in Kazakhstan and Kyrgyzstan.

China

Good early summer grain harvests in China. China this year produced over 100 million tonnes of summer grain, a 5 % increase from a year earlier. This year's total grain harvest is also anticipated to exceed last year's. The good harvests largely reflect favourable weather conditions and an increase in the area of land under cultivation. The big harvests also have unwanted consequences for farmers; grain prices have already begun to slide (in September, the price was 1 % lower than a year ago). This situation could reduce the motivation of farmers to increase grain production. After several years of declines in the volume of grain harvests, China only last year succeeded in reversing that trend.

China introduces new measures of unemployment. Official figures have long shown that the share of registered unemployed in urban areas hovered around 4 % of the workforce. In reality, the number of unemployed is greater; many of the unemployed do not bother or even have the possibility to register.

To get a more reliable picture of unemployment, China will begin next year to publish unemployment figures based on survey methods. The data collection is in line with international methodology. Although the National Bureau of Statistics has used it since 2000, it has not yet released its findings. By some estimates, the unemployment rate in cities is at least 10 % of the workforce. Although not directly measured, the number of unemployed or underemployed in the countryside is believed to be as high as 200 million people. China is currently performing a small-scale census of about 1 % of the population. The 13 million people in the survey will for the first time be asked to provide information about their work status and income levels.

US and China agree on textile trade. China and the US agreed this week on new clothing and textile quotas for the next three years. Of the 34 product categories covered under the deal, 19 were already included under import quotas. Products under quota represent nearly half of Chinese textile exports to the US. The agreement allows Chinese textile exports to the US to grow at a rate slightly over 11 % a year. Since talks launched in May, growth in textile exports was limited to 7.5 %. The current deal will be in force until the end of 2008, after which the use of quotas will not be permitted under WTO commitments. China and the EU earlier this year penned an agreement on limiting textile trade through 2007.

Textile imports have been a sore subject for both the US and China due to the implications for employment in

the sector. After textile trade was liberalised last January, Chinese clothing imports to the US rose over 50 % in the first eight months of the year. The deal was reached ahead of president George W. **Bush**'s upcoming visit to China this month.

Central bank publishes report on stability of financial system. On Monday (Nov. 7), the People's Bank of China rolled out its first stability report. The debut report concludes that the financial system is generally quite stable, with the political and economic environment, financial sector reforms and favourable trends in the financial markets all contributing to financial stability. Nevertheless, the report identified substantial risks facing the financial system. These include China's heavy dependence on investment and export growth to sustain economic growth, overheating in the real estate sector and growth in the stock of non-performing loans due to structural changes in the economy. It also noted that the banking sector presently carries most of the risk in China's financial system. The report thus emphasised the importance of implementing securities market reforms with a view to distributing risk. Uncertainty in the system is also caused by external factors such as higher crude oil prices, dollar depreciation and an international rise in interest rates. The report stressed that individuals and enterprises need to take currency risk into account. The PBoC plans to develop banking system supervision and publish the stability report on an annual basis.

Limiting of foreign ownership in Chinese bank sector discussed. The vice chairman of the China Banking and Regulatory Commission (CBRC) last week mentioned possible new limits on foreign ownership in the Chinese banking sector, specifying that foreign investors would not be allowed to sell their stakes for at least three years, and that no foreign investor would be allowed to hold stakes in more than two banks. The comments appear to be the opening salvo in negotiations that may or may not lead to amendments in the law. The total amount of foreign ownership was already limited earlier to 25 % per bank. Moreover, a single foreign investor can own no more than a 19.99 % stake in a Chinese bank. Limiting ownership to two banks could be justified for competitive reasons and the demand for longer ownership periods may help reduce speculative investment operations in the banking sector. It is also likely that China wants to prevent foreign owners from gaining a dominant position in the country's banking markets. The total stock of foreign investment in China's banking sector has climbed to \$17 billion this year.

Russia

Growth in Russian foreign trade remains brisk. For the first nine months of this year, the value of Russian *goods exports* was \$178 billion, an increase of 38 % y-o-y. Nearly half of goods exports consisted of crude oil and oil products. Exports in this category soared 53 % in January-September. Although crude oil exports in volume terms declined by several percentage points from a year earlier, the huge increase in crude oil prices over the past year has substantially lifted the value of oil-related exports. High oil prices have also encouraged the exporting of refined oil products, which, in volume terms, were up nearly 20 % in January-September. Natural gas and metals each accounted for about 13 % of goods exports. A large part of other exports consisted of other raw materials. The share of machinery and equipment in goods exports was just 5 %. Russia also exported *services* valued at \$18 billion in January-September, a 22 % y-o-y increase.

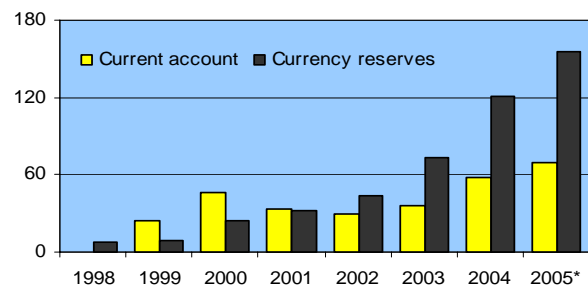
The value of Russian *goods imports* was \$86 billion in January-September, an increase of 28 % y-o-y. The lion's share of imports consisted of industrial equipment and consumer goods. Machinery and equipment represented 41 % of imports; with 8 % of total imports coming solely from passenger cars. *Services imports* amounted to \$28 billion in the period, an increase of 14 % y-o-y. Russia's largest trade partners in January-September were Germany, the Netherlands and Italy. Finland fell to 13th largest trade partner in 3Q05, falling from 9th place in 1H05.

Rouble appreciation slows. The Central Bank of Russia reports that the rouble's real effective (foreign-trade-weighted) exchange rate strengthened 9.3 % in the first ten months of the year. The rouble this year has appreciated 15.9 % against the euro and 1.1 % against the dollar. The rouble's climb in the first half of the year stopped during August-September. The end-October real exchange rate was identical to the end-July rate. The rouble's real exchange rate for the year has nevertheless increased faster than expected due to the large inflow of foreign currency earnings generated by high oil prices. The CBR started the year with an 8 % appreciation target for the rouble's effective real exchange rate.

CBR currency reserves up by a third this year. Thanks mainly to high world prices for raw materials, particularly oil, Russia has managed in recent years to sustain large current account surpluses. Most of the money has been saved as central bank foreign currency reserves. Russia's foreign currency and gold reserves stood at \$164 billion as of end-October, an increase of 32 % since the start of this year. Russia's foreign currency reserves far exceed the foreign debt of the public sector, which shrank over 6 % in

the first half of the year and stood at \$91 billion in July. Over half of Russia's federal foreign debt is a legacy of the Soviet era. Nearly all of that debt is owed to Paris Club creditors.

Current account balance and CBR currency reserves, 1998–2005, US\$ billion



*January-September figures
Source: Central Bank of Russia

Russia's private sector takes on foreign debt. There has been a substantial increase in foreign borrowing on the part of private-sector companies. The gross stock of foreign borrowing at the beginning of July stood at \$130 billion, of which financial institutions accounted for nearly a third. In the first half of this year, the debt of financial institutions grew 17 % and other private sector debt 20 %. Capital flight makes it difficult to accurately assess the net debt position of the private sector.

Large Russian companies this year have found it easy to get a loan from international capital markets. Russia's improved sovereign credit rating is now being reflected in the credit standing of Russian companies and banks. Sberbank recently took a syndicated \$1 billion loan with just a 0.55 percentage point premium on the LIBOR rate. The loan was the largest dollar-denominated loan ever granted to an East European company. Steel company Evraz also set a record for the Russian bond market with its \$750 million eurobond issue. The 8.5 % annual yield on the bond is attractive in international comparison.

President Putin reshuffles his cabinet. On Monday (Nov. 14), the president promoted his chief of staff Dmitri **Medvedev** to first deputy prime minister. Medvedev also currently serves as chairman of Gazprom's board and chairman of the just-established national projects council. Defence minister Sergei **Ivanov** will continue to hold the defence portfolio while also assuming the duties of deputy prime minister. Putin's new chief of staff will be Sergei **Sobyanin**, governor of the oil-rich Tyumen oblast. Observers point out that the appointments mainly have to do with a general focusing of cabinet activities, clarifying the state's role in the energy sector, and setting the stage for Putin's successor to run in the 2008 presidential election.

China

Chinese consumer price inflation accelerated slightly in October. Consumer prices were up 1.2 % from a year earlier and ahead of September's 0.9 % on-year inflation rate. There is presently no difference in the average pace of inflation in cities or the countryside. Food prices have risen at about the same rate as consumer prices overall, although prices of some items in the consumer food basket such as grains, meat and poultry have declined. Vegetables were up over 17 % from 2004. The prices of gasoline and automobile spare parts have risen 10 % this year. Prices for services overall were up 3.1 % y-o-y in October.

Producer price inflation slowed from 4.5 % y-o-y in September to 4.0 % in October. Industrial energy and raw material costs led the rise in producer prices. Crude oil prices were up by a third in October compared to a year earlier. Overcapacity drove down prices of some steel products, although the average price of products in the steel category has remained flat over the past year.

The People's Bank of China reports no signs of deflation. The growth of the broad money supply (M2) accelerated in recent months, with on-year money supply growth standing at 18 % in October. Money supply growth in 2004 was just under 15 %, the central bank's target value for this year.

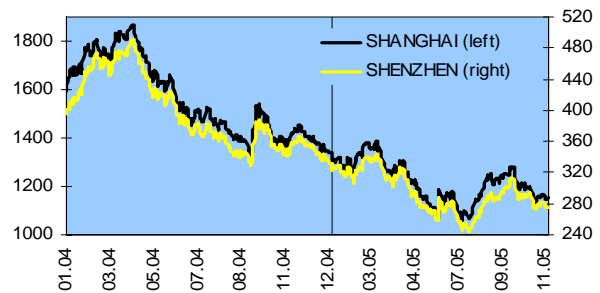
Foreign trade surplus continues to grow. Chinese customs reports that the country posted a \$12 billion foreign trade surplus in October. The total trade surplus for this year now exceeds \$80 billion, well ahead of the total of \$32 billion for 2004. Chinese exports in October were valued at \$68 billion and imports at \$56 billion. Export growth has outpaced import growth throughout this year. Export growth (30 % y-o-y) continued that trend last month by beating out import growth (23 %). While the US remained the biggest single export market for China, there has been a notable rise in exports to Russia (up 50 % y-o-y). Exports of machinery and equipment grew about 30 % y-o-y in January-October and clothing exports 20 %. Most imports continued to come from other Asian countries. Goods imports growth was led by Australia (up 42 % y-o-y).

Stock market reforms continue. The conversion of non-tradable state shares to tradable shares continues. Even so, only a fraction of China's 1,400 listed companies have yet made the shares conversions so the reform has proceeded more slowly than officials had hoped. Some companies fear that increase in the number of shares on the stock markets will drive down further already depressed share prices. This week China decided to speed up the conver-

sion by offering subsidies to companies that have made the conversion. Officials have yet to specify the amount or form of the promised subsidies.

Chinese bourses still show no signs of recovering from the onslaught, and the decline in share prices has made life tough for stock brokers. China has launched a two-year program aimed at regulatory reform and making stock brokers financially sound. Under the program, officials have pulled the operating licences of 15 brokers suspected of abusing their positions. In addition, the China Securities Regulatory Commission has directly subsidised brokers and allowed some brokers to receive small amounts of foreign capital (see *BOFIT Weekly* 36/2005). The CRSC, which oversees the stock markets, has been given greater supervisory authority through recent amendments to the securities law.

Shanghai and Shenzhen stock markets, A-share indices



Sources: Shanghai and Shenzhen bourses

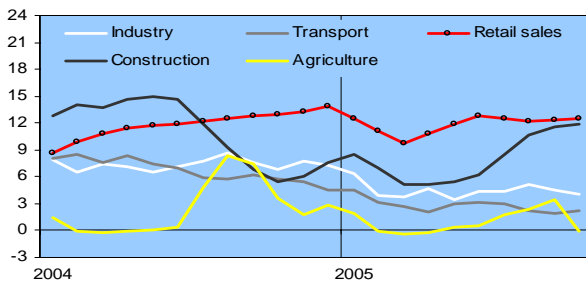
OECD assesses Chinese agriculture policy. According to the newly published *OECD Review of Agricultural Policies – China*, agricultural reforms launched at the end of the 1970s have substantially supported economic growth, helped reduce poverty and improved the level and quality of food consumption. The policy brief notes, however, that Chinese agriculture suffers from limited arable land and an oversupply of farm labour. The result is that there has been little progress in raising productivity in the agriculture sector, which employs about 40 % of China's labour force. The report found that environmental pollution limits possibilities to further increase agricultural output. There are also pressures to reform land ownership rules.

The report states that the transition of labour from agriculture to other sectors of the economy is crucial to improving rural living conditions and labour force productivity. It will also help reduce the rural-urban gap in living standards. To make moving around the country easier, China has recently announced it will try out in several provinces a policy of guaranteeing rural residents the same access to jobs, education and social benefits as urban dwellers. China has traditionally limited internal migration by tying benefits to household registration (the Hukou system).

Russia

Russia's total economic output continues to revive. Highest output growth in the past ten months was registered in construction and retail sales. *Construction* increased 9.0 % and *retail sales* 11.8 % y-o-y. Although growth in *transport* accelerated last month, on-year growth in January-October was a mere 2.6 %. In contrast, growth in industrial output and agricultural output has slowed. In the first ten months of the year, *industrial output* grew at a rate of 3.9 % y-o-y, of which manufacturing grew 6 %, and mining output was up about 1 %. On-year growth in *agricultural output* in the period was 1.8 %. The economy ministry's preliminary figures show GDP increased 5.9 % y-o-y in the first three quarters of the year.

Change in output of core production sectors, 2004–2005, 3-month moving average, %



Source: Rosstat

CBR sticks with current monetary policy. The Central Bank of Russia last week submitted its revised proposal of 2006 monetary policy guidelines for Duma approval. CBR chairman Sergei **Ignatyev** said no big changes in monetary policy were expected next year.

This year the CBR has had to deal with a pickup in inflation (2005 target 8.5 %) and an appreciating exchange rate (target 8 %). Ignatyev says he expects Russian inflation this year to come in at around 11 %, due in large part to massive inflows of oil earnings and higher-than-expected increases in the costs of housing, meat and gasoline. In January-October the real effective exchange rate appreciated by over 9 %. The World Bank and the International Monetary Fund have criticised the central bank for failing to let the rouble's nominal exchange rate appreciate sufficiently to curb inflation.

On November 16, the Duma approved Ignatyev's second four-year term as central bank chairman. The Duma praised the achievements of Ignatyev's first term, including greater predictability of central bank actions, rapid growth in the CBR's foreign currency reserves and improved supervision of the banking sector. In his speech to the Duma, Ignatyev declared that the central bank would

seek over the next 3–5 years to shift its policy emphasis from attempting to curtail rouble appreciation to directly fighting inflation and implementing a more flexible rouble exchange rate.

Foreign investment down slightly in January-September. Rosstat reports that foreign investment in Russia in the first nine months of this year amounted to \$26.8 billion, or 7.9 % less than a year earlier. The drop can be attributed to the 25 % decline in international borrowing, which accounts for most of Russia's foreign capital inflows. Direct investment, on the other hand, increased 18 % y-o-y. A third of investments went to retail and wholesale trade, followed by investment in value-added industries (28 %), mineral extraction industries (17 %) and telecommunications (8 %).

The stock of foreign investment in Russia exceeded \$96 billion as of end-September, an increase of nearly a third from a year earlier. Of that amount, over half still consisted of various credits, although the share of credits in the total stock of foreign investment declined four percentage points from a year earlier. On the other hand, direct investment grew by a corresponding amount. The share of portfolio investment remained unchanged at 2 %.

Russian investments abroad in the first nine months of the year were just below \$23 billion, a decline of 10 % from a year earlier. Some 44 % of investments went to the United States. Popular investment destinations also included the Virgin Islands and Austria.

Breakdown of foreign investment stock in Russia, US\$ million, 2005

	Total stock (Oct. 1)	%	Direct investment	Portfolio investment	Other investment
	96,474	100.0	43,330	1,888	51,256
Source					
Cyprus	17,576	18.2	12,682	888	4,006
Luxembourg	16,101	16.7	399	1	15,701
Netherlands	15,586	16.1	12,085	31	3,470
Great Britain	9,642	10.0	1,802	144	7,969
Germany	9,321	9.7	2,587	15	6,719
US	7,157	7.4	4,361	402	2,394
France	3,483	3.6	424	0	3,059

Source: Rosstat

Cabinet shake-up continues. President Vladimir **Putin** has appointed Sergei **Kirienko**, presidential envoy to the Volga Federal District, to head Russia's nuclear energy agency Rosatom. Kirienko served briefly as Russia's prime minister during the 1998 financial crisis. Bashkortostan state prosecutor Alexander **Konovalov** was named as Kirienko's successor to the Volga Federal District envoy post. Kazan mayor Kamil **Iskhakov** was appointed as the new presidential envoy to the Far East Federal District.

China

No slowing in fixed investment in China. Defying the many predictions at the start of this year that a substantial slowdown in investment lay ahead, growth in fixed investment has continued to boom throughout 2005. In January-October, fixed investment increased nearly 28 % y-o-y in nominal terms, matching the pace of growth in 2004. While prices of investment goods have risen slower this year than last, investments have grown faster in real terms than in 2004.

China's fixed investment figures cover only investments made in urban areas, and thus give no indication of agricultural investment. Investments reached CNY 5,600 billion (€60bn) in January-October. Of that, about 60 % was directed to the service sector, with the rest going to industry and construction. Highest investment growth was registered for mining (up over 50 % y-o-y), railways (44 %) and electrical power generation (33 %). Investments in iron and steel production increased 26 % y-o-y.

Although China expects investment growth to slow to about 15 % y-o-y next year, it plans to substantially increase investment in infrastructure, particularly railways and ports.

Industrial profits and rapid production growth continues. Industrial output increased 16 % y-o-y in October. The pace of growth has been fairly constant this year. High growth in October was posted in metal production (19 % y-o-y) and manufacturing of computers and communication devices (23 %). Growth in crude oil production accelerated to 5 % and car production to 68 % y-o-y.

Industrial profits were up 20 % y-o-y in January-October. The rise in profits has slowed substantially from last year and is believed to reflect stiffer competition among producers. The strongest profit rises were seen in raw materials. For example, coal producers saw profits jump over 70 % y-o-y and non-ferrous metal production nearly 120 %. On the other hand, profits of producers of building materials fell and oil refining remains a money-losing proposition. Chinese industrial profits and production figures include all state-owned enterprises as well as firms with annual turnovers above CNY 5 million (€500,000).

President Bush visits China. United States president George W. **Bush** spent two days in China as part of his weeklong Asia tour. Following talks between the nations' leaders, president **Hu** Jintao affirmed China's

dedication to continuing with currency reforms, improving protection of intellectual property rights and assuring access of US firms to China's vast markets. However, no concrete measures (such as further revaluation of the yuan) were announced for ameliorating the huge trade imbalance between the two countries.

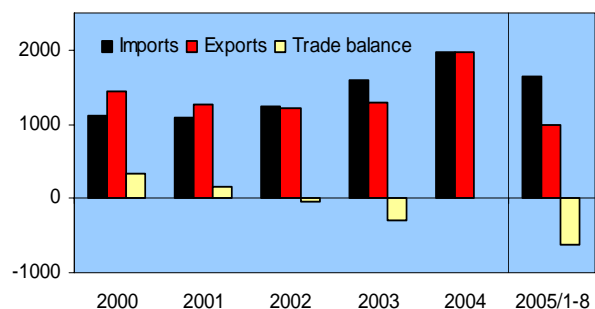
The presidents agreed on cooperation in taming the impacts of a potential avian flu pandemic. China announced the purchase of 70 US-built Boeing aircraft in a deal estimated to be worth \$3-4 billion. Bush's calls for increased religious and political freedom in China were well publicised. It was Bush's third visit to China during his presidency.

Finland running trade deficit with China this year.

Finland posted a €30 million trade deficit with China in the first eight months of this year. The trade gap widened as imports from China increased 40 % y-o-y in January-August, while exports rose a mere 3 %. China accounted for about 3 % of Finland's exports and 5 % of imports. Both shares have increased rapidly in recent years.

Growth in Finnish trade with China this year was close to the EU average (EU exports to China in January-August were up 2 % and imports 23 %). Major paper machine deliveries from Finland to China brought trade balance into near equilibrium last year. Finland mainly imports from China electronic machinery and equipment, and clothes. Finland's exports mainly consist of industrial machinery and telephone equipment. Growth of Finland-China trade is expected to continue to expand rapidly. China expects to become the world's second largest presence in world trade within the next five years.

Finnish imports and exports to China, €million



Source: Finland's National Board of Customs

Russia

Russia's economy ministry announces winning hosts of six special economic zones. The economy ministry suggests establishing special economic zones in Zelenograd and Dubna in the Moscow Region, and in the cities of St. Petersburg and Tomsk. Economy minister German Gref said Zelenograd would specialise in microelectronic production, Dubna in nuclear technology, St. Petersburg in information technology and Tomsk in development of new materials. He stated industrial production would be the theme in zones in the Lipetsk Region (household appliances) and Yelabuga city in the Tatarstan Republic (car components, high-tech oil products). A total of 72 applications from 47 regions to host zones were submitted.

The slate of winners was immediately criticised for its disproportionate emphasis on St. Petersburg and Moscow. Observers also hoped for more zones focused on information technology production. The economy ministry's proposal for six special zones is expected to get final cabinet approval by the end of this year. The Duma approved the establishment of special economic zones in July with passage of an act on special economic zones. The newly created zones are expected to stimulate economic growth, diversify the structure of the Russian economy and attract investment. The government has earmarked RUB 8 billion (€24m) of next year's budget for improvement of regional infrastructure. Companies hoping to locate in industrial special economic zones must commit to investing at least €10 million over the next 20 years.

State increases corporate ownership. Via its holding companies, the federal government has this year expanded its presence in Russian business life, especially the energy sector. In early November, state-owned gas giant *Gazprom* acquired a majority stake in oil company *Sibneft*. *Gazprom* is currently said to be eyeing the possibility of taking full ownership in oil company *Slavneft* (*Gazprom* has had a 50 % stake in the company since 2002; the other half is owned by *TNK-BP* and *Sibneft*). With the acquisition of all outstanding *Slavneft* shares, *Gazprom* would account for about a third of Russian oil production. *Gazprom* also gradually acquired the majority stake in nuclear power and mining equipment manufacturer *OMZ*. Electricity monopoly *RAO UES*, in which the state already holds the majority stake, has announced its intentions to acquire a fifth of *Siloviye Mashiny*, Russia's second largest maker of heavy machinery.

The state has also shown an interest in increasing its position in struggling carmaker *AvtoVAZ*. The maker of Lada-brand cars is a major employer, but has been unable to respond to competition from foreign car manufacturers. The state is said to have increased its stake in the company

to 51 % via its weapons export company *Rosoboronexport*. This month, two members representing state interests on *AvtoVAZ*'s 12-member board will be replaced with six new representatives of state interests.

The cabinet's leading proponents of liberal economic policies, ministers German Gref and Alexei Kudrin, along with presidential adviser Andrei Illarionov, have criticised the state's increased intrusion into business life. Observers say that corporate takeovers by the state typically lack the perspectives of economic and technical efficiency. Instead, they reflect enthusiasm on the part of the state for greater supervision and control. This is often accomplished by simply designating a particular business as "strategic."

St. Petersburg surpasses Moscow in investment attractiveness. *Expert*, Russia's leading business weekly, has published its latest annual survey of attractiveness of Russian regions to investment. In terms of low risk, St. Petersburg rose from third position in 2004 to number one. The city ranked second after Moscow in terms of investment potential. Measures of risk include involvement of politicians in local business life, the likelihood of social unrest, economic balance, law enforcement and crime rates. St. Petersburg was praised for its progress in administrative reform, the high satisfaction of residents with their city, local poverty reduction efforts and the city's well-maintained public infrastructure.

Moscow ranked ninth in the overall list. The city, with a population over ten million, offers tremendous investment potential, yet suffers from vague local regulations and erratic enforcement. The wealthy business community attracts criminal elements and is subject to political risk. The lowest political risk was found in Chukotka district, which is led by the popular governor Roman Abramovich. From the standpoint of investment, the study found the most business-friendly regulatory environment the Yaroslavl Region.

Key investment attractiveness rankings of Russian regions

Region	Risk rank	Investment potential rank
St. Petersburg	1	2
Lipetsk	2	34
Novgorod	3	66
Belgorod	4	24
Tatarstan	5	8
Rostov	6	10
Yaroslavl	7	37
Nizhny Novgorod	8	6
Moscow	9	1
•••		
Moscow Region	19	3
Leningrad Region	21	19

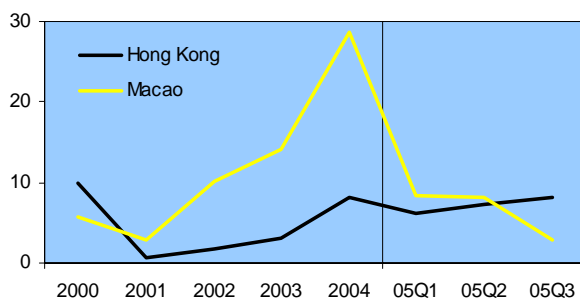
Source: Expert RA

China

Third quarter growth figures for Hong Kong and Macao. On-year growth in total economic output in the Hong Kong special administrative region (SAR) climbed to 8.2 % in real terms in the third quarter of 2005. The second-quarter GDP growth figure for the 7-million-resident SAR was also revised upwards to 7.3 %. The robust GDP growth was attributed to strong exports of products and services, as well as robust consumer demand and investment in machinery and equipment. However, high growth did not boost inflation. In October, the consumer price index was up a mere 1.8 % y-o-y. On-year inflation averaged just 1 % in the first ten months of 2005.

The Macao SAR, with a population of a half million, saw lower growth than Hong Kong. Macao's GDP grew at a real rate of 2.8 % y-o-y in the third quarter. GDP growth figures for 1Q05 and 2Q05 were also revised downwards to 8.3 % and 8.1 %, respectively. Third-quarter growth was the weakest since the start of 2003, despite a 5.2 % y-o-y growth in real spending by tourists to Macao (excluding the gambling sector). Although growth in exports from the Macao SAR has been slow overall this year, imports of goods and services climbed briskly in the third quarter.

Real GDP growth, Hong Kong and Macao, %



Source: Regional statistical authorities

Further liberalisation of China–Hong Kong trade.

Under phase three of the Closer Economic Partnership Arrangement (CEPA III), all tariffs on products of Hong Kong origin will be gradually phased out. CEPA III calls for the elimination of tariffs on 260 products, bringing the current number of tariff-free products categories to nearly 1,400. China and Hong Kong will meet twice a year to decide additional tariff-free products. Hong Kong firms also gain new opportunities to operate in ten service industry segments in Mainland China. However,

China's WTO commitments require that it open access of foreign companies to these segments, which include legal services and bookkeeping, in coming years. CEPA III enters into force in January 1st 2006. The first CEPA agreement was signed in autumn 2003 as part of effort to revive the Hong Kong economy in the wake of the SARS epidemic.

Liberalisation of trade between China and Hong Kong has been highly beneficial for Hong Kong. Hong Kong officials estimate that liberalisation has brought Hong Kong nearly 30,000 new jobs. Hong Kong officials expect the elimination of tariffs will especially benefit local manufacturers of luxury and speciality products.

Easier to use yuan in Hong Kong. The People's Bank of China has moved to increase the possibilities for using the yuan in Hong Kong. Under its decision last month, yuan payment would be allowed for PBoC-approved services such as transportation, telecommunications services, health care and education. Foreign exchange rules will also be relaxed. The new regulations allow the exchange of CNY 20,000 (€2,000) at a time. The earlier limit was CNY 6,000. Hong Kong residents can also make larger one-time transfers between yuan accounts and other accounts. Many Hong Kong shoppers are attracted by the low prices in Mainland China. Hong Kong visitors will now be able to pay for their purchases in Guangdong province with yuan-denominated checks.

China began to liberalise the use of the yuan in Hong Kong in early 2004 after the central bank granted Hong Kong banks permits to offer yuan-based services to Hong Kong residents. The PBoC is going to further increase yuan-use possibilities in Hong Kong, but has yet to announce any specific plans or schedules.

China ratifies UN anti-corruption convention. China expects that its participation in the convention will help it catch criminals who embezzle and export state assets. These wrongdoers are typically former government bureaucrats or heads of state-owned enterprises. As of end-2004, China suspected of corruption over 500 people who had departed the country. These people were thought to have smuggled state assets worth a total of CNY 70 billion (€7bn) out of China. China hopes to recover part of that sum through operation of the anti-corruption treaty. More than 30 countries to date have ratified the treaty, which enters into force this month.

Corruption is also a problem inside China. Between January and June of this year, 240 incidents of corruption, involving a total of nearly CNY 2 billion (€200m) in assets, were identified at the major state-owned commercial banks. Chinese officials also revealed in November that several officials had taken ownership shares in coalmines as bribes.

Russia

Russian inflation slowed in late autumn. Russia's 12-month inflation rate for November was 11.2 %, a slight drop from October's pace but still above the 2005 initial goal of 7.5–8.5 %. Prices of *services* rose 21.2 % y-o-y in November, while *foodstuffs* were up 10.3 % and *other goods* 6.3 %.

After heated debate, the government last month approved an anti-inflation program to subdue rising prices. Proposed measures include limits on the international borrowing of privat companies, further liberalisation of foreign trade and the transfer of state assets from central bank accounts to the stabilisation fund. Russia's recent high inflation has been driven by large hikes in regulated prices (especially soaring prices for municipal services) and higher prices of food products subject to import tariffs. The Moscow Region has announced increases in rates for electricity and heating at the start of next year. With other regions also facing pressures to increase prices, a rapid rise next year in prices for services is anticipated.

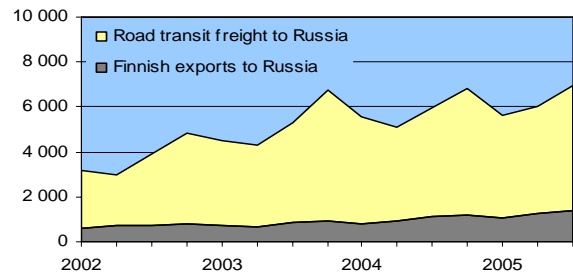
Russia becomes Finland's largest trading partner.

Finland's Board of Customs reports that Finnish-Russian trade grew 27 % y-o-y in the first three quarters of 2005. Measured by trade volume, Russia moved ahead of Germany to become Finland's overall largest trading partner in the third quarter. Imports from Germany, however, remained slightly larger than Russian imports, while Finnish exports to Sweden held a slight lead on Russian exports. Finnish exports to Russia in the January-September period had a value of €4.0 billion, an increase of 30 % y-o-y. The value of imports was put at €4.9 billion, up 27 % y-o-y. In the nine-month period, cell phone exports soared 71 % and accounted for 21 % of all Finnish goods exports to Russia. Passenger car exports in January-September climbed 42 %, and accounted for 7 % of exports. About two-thirds of Finland's imports from Russia were energy products, with crude oil and oil products representing slightly more than half of that amount. Although crude oil imports were down 8 % in volume terms in January-September, their value was up 31 % y-o-y. The rise in crude oil prices contributed 44 % of the rise in the value of Russian exports to Finland (i.e. nearly half of the growth in Russian exports to Finland came from the rapid rise in global oil prices). Other Russian imports to Finland were dominated by raw materials such as iron (6 %), other metals (6 %) and raw wood (8 %).

Flow of transit freight moving through Finland to Russia continues to increase. The value of road transit freight moving through Finland to Russia in January-September

was estimated at €14.9 billion, an increase of 8 % y-o-y. The value of road transit freight to Russia was 3.7 times greater than all Finnish exports to Russia. Passenger cars accounted for 17 % of road transit cargoes in January-September, an increase of 84 % y-o-y. Transit freight of electrical equipment also increased rapidly. Rail transit freight accounted for about 7 % of the total volume of transit freight to Russia in January-September. Rail transit freight tonnage, however, fell 11 %.

Finnish exports to Russia, road transit freight to Russia, €m



Source: Finland's Board of Customs

Russian firms borrowing like never before. In the three-year period from the start of 2002 to the start of 2005, the stock of rouble-denominated loans issued by Russian banks to the enterprise sector increased over 180 %. Foreign currency-denominated loans were up over 140 % in the same period. Even adjusting for inflation, the growth in corporate borrowing has been spectacular. For the over four million enterprises operating in Russia, each owed an average of 22,000 euro to banks at the start of this year.

Broken down by business sectors, lending flowed quite evenly to the construction, trade and transport sectors in all parts of the country. Agricultural loans constituted over 10 % of enterprise borrowing only in the South and Far East federal districts. The share of loans granted to the industrial sectors was lowest in the Central Federal District. Industrial borrowing accounted for almost a fifth of total corporate borrowing in Moscow. In contrast, lending to industrial enterprises in the Urals, Siberia and Far East federal districts constituted over 50 % of all corporate borrowing. The share of loans granted to service enterprises was largest in the Central District and Moscow.

Both rouble and foreign-currency borrowing increased dramatically in all federal districts, except the Far East Federal District, where the stock of forex loans increased a mere 27 % over the past three years. The share of loans granted to Moscow-based firms in Russia's total corporate borrowing continued to increase. Although only a fourth of Russian companies are domiciled in Moscow, half of all corporate forex loans were granted to Moscow companies. Moscow firms also accounted for 40 % of all rouble-denominated corporate borrowing.

China

China further opens its banking sector to foreign investors. The China Banking and Regulatory Commission (CBRC) announced this week that it was increasing the number of cities where foreign banks can operate from 18 to 25. The opening mainly affects cities in the poor western and north-eastern parts of China and is hoped to promote regional economic development and boost industrial production. Five cities were opened to foreign investors a year earlier than required under China's WTO commitments.

Officials also announced a lowering in the capital requirements placed on foreign investors in China's banking sector. The operating capital requirement for foreign investors to open a bank branch was reduced from CNY 500 million to CNY 400 million (€40m). Capital requirements were also relaxed for joint projects involving Chinese and foreign investors. Even with the changes, some estimates still find that banks will have trouble making profit from banking operations in China's poor and remote provinces. Thus, foreign investment is expected to continue to focus on Eastern China's wealthy provinces.

Census of Chinese economy completed. This week the initial results of a wide-ranging census of the service, industrial and construction sectors were released. The survey, launched in January, asked companies to identify their production volumes and capacity, number of employees, financial situation, and consumption of raw materials and energy. The survey's greatest value perhaps was in helping gauge the reliability of China's statistical systems.

As official labour statistics are generally considered to be quite inaccurate, common interest has focused on the employment findings. The initial released census data show that over 300 million workers were employed in China's industrial, construction and service sectors as of end-2004. The number of workers is slightly greater than the earlier figure published by National Bureau of Statistics. The survey found that the largest group of workers (80 million) were employed by manufacturing.

Information about the capital structures of Chinese companies was also provided by the survey. Half of corporate investment was found to originate from the state, while about 15 % came from abroad (including Hong Kong, Macao and Taiwan). Much of the other released survey information had to do with the number of companies. The NBS was generally satisfied with the quality of the first independent wide-ranging economic census.

Excess production of steel and aluminium; copper supplies inadequate to meet demand. Over-investment in steel production capacity in recent years was manifested by a flood of cheap steel onto Chinese markets this year. In the first nine months of 2005, Chinese steel production capacity increased by 40 million tonnes. To support steel prices, the steel industry this autumn moved to cut production. The over-supply of steel has resulted in increased steel exports, which has led to a balancing in the volumes of Chinese steel exports and imports. This is a clear shift from recent years when China was a net importer of steel.

China expects steel production to hit 450 million tonnes in 2006, i.e. an amount that would exceed China's estimated steel needs by about 100 million tonnes. Next year, the steel glut is expected to bolster Chinese steel exports and drive down world steel prices for the steel grades exported by China.

The over-capacity problem has officials struggling to come up with solutions. Most officially approved investments are already under implementation and will be completed by the end of next year, when production capacity growth will peak. Officials have this year ceased to approve any new investment that would further increase steel production capacity. In addition, officials have started to push for greater efficiency in steel production by demanding the closing down of small, antiquated mills and the merging of steel producers (see *BOFIT Weekly 31/2005*). The aim is to form a few large, globally competitive steel companies.

China has also invested heavily in aluminium production and is a net exporter of aluminium. Like steel producers, aluminium producers have cut their production to support prices. Profitability has also been seriously eroded by higher alumina prices. Chinese officials report 40 aluminium producers have already closed their doors due to high alumina prices. China's Ministry of Commerce estimates that aluminium exports should decline next year from this year's level.

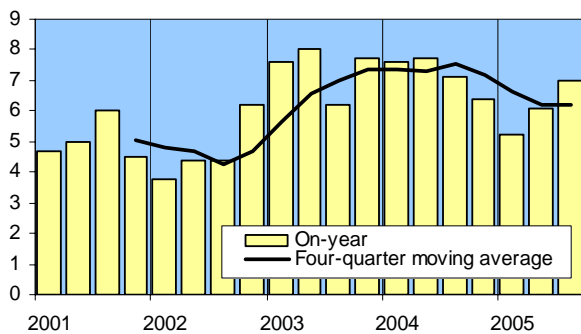
Meanwhile, Chinese demand for copper has surged in recent years with domestic production unable to keep up with demand. Indeed, domestic copper production was only sufficient to cover a quarter of demand in 2004. This situation has remained about the same this year. The rapid rise in Chinese demand has increased world prices for copper.

Russia

Russian GDP growth accelerated in the third quarter.

Rosstat reports Russian GDP grew 7.0 % y-o-y in the third quarter of 2005, well ahead of the pace of economic growth registered in the first half. The fastest rising GDP supply components were retail sales, construction and real estate. After already revising upwards its GDP growth estimate for 2005 this autumn, the economy ministry further adjusted at the beginning of December its forecast for GDP growth for all of 2005 to 6 %.

On-year quarterly GDP growth, %



Source: Rosstat

Duma approves 2006 federal budget proposal. The 2006 budget bill projects revenues of RUB 5,046 billion (20.7 % of GDP) and expenditures of RUB 4,270 billion (17.5 % of GDP). This yields a budget surplus of RUB 776 billion (3.2 % of GDP). The budget assumptions anticipate 2006 GDP growth of 5.8 %, inflation in the range of 7–8.5 %, an average rouble-dollar exchange rate of 28.6 and an average price of \$40 a barrel for Urals-grade crude.

Both spending and revenues climb rapidly relative to GDP when compared to the 2005 budget. Federal budgets in recent years have tended to be cautious, while realised revenues, driven by the upward spiral of oil prices, have far exceeded the budget assumptions. When the approved budget for 2006 is compared to the estimated outcome of this year's budget, revenues would shrink slightly in real terms, while spending would rise about 15 %. The largest increases of budget spending next year are targeted at the defence and security sector, as well as the four national priority areas: health care, housing, education and agriculture.

Duma accepts CBR's 2006 monetary policy program.

The Central Bank of Russia's program offers four scenarios for next year, whereby the price of Urals-grade crude oil would average \$28, \$40, \$50 and \$60 a barrel (during the first nine months of this year, the world price of Urals crude averaged just under \$50/bbl). If oil prices remain in the range of \$40–60, GDP would grow 5.8–6.1 % in 2006. Under the lowest oil-price scenario, economic growth would be 4 %. The current account surplus is substantial under all scenarios, allowing for the expected brisk rise in imports (14–17 % under the high-end oil-price estimates).

Given Russia's continued current account surpluses, appreciation pressure on the rouble's exchange rate is expected to remain. The CBR program affirms a commitment to its policy for steering the rouble's exchange rate, implying that the CBR will continue to buy foreign currency to stem the rise in the rouble's value. CBR currency market interventions are expected to increase the central bank's foreign currency reserves by an additional \$80–100 billion if the oil price averages between \$50–60 a barrel. The CBR also expects to reduce consumer price inflation to 7–8.5 % in 2006. The inflation objective differs little from the original 2005 inflation goal (7.5–8.5 %), which, due e.g. to higher-than-anticipated oil prices, never came close to being realised (November consumer prices rose over 11 % y-o-y). Appreciation of the rouble's real exchange rate would be limited to 9 % in relation to the trade-weighted currency basket. The CBR's real exchange rate ceiling for this year was a strengthening of 8 %. In November, the rouble's real exchange rate was almost 11 % higher than a year earlier.

Duma and Federation Council approve direct foreign ownership of Gazprom shares.

In a move long-awaited by foreign investors, both houses of the Russian parliament have approved amendments to Russia's act on gas supplies. When the amendments enter into force, shares of natural gas giant Gazprom held by foreign investors will receive identical treatment as shares held by Russians. The amendments abolish the 20 % ceiling on foreign ownership of Gazprom shares and pave the way for foreigners to trade Gazprom shares on Russian stock exchanges. Under the amendments, the state's stake in Gazprom must be at least 50 % plus one share. Duma opponents to the amendments argued that privatisation of half of Gazprom shares would likely increase domestic gas prices and aggravate inflation. Gazprom's executive board would like to see president Putin sign the amendments into law before the end of this year.

China

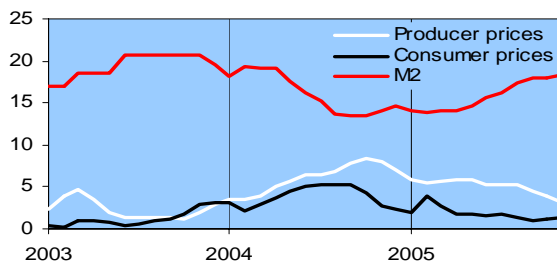
China considering radical upward revision of GDP.

With the findings of a wide-ranging census made early this year, China's National Bureau of Statistics is considering a substantial upward revision of its official GDP figure. According to published news reports, the increase could be as much as 15–20 %. The NBS will hold a press conference on the matter next week. The adjustment mainly reflects consistent underestimation of the actual size of China's service sector. The adjustment would have a major impact on GDP-based indicators used to compare the Chinese economy with other economies. It is as yet unknown how the possible revision will impact growth figures and other statistics from earlier years.

Despite rapid money supply growth, consumer price inflation remained low in November. Consumer prices rose 1.3 % y-o-y in November, compared to 1.2 % on-year growth in October. Food prices rose 1.6 %. Larger price increases were registered for services, which grew 2.7 % (although on-year growth slowed from 3.1 % in October). There was little difference between the average November consumer price inflation in the countryside and in cities. Producer price inflation fell in November. Producer prices increased 3.2 % y-o-y in November, down from 4.0 % in October. Producer price inflation was largely sustained by higher prices for energy and raw materials.

Inflation pressures in the Chinese economy have remained modest despite an increase in the *broad money supply* (M2). M2 was up 18.3 % y-o-y in November, or more than three percentage points above the PBoC's 2005 target. The central bank says the rapid expansion of the broad money has been driven mainly by growth in household and corporate deposits. This is partly a reflection of the fact that China still offers few investment alternatives to keeping one's money in a traditional bank savings account.

CPI, PPI and money supply (M2), %-change y-o-y



Sources: NBS and PBoC

Eerie consistency in industrial output growth. Chinese industrial output was up 16 % y-o-y in November, matching the pace throughout 2005. The differences in growth rates among industrial branches have been astonishingly modest: among China's leading industrial branches, growth was highest in electronics (22 %) and lowest in textiles (14 %). In the energy sector, crude oil production was up over 2 % y-o-y, while coal production climbed some 11 %. Electrical power generation capacity increased 11 % and steel output (a growing headache for world markets) increased 17–20 %.

Export growth cooled in November. Chinese customs announced that \$72 billion worth of goods were exported in November, an increase of 18 % y-o-y. Export growth slowed considerably, as exports have grown around 30 % this year. Imports, on the other hand, were up almost 24 % y-o-y in November and valued at \$62 billion. It was the first month this year when import growth outstripped export growth. Despite slowing export growth, the November foreign trade surplus was \$10 billion. It boosted the overall surplus for the year to more than \$90 billion. The 2005 surplus is expected to reach \$100 billion, over three times the 2004 surplus. The national research institute under China's Ministry of Commerce expects the goods trade surplus to widen even further in 2006.

China meeting its WTO commitments for 2005. China has met most of its WTO commitments for this year. The state slashed import tariffs as agreed on about 400 product categories, as well as eliminated import quotas. In addition, it removed barriers on foreign direct investment for the transport sector. Retail sales were also liberalised for all products except tobacco. Although China's implementation of its WTO commitments is generally considered to be going well, some countries still would like to see greater enforcement, especially in protection of intellectual property rights. The biggest debate in WTO countries this year has centred around the lifting of restrictions on global textile and clothing trade. The change has resulted in a flood of China-produced clothing, especially into the US and the EU. The EU and US responded with safeguard measures to restrict Chinese imports. Temporary agreements were reached with China on the matter.

Starting next month, China must lower import tariffs on over 100 product categories. These include cars and automotive spare parts, as well as certain food products and chemicals. The lion's share of import tariff reductions, however, has already been implemented. China will also eliminate export tariffs on textiles. A major reform is scheduled for the second half of next year, when foreign banks will get greater access to the Chinese market.

Russia

Retail sales and construction continue to drive Russian economic output. Rosstat reports that in January-November retail sales were up 11.8 % y-o-y, followed by construction with 9.8 % growth. Output in both sectors climbed rapidly in November. Services output was also up over 7 %. Industrial output increased 4.0 %, with growth in that sector driven by manufacturing output, which accelerated in November and was up 6.1 % in January-November period. Transport rose 2.4 % and agricultural output just 1.6 % in the eleven-month period. The economy ministry tentatively puts GDP growth for January-October at 5.9 % y-o-y and has boosted its forecast of overall economic growth in 2005 to 6.4 %.

Euro's weight in CBR currency basket increased further. The Central Bank of Russia announced that as of December 2 it had boosted the euro's weighting in the dual-currency basket used for day-to-day steering of the rouble's external value to 0.4 (and correspondingly lowered the dollar weight to 0.6). For the previous four months the euro weight was 0.35 and the dollar 0.65. The currency basket is used to balance the rouble's exchange rate fluctuations in relation to the two major currencies; i.e. increasing the euro's weight reduces its daily exchange rate fluctuation in relation to rouble and increases volatility with respect to the dollar. The euro's share remains 36 % in the CBR's trade-weighted basket of currencies of Russia's main trading partners, which is used mainly to track the rouble's nominal and real exchange rates. The euro area accounted for 37 % of Russian foreign trade in the first nine months of this year.

Russia's WTO accession pushed back to mid-2006 at the earliest. Russia failed to meet its target of concluding WTO membership talks by the end this year. At the sixth WTO ministerial conference earlier this month in Hong Kong, Russia concluded its bilateral negotiations with Canada, Paraguay, Nicaragua and the Philippines. The sticking points in ongoing talks with the US, Switzerland, Columbia and Australia are industrial property rights and copyright protection, access of foreign entities to Russia's financial markets, aircraft import tariffs and agricultural subsidy levels. The most intractable issues for the US and Russia involve Russia's insistence on protecting its aerospace industry with import tariffs and preventing money laundering by restricting the operations of foreign banks in Russia.

Economy minister German **Gref** stated recently that Russia's WTO membership now appears to be delayed at least until summer 2006 and could well be postponed into

2007. The new WTO members accepted at the Hong Kong summit, Saudi Arabia and Togo, have the right to place additional demands on Russia's accession. Georgia and Moldova are also threatening to reopen their negotiations with Russia.

Russia to hike gas prices for Ukraine. Russian gas giant Gazprom announced it will raise the price of natural gas supplied to Ukraine to be more in line with the European price level. Russia has long subsidised the price of natural gas for CIS members, and Ukraine is currently paying only about \$50 per thousand cubic meters of gas. At the beginning of 2006, Gazprom would like to triple the price. Gazprom board vice chairman Alexander **Medvedev** claims Ukraine should take the deal, as the actual price for gas should be about \$220–230. Gazprom has given Ukraine two weeks to accept the price increase; otherwise, the flow of gas from Russia will be shut off. Ukraine imports about half of its natural gas from Russia. In recent years, the country has sought to reduce its dependence on Russia by increasing gas imports from e.g. Kazakhstan. Russia already hiked gas prices to e.g. the Baltics and Georgia earlier this year.

Ukraine and Russia have a long-running dispute over pipeline transit fees for gas to European markets. Russian dissatisfaction with Ukraine's large transit fees is seen as partly responsible for Russia's decision to construct a new gas pipeline along the bottom of the Baltic Sea to Germany. Russia has sought to reduce its energy exports moving through Ukraine and the Baltics for strategic reasons.

European natural gas imports 2004

Russian natural gas	Imports billion m3	% share of consumption
Moldova*	2.7	245
Serbia and Montenegro	2.3	100
Estonia	0.9	100
Bulgaria	3.1	100
Finland	4.3	99
Latvia	1.5	94
Lithuania	2.9	93
Greece	2.2	90
Slovakia	5.8	86
Czech Rep.	6.8	77
Hungary	9.3	72
Turkey	14.5	63
Austria	6.0	64
Belarus	10.2	55
Ukraine	48.5	49
Poland	6.3	48
Germany	37.3	43
France	13.3	30
Italy	21.6	30

*Include gas transit shipments

Source: Izvestiya

China

Chinese GDP revised upwards by 17 %! The National Bureau of Statistics' census of industrial and service sectors this year was to give a clearer picture of the true size and structure of the Chinese economy. Based on its results, the NBS has had to revise its 2004 GDP estimate up by CNY 2,300 billion (\$278bn) to CNY 15,989 billion (\$1,931bn).

The census suggests service sector output has been consistently underestimated in the past, due to material accounting principles used by the centrally planned economy and the fact that the run-away growth in the service sector has been difficult to track. The adjustment of the service sector figures accounts for 93 % of the overall GDP revision. Services as a share of total GDP rose from 32 % to 41 %. The share of industry in total economic output fell from 53 % to 46 %. According to the new figures, primary production accounted for 13 % of GDP.

The increase in China's GDP is an amount comparable to half of Russia's 2004 GDP. Under the revised nominal GDP figure, China last year displaced Italy as the world's sixth largest economy. China this year apparently also eclipsed France and the UK in terms of nominal GDP. The change boosts Chinese annual GDP per capita by over \$200 to about \$1,500, making China a typical lower middle-income country under the World Bank's classification system.

Lifting the value for total output and modification of the structure of the economy will impact a number of key economic indicators. For example, the investment ratio and energy intensity indicators will drop, along with relative size of the non-performing loan stock of banks and degree of state indebtedness. More darkly, spending on research, education and health care as a share of GDP should decline.

The NBS says it plans to use the new data to retroactively adjust China's GDP figures back to 1993 using OECD methodology.

Rapid investment growth continues. In January-November, nominal fixed investment in urban areas was up 28 % y-o-y. Nominal investment growth in January-November matched the 2004 growth figure and was slightly higher in real terms. Growth had been expected to slow substantially in 2005. The highest investment growth was in coal production (80 % y-o-y), electrical power generation (32 %), railways (38 %) and non-ferrous metal production (38 %). Despite government efforts to diminish the pace of investment in the steel industry, investment in steel produc-

tion was up 26 % y-o-y. China is next year expected to produce about 100 million tonnes more steel than it can use domestically.

2005 monetary policy and financial market highlights.

The People's Bank of China started the year with monetary policy targets for broad money and credit growth (15 % and 14 %, respectively) in line with previous years. Even with a tighter monetary stance, which dragged down growth below its target values for money supply growth and credit expansion in the first half, broad money (M2) growth accelerated in the second half.

Under China's exchange rate reform, the long-standing dollar peg was abandoned and the yuan was revalued by 2.1 % in July 2005. Officially, the yuan's value is now determined against a currency basket that gives greatest weights to the US dollar, the euro, the Japanese yen and the Korean won. Even so, the yuan's exchange rate has remained essentially unchanged in relation to the dollar.

Foreign exchange regulations were eased by raising the ceiling on the amount of foreign currency that could be held by Chinese companies. Possibilities to use the yuan in Hong Kong were increased, along with easier use of credit cards abroad. Private individuals can now buy larger amounts of foreign currency for foreign travel purposes.

Foreign investors clamoured to enter the Chinese banking markets in 2005, despite the sector's huge stock of non-performing loans and poor risk management. Three of the four large state-owned banks and some smaller commercial banks took on foreign participation. In October, China Construction Bank (CCB) became the first large Chinese bank to be listed on the Hong Kong stock exchange. Other state giants Industrial and Commercial Bank of China (ICBC) and the Bank of China (BOC) are planning foreign listings in 2006.

The capital structure of ICBC, China's largest state bank, was shored up with central bank foreign currency reserves in April 2005. China's banking supervision authorities announced this month that they were reducing the capital requirements imposed on foreign investors and opening up banking markets in poorer regions to foreign investors.

Despite government reforms, share prices remained weak in 2005. The conversion of nontradable state shares to tradable shares was extended to cover all listed firms. Under a regulation published in June, trades in state shares ceased to be subject to stamp and income taxes. Stockbrokers, hurt by falling share prices, received state support. In the bond market, the Asian Development Bank and the World Bank's International Finance Corporation were granted permission to issue yuan-denominated bonds.

Russia

Central bank lowers interest rates. The Central Bank of Russia in late December lowered its refinancing rate from 13 % to 12 %. Although the refinancing rate only indirectly influences money market rates, the CBR has paralleled its rate moves in recent years with drops in the overnight lending rate to banks and the rouble interest rate on currency swaps. The CBR last lowered its rates one percentage point in June 2004. Throughout 2005, the CBR incrementally broadened its list of public and private sector securities which it accepts as collateral for liquidity credits.

Parliament approves greater oversight of non-governmental organisations. This week the Federation Council approved amendments to laws covering the activities of national non-governmental organisations (NGOs). Observers note that NGOs were the last sector of Russian society free from state oversight. During its time before the Duma, the proposed amendments were revised to reflect softening changes suggested by president Vladimir **Putin**. NGOs claim the final formulation still gives officials overly broad latitude for interpretation. The government justifies its need for increased oversight as part of its efforts in fighting spying, terrorism and money laundering. President Putin says Russia needs to prevent political activity backed by foreign financing in Russia. The amendments, which have been widely condemned in Russia and abroad, are feared to make NGO operations more difficult, especially if they involve promoting democracy and human rights. The president is expected to sign the amendments into law soon.

Business environment for small firms worsened in 2004. The fifth round survey of administrative barriers to small business in Russia conducted by the Moscow-based Center for Economic and Financial Research (CEFIR) suggests the small business environment deteriorated in 2004. Earlier rounds showed improvements in 2002 and 2003. Small businesses saw their biggest challenges in the last half of 2004 coming from the flurry of legislative changes and macroeconomic instability. In addition, firms experienced more macroeconomic instability, greater barriers to competition, increased corruption and less access to capital than in 2003. Certain indicators such as stiffening competition, however, may actually signal healthy trends in the business environment. Regulation of corporate activities was perceived as declining slightly.

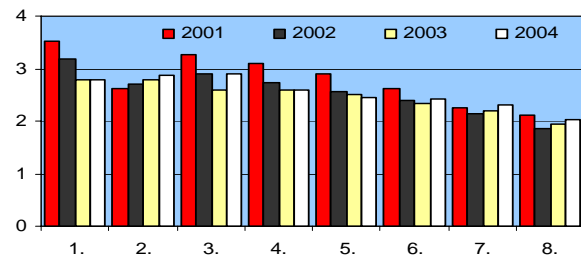
With respect to administrative regulation, nearly all firms experienced general documentation requirements

and firm inspections as burdensome. The amount of official inspections actually fell slightly from 2003, with most inspections still performed by tax or fire inspectors. On-site tax inspections, however, tended to last longer, averaging six days. Small firms found it harder to lease or buy land and commercial space. On the other hand, the practice for registering a new firm has eased slightly.

CEFIR defines small businesses in terms of the number of employees. In the latest round, CEFIR surveyed 2,000 firms in 20 regions. The average sample firm had ten employees. In 2004, 16 % of employed persons worked for small firms.

Barriers to small business activity, 2001–2004

(1 - barrier not a problem, 5 - threatens the existence of the firm)



- | | |
|------------------------------|------------------------------|
| 1. Tax level | 5. Business regulation |
| 2. Competition | 6. Access to capital |
| 3. Macroeconomic instability | 7. Anti-competitive barriers |
| 4. Tax administration | 8. Corruption |

Source: CEFIR

Duma opens spring session on January 10. The Duma's 2006 spring session should finally get to long-pending revision of the forest code and acceptance of the water code. In addition, the lower house is expected to take up amendments to the land code with respect to pricing of lots under existing buildings, as well as amendments concerning "strategic" deposits under the act on subsoil use and mineral extraction and amendments to the competition act. The Duma's to-do list also includes modifications to the tax and banking legislation, as well as amendments to the federal act on protection of information and the personal data act. Last week, the cabinet gave the green light to its 2006 legislative program, which consists of nearly 50 legislative drafts.

The legislative achievements of the Duma 2005 autumn session included an act on special economic areas, extension of the Kaliningrad special economic area for 25 years, an act on public-private partnerships in civil projects, as well as granting to foreign investors the direct right to purchase shares in gas giant Gazprom. The Duma also raised the base oil price that determines contributions to the stabilisation fund. That change is effective from the start of 2006.

China

Chinese investment abroad continues to increase.

Foreign direct investment to abroad by Chinese enterprises rose from \$5.5 billion for all of 2004 to \$5.6 billion in the first eleven months of 2005. Chinese oil company CNPC set a record for international investment by a Chinese enterprise last summer with its acquisition of PetroKazakhstan, a Canadian-owned oil company operating in Kazakhstan (see *BOFIT Weekly 34/2005*). In addition to the energy sector, FDI outflows in 2005 were directed at investments in businesses involved in the IT sector, mining and manufacturing. Although Chinese investment abroad has increased in recent years, the amount is still dwarfed by the investment flows into China. Officials have encouraged Chinese firms to increase their international reach, e.g. by simplifying licensing processes and offering expert assistance in investment projects.

The value of FDI inflows into China in January–November was \$53 billion, a 2 % drop from a year earlier. Officials report a particularly strong increase this year in investment in service sector businesses such as banking and retail sales.

Pension scheme revised. Chinese workers in pension scheme contribute 20 % of their gross wage (based on the previous year's earning) to their pension, with 11 % of the gross wage going to a personal pension account and 9 % going to the national pension fund. Under a new arrangement entering into force next week, the share paid into personal pension accounts will go down to 8 % and a correspondingly larger share will go to the pension fund. The last time the share going to personal accounts was reduced was in 1997. The reform is expected to increase the possibilities for public administrators to pay out pensions as it has greater access to assets in the pension fund. The reform hopefully also reduces earlier problems with abuse of personal pension accounts, as supervision of the fund is easier.

By some estimates, the pension scheme is currently under-funded by more than CNY 700 billion (€70bn). Without any reform, the pension scheme would be more than CNY 6 trillion (€600bn) in the red within three decades. China estimates that the number of people receiving pensions this year surpassed 40 million, which represents only about a fifth of the pension-aged population. Some 170 million workers, about a quarter of the working-age population, currently contribute to the pension scheme. China seeks to raise the amount to 220 million by 2010. The rule remains in place that persons

who have contributed for less than 15 years to the pension scheme are only entitled to draw pension payments from their personal pension accounts.

Industry profitability keeps climbing. Industrial profits rose 20 % y-o-y in the first eleven months of 2005. The pace of growth was off slightly from peak figures of 2004, probably due to a tougher competitive environment. Even so, profits of privately held firms soared more than 42 % y-o-y in January–November. State-owned industrial enterprises enjoyed 15 % y-o-y increases in profits and a 21 % y-o-y rise in sales volumes. The tax take from industrial companies operating in China grew 20 % y-o-y in January–November.

The rise in profitability continued strong in raw material industries, despite overcapacity in some fields. Steel production for example saw lower profit growth and oil refining remained unprofitable. The National Bureau of Statistics' profitability statistics cover all state-owned enterprises and private firms with annual sales exceeding CNY 5 million (€500,000).

China closes factories and limits investments. A recently published report from China's National Development and Reform Commission (NDRC) suggests that China aims to adopt a more efficient and environmentally friendly industrial structure. The report complements the 2006–2010 five-year plan. The structural reforms bar certain manufacturing methods and require a complete halt in the manufacture of certain products. The ban will be implemented incrementally over coming years. About 400 processes and products are slated for the phase-out, including certain textiles, building materials, chemicals as well as certain types of production of steel, coke and coal. The commission announced that banks will be forbidden from granting credit to firms that use the outlawed processes or making banned products, and banks even should take measures to recover loaned money.

The NDRC also defined about 200 manufacturing processes and products where no further investment is desired. These processes and products generally are found in fields facing a total ban. Banks are no longer allowed to finance new projects in the proscribed fields, nor will land be released for construction of new projects in those fields. While investments for maintaining existing production capacity will be possible, the NDRC is also considering killing several projects already in the implementation phase.