BOFIT

BOFIT Weekly
Yearbook 2008

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Bank of Finland, BOFIT
Institute for Economies in Transition

BOFIT Weekly
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Helsinki 2009

BOFIT Weekly – Russia 2008

4.1.2008	BOFIT Weekly 1/2008
	Russia, Turkmenistan and Kazakhstan agree on construction of a new pipeline.
	Russia's foreign debt stock climbing rapidly, even as overall levels of indebtedness remain low.
	Russian stock markets showed modest gains in 2007.
11.1.2008	BOFIT Weekly 2/2008
	Russian inflation climbed to 11.9 % in 2007.
	Wages continue to rise rapidly.
	Income disparity in Russia has increased only slightly over the last seven years.
18.1.2008	BOFIT Weekly 3/2008
	Rouble continues to strengthen.
	Current account surplus shrinks, while capital keeps pouring into Russia.
	Foreign currency reserves continue to grow rapidly.
25.1.2008	BOFIT Weekly 4/2008
	Economic policy as presidential election approaches.
	Investment rules for stabilisation fund assets approved.
	Project to run gas pipeline under the Black Sea to Bulgaria moves ahead.
1.2.2008	BOFIT Weekly 5/2008
	Consumption and investment up strongly in 2007.
	Russian car market expands rapidly.
	List of presidential candidates confirmed.
8.2.2008	BOFIT Weekly 6/2008
	Consumption and investment lifted Russian economic growth in 2007.
	Inflation accelerated in January.
	Authorities to take measures to fight accelerating inflation.
	CBR raises interest rates and tightens reserve requirements.
	Increases in social benefits and public sector wages.
15.2.2008	BOFIT Weekly 7/2008
	Latest BOFIT forecast sees modest slowing in Russia's economic growth in coming three years.
	Trade surplus shrank slightly last year.
	2007 was an above-average year for Russian farmers
22.2.2008	BOFIT Weekly 8/2008
	Russia's WTO talks grind on; Ukraine gets go-ahead on WTO membership.
	Rapid banking sector growth continues.
	Share of population living in poverty continues to decrease.
29.2.2008	BOFIT Weekly 9/2008
	Growth in housing prices and housing construction slowed last year.
	Cabinet tackles environmental issues.
	CIS states continued to enjoy high economic growth in 2007.

7.3.2008	BOFIT Weekly 10/2008
	Dmitri Medvedev wins presidential election.
	Finnish trade with Russia kept growing in 2007.
	Huge Finnish investment in Russia's electrical power sector.
14.3.2008	BOFIT Weekly 11/2008
	Economic trends by federal district.
	Inflation continues to accelerate.
20.3.2008	BOFIT Weekly 12/2008
	2007 federal budget in the black for the eighth year in a row.
	Public-sector economy posts overall surplus in 2007.
	Stabilisation fund split in two.
	Ukraine and Gazprom agree on gas deliveries.
28.3.2008	BOFIT Weekly 13/2008
	Duma passes law limiting foreign investment in strategic enterprises.
	New measures to assure banking sector stability introduced.
4.4.2008	BOFIT Weekly 14/2008
	Russian 2007 current account surplus declined, while capital and financial account surplus increased.
	No big changes in structure of fixed capital investment.
	Higher raw wood export tariffs now in effect.
11.4.2008	BOFIT Weekly 15/2008
	Public debate on direction of government economic policies heats up.
	Inflation continues to accelerate, current account surplus keeps growing.
18.4.2008	BOFIT Weekly 16/2008
	Russian cabinet approves national mineral exploration program.
	Tax changes in the works.
	Industry ministry unveils development plan for forest sector.
25.4.2008	BOFIT Weekly 17/2008
	Brisk economic growth abides.
	Russia now one of Europe's top retail markets.
	Getting regions involved in their own economic development.
30.4.2008	BOFIT Weekly 18/2008
	Central bank raises rates again.
	Public offerings gain popularity in Russia.
	Foreign forest companies embark on joint projects with Russian counterparts.
9.5.2008	BOFIT Weekly 19/2008
	Putin hands over the reins to Medvedev.
	Law on foreign investment in strategic industries gets final confirmation.
	Government decides to raise regulated prices.
	Oil price rise drives oil export duty to record levels.

16.5.2008	BOFIT Weekly 20/2008

Prime minister Vladimir Putin submits cabinet proposal.
Putin rolls out economic policy.
Growth in corporate borrowing remains strong.

23.5.2008	BOFIT Weekly 21/2008

New administrative structures take form.
Rapid growth in foreign trade continues.
Ukraine joins WTO; Russia's negotiations continue.
Salonen to head Sberbank's international operations.

30.5.2008	BOFIT Weekly 22/2008

Central bank hikes reserve requirements further.

First gathering of cabinet's presidium group focuses on taxation policy and social issues.
Russia launches major anti-corruption crackdown.

6.6.2008	BOFIT Weekly 23/2008

World Bank and IMF warn of economic overheating.

Russia launches biggest investment program ever to develop transport infrastructure.
Russia's insurance sector evolves.

13.6.2008	BOFIT Weekly 24/2008

Inflation continued to accelerate in May; slowing expected towards year's end.
IMF sees inflation as main risk to Russian economic growth.
CBR adjusts exchange rate policy.
St. Petersburg International Economic Forum convenes for 12th time.

19.6.2008	BOFIT Weekly 25/2008

GDP growth remained strong in first quarter.
CBR raises key rates for third time this year.
Reinvested profits dominate FDI inflows to Russia.
Gazprom expects gradual rise in its production levels.

27.6.2008	BOFIT Weekly 26/2008

Wages continue to rise rapidly.
Wide variations in labour demand across regions.
Russian population to shrink in coming years.

4.7.2008	BOFIT Weekly 27/2008

Government approves budgetary frame for 2009–2011.
Winding down of Russian electricity monopoly RAO UES completed.
Talks started on new EU-Russia agreement.

11.7.2008	BOFIT Weekly 28/2008

Inflation still high; rouble strengthens in real terms.
Current account surplus balloons; financial account also in surplus.
High volatility characterises first half for Russian stocks.

18.7.2008	BOFIT Weekly 29/2008	

Makeup of commission on foreign investment in strategic sectors now defined.
Management shakeups at state-owned companies.
Structure of state conglomerate Rostekhnologi emerges.

25.7.2008 BOFIT Weekly 30/2008

Rapid first-half economic growth despite lower oil production volumes.
Massive domestic demand undergirds growth.
Duma wraps up spring session and heads for vacation.

1.8.2008 BOFIT Weekly 31/2008

Stock markets react to prime minister's statements.
International researchers examine impacts of climate change on Russia.

8.8.2008 BOFIT Weekly 32/2008

CBR raises reserve requirements and key reference rates for the fourth time this year.
Sustained banking sector growth.
President Medvedev approves national anti-corruption plan.

15.8.2008 BOFIT Weekly 33/2008

Russian economy not expected to suffer significant impacts from Russia-Georgia conflict.
High oil prices boost foreign trade to record levels.
New law restricts access to continental shelf drilling and production.

22.8.2008 BOFIT Weekly 34/2008

Federal economy remains in good shape.
Duma approved the second supplemental budget this year.
Even with new SME legislative support, running a small business in Russia remains challenging.

29.8.2008 BOFIT Weekly 35/2008

Government goes with plan for relatively modest growth in public spending in coming years.
Cabinet approves CBR's monetary policy proposal for 2009–2011.
Foreign companies investing in strategic branches now required to submit detailed business plans.

5.9.2008 BOFIT Weekly 36/2008

Georgia conflict reflected on Russian financial markets.
Russia reconsiders its WTO commitments.
Georgia's critical role as a channel for energy exporters.

12.9.2008 BOFIT Weekly 37/2008

BOFIT forecast sees strong economic growth to continue in Russia.
Inflation remains high; monopoly pricing under investigation.
Tightness in money market continues.

19.9.2008	BOFIT Weekly 38/2008
	Government supports the finance sector.
	Russian stock market plunges as crude oil price tanks.
	Record grain harvest expected; state grain export company to be established.
	Finnish-Russian trade continued to expand rapidly in 1H08.
26.9.2008	BOFIT Weekly 39/2008
	Financial markets calmer this week.
	Bank health varies.
	Further changes in taxation under consideration.
	Fairly rapid growth continues.
3.10.2008	BOFIT Weekly 40/2008
	International uncertainty begins to hurt Russian economic growth.
	CBR currency reserves down slightly
	New government measures to support the finance sector.
	Finance ministry prepares principles on investment and use of assets in the National Welfare Fund.
10.10.2008	BOFIT Weekly 41/2008
	Share price swings on Moscow stock exchanges give new meaning to the term “volatility.”
	Government announces further measures to support Russian finance sector.
	Russia lending $4 billion to Iceland?
	High inflation continued in September.
	Hefty current account surplus persists, capital account in balance.
	Cabinet comes together on reform of pension system financing.
17.10.2008	BOFIT Weekly 42/2008
	Rouble’s exchange rate stays relatively stable.
	Duma quickly approves measures to stabilise financial markets.
	First foreign investments in strategic industries approved.
	Low voter turnout for regional and local elections.
24.10.2008	BOFIT Weekly 43/2008
	Rouble exchange rate weakens suddenly at bureaux de change.
	Russian credit risk rising.
	State development bank VEB and Deposit Insurance Agency support banks.
	September data reveal no evidence of slowing economic growth.
31.10.2008	BOFIT Weekly 44/2008
	Seesaw trend continues on Russia’s financial markets.
	Russia’s foreign debt relatively small by international standards.
	Distribution of financial sector support commences.
7.11.2008	BOFIT Weekly 45/2008
	First decisions reached on distribution of refinancing loans.
	Cabinet prepares to support real sector of the economy.
	Further reduction in oil export duty.
	Investment of oil tax revenues transferred to special state agency.
	President Medvedev delivers his first major policy speech.

14.11.2008	BOFIT Weekly 46/2008
	Rouble’s fluctuation band widened, interest rates increased.
	Duma approves 2009 federal budget.
	Banking sector performance reflects crisis in international financial markets.
21.11.2008	BOFIT Weekly 47/2008
	Market rates surge
	World Bank lowers economic outlook for Russia
	First three quarters show brisk foreign trade growth
	Putin and Medvedev participate in international talks
28.11.2008	BOFIT Weekly 48/2008
	Economic growth cools in October.
	Further widening of the rouble fluctuation band
	CBR discloses allocation of currency reserves.
	Financial market regulators in Russia and Cyprus agree to exchange information.
5.12.2008	BOFIT Weekly 49/2008
	Further widening of rouble trading band accompanied by interest rate hike.
	Unrelenting decline in oil prices defies budget assumptions.
	Currency reserves rise.
	State moves ahead with tax relief measures.
	Financial crisis also reflected in corporate profits.
12.12.2008	BOFIT Weekly 50/2008
	Rouble trading band widened again.
	S&P lowers Russia’s sovereign credit ratings.
	Deposit stock continued to shrink in October.
	Government plans to dip into the Reserve Fund.
	Federal budget remains in surplus.
19.12.2008	BOFIT Weekly 51-52/2008
	Further widening of the rouble’s trading band.
	Industrial output contracted in November.
	Lower foreign trade growth emerged in October.
	Economic downturn hurts employment and increases wage arrears.

BOFIT Weekly – China 2008

4.1.2008	BOFIT Weekly 1/2008	
	Yuan appreciation against the dollar accelerated in the second half of 2007.	
	Chinese share prices doubled in 2007.	
	Personal income tax limit raised.	
11.1.2008	BOFIT Weekly 2/2008	
	Recent legislation in China.	
	Nominal wage growth accelerates.	
	Change in holiday policies.	
18.1.2008	BOFIT Weekly 3/2008	
	Further tightening of monetary policy.	
	China posts record foreign trade surplus in 2007.	
	China-Indian trade keeps growing despite imbalances.	
25.1.2008	BOFIT Weekly 4/2008	
	China's economic growth remained brisk throughout 2007.	
	China's share of global production considerably less than earlier thought.	
	Chinese and Russian share prices take a dive.	
1.2.2008	BOFIT Weekly 5/2008	
	Yuan appreciating in real terms.	
	Energy shortages in China.	
	China's booming car industry.	
8.2.2008	BOFIT Weekly 6/2008	
	China's foreign currency reserves reached $1,530 billion at the end of 2007.	
	Foreign expansion characterises China's banking sector in 2007.	
15.2.2008	BOFIT Weekly 7/2008	
	Latest BOFIT forecast sees modest slowing in China's economic growth in coming three years	
	Good harvests in 2007.	
22.2.2008	BOFIT Weekly 8/2008	
	Chinese inflation rate remains high.	
	China loses car part dispute at WTO.	
29.2.2008	BOFIT Weekly 9/2008	
	China Investment Corporation expands its foreign in-vestment activity.	
	China's stream of patent application gathers force.	
7.3.2008	BOFIT Weekly 10/2008	
	Surging production costs force Chinese companies to stress efficiency.	
	Despite rising costs, steel production in China continues to soar.	
	Large Chinese investment in Australian mining giant.	

14.3.2008	BOFIT Weekly 11/2008
	Chinese inflation hits highest level in over 11 years.
	State budget report anticipates higher spending.
	Chinese share prices continue to slide.
20.3.2008	BOFIT Weekly 12/2008
	Yuan exchange rate affected by financial market turbulence.
	Annual meeting of National People's Congress adjourns.
	Growth in Finland-China trade flagged in 2007.
28.3.2008	BOFIT Weekly 13/2008
	Chinese banks and stock markets also feeling global financial woes.
	PBoC hikes reserve requirement again.
	China's rough winter leaves long-lasting legacy.
	Fuel shortages plague China once again.
4.4.2008	BOFIT Weekly 14/2008
	China's ballooning trade surplus with Russia.
	Arms imports from Russia collapsed last year.
	Paulson visits China.
11.4.2008	BOFIT Weekly 15/2008
	China revises 2006 and 2007 GDP figures upwards.
	Rapid growth in the insurance sector.
	Ping An acquires 50 % stake in Belgian investment company.
	Warming China-Taiwan relations.
18.4.2008	BOFIT Weekly 16/2008
	GDP growth remained strong in January-March.
	Consumer price inflation remains high.
	Imports up sharply in first quarter.
25.4.2008	BOFIT Weekly 17/2008
	Yuan shows real appreciation.
	Officials see speculative capital flows increasing.
	Rapid growth in Chinese productivity reflects structural reforms.
30.4.2008	BOFIT Weekly 18/2008
	Report finds reforms improving China's business environment, even in the country's interior.
	EU and China launched high-level dialogue on economy and trade.
	Policy measures rock Chinese share prices.
9.5.2008	BOFIT Weekly 19/2008
	Profits of large commercial banks up sharply in the first quarter.
	Increased use of SHIBOR reflects evolution of China's money markets.
	China and Japan mend relations.

16.5.2008	BOFIT Weekly 20/2008

Largest earthquake in over 30 years rocks southwest China.
Chinese inflation remained high in April; bank reserve requirements increased.
Despite rising production costs, growth in exports of clothing and textiles remains strong.
China's commercial aircraft industry aspires to becoming a global player.

23.5.2008	BOFIT Weekly 21/2008

Extent of damage caused by Sichuan quake becoming clearer.
China maintains its appeal for foreign direct investment.

30.5.2008	BOFIT Weekly 22/2008

Yuan exchange rate strengthens only slowly against the dollar.
WTO member countries concerned about numerous trade and market access problems with China.
Medvedev's first China trip headlines deepening Russia-China energy cooperation.

6.6.2008	BOFIT Weekly 23/2008

Residential housing sales slow slightly in early 2008, prices continue to climb.
Mainland China bank acquires majority stake in Hong Kong bank.
Rise in Chinese living standards causing structural changes in demand for health care services.

13.6.2008	BOFIT Weekly 24/2008

Inflation backs off slightly; PBoC continues to tighten monetary stance.
Stock market decline in China continues.
Private equity funds play increasing role as providers of corporate finance.

19.6.2008	BOFIT Weekly 25/2008

China posts record current account surplus in 2007.
Imports grew faster than exports in January-May.
China and Taiwan agree on regular direct flights.

27.6.2008	BOFIT Weekly 26/2008

China raises fuel prices.
China and Japan reach partial agreement on gas field dispute.
Environment and investment top agenda at 4th US-China strategic dialogue.

4.7.2008	BOFIT Weekly 27/2008

Despite many challenges, foreign banks upbeat on their prospects in China's banking sector.
China's steelmakers accept Australian demands for a 96 % increase in the iron ore price.

11.7.2008	BOFIT Weekly 28/2008

China prepares new restrictions for exporters to reduce speculative foreign currency inflows.
Good summer harvests expected.

18.7.2008	BOFIT Weekly 29/2008
	Economic growth slows as predicted, high inflation persists. Foreign trade surplus contracts with slowing export growth and rising import prices.
25.7.2008	BOFIT Weekly 30/2008
	Inflation a concern for China. Rapid rise in income continues.
1.8.2008	BOFIT Weekly 31/2008
	China's new anti-monopoly law enters into force today. Summer's electricity supply problems worst in years.
8.8.2008	BOFIT Weekly 32/2008
	Beijing Olympics expected to have minor impact on Chinese economy. Higher credit ratings for China and Russia. Economic cooperation between mainland China and Hong Kong deepens; CEPA VI signed.
15.8.2008	BOFIT Weekly 33/2008
	July producer price inflation rises to highest level in over a decade. Housing price development varies from city to city, but overall trend is to slower increase in prices. Increased export subsidies for clothing manufacturers.
22.8.2008	BOFIT Weekly 34/2008
	Spending on children's education represents a substantial share of Chinese household spending. Stock market decline continues; IPO enthusiasm wanes. Sharp slowdown in Hong Kong's economic growth.
29.8.2008	BOFIT Weekly 35/2008
	Investment rising fastest in China's interior provinces. Corporate profits continue to make robust gains.
5.9.2008	BOFIT Weekly 36/2008
	Grain production keeps rising; new hikes on fertiliser export tariffs. Tracking the progress of China's gas and oil pipeline projects. National audit office again finds widespread mismanagement of public funds.
12.9.2008	BOFIT Weekly 37/2008
	BOFIT forecast sees China's high GDP growth continuing. Yuan continues to climb against euro. While rise in consumer prices slows, producer price inflation is high.
19.9.2008	BOFIT Weekly 38/2008
	China's central bank relaxes its monetary stance. Industrial output growth slows. China continues to favour domestic carmakers.

26.9.2008	BOFIT Weekly 39/2008
	Officials move to prop up China's share markets. World Bank survey finds China more business-friendly; TI corruption ranking unchanged.
3.10.2008	BOFIT Weekly 40/2008
	China embarks on second major economic census of business activity. EU-China Joint Economic and Trade Committee meets to discuss trade and investment issues. Slowing growth in Finnish-Chinese goods trade.
10.10.2008	BOFIT Weekly 41/2008
	China's central bank relaxes monetary stance. IMF forecasts slowing economic growth in both China and Russia. EU continues sanctions on Chinese footwear – for the time being.
17.10.2008	BOFIT Weekly 42/2008
	China's foreign currency reserves climb to $1.9 trillion. Record foreign trade surplus in September. Communist party central committee lays out policy goals at its autumn meeting.
24.10.2008	BOFIT Weekly 43/2008
	China's economic growth slows more than expected in July-September. Rise in consumer prices continued to slow in September.
31.10.2008	BOFIT Weekly 44/2008
	More measures to ease monetary policy. Commercial bank profits show slightly lower growth; new opportunities sought abroad. Rapid rise in disposable income continues. China increases export subsidies.
7.11.2008	BOFIT Weekly 45/2008
	Central bank further relaxes monetary stance. China and Taiwan agree to allow direct sea cargo and flights. China and Russia pen deal on Siberian oil pipeline.
14.11.2008	BOFIT Weekly 46/2008
	China announces massive economic stimulus package. IMF lowers its economic outlook for China; NBS and China Customs October figures inconclusive on trends. Business barometers hint at slowdown in industrial output growth.
21.11.2008	BOFIT Weekly 47/2008
	Yuan exchange rate stabilises againt the dollar Share prices on China's stock exchanges in full retreat G-20 policy shift signals larger role for China
28.11.2008	BOFIT Weekly 48/2008
	China substantially eases monetary stance. China posts huge current account surplus again. Hong Kong economy falls into recession.

5.12.2008	BOFIT Weekly 49/2008
	November PMI figure drops below 40.
	China considers easing controls on retail pricing of gasoline and other oil products.
	Fiscal policy takes aim at the countryside.
	Chinese firm takes over container handling operations at the port of Piraeus in Greece.
12.12.2008	BOFIT Weekly 50/2008
	Both consumer- and producer-price inflation slow sharply.
	China’s export growth turned slightly negative in November, imports nosedive.
	Paulson holds final round of talks in China.
19.12.2008	BOFIT Weekly 51-52/2008
	China’s industrial output growth collapses to record low.
	Officials move to support flat housing market.
	China’s fuel pricing reforms set to take effect.

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1 • 4.1.2007

Russia

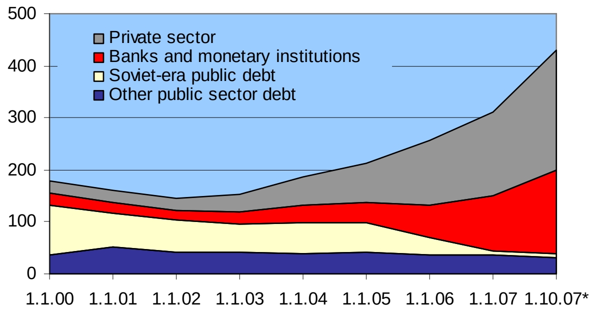
Russia, Turkmenistan and Kazakhstan agree on construction of a new pipeline. Under an agreement signed at the end of December, a natural gas pipeline with a planned annual capacity of 20 billion cubic metres will extend from Western Turkmenistan through Kazakhstan to Russia and be in use by the end of 2010. The project calls for construction of new parallel pipelines and extensive renovation of the Central Asia trunk pipeline. The "Caspian Pipeline Project" is the outcome of years of negotiation. No information has been publicly released about the ownership structure or financial arrangements behind the project.

Russia needs ever-increasing quantities of Turkmenistani gas to meet its export commitments under delivery contracts with Europe. Last year, Turkmenistan exported about 45 billion m^3 of gas to Russia, and via Russia to Ukraine. Gazprom plans to boost annual imports from Turkmenistan to about 70 billion m^3 in coming years. The substantial increase in export volumes would not have been possible without agreement on the new pipeline project. Turkmenistan has also agreed to construction of a gas pipeline running from its eastern areas to China. The pipeline should be ready in 2009. China has contracted to annually purchase 30 billion m^3 of gas from Turkmenistan once the pipeline is ready. Turkmenistani gas production last year was estimated at about 70 billion m^3.

Russia's foreign debt stock climbing rapidly, even as overall levels of indebtedness remain low. The Central Bank of Russia reports that Russia's stock of foreign debt at the beginning of October was $431 billion, of which about a tenth was held by the public sector. In recent years, the Russian state has aggressively paid down foreign debt. At the beginning of October, the state debt ratio was a mere 7.4 % of GDP and the foreign state debt stock just 3.2 % of GDP. As of mid-December, the state stabilisation fund held $151 billion, or nearly four times more than the entire public sector foreign debt. Russia's public sector foreign debt consists almost entirely of long-term (over one year) foreign currency bonds that the Russian Federation inherited after the collapse of the Soviet Union. Soviet-era debt at the beginning of October amounted to about $8 billion.

In contrast, borrowing of private sector firms has increased rapidly. This has been facilitated by Russian Federation's improved credit ratings due to its low public sector foreign debt. The improved ratings have again lowered the price of foreign money for Russian banks and firms. In addition, the abundance of excess liquidity in the global economy earlier this year increased opportunities for Russian firms to borrow relatively cheaply from abroad. The foreign debt stock of banks and financial institutions at the beginning of October was $161 billion, and $230 billion for the private sector (mainly companies). About a third of foreign borrowing by banks is short-term (up to 12 months), while only a fifth of foreign debt held by firms is short-term. The tighter liquidity situation prevailing in global financial markets since late summer has increased the cost of borrowing, especially short-term borrowing. Current debt figures reflect the turbulence of late summer as a small slowing in the growth of foreign borrowing in the third quarter. However, the growth of borrowing overall in January-September clearly accelerated from the same period a year earlier. At the beginning of October, private-sector foreign debt corresponded to 30 % of GDP, which is still quite low by international standards.

Russia's foreign debt 2000–2007, US$ billion



Source: Central Bank of Russia **latest observation*

Russian stock markets showed modest gains in 2007. As of end-2007, the RTS index was up 19 % y-o-y and the MICEX 12 %. Stock market growth, however, was distinctly lower than in earlier years and the trend lines in Russian bourses were flatter than in most other emerging markets.

Rising world metal prices increased the price of companies in the metals sector much faster than in other sectors. Unlike in earlier years, growth in the oil and gas sector was slower than in other sectors, even despite a leap in oil prices in the second half. The oil and gas sector has a weighting of about half of Russian stock market indices. Other important sectors include the finance sector (weighting of one-fifth) and the metals sector (weighting of about 14 %). The RTS finance sector index, which has risen briskly in earlier years, slowed down last year, reflecting the uncertainty in international financial markets.

Russian firms also staged several share offerings last year. Analysts estimate that the total value of offerings was about $30 billion, of which over half was raised last spring in the offerings of Russia's largest banks – Sberbank and VTB.

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BOFIT Weekly
1 • 4.1.2007

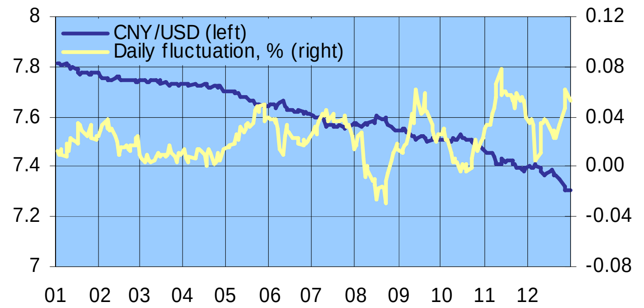
China

Yuan appreciation against the dollar accelerated in the second half of 2007. Last year ended with the yuan-dollar exchange rate at 7.30, a 6.9 % rise for the year of the Chinese currency against the US dollar. In the first half of 2007, Chinese officials and most investment banks projected that yuan appreciation for the year would only reach about 4 %. In contrast to the dollar, the yuan lost ground against the soaring euro, declining 4.4 % for the year. On December 31, one euro bought 10.75 yuan. Since the "mini-revaluation" and abandonment of the dollar peg in July 2005, the yuan has strengthened more than 13 % against the dollar and weakened 8 % against the euro.

China's foreign exchange policy, especially the rate of yuan appreciation, has clearly been influenced in recent months by the fall of the dollar against the euro. Interestingly though, there has been a distinct increase in the daily swings in the yuan-dollar exchange rate already since May (see figure below), when the People's Bank of China broadened the yuan's daily fluctuation range to encourage Chinese companies and financial institutions operating in the market to be more prudent than earlier in hedging their foreign exchange risks. Under the current rules, the yuan can strengthen or weaken against the dollar up to 0.5 %. The earlier range was ± 0.3 %. The biggest daily fluctuation was recorded at the end of December, when the yuan exchange rate rose against the dollar 0.41 % in a single day.

As a result of high economic growth, massive foreign trade surpluses, a spike in the inflation rate and a tighter monetary policy stance, there are no signs yuan appreciation will slow any time in the near future. On Friday (Jan. 4), one US dollar purchased 7.27 yuan.

Yuan-dollar exchange rates and daily fluctuation (%, 20-day moving average) in 2007

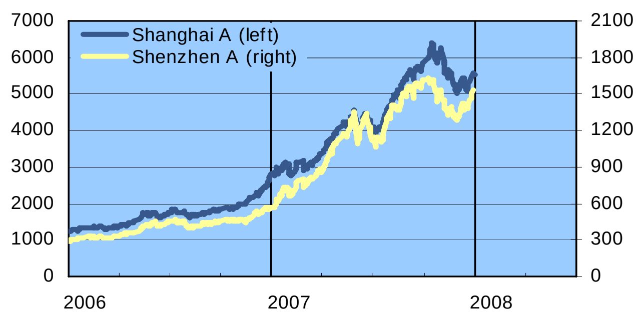


Sources: Reuters, Bank of Finland

Chinese share prices doubled in 2007. The Shanghai A-share index rose nearly 100 % last year, while the Shenzhen A-share index was up nearly 170 %. Widespread interest among Chinese in keeping their savings in shares increased last year when real deposit yields turned negative. The rise in share prices was also boosted by better-than-expected earnings posted by Chinese firms. 2007 saw stock exchange listings of several large state-owned enterprises. After a brief decline this autumn, share prices recovered in December. The role of foreigners in China's markets remains relatively small, and moves on international bourses seem to have little impact on trends in Chinese stock markets.

A central bank barometer survey conducted in November found that the interest of private investors in investment in shares and mutual funds declined sharply compared to surveys in May and August. Interest in holding shares has faded with higher volatility in the stock market and central bank reference rate hikes.

Shanghai and Shenzhen A-share indexes



Sources: Shanghai and Shenzhen stock markets

Personal income tax limit raised. At the end of December, the Standing Committee of the National People's Congress voted to increase the exemption on personal earned income. Effective March 1, the first 2,000 yuan (€190) in monthly wages will not be subject to income tax. The current limit is 1,600 yuan (€150). Earnings above that level will be taxed progressively up to the highest tax bracket, which carries a rate of 45 %. The base personal income tax limit was last increased two years ago. After the change, it is expected that 70 % of wage earners will be exempt for personal income tax. The change is also an acknowledgement that wages have risen rapidly, which has significantly increased the share of wage-earners obliged to pay income tax.

The Ministry of Finance predicts the increase in the income tax limit will reduce state revenues annually by 30 billion yuan (€3bn). On the other hand, state revenues have risen faster than expected in recent years. Revenues were up last year by 30 % by some estimates to almost 5 trillion yuan (nearly €500bn). Last spring's budget set expenditures for the year at 4,600 billion yuan and the budget was expected to come in slightly in the red.

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EUROJÄRJESTELMÄ
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BOFIT Weekly

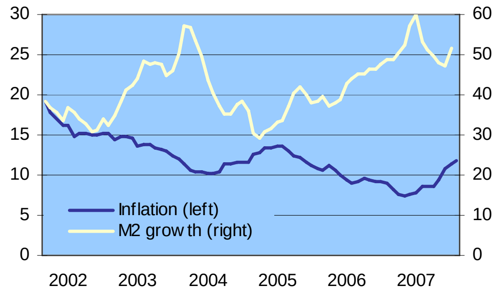
2 • 11.1.2008

Russia

Russian inflation climbed to 11.9 % in 2007. Russian inflation rate was driven up last year by increases in food prices in line with rising food prices around the world, and record foreign currency inflows from soaring oil prices and increased foreign investment. The broad money supply (M2) climbed over 50 % y-o-y at the beginning of December. Food prices increased 15.6 % y-o-y.

The economy and finance ministries forecast inflation will slow this year to 7.5–8.5 %. Inflation pressures, however, will sharpen through e.g. scheduled rate increases for electricity and gas, as well as for regulated prices for municipal services and more budget spending.

12-month inflation and M2 growth, 2002–2007, %



Sources: Rosstat, Central Bank of Russia

Wages continue to rise rapidly. Last November, the average monthly wage in Russia was 14,400 roubles (€400). In real terms, wages were up 15 % from a year earlier. Despite the rapid rise in Russian wages, only a small percentage of Russian employees earn more that €1,000 a month. About a tenth of Russian employees are paid less than €100 a month. The price of a hypothetical basic basket of goods and services for a month stood at about 6,000 roubles (€170) at the beginning November.

The highest wages continue to be paid in the finance and oil-and-gas sectors, where average wages are more than double the average. Wage growth was also high in the financial sector. Growth of wages in oil and gas related sectors, in contrast, was somewhat lower than average.

Russia's lowest wage levels, only about half the average, continue to be found in agriculture, forestry and the textile industry. Wage growth in the agriculture sector, however, increased sharply and was higher than in other sectors. The growth spurt reflected, e.g. higher food prices and increased support for the agricultural sector.

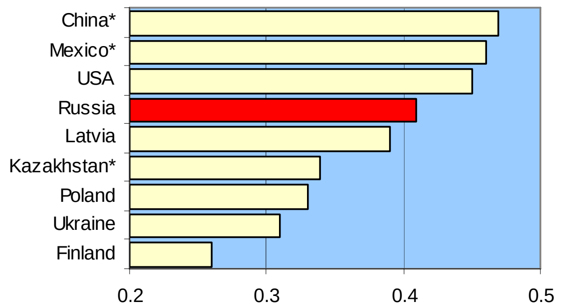
Wage hikes in the budget sector have lifted the average wage of civil servants above the average wage at all levels of administration. The fastest increase has been in the wages of federal executive officials, which saw their wages climb 25 % y-o-y in real terms during January-September 2007. Regional-level officials, however, continued to enjoy the highest wages – nearly double the average wage. Further wage hikes in the budget sector are slated for this year.

Income disparity in Russia has increased only slightly over the last seven years. In November 2007, the average monthly income in Russia was 13,700 roubles (€380). Wage income accounts for slightly over two-thirds of total income. In addition to wages, Russians get income from such sources as small side businesses, capital earnings and various social payments. During January-September 2007, the top quintile accounted for 47 % of all income, while the second quintile enjoyed 23 %. The poorest quintile received just 5 % of all income. About half of the population has incomes that are only two-thirds of the average income, and nearly 13 % of the population lives on less than €100 a month.

According to Rosstat Russia's Gini coefficient was 0.41 at the end of 2006. When the Soviet Union collapsed, Russia had a Gini coefficient of 0.29. The Gini coefficient indicates income disparity in a given society, ranging from zero, which indicates perfect income distribution (no inequity), to one, where all income goes to the richest. Income disparity took off in Russia during the 1990s, but even with the booming economy in the 2000s, Russia's Gini coefficient barely changed. Russia's Gini coefficient reached 0.40 in 2000 and has only increased slightly since.

By international standards, income distribution in Russia is slightly more inequitable than in any EU country, including Latvia, which has the highest Gini coefficient in the EU. Russian incomes are still distributed more evenly, however, than in the US or China.

Gini coefficients for select countries, 2006



0.0 = perfectly even income distribution
1.0 = all income goes to the wealthiest

Sources: Rosstat, Eurostat, CIA **data from 2003, 2004*

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China

Recent legislation in China. The turn of the year saw the entry into force of the new labour contract law and the corporate tax law. Other key laws have seen important amendments: e.g. an amendment to the substantive property protection law went into force last October and at the beginning of this June a law on arbitration of employer-employee disputes will be inaugurated.

The new labour contract law significantly improves worker rights. Under the law, all workers have the right to a written employment contract. The law also defines severance pay rules for worker termination, and sets limits on the uses of temporary and part-time labour, as well as leased labour, which is extremely common in some fields. The law is likely to increase production costs.

The law unifying the corporate income tax for domestic and foreign companies also entered into force this month. The standard income tax on enterprises is now 25 %. Earlier, domestic firms were expected to pay a 33 % profit tax rate and foreign firms 15 %. The change applies immediately to domestic firms, while foreign firms will move incrementally to the new rate over a five-year transition period (18 % in 2008, 20 % in 2009, 22 % in 2010, 24 % in 2011 and 25 % in 2012). During the transition period, many of the preferential tax policies granted to foreign invested enterprises will also be eliminated. Several exemptions to the corporate income tax will remain. High-tech firms and firms operating in Western China, for example, will continue to pay a 15 % income tax rate.

After years of preparation, the amended substantial property protection law finally entered into force in October 2007. The law e.g. defines of ownership rights, set damage settlements and compensation rules, and establishes rules governing property transactions. Under the law, the state still owns the land and grants rights of use. The law also makes it possible to use fixed capital as collateral.

In May this year, a road traffic safety law enters into force. The law is designed to improve the rights of pedestrians and cyclists in the event of traffic accidents and prevent traffic incidents. The beginning of June will see implementation of a law that speeds and eases resolution of disputes between employers and employees.

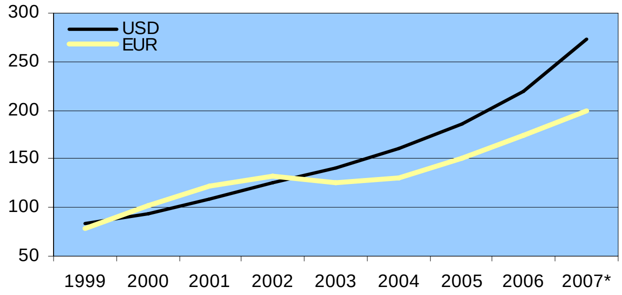
Most of the new laws have been received quite positively. Some observers, however, expect the impacts of the new laws to be limited, due to a failure to put adequate oversight mechanisms in place.

Nominal wage growth accelerates. January-September figures show that growth in nominal wages accelerated last year. Nominal wages climbed around 14–15 % a year in 2005 and 2006, while 2007 they rose about 18–19 %. The acceleration in realized inflation last year has fed inflation expectations, which has translated into demands for higher wages. Officials report real wages have risen in recent years slightly more than 10 % a year, and last year's increase was probably about the same magnitude.

If the first three quarters of last year were a good indicator, one can estimate that the average monthly wage in 2007 rose to about 2,100 yuan (about €200 or $270). Last year, the yuan lost 4 % against the euro, but gained about 7 % against the dollar (see graph below).

One problem with Chinese wage statistics is their poor coverage. Until now, the reported monthly wage described wages of people working in the public sector or urban cooperatives. The situation should improve this year, when statistics data are broadened to include the private sector. Because private wages are on average lower than public sector wages, the inclusion of the private sector data should reduce China's average wage figure.

Average Chinese monthly wage in dollars and euros



** estimate*
Sources: CEIC, BOFIT

Change in holiday policies. The traditional three-day holiday surrounding the First of May has been reduced to a single day, while, three new one day public holidays have been added to the calendar: the Tomb-Sweeping Day in early April, the Dragon Boat Festival in summer and the Mid-Autumn Festival. The traditional three-day holiday that includes Chinese New Year and National Day (Oct. 1) will continue. In practice, several Chinese have extended three day holidays to cover whole week by ia working extra days beforehand.

From the start of the year, workers who have served the same employer for 1–10 years will get five days of paid vacation annually, those who have served 10–20 years will get ten days as year, and those with more than 20 years of service will get 15 days. If the worker is forced to work on a scheduled vacation day, he is entitled to triple pay.

Despite the rules, Chinese holiday practices are diverse. One study showed that in urban areas about 10 % of workers worked seven days a week all year.

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Russia

Rouble continues to strengthen. The rouble's real effective (trade-weighted) exchange rate strengthened 5.3 % in 2007. A year earlier, the rouble strengthened 7.4 % in real terms. The strengthening of the rouble's real exchange rate last year was sustained by increased export earnings, as well as rapid growth in capital inflows into Russia. The economy ministry forecast last October that the rouble's real effective exchange rate would strengthen this year by about 3 %. The rouble's real exchange rate last year appreciated 5.7 % against the euro and 14.8 % against the dollar. The large difference in the exchange rate rising against the euro and dollar reflects the euro's strengthening against the dollar.

The Central Bank of Russia has strived to keep the rouble's nominal exchange rate relatively stable and the nominal effective exchange rate last year was nearly unchanged (down 1 %). This has made it more difficult for the CBR to deal with inflationary pressures and the inflation rate accelerated to 11.9 % last year. The rouble's nominal exchange rate declined 3 % against the euro and strengthened 7 % against the dollar. At the end of 2007, the rouble's nominal dollar exchange rate was 24.6, while the euro was 35.9.

Current account surplus shrinks, while capital keeps pouring into Russia. Preliminary balance-of-payments figures from the CBR show that the current account surplus in 2007 was $77 billion, or about a fifth less than in 2006. The reduction in the current account surplus was a reflection of import growth outstripping export growth.

According to the preliminary figures, the value of Russian goods exports climbed 16 % in 2007, while the value of imports grew 37 %. Export earnings increased more slowly than a year earlier due to lower oil prices at the start of the year. The growth in spending on imports, on the other hand, picked up from a year earlier.

The value of crude oil exports increased last year by nearly a fifth, while the value of gas exports remained at the last year's level. Growth in the value of exports of oil and gas, however, spiked in the last quarter, along with the oil price internationally. Oil, oil products and gas together represent 61 % of Russian goods exports.

In the trade in services, imports grew faster than exports, and the services trade continued to be clearly in deficit. Services accounted for 10 % of Russia's total exports and 21 % of total imports.

The financial account indicates a record amount of capital inflows into Russia. Most of the capital came from borrowing as the private sector piled on debt. Preliminary estimates show private sector borrowing from abroad (excluding banks) exceeded $75 billion in 2007, up from $17 billion a year earlier. There seems, however, to have been a distinct slowing in foreign borrowing in the fourth quarter. Growth in direct and portfolio investment of Russian firms abroad was up sharply from a year earlier. Growth in investment into Russia slowed. Direct and portfolio investment flows into Russian companies and from them were on par.

Main items of Russia's balance-of-payments, 2005–2007, US$ billion

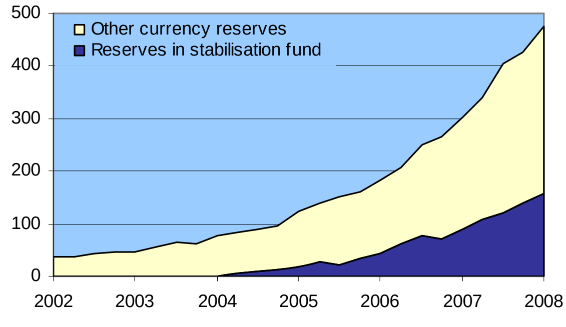
	2007*	2006	2005
Current account	**76.6**	**94.3**	**84.4**
Goods balance	128.7	139.2	118.4
Services balance	-19.7	-13.8	-13.9
Income balance	-28.9	-29.6	-19.0
Current transfers	-3.5	-1.5	-1.0
Capital and financial accounts	**75**	**5.8**	**-14.6**
Net errors & omissions	**-2.7**	**7.5**	**-8.3**
Currency reserves (– growth , + decline)	**-148.9**	**-107.5**	**-61.5**

Source: Central Bank of Russia **preliminary*

Foreign currency reserves continue to grow rapidly. At the beginning of 2008, Russia's foreign currency and gold reserves stood at $480 billion, or nearly 60 % more than a year ago. At the beginning of last autumn, growth of the foreign currency reserves slowed sharply in the face of insecurity on international financial markets. By the end of the year, however, the reserves had begun to climb rapidly again as world oil prices hit new highs. At the beginning of this year, some $157 billion of Russia's foreign currency reserves were set aside in the stabilisation fund. Russia has the world's third largest foreign currency reserves after China and Japan.

The most recently released figures showing the composition of Russia's foreign currency reserves are from March 2007, when the reserves were made up of assets denominated 49 % in dollars, 40 % in euros, 10 % in British pounds and 1 % in Japanese yen.

Russia's foreign currency reserves 2002–2008, US$ billion



Sources: Central Bank of Russia, Ministry of Finance

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China

Further tightening of monetary policy. The People's Bank of China this week announced it was raising the mandatory reserve requirement for commercial banks one-half of a percentage point to 15 %, effective January 25. Last year the reserve requirement was raised incrementally from 9 % at the start of the year to 14.5 %. The move is intended, above all, to dampen the acceleration in Chinese inflation. Other officials are increasingly turning to the use of administrative regulation to slow inflation. China's National Development and Reform Commission (NDRC) said this week it was setting limits on e.g. the rise in food prices.

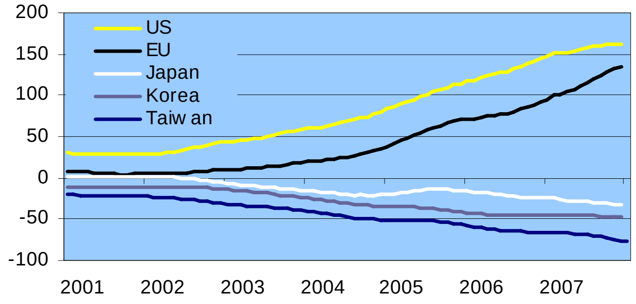
China posts record foreign trade surplus in 2007. China Customs reports that last year exports amounted to $1,218 billion and imports $956 billion, resulting in a foreign trade surplus of $262 billion. The 2007 trade surplus was $177 billion. The surplus widened as export growth (up 26 % y-o-y) continued to outpace import growth (up 21 % y-o-y). In the fourth quarter of 2007, the direction flipped and import growth was slightly higher than export growth. Import growth is expected to continue to slightly outpace exports, so trade surplus growth is expected to slow this year.

In 2007, China's top trading partners (in descending order) were the EU, the US, Japan, Korea and Taiwan. While China Customs figures show the EU surpassed the US as China's top export market, the foreign trade surplus was still the largest with the US, even if the surplus growth with the US slowed last year. In 2007, China still ran a significant trade deficit with Japan, Korea, Taiwan and some other Asian countries. China's exports to oil producing countries and Latin America grew rapidly. For the first time in many years, China showed a surplus in China-Russia trade.

China's main goods exports are machinery and equipment. Products in the category account for nearly 60 % of China's total exports. Textiles and clothing account for about 15 % of exports. Steel exports, however, skyrocketed last year (up 70 % y-o-y). About half of China's imports consist of machinery and equipment. Oil constitutes an 8 % share of imports. The amount of refined oil products contracted last year compared to previous years.

Foreign trade figures suffer from a number of statistical peculiarities. For example, China's export customs figures often disagree with the figures of the importing country's customs on the other side of the trade. The export figures given by China Customs are smaller than e.g. the figures the EU and the US give for imports from China. China's trade figures are distorted especially by trade moving through Hong Kong, which as a separate customs area is not included in China Customs figures. Some 15–20 % of China's trade moves through Hong Kong.

China's bilateral trade balances with its main trading partners, 12-month moving average, US$ billion



Source: China Customs

China-Indian trade keeps growing despite imbalances. China Customs reports that exports to India in 2007 grew to $24 billion (65 % on-year growth) and imports from India reached slightly more than $10 billion (up 40 % y-o-y). After many years of balance, the bilateral trade started to favour China in the first half of 2006. Since then, China has enjoyed a rapidly increasing surplus in its trade with India.

Although in dollar terms, the Indian economy has surpassed Korea as Asia's third largest economy after Japan and China and India shares a common border with China, bilateral trade between China and India remains relatively modest. India's share of China's exports and imports was a mere 2 %. According to Indian statistics, China (including Hong Kong) accounts for over 10 % of exports and imports, with particularly strong growth in imports.

At the start of this week, Indian prime minister Manmohan Singh visited China for the first time since taking office in 2004. Although the theme of the visit was deeper economic cooperation, the Indian contingent was concerned about the growing trade deficit with China and the structure of trade. China mainly imports raw materials and low-value-added products from India, while it exports products to India with high value-added. Minerals constitute over 60 % of the value of Indian exports to China, while machinery and equipment are a mere 3 %. Conversely, machinery and equipment represent over 40 % of China's exports to India and the share of raw materials is quite small.

While weaknesses in the Indian economy account in part for the modest level of China-India bilateral trade, the Indians during Singh's visit also pointed to China's imposed barriers to trade and difficulties in access to Chinese markets as additional factors.

Border disputes remain the highest profile problems in bilateral relations. When China's premier Wen Jiabao visited India in April 2005, the parties agreed in principle that the border disputes would be resolved. Despite several rounds of negotiation, however, little progress has been made. Nevertheless, border disputes have not prevented firms in both countries from advancing business relations.

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Russia

Economic policy as presidential election approaches. President Vladimir Putin laid out some of the directions of economic policy in coming years in his speech to representatives of upper-house Federation Council at the start of its latest session. The president's main theme was social policy, putting emphasis on the importance of a good social environment (including health care, housing, education and working conditions) for the country's economic success. Putin said that the public social services system needs to be reformed, but did not specify how. Reforms of the social system, which definitely needs reform, have been stopped since broad protests in 2005 after an attempt to replace some free and supported social services by monetary compensation. In his speech, Putin said that the private sector can participate in funding the production of social services. Putin said the social services branch would offer abundant opportunities to small and medium-sized companies if excessive regulation is eliminated.

On Monday (Jan. 21), the Central Election Commission registered the presidential candidacy of first deputy prime minister Dmitri Medvedev. On Tuesday, Medvedev spoke at the Civic Forum arranged by the Public Chamber, which was started at the initiative of the Kremlin three years ago. The speech was Medvedev's first policy speech as a presidential candidate. Medvedev emphasised the stability that has come to Russia in the 2000s and its continuing importance to the country's future development. Among the challenges facing Russia, Medvedev addressed in particular the lack of respect for the law in all aspects of Russian life from the small-time pirating of digital recordings to large-scale corruption. If Russia wants to be a state with a high cultural standard, Medvedev said that Russia must first become a country of the rule of law.

Investment rules for stabilisation fund assets approved. As of end-2007, stabilisation fund assets increased to $157 billion (3,850 billion roubles), corresponding to about 12 % of last year's forecast GDP. The fund collects federal budget surpluses and a part of production taxes and export tariffs on oil and gas.

At the beginning of February, when last year's budget surplus has been finalised and transferred to the stabilisation fund, the stabilisation fund will be divided into a reserve fund and a national prosperity fund. The ceiling on the reserve fund is 10 % of estimated GDP in a given year. If this level is exceeded, the surplus funds will be transferred into the national prosperity fund. Reserve fund assets can be used to pay down state foreign debt ahead of schedule and cover budget deficits. No decision has yet been reached on the use of assets in the national prosperity fund, but in principle the assets are meant to finance major government reform such as the reformation of the pension system.

Stabilisation fund assets are held in the finance ministry's accounts at the central bank, and since 2006 the central bank has invested them on the same principles as other currency reserves, i.e. assuring investment liquidity and low risk. There has been a spirited debate over use and investment of stabilisation fund assets since the fund was established four years ago, and the finance ministry has been accused of tolerating excessively low yields on the funds. The government decisions at the shift of the year say the assets of the reserve fund and the national prosperity fund will be invested somewhat wider than other currency reserves, but nevertheless conservatively. The assets can be invested in euros, US dollars, and Great Britain pounds, as well as treasuries and bonds issued by some of the most creditworthy countries and international financial institutions and as deposits in top foreign banks. So far, assets cannot be invested in shares of foreign corporations.

Project to run gas pipeline under the Black Sea to Bulgaria moves ahead. Gazprom and the Italian energy company ENI agreed last week to establish a joint company to prepare a feasibility study on running a pipeline under the Black Sea. The study should be ready sometime this year. The project, which has been under planning for years, is known as South Stream. The planned capacity of the pipeline is 30 billion cubic meters a year and it could be in partial operation as soon as 2013. Upon completion, the pipeline would probably reduce the amount of gas transmitted through Ukraine to European markets.

Under the plan, the pipeline would split in Bulgaria into a southern and northern branch. The northern branch would travel through Serbia and Romania, perhaps as far as Austria. The southern branch would bring gas to Greece and Italy.

The South Stream pipeline is a rival to the EU-backed Nabucco gas pipeline. Years in planning, the Nabucco pipeline would carry gas from Azerbaijan (and perhaps Central Asia) via Turkey and Bulgaria to Western European markets.

During last week's visit of president Putin to Sofia, it was announced that the Bulgarian state and Gazprom had reached agreement on construction of a gas pipeline to Bulgaria. The specifics of the deal were not revealed.

In conjunction with the visit, the parties also signed a deal on a feasibility study on the proposed Burgas-Alexandroupolis oil pipeline to Greece, and construction of a nuclear power plant in Belene in Northern Bulgaria.

Gazprom and Serbia are expected to soon reach agreement on energy cooperation, which would guarantee both the continuation of the gas pipeline to Serbia and would make Gazprom the dominant shareholder in the Serbian national energy company NIS.

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China

China's economic growth remained brisk throughout 2007. The National Bureau of Statistics reports China's GDP grew 11.4 % last year in real terms to 24,660 billion yuan (€2,400 billion). Growth peaked last year in the second quarter, and slowed slightly thereafter. In the last quarter of 2007, GDP rose 11.2 % y-o-y in real terms. Last year, industry accounted for 49 % of GDP, services 39 % and agriculture 12 %. This breakdown did not change from 2006. GDP growth is expected to remain brisk this year, and China's nominal GDP should surpass Germany's, making it the world's third largest economy after the US and Japan (see purchasing power parity comparison below).

Soaring export growth fuelled the acceleration in GDP growth last year, bringing the foreign trade surplus to $260 billion. Growth of fixed capital investment also remained high (nominal rise of 25 % y-o-y). Retail sales, a measure of domestic consumption, climbed 17 % last year in nominal terms.

China's inflation accelerated last year to levels not seen for over a decade. In December, consumer prices were up 6.5 % y-o-y. The rise in consumer prices has been led by higher food prices.

China's share of global production considerably less than earlier thought. December saw the release of the World Bank's International Comparison Program (ICP) report. The ICP compiles purchasing power parity (PPP) based exchange rates for different countries, and uses them to calculate real national GDP. The figures in the latest report are based on 2005 data. A particularly striking feature of the new data is that the PPP-adjusted GDP figures for China and India are considerably smaller that previously estimated. China's PPP-adjusted GDP dropped 40 % in the new calculation and India dropped 45 %. On the other hand, the PPP-adjusted GDP of oil-producing countries increased in the new estimates.

Based on the 2005 data, the PPP-adjusted exchange rate for the yuan is 3.4 yuan to the dollar, a considerable change from the earlier value of 2.1 yuan to the dollar. The nominal yuan-dollar exchange rate in 2005 was 8.2. The ICP report authors emphasise that PPP-adjusted exchange rates should not be used to estimate the actual nominal exchange rates. As a result, the new figures add no new insights to the current debate on China's exchange rate policy.

With the finding that the significance of China and India to the global economy has been smaller than assumed, the IMF lowered its 2007 growth estimate for the global economy from 5.2 % to 4.7 % at the beginning of this month. Even so, the contribution of the world's largest developing economies to global economic growth has increased considerably in recent years. Using the new figures, China alone accounted for 27 % of global growth last year. The IMF reports China's share of global production rose to 10.9 % in 2007. China was the world's second largest economic power after the US (with a 21.4 % share in 2007) in terms of PPP-adjusted GDP.

Per capita GDP and global GDP shares for BRIC countries and Japan in 2005

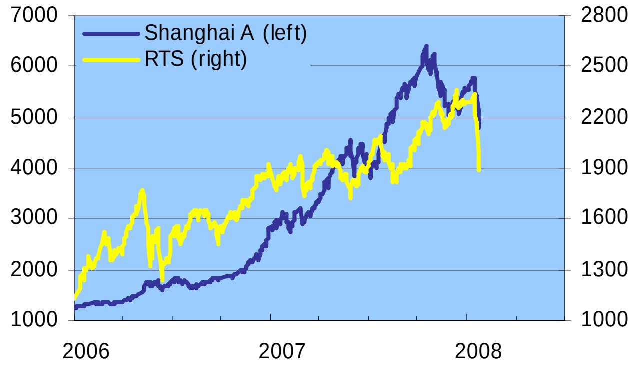
	Per capital GDP, US$		Share of global production, %	
	Nominal	PPP	Nominal GDP	PPP GDP
China	1,700	4,100	5.1	9.7
India	700	2,100	1.8	4.3
Russia	5,300	11,900	1.7	3.1
Brazil	4,800	8,600	2.0	2.9
Japan	35,600	30,300	10.3	7.0

Source: 2005 ICP

Chinese share prices take a dive. Despite daily price gyrations, China's share markets have generally tracked trends elsewhere in the world since share prices on the major international bourses began to erode last October. The global decline has been fed by fears that the US economy may be falling into recession. China's share prices this month suffered the same case of the jitters seen elsewhere, falling as much as 7 % in a single day. For January to date, China's share prices are down about 10 %, although share prices have rebounded a bit in recent days following the US Federal Reserve's surprise 0.75 % lowering of its prime lending rate.

Despite weakness elsewhere, Russian share prices, sustained by rising energy prices, climbed throughout last autumn until mid-January, at which point they fell off a cliff. As of Thursday (Jan. 24), Russian share prices were down an average of 14 % from the start of the month.

Shanghai A-share index and Moscow RTS index



Source: Bloomberg

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Russia

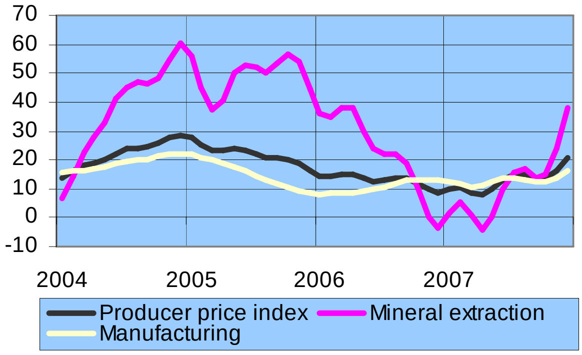
Consumption and investment up strongly in 2007. Rosstat reports that highest growth among Russia's core economic sectors continues to be registered in construction and retail sales. Construction increased 18 % and retail sales were up 15 %. On-year growth in industrial production accelerated to 6 %, led by 9 % growth in manufacturing. This suggests gradual diversification of the structure of production. High growth was seen e.g. in production of some construction materials. Mineral extraction industries (including oil and gas) saw growth slow slightly to below 2 %. Last year, growth was slightly above 2 %. Transport growth also declined to 2 % and agricultural growth stalled at about 3 %. According to Rosstat's initial estimate, GDP growth in 2007 was 8.1 %.

Growth in fixed capital investment accelerated to 21 % and the share of investment in GDP is estimated to have risen to over 20 % in the second half of 2007.

The average monthly wage rose 16 % in real terms last year to 13,500 roubles (€390).

The rise in consumer prices accelerated to nearly 12 % and producer prices to 25 %, when in 2006 consumer prices rose to 9 % and producer prices 10 %. The rise in industrial producer prices accelerated fastest in mineral extraction industries (52 %). Producer prices in manufacturing rose 18 %. The rapid rise in producer prices drives up production costs for Russian industry and degrades price competitiveness.

On-year change in industrial producer prices 2004–2007, 3-month moving average, %



Source: Rosstat

Russian car market expands rapidly. Rising incomes and increased availability of car loans have stoked fierce demand for cars in Russia. Most of this demand is already satisfied through imports, which have increased many-fold during the 2000s. According to preliminary estimates, Russia last year imported over 1.6 million passenger cars. The number of passenger cars imported to Russia via Finland last year as transit freight was about 720,000, or 60 % of Russian car imports.

Russia manufactured 1.3 million passenger cars in 2007, an increase of 10 % y-o-y. The growth was due to a strong increase in assembly of foreign car makes in Russia. Assembly operations now represent about a third of total car production. Less than a tenth of car production goes to exports, mainly to CIS markets.

The manufacture and sale of Russian car makes is estimated to have declined last year. Despite some severe problems, AvtoVAZ, Russia's largest carmaker, managed to increase its sales last year due to foreign makes it produces. After a long search, the carmaker, which is administered by the state corporation Rostechnology, last year found a strategic foreign partner in Renault, which plans to take a 25 % plus one share stake in AvtoVAZ this year.

Nearly all major carmakers have production in Russia – either in their own plants or as assembly operations at plants owned by Russian carmakers. Assembly operations are usually based on industrial assembly agreements that allow carmakers to import parts to Russia at lower tariff rates. In exchange for the low tariff treatment, however, it is expected that the content of domestically made components in the assembled foreign makes increase gradually in order to boost local value-added and job creation. Increasing the domestic component content, however, has posed problems for car manufacturers as it is difficult to find competent supplies in Russia that can meet their quality and price demands.

Economy minister Elvira Nabiullina said that at the moment the total value of investment in assembly plant projects under construction or in planning exceeds $6.5 billion. The latest investment agreement was signed this week with Peugeot-Citroen for construction of a plant in Kaluga. The Kaluga region is a rising star in car manufacture, joining Russia's other carmaking centres in St. Petersburg, Samara and Tatarstan.

List of presidential candidates confirmed. The official candidate list for the March 2 presidential election consists of first deputy prime minister Dmitri Medvedev, Communist party chairman Gennady Zyuganov, Liberal Democrat leader Vladimir Zhirinovsky and the head of the tiny Russian Democratic party Andrei Bogdanov.

The first three candidates were nominated by parties represented in the Duma, meaning their candidacies were approved without the need for collecting signatures. The other two presidential candidates had to collect at least two million valid signatures. The Central Election Commission approved the candidacy of Andrei Bogdanov, while it rejected former prime minister Mikhail Kasyanov's registration, claiming it contained too many invalid signatures.

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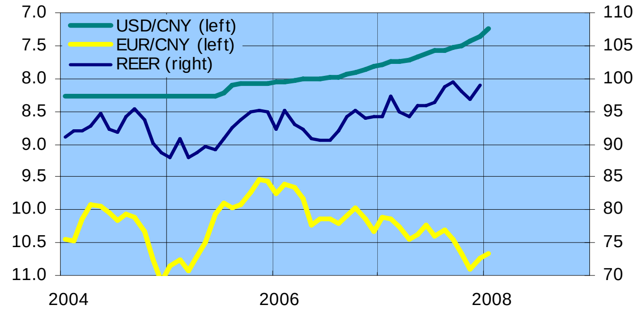
China

Yuan appreciating in real terms. After an accelerated strengthening in the second half of 2007, the yuan continued to gain value throughout January against the dollar. The yuan has also climbed against the euro over the past two months. The yuan gained 1.8 % against the dollar for the month of January and 0.7 % against the euro. On Thursday (Jan. 31), one dollar bought 7.18 yuan and one euro 10.65 yuan.

The yuan's real effective exchange rate (REER) weakened about 15 % during the period early 2002 to early 2005. Since mid-2006, however, the yuan REER has risen about 10 %, tracking closely the rise of the nominal exchange rate against the dollar. The REER is an important indicator of price competitiveness. It considers exchange rate development relative to other exchange rates and inflation differences between China and its trading partners. The appreciating real exchange rate in China's case reflects the country's economic development and the convergence of Chinese price levels with those in developed countries. Although a stronger currency reduces a country's price competitiveness, cheaper imports increase competition domestically and drive productivity growth.

Yuan-dollar and yuan-euro rates, REER* (inverted, increase shows appreciation)



* Index average, 2000=100
Sources: Reuters, BIS

Energy shortages in China. Over half of China's provinces have been hit recently by power outages and brownouts as snow storms continue to hamper coal deliveries. Several provinces imposed electricity rationing after dozens of coal-fired power plants were temporarily shut down due to the lack of fuel. In addition, the fragile power transmission grid has been damaged in several places. Some observers estimate China's electricity deficit is about 70 million kWh. Snow storms have also made it difficult to deliver other key raw materials and food. Power shortages are nothing new in China, especially in southern China, which has experienced power shortages for several summers in a row.

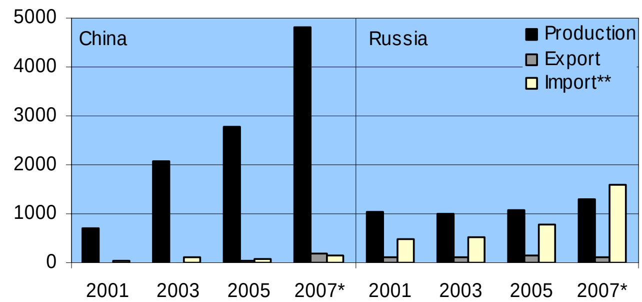
In addition to the bad weather, China's electricity production has been afflicted by problems stemming from regulation of electricity prices. While the setting of coal prices is fairly liberal, the price of electricity is strictly regulated. Chinese electricity rate hikes in recent years have not kept up with coal prices. Several coal-fired power plants have been waiting for coal prices to decline and have turned to consuming their inventories. Power plants are also unwilling to purchase coal from abroad as purchasing costs for domestic coal are substantially lower. Domestic coal producers are also required to sell coal to Chinese power producers at somewhat lower prices than they give to other customers.

Last year, China consumed about 3,200 billion kWh of electricity, of which 80 % was generated by coal, 15 % from hydropower and 2 % from nuclear power. China buys very little electricity from abroad. In addition to electrical power production, the Chinese use significant amounts of coal in heating and steel manufacture.

China's booming car industry. China produced nearly five million passenger cars in 2007. Production climbed 25 % y-o-y. The rapid growth of car markets was accelerated by the rapid rise in Chinese incomes and stiff price competition. Nearly all large international carmakers have production in China. Due to Chinese regulations, they operate as joint ventures with Chinese manufacturers. Officials have sought to encourage Chinese to acquire small-engine cars, but car engine sizes continue to increase.

China last year became a net exporter of cars as passenger car exports nearly doubled and imports increased 20 %. The export of Chinese cars to the US and Europe has been slowed by e.g. poor performance in vehicle safety testing. In addition to exporting, Chinese carmakers have built assembly plants abroad (e.g. in Russia).

Trends in the Chinese and Russian car markets, 1 000 cars



* Export and import estimates based on January-November figures.
** The figure for Russian imports includes imports of used cars.
Sources: CEIC, Rosstat, Russian Customs Service

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EUROJÄRJESTELMÄ
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Russia

Consumption and investment lifted Russian economic growth in 2007. Rosstat's first estimates show Russian GDP grew 8.1 % in 2007 or about 33,000 billion roubles (€920 billion). Growth in private consumption, the largest demand-side component of GDP, accelerated to 13 % supported by the rapid rise in incomes. Public consumption also rose to nearly 5 % ahead of elections. Growth in fixed capital investment remained strong in the second half and investment was up 21 % for the year. The investment rate climbed over 20 % for the first time since 1995. Growth in export volume grew over 7 % even with a modest slowdown in production growth in mineral extraction industries. Import volume growth accelerated to 30 % in response to higher wages and rouble appreciation.

Inflation accelerated in January. Consumer prices rose 2.3 % in January, beating the January 2007 pace. On-year inflation was 12.6 %. Last year's 11.9 % inflation rate substantially exceeded the target and this year it is also widely expected that the official 8.5 % target will be exceeded. The largest price hikes in January were in foods and housing services (e.g. gas and electricity).

Authorities to take measures to fight accelerating inflation. The cabinet last week discussed inflation-fighting measures suggested by the economy and finance ministries and the Central Bank of Russia. The government then tasked them with preparing an anti-inflation programme.

As a short-term measure to quell rising prices, the government revised its deal with large producers and retail chains on the freezing prices for six basic foods. The previous deal ended at the end of January and the new deal is in force until end-April. Prior to the new price freeze, prices of the six food items were increased "to reflect developments in inflation." Moreover, many doubt the effectiveness of the freeze as producers and stores have apparently raised the prices of other foods to compensate.

High inflation has been also sustained by powerful capital flows into the country. In particular, the foreign borrowing of state-owned companies has increased substantially. The government is considering keeping record on foreign borrowing and giving recommendations on it, but according to finance minister Kudrin direct limitations of loan-taking are not yet planned.

In the longer run, the government hopes to fight inflation by e.g. improving market function through enhanced competition and limiting of monopoly power. Financial markets would be developed in ways that encourage saving and investment in securities.

Lowering inflation has been difficult under the current monetary policy, which is focused on stabilising the rouble's nominal exchange rate. The government says that in the next three years it will strive to shift from steering the rouble's exchange rate to a floating regime, thus making inflation restraint the main focus of monetary policy.

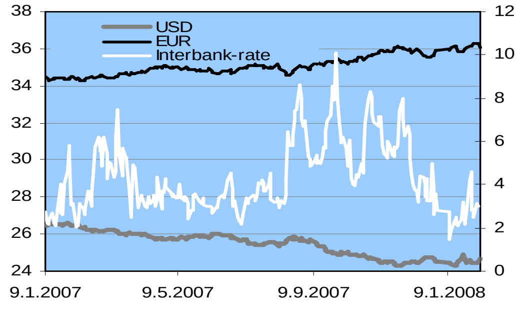
CBR raises interest rates and tightens reserve requirements. As part of the anti-inflation package, the CBR has increased key interest rates 0.25 percentage points, effective February 4, 2008. The minimum level of the CBR's most potent tool, the one-day repo rate, was raised to 6.25 %. The CBR also increased the overnight rate from 10 % to 10.25 %, and deposit rates by a similar amount.

Reserve requirements for banks were increased by a half percentage point to 4.5 % for household deposits and a full percentage point for receivable claims of foreign banks to 5.5 %. The move is effective from March 1, 2008.

The move came as a surprise to the markets. Since last summer, the CBR has been lowering rates to pump liquidity into the market to ease the tight money situation in the banking sector. Recently, the liquidity crunch has begun to abate and interest rates have been falling. For example, the one-day Interbank rate is currently around 3 %. The impact of CBR rates on the money supply is still weak in Russia, and experts say that the hike in interest rates will only have a minor impact on liquidity levels, and thus on inflation.

CBR deputy chairman Alexei Ulyukaev has announced that the central bank will strive for greater use of interest rate policy in regulating the money supply and fighting inflation. The money supply continued to grow briskly in 2007: the 48 % increase in broad money (M2) was a significant factor in higher inflation.

Rouble-euro, rouble-dollar rates (left scale) and one-day Interbank rate (right scale)



Source: Central Bank of Russia

Increases in social benefits and public sector wages. The government approved changes in this year's budget, which are scheduled for endorsement by the Duma later this month. Budget revenues are growing due to higher-than-assumed oil prices, which enables e.g. a 14 % hike in public sector wages.

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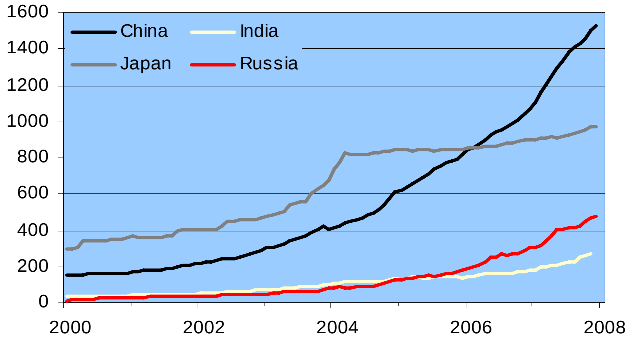
China

China's foreign currency reserves reached $1,530 billion at the end of 2007. China's foreign currency and gold reserves jumped an eye-popping $460 billion during 2007, of which over $260 billion was provided by the booming goods trade surplus. The current account surplus was even larger than the trade surplus due to investment yields and remittances from Chinese nationals living abroad. Direct investment, a key aspect of capital movement into China, increased last year to $75 billion (excluding financial sector). Detailed 2007 balance-of-payment data and foreign currency reserve changes will be available in a few months.

China does not release the structure of its foreign currency holdings. According to observers, dollar-denominated assets account for 70 % of currency reserves, with euros representing another 20 %, and yen and all other currencies making up the remaining 10 %. With the increase in foreign currency reserves, dollar-related risks have increased correspondingly. To deal with the increased exposure, China's exchange rate policies are becoming more flexible and less beholden to the dollar. As a result, a smaller share than previously of the recent foreign currency reserve growth may have been invested in dollars and larger share in other currencies.

In early 2006, China surpassed Japan as holder of the largest foreign currency reserves – and China's reserves continue to swell. China currently holds nearly a quarter of the entire world's currency reserves. Russia's foreign currency reserves increased last year by over $170 billion to nearly $480 billion, placing it in third position in the rankings. India has risen to nose out both Korea and Taiwan for fourth place. Foreign currency reserves have increased through current account surpluses in many Asian countries since the financial crisis that swept the region in the late 1990s.

Countries with largest foreign currency reserves, US$ billion



Source: CEIC

Foreign expansion characterises China's banking sector in 2007. China's largest commercial bank, Industrial and Commercial Bank of China (ICBC), announced at the end of October it was acquiring a 20 % stake in the South African Standard Bank, which is Africa's largest bank in terms of total assets. In August, ICBC also received permission to establish a subsidiary in Russia, where it will be able to operate in the corporate sphere. The China Development Bank, which is a policy bank, last year took stakes in the British Barclays Bank, while China's Minsheng Bank took a stake in the US-based UCBH Bank.

Following the lead of major oil-producing countries and some other Asian nations, China moved last year to set up its own sovereign wealth fund, the China Investment Corporation (CIC). The CIC recently purchased a $5 billion stake in Morgan Stanley. The expansion to foreign banking sector should give China greater ability to manage risk and expertise in the finance sector. The expansion also provides a way to channel some of the flood of liquidity from high company profitability and economic growth in China into new foreign investment targets.

Due to strict limits on the movement of capital, China's banking sector appears to have escaped most of the direct fallout from the uncertainty plaguing global financial markets. The largest Chinese holder of subprime mortgage-based securities is reportedly the state-owned Bank of China. ICBC and the China Construction Bank are also likely holders of such securities, but with lesser exposure. China's interbank markets have not experienced the same tightening of liquidity seen in most Western money markets. Indeed, the People's Bank of China (the central bank) has sought to rein in inflation through higher interest rates and reserve requirements, as well as by administrative rules. During the year, the PBoC also slightly reduced the margin between the reference rates for loans and deposits. The margin has traditionally been a significant determinant of profitability for domestic banks.

The health of China's banking sector improved last year as state-owned banks were recapitalised with money infusions from the newly created CIC. A decision was taken to grant the Agricultural Bank of China – the last remaining one of China's four large state banks to list on a stock exchange – an infusion of some $40 billion. Other infusion recipients included the China Development Bank ($20 billion) and the Everbright Bank ($3 billion). China's banking regulatory officials say the share of non-performing loans as a share of the total loan stock was 6.2 % as of end-September 2007. China's central bank continues to press domestic commercial banks to improve their international competitiveness.

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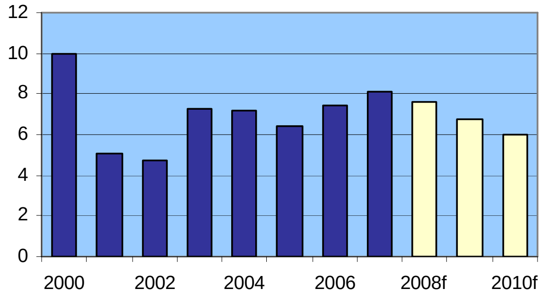
Russia

Latest BOFIT forecast sees modest slowing in Russia's economic growth in coming three years. BOFIT's latest forecast for Russia (see http://www.bof.fi/bofit_en/) expects GDP growth to reach 7.6 % this year as a result of high oil prices. Growth is expected to settle back to the 6 % level towards 2010 as oil prices are expected to fall slightly. Booming consumption keeps driving economic growth, although the recent spurt in investment has also begun to exert a more important influence. Strong growth in domestic demand and an appreciating rouble are feeding import growth, and import growth in excess of export growth could shrink the current account surplus in coming years.

In the near term, the biggest risk to the sustainability of Russia's robust economic growth would be a substantial drop in oil prices. Despite development in other sectors, Russia remains highly dependent on its energy sector. If investment growth remains strong, however, the outlook for diversification of the economy looks better.

Russia: Real on-year change in GDP, 2000–2010, %



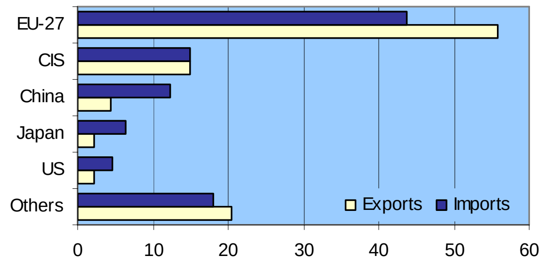
Sources: Rosstat, BOFIT forecast for Russia 2008–2010

Trade surplus shrank slightly last year. The Central Bank of Russia reports that in 2007 the value of Russian exports increased 17 % and imports 35 %. Slowing export growth and surging imports reduced the trade surplus by 5 % for the first time since the early 2000s. Both exports and imports, however, reached record levels as the value of exports hit $355 billion and imports $223 billion.

The Federal Customs Service reports the export share of EU-27 countries shrank slightly to 56 %. CIS countries received 15 % of Russian exports. The top export destination countries in 2007 were the Netherlands, Italy and Germany. EU-27 countries accounted for 44 % of imports and CIS countries for 15 %. Germany was still Russia's top import provider. China has moved swiftly into second place, accounting for 12 % of Russian imports last year – a four-fold increase from eight years ago. Finland accounted for about 3 % of both Russian imports and exports.

Energy products continued to dominate Russian exports. Crude oil exports rose a few per cent in volume terms, while gas exports fell slightly. Raw wood export volumes declined a bit, even as their value rose in line with higher prices. Half of Russian imports consisted of machinery and equipment; their value rose by nearly 60 %. Passenger cars represented over 10 % of imports. Other significant import categories included chemical products and foodstuffs, each with 14 % shares of imports.

Russia's leading trading partners in 2007, %



Source: Federal Customs Service

2007 was an above-average year for Russian farmers. Russia's grain harvest climbed to 81.8 million tons in 2007, up 4 % from 2006. Harvests have been a bit below the long-term average in recent years, while the 2007 harvest slightly exceeded the average. Yields averaged about 2,000 kilograms per hectare.

While the potato crop was down 5 % from 2006, vegetable crops were unchanged. Milk production rose 2 % to 32 million tons. Annual milk production per cow increased 5 % to 3,800 kilograms (compared to 7,600 kg per cow for Finland). Meat production grew 9 %. While commercial animal husbandry operations are officially one of the cornerstones of current agriculture policy, the number of cattle has continued to decline since the start of the 1990s. Recently this trend has slowed, however.

Informal food production (e.g. home garden plots, orchards and small-time animal husbandry) remains a significant contributor to overall agricultural output. Informal production in 2007 accounted for 89 % of potato production, 79 % of vegetables, 52 % of milk and 47 % of meat supplies. The contribution of informal operations to production of vegetables and milk was up slightly from 2006.

Large farms retained their dominance in grain production, accounting of 79 % of output last year.

A third producer group, small farms, has enjoyed booming production increases in recent years. The top crop of small farms is sunflower seed. Small farms accounted for 29 % of sunflower seed production last year, as well as 20 % of grain production.

While Russia is basically self-sufficient in grain production, it relies on imports for about a quarter of its milk and milk product supplies and more than a third of its meat supplies.

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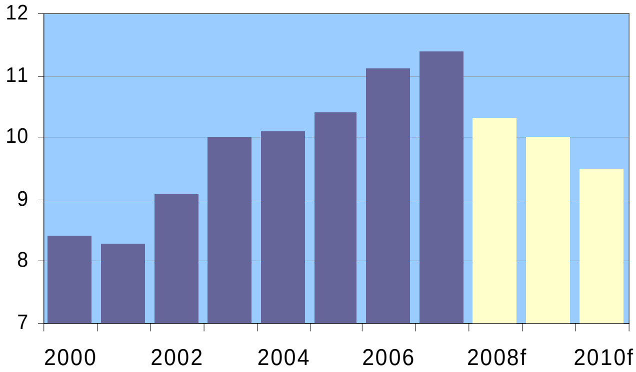
China

Latest BOFIT forecast sees modest slowing in China's economic growth in coming three years. Our latest forecast for performance of the Chinese economy (http://www.bof.fi/bofit_en) anticipates continued robust growth of total output, albeit with some slowing. We expect GDP growth to fall from 11.4 % last year to just over 10 % this year. Further out in 2009 and 2010, growth should continue to diminish and gradually fall to around 9 %. The slightly lower growth outlook reflects a weakening outlook for the global economy and evidence that recent economic growth has exceeded its long-term potential. This has led to symptoms of economic overheating such as high wage growth.

China: Real on-year change in GDP, 2000–2010, %



Sources: NBS, BOFIT Forecast for China 2008–2010

Capital investment remains a large contributor to China's economic growth. The population shift to cities and increased infrastructure needs have boosted activity in the construction sector. At the same time, the outlook for continued growth has spurred industrial investment. Changes in investment growth have a strong impact on economic growth, reflecting China's exceptionally high investment ratio (43 % of GDP). The role of consumption in the economy also continues to increase gradually. Growth in incomes and employment increases the purchasing power of households and boosts tax revenues, which in turn helps support higher public-sector consumption spending.

The weakening outlook for the global economy should negatively affect Chinese exports. The share of net exports in economic growth contracted towards the end of last year, as import growth accelerated. China's export competitiveness remains excellent, however, and China has made up for its slowdown in exports to the US by vigorously boosting exports to e.g. oil-producing countries.

The downside risks in the forecast period appear to have grown compared to the previous forecast six months earlier. Most notably, lower-than-expected growth in the US could affect the entire global economy, in which case China's export prospects would decline rapidly. A second large risk factor is the over-dimensioning of macroeconomic measures to fight inflation. If a slowdown in exports or tighter monetary policy has a strong impact on investment growth, economic growth could decline to levels below current expectations. In the longer run, China's deteriorating environmental conditions will also increasingly limit economic growth.

Good harvests in 2007. China's Ministry of Agriculture reports the harvest of top crops (beans, maize, potatoes, rice and wheat) collectively amounted to about 500 million tons. Despite several spells of bad weather last year, overall crop levels were about the same as in 2006. The figures consist mainly of the autumn and summer harvests. The autumn harvest accounts for about 70 % of the total annual harvest and the summer harvest slightly over 20 %. Since farm production hit a low of 430 million tons in 2003 (the lowest level since the 1980s), officials have actively promoted measures to support farmers and assured that farmland is not repurposed for other uses such as construction. Despite the good harvest last year, domestic grain prices have risen rapidly in the wake of soaring international grain prices. Prices of several other key agricultural commodities have also climbed sharply. Chinese officials have yet to release last year's figures for meat production.

China is fairly self-sufficient in agricultural terms. China Customs reports the country last year exported about 10 million tons of cultivated crops, about half of which was maize. China also exported a certain amount of fruits and vegetables. Despite China's widely reported problems with meat production last year and soaring meat prices, the country exported nearly two million live pigs and 16 million live chickens. With the exception of soybeans and vegetable oil for cooking, China imports virtually no agricultural products in significant amounts from abroad.

China can still do much to improve the efficiency of its agriculture. Farmers typically work tiny plots and there is a dearth of modern farm machinery. In 2005, for example, there was just one tractor for every twenty farmers in China. Fertilizers are also used ineffectively, so officials have in recent years developed programs to educate farmers on fertilizer use.

In some areas, agriculture has been affected by reduced access to water for irrigation. China's policies have made water use very inexpensive, which has encouraged extensive waste of the valuable water resources. China is water-poor by international standards, especially in per capita terms. Much of China's water supplies today are polluted.

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Russia

Russia's WTO talks grind on; Ukraine gets go-ahead on WTO membership. EU trade commissioner Peter Mandelson visited Moscow last week to discuss issues holding up Russia's WTO membership. The EU is particularly concerned about Russia's increases in tariffs on raw wood exports. Although the matter remains unresolved, Russia and the EU agreed to revisit it in a few weeks. Russia's bilateral and multilateral talks on WTO membership resumed this week in Geneva.

Ukraine, which has pursued WTO membership during the same time as Russia, managed to wrap up its talks and get an accession go-ahead from the WTO at the start of this month. The Ukrainian parliament now has six months to ratify the deal, at which point Ukraine would be clear to join. If Ukraine's membership happens before Russia completes its negotiations, Ukraine could in principle open bilateral talks with Russia and further impede Russia's WTO membership process. The countries, however, already have a free-trade agreement and Ukraine's president and prime minister have both given assurances that Ukraine has no plans to interfere with Russia's membership process. With Ukraine's WTO negotiations completed, Ukraine and the EU have launched also discussions on creation of a free-trade area.

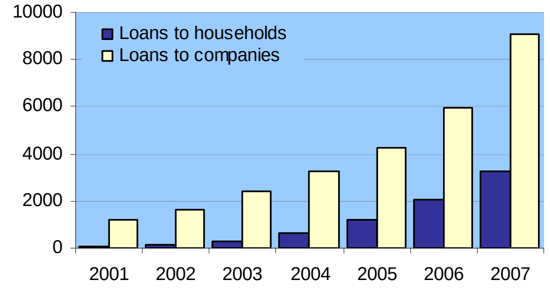
Rapid banking sector growth continues. The total assets of Russia's banking sector rose 44 % in 2007, matching the growth pace set a year earlier. Month-to-month growth, however, nearly ceased in October during a liquidity pinch. At the end of 2007, the banking sector's total assets corresponded to 61 % of GDP, which is still low by international standards.

Growth in lending to households slowed to 56 %, while growth in corporate lending accelerated to 52 %. The corporate loan stock is now about three times larger than the stock of household loans. Banks are more willing to lend to companies than households because companies carry lower risk and borrow for shorter terms.

Last year saw a slight slowing in the growth of both household and corporate deposits. Deposits, however, have become more important to banks than before due to low liquidity of world money markets, which has raised the price of money on international markets and dried up access to finance for many of Russia's smaller banks. Household deposits corresponded to 16 % of GDP, which is insufficient to cover the rapidly growing overall lending. Growth in deposits is expected to slow further due to negative real interest rates and high inflation. Both conditions dampen the willingness of depositors to let their money sit in the bank.

Representatives of the biggest Russian banks have complained that the central bank's recently more active inflation-fighting policies have tightened the liquidity situation further. The bank leaders are particularly concerned with their upcoming foreign debt payments and tax payments this spring, and want the state to get more involved in assuring banking sector liquidity. Ministers have not directly rejected this proposal and the markets generally believe the Russian state will come to the aid of the banking sector if needed.

Household and corporate loans 2002-2007, billions of roubles



Source: Central Bank of Russia

The number of banks operating in Russia continued to contract last year, but there is still plenty of room for further consolidation. As of year's end, there were 1,136 banks in Russia. The banking sector structure remained dominated by the five largest banks, which held 42 % of all banking sector assets. The top 50 banks accounted for 77 % of all assets. The state holds majority stakes in Russia's three largest banks. Their market share increased slightly last year.

Foreign ownership of Russian banks rose last year from 16 % to 25 %, largely the result of the Sberbank and VTB IPOs. The state, however, retains its majority position in both banks. Russia has 202 banks with foreign participation. Of those, 62 are completely foreign owned.

Share of population living in poverty continues to decrease. Rosstat's figure for the minimum income needed to cover one person's basic living costs for one month averaged 3,847 roubles (€110) last year. The calculated minimum income for a working-age person was 4,159 roubles and for a pensioner 3,065 roubles. The average worker pension last year was 3,169 roubles, i.e. slightly over the minimum income of pensioners. The nominal worker pension last year increased 14 % or 5 % in real terms. Nominal wage growth was 27 % and real growth 16 %.

Last year, 14 % of Russia's population lived below the official poverty level (incomes below the monthly minimum). In 2002, about 25 % lived below the poverty level.

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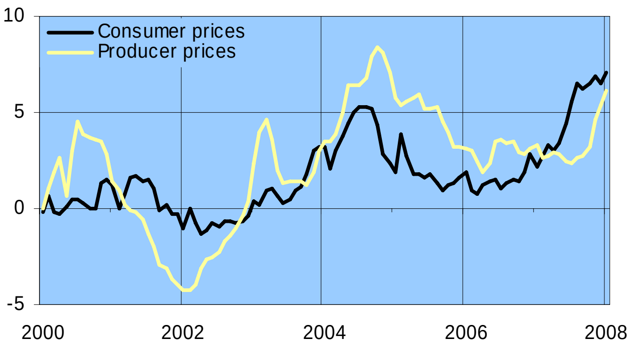
China

Chinese inflation rate remains high. On-year consumer price inflation in January was 7.1 % (in December 6.5 %). Consumer price inflation was still led by food prices, which were up over 18 % y-o-y for January. Pork prices rose fastest, up nearly 59 % from a year earlier. Prices of non-food items in the consumer price index were up 1.5 % y-o-y. The pick-up in inflation has already fuelled inflation expectations and higher wage demands. As a result of higher energy and raw material prices, producer price inflation accelerated to 6.1 % in January. Snow storms in China this winter have significantly affected the transport of coal and agricultural goods, further adding to price pressures.

Subduing inflation is an important official goal in maintaining economic and social stability. China earlier this year imposed administrative restrictions on price rises of important food items, electricity and gasoline in order to stem inflation. Sellers were also advised to inform officials if they intend to raise their prices. Administrative price restrictions, however, run the risk of reducing supply of goods, in which case inflation problem might not disappear, or inflation acceleration is postponed. Moreover, the People's Bank of China is expected to keep tightening its monetary stance to restrain inflation. Currently, inflation-adjusted real interest rates (which affect consumption, investment and saving decisions) are negative for depositors and very low for borrowers. Exchange rate strengthening can restrain inflation by lowering import prices. Indeed, since the start of 2008, the yuan has strengthened 2.3 % against the dollar and 2.2 % against the euro. Daily swings in the yuan-dollar rate increased significantly in the second half of 2007. On Thursday (Feb. 21), one dollar bought 7.14 yuan and one euro 10.52 yuan.

12-month change consumer and producer prices, %



Source: China National Bureau of Statistics

Inflation pressures are also fed by money supply growth. Abundant liquidity has long supported the rise in Chinese share prices. M2, a broader measure of the money supply (includes cash in circulation, demand accounts and some time accounts) was up 18.9 % y-o-y at the end of January. M2 growth reflects growth in bank lending. The PBoC reports the amount of yuan-denominated loans as of end-January was up 16.7 % y-o-y.

China loses car part dispute at WTO. WTO Dispute Settlement Body broke new ground last week with the issuance of an interim ruling against China for violation of its WTO commitments through unfair tariff treatment of imported car parts. China has a minimum local-content requirement of 60 % for domestically produced cars. If the requirement is not satisfied, it levies a 15 % higher tariff on the vehicle as if it was imported completely built. Canada, the EU, and the US petitioned the WTO on the matter in spring 2006. China is appealing the ruling, and the final ruling is not expected until the end of this year. The WTO's position, however, is not expected to change. China imported about $10 billion worth of car parts last year.

Complaint filings with the WTO against Chinese practices have increased in recent years. Two incidents besides car parts are also under process. Last spring, the US complained about China's poor protection and monitoring intellectual property as well as Chinese restrictions on the sale of foreign books and recordings. The US and Mexico also complained last year about the unequal treatment of domestic and foreign-owned firms in China, as well as China's subsidy policies in violation of its WTO commitments. The matter was settled by arbitration in December 2007. The EU is currently considering filing complaints about China's restrictions on foreign media companies.

In addition to disputes, countries have in line with their WTO commitments introduced such measures as anti-dumping and countervailing duties against China to protect their domestic economies. As of end-June 2007, almost a hundred anti-dumping measures and four countervailing duties against China were in force. China filed its own complaint that the US last year unfairly imposed a countervailing duty on coated fine paper imports from China. China also protects in own production with anti-dumping tariffs. At the end of June, nine tariffs were in force and seven were under consideration.

Despite several WTO actions against China, China's foreign trade surplus continues to balloon. Last year's surplus hit $260 billion. Growth of the trade surplus continued apace in January, reaching $19 billion for the month.

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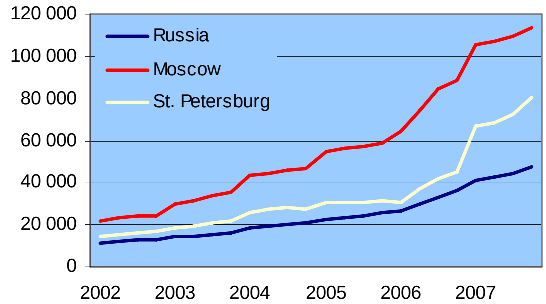
Russia

Growth in housing prices and housing construction slowed last year. Although housing prices in Russia increased 23 % last year, it was substantially lower growth than in 2006. In the fourth quarter of 2007, the average price of an apartment, measured by floorspace, reached 47,500 roubles (€1,330) per square metre. In St. Petersburg, apartment prices rose at about the same rate as nationally, while in Moscow prices lagged the national pace. According to real estate experts, however, rise of prices in Moscow has accelerated strongly this year.

A total of 60.4 million square metres of new housing was build last year, which was about a fifth more than in 2006. In St. Petersburg, housing construction rose 11 %, while production in Moscow was up just 1 %. In the Irkutsk Region in Siberia and the Kaluga Region near Moscow, over 70 % more apartments were built than a year earlier. The production of construction contracted substantially in both the Kamchatka Region in the Far East and the Chechen Republic.

Average housing prices per m², 2002-2007, in roubles



Source: Rosstat

Cabinet tackles environmental issues. At its February 21 session, the Russian government took up a report of the Federal Ecology, Technology and Nuclear Regulatory Service on the state of the Russian environment. The report found that in recent decades, industrial activity (particularly in the metal, chemical and military supply industries) and mining (including oil and gas extraction) have caused widespread environmental damage. When economic growth revived at the start of this decade, environmental pollution again began to increase. The situation has been aggravated by aged production technology. The Soviet-era legacy of massive environmental destruction, caused in particular by the chemical and military equipment industries, poses a special problem. Remediation of these problems call for resolution of who will ultimately take responsibility for the damage so there has been little willingness to tackle the problem.

The report states that as environmental damage and soil conditions are not systematically recorded in Russia, it is difficult to get a true picture of the overall situation. Russian legislation does not define what constitutes environmental impact, nor are there adequate measures in place to identify and assess the extent of environmental degradation. Russia lags the current environmental monitoring and remediation regimes of most OECD countries by a good 15–20 years.

In relative terms, the most polluted regions are the Krasnoyarsk Krai, the Kemerovo, Sverdlovsk and Chelyabinsk regions, as well as the cities of Moscow and St. Petersburg. The most polluted areas in absolute terms are found in the autonomous regions of Yamal-Nenets (1,200 km²), Koryakia (1,150 km²) and Hanti-Mansi (780 km²) as well as the Sverdlovsk (630 km²) and Kemerovo (620 km²) regions. Some 56 % (about 58 million) of Russia's urban population live in cities where the air pollution has reached high or extremely high levels.

Russia is preparing a petition to the World Bank for funding on a project in which the Bank would supply technical assistance in the creation of new legislation, financing solutions and technical methods for identifying, assessing and remediation of damaged environments.

CIS states continued to enjoy high economic growth in 2007. CIS countries, like many low-income countries, have experienced high economic growth throughout the entire 2000s. Last year, on-year economic growth in most CIS countries exceeded 7 %. Fastest growth was in the Caucasus countries: Azerbaijan, Armenia and Georgia.

Investment in most CIS countries is also up sharply, even if the annual fluctuations have been fairly large. Inflation has been rapid during the 2000s, but was moderating. In the last two years, however, prices again began to rise more sharply than earlier.

CIS economic development in 2007, %-change from a year earlier

	GDP	Industrial output	Investment	Inflation
Armenia	13.8	2.6	19.7	6.6
Azerbaijan	25.0	24.0	17.8	19.6
Georgia	12.7 1)	…	…	11.0
Kazakhstan	9.7 1)	4.5	8.2	18.8
Kyrgyzstan	8.2	7.3	3.7	20.1
Moldova	3.3 1)	– 2.7	19.9	12.3
Tajikistan	7.8	9.9	103.6	19.7
Turkmenistan	…	…	…	…
Ukraine	7.3	10.2	28.5 1)	16.6
Uzbekistan	9.8 1)	11.9	31.3	…
Belarus	8.2	8.5	15.1	12.1
Russia	8.1	6.3	21.1	11.9

1) January-September

Source: CIS STAT

An informal CIS summit was held in Moscow on February 22. The heads of all member governments showed up to honor president Vladimir Putin, who is soon to step down. At the get-together, Putin presented his heir-apparent, first deputy prime minister Dmitri Medvedev.

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China

China Investment Corporation expands its foreign investment activity. China's state investment company, the CIC, is expected to announce soon the identities of the international asset management firms chosen to manage and invest as much as $30 billion in CIC fund assets in foreign markets. According to Japanese sources, one major investment target will probably be companies listed on the Tokyo stock exchange, particularly companies involved in Japan's energy sector. To date, the CIC's foreign investments have been modest. Yet, even before the CIC opened officially for business at the end of last September, it invested $3 billion for a 9 % stake in the American Blackstone Investment Group. In December, CIC acquired for $5 billion a 10 % stake in Morgan Stanley, the second largest investment bank in the US.

CIC assets currently amount to about $200 billion. The company has been funded out of the country's massive foreign exchange reserves on the hope that the CIC will be able to improve the yield on the government's current investments. About a third of the fund's assets have been used to acquire a stake in the Central Huijin Investment Company. The company administrates part of the state holdings in China's large state-owned commercial banks and it has served as a vehicle for channelling state subsidies to the banks. At the end of last year, it was confirmed that another third of CIC assets will be poured into recapitalising state banks. Agricultural Bank of China, which is struggling with a huge portfolio of non-performing loans, has been decided to receive $40 billion. The bank is the only one of China's four major state banks yet to receive a massive capital infusion from the state and be listed. China Development Bank has been decided to receive $20 billion in subsidies, while Everbright Bank has been decided to receive $3 billion. The remainder of CIC investment assets, some $60–70 billion, are designated to be invested outside China.

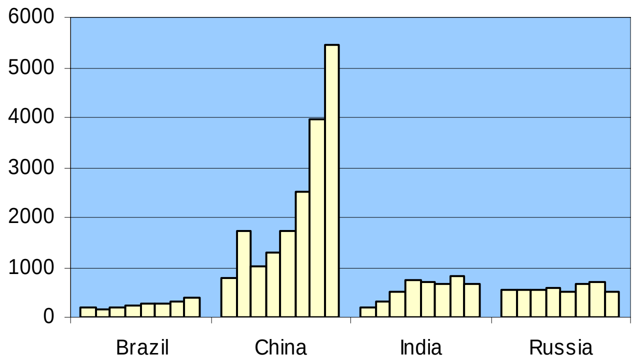
Although Chinese officials have given assurances that CIC is not seeking controlling stakes in the companies it is investing in, the investment activity has aroused widespread attention. This suspicion applies to sovereign wealth funds almost anywhere in the developing world. For one thing, the CIC investments have been gladly welcomed by financial markets plagued with declining share prices and credit losses. At the same time, there is huge mistrust of fund operators, as investment policies are feared to favour the wider strategic goals of the government rather than traditional business interests. In order to avoid an increase in protectionist sentiments or unnecessary regulation, the possibility of creating a code of conduct for sovereign wealth funds is under discussion in IMF and EU circles. The central goal is increasing the transparency of fund activities.

China's stream of patent application gathers force. The World Intellectual Property Organization (WIPO) received about 156,000 international patent applications filed under the Patent Cooperation Treaty (PCT) last year, an increase of about 5 % from 2006. A third of the applications came from the US, almost a fifth from Japan and 12 % from Germany. China submitted nearly 5,500 patent applications, which was 38 % more than in 2006. China recently surpassed the Netherlands to take over seventh place in terms of patent activity. South Korea's performance further emphasises the role of Northeast Asia in the field of patent activity. Korea's patent filings rose 20 % last year, making the country fourth overall in patent activity. France and the UK were in fifth and sixth place.

Although Russians are quite active in filing for patents domestically, the amount of Russian international patent activity is quite small. According to preliminary figures, the number of Russian patent applications fell last year by nearly 200 to around 500 applications. Finland, with nearly 2,000 applications, ranked 14th on the list of countries generating PCT-based patent applications. Mobile phone maker Nokia accounted for over 800 of Finland's patent applications, making it the world's number-ten company in terms of international patent applications. Japanese electronics giant Matsushita last year filed the most international patent applications. Among the top fifty companies in terms of the patent applications, the telecommunications network supplier Huawei (in 4th place) was the sole Chinese firm.

Half of all patents that were in force in 2005 were based on applications originating from Japan and the US. Despite the rapid growth in patenting activity, the Chinese still have fewer patents in force than the Russians.

Number of international patent applications (PCT) in BRIC countries, 2000–2007



Source: WIPO (www.wipo.int)

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Russia

Dmitri Medvedev wins presidential election. Medvedev garnered 70 % of the vote in Sunday's (Mar. 2) election. Communist party leader Gennadi Zyuganov came closest with an 18 % share of the vote, while nationalist Vladimir Zhirinovsky got 9 % and newcomer Andrei Bogdanov 1 %. Voter turnout was 70 % of registered voters (64 % in the 2004 presidential election and 63 % in the December 2007 Duma election).

Medvedev posted highest support (92 %) in the North Caucasus republics of Dagestan and Ingushia. Lowest support (around 60 %) was registered in the Smolensk, Ryazan and Omsk regions.

Medvedev takes office on May 7. When the election results were clear, Medvedev announced his intent to continue Vladimir Putin's policies. He also said he would work over the next two months with outgoing president Putin in deciding his cabinet and presidential staff picks. Putin significantly increased the role of the presidential executive office during his two terms. Today the presidential administration handles such functions as setting policy lines and drafting and vetting key legislative proposals.

Ahead of the election, Medvedev delivered a speech on economic policy to the Krasnoyarsk economic forum. He emphasised liberal values and the importance of the rule of law, while deploring Russia's current corruption. Medvedev proposed lowering taxes and making the rouble an international reserve currency by e.g. shifting to the use of the rouble as a payment currency for raw material exports. He said improved economic conditions would require investment in Russia's transport and energy infrastructure and the creation of favourable conditions for innovation.

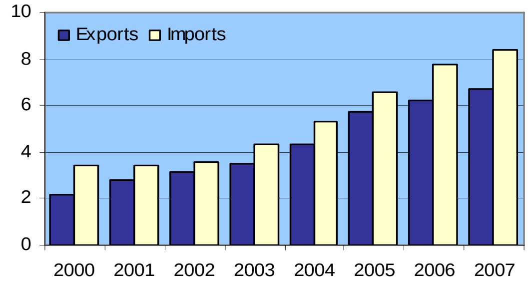
Finnish trade with Russia kept growing in 2007. Finland's exports to Russia last year rose to €6.7 billion, while imports from Russia reached €8.4 billion. The value of both imports and exports rose 8 % y-o-y. Russia was Finland's most important supplier of imports in 2007 (14 % share) and, after Germany and Sweden, the third most important export destination (10 % share).

Finnish exports to Russia are still dominated by electrical equipment and machinery. The share of electrical equipment in such imports fell, however, while the share of machinery increased. Each product category accounted for about a fifth of total exports. Other important product groups included transport vehicles (especially passenger cars) and chemical products. Passenger cars counted as Finnish exports are in fact mostly cars imported from elsewhere that are then re-exported to Russia.

Some 60 % of imports to Finland from Russia are mineral products such as crude oil. Other important imports include metals, chemical products and raw wood. The value of raw wood imports remained at the 2006 level, while the volume of imports contracted by a quarter.

Over €30 billion worth of goods to Russia transited Finland last year. Transit freight was up about a quarter from 2006 in both value and volume terms. Cars, the top category in transit freight, were followed by machinery and equipment.

Finnish trade with Russia 2000–2007, € billion



Source: Customs Finland

Huge Finnish investment in Russia's electrical power sector. Finland's leading energy company Fortum agreed last week on acquiring a majority stake in Ural-region power producer TGC-10. The contract price is about €2 billion. Fortum also reserved the option to later purchase any outstanding TGC-10 shares, which would bring the total value of the deal to nearly €3 billion. The acquisition constitutes the largest ever Finnish investment in Russia. A survey published in February by the Confederation of Finnish Industries found that Finnish industrial companies last year invested over €200 million in Russia, nearly a tenth of their total €2.3 billion international investment.

Several Finnish companies are wrestling with problems in the Russian market. The Ruukki Group, for example, announced plans this week to suspend its saw/pulp mill project in the Kostroma region after the Kostroma regional administration rescinded the project's status as a priority investment. The regional administration claims Ruukki failed to keep to its agreed investment plan. The regional governor added the tax breaks granted to Ruukki under the deal will burden the regional economy. Ruukki denies the allegations and plans to recover damages against the regional administration for breach of contract. The company is now studying possibilities for relocating the project elsewhere in Russia. In mid-February, Russia's second largest bank, majority state-owned Vneshtorgbank, purchased a 10 % stake in the Ruukki Group.

Finnish electronics company Elcoteq recently agreed to sell its St. Petersburg plant to Singaporean competitor Flextronics. Elcoteq reports the St. Petersburg facility has been a consistent money-loser, due in part to high import tariffs on components. Elcoteq has been one of the few Finnish firms operating in Russia with production geared to exports rather than the domestic market.

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China

Surging production costs force Chinese companies to stress efficiency. A number of media reports claim soaring production costs are driving many low value-added manufacturers to close facilities or move inland from the developed coastal areas. Rising wages and the yuan's strengthening against the dollar have hit footwear and textile manufacturers particularly hard. The loss of small, inefficient companies helps improve production efficiency generally. The efficiency gains do not yet diminish China's role in the international division of labour for low value-added products. Exports of both footwear and clothing continue to grow rapidly. In dollar terms, the value of shoe exports increased an average of 17 % last year, while clothing exports were up 22 %. Given the magnitude of production, any wide-scale producer migration to countries with lower production costs such as Vietnam or Bangladesh could only happen slowly.

One underlying pressure to raise wages comes from labour shortages that in particular afflict the coastal provinces. High living costs make it increasingly difficult to attract migrant workers from elsewhere in the country. China's one-child policy is reducing the pool of younger workers and the overall size of the labour force is expected to begin to diminish sometime within the next five years. Labour shortages affect both the worker and managerial levels. Guangdong province, which has a considerable amount of low value-added production, has responded to the situation by announcing a minimum wage hike from the start of April. The minimum monthly wage in the city of Guangzhou will rise to 860 yuan (€80), while the minimum wage in the less-developed areas of the province will rise to 530 yuan (€49). The turnover of Chinese workers is among the highest in Asia, which increases the importance of wage levels when companies are competing for employees. Local officials are backing education programs to encourage rural people to leave the farms and take better-paying factory jobs.

In addition to higher wage demands, labour costs have also been rising as a result of the new labour contract law that entered into force in January. Among other things, the law reduces employer possibilities to use temporary labour and increases the cost to firms for terminating the contracts of permanent staff. Official measures also seek to transfer low value-added production inland (e.g. by reducing tax breaks on export goods in coastal provinces).

Despite rising costs, steel production in China continues to soar. China last year produced 490 million tons of steel, or nearly 40 % of world production. Chinese steel production continues to grow briskly (up 16 % in 2007), even as officials stepped up their efforts to shut down inefficient steel smelters. Officials have also worked to encourage efficiency in steel production by promoting mergers and consolidation within the sector.

China's rapid growth in steel production made it a net exporter of steel for the first time in decades in 2006. Last year, China exported 63 million tons of steel products and imported 17 million tons. China mainly imports high-grade steel products and exports cheaper products. China's booming steel exports have forced the EU to consider anti-dumping tariffs to protect European steel producers. There has also been discussion in the US about the subsidies China grants to its domestic steel producers. At the start of 2008, China raised its export tariffs on several steel products.

In any case, steel production costs continue to soar. The world's largest iron ore producer, the Brazilian Vale, and Chinese steelmakers agreed at their annual negotiations last month on a 65 % hike in iron ore prices for this year. Negotiations with the giant Australian iron ore producers Rio Tinto and BHP Billiton are on-going, but the price hike will be at least as large. The three companies together account for over 70 % of the global iron ore trade. As a result of China's skyrocketing demand, the world price for iron ore has quintupled since 2001. China imported 380 million tons of iron ore in 2007, or about half of all iron ore sold on the world market. The Chinese are seeking to secure their access to iron ore supplies through e.g. foreign investment.

In addition to the rapid rise in iron ore prices, the cost of coke used in the production of steel has also increased sharply. China's largest steelmaker, Baosteel, announced it would raise the prices of its steel products by 20 % this summer.

Large Chinese investment in Australian mining giant. Last month, large aluminium producers, the mostly state-owned Chinese Chinalco and US-based Alcoa, purchased a 12 % stake in Rio Tinto for $14 billion. Rio Tinto, in addition to being a major supplier of iron ore (see item above), is a significant producer of bauxite, the raw ingredient for aluminium. The Chinese reportedly want to pre-empt BHP Billiton's offer to acquire Rio Tinto. Chinalco's share of the deal was about $13 billion, making it the largest ever single foreign direct investment by a Chinese company.

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Russia

Economic trends by federal district. The *Central Federal District*, which includes Moscow, accounted last year for about a quarter of Russia's total industrial output and a third of retail sales (industrial output includes process industries and manufacturing, as well as mining and oil and gas production). The City of Moscow and the Moscow region contributed 15 % of industrial output and a quarter of retail sales, even though they represent just 12 % of the population. Industrial output grew substantially above the national average last year in both Moscow and the Moscow region (12–13 %). Retail sales in Moscow increased a mere 5 %, compared to 25 % for the Moscow region. The difference largely reflects the fact that most new shopping centres are built on the outskirts of Moscow.

The *Northwest Federal District* last year contributed 12 % of Russian industrial output and 9 % of retail sales. The combined industrial output contribution of the City of St. Petersburg and the Leningrad region (together slightly over 4 % of the population) was about 10 %. In St. Petersburg, industrial output climbed 10 % and retail sales 15 %. In the Leningrad region, industrial output growth was just 3 %, while retail sales were up 21 %. Industrial output in Murmansk contracted several per cent.

The *South Federal District*, which accounted for 6 % of industrial output and 12 % of retail sales, contains 16 % of Russia's population. The Chechen Republic posted a 39 % growth in retail sales – the highest retail sales growth nationwide. Industrial output in the Kalmukia and Ingushia republics contracted sharply.

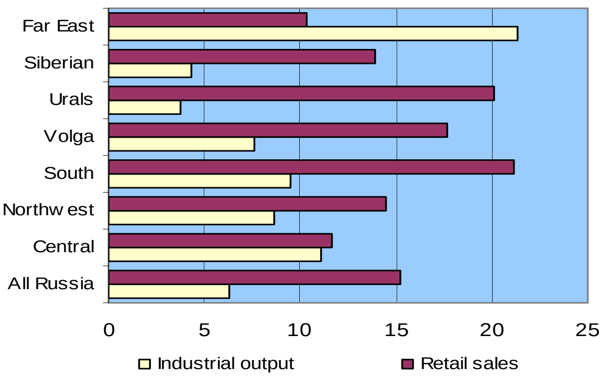
The *Volga Federal District* had about a fifth of Russian industrial output, retail sales and population. Industrial output climbed strongly in the Mari-El Republic. Meanwhile, retail sales growth soared in Bashkortostan.

The hydrocarbon-rich *Urals Federal District*, with 9 % of Russia's population, contributed about a fifth of industrial output and 10 % of retail sales. The oil and gas producing Tyumen region in itself accounted for 12 % of the country's industrial output. Output growth, however, was less than 1 % last year. The Tyumen region's share of retail sales was 4 % – a respectable slice given the region has just 2 % of the country's population.

The *Siberian Federal District's* share of industrial output and retail sales was 11–12 %. The federal district has 14 % of Russia's population.

The *Far East Federal* District, with 5 % of the population, accounted for 3–4 % of industrial output and retail sales. Industrial output rose 21 %, the highest in the country, and retail sales 10 %. The 110 % industrial output growth registered in the hydrocarbon-rich Sakhalin region lifted the federal district's industrial output figure overall. Industrial output in the Magadan region contracted sharply.

On-year change in industrial output and retail sales by federal district, %



Source: Rosstat

Inflation continues to accelerate. February consumer prices were up 12.8 % y-o-y. Inflation started to pick up last autumn, and the current pace of inflation has not been seen since 2005. Food price inflation worldwide contributed to food being the product group with biggest increase in prices over the past 12 months in Russia.

Inflation continues to partly reflect a deluge of foreign currency pouring into Russia, sustained by high crude oil prices and capital inflows. Lower growth in Central Bank of Russia's foreign currency reserves in recent months, however, suggests this inflow is slowing. The CBR's reserves grew by $7 billion in February to $491 billion. The rising dollar value of the reserves partly mirrors the collapse of the dollar, as about half of CBR reserves are now held in currencies other than the dollar (mainly euro).

The central bank has sought to keep the nominal value of the rouble relatively stable against a dual-currency (dollar and euro) basket in recent years. Lately, however, the CBR has largely abandoned market interventions due to the fact that the onshore flow of foreign currencies has slowed. Between last December and February, the rouble's nominal exchange rate declined 0.9 % against a basket of currencies of Russia's main trading partners. Over the past 12 months, the rouble weakened 2 % in nominal terms against the currency basket.

As foreign currency pressures ease, the CBR aims at shifting its inflation-fighting emphasis from exchange rate steering to monetary measures, especially the use of reserve requirements. Last month saw hikes in both reserve requirements and interest rates.

Tight liquidity in the banking sector, however, limits the central bank's ability to implement monetary policy. When interbank rates spiked briefly at the end of February due to scheduled company tax payments, the CBR moved to make funds available to commercial banks. The liquidity situation is expected to tighten again on the cusp of March-April, when companies again must come up with large mandatory payments.

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China

Chinese inflation hits highest level in over 11 years. Consumer prices in February were up 8.7 % y-o-y (7.1 % in January). The rise in producer prices also accelerated last month to 6.6 % y-o-y.

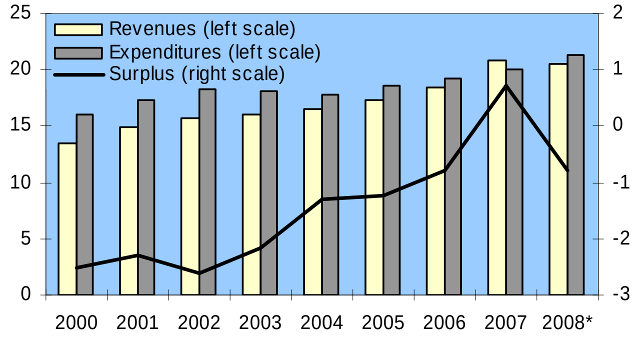
Some inflationary pressure was created by the heavy snow storms that crippled transport and goods deliveries, and interrupted power generation in many parts of the country. While there are increased inflation expectations and a rising trend in nominal wages, inflationary pressure is still driven largely by food prices, which soared over 23 % y-o-y in February. Prices of non-food items were up just 1.6 % from a year earlier, indication that current rates of growth in many sectors of the Chinese economy are near their long-term potential. Inflation in food prices, that started to accelerate in the end-2006, has nevertheless remained longer than was widely expected.

Speaking to the first plenary session of the 11th National People's Congress last week, premier Wen Jiabao identified restraining inflation as a major priority facing the current government. Proposed measures to rein in inflation include market-based actions and administrative decrees. One risk to China's economic growth is that the economy could be hit by heavy-handed official measures just at a time when global demand for Chinese goods is drying up.

State budget report anticipates higher spending. The Ministry of Finance presented to the People's Congress last week its assessment of the realised 2007 state budget and the 2008 budget estimate. Last year's realised revenues and expenditures clearly exceeded original budget estimates. State spending increased 23 % to nearly 5 trillion yuan (20 % of GDP or €480bn). About 20 % of expenditures went to the central administration and about 80 % to various levels of local administration. Realised revenues were up 32 % from a year earlier to slightly over 5.1 trillion yuan. With growth of revenues well above budget, the realised budget was in surplus for the first time in over 20 years (0.7 % of GDP). State revenues have been boosted by robust economic growth and more effective tax collection.

This year's budget is anticipated to come in 230 billion yuan in the red. Public spending is expected to increase 23 % from 2007, while revenues will go up just 14 %. The central administration has budgeted a 45 % increase in spending on education in order to eliminate fees for the school term and other payments to compulsory schools, e.g. by increasing subsidies to rural schools. Spending on research and development and health care should also increase slightly more than the average in the budget. Spending on agriculture will be boosted 17 % y-o-y and defence spending 18 %. The structure of spending by local administrations was not published.

State revenues, expenditures and surplus, % of GDP



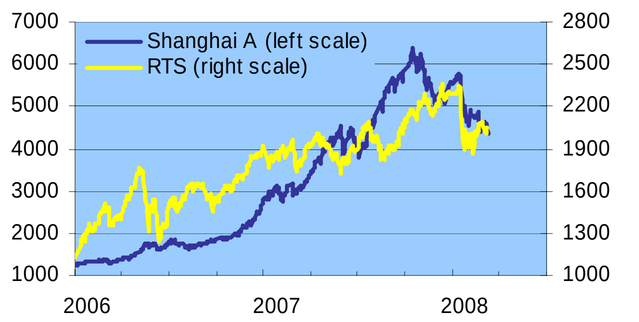
*) Estimate, assumes nominal annual GDP growth of 16 %.
Sources: China National Bureau of Statistics and Ministry of Finance budget estimates for 2008

Chinese share prices continue to slide. Although Chinese share prices have overall stabilized somewhat after the sharp drop in share prices in late January, share prices on the Shanghai bourse continue to decline. Share prices on the Shanghai exchange this week were down about a fifth from the end of 2007. China's share markets have been shaken by news of accelerating inflation and anticipated tightening of monetary policy, as well as general insecurity about trends in the global economy.

People's Bank of China governor Zhou Xiaochuan said recently that the country must continue preparations to allow Chinese direct investment in foreign exchanges. Currently, individual investment outside Mainland China is generally limited to the purchase of fund products offered by qualified domestic institutional investors (QDII). QDII approvals have now been extended beyond the Hong Kong exchange to include exchanges in London, Singapore and Tokyo.

The RTS index, which tracks the performance of Russian shares, is currently down about 12 % from end-2007.

Shanghai A-share index and Moscow RTS index



Source: Bloomberg

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Russia

2007 federal budget in the black for the eighth year in a row. Preliminary figures for the realised 2007 budget performance indicate a federal surplus of 1.8 trillion roubles (nearly €50 billion), or 5.5 % of Russian GDP. In the two preceding years, the realised surpluses were even larger, about 7.5 % of GDP.

Realised federal budget revenues amounted to 7.8 trillion roubles (€210 billion), while expenditures were about 6.0 trillion roubles (€160 billion). Revenues climbed 24 % in nominal terms and spending was up a record 40 %. Last year's nearly 12 % inflation rate, however, cut into real growth. The share of revenues was equal to about 24 % of GDP, while spending had an 18 % share. Expenditure as a share of GDP increased two percentage points from a year earlier. The GDP share of revenue also increased slightly.

Revenues were boosted by robust economic growth and soaring crude oil prices, which due to a progressive oil tax scale translated into larger income for the state. Budget revenues were further increased by the one-time income from the sale of the assets of the bankrupt YUKOS oil company.

Sharp spending hikes were seen in public investment, funding of housing and utilities, as well as spending on health care. A large part of the spending increases were accomplished as capital transfers to development funds established last year. The new funds are part of the state's economic innovation policies. The Bank for Development and Foreign Economic Affairs received capitalisation funds of 180 billion roubles (€4.8 billion), the Russian Corporation of Nanotechnologies got 130 billion roubles (€3.5 billion) and the state investment fund, which was added to the 2006 budget, was given 90 billion roubles (€2.4 billion). A fund created last year for basic upgrades in municipal infrastructure and housing took in 240 billion roubles (€6.5 billion).

Although spending on defence and national security increased in nominal terms, spending as a share of GDP was little changed from earlier years. Defence spending as a share of GDP remained under 3 %.

Russia's public debt is miniscule by international standards. Foreign public debt at the beginning of this year was €31 billion and domestic €36 billion (1,331 billion roubles). Public-sector debt corresponded to 7 % of GDP.

Public-sector economy posts overall surplus in 2007. The public sector's consolidated budget, which includes the federal budget, as well as regional and local administration budgets and off-budget funds (notably the pension fund and the social fund), were strongly in surplus last year. The surplus was 2.0 trillion roubles, i.e. 6 % of GDP. The consolidated budget revenues were equal to 40 % of GDP, while expenditures amounted to 34 % of GDP. Spending as a share of GDP increased three percentage points from a year earlier.

The surplus of consolidated regional budgets (including local budgets) amounted to 40 billion roubles. The GDP shares of both revenues and expenditures were around 15 %. Regions have limited decision-making power on budget issues as most regions get the lion's share of their revenues in the form of transfers from the federal budget. The central administration also limits the borrowing possibilities of regions, which in part explains their conservative budget stand.

Stabilisation fund split in two. The state stabilisation fund that collects federal budget surpluses and tax income from crude oil production and exports amounted to 3,841 billion roubles (€104 billion) after the inclusion of last year's federal budget surplus. At the beginning of February, most of this money (3,058 billion roubles) was shifted to a new Reserve Fund intended to finance budget spending in the event of a large drop in oil prices. The ceiling on the Reserve Fund is 10 % of GDP. The remaining amount (783 billion roubles) was transferred into the new National Wealth Fund. Money from that fund will go to financing e.g. reform of the pension system. The new funds accumulate over time as budget revenues are collected.

The finance ministry is currently drafting a proposal for the government on investment of the funds' assets. While the assets are currently invested abroad in a very conservative manner, there is an active debate over the most prudent investment policy. One side favours investment abroad as a means of reducing domestic inflationary pressures, but with higher yields than so far. The other side argues that the wisest course is to invest domestically to promote economic diversification.

Ukraine and Gazprom agree on gas deliveries. Gazprom temporarily reduced gas supplies flowing to Ukraine early this month after it failed to reach agreement with Ukraine on how the country would pay off its gas bill. Gazprom, the Ukrainian Naftogaz, as well as their jointly and separately owned intermediary companies have been at odds for the last few years over the price and volume of gas supplies to Ukraine.

Ukraine meets about 80 % of its annual gas needs with gas supplied by Gazprom (around 60 billion m^3). About 50 billion m^3 of gas imports to Ukraine are supplied by Gazprom from fields in Central Asia (mainly Turkmenistan). The remaining amount comes from Gazprom's own production.

Information released last week shows the parties agreed on a price of $180 per 1,000 m^3 for Turkmenistani gas for the remainder of the year. The price for Russian gas delivered in January-February 2008 was set at $315 per 1,000 m^3, supposedly the average price Gazprom sells gas to its EU customers.

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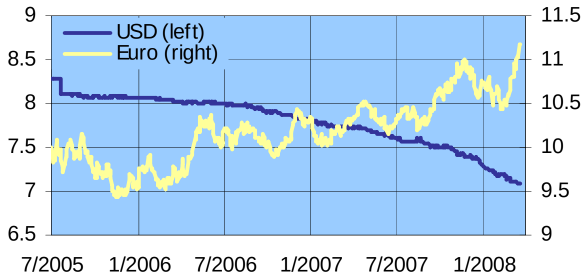
China

Yuan exchange rate affected by financial market turbulence. Faced with nervousness on international financial markets that has led to a weakening of the US dollar against most major currencies, China's monetary officials are allowing the yuan to appreciate against its traditional anchor at a faster rate. The yuan has gained nearly 3.2 % against the dollar over the past two-and-a-half months, and nearly 17 % altogether since the July 2005 mini-revaluation. Nevertheless, China's exchange rate policy, which traditionally stresses tracking the dollar, also has made the yuan decline by 3.7 % against the euro this year. While rapid strengthening of the yuan has the potential to help China tame its domestic inflation pressures, the Chinese currency's moves in different directions relative to the dollar and the euro mean that any change in the trade-weighted exchange rate, and thus import price inflation effects, may be small. As of Wednesday (Mar. 19), one dollar bought 7.1 yuan and one euro 11.1 yuan.

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



Source: Reuters

Annual meeting of National People's Congress adjourns. The nearly three thousand participants at this year's two-week session of the 11th National People's Congress wound up business on Tuesday (Mar. 18). Rather than take up legislation issues, the country's highest plenary body this year focused on appointing the president, the State Council and permanent committee, and a reform of administrative bodies. There were also no surprise high-level appointments. Hu Jintao will continue as president and Wen Jiabao as premier. Xi Jinping was named the new vice president and Li Keqiang was designated as the vice premier. The duo is expected to eventually take over China's top leadership posts.

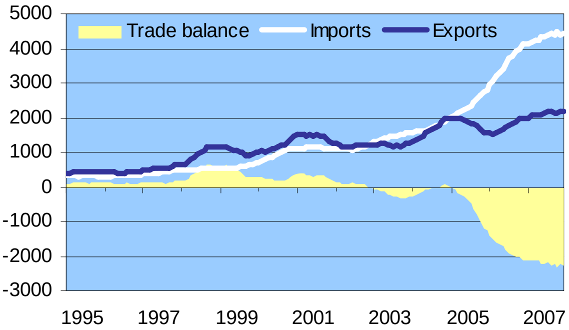
The NPC also decided on reform of ministry structures. Some ministries were augmented by upgrading their lower administrative agencies, while two ministries were merged with other ministries. Change also included creation of a new transportation ministry, an industry and information ministry, a health ministry, as well as a labour and social security ministry. The long under-respected State Environmental Protection Administration (SEPA) was conferred a ministry status. Under the new arrangement, the number of ministry-level agencies declines to 27. Although the traditionally influential National Development and Reform Commission (NDRC) saw its role nominally diminished, Chinese observers expect that in the end the NDRC will retain its status. Indeed, energy issues were transferred to a new national energy commission under the NDRC.

Growth in Finland-China trade flagged in 2007. Customs Finland reports that Finland last year exported goods worth €2.1 billion to China, and imported goods from China worth €4.5 billion. Finnish exports to China in 2007 were up 9 % (growth in 2006 was closer to 25 %). The slowing of imports was even sharper: import growth was down to 9 % from over 40 % during the previous two years. Finland's trade with China last year grew only slightly faster than Finnish exports and imports overall (7 % and 8 %, respectively). Measured in trade volumes, China (including Hong Kong) has risen rapidly to become Finland's fourth largest trading partner after Germany, Russia and Sweden.

The January-July 2007 data show two-thirds of Finnish exports to China consisted of various kinds of machinery and equipment. The share of mobile telephones and related components rose to about a quarter of total Finnish exports to China. Other important export products were iron and steel, pulp for papermaking, paper and cardboard, as well as metals and metal scrap. Some 43 % of the value of imports consisted of mobile phones and related components. When office technology and other electrical appliances and devices are included, their value rises to two-thirds of all imports. Clothing accounted for 8 % of imports and footwear 2 %.

About 260 Finnish companies currently operate in China. Of these, half engage in production, while the rest maintain sales or representation offices. Chinese direct investment in Finland is still minimal.

Finland-China trade 1995–2007, 12-month moving sum, € million



Source: Customs Finland

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Russia

Duma passes law limiting foreign investment in strategic enterprises. After long preparation, the Duma's decisive second reading of a law on foreign investment in strategic branches was approved last Friday (March 21) in a vote of 355–3. Approval in the third reading is essentially a formality and further changes to the bill are unlikely. After Duma approval, the bill goes to the upper house Federation Council for consideration. The bill is expected to move ahead swiftly and should be signed into law before president Putin completes his term. If everything goes according to plan, the law would go into effect later this spring.

The original initiative for regulation came from president Putin in 2005. The first Duma reading of the bill took place in September 2007. Preparation of the law involved several ministries and administrative bodies. They were often at odds over which sectors should be classed as strategic, how ownership of foreign investors should be limited and the size of a foreign stake the law applies to. The bill was tightened up in all these aspects after its first reading.

The law's main thrust is that foreign companies need to seek approval of a special commission led by the prime minister before they invest if their acquisition involves taking a stake of more than a 50 % in a company operating in a strategic branch. The strategic ownership rules for the mineral extraction industry, which includes oil and gas, are even stricter – those seeking even a 10 % stake must seek official approval. If the foreign firm is state owned, it needs permission to invest in a 25 % or greater stake in an enterprise operating in a strategic sector or a 5 % or higher stake in a company in the mineral extraction sector.

The commission makes its decision on foreign company participation after it receives a statement on the application from the Federal Security Service and the committee overseeing state secrets.

The approved legislation identifies 42 branches, mainly related to the defence industry, as partly or totally strategic from the standpoint of national security. Branches include weapons systems, atomic energy, aerospace, metals production and mineral extraction industries. After the first reading, items added to the list included fishing, magazines with high circulation and major radio and TV networks, as well as publishers. There was a last-minute decision to delist Internet companies and reduce the strategic sphere in the telecommunications sector.

The law is not retroactive and it is not applied to acquisitions completed before the law goes into force. Even so, the law requires all foreign firms owning more than 5 % of a strategic company to report it to the officials within six months.

One goal of the law was to give foreign investors clear information as to the branches they will be allowed to operate and how their activities may be limited. Observers comment that it is possible that this goal will not be fulfilled as hoped, since the language of the law has become increasingly opaque and equivocal during the drafting process. The law's impacts will depend to a large extent on how it is applied in practice.

New measures to assure banking sector stability introduced. The Russian state is preparing to support the banking sector during tight liquidity situations by investing public funds to the sector. At the start of the week, the government decided that the assets of two development funds established last year, i.e. the Nanotechnology Fund and the Housing and Municipal Infrastructure Fund, will be invested on the domestic market. Some 340 billion roubles (about €9 billion) from the funds will be invested as bank deposits and in corporate securities by the end of the year.

The government further decided that unallocated budget funds would also be invested as deposits in banks. The finance ministry says that in the near future it will begin to auction the assets to Russia's 30 best-rated banks. At most 600 billion roubles (about €16 billion) of budget assets will be invested in banks. At the start of the program the investment period will be one week.

In February, Russia's largest banks requested that the government and the central bank commit to supporting banks in the event they get into financial trouble. The finance ministry, which had long opposed investment of development fund assets domestically (mainly out of worries over fuelling inflation), has gradually changed its position last weeks. Most ministries and large enterprises hurting from rising interest rates on international markets already supported placing these assets in domestic banks. President Putin has pushed heavily for domestic investment of fund assets.

The government estimates that the proposed measures will sustain growth in banking sector lending this year in the range of 35–40 %, a level that is seen as adequate to support economic growth at or above 7 %. Bank lending grew over 50 % last year.

Other measures to increase market liquidity have also been launched. The Central Bank of Russia last week expanded its list of securities banks can use as collateral for loans from the central bank to include municipal bonds. Further, the state development bank VEB, which manages part of pension fund assets, is pushing for permission to invest these assets in top-tier Russian banks.

For the moment, the Russian banking sector has not suffered significantly from the current distress in global financial markets. The sector's liquidity situation, however, tightens at certain points, e.g. on days corporate tax payments come due.

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China

Chinese banks and stock markets also feeling global financial woes. The Bank of China and the Industrial and Commercial Bank of China (ICBC) this week released their 2007 financial results. The two banks are mostly state owned. The Bank of China, reportedly the most aggressive Chinese bank involved in purchasing securities based on US subprime mortgages, wrote down a $1.3 billion loss on these investments. Nevertheless, the bank's 2007 net income was up 31 % from 2006. ICBC, the world's largest bank in terms of market capitalisation, wrote down $400 million in subprime mortgage losses. Despite the hit, however, ICBC's net income was up 65 % from the previous year. The overall positive performance of these Chinese banks was supported by continued strong lending businesses in the rapidly expanding domestic economy. Last year, the non-performing loan portfolios of both banks fell to a level of around 3 % of their overall loan stocks.

Due to China's controls on capital movement, the direct impact of global financial turmoil on China's banking sector is expected to be marginal. Nevertheless, financial market jitters have depressed prices on Chinese stock exchanges, which, like many bourses in emerging market exchanges, are subject to large swings in share prices. Investors in China are spooked by accelerating domestic inflation and the government's expected tightening of monetary policy in response. The tighter monetary condition should depress the lending of commercial banks. At the same time, demand growth in foreign export markets is seen as increasingly unlikely, which has reflected to share prices. The Shanghai stock exchange's A-share index has fallen 30 % this year, and currently is at the same level as it was last summer.

PBoC hikes reserve requirement again. The People's Bank of China announced a half-percentage-point increase in its mandatory reserve requirement for commercial banks to 15.5 % of deposits. The requirement entered into force on Tuesday (Mar. 25). The reserve requirement has become an actively used monetary policy tool of the central bank for controlling money supply growth and restraining inflation. At the beginning of 2007, the reserve requirement was just 9.5 %. Raising the reserve is a relatively cheap way for the PBoC to tighten its monetary stance, because the interest rate it pays on mandatory deposits is lower than it pays on paper issued by the central bank. Moreover, hikes in the reserve requirement do not attract foreign capital into the country in the way interest rate hikes do. Beside market-based measures, the PBoC has established strict limits on bank lending. According to certain media sources, the tighter monetary stance is already causing problems for smaller banks.

China's rough winter leaves long-lasting legacy. The exceptionally severe snowstorms that afflicted provinces in central and southern China from mid-January through February this year have left in their wake massive economic losses that should be seen in figures for first quarter economic performance. The storms profoundly disrupted the country's transport systems, energy distribution and telecommunications. Delayed coal deliveries and the collapse of tens of thousands of power lines under the weight of snow led to widespread power outages. The Bejing Review reports that the two companies that maintain China's national power grid (SGCC and CSG) suffered direct losses of at least 30 billion yuan (€2.7 billion) from the storms. Repair of the power grid will be even more costly, however, as the companies will be subject to higher tolerance standards for power lines. The winter storms also hit the forest sector heavily, causing destruction in about a tenth of China's forests. The State Forest Administration (SFA) reports direct economic losses to the forest sector are on the order of 60 billion yuan (€5.4 billion) and that recovery from the damage could take more than a decade.

The harsh winter added to pressures to raise prices and worsened China's already severe problems with endemic energy shortages. This has stoked discussion about energy pricing policies. Most electricity is currently produced by coal-fired plants. While the coal price is set by the market, the price of electricity remains strictly regulated. In mid-March, the National People's Congress approved a 2008 budget that includes 56 billion yuan (€5 billion) for repairing winter storm damage and helping people in need. That amount corresponds to about 1 % of budgeted spending.

Fuel shortages plague China once again. Numerous provinces have declared fuel shortages, causing long lines at gas stations. Large, mostly state-owned oil companies have begun to ration fuel sales. Both supply and demand factors are contributing to the current fuel shortages. Chinese officials have been reluctant to increase inflation pressures through hikes in regulated fuel prices, even as world prices for crude oil have risen. China's second largest oil refiner, the largely state-owned PetroChina, estimates the price of a barrel of crude oil would have to fall below $67 for refining to be profitable at current regulated retail prices. Sinopec, which refines over half of the crude oil consumed in China, receives billions of yuan in state support annually to cover its losses. According to media reports, several small oil refiners have temporarily suspended fuel sales to avoid losses. Fuel demand has been boosted lately by recovery efforts associated with the winter storms, spring sowing on farms and hoarding of fuel in anticipation of price hikes.

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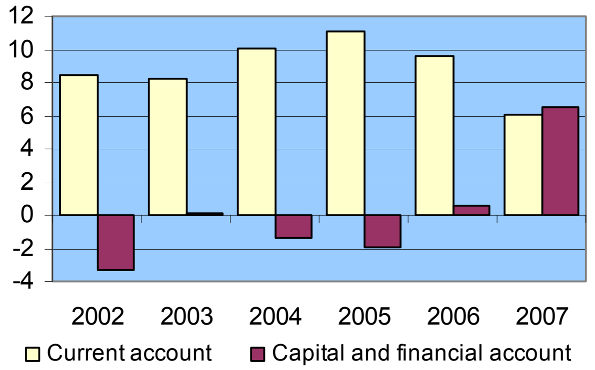
Russia

Russian 2007 current account surplus declined, while capital and financial account surplus increased. The Central Bank of Russia's vetted balance-of-payments figures show a current account surplus for 2007 of $78 billion (6 % of GDP). The current account surplus shrank as growth in imports outpaced exports; exports were up only 16 % compared to 36 % for imports. The goods trade surplus shrank to 10 % of GDP. Export earnings from oil and gas were up 15 % last year, in line with higher oil prices. The total share of oil and gas in goods exports revenues was 62 %. The services trade deficit persisted, amounting to nearly 2 % of GDP. The income account deficit grew slightly to $30 billion (just over 2 % of GDP).

Last year's combined capital and financial account surplus, about $84 billion (7 % of GDP), was larger that the current account surplus for the first time. The financial account surplus was boosted by foreign investment in Russia, as well as the increased foreign borrowing of Russian companies and banks. The balance-of-payments figures indicate foreign direct investment in Russia increased last year to $52 billion (4 % of GDP), clearly more than a year earlier. Foreign portfolio investment in Russia rose to $13 billion. At the same time, Russian direct investment abroad nearly doubled to $46 billion. Russian portfolio investment abroad climbed to $7 billion. Russian firms and banks last year borrowed about $139 billion from abroad, bringing the stock of foreign borrowing at year's end to $413 billion (32 % of GDP). Financial flows associated with other exports, imports and portfolio capital flows from Russia rose to $30 billion.

The CBR's foreign currency reserves increased by $149 billion last year. As of the beginning of March 2008, the reserves stood at $491 billion.

Russia's current account and finance and capital account balances as shares of GDP, 2002–2007, %



Source: Central Bank of Russia

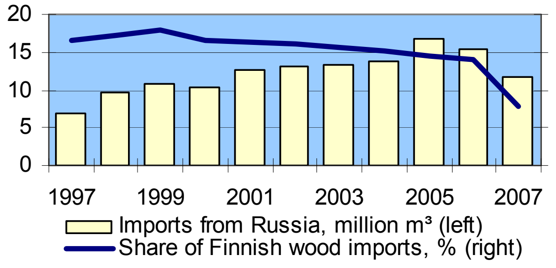
No big changes in structure of fixed capital investment. Rosstat reports that 2007 fixed capital investment in Russia amounted to 6.6 trillion roubles (€190 billion), an increase of 21 % y-o-y. The investment rate, i.e. fixed capital investment as a share of GDP, rose to 20 %. About a third of fixed investment went to machinery, equipment and transport equipment. Machinery imports as a share of machinery and equipment investment contracted slightly to about 17 %. Increased oil revenues and higher budget spending ahead of the elections nudged slightly up the state's share of fixed investment. At the same time, the share of foreign investor participation in fixed capital formation fell.

There were few changes from 2006 in the structure the investment patterns sector wise. Of fixed investments 17 % went to mineral extraction industries (excluding small firms) and 16 % to manufacturing industries. Growth in investment in the manufacturing category was highest in the manufacture of transport equipment where investment where up nearly 40 %. Modernisation of Russia's electrical power industry was also apparent; fixed capital investment in electrical power production and distribution increased over 50 %. A quarter of investment continued to flow to the transport sector, although investment in oil and gas transmission by pipelines declined slightly from 2006.

Higher raw wood export tariffs now in effect. In accordance with a plan approved last year, Russia raised tariffs on raw wood exports on Tuesday (Apr. 1). Under the new rates, the state collects a 25 % tariff on the wood's value, with a minimum rate of €15 per m^3. The previous rate, which was imposed in July 2007, charged a 20 % rate, with a floor rate of €10 per m^3. Russia currently plans to raise raw wood export tariffs again on January 1, 2009 to 80 % of the wood's value or €50 per m^3.

Finland's forest industry has been hit hard by the increased tariffs, as Russia is Finland's main non-domestic source of raw wood. Raw wood imports from Russia contracted already severely last year due to supply problems and higher prices. The tariff hikes are seen contradicting the terms of the EU-Russia bilateral WTO-trade terms agreed in 2004. EU trade commissioner Peter Mandelson, who has overseen discussions with Russia on the wood tariff dispute, said last week the raw wood policy has become Russia's largest obstacle to WTO membership.

Russian raw wood imports to Finland, 1997–2007



Source: Finnish National Board of Customs

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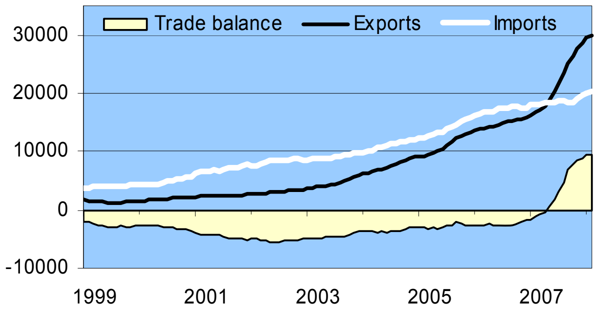
China

China's ballooning trade surplus with Russia. China's goods trade with Russia entered positive territory in early 2007 and the trade surplus continued to increase fast towards the end of the year. China Customs reports exports to Russia last year rose to $28 billion (up 80 % from the previous year), while imports from Russia increased to $20 billion (up 12 %). Russia accounted for slightly over 2 % of China's total exports and imports.

China's exports and imports with Russia, US$ million 12-month moving sum



Source: CEIC, China Customs

Despite ambitious plans by both countries to increase Russian oil supplies to China, Russia last year only shipped about 8.2 million tons of crude oil to China by rail. Russia shipped 10.2 million tons in 2006. The drop was attributed largely to Russia's decision to raise rail freight tariffs. This year, Russia hopes to send more crude oil to China by making use of the Kazakhstan oil pipeline. The Chinese and Russians have also been at odds over the price of electricity from Russia. The issue came to a head in February 2007, when China decided to cut off its electricity imports from Russia. Despite the wrangling, Russia has big plans to increase hydroelectric production capacity in the Russian Far East with an eye to supplying the Chinese market. Russia's lousy export performance with China last year also reflected a collapse in arms sales to China (see following item).

Russian customs figures show China-Russia trade was slightly lower than the corresponding Chinese figures. Even so, the trend was in line with the picture given by the Chinese figures. China is gobbling up an increasing share of Russian imports. China's share of Russian imports was 3 % in 2000, 7 % in 2005 and 12 % last year. In contrast, China's relative significance as a destination for Russian exports has fallen slightly. In 2007, China accounted for less than 5 % of Russia's total exports.

Arms imports from Russia collapsed last year. One of the more interesting developments in China-Russia trade last year was noted by the Stockholm International Peace Research Institute (SIPR) in a report released at the end of March. It showed China's overall imports of arms fell 62 % from 2006, declining from $3.7 billion to $1.4 billion (expressed at constant 1990 dollars). The loss of trade directly affects Russia, which in recent years has accounted for over 90 % of foreign arms and weapons systems sales to China. SIPR researchers found that China and Russia also failed to agree on new major delivery contracts, signalling the plummeting trade is more than just a year-to-year fluctuation typical on arms trade. The researchers suggested that the collapse in trade and lack of orders could be a sign that China's domestic arms industry has caught up with Russia's former lead and the age of large-scale weapons trade, at least on its current basis, is over. Russia has not made its most advanced weapons systems available to China.

The drop in arms sales to China was a huge blow to Russian arms exports. SIPR estimates that China accounted for 54 % of Russian arms imports in 2006. Even with the collapse, China still accounts for 28 % of Russian arms exports. SIPR valued Russia's total arms exports last year at about $4.6 billion, measured in constant 1990 dollars. It put the 2006 amount at $6.5 billion. Despite strong growth in Russian weapons exports elsewhere (in particular Malaysia and Venezuela), the growth was only sufficient to make up for a fraction of the lost China business.

Paulson visits China. United States treasury secretary Henry Paulson this week visited Beijing to meet with China's newly selected president Hu Jintao, premier Wen Jiabao and a number of key ministers. The discussion touched on the state of the global economy, energy issues, environmental problems, China's exchange rate policies and preparation for the next strategic dialogue of the two countries this summer. President Hu stated that both China and the US have to carry their responsibility for stability of the global economy. Paulson said that a financial market crisis could slow the opening of China's financial sector, and emphasised the mutual need of both countries to seek ways to improve energy security. The US secretary hoped that China would eliminate import tariffs on environmental technologies. He praised the Chinese for allowing the yuan to appreciate rapidly against the dollar and hoped that China would continue on the same path. On Friday (Apr. 4), one dollar bought 7.02 yuan.

There was no growth in Chinese exports to the United States in January-February. The export figures might not only reflect depressed US demand but also events in China such as the Chinese New Year holiday and an unusually harsh winter.

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Russia

Public debate on direction of government economic policies heats up. In recent weeks, cabinet members have aligned themselves in to two competing camps on economic policy. The first group, led by the finance ministry and central bank, emphasises application of conservative fiscal policies directed at maintaining macroeconomic stability and subduing inflation. The opposing view, led by the ministry for economic development and trade and economic experts in the presidential administration, calls for economic diversification and long-run development through public investment, now made possible by the current hefty tax revenues. The flare-up of the public debate signals jockeying for who gets to set economic policy when power changes hands next month.

Deputy prime minister and finance minister Alexei Kudrin warns of the risk of economic overheating, noting last year's sizzling GDP growth of 8.1 %. He argues that, after a couple years of fiscal loosening, the fiscal stance must be tightened at this phase in the economic cycle. To assure the long-term goal of a stable federal economy, the budget cannot be based on an assumption that crude oil prices will remain high forever. Rising pension costs also call for tighter fiscal policy.

The finance ministry says the volume of bank lending this year is expected to increase 40 %. In combination with significant capital imports, this will sustain inflation. In this situation, higher state investment will increase bottlenecks and accelerate inflation. Furthermore, public resources are not used effectively. Increasing their effectiveness would be the right measure to start with.

The central bank is expressing its own concern that the economic overheating will reduce the economy's ability to withstand external shocks. The imbalance between supply and demand continues to increase. Growth in household deposits in the first quarter of this year was halved from 1Q07, while wages are increasing twice as fast as productivity gains. The central bank is also worried about increased credit risk generated by the rapid increase in bank lending.

In contrast, the ministry of economic development and trade sees no present threat of economic overheating. The ministry argues that Russia lags developed countries, so it needs rapid economic growth to catch up. To be sustainable, however, growth must be based on innovation rather than raw material resources as has been the case to date. Both public and private investment is needed for this. The state must invest more than at present in basic infrastructure and human capital to promote private sector activity.

Tax reform has become a major issue in economic policy. The economy ministry has demanded reduction of the VAT from the current 18 %, while the finance ministry replies that any lowering of the VAT is unjustified in the current situation. The finance ministry is currently drafting the tax policy programme for 2009–2011. The proposal should be submitted to the cabinet late this month or early next month.

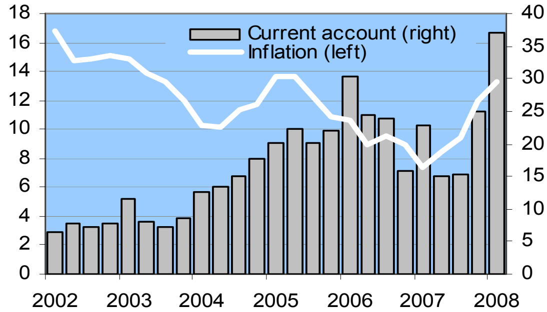
Inflation continues to accelerate, current account surplus keeps growing. In March, consumer prices were up 13.3 % y-o-y, a considerable pick-up from the 7.4 % pace in March 2007. March prices were up 1.2 % m-o-m, led by rising food prices. Russian inflation has not just been driven by the spike in food prices globally but also money supply growth caused by significant foreign exchange inflows sloshing around in the system.

Russia's revenues from energy exports continue to soar with record energy prices. Central bank advance information shows that the current account surplus in the first three months of this year rose to $37 billion, a 62 % increase from 1Q07. Moreover, the surplus grew in the face of a massive 42 % increase in imports.

On the other hand, the net flow of private capital turned negative; there was a net export of $23 billion in the first quarter from Russia. In contrast, Russia had net imports of private capital worth $14 billion in 1Q07 – and for all of 2007 record private capital imports of $81 billion. In the first quarter of 2008, most of the net capital outflow reflected the fact that Russian firms reduced their borrowing on international markets in response to higher interest rates. At the same time, Russian private direct investment abroad continued to grow briskly. The central bank estimates net private capital flows this year will turn back towards Russia, bringing capital imports for the year to around $35 billion. Russia has been a net importer of private capital since 2005.

The ministry for economic development and trade boosted its inflation forecast for 2008 by one percentage point to 9.5 %. Most observers, however, expect on-year inflation to substantially exceed 10 % by the end of the year.

12-month inflation (%); current account surpluses (US$ billion)



Sources: CBR, Rosstat

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China

China revises 2006 and 2007 GDP figures upwards. The National Bureau of Statistics raised its figure for real GDP growth in 2006 from 11.1 % to 11.6 % and the 2007 figure from 11.4 % to 11.9 %. New estimates that increased the size of the service sector from what was earlier assumed largely account for the upward revisions. The NBS reduced the size of the agricultural sector slightly for 2006 and raised it a bit for 2007. There were no changes in the industrial figures. Industry generates slightly less than 50 % of China's GDP. Services account for about 40 % of GDP and agriculture just over 10 %. Even with the increase in last year's GDP figures, China is not expected to surpass Germany as the world's third largest economy after the United States and Japan. Germany has yet to release its figures.

Rapid growth in the insurance sector. Insurance premia paid to Chinese insurance companies climbed 25 % y-o-y in 2007 to 700 billion yuan (about €66 billion). They accounted for about 3 % of GDP, whereas the average share in OECD-countries is 8 %. Over 60 % of Chinese insurers' premia came from life insurance policies and about 20 % from motor vehicle insurance policies. The number of motor vehicle insurance policies, in particular, has increased rapidly in recent years, in line with China's booming increase in the number of cars on the road. Claims paid out by insurance companies have increased rapidly. Last year, claims paid out increased over 50 % from a year earlier to nearly 230 billion yuan.

Despite rapid increase in the amount of claims paid out, insurance company profits continue to increase. China's largest insurers China Life and Ping An saw their profits double last year. China's finance sector has also witnessed the creation of financial conglomerates, with the insurer Ping An beginning to offer banking services. Some domestic banks, in turn, have applied for permits to offer insurances.

At the end of 2007, China's insurance sector assets amounted to a total of 2.9 trillion yuan (€270 billion). In recent years, officials have increased opportunities for insurance companies to invest in domestic shares and abroad. Last summer saw a reform that gave insurance companies the possibility to invest 10 % of their assets directly in domestic shares. Some of the big insurance companies in recent months have announced they are reducing the amount of shareholdings in their investment portfolios. China's exchanges have been headed downhill for about six months. Insurance companies have been allowed to invest up to 15 % of their assets in approved foreign securities since last summer. At the end of last month, the China insurance regulatory commission (CIRC) and Hong Kong's securities and futures commission signed an agreement to encourage Mainland Chinese insurance companies to establish investment companies in Hong Kong.

Ping An acquires 50 % stake in Belgian investment company. China's mainly state-owned insurance company Ping An purchased a 50 % stake in the Belgian Fortis Investments for a price of nearly €2.2 billion. Ping An earlier took an almost 5 % stake in the Belgian company's parent Fortis. The deal still requires official approval. When realised, the deal will be the largest foreign direct investment of a Chinese insurance company. The resulting company, Fortis Ping An Investments, will assume responsibility for operation of Ping An's foreign investment funds.

Warming China-Taiwan relations. China and Taiwan relations appear to be on the upswing following Taiwan's presidential election late last month. President-elect Ma Ying-jeou and his party the Kuomintang (KMT) are less strident proponents of Taiwanese independence than the current president Chen Shui-bian and his Democratic Progressive Party (DDP). Chen must hand over power next month. President-elect Ma made normalisation of economic relations with China his top theme in his post-election speeches. Ma also said he would try to eventually secure a free-trade agreement, as well as advance opportunities for Taiwanese finance companies to operate in Mainland China markets. Currently, the China Banking Regulatory Commission is considering the first Taiwanese bank's Hong Kong subsidiary's offer to buy share in the Mainland bank. China's leaders seem to be satisfied with a wait-and-see approach on other issues as they let the situation unfold.

President-elect Ma will also push for direct flights between Taiwan and Mainland China. Such flights have been limited in recent years mainly to charter flights during the Chinese New Year season. In summer 2006, the first direct cargo flights since the 1940s also began (although they still had to pass through Hong Kong airspace). At the moment, each cargo flight is required to get a permit from the officials. As a result, the bulk of freight and people flying between Taiwan and Mainland China still travels via Hong Kong, and involves at least one plane change.

Taiwan is a major trading partner for China. China Customs reports that in 2007 the country imported goods worth a total of $100 billion from Taiwan (11 % of total imports). Exports to Taiwan amounted to $23 billion (2 % of total exports). For Taiwan, China is clearly the most important export destination, and after Japan, it is the second most important provider of imports.

Several Taiwanese-owned companies operate in Mainland China. In recent years, foreign direct investment from Taiwan into China has averaged about $2 billion a year. Some Taiwanese assets, however, first pass through Hong Kong before going into China, which distorts the statistics.

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Russia

Russian cabinet approves national mineral exploration program. The program extends through 2020 and should increase significantly state investment in mineral exploration, resource inventory and development of extraction methods. The current proposal, for which most of its main parameters are now approved, replaces a program adopted in 2004. Some 550 billion roubles (€15 billion) in investment would be spent on the program between 2010 and 2020, or more than double in nominal terms the amount dedicated under the previous programme. Over half of the investment will go to oil and gas exploration and about 12 % will be directed to precious metal prospecting. The program's geographic emphases are in the Far East and Southern federal districts, as well as Western Siberia.

Natural resource minister Yuri Trutnev observed that about 60 % of Russian budget revenues currently come from the natural resource sector, while public investment directed to sector development constitutes less than one percent of budget spending. Between 1990 and 2003, the state has basically spent nothing on exploration for mineral resources. Moreover, the state was last involved in large-scale geological mapping of the country 35 years ago. Given the sector's importance to the economy as a whole, the program is considered to be high priority.

Even with state help, budget financing represents a tiny fraction of the sector's investment needs. In particular, oil companies are blamed for their reluctance to invest in exploration in recent years. As a result, production has begun to decline. Despite record world market prices, oil production growth stagnated completely in the first quarter. Investment has been held back by uncertainties in the operating environment (including property rights) and the extremely high taxes levied on oil companies. Lowering taxes in the oil sector is currently a hot topic.

Tax changes in the works. The finance ministry is currently drafting its fiscal policy program for 2009–2011. The main thrust is for a partial tax reform. Conflicting ministry views have caused the cabinet to postpone discussion of the program twice this spring.

Increased tax revenue in the wake of higher world energy prices and a string of substantial federal budget surpluses have sharpened calls for tax reductions. The economy ministry e.g. is seeking a drop in the value-added tax rate from 18 % to 12–13 %. Also the presidential administration backs a VAT reduction. The finance ministry and economy ministry have been given until August to present figures on the impacts a tax reduction would have on the economy. The economy ministry also argues for broader tax deductions and write-offs on corporate taxes. The industry ministry and oil producers are pushing for tax cuts on oil production to raise production levels.

A major problem in the current tax system is the ongoing underfunding of pensions created when the rate of social contributions collected from firms was lowered in 2005. The social ministry suggests an overhaul of the social payment scheme as a partial fix for the problem.

The finance ministry opposes tax reduction generally and VAT lowering in particular. The ministry claims that taxation including natural resource fees corresponds to slightly less than 35 % of GDP in Russia, while the average in developed countries is about 36 %. Recently, the ministry has retreated somewhat from its stance.

The finance ministry's fiscal policy proposal supports a modest lowering of energy taxes in order to enhance investment. Mineral extraction fees could be lowered by increasing the tax-free share on oil from $9 to $15 a barrel. A zero-tax rate for oil produced during the first years of off-shore production on the continental shelf is also proposed. To Gazprom's apparent benefit, the ministry has not proposed an increase in the extraction fee for natural gas, which currently is substantially lower that the similar fee charged for oil extraction.

The finance ministry wants to limit growth in federal spending this year to a real rate of no more than 9–10 %, and thereafter constrain spending growth to 4–5 % a year.

Industry ministry unveils development plan for forest sector. The industry ministry is drafting a forest sector development plan that extends through 2020. It should be submitted to the government for consideration this summer. Under the optimistic development scenario, forest industry production would rise to 3.5 times above the current level by 2020, with the value-added production component growing substantially. The ministry believes capacity utilisation in the forest industry is already high and that its development scenario will require a 1.2 trillion rouble (€33 billion) investment in forest industries through 2020. Measures to increase investment in the sector have included hikes in raw wood export tariffs and reductions in forest leases for "priority projects". The ministry says that 13 projects with a combined value of 144 billion roubles have been declared priority projects by now. The forest sector has additional massive investment needs due to inadequate infrastructure, particularly poor road system. Development of the forest sector is also held back by a lack of available skilled labour.

Under the plan, the emphasis on regional forest industry development will shift to exploitation of new forest areas in e.g. Siberia and the Far East. Prime minister Zubkov soundly criticised the fact that raw wood exports to China have grown despite higher export tariffs. He also complained about the passivity of Far East regions in developing value-added industries.

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China

GDP growth remained strong in January-March. China's National Bureau of Statistics (NBS) reports GDP climbed 10.6 % y-o-y in the first quarter. While economic growth slowed slightly from the 11.9 % posted in 2007, some of the first-quarter slowdown can be attributed to the harsh winter storms in January and February that caused extensive power outages and transport disruptions.

China still does not release a proper breakdown of its quarterly figures for GDP, so actual sector-specific trends regarding volume and inflation are hard to estimate. Published figures suggest, however, that industrial output and construction were up nearly 12 % y-o-y in 1Q08. Services output continued to boom at 11 % a year.

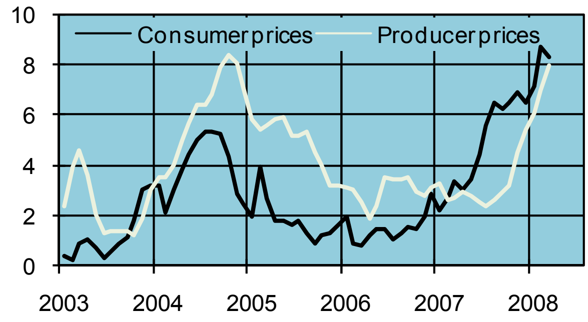
Demand item trends suggest China's growth prospects increasingly are tied to domestic demand. There are no signs of slowing in the growth of fixed capital investment. Driven by rapid urbanisation, construction investment increased in real terms during the first quarter by about 25 % from the same period a year earlier. Private consumption growth has been sustained by strong income growth. Per capita disposable incomes of city-dwellers in the first quarter climbed 12 % in real terms, while in the countryside incomes were up 19 %. Robust growth in goods imports and slowing export growth mean that the role of domestic factors in sustaining economic growth will be increasingly emphasised.

The current slowdown in the global economy will undoubtedly impact China's development. China's decision-makers must now balance inflationary pressures against the weakening global economic outlook. Comments of Chinese decision-makers imply that they are now becoming more concerned about the global recession and its impact on China than domestic inflationary pressures and economic overheating. On the other hand, the strong domestic demand registered in January-March could help offset impacts from the slowing global economy. While some investment banks have raised their China growth projections for the current year based on first-quarter performance, only the coming months will show the actual impact of the global slowdown on China's trade balance and investments.

Consumer price inflation remains high. The NBS reports March consumer prices were up 8.3 % y-o-y. Inflation was largely driven by soaring food prices. The rise in producer prices accelerated in March, reaching 8.0 %. Higher producer prices reflect rapid gains in prices for oil, coal and steel. Price pressures can also be seen in the real estate market, where prices for commercial space and apartments rose over 10 % last year. January figures, however, suggest growth may be slowing.

Officials have sought to curb inflation through both direct administrative measures and market-based measures. Recently, the central bank decided to raise its reserve requirement for commercial banks by a half percentage point to 16 % of the deposit stock. The higher reserve requirement enters into force on April 25. On-year growth of the broad money supply (M2) slowed in March to 16.3 %.

12-month change in consumer and producer prices, %

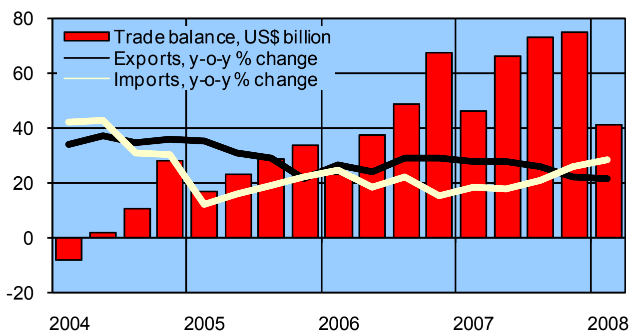


Source: NBS

Imports up sharply in first quarter. China Customs reports import growth continued to outpace export growth in the January-March period (see graph). Exports were valued at $306 billion and imports $264 billion. Imports from developing economies such as Brazil, India and Vietnam grew especially fast. Imports from the EU and the US also revived in the first quarter.

Crude oil imports increased 15 % y-o-y in 1Q08 to 45 million tons. The value of imports rose 90 % y-o-y to $16 billion. Fuel shortages are increasingly common in China, so officials are demanding that mainly state-owned oil companies boost fuel production. The fuel bottleneck has also led to increased imports of refined oil products. This trend is expected to continue since officials announced they would grant tax breaks to fuel importers during April-June. The fuel shortage stems from regulated fuel prices that have failed to keep up with world crude oil prices.

China's foreign trade quarterly development



Source: China Customs

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Russia

Brisk economic growth abides. In the first quarter of 2008, manufacturing output increased 9 % from the same period a year earlier (in 1Q07 the growth was 13 %). Rapid growth was led by manufacturing of rubber and plastic products (up 30 %), production of machinery and equipment (16 %), saw goods and wood products (16 %) and vehicles production (14 %). Mineral production (including energy minerals) rose less than 1 %, due mainly to a slight drop in crude oil production volumes. Natural gas production on the other hand was up 1 % in volume terms. The pace of construction activity accelerated by 29 % (compared to 17 % in the same period a year earlier), while housing construction growth slowed to 8 %. Freight transportation grew 4 %.

Both investment and consumption continued to boom. Investment in the first quarter of this year was up 20 %, even if that pace was slightly lower than in 1Q07. Retail sales were 17 % higher than a year ago (15 % in 1Q07).

Disposable real incomes continued to shoot up – 10 % in the first quarter compared with 1Q07, the same rate as a year earlier. Real wages grew 14 % (18 % in 1Q07). The average monthly wage in March was 16,400 roubles or about 440 euros.

According to Rosstat preliminary figures, GDP growth in the fourth quarter of 2007 was 9.5 % y-o-y. Growth was the highest since 2000, when the economy was bouncing back from the collapse of the 1990s. According to the economy ministry's recent estimate GDP increased 8 % in the first quarter of this year.

The economy ministry is presently preparing its forecast for economic growth in the next three years to provide basic assumptions for preparation of the federal budget. The ministry has boosted its forecast for GDP growth this year from 6.7 % to 7.1 %. Its GDP growth outlook is 6.3 % for 2009, 6.6 % for 2010 and 6.1 % for 2011. The growth in real incomes in coming years will remain high, but is however forecast to fall from this year's expected 11 % to 8 % in 2011.

The IMF's *World Economic Outlook* published this month foresees Russian GDP growth reaching 6.8 % this year and 6.3 % next year. The IMF's Moscow representative warns that there are now definite signs of overheating in the Russian economy, including a continued acceleration in inflation and a rapid shrinking of the country's current account surplus due to soaring imports. On the brighter side, Russia remains one of the world's most important energy exporters, so its economy is buffered to some extent from major shocks to the international financial system.

Russia now one of Europe's top retail markets. A survey by the International Marketing and Sales Group (IMSG) shows that Russia was Europe's fourth largest market after Germany, France and Great Britain last year when measured in dollar terms. The survey forecasts that the rapid growth of retail sales makes Russia Europe's largest retail market already this year. The powerful sales growth has been driven by both higher sales volumes and pricing gains.

Among European cities, Moscow overtook the number-one London market last year.

Retail sales per capita in Russia are still relatively small; less than half the level of Europe's retail sales leader Great Britain. By 2010, however, Russian is expected to cut Great Britain's lead to less than 30 %, and Moscow should beat out the London market on a per capita basis.

Russia's economy ministry estimates that over 70 % of disposable income already goes to consumption, and that this share continues to increase. Sales of non-food goods are rising particularly fast. Flush with cash, the well-heeled segment of the population tends to go for pricier items, while the hoi polloi go for cheap stuff – but in bigger amounts. An indication of the rise in living standards is the fact that the share of sales in outdoor markets, traditionally selling shoddy, inexpensive goods fell from a 20 % of all retail sales in 2006 to 15 % last year.

Getting regions involved in their own economic development. In his recent speeches, Dmitri Kozak, regional development minister since last autumn, has stressed the importance of increasing regional input into the planning of their economic development and reducing the reliance of regions on central power. Even as regions should have a greater say in how investment spending is deployed, he also expects the central government to demand greater efficiency from regions.

The economic dependence of regions on central power has been increasing in recent years. In 2007, the budgets of just seven of Russia's more than 80 regions had federal budget transfers accounting for less than 5 % of total regional budget income – a significant decline from 2006. At the same time, federal transfers accounted for more than 60 % of a regional administration financing in ten regions. While budget reforms of recent years have shifted responsibility to regions to take care of many tasks that earlier were handled by the federal authorities, regional tax bases have not been increased correspondingly.

Kozak said the goal of regional policy is still reduction of disparities in regional living standards, but income transfers from the federal budget are no longer seen as the best way to promote equity as they do not encourage regions to develop on their own terms.

Kozak suggests that regional policy be based on ten so-called "macroregions." The division would be based on geographical proximity and roughly follow the borders of federal districts established in 2000. Earlier announced regional policy plans, on the contrary, emphasised the need to group together regions with similar economic and social characteristics.

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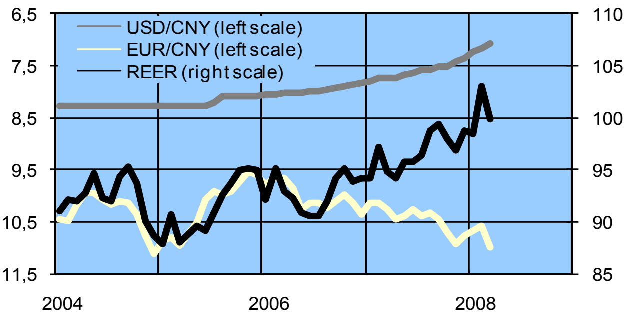
China

Yuan shows real appreciation. Changes in China's real international price competitiveness can be hard to detect simply by comparing exchange rates at face value. Price competitiveness is better described by the real effective exchange rate (REER), which takes into account the share China's trade partners and inflation differences across countries. Over the past twelve months, the REER of the yuan has appreciated 5.3 %. In nominal terms, the yuan strengthened 7.2 % against the dollar and weakened 8.6 % against the euro over the same period. However, to counterbalance weakened price competitiveness, yuan's strengthening increases imports and competition, which leads to productivity gains.

Yuan-dollar and yuan-euro rates (inverted scale) and yuan's real effective exchange rate (yuan strengthens as trend rises)



Source: BIS

Officials see speculative capital flows increasing. During the first quarter, China's foreign currency reserves grew by $154 billion to $1,682 billion as of end-March. The rapid swelling of China's reserves increased concerns over speculative foreign currency flows into China. Chinese officials estimate that speculative capital inflows into China during January-March, given already released figures for foreign trade and direct investment flows into China, amounted to about $80 billion. Moreover, they estimate that the speculative capital inflows into China for all of 2007 amounted to $120 billion. Explanations for the surge in foreign currency inflows include the expectations that the yuan will continue to strengthen against the dollar and profitable investment opportunities available in China. The problem is that speculative flows hamper central bank monetary policy efforts and may precipitate instability in financial markets.

Some observers take a contrary view, as they see true speculative flows as rather small. They note that a large part of official flow estimates are ordinary capital inflows. More specific information on last year's foreign currency flows will appear in the balance-of-payments figures due in May.

Rapid growth in Chinese productivity reflects structural reforms. The Conference Board's latest comparison of productivity trends globally found that productivity growth has been a central factor in China's economic miracle. Deconstructing China's average GDP growth of 8.6 % in 1995–2007, researchers found that 7.5 percentage points of that growth came from gains in labour productivity, and only about one percentage point was due to growth in the size of labour force.

The growth in labour productivity in China has been propelled by massive investment in infrastructure and modern production equipment, as well as shifting labour out of low productivity sectors such as agriculture and inefficient state enterprises into productive sectors and businesses. The study notes remarkably high job creation and job destruction in China, suggesting rapid structural reform is in progress. The development has been pushed especially by Chinese companies own adaptation, not only the arrival of foreign companies in China. Although China could continue to grow on the back of imported technology, top Chinese companies already now actively seek to increase their productivity through intensive investment in R&D. China's big remaining challenge is to raise service sector productivity.

Despite rapid growth, Chinese productivity relative to developed countries remains low. The Conference Board estimates that work productivity in industry is just 14 % of the productivity level in the United States. Because wage level differences relative to developed countries are larger than productivity level differences, China's recent fast wage growth that clearly exceeds productivity gains still poses no threat to the country's competitiveness. The study found labour costs per unit of output for Chinese industry is currently just over one-fifth of the US level.

While there are big problems in comparing productivity figures across countries, it appears that labour productivity growth in China remains in a class of its own compared to the other BRICs (Brazil, India and Russia). Much of Russia's growth comes from the capital-intense commodities sector and the pace of job formation and destruction in Russia is modest compared to China. Consequently, researchers suspect that real structural change in Russia has been quite limited. The study found that the rise in productivity in the US and the EU-15 has been around 1.0–1.5 % in recent years.

2007 growth in number of persons employed, labour productivity and real GDP in BRIC countries, %

	Brazil	Russia	India	China
Persons employed	2.1	0.3	2.5	0.8
Labour productivity	1.9	6.7	5.9	10.6
Real GDP	4.0	7.0	8.5	11.5

Sources: The Conference Board and Groningen Growth and Development Centre

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Russia

Central bank raises rates again. On Tuesday (Apr. 29), the Central Bank of Russia moved to quell inflationary pressure by raising its key rates a quarter of a percentage point. Its most potent monetary tool, the one-day repo rate was hiked to 6.25 %. The short-term deposit rate went to 3.25 %. The CBR also raised rates a quarter percentage point in its previous hike at the beginning of February.

On-year inflation has climbed to around 14 % in recent weeks. The net flow of private capital turned outward in the first quarter, and in April it again reversed direction to Russia, prompting the CBR to intervene in the market and buy foreign exchange to curb rouble appreciation.

Public offerings gain popularity in Russia. The value of initial public offerings (IPOs) and secondary public offerings (SPOs) by Russian corporations nearly doubled last year from the 2006 level. Some 22 of the 28 public offerings arranged last year were IPOs. The total value of all public offerings was about $31 billion, which was greater than the total value of offerings by companies of any other European country. The issue of the state-owned VTB bank was the world's largest IPO last year. Combined with the SPO of state savings bank Sberbank, the two issues represented over half of the total value of Russian public offerings last year. Other IPOs exceeding the one-billion-dollar limit came from the real estate sector (AFI Development and PIK Group) and the metal sector (Magnitogorsk Steel).

The rush to initial public offerings is expected to keep going this year. Russian companies desperately need money for investment at a time when borrowing from domestic banks has become more difficult. Russian banks have so far got their financing to a large extent from foreign borrowing, but now their financing possibilities have been impaired by higher interest rates on international financial markets.

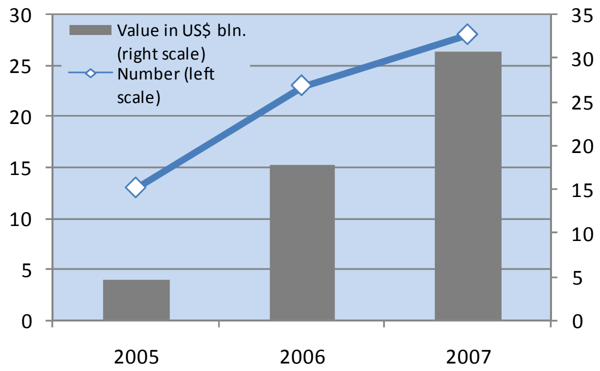
Most Russian share issues were dual listings, i.e. firms held share issues simultaneously in Russia and on international exchanges. Russia was the largest foreign issuer last year on the London Stock Exchange. Even so, the domestic market, which is now fairly liquid, has become more attractive to Russian firms. In 2006, just 6 % of the total value of public offerings of Russian firms was targeted solely to the Russian market. Last year's figure was 38 %.

A structural change has also occurred in distribution by industry. Unlike previous years, most public offerings arranged in 2007 involved companies in real estate, banking or the consumer sector. Although last year's figures were boosted by the share issues of two major state banks, observers expect upcoming issues will involve privately held banks. Small and medium-sized enterprises are also expected to begin seeking to raise capital through share emissions.

According to information from Moscow's MICEX exchange, approximately 150 Russian firms are considering listings this year with a combined launch value in the range of $50 billion. Whether the situation materialises depends, of course, on the market situation. When markets were down last year, a large part of public offerings was either postponed or scrapped altogether.

The first reading of a bill revising the law on securities markets took place at the beginning of April. The proposal calls for opening Russian markets to trading in foreign securities and grants foreign firms an opportunity to list in Russia. A specific goal is to attract listing of firms based in other CIS countries. Amendments to the securities market law that went into effect last year permitted the introduction of RDRs (Russian Depositary Receipts). In principle, RDRs allow foreign companies to list on a Russian exchange, although the system has not been used so far.

Total values and number of Russian SPO/IPOs, 2005–2007



Source: MICEX

Foreign forest companies embark on joint projects with Russian counterparts. Last week, the Finnish UPM signed a partnership agreement with the wood processing company Sveza, which is owned by Russian business tycoon Alexei Mordashov. The deal stems from an earlier letter of intent signed last year. Both companies hold 50 % stakes in the new joint venture, which plans to build a pulp mill, saw mill and OSB building panels mill in the Vologda region. UPM reports total investments would exceed €1 billion, but the feasibility studies are still in the works and the first investment decisions will not come down until autumn at the earliest.

Russia's largest forest industry joint venture, the Ilim Group, was created last year with 50-50 participation of the American International Paper and largest Russian paper mill, Ilim Pulp. The venture plans to invest $1.5 billion over the next five years to modernise pulp and paper mills in in Arkangel and Siberia.

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China

Report finds reforms improving China's business environment, even in the country's interior. The International Finance Corporation of the World Bank Group and China's Academy of Sciences last week published the first comprehensive assessment of China as part of the World Bank's *Doing Business* series. The China study compared business conditions in 30 cities around China from the perspective of private business. The rankings focus on the degree of official intervention, based on such factors as how easy it is to start a company, register property, get finance and enforce contracts. The study covers all of 2006 and the first half of 2007, during which over 50 reforms to encourage business were implemented in the studied cities.

Doing Business in China found that, despite significant local differences in reform policies, local administrations across China actively reformed their regulatory regimes and promoted business. While unsurprisingly provinces in the eastern and southern parts of China were most advanced with their reform programmes, some cities in the interior (including Chongqing and Chengdu) strived to match the reform-mindedness of coastal provinces. According to the study, the most reform-minded cities were also best at attracting domestic and foreign investment.

The report-makers found regional differences in business environments reflected the abilities and effectiveness of local officials in enforcing national legislation and regulations. In this respect, China's cities could take advantage of both experiences in other provinces and other countries.

Doing Business in China is part of the World Bank's global tracking of differences in business regulations and reform policies across countries and subnational units. Its latest *Doing Business 2008* report assesses regulatory impacts on business in 178 countries. China achieved an overall ranking of 83rd and was credited as one of the most successful reformers in 2006-2007. Improvements were seen in such categories as strengthening of private property rights, changes in collateral rules to ease access to finance and new bankruptcy laws. Processing of building permits has also been greatly expedited with the introduction of an electronic processing system. Regarding China's reform potential, the drafters of the China report note that the country's overall rank would rise to 67th place if the entire country followed the good practices found in China's most business-friendly cities.

According to *Doing Business 2008*, the official regulatory burden is lightest in Singapore, New Zealand and the United States. Finland ranked in 13th place between Japan and Sweden. Of the other BRIC countries, Russia ranked 106, India 120 and Brazil 122.

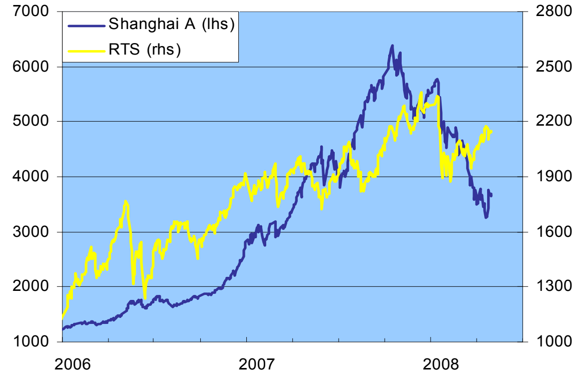
EU and China launched high-level dialogue on economy and trade. The first meeting under the EU-China High Level Economic and Trade Dialogue Mechanism (HLM) took place late last week in Beijing. The dialogue was suggested by China at last November's EU-China summit as a way to create a framework for dealing with issues arising from the EU-China trade imbalance. The HLM meeting was chaired by China's vice premier Wang Qishan, while the EU delegation was led by EU trade commissioner Peter Mandelson. The talks dealt with trade, investment, technology transfer, intellectual property rights, access to markets, regulations and standards for trade.

The HLM is seen as a sign that China has become more sensitive to EU concerns and their effects on economic cooperation. The United States and China established their own high-level arrangement under the banner "strategic dialogue" in 2005.

Policy measures rock Chinese share prices. Chinese officials last week announced they were reducing the stamp tax on share trades from 0.3 % to 0.1 %. The move returns the stamp tax to the pre-May 2007 level. Last year, officials imposed the tax hike as part of attempts to deal with the share price bubble. Stock markets jumped in response to the lowering of the stamp tax. China's officials also imposed limits on the selling of new, previously non-traded, shares of listed companies to prevent dilution of share values. The official response came after months of broad declines in share prices in China. The Shanghai share index has lost over half of its value from highs reached just last October. Nevertheless, the drop in prices apparently has had no significant impacts on the real economy.

Large fluctuations in share prices are a common feature of stock markets in developing economies. Changes in tax rules can add to already high volatility if official measures and expectations become the driving determinants of share prices.

Shanghai A-share index and Moscow RTS index



Source: Bloomberg

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Russia

Putin hands over the reins to Medvedev. On Wednesday (May 7) at the Kremlin, first deputy prime minister Dmitri Medvedev assumed a four-year term as Russia's president to serve from 2008–2012. On Thursday (May 8), the Duma complied with a presidential request to name Vladimir Putin prime minister. The political careers of both men began in the St. Petersburg mayor's office.

Law on foreign investment in strategic industries gets final confirmation. On May 5, president Putin signed into law the act passed two weeks earlier by the Duma. The law requires foreign investors to seek official permission before moving to acquire over 50 % of an enterprise operating in a strategic field. Permission is required for stakes above 25 % if the investor is a state-owned company. When investing in a mineral extraction company, foreign investors must seek permission for more than 10 % or, if the investor is state-owned, more than 5 % of the firm.

The strategic label applies mainly to firms dealing with nuclear technology, defence, intelligence, aerospace, natural resources or media-related activities. A summary of strategic activities appears below.

Strategic activities

- Hydrometeorology, geophysics
- Nuclear energy (materials, waste handling, research, equipment design and construction, safety studies)
- Manufacture, maintenance and sales of technology used for intelligence or code encryption
- Design, manufacture, maintenance, sales and use of weapons systems and arms
- Design, testing, manufacture and maintenance of aerospace technology, air safety, space activities
- Large circulation publishing, TV and radio broadcasting
- Natural monopolies (excluding electrical power and municipal heating distribution, postal services)
- Major telecommunications companies (excluding Internet providers)
- Major metals producers if their products are used by defence industries
- Prospecting and quarrying of important minerals
- Fisheries

Source: Law on foreign investment in strategic industries

Government decides to raise regulated prices. In the latest round of hikes, the average price of electricity is set to double by 2011. Hikes for industrial users of electricity are in line with the policy adopted in 2006, while households face heftier increases than earlier planned. Industrial users should see the share of electricity purchased at unregulated prices increase significantly in coming years from the current about 20 % share.

Wholesale prices of natural gas are expected to increase an average of 29 % this year, 20 % next year, 28 % in 2010 and 40 % in 2011. In 2011, the price domestic industrial users pay for gas should match export price levels, excluding transmission costs and tariffs. Rates for households will remain regulated. The government decided on more modest rate hikes for other natural monopolies e.g. rail transport and telecommunications services. Due to the increases in regulated prices, the government also revised its inflation targets for coming years slightly upwards.

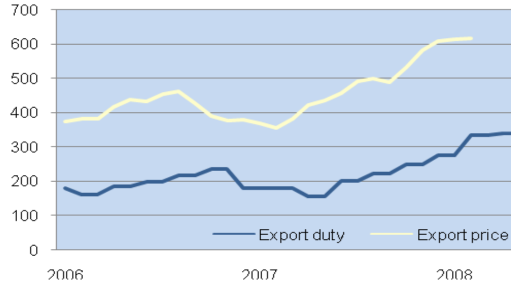
In April, 12-month inflation rose to 14.3 %. Prices for food were up over 20 % y-o-y, whereas among other goods, prices of building materials and gasoline increased nearly at the same pace. A price freeze on basic food items ended at the start of this month.

Oil price rise drives oil export duty to record levels. Under a law from 2004, the maximum oil export duty is based on the realised world-market price of Urals, Russia's main crude oil export blend. Now, as the oil price exceeds \$182.50 per metric ton (about \$25 a barrel), the maximum level of the export duty is defined according to the principle of \$29.20 per ton plus 65 % of the amount exceeding the \$182.50 level. The export duty is reviewed every other month. The duty went up to \$340.10 a ton at the start of April and will be raised to \$398.10 on June 1.

The oil export duty accounted for about a fifth of the realised average export price in 2003. Since then, skyrocketing world oil prices have increased that share to about a half. Russian oil companies now demand a lowering of the oil duty, so that they are left with money for investment. Other government levies on oil include e.g. the mineral extraction fee.

Russia's tax administration estimated last summer that the average overall tax burden on companies involved in extracting or mining energy materials was 49 % (paid taxes as a share of turnover), compared to an overall average for all companies of 12 %. Nevertheless, several Russian oil companies report huge leaps in profits in the first quarter, sometimes more than double from 1Q07. Larger dividend distributions than last year are also planned.

Monthly average export price and oil export duty, US\$/ton



Sources: Rosstat, BOFIT

EUROJÄRJESTELMÄ
EUROSYSTEMET

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China

Profits of large commercial banks up sharply in the first quarter. Profitability at China's largest commercial bank, Industrial and Commercial Bank of China, climbed nearly 77 % y-o-y in the first quarter of 2008. Bank of China profits grew even more – 85 % in the period. Commercial banks also announced they had reduced their exposure to sub-prime securities. Chinese commercial banks have increased their lending after the end of 2007, when lending was significantly quelled by official administrative measures. Officials evidently tolerate the increased borrowing as production throughout the country suffered in the wake of harsh winter storms. A lowering of the corporate tax rate to 25 % at the start of January has also been a boon for banks.

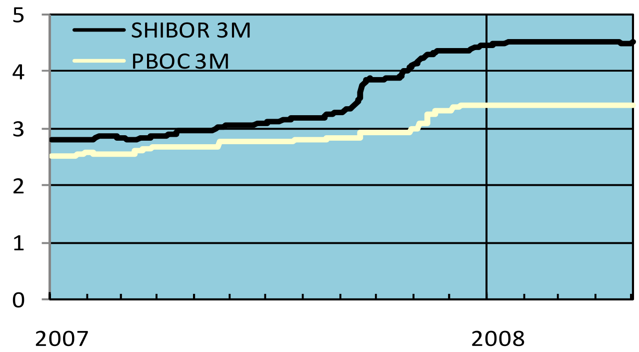
While slowing of the global economy has yet to significantly impact growth of China's real economy, the exceptional first-quarter rise in bank profits is not generally believed to continue for the rest of this year. Officials are concerned over persistent high inflation in the domestic economy, portending tighter monetary policy. Official statements suggest the volume of new lending this year will not be allowed to exceed last year's volume.

Increased use of SHIBOR reflects evolution of China's money markets. At the beginning of 2007, China began quoting the Shanghai Interbank Offered Rate (SHIBOR) as part of its financial market reform programme with a view to implementing a market-based interest-rate regime. Official sources say the use of SHIBOR as a reference rate has clearly increased. However, use of SHIBOR varies significantly depending on the instrument and the maturity. SHIBOR rates are mainly used at present as a reference rate for contracts of less than three months, which illustrates the actual thinness and underdeveloped state of Chinese financial markets.

By some estimates, use of reference rates has remained lower than hoped, which is evidenced by the grown interest rate spreads between different instruments. Currently, the three-month SHIBOR is about one percentage point higher than the rate for central bank bills (see chart). The situation may reflect problems in setting reference rates, or it could show that the central bank is using the opportunity to sell its own bills below established market rates. There is essentially no difference between the one-week and overnight SHIBOR and repo rates, which implies that these short-term markets function reasonably well.

The goals of reform of the interest rate regime include increased awareness of interest-rate risk among banks and deepening China's financial markets. These conditions must be met before China can shift from a monetary policy regime based on regulation of the quantity of money to an interest-rate-based system. China's long-term goal is a market-based financial system, but the central bank currently imposes strict limits on bank lending and deposit-taking. The general ceiling set by the central bank today for the bank deposit rate (3-month) is 3.33 % and the lowest lending rate (6-month) is 5.91 %.

3-month SHIBOR and yield on 3-month central bank bills, % p.a.



Source: CEIC

China and Japan mend relations. Chinese president Hu Jintao visited Japan on the invite of prime minister Yasao Fukuda. The five-day visit began on Tuesday (May 6). It is the second visit ever by a Chinese head of state to Japan. Jiang Zemin visited Japan ten years ago. Historically strained China-Japan relations have improved notably since Japan's former prime minister Yunichiro Koizumi was unseated in the election of autumn 2006. Chinese sources say the main purposes of the visit are to improve trust and deepen cooperation.

Japan and China have long engaged in a bitter boundary dispute over sea areas with gas reserves. Some of the gas fields are indisputably located in Chinese territory and the Chinese have for some time pumped gas from these fields. Japan's worry is that China may also be pumping gas from the disputed area. Prime minister Fukuda said the gas dispute is near resolution and that the parties had agreed to launch regular high-level visits to resolve the boundary dispute. During this week's visit, the countries are also expected to issue a joint statement on slowing climate change.

Japan is China's top import provider and its third largest export destination. Japan runs a healthy trade surplus with China. China Customs reports imports from Japan grew 16 % last year and exports to Japan 12 %. In the first quarter of this year, trade grew at last year's pace. China is the most important import country for Japan and the second largest export destination. China-Japan trade consists largely of machinery and equipment.

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Russia

Prime minister Vladimir Putin submits cabinet proposal. On May 12, the number of ministries climbed from 16 to 18 and the number of deputy prime ministers from five to seven. As in the previous cabinet, two deputy prime ministers will share first deputy prime minister duties. Two-thirds of ministers from the previous government retain their old posts, while newcomers are mostly transfers from Putin's presidential administration.

Observers note that balancing between "hard line" and "liberal line" personalities continues, although the appointments on the whole appear to strengthen the liberal line. The keeping of Alexei Kudrin, who has pursued moderate fiscal policies, in the post of finance minister and deputy prime minister with economy portfolio has been taken as positive signal for Russian economic policy. Liberal Alexander Zhukov continues as deputy prime minister with portfolios that include social policy. Elvira Nabiullina also retains her job as economic development minister, although the ministry's responsibility for trade issues has been handed over to the new industry and trade ministry. The new first deputy prime minister Igor Shuvalov, who earlier served as an advisor to the president, is known as a liberal economics policy expert. He will handle part of economic issues, including international economic matters.

Viktor Zubkov, prime minister in the previous government, is the other first deputy prime minister. His portfolios include agriculture, forestry, fishing and customs issues. Hard-liner Igor Sechin, former deputy head of the Kremlin administration was picked as a deputy prime minister. His responsibilities include industrial policy, energy issues and environmental protection. The duties of the former industry and energy ministry were divided between the new industry and trade ministry and the energy ministry. Viktor Khristenko continues to head the former, while Sergei Shmatko, president of Atomstroieksport, was appointed energy minister.

Putin rolls out economic policy. Ahead of his confirmation as prime minister, Vladimir Putin spoke to the Duma on May 8 on the main themes of economic policy for the new government. Among other things, Putin mentioned that harsh taxation of the oil sector needs to be relaxed to promote oil exploration and production. Long-discussed proposed tax changes for oil producers and a drop in the VAT should be decided on by August. Putin repeated a goal of making Russia a global financial centre, which means inadequate laws for the financial branch need to be revised, infrastructure developed and financial supervision rationalised. The basic legislation should be ready before the end of this year.

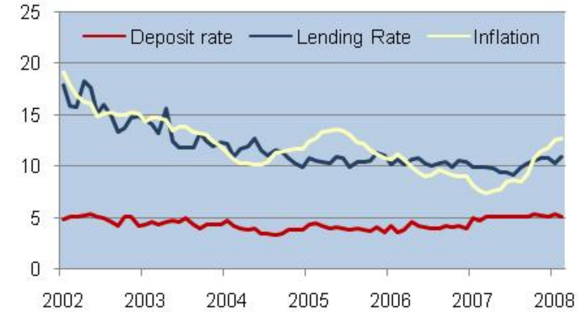
Growth in corporate borrowing remains strong. CBR figures show the total assets of the banking sector as of end-March 2008 amounted to 21,323 billion roubles (€580 billion), an increase of 37 % y-o-y. First-quarter growth was 6 %, a rate clearly lower than in 1Q07. Especially growth in household deposits diminished, which partly reflects the acceleration in inflation. Deposits grew just 3 % in January-March, while growth for 1Q07 was 6 %. In addition, borrowing from foreign banks nearly ceased.

On the other hand, accelerating growth in the stock of loans to companies continued. The corporate loan stock as of end-March 2008 stood at 10,253 billion roubles, with on-year growth of 54 %. Loans to households shot up 57 % y-o-y, but growth was clearly lower than in 1Q07 when the loan stock expanded by 76 %. The stock of household loans amounted to 3,199 billion roubles at the end of March. The average borrowing rate paid by firms in February was 11 % and the inflation accelerated to 13.3 %. Real rates therefore remain negative.

Banking sector profits overall increased 15 % y-o-y (22 % in 1Q07). Of the 1,130 banks operating in Russia at the end of March, 86 declared losses (53 more than a year earlier). Among Russia's top 100 banks, seven banks declared losses.

Contrary to some expectations, large foreign loan repayments and major tax bills coming due in April-May did not lead to serious tightening of liquidity in the banking sector. The finance ministry was prepared to support liquidity by arranging three auctions in April-May. These involved investing available budget assets to banks as deposits. The first auction in April offered the market 300 billion roubles, but contracts of only 24 billion roubles were sold. In April's second auction, 250 billion roubles were offered and contracts of 18 billion roubles sold. The May auction only offered 50 billion roubles, of which about half was sold. Russia's 30 largest and most stable banks were allowed to participate in the auctions without collateral. Enthusiasm for the auctions was dampened by the relatively high interest that exceeded the interest rate of normal central bank funding.

Deposit rate, lending rate and inflation in Russia, %



Sources: Central Bank of Russia, Rosstat

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China

Largest earthquake in over 30 years rocks southwest China. On Monday (May 12), Sichuan province was hit by a earthquake with a magnitude of 7.9 on the Richter scale. Current estimates put the number of deaths at 20,000 people, a number that will likely continue to rise as rescue efforts sift through the rubble. Buildings, power lines, railways, roads and telecommunications infrastructure all sustained severe damage. Officials also warn that dams in the area may have been weakened by the event. The areas closest to the epicentre in Wenchuan county have no significant industry, so the injury to the Chinese economy overall is expected to be smaller than the damage caused by the major winter storms in January and February. The quake was the most destructive since the 1976 Tangshan quake in the Hebei province near Beijing that killed at least a quarter million people. This year there have been at least six quakes in China registering magnitudes above 5 on the Richter scale. The level of seismic activity has been clearly higher this year than in recent years.

Chinese inflation remained high in April; bank reserve requirements increased. April consumer prices were up 8.5 % y-o-y. The 12-month rise in consumer prices was two-tenths of a percentage point higher than in March, but slightly lower than in February. Food prices are still the main driver of inflation, rising more than 22 % y-o-y. As in other developing economies, a large share of spending by China's poorer households goes to food and their purchasing power is being squeezed by food inflation.

In non-food product groups, inflation in April remained unchanged at 1.8 %, still a moderate level given China's rapid economic growth. However, the acceleration in producer prices (up 8.1 % y-o-y in April) and the economy's general inflation expectations suggest continuing inflationary pressure. Retail prices, which rather closely track movements in consumer prices in China, have also climbed rapidly.

In an effort to reduce liquidity in the face of high inflation, the People's Bank of China this week increased the reserve requirement for commercial banks to 16.5 % of deposits. The PBoC left its reference rates untouched. Real interest rates on deposits in China remain clearly negative, and real lending rates are still quite low given the rate of economic expansion. At the moment, lending quotas and other official regulatory actions play crucial roles in the implementation of China's monetary policy.

Despite rising production costs, growth in exports of clothing and textiles remains strong. The value of exports of textiles and clothing increased last year by nearly 20 % y-o-y. The rise in the value of exports continued at the same pace in the first four months of this year, even as export volumes in certain categories contracted. Due in part to recent trends in exchange rates, China saw a rise in the value of its exports to Europe. In contrast, the value of exports to the United States remained essentially unchanged. China is the world's largest exporter of clothing and textiles, which accounted for 14 % of China's total exports last year.

The situation of China's textile and clothing industry, which already operates on low margins, has been hurt by rising prices of raw material inputs, tighter environmental regulations, reduced tax rebates for export products and rising labour costs. Officials have sharply increased provincial minimum wages and at the beginning of the year imposed a new labour contract law that restricts e.g. the use of leased labour. Rising clothing and textile production costs are expected to increasingly drive production in coming years to lower-cost countries such as Bangladesh and Vietnam, as well as shift production within China to inland from the coast. Companies in the sector are also expected to merge for efficiency gains.

Under WTO agreements, international trade in textiles and clothing was freed of quota restrictions from the start of 2005. To smooth the transition, WTO rules allowed countries to implement temporary safeguard measures. The US will continue to limit imports of certain clothing and textiles from China until the end of this year. The EU abandoned its quotas at the end of 2007.

China's commercial aircraft industry aspires to becoming a global player. At the beginning of May, China established China Commercial Aircraft Corporation (CCAC). The new company's first mission is to bring a passenger jet seating over 150 passengers to market by 2020. Costs of developing the plane are estimated at €5–6 billion. The new company is backed by the state asset management company SASAC, the Shanghai regional administration, two of China's leading aerospace firms and several other large Chinese companies. The new company seeks to exploit the rapidly expanding commercial aircraft industry. By some estimates, Mainland China will need about 2,700 new passenger jets by 2026, and CCAC plans to go head-to-head with giants Boeing and Airbus in the large jet categories. The project is part of China's larger efforts to increase its technology capabilities level and raise national pride.

There are large risks associated with the project, however, reflected recently in firms problems in getting new models to the market. At the end of last year, China rolled out a prototype of a short range passenger jet (ARJ21), only to have the plane's maiden flight delayed for over a least half a year. About 180 planes have been ordered by Chinese airlines. CCAC will take over the ARJ21 project. Many foreign suppliers are involved in the projects.

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Russia

New administrative structures take form. Prime minister Putin announced the creation of a 15-person core body in the cabinet. The *presidium* is made up of Putin himself, his two first deputy prime ministers and five deputy prime ministers, as well as the heads of seven ministries (health and social development, agriculture, regional development, foreign, economic development, interior and defence). The presidium will meet once a week, while the full cabinet will convene approximately once a month. Putin explained the presidium was part of a move to make cabinet meetings more efficient.

Meanwhile, president Medvedev has been naming his own advisers. The appointments bring only minor changes in the presidential staff. Former deputy prime minister Sergei Naryshkin has been designated head of presidential administration. Vladislav Surkov was tapped as the first deputy to Naryshkin. The six-person presidential aide team includes Arkady Dvorkovich as economic aide.

A new presidential decree again strengthens ministerial decision-making power over government services and agencies as it changes the principles of power-sharing set forth in the government administration reform of 2004. At the time, greater efficiency and smaller possibilities for corruption were sought by giving services and agencies more independence from their ministries and clearly defining the functions of each of the three types of organs. However, the arrangement never worked as planned.

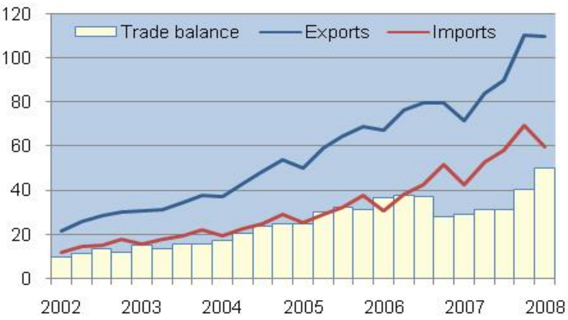
Rapid growth in foreign trade continues. The Central Bank of Russia reports the value of Russian exports in 1Q08 was about $110 billion, a 53 % increase from the same period a year earlier. Compared to 4Q07, the value of exports remained essentially unchanged. The value of Russian imports was $60 billion, up 40 % y-o-y. The combination of high oil prices, which caused the value of exports to remain high, and the slight drop in the value of imports from the record high of 4Q07, meant that Russia's trade surplus soared to a record of almost $50 billion.

According to Russian Customs statistics the EU continues to account for about half of Russian trade while CIS countries represent about 15 %. Russia's most important single trade partner is still Germany, which accounted for 10 % of all trade. Russia's largest export destination was the Netherlands, and China has become the leading source of imports. Russian imports from China rose 85 % y-o-y in the first quarter.

Russian Customs reports that the volume of crude oil exports fell a few per cent in the first quarter, but the value of exports increased over 60 %. The volume of natural gas exports increased nearly a third from a year earlier. The combined value of oil, oil products and gas accounted for 65 % of all exports. The export volume of raw wood declined slightly from 1Q07.

About half of imports were machinery, equipment and transport vehicles. The value of imports in these categories increased over 60 % y-o-y. Over 430,000 passenger vehicles were imported in 1Q08, an increase of 50 % y-o-y.

Russian foreign trade by quarters, US$ billion



Source: Central Bank of Russia

Ukraine joins WTO; Russia's negotiations continue. Last Friday (May 16), Ukraine ratified its accession agreement to become the WTO's 152nd member. According to media reports, Ukraine will participate in the working group on Russian membership. Russia still has bilateral talks open with Saudi Arabia. Georgia, which is unhappy with Russia's attempts to build up relations with its separatist regions, recently called off its bilateral talks with Russia.

Russia's multilateral talks continued this week in Geneva. Agricultural subsidies and intellectual property rights were among the topics discussed.

The EU continues to oppose Russia's raw wood export policies, as the export tariff hikes are seen to conflict with the bilateral WTO agreement between EU and Russia. EU countries announced this week that they had reached a common understanding on opening talks on a new partnership and cooperation agreement with Russia.

Salonen to head Sberbank's international operations. Ilkka Salonen, a Finn with long experience in Russian banking, including an eight-year stint as board chairman of International Moscow Bank (now UniCredit Bank), has been tapped to head Sberbank's international business. His duties include oversight of foreign subsidiaries and funding. Salonen is well known and respected in Russian banking circles. The post makes him the first foreigner to serve on the board of Russia's largest bank.

Former economy minister German Gref, who took over the reins of Sberbank's management late last year, wants to expand Sberbank operations into the international arena. He recently announced his intent to lift Sberbank into the ranks of the world's ten largest banks (according to *The Banker*, Sberbank ranked 66th in the world in 2007).

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China

Extent of damage caused by Sichuan quake becoming clearer. The official number of victims from the May 12 Sichuan Earthquake now exceeds 40,000. This number is expected to climb as over 30,000 people remain missing. The official number of injured now exceeds 250,000. The Richter-scale 8.0 quake caused the collapse or severe damage of millions of structures. The number of persons displaced and needing assistance is currently estimated at 12 million.

Despite the humanitarian crisis and massive property damage, the overall impact of the quake on the Chinese economy is expected to be limited. The areas worst hit by the quake are minor contributors to Chinese GDP, and per capita incomes in the quake area are among the lowest in China. Counties around the epicentre of the quake produce coal and natural gas, but lack a manufacturing base. The agricultural lands most affected by the quake account for less than 1 % of China's total agricultural output.

Reconstruction will offset some of the quake's economic effects by boosting economic activity in the province. The government has indicated it has no plans to significantly increase public spending in response to the quake, as the central government departments have been told to cut other expenditures by 5 % in order to finance the $10 billion relief fund.

The Agricultural Bank of China, which is in the worst shape of China's four large state banks, is expected to see its share of non-performing loans increase. While insurers also expect a spike in claims, they say their losses should be fairly minor as few had insurance in the affected areas. Moreover, there are statutory limits on claim reimbursements for earthquake damage. The insurance sector could even attract new clients as a result of the quake.

There are still worries of aftershocks and possible damage in the quake area, particularly dams already weakened by the quake.

China maintains its appeal for foreign direct investment. China's trade ministry reports FDI inflows to China last year amounted to $83 billion. While the level of annual investment flows has increased modestly in recent years, China continues to dominate as the largest receiver of FDI among all emerging economies. Last year, manufacturing received about half of all investment, with the lion's share going to communications device makers and the computer industry. Investment in the real estate sector more than doubled from 2006, accounting for more than a fifth of all FDI. This year, investment is expected to flow especially to the service sector. In spite of official incentives, direct investment to China's western provinces remain minor.

As usual, Hong Kong was the lead FDI provider to mainland China last year, accounting for about a third of total FDI. The share of FDI inflows from tax havens, which has increased in recent years, was about a quarter in last year. The EU, Japan, Korea, Taiwan and the US each have FDI percentage shares in the single digits. Chinese sources estimate Finland and Russia each contributed about $50 million in FDI last year.

Although China's cost levels are still low by international standards, costs for companies operating in China have been rising rapidly. Foreign companies operating in China that once enjoyed juicy income tax breaks are now seeing those breaks gradually eliminated under the new tax law introduced at the start of this year. The law largely cancels differences in income taxes between foreign and domestic firms by 2012. Soaring personnel costs have also forced many low value-added companies to announce that they will move to lower cost countries.

Direct investment from China into other countries has grown rapidly in recent years. Last year, direct investment from China (excluding the financial sector) amounted to nearly $19 billion and the stock of investment rose by official calculations to $94 billion. Preliminary Finnish balance-of-payments figures show Chinese investment in Finland was essentially nothing as of end-2007.

Due to its economic significance, the subject of FDI has received extensive academic scrutiny. Some studies find China's export-focused policies and cheap labour have lured foreign export oriented companies to move their production to China. This is one reason for the heavy investment from Hong Kong and Taiwan, which not only share cultural and geographic proximity, but also have open, export-oriented economies. In addition, research shows the potential size of the domestic market, good infrastructure, economic policies that favour foreign investment and political stability have attracted direct investment into China. The decision to invest in China is also affected by China's exchange rate policy; the yuan's real depreciation in the early 1990s increased China's competitiveness by lowering relative production costs. On the other hand, FDI received by China has not been found to significantly decrease the amount of FDI flows to e.g. South America. China's own FDI abroad has tended to go to countries with natural resource wealth, although the size of the destination country's market has also been important.

Analysis of the allocation of investment across China's provinces shows that direct investment, especially from developed economies, reacts sensitively to the skill levels of the provincial labour force. A positive correlation has also been found among the following factors: provincial industrial output, income levels, infrastructure development and amounts of FDI received. Nevertheless, policies at the local level had significant impacts. Localities with policies that supported FDI tended to receive more FDI.

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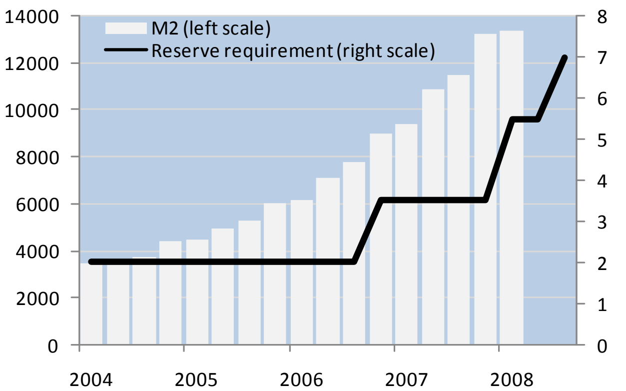
Russia

Central bank hikes reserve requirements further. Mandatory reserve requirements for commercial banks will go up July 1, with the requirement rising from 4.5 % to 5 % for rouble household deposits, from 5.5 % to 7 % for liabilities to foreign banks, and from 5 % to 5.5 % for other liabilities.

The Central Bank of Russia is seeking to curb money supply growth and thereby reduce inflationary pressures by raising reserve requirements. The sharp hike for liabilities to foreign banks reflects CBR efforts to dampen the enthusiasm of Russian banks to borrow from foreign banks and staunch the flow of foreign currency into the country.

The CBR last increased reserve requirements on March 1, after a decision to raise the refinancing rate a few weeks earlier. The central bank also boosted its refinancing rate at the end of April. The refinancing rate serves mainly as a reference for other interest rates and has little direct effect on Russian markets. The current increase of reserve requirements is also expected to have only minor impact on money supply growth and inflation.

Broad money (M2) in billions of roubles and reserve requirement ratio for liabilities to foreign banks, %



Source: Central Bank of Russia

First gathering of cabinet's presidium group focuses on taxation policy and social issues. The first presidium meeting approved for submission to the Duma several draft bills, including a bill decreasing taxes on oil production already previously discussed by the government. The bill calls for exempting more of the crude oil price from the mineral extraction tax (from \$9 to \$15 per barrel), freeing companies of tax obligations for oil produced from drilling on the continental shelf for the first 10–15 years, and elimination of the tax on new production in the Timano-Pechora and Yamal fields for seven years. The changes would enter into force at the start of 2009.

The finance ministry calculates that a reduction in the mineral extraction tax would provide oil companies with over 100 billion roubles (nearly €3 billion) in extra income both next year and in 2010.

The presidium also moved to submit to the Duma proposals on increasing social spending to keep up with the unanticipated surge in inflation. The government proposes increases in pensions as well as one-time payments such as maternity grants. Families with children would get an income tax break. A tax break would also be granted to companies that fund education and improvements in their employees' living conditions.

The Duma, which is dominated by the United Russia party, is likely to approve the government's proposals quickly and without modifications.

Russia launches major anti-corruption crackdown. At the start of the week, president Medvedev signed a decree on a new national anti-corruption program. It will be led by an anti-corruption council headed by the president himself. The council's expert group has one month to define the scope of the program. In addition, a working group led by the president's chief of staff Sergei Naryshkin will monitor corruption of government bodies.

Furthermore, president Medvedev has established a separate working group to study the legal changes needed to assure the impartiality and independence of the judiciary. The working group should prepare a proposal on the reforms by next autumn. The president said corruption in the justice system is particularly disconcerting, and suggested such measures as unification reforms in legal training.

The Duma has also established its own 12-man anti-corruption commission to study the law and transparency of legislative proposals.

Medvedev said changes in citizen attitudes are an important part of reducing Russia's rampant corruption. The research institute INDEM made wide survey of corruption in Russia in 2005. Since then it has tracked the situation and found corruption on the rise in recent years. INDEM estimates that corruption currently costs Russians at least €190 billion a year.

The announcements were met with a certain amount of scepticism. Both the anti-corruption task force created during Putin's presidential term, as well as the anti-corruption task forces set up by the previous Dumas have little to show for their efforts. On the other hand, some observers believe that Medvedev – who already before the presidential elections campaigned against corruption – would be more likely to successfully fight corruption than his predecessor.

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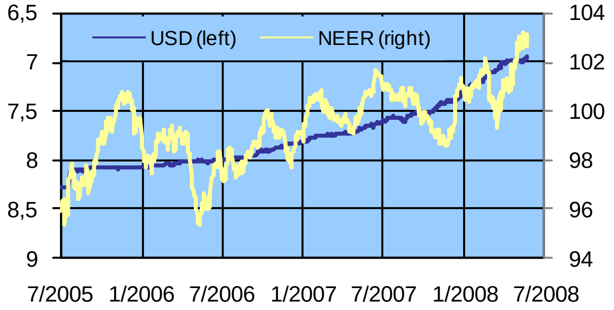
China

Yuan exchange rate strengthens only slowly against the dollar. In April and the first half of May, the yuan's exchange rate remained relatively stable against the US dollar. In recent days, the yuan resumed its appreciating trend against the dollar. The yuan's nominal effective (trade-weighted) exchange rate (NEER) has in contrast strengthened significantly. The higher NEER may help contain domestic inflation through lowering import prices more effectively than simply allowing the Chinese currency to appreciate against the dollar. China's real effective exchange rate (REER), which is often used as an indicator of the country's price competitiveness, has strengthened as a result of China's high inflation relative to its trading partners. On the other hand, China's rising affluence and productivity mean that the yuan's real exchange rate can be expected to strengthen. On Thursday (May 29), one dollar bought 6.94 yuan and one euro 10.79 yuan.

Expectations of yuan appreciation can also be analysed in terms of yuan pricing on the offshore forward markets (non-deliverable forward contracts) where foreign companies dealing with China seek to hedge against foreign exchange risk. Last Friday (May 23), the one-year forward rate was 6.46 yuan to the US dollar, and the six-month forward rate was 6.73 yuan. In the first two weeks of May the forward markets anticipated slightly slower yuan strengthening, which was in line with the trend in spot markets. In recent days, expectations of a slightly higher yuan appreciation rate have returned.

Yuan-dollar exchange rate (inverted scale) and nominal effective exchange rate (rise means yuan appreciation)



Sources: Reuters, JP Morgan

WTO member countries concerned about numerous trade and market access problems with China. The WTO completed its second China's Trade Policy Review since the country joined the organisation in December 2001. By and large, China was credited for removing barriers to access and elimination of restrictions on trade. Nevertheless, WTO members were concerned about numerous trade-related issues. Topping the litany of concerns were problems with customs procedures, import restrictions, the fact that China's own product standards and technical requirements diverge from international practice, China's anti-dumping tariffs, and limits on direct investment. Worries about China's recent increases in export quotas were also expressed. Several WTO countries would like to see China increase the transparency of its trade policies and clarify its regulatory regime. The lack of enforcement and monitoring for infringement of industrial patents and other intellectual property rights was also mentioned.

China is the world's third largest trading power. Its contribution to global trade has more than quadrupled since 2001. The country has held its average import duty rate essentially unchanged at 9.7 % since 2005. A total of ten disputes charging that China has violated its WTO commitments have been filed with the WTO. In addition, about a hundred anti-dumping tariffs have been imposed on Chinese goods by WTO members.

Medvedev's first China trip headlines deepening Russia-China energy cooperation. Instead of making his debut abroad in the West, Russia's new president Dmitri Medvedev paid his first state visits to Kazakhstan and China. Energy issues headed the agenda in the discussions between Medvedev and Chinese president Hu Jintao. The countries also issued a joint communiqué condemning US plans to construct a missile defence system partly located on Polish and Czech soil.

During the state visit, Russia affirmed its role as a supplier of equipment, technology and raw materials for China's growing nuclear industry. The countries made an approximately billion-dollar deal, under which the Russian nuclear energy agency Rosatom will build a uranium enrichment facility in China, as well as supply uranium for enrichment. After the United States, China is the world's second largest energy consumer. China plans to increase the share of nuclear power in electrical production from 2.3 % at present to 5 % by 2020 with the construction of 30 new reactors.

Russia and China have long negotiated on increasing crude oil deliveries between countries. If the countries can agree on the price of the crude oil to be supplied, Russia would agree to running an oil pipeline from the Siberian oil fields to the border of China. Last year, slightly over half of the crude oil supplied from Russia to China was shipped by rail. The remainder of Russian oil entering China came in via a oil pipeline that runs through Kazakhstan. China's crude oil consumption increased about 50 % between 2002 and 2007. China currently consumes about 340 million tons of crude oil a year, of which about half is produced domestically. Russia's share of Chinese crude oil imports last year was about 10 %.

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Russia

World Bank and IMF warn of economic overheating. The latest World Bank survey of Russia finds distinct signs of economic overheating. Factors include GDP growth in excess of 8 %, growth in real wages far outstripping productivity gains, a decline in unemployment below 7 % and accelerating inflation. The findings were echoed in the latest IMF mission's assessment that Russia needs to reduce money supply growth by imposing stricter fiscal and monetary policies. Failure to get a handle on the situation could lead to further inflation and weaken conditions for economic growth over the long run.

The World Bank notes tight fiscal policy in earlier years provided Russia with a basis for stable economic growth. Over the past two years, increasing budget spending has fuelled the pick-up in inflation. The World Bank recommends that economic policy in the short term focus on bringing inflation under control and not on increasing budget spending on social projects and investment in infrastructure.

The Russian government expects inflation will start to decline towards the end of the year, noting it has already tightened its fiscal stance from last year. Although federal budget spending continues to increase, it lags GDP growth.

Russia launches biggest investment program ever to develop transport infrastructure. Prime minister Putin presented a record 13,500-billion-rouble (nearly €370 billion) investment program targeting development of transport infrastructure to run between 2010 and 2015.

The federal government will provide about a third of funding, dedicating 4,650 billion roubles (€125 billion) in federal budget spending over the period. For 2008, 300 billion roubles are earmarked in the federal budget for transport infrastructure projects. The bulk of the investment should be provided by companies and private financiers. "Infrastructure bonds" backed by a federal guarantee have also been suggested as a financing instrument that could be sold to portfolio investors.

The investment program envisions the construction of e.g. 17,000 km of roads, 3,000 km of railways and over 100 airport runways. It would also double port cargo handling capacity to 450 million tons per year.

Putin observed that Russia's creaky infrastructure constitutes an obstacle to economic development and that many natural resources cannot be exploited properly without better infrastructure. He added that Russia should also provide more goods transit, noting that only 1 % of goods trade between Asia and Europe presently flows through Russia. Another goal is to increase air traffic, especially trans-Russia passenger traffic.

The ambitious program calls for the establishment of a new state company to be responsible for construction and upkeep of the road network. Putin also spoke about the necessity of regional development and improving transport connections in the countryside. Nearly a third of investment program spending, however, will go to development projects in the Moscow region.

Russia's insurance sector evolves. Russia's Department of Insurance Supervision reports insurance premium income last year reached 776 billion roubles (over €20 billion), up 27 % y-o-y. Growth was slightly higher than in 2006. Nevertheless, Russia's insurance sector is still small; premium income corresponds to only about 2.5 % of GDP (e.g. the EU average exceeds 8 % of GDP).

Slightly over half of insurance premium income comes from voluntary policies. About two-thirds of voluntary policies relate to property insurance. Personal insurance accounts for about 5 %, which is significantly less than in EU countries, where personal insurance typically represents over half of the national insurance market.

Growth in the amount of paid claims last year was 37 %, i.e. higher than for premium income. The growth in paid claims accelerated significantly from the 2006. Two-thirds of paid claims were based on compulsory insurance policies (medical, motor, etc.)

As of end-2007, Russia had 857 insurance licenses in force. Officials divided the insurance industry last July into Life and Non-Life segments, and required companies to seek separate operating licenses for each segment. As a result, the number of issued licenses is presently about double the number of insurers. Increased insurance supervision and stricter requirements have reduced the overall number of insurers. As recently as 2003, Russia had about 1,200 insurance companies. The Department of Insurance Supervision last year cancelled the operating licences of 114 companies and granted new licences to 18 new companies.

Russia's insurance market is less concentrated than in EU countries. Russia's five top insurers generate less than a quarter of total premium income. Rosgosstrakh, Russia's largest insurer, has its roots in Soviet times and is still one-quarter state owned. Number-two Ingostrakh is also established already in the Soviet-era and now over half of it is owned directly or indirectly by the oligarch Oleg Deripaska.

The Russian law currently limits foreign ownership to 25 % of the insurance sector's total capitalisation. Foreign ownership in the sector rose last year from below 7 % to nearly 10 % as several foreign companies, attracted by the large growth potential of the market, took stakes in Russian insurance companies.

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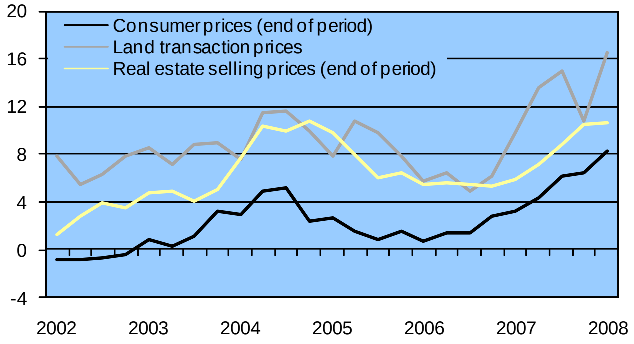
China

Residential housing sales slow slightly in early 2008, prices continue to climb. The volume of residential building sales in China, measured in terms of liveable floorspace, declined 4 % y-o-y in the first four months of this year. Nevertheless, overall investment in real estate in China grew substantially, particularly in the country's central and western provinces (up nearly 45 % y-o-y in both regions). Recent barometer surveys confirm that the real estate market is still on the upswing.

The rise in prices for land use rights and building properties in China accelerated in 2007 from 2006. In the first quarter of 2008, prices for both land use contracts and real estate properties were over 10 % higher than a year earlier. Residential housing prices rose slightly faster than prices for commercial properties, and their rapid rise continued this year in the three first months. Higher housing prices are in line with real GDP growth and rising incomes.

At the end of 2007, Chinese officials encouraged local governments to set aside at least 70 % of land zoned for residential housing for construction of small and low-rent apartments. Chinese officials are concerned about rising real estate prices and the housing situation of low-income members of the population. Officials have tried to curb housing price increases by tightening the conditions for purchasing second homes and restricting foreign investment in the Chinese real estate market.

Consumer and housing market prices quarterly, % change, y-o-y



Source: China National Bureau of Statistics

Mainland China bank acquires majority stake in Hong Kong bank. China's sixth largest commercial bank, China Merchants Bank (CMB), will pay nearly $2.5 billion for a 53 % stake in the Wing Lung Bank of Hong Kong. Both the size of the stake and the price could go higher, as under Hong Kong share trading rules, China Merchants Bank must also submit a similar offer to purchase the outstanding shares of the Wing Lung Bank. The deal is one of the largest direct investments ever made from Mainland China. The deal still requires official approval. China's largest bank, Industrial and Commercial Bank of China, and the Australian ANZ Bank were also short-listed in the final bidding phase. All large Mainland Chinese banks have operations in Hong Kong.

Rise in Chinese living standards causing structural changes in demand for health care services. Using the indicators of population health promulgated by the World Health Organization (WHO), including life expectancy and infant mortality, there is strong evidence that the health of Chinese has approached levels in developed countries in recent years. As a result of significant economic and social change, the emphasis in China's health care policies need to shift from dealing with infectious diseases and epidemic control typical of poor agrarian populations to the chronic diseases of modern societies such as heart disease, diabetes and cancer.

Nevertheless, China's health care sector has not been reformed in the face of changed structural demands. The largest stumbling blocks are the dysfunctional financing system and the lack of an efficient network of primary care clinics. By international comparisons, China's health care clinics get a passing grade when measured by the number of available hospital beds and doctors. In reality, there is a huge shortage of general practitioners to work at health care clinics. Most small clinics lack the resources to provide basic health care services.

China's central administration in recent years has promised large changes in the national health care system. Even so, health care has remained a low priority, with only about 1 % of the central government budget for several years now. Comparable spending on health care in 2005 was 12 % in Finland and 10 % in Russia. China's state budget covered 39 % of total health care costs in 2005, which is exceptionally low by international standards. As only about half of China's urban populations and about 13 % of rural dwellers are covered by health insurance, a large share of health care costs must be borne by households. Household spending on health care has risen in recent years; prices of health care services rose twice as fast as average household incomes during 1997–2006.

About 10 % of Chinese clinics are private. Most operate in some special branch of medicine and serve only about 2 % of people needing medical care. Foreign companies have limited possibilities of establishing hospitals in China. Such hospitals are found mainly in major cities and serve expatriate communities.

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Russia

Inflation continued to accelerate in May; slowing expected towards year's end. May consumer prices were 15.1 % higher than a year earlier. The last time prices rose this fast was in 2002. Food prices climbed 22 % y-o-y, other goods just over 8 %, and services 14 %.

The rise in prices is expected to moderate towards the end of the year, due in part to a significant slowing in the growth of money in circulation. At the height of money supply expansion in May 2007, broad money (M2) increased 59 % y-o-y. This April, M2 growth was 33 %. The declining trend partly reflects a contraction in overall capital flows into Russia.

Fiscal policy is expected to be moderate and the government is not expected to present large supplemental budgets as last year. Good grain harvests in Russia are also expected to mitigate soaring food prices.

The government is sticking to its inflation target of 10.5 % by the end of this year. Also investment banks expect inflation to moderate in the second half of the year, but finishing out the year at 12–13 % or higher.

IMF sees inflation as main risk to Russian economic growth. The concluding statement of the IMF's regular Article IV consultation with Russia, issued at the start of the month, emphasised the need to rein in inflation pressures. The IMF mission reiterated its call for Russia to implement a more flexible exchange rate policy and refrain from further fiscal relaxation.

The IMF anticipates the Russian economy will grow 7.8 % this year. The mission noted that higher inflation and its accompanying drawbacks is the biggest risk to economic growth in coming years.

The mission assesses that uncertainty in international financial markets has not been significantly reflected in the Russian economy. The problems have concerned mainly a few mid-sized banks that have financed their lending with money borrowed from abroad. Potential threats to the financial system include the rapid expansion of credit and liquidity problems. The IMF offered no support for proponents of reducing the value-added tax, which has received wide public discussion lately. The IMF said the tax is not distortionary; Russia's VAT-related problems are largely administrative. The mission also stated that public sector spending needs to be focused on solving structural problems, especially reform of the pension system.

CBR adjusts exchange rate policy. At a banking seminar in St. Petersburg at the end of May, Central Bank of Russia chairman Sergei Ignatyev confirmed for the first time that the CBR steers the rouble's value within a fluctuation band, i.e. the external value of the rouble is allowed to fluctuate with defined limits. If an upper or lower limit is exceeded, the CBR intervenes. The rouble is pegged to a currency basket composed of 0.55 dollars and 0.45 euros.

Ignatyev said the central bank is gradually widening the rouble's fluctuation band and hence slowly approaching an eventual free float. The fluctuation band was widened on Tuesday (June 10), but the band limits have not been published. Before widening, the band limits were estimated to be about 0.5 % from average.

In mid-May, Russia's central bank announced it would engage more actively in trading on the foreign exchange markets. The goal is probably to discourage capital flows involving short-term speculation by making the rouble's exchange rate trend become harder to anticipate.

St. Petersburg International Economic Forum convenes for 12th time. The annually held forum this year brought together Russia's leading politicians, top corporate leaders from Russia and abroad, along with a host of economic experts. The forum gained ever higher profile and basically served as an arena for state leaders to present their views to the international media.

President Medvedev's speech focused on problems in the global economy and criticised the prevailing notion of "economic nationalism." As problems of the financial markets, he mentioned the deficiencies of international institutions and the excessively dominant role of the United States in the global economy. Russia's new president stated that his country's goal was to develop Moscow into an international financial centre and make the rouble into a regional reserve currency. Medvedev gave assurances that Russian firms would invest abroad for pragmatic – not aggressive or speculative – reasons. He also wanted to bring forth Russia's willingness to participate in international cooperation to solve problems related to rising food and energy prices.

A speech by first deputy prime minister Igor Shuvalov aroused the most attention. Shuvalov criticised efforts in recent years to boost the role of the state in the Russian economy. He claimed poor state guidance creates economic problems far larger than those stemming from the markets. Shuvalov also mentioned that the president had tasked the cabinet with reduction of the amount of about 1,500 state enterprises that are currently impossible to privatise under the law. Shuvalov said the state's share in the economy is exaggerated, and that it would be possible to establish still new state corporations in fields where they were needed.

Shuvalov mentioned one of the risks to Russian economic development was the sentiment of trailing behind prevailing in the country. He said Russia does not need to copy other countries but create its own economic development model. The energy sector should serve as a motor of economic development and innovation and energy efficiency should be increased by raising energy prices.

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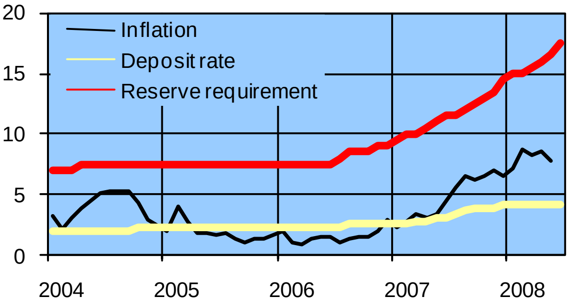
China

Inflation backs off slightly; PBoC continues to tighten monetary stance. Consumer prices climbed 7.7 % y-o-y in May. The yearly rise in prices slowed slightly from a high of 8.7 % in February. Although food prices continue to rise briskly, the rise has moderated somewhat since February and reduced overall inflation. The rise in prices of other products has remained fairly steady. It is already obvious that the official inflation target this year of 4.8 % will be missed. Moreover, there has been no slowing in the rise of producer prices, which were up 8.2 % y-o-y in May.

To deal with galloping inflation, the People's Bank of China will again tighten its monetary stance this month by hiking reserve requirements for commercial banks. The one-percentage-point increase will be implemented in two half-percentage point hikes on June 15 and 25, after which the reserve requirement will be 17.5 % of deposits. China's reserve requirement is high by international standards; India and Russia, for example, have reserve requirements under 10 %.

Reserve requirements have become one of the PBoC's main monetary policy tools in recent years. The use of reserve requirements is preferred because it is relatively inexpensive compared to the central bank's other market-based measures. Commercial banks are paid less than 2 % interest on mandatory deposits with the PBoC. The central bank has avoided reference interest rate hikes due to the increased rate spread with the United States, which would drive larger flows of foreign currency into China. The lending of commercial banks this year has also been limited by direct regulations. In spite of above mentioned measures, money supply growth has been excessive and the PBoC has had to sell bonds to curtail money supply.

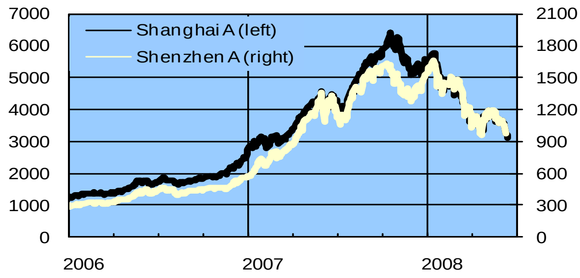
Consumer prices, reference 12-month deposit rate and reserve requirement, %



Sources: National Bureau of Statistics and PBoC

Stock market decline in China continues. This week the Shanghai A-share index experienced its largest single-day drop in over a year after Chinese officials announced they were tightening their monetary stance. The index has lost 42 % of its value since the beginning of the year and is down 50 % from its peak last October. The Shenzhen A-share index has tracked the performance of the Shanghai index. A recent Deutsche Bank study found that 80 % of the approximately 650 A-share investors interviewed had suffered substantial financial losses in recent months due to the stock market decline. Rumours have circulated that Chinese officials, fearing a stock market crash, forbid Chinese mutual funds from selling listed shares under threat of sanction.

Shanghai and Shenzhen A-share indexes



Source: Bloomberg

Private equity funds play increasing role as providers of corporate finance. Tighter bank lending and the decline in Mainland China stock markets in recent months have boosted growth of the role of private equity funds as sources of finance for Chinese companies. Private equity funds take positions in companies not listed on the stock exchanges. China's first private equity fund was established in 2006, although actual investment operations only began last year. According to some estimates Chinese and foreign private equity funds invested a total of $13 billion in Chinese companies last year.

China's central administration has displayed an interest in private equity investment. This week, the government gave China's national social security fund (NSSF) permission to invest 10 % of $74 billion in pension fund assets in private equity funds. After receiving permission, the NSSF announced it would invest 4 billion yuan (nearly $600 million) in Hony Capital and CDH Investments.

Chinese investment in foreign private equity funds has also increased. This week, China's State Administration of Foreign Exchange announced it was investing $2.5 billion in the American TPG private equity fund. China's sovereign wealth fund CIC earlier placed $3.2 billion with J.C. Flowers & Co. and $3 billion with the Blackstone Group.

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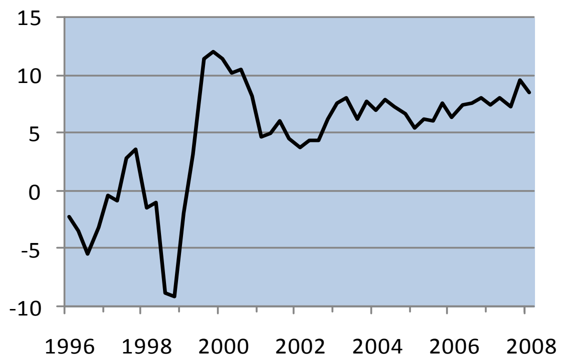
Russia

GDP growth remained strong in first quarter. Rosstat figures show GDP was up 8.5 % from a year earlier in the first quarter of 2008. Highest growth was posted in construction (up 28 %), wholesale and retail trade services, including hotel and restaurant services (12 %), transportation and telecommunications (10 %), financial services (10 %), and real estate and business services (9 %).

Industrial output growth (8 %) slowed somewhat from the same period in 2007, as did growth in mineral extraction activity (1.5 %).

Annual changes in GDP growth (y-o-y), %



Source: Rosstat

CBR raises key rates for third time this year. The Central Bank of Russia surprised the markets by raising key rates a quarter of a percentage point from June 10. The floor on the one-day repo rate, the CBR's most important lending rate, was hiked to 6.75 %. The floor on the 7-day lending rate went to 7.25 %. Deposit rates were raised correspondingly.

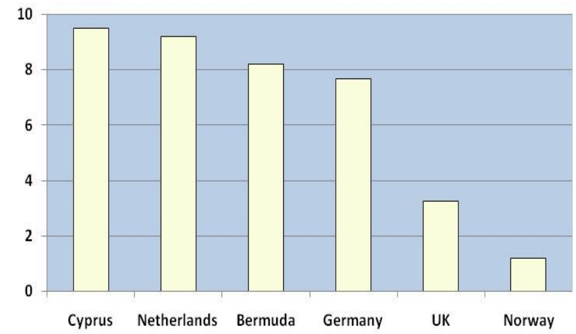
The central bank also raised its key rates in February and April, as well as hiked commercial bank reserve requirements twice this year. The latest increase in reserve requirements goes into force at the beginning of July.

Reinvested profits dominate FDI inflows to Russia. The CBR has published for the first time a detailed breakdown of the origins of direct investment entering Russia. In 2007, FDI inflows into Russia amounted to $52 billion, up 62 % y-o-y. Nearly half of direct investment consisted of reinvested profits. Investment in newly issued shares (including greenfield investments) accounted for nearly 40 % of FDI, while mergers and acquisitions (M&A) accounted for 12 %.

Direct investment in the banking sector amounted to over $7 billion, which was up nearly three times from the previous year. Foreign investors eagerly took part in offerings of Russia's largest banks, and half of all FDI went to M&A transactions. A quarter of investment consisted of reinvested profits. Foreign investors purchased nearly $800 million in newly issued banking sector shares. About half of this money came from the Netherlands alone.

Investments in other sectors amounted to $45 billion, an increase of 50 % from the year before. About half of investment consisted of reinvested profits and 40 % involved purchase of newly issued shares. The largest investment flows came from Cyprus, the Netherlands and Bermuda. Half of investment from Cyprus and Bermuda went to purchase of new shares. The general view is that most of the investment flowing in from tax havens originates in Russia. This recycling of money is to some extent mirrored in Russia's figures for FDI investment abroad. Unremarkably, two-thirds of Russian FDI outflows last year went to Cyprus, the Netherlands or Bermuda.

Largest sources of FDI inflows to Russia in 2007, US$ billion



Source: Central Bank of Russia

Gazprom expects gradual rise in its production levels. Russia last year produced 651 billion cubic metres of natural gas. Of this, 85 % or 550 billion cubic metres were extracted by state-owned gas giant Gazprom. Gazprom announced its production targets through 2020 early this week. The current plan is to increase production to a level of 610–615 billion cubic metres by 2015 and 650–670 billion cubic metres by 2020. Reaching these goals will require an average output increase of 1.5 % a year.

While most gains in the near term will come from more efficient extraction at existing gas fields, sustained production growth will require massive investment in development of new fields. Gazprom expects nearly half of its production in 2020 to come from new fields in challenging locations, including the Yamal peninsula in Northwest Siberia, the Barents Sea continental shelf and Eastern Siberia.

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China

China posts record current account surplus in 2007. Balance-of-payments data released last week by the State Administration of Foreign Exchange (SAFE) shows a current account surplus of $370 billion for last year. The surplus corresponded to 11 % of GDP, up from 9 % in 2006 and 7 % in 2005. While the surplus got its biggest boost from goods trade, currency flew into China also through income and current transfers. The country continued to run a services deficit.

Portfolio investment (surplus of $19 billion) and FDI inflows into China (surplus of $138 billion) helped swell the financial account surplus. The direct investment numbers were perhaps the most surprising in the balance-of-payments data in that they suggested a near doubling over the figure published by the Ministry of Commerce this spring. In earlier years, SAFE's balance of payments FDI figures have closely matched the ministry's figures. The difference this year might relate to a general problem with measuring direct investment as the figure has to be inferred from survey responses. Direct investment from China abroad amounted to $17 billion. Capital outflows from China increased sharply via other investment channels in the financial account.

Due to the large current and financial account surpluses, China's foreign currency reserves swelled by $460 billion to $1,530 billion at year-end. Currency reserve growth remained strong in the first quarter, when net foreign currency inflows to China reached $150 billion.

Balance-of-payments categories and foreign currency reserves, US$ billion

	2005	2006	2007
Current account	161	250	372
Capital account	4	4	3
Financial account	59	6	70
Net errors and omissions	-17	-12	16
Growth in reserves	207	247	462
Foreign currency reserves (as of Dec. 31)	819	1,066	1,528

Source: SAFE

Imports grew faster than exports in January-May. China Customs reports the country's foreign trade surplus shrank 7 % y-o-y in the first five months of this year. The biggest reason imports growth outstripped exports growth was a near doubling in the crude oil and its refined products' import values from the same period in 2007. Although volumes of crude oil imports rose only about 13 % from the previous year, the value of imports skyrocketed from the huge rise in world oil prices. The total value of imports in January-May reached $467 billion (up 30 % y-o-y), while exports were worth $545 billion (up 23 %). In the last quarter of the last year, import growth surpassed export growth for the first time in four years.

China and Taiwan agree on regular direct flights. Last Friday (June 13), China and Taiwan decided to resume scheduled direct flights after a nearly 60-year hiatus. The deal was the product of the first official meeting between China and Taiwan in a decade. The carriers Eastern China and SH Air will commence regular weekend flights between Taiwan and the mainland on July 4. Taiwanese officials allow about 3,000 mainland Chinese to arrive on flight days. Apart from few exceptions, people and freight moving between Taiwan and the mainland have had to go through Hong Kong in recent decades. To ease tourism, the Taiwanese parliament last week approved a bill permitting currency exchange of yuan for Taiwan dollars.

China's financial sector is also expected to open gradually to Taiwanese banks as relations between the two countries continue to thaw. Last March, China and Taiwan agreed that Taiwanese banks would get the right to invest in mainland China banks via foreign subsidiaries, most of which are based in Hong Kong. Taiwan's banks as a rule can only operate in mainland China's financial markets on a limited basis, which is a particularly large drawback for Taiwanese firms operating in China. According to some estimates, Taiwanese firms have invested in China about $150 billion.

Expectations of China-Taiwan rapprochement increased in March, when Taiwan elected its new president Ma Ying-jeou, a moderate on China relations. His hard-line predecessor Chen Shui-bian campaigned actively for an independent Taiwan. Push for independence has fostered poor relations with the mainland for a decade. Increased cooperation between China and Taiwan over the long run could be a challenge also for Taiwan's new president as the interests of China and Taiwan are at odds. Ma Ying-jeou has declared that above all he seeks closer Taiwan-China economic cooperation. China, on the other hand, hopes increased cooperation will unite the territories at the end.

Taiwan's economic growth has averaged 4 % a year in the 2000s. At the start of the year, statistics officials forecast that 2008 growth would reach 4.8 %. Rising tourism and improved transportation connections with mainland China, however, could push growth higher. Taiwan's top trading partners are China and the US. In January-May, exports from Taiwan to China reached $45 billion (up 24 % y-o-y) and imports $10 billion (up 18 %).

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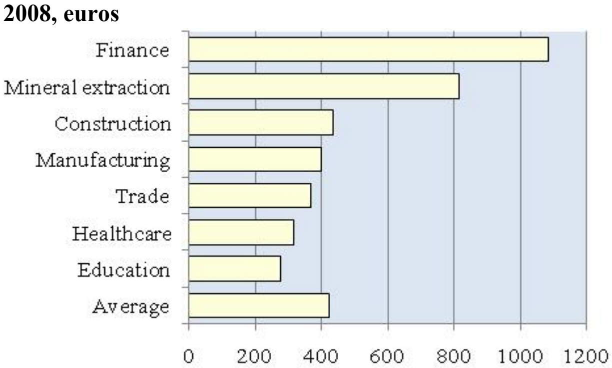
Russia

Wages continue to rise rapidly. The average monthly wage in Russia during January-May of this year was 16,000 roubles (430 euros). Pay levels, however, varied widely across branches and regions. In real terms, the average wage rose 14 % y-o-y, which was actually somewhat lower than a year ago. The deceleration in real wage growth reflects the pick-up in inflation; wage growth was up slightly in nominal terms. Wages have been pushed up by wage increases for budget sector employees, as well as a lack of skilled labour in certain branches. Rapidly increasing wages also make the task of lowering inflation more difficult.

In recent years, real wages have substantially outstripped productivity gains (even if the productivity gains have averaged a respectable 6 % a year lately). Compared to the US and Western Europe, Russian wage levels are still quite modest. Productivity, however, is also only about a quarter or a third of the level in top industrialised countries.

Average monthly wage in Russia by sector in January-April 2008, euros



Source: Rosstat

Wide variations in labour demand across regions. Russia's labour force as of end-May numbered about 75.3 million people. The number of unemployed persons (ILO-definition) continued to fall putting the unemployment rate at 6.4 %.

Due to the rather low unemployment rate and weak mobility of labour, labour shortages have appeared in several of Russia's fastest growing regions. Rosstat reports the unemployment rate at the end of 2007 was less than 1 % in Moscow and only 2 % in St. Petersburg. Regional differences remain huge, however. For example, in the poor southern regions of Chechen and Ingush republics, unemployment last year hovered around 50 %. The opportunities for workers to move to regions offering better employment are limited by the availability of housing, as well as a lack of transport infrastructure that would allow commuting from the suburbs to jobs downtown.

To sustain long-term economic growth, the World Bank estimates Russia needs about a million new foreign workers every year. The need for foreign labour could be reduced, however, if the healthcare system did a better job of improving Russians' working ability and productivity. To date the number of foreign workers in Russia remains low. Rosstat reported 1 million foreign workers in 2006. However, most foreign labour in Russia is unregistered, so they are not counted in the official figures. 2006 figures show over a third of foreign workers worked in Moscow and that the construction sector was the largest employer of foreign labour (41 %).

In recent years, the share of public workers in the workforce has fallen, and was just 32 % in 2007. The significance of foreign firms as providers of employment, in contrast, has risen steadily. Their share is nevertheless still small, as foreign firms employed 4 % of workers last year.

Russian population to shrink in coming years. Rosstat figures put the Russian population at 142 million at the start of this year. The country's numbers peaked at the start of the 1990s at 148.6 million. The mortality rate, however, has exceeded the birth rate since 1992. Russia's population shrank by 800,000 persons a year on average during 2000–2007. Immigration has helped to slow the decline in population somewhat. The decline in population reflects both a sharp fall in births and higher death rates especially for working-age men. The average life expectancy of a Russian man is today about ten years shorter than in other countries with similar income levels. According to a recent UN report, Russia's population could contract to 122–125 million by 2025 without substantial changes in birth and death rates.

The declining birth rate trend reversed in 2007 with births up 8.3 % from the previous year. The change may be only temporary, however, as demographic realities set in. While births should rise in the next couple of years, the birth rate will again begin to decline after 2012 as the number of women of child-bearing age decreases. The cohort of persons born in 1990 was smaller than any of its living predecessors, and the number of those in the cohorts currently aged 10–17 are even smaller. The decline in the number of working-age persons also presents problems for labour markets and pension financing. Russia's pension scheme must deal with both a drop in working-age population and the retirement of Russia's baby boomers.

Despite the growth of recent years, birth rates remain relatively low. In 2007, the overall fertility rate was 1.3 children per woman of child-bearing age. Even with lower mortality rates the indicator should be above two in order to halt the population decline.

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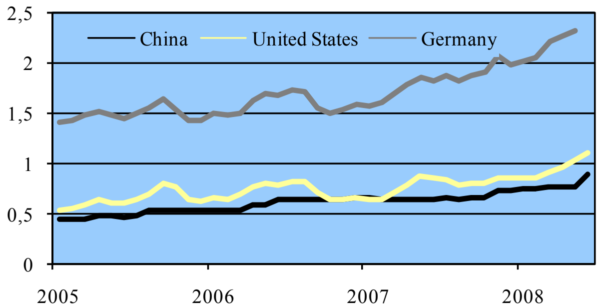
China

China raises fuel prices. China's National Development and Reform Commission (NDRC) last week boosted gasoline prices by 17 % and diesel 18 %. Gas stations can diverge up to 8 % from official prices. The increase pushed the price for one litre of 97-octane gasoline in Beijing to 6.2 yuan (0.58 euro). Fuel prices were previously hiked last autumn. The move by officials surprised many as May consumer price inflation was still high. Others suggest that the government's willingness to move indicates that inflationary pressures are subsiding.

China tightly regulates fuel prices. In addition to political decisions, domestic prices are changed when there are sufficient changes in international prices. The hikes in domestic fuel prices, however, have usually been small and implemented with delay. While low fuel prices have struck oil refiners with large operating losses, they have been compensated by official direct subsidies. China's largest refiner, the mainly state owned Sinopec, has already received this year over 12 billion yuan (€1.1 billion) in direct subsidies from the central government.

Average gasoline price at the pump in China, the US and Germany, US$ per litre



Sources: News reports, EIA, Association of the German Petroleum Industry

China and Japan reach partial agreement on gas field dispute. The recent peaceful resolution of the dispute over claims to the offshore Chunxiao (or Shirakaba in Japanese) oil and gas field signals a warming in China-Japan relations. The two countries agreed last week to work together in developing and exploiting hydrocarbon resources in the East China Sea. Under the arrangement, Japan's private sector is to invest in the field already partly built up by China. The countries haven't yet reached a mutual understanding over the Japanese contribution, which determines distribution of the profits. No agreement was reached on claims to other oil and gas fields in the area.

Interest in hydrocarbon reserves in the East China Sea has a long history. The dispute over the Chunxiao field flared in 2004 when China was angered by the political disagreements and sent a nuclear submarine into waters near the gas field. The Japanese claim that territorial bounds are defined by a median line between the countries that divides the sea area equidistant from their shorelines. In this case, offshore oil and gas deposits on the continental shelf would belong to both countries. China claims its territory follows the edge of the continental shelf, which basically means that all the fields are situated in China's sea area.

The oil and gas reserves of the Chunxiao field are estimated at about 12 million tons. The continental shelf of the East China Sea area likely holds several times this amount. British Petroleum estimates China consumed 60 million tons of gas last year, a 20 % increase from 2006 and a tripling of gas consumption since 2000. Even so, China consumes less gas than Japan, which last year used a total of 80 million tons. Japan's consumption in the 2000s has risen by about 25 %. In 2007, China accounted for 2.3 % of global gas consumption. Japan, which relies on gas for about 15 % of its energy, must import virtually all its gas from abroad. China, on the other hand, is nearly self-sufficient in meeting its own gas needs.

Environment and investment top agenda at 4th US-China strategic dialogue. The United States and China, the world's two top producers of greenhouse gases, established a framework for energy and environmental cooperation for the coming ten years at the latest strategic economic dialogue meeting in Annapolis, Maryland in the US. The meeting was headed by US treasury secretary Henry Paulson and Chinese deputy prime minister Wang Qishan. The parties also started planning an agreement on easing bilateral restrictions on investment. In conjunction with the dialogue, American and Chinese firms signed deals worth a total of about $14 billion.

No concrete progress was made in the areas of trade, product safety or industrial and intellectual property rights. When it comes to the investment agreement, the US would like to see equal treatment for its investments with respect to Chinese firms. China, in turn, wants broader market access for its state-owned firms. This includes the newly created China Investment Corporation (CIC), which oversees investment of some $200 billion in assets of the country's almost $2 trillion in foreign currency reserves. The US considers active investment by Chinese state firms as problematic from the standpoint of national security. To date, the Americans have limited China's proposed investments in American companies.

Since the first strategic economic dialogue in 2006, the discussion has broadened from Chinese foreign exchange policy to a variety of economic issues. The next strategic dialogue will be held in Beijing in December.

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Russia

Government approves budgetary frame for 2009–2011. Russia last year implemented a moving three-year budgeting framework to smooth long-term budget planning. The second three-year framework budget was released this week.

Growth of federal budget revenues is expected to slow sharply in the coming three-year period. During 2009–2011, budget revenues are anticipated to average real growth of slightly over 1 % a year. During the preceding three-year period the realized income growth was 9 % a year on average. The decline in revenue growth reflects a number of factors: plateauing growth in oil production and exports, expected continuation of rouble appreciation and possible future declines in oil prices. The oil and gas sector's contribution to budget revenues is expected to fall from nearly half this year to less than a third in 2011. The three-year budgetary frame is based on forecast which assumes the average price for Urals-grade crude oil will go down from $92 a barrel this year to $72 in 2011. Annual economic growth is forecast at over 6 %.

As the revenues are expected to shrink, the government aims also to curb growth in budget spending. While 2009 budget spending is still planned to climb 17 % in real terms, real growth in expenditures in subsequent years will be kept to a few per cent. In 2011, spending should reach nearly 11 trillion roubles, or 17 % of GDP.

As spending is expected to rise faster than revenues, budget surpluses are expected to diminish. The federal budget surplus last year was equal to 5.4 % of GDP. It is expected to fall to around 1 % by 2011.

The framework budget will now go to the Duma for approval. The specific budget parameters will be detailed separately as part of the annual budget process. In his recent budget address, president Medvedev said the spending priorities should be the building up a national innovation system through support for science and research, investment in human capital through e.g. education and healthcare, infrastructure development, and improvements in efficiency of state institutions (e.g. the justice system).

Winding down of Russian electricity monopoly RAO UES completed. The massive restructuring of Russia's electricity sector continues to proceed according to plan as the state-majority-owned electricity giant RAO UES phased out its operations on Tuesday (July 1). The former monopoly is now officially divided into an infrastructure side in which the government retains a majority stake, and a mainly privatised production side. The state-majority-owned side includes the Federal Grid Company, intra-regional distribution grid companies, a system operator, as well as the RosHydro hydropower company and nuclear power plants from the production side. The divested side of UES is made up of 20 generation companies. Many of these companies are already majority owned by private investors and listed on stock exchanges. The shares of generation companies that were still owned by the UES are distributed among the owners of the UES (i.e. owner gets a stake in all UES-owned generation companies). In several generation companies, the majority owner is a strategic investor such as Russian gas giant Gazprom, metals producer Norilsk Nickel or a foreign energy company such as Fortum, Enel or E.On.

The massive shake-up in Russia's electrical power sector has taken years. The goal is to make electricity markets competitive and secure needed investment for development of the sector. Currently, the price of about a quarter of the electricity sold to Russian industrial users is set on a power exchange. The rest is still sold at regulated rates. The share of electricity sold at regulated rates should decline incrementally until 2011, when all electricity will be sold at prices determined by the market. All electricity sold to households is still provided at regulated rates.

The electricity sector requires substantial investment to upgrade its aging infrastructure and fill gaps in production capacity. Although investment in the electrical power sector is on the rise, there are still ambitious plans for building huge new production capacity in coming years. Implementation of plans is complicated also by the compressed project schedules, which make it difficult to get e.g. the new turbines needed for production even from the major international suppliers in such a short time. Russia's electricity sector also suffers from a dearth of properly skilled workers, which should make construction and implementation of new capacity even more difficult.

Talks started on new EU-Russia agreement. At the EU-Russia summit on June 26 and 27 in the Siberian city of Khanty-Mansiysk, the participants agreed preliminarily on moving ahead with a new cooperation agreement to replace the 1997 Partnership and Cooperation Agreement. After a year-and-a-half delay, talks on the content of the agreement are finally underway. The negotiation process, however, is expected to take time. The earlier agreement will continue to be extended until the new agreement is signed.

President Medvedev led the summit for the first time and the atmosphere of the gathering was described as positive and constructive. Discussions touched on among others energy cooperation and security policy. Cooperation on setting up seven new Cross Border Cooperation programmes was also agreed. Russia's planned hikes in raw timber export tariffs were also brought up in the discussions, but no solution was achieved. The negotiations on raw timber policy will continue in July.

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China

Despite many challenges, foreign banks upbeat on their prospects in China's banking sector. A recent survey by PricewaterhouseCoopers documents experiences and future aspirations of over 40 foreign banks operating in China. Nine of the surveyed banks expect their revenues to more than double this year, while another 16 see their revenues climbing 40–100 %. Banks predict the number of foreign banks to increase from the current number of less than 80 to 100 by 2011.

The study states that foreign banks see official regulation and shifts in regulation among the biggest challenges facing them. Under China's WTO commitments, foreign commercial banks have been allowed to establish subsidiary banks in China since December 2006. Although in principle this allows the possibility to make money on providing customers with yuan-based services like Chinese banks, foreign banks have found the process of setting up subsidiary banks expensive and time consuming. The establishment of branch office networks has been slowed by high capital requirements for individual branch offices. Despite this, the number of foreign subsidiary banks operating in China is expected to rise from a current number of about 20 to over 50 by 2011 (assuming all banks seeking licences receive them). Foreign banks have also been constrained by recent official regulatory measures to limit the expansion of credit growth.

Problems in attracting competent workers and trouble in retaining them once they have been hired have become significant challenges for foreign banks. This is clearly reflected in wages, which are expected to rise 15–30 % this year. The number of people working for foreign banks reached 10,000 last year. The banks surveyed expected this number to nearly double by 2011. The turnover of Chinese workers is high at foreign banks as it is in Chinese labour markets generally, and it is expected to generally exceed 20 % in 2008.

The total assets of foreign banks relative to the banking sector overall is still low, but continues to increase rapidly. In 2007, the share of foreign banks in the banking sector rose by nearly 50 % y-o-y to slightly over 2 %. The total lending stock of foreign banks also climbed nearly 50 % from a year earlier. The Chinese market is attractive to international banks because it offers opportunities to take advantage of the country's rapid economic growth and the increase in wealth, as well as increased access to the banking sector under the conditions of WTO membership.

China's steelmakers accept Australian demands for a 96 % increase in the iron ore price. Australia's iron-ore producers Rio Tinto and BHP Billiton (the world's number two and number three producers) refused to go along with price hikes in the range of 65–71 % earlier agreed by steelmakers and other iron ore producers. Moreover, the new supply contract reached last week is backdated to April 1. The agreement recognises China's growing need for security in supplies to feed its thriving steel industry and the growing clout of iron-ore producers. The Australian companies jointly control about a third of the world's iron-ore trade. Even though the world market price for iron ore has quintupled over the last eight years, prices of steel products have risen even faster. Iron ore prices negotiated this year are expected to pass through to industries heavily dependent on steel products, especially carmakers and builders. This, in turn, will fuel inflation pressures globally.

The largest steelmakers (earlier Japan, and from last year on China) and iron ore producers have traditionally agreed annually on the reference prices on iron ore. Once a reference price was established, other iron ore producers have then followed the agreed price. This year's frame-breaking agreement overturned the traditional routine as Rio Tinto and BHP Billiton saw their chance to demand higher prices relative to Brazil, which has higher shipping costs to China. By some estimates, the price negotiated by the Australian firms reflects only around 10 % of the difference in transportation costs between the two continents.

China also seeks to secure iron ore supplies through foreign investment. Several Chinese companies have sought stakes in mining companies and mines. Chinese efforts to acquire Australian assets have met with opposition from Australian officials however.

With annual output of 700 million tons a year, China is by far the world's largest producer of iron ore. Chinese iron-ore production has doubled during the last five years. Even so, the increases are inadequate to keep up with the rising needs of the domestic steel industry. Although growth in China's steel output has slowed slightly in recent years, it continues to grow five times faster than steel production globally. Last year, China imported 380 million tons of iron ore (up 17 % from the previous year), of which 38 % originated from Australia and 20 % from Brazil. Iron-ore supplies from Russia are expected to increase this year, although their volume is still marginal relative to the main iron-ore suppliers. Growth of China's domestic demand for steel has continued to outpace growth in steel exports in recent years.

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Russia

Inflation still high; rouble strengthens in real terms. Russia's on-year inflation remained at 15.1 % in June. Galloping food price inflation moderated slightly to 21 % y-o-y. While the rise in prices of grain products and edible oils and fats continued unabated, inflation in prices for fruits and vegetables slowed in June.

The government has tried since late 2007 to calm the rise in prices for grains and grain product by selling out state grain stores and imposing tariffs on grain exports. While the export tariffs ended at the beginning of this month, bumper harvests in Russia and other countries are expected to reduce inflation pressures.

Gasoline prices have risen sharply, up over 25 % y-o-y. According to energy minister Sergei Shmatko, the government will continue to fight rising prices by e.g. increasing competition in the oil refining sector and supporting domestic refiners through tax policy.

Inflation pressures have also been fuelled by growth in export earnings from higher oil prices which has, however, been compensated to some extent by the reduction in capital inflows. The Central Bank of Russia has already hiked interest rates and reserve requirements several times this year. Money supply growth has also slowed significantly in recent months.

Quelling inflation has been complicated by the central bank's goal of maintaining the nominal exchange rate of rouble rather stable. The rouble's nominal effective exchange rate (NEER) in June had weakened 1.1 % from the start of the year. However, because Russian inflation is higher than in other countries, the rouble's real effective exchange rate (REER) strengthened in June 2.9 % from the start of the year. In real terms, the rouble gained 3 % against the euro and nearly 9 % against the dollar.

Current account surplus balloons; financial account also in surplus. According to preliminary balance-of-payments data, Russian foreign trade reached record levels in January-June on the wings of high oil prices. The value of goods exports climbed over 50 % in the first half of the year (compared to 9 % in 1H07). Growth in goods imports also accelerated somewhat to more than 40 % y-o-y. Some 67 % of the value of exports came from oil, oil products or natural gas. The current account surplus nearly doubled from a year earlier to $69 billion. In the first half of 2007, the current account surplus contracted by about a third.

The service balance remained in deficit. Service exports and imports each grew by about a third. The share of services was 10 % in exports and 25 % in imports.

Interest payments of banks to abroad shown on the income account continued to grow rapidly, reflecting the large increase in bank borrowing on international markets.

The financial account surplus has contracted substantially from last year's highs. The financial account surplus was $63 billion in 1H07, compared to just $12 billion in 1H08. The decline in the surplus reflects the contribution last year of major share offerings and the tight liquidity situation in international financial markets that depressed foreign borrowing of Russian firms especially in the first quarter. In contrast, direct investment flows into the country were up by 20 % from a year earlier to about $30 billion (excluding the banking sector).

The increase in capital outflows from Russia has been driven largely by the banking sector. Non-bank direct and portfolio investment from Russia abroad contracted slightly from a year earlier to $26 billion.

Despite lower growth in Russia's currency reserves, they were at an all-time high of $570 billion on July 1.

High volatility characterises first half for Russian stocks. While the general trend on world bourses was downward in the first half of the year, Russia's stock exchange experienced a roller-coaster ride of ups and downs. Initially, the Russian stock market fell as elsewhere, but then rebounded at the end of March. By mid-May, the RTS index hit an all-time high, nearly 2,500 points, a level 8 % higher than at the start of the year. The overall trend on the MICEX was quite similar to the RTS. The market capitalisation of both the RTS and MICEX exchange at the end of June was about 30,000 billion roubles ($1,280 billion or more than 90 % of last year's GDP). On the other hand, the value of turnover on the MICEX was 50 billion roubles compared to just 0.6 billion roubles for the RTS.

Growth was led by shares in oil and gas companies supported by the rise in oil prices. Planned tax cuts for the oil sector were also seen to have a positive impact on their stock development. The weight of the oil and gas companies in the RTS index is about half. An important factor in the bourse development was also increased international investor preference for Russian stocks over stocks listed on other emerging markets. The price-to-earnings (P/E) ratios of Russian companies are still on average about 25 % lower than for companies listed on exchanges in other emerging markets.

RTS index and Shanghai A-share index

Source: Bloomberg

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China

China prepares new restrictions for exporters to reduce speculative foreign currency inflows. Officials suspect export firms of smuggling money into the country by exaggerating their export earnings. The State Administration of Foreign Exchange (SAFE) last week announced it was mandating that export firms operating in China direct their foreign earnings through officially monitored accounts. Export companies are further required to provide proof of foreign transactions before they can convert their foreign currency to yuan. The new rules, which enter into force August 4, are part of efforts to more precisely track the actual volume of goods and services sold abroad and reduce the amount of money illegally flowing into the country. Because goods and services move more freely than capital investment, companies may transfer money across borders under the guise of trade. China's goods exports in January-May amounted to $550 billion.

In recent months, a number of estimates of capital inflows into China have been presented. The guesswork is tricky as China's balance-of-payments figures appear only twice a year. Even those figures don't tell us how large part of the trade in goods and services is actually investment flows. One way to roughly estimate the flow of short-term capital into China is to subtract foreign direct investment and the trade surplus from growth in the country's foreign currency reserves over the same period. According to newspaper reports, China's foreign currency reserves increased by about $270 billion in January-May, of which about $90 billion could not be attributed to either trade or direct investment. If this figure is compared to balance-of-payments figures released for previous years, one can infer that net amount of speculative investment in China and borrowing from abroad have increased substantially. Final figures, however, are often very different from earlier presumptions. The uncertainty is heightened by the fact that estimates of the size of speculative money flows in the trade figures vary considerably. It has also been suggested that the recent growth in foreign direct investment in China is to some extent an increase in disguised capital flows.

The flood of foreign currency into China has been the main driver of rapid money supply growth, which in turn has added to inflationary pressures. China has sought to calm this trend by imposing limits on credit, raising bank reserve requirements and selling bonds. Officials seem to be reluctant to raise interest rates substantially probably because research suggests that interest rates play only a minor role in the Chinese economy and further widening of the interest rate gap with ia the US might boost speculative inflows even further. Foreign investors consider China's capital markets attractive because internationally rather high interest rates and anticipated yuan appreciation.

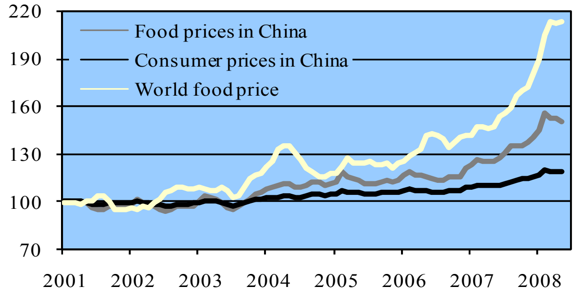
Good summer harvests expected. Despite China's recent spate of natural disasters, officials expect the summer harvest of key food crops (maize, tubers, legumes, rice and wheat) to be slightly larger than last year. Farmers in most Chinese provinces can raise two crops a year, and the summer crop accounts for about a quarter of the total annual harvest. Officials estimate that for all of 2008 production of key crops will be about as big as last year, i.e. just over 500 million tons. Farm output has grown since 2003, when the harvest dipped to 430 million tons. Meat production is also expected to increase this year, although specific figures are unavailable.

Despite good harvests and rising meat production, Chinese food prices have climbed briskly since autumn 2006. In May meat prices were up nearly 40 % y-o-y and grain nearly 9 %. Problems in production and higher world market prices have pushed up food prices. Rising incomes in China, as in many emerging economies, have also increased demand for certain foods, particularly meat and milk. While production of biofuels has increased rapidly in China, it has not expected to significantly affect food crop production.

In last 12-months officials have imposed strict measures to boost domestic food supply and rein in soaring prices. As a result, price trends on China's domestic market have begun to diverge from trends in the world market. Domestic supply has been further increased through ia higher subsidies to agricultural producers, reductions in state grain inventories and new export restrictions.

China's stated goal is to be self-sufficient in food supply. The country's grain trade is largely in balance and China is presently a net exporter of meat. China's only significant import items in agricultural products are oilseed (mainly soy) and vegetable oils, which it imports about 40 % and 20 % of world trade respectively. Import of milk powder has grown rapidly in recent years: 2007 import volumes corresponded to about 6 % of world trade.

Price trends in China and the world market, index: January 2001 = 100



Sources: CEIC, IFS, own calculations

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Russia

Makeup of commission on foreign investment in strategic sectors now defined. In early May, a law regulating foreign investments in "strategic" sectors entered into force. The law requires that foreign buyers apply to a governmental commission for approval of their acquisition if they seek a majority stake in a company operating in one of 42 designated strategic sectors, which include nuclear power, arms industries and significant mineral extraction.

The commission to monitor foreign investment is set to start its operations now that prime minister Putin, who chairs the commission, finalised the composition of commission last week. Its 16 other members include ministers and heads of official agencies including the Federal Antimonopoly Service and Federal Security Service and the state nuclear corporation Rosatom. Investment approvals require simple majority support from the commission. The Federal Antimonopoly Service is responsible for implementation of commission rulings.

The Federal Financial Markets Service, which supervises financial markets, has ruled that strategic enterprises can issue up to 25 % of their listed shares on foreign exchanges, with the exception of companies involved in mineral extraction (no more than 5 % of their shares on international markets). For non-strategic firms, the foreign share limit was reduced from 35 % to 30 %. The restrictions are seen as part of the effort to promote development of Russia's domestic securities market and keep ownership of strategic enterprises in Russian hands.

Management shakeups at state-owned companies. In March this year, presidential candidate Dmitri Medvedev promised listeners at the Krasnoyarsk Economic Forum that his economic policies would include improving governance of state enterprises. His intent was to replace many of the public officials who sit on state enterprise boards with independent directors.

First deputy prime minister Igor Shuvalov last week presented president Medvedev with a list of independent directors for seats on boards of 11 companies with 100 % state ownership. New board members have been designated e.g. for oil pipeline operator Transneft, Russian railways, Sheremetyevo international airport, agriculture banking specialist Rosselhozbank and the Mortgage Housing Loan Agency. The new board designates include former state-company directors and bureaucrats, as well as officers from private firms, investment banks and research institutes.

The government is compiling a separate list of independent candidates for boards of 50 enterprises where the state is majority shareholder. The list should be ready by November.

Medvedev's efforts to improve governance and transparency in state firms has ignited a broader discussion on management of state enterprises, including a debate on how much independence should be given to board members representing the state. The discussion has also focused on selection of independent directors and possible conflicts of interest they might face.

Structure of state conglomerate Rostekhnologi emerges. Rostekhnologi is one of six in a new breed of state corporations established last year under special laws to promote economic development and diversification of Russia's production structure. The other five new corporations are state nuclear corporation Rosatom, state development bank VEB, Rosnanotekh (funder of basic research in frontier technologies), Olimpstroi (constructor of facilities for the Sochi Olympics), and the Housing and Municipal Infrastructure Development Fund.

Rostekhnologi grew out of Russia's state-owned arms exporter Rosoboronexport, which had earlier merged into itself the carmaker AvtoVAZ and several defence industry firms. Rostekhnologi's mission is to modernise Russia's machine-building industry.

Since the inception of Rostekhnologi, there has been a dispute over which companies will be absorbed into its scope of influence. Rostekhnologi CEO Sergei Chemezov identified as much as 600 candidates suitable for take-over by the corporation. President Dmitri Medvedev last week signed a decree giving Rostekhnologi ownership in 426 firms in different branches. Of these, 180 are fully state owned and the remaining 246 have state participation. The companies represent a wide range of businesses, including weapons manufacture, electronics, machine-building, metallurgy and metal fabrication, chemicals, pharmaceuticals, aerospace, research and foreign trade. In addition, Rostekhnologi will take over e.g. ownership shares in a number of airlines and two spas. The initial plan was to have Rostekhnologi focus on the defence sector, but it received several companies from the civil sector as well.

Rostekhnologi can sell any of the companies transferred into its ownership. The finance ministry opposed the transfer of several major firms and high-value properties to Rostekhnologi on the grounds that the state would lose revenues it might otherwise raise from privatisation sales. The economy ministry also wanted to reduce the number of companies going to Rostekhnologi and was highly critical of transferring companies other than those in the defence sector. The Federal Antimonopoly Service opposed the notion of combining under a single umbrella companies that have so far competed with each other.

The state corporations have been publicly criticised for being capitalised out of the federal budget, when their operations are not scrutinised as carefully as operations of typical state-owned companies. Particular criticism has been directed at Rostekhnologi's logic of creating a hodgepodge of competences.

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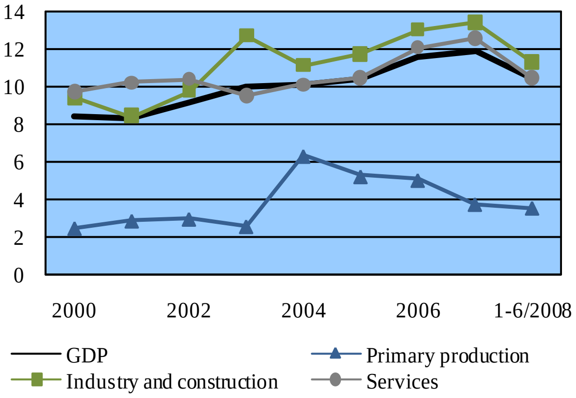
China

Economic growth slows as predicted, high inflation persists. Preliminary figures show China's real GDP growth in the first half of 2008 was 10.4 % y-o-y. In the April-June period, growth was 10.1 % y-o-y. The current slowing in economic growth from last year's blistering pace of nearly 12 % is in line with earlier forecasts.

There are several factors underlying the deceleration. The weakened development of the global economy has depressed growth in Chinese exports, even if they are still respectably strong. The slower growth was anticipated also because last year's growth rate was considered too high and had touched off e.g. acceleration in the inflation rate. In addition, a number of single events, including severe winter storms and the Sichuan earthquake in May have impacted economic development.

Preliminary figures show growth on the production side has generally slowed. In China's main production sectors, highest growth was posted again in industrial production and construction (up 11 % y-o-y). However, just like services and primary production (e.g. agriculture), it experienced a slightly lower growth than a year earlier.

Real GDP growth by production sectors, % change from previous year



Source: China National Bureau of Statistics

An exact sector-specific assessment of trends will only be possible when data on demand-side factors are released. A World Bank estimate suggests the overall contribution of foreign trade to GDP growth was still positive in the first half of the year, even if its share of growth contracted sharply from 2007. The rate of nominal growth in investment remained high but the real growth rate is weakened by the rising costs. Strong private and public domestic consumption demand seemed to hold up and increased in real terms at least at last year's pace.

12-month consumer price inflation moderated in June to 7.1 % (7.7 % in May). On-going pressure on prices was highlighted by a surge in producer price inflation, which climbed already to 8.8 % in June (up from the level of 8.2 % in May).

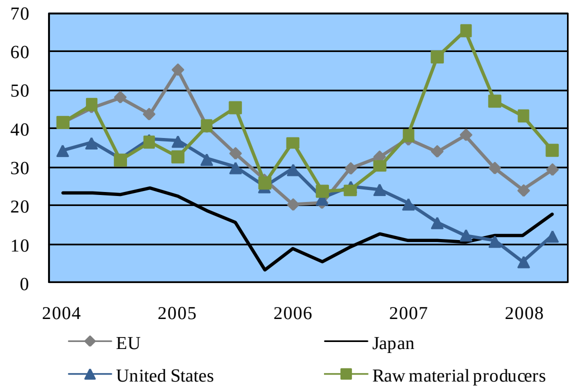
Foreign trade surplus contracts with slowing export growth and rising import prices. China's foreign trade surplus contracted in January-June by 12 % and in June 21 % compared to last year. In the first half of this year, China exported goods worth $667 billion and imported goods worth $568 billion. Export growth slowed 6 percentage points from last year to 22 %, while import growth rose 13 percentage points to 31 %. The accelerating growth in imports reflects the rise in prices of energy and raw material imports to China and also strong growth in domestic demand. In contrast, growth in demand for Chinese exports goods has declined in many countries.

China's foreign trade deficit with its top ten energy and raw material supplier countries more than doubled in January-June compared to 1H07. The increase in the deficit in the first half reflected higher import prices and to some extent also higher import volumes. On the other hand, Chinese exports to countries providing raw materials have also expanded rapidly in recent years.

Declining export growth from China to the United States has been evident for the past two years. As the United States is China's second largest trading partner after the EU, changes in US demand are clearly seen in China's export figures.

For the first time in a long while, growth in EU exports to China grew faster than imports in the first half of this year. China's trade with Japan and Taiwan has developed steadily for several years now. The recent improvements in China's relations with Japan and Taiwan are expected to have a positive influence on trade.

Growth in China's exports to selected countries, % change from a year earlier



Sources: CEIC, China customs

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EUROJÄRJESTELMÄ
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Russia

Rapid first-half economic growth despite lower oil production volumes. Rosstat figures show January-June industrial output was nearly 6 % higher than a year earlier. However, growth was lower than in 1H07 (7 %). Industrial output in June was less than a percentage point higher than in June 2007. Most observers believe the steep June slowdown in growth is transitory, however, and in part is merely due to the high comparison point of last June. Economic growth in longer term should remain high, sustained by strong domestic demand.

Crude oil production may be peaking in Russia. The volume of oil produced in the first half of this year was 0.6 % less than in 1H07. In the first half of 2007, crude production was still increasing at a rate of 3 % y-o-y. Natural gas production increased less than 2 % in 1H08.

Growth in the manufacturing sector in the first half was led by vehicle manufacture (up 17 %), followed by production of plastic and rubber products (16 %), sawn goods and wood products (13 %), as well as machinery and equipment (10 %). Growth in the food industry accelerated to nearly 8 % y-o-y, with highest growth posted in the fish and meat processing industries (13–14 %). Production of milk and vegetable oils was down from a year earlier.

The overall pace of construction accelerated in January-June, up 22 % y-o-y. Growth in housing construction, however, slowed substantially. The number of completed apartments was up 34 % y-o-y, while 1H08 growth was just 3 %. Some observers blame the slowdown in housing construction on higher building and financing costs, and greater difficulties in getting access to finance. The tight situation has made things particularly difficult for small builders, and problems in the sector have generally been aggravated by difficulty in acquiring land for building.

Agricultural output growth remained at 4 %, the same level as 1H07. Cut timber production was down 8 %, a significant slowing from 8 % growth in 1H07.

Retail sales increased 15 %, matching the growth rate of the first half of 2007. Food sales grew 8 %, while sales of non-food goods were up 21 %.

Massive domestic demand undergirds growth. Fixed investment in the first half was up 17 % y-o-y. Investment growth slowed from the record 24 % y-o-y level of 1H07. The slowing investment growth reflects e.g. more difficult access to finance and higher interest rates domestically.

The rise in personal purchasing power was sustained by real growth in incomes, which reached an on-year growth in the first half of this year of 8 %. Real wages grew even faster (13 %). The growth rate of both, however, slowed a bit compared to last year.

Duma wraps up spring session and heads for vacation. In its first session, the new Duma passed 167 bills of the over 500 considered. The President has already signed 112 of them into law. The flurry of legislative activity reflects the dominance of the United Russia party in the Duma and the fact that bill proposals from the government and the presidential administration usually pass through Duma committees and floor votes with few major modifications.

Several of the bills passed in the spring session focused on raising incomes. The minimum wage was increased to match the official subsistence minimum rate. Pensions and public sector wages got a boost, along with increases in the state child allowance, student allowances and some other social entitlements. To encourage workers to participate in voluntary pension saving programs, the state will pay money into voluntary pension savings accounts over the next five years.

During the spring session, the Duma approved a number of laws affecting the economy, including the long-debated act on foreign investment in strategic sectors, as well as a law on a state corporation for housing development assistance (Housing Construction Development Fund). The highlight of the spring session for tax legislation was approval of law providing tax relief to oil producers. Small enterprises also benefited from simplification of their tax rules.

During their summer holidays, some Duma representatives will meet with finance ministry officials on the preliminary draft budget for 2009 and the budget plan for the following two years. The idea of the meeting is to hammer out the budget details before the government draft budget is officially submitted to the Duma by the beginning of the autumn session. This preemptory budget handling approach, a “zero handling,” has been in use for a few years now. It allows the budget to pass through the Duma with little need for changes and has sped up the budget process considerably.

The Duma returns to work at the beginning of September. The agenda for the autumn session will be topped by a number of high-profile anti-corruption laws and reforms to ease operating burden of small firms. The government is currently considering a controversial reduction in VAT rate. The proposal should go to the Duma during the autumn session.

A survey by the Russian Public Opinion Research Centre (VCIOM) finds the current Duma enjoys far more popularity with the general population than its predecessor, even if most respondents were not satisfied with Duma operations. Some 35 % of respondents were satisfied with the current Duma, while 40 % said they were dissatisfied.

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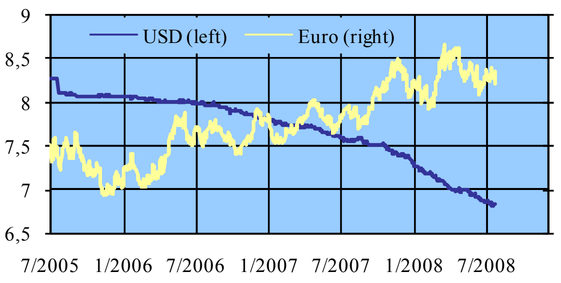
China

Inflation a concern for China. Many of China's leading officials still see inflation as the largest economic policy challenge, despite the country's slowing economic growth. While 12-month consumer price inflation in June slowed to 7.1 %, increasing prices of energy and raw materials drove producer inflation up to nearly 9 %.

Money supply growth remains high, with broad money (M2) up 17.4 % y-o-y at the end of June. The currency inflow from abroad to China has been one of the main drivers of money supply growth and the resulting inflationary pressure (see *BOFIT Weekly 28/2008*). To restrain the appreciation of the yuan, the People's Bank of China intervenes in the market to buy up the excessive foreign currency. Due to the interventions China's foreign currency reserves ballooned in the first half of 2008 by $280 billion to already over $1.8 trillion.

As a consequence of PBoC interventions, the amount of yuan in circulation has increased. To calm the monetary growth, the PBoC has tried to soak up the excess yuan liquidity by selling central bank bills to financial institutions and by raising reserve requirement ratio to 17.5 %. According to our rough estimate, the authorities have by these measures fully sterilised the impact of interventions on the market this year. However, the central bank's most potent measure for limiting loan growth has been to impose direct quantitative restrictions on bank lending. China's monetary policy still concentrates on quantitative policy instruments. The use of interest rates is still small. Interest rates were last hiked at the end of 2007 and real deposit rates are clearly negative.

Yuan-dollar, yuan-euro exchange rates



Source: Reuters

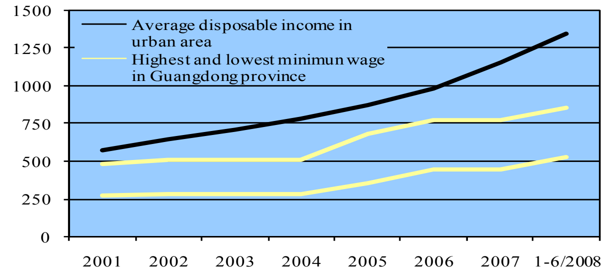
The debate in China over exchange rate policy has been fairly vocal in recent weeks with leading officials giving contradictory statements on what should be done. So far this year, officials have allowed the yuan to appreciate about 7 % against the dollar, while the rate against the euro as of Thursday (July 24) was essentially unchanged from the start of the year. Some officials fear the constant strengthening of the yuan against the dollar will add to foreign currency inflows from abroad. In addition, there are reports from e.g. clothing and shoe manufacturers of weakening export prospects and lower growth. On the other hand, high inflation and rapid overall economic development support demands for letting the yuan appreciation further.

Rapid rise in income continues. The National Bureau of Statistics reports that in the first half of the year incomes increased rapidly in China's cities and rural areas. The average disposable monthly income in urban areas was 1,340 yuan (€124, up 6 % in real terms), while rural cash incomes averaged 420 yuan (€39, up 10 %). Rising food prices helped boost agriculture incomes. About 60 % of average rural incomes came from agriculture, with another 30 % from wages and nearly 10 % from income transfers. The average urban income consisted mainly of wages (70 %) and income transfers (over 20 %). Capital income was essentially unchanged at 2 % of income.

While China's income figures are considered fairly comprehensive, there are numerous problems associated with official wage data. The data mostly cover wages of public servants working directly for the state, local administrations or state-owned companies. Wages of workers at private firms, for example, are not tracked. However, the rise in wages can be seen in city-specific minimum wage levels. Monthly minimum wages range from 1,000 yuan in Shenzhen down to 380 yuan in some small cities. While cities have no coordinated policy on raising minimum wages, most cities have been increasing minimum wages at a rate above 10 % a year over the past three years.

Rising labour costs have had the hardest impact on labour-intensive sectors. In those sectors also the labour supply has decreased, as higher food prices have made agriculture more lucrative and living expenses in cities have increased rapidly. As a part of natural structural change, labour-intensive sectors are expected to move gradually from the largest coastal cities to other areas.

Minimum wages and average incomes, yuan



Sources: China National Bureau of Statistics and www.51labour.com

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Russia

Stock markets react to prime minister's statements. In a discussion on the state of Russia's metals industry on July 24, prime minister Vladimir Putin took direct aim at Russian mining and metals company Mechel Group and its main owner Igor Zyuzin, claiming that the company sells coal to its foreign customers far cheaper than to its domestic customers. The prime minister requested that the Federal Antimonopoly Service and the Prosecutor General's Office investigate Mechel's export activities. A few days later, Putin renewed his criticism and accused Mechel of tax evasion through transfer pricing schemes.

Putin's statements convulsed Russia's stock market, which was already in retrograde from woes on international exchanges. The core RTS index declined after both statements, ultimately reaching its lowest point since February. Shares of Mechel, which are listed on both the Moscow and New York stock exchanges, lost half of their value. After some recovery, the RTS index was on July 31 still about 7 % lower than before the prime minister's statements. Since the start of the year, the RTS index has lost 15 % of its value.

Observers have criticised the prime minister's sharp statements about an exchange-listed firm. According to them, the incident highlights the uncertainty in the current business climate and indicates how non-economic factors can have profound impacts on Russia's securities markets.

President Medvedev tried to assuage market worries last Tuesday (July 29) by noting that Russia's securities markets remain among the most alluring to investors and that both the state and enterprises act to develop the market further. First deputy prime minister Igor Shuvalov publically said that it is very unlikely that Mechel would be headed for the same fate as the oil company YUKOS.

Prime minister Putin's criticism is thought to reflect concern over the acceleration in inflation and its impact on production costs. For example, the domestic steel industry has expressed concerns over the impact of rising production costs on manufacturers of critical items needed in investment projects in the oil industry. Analysts report Mechel has distinguished itself from other mining companies by pursuing an aggressive, growth-focused strategy and by concentrating on exports at the expense of domestic customers. The prime minister's criticism is seen as a reminder to large firms that they need to be loyal to the state and support state investment plans.

At the beginning of the week, the Federal Antimonopoly Service announced that it was also investigating two other large coal producers, Evraz Holding and Raspadski Ugol, which it suspects of e.g. practicing price discrimination against the domestic market. Mechel, Evraz Holding and Raspadski Ugol together account for over 50 % of the Russian coking coal market.

International researchers examine impacts of climate change on Russia. According to a new study from the WWF and Oxfam, the polar amplification effect is causing north-lying countries like Russia to experience the climate change more sharply than elsewhere. Indeed, temperatures in the Arctic in recent years have been climbing at a rate nearly double the global average.

Russia's arctic areas will continue to bear the brunt of climate change in the coming years. 60 % of Russia is a permafrost area. Global warming accelerates the thawing of permafrost which in turn increases flood risks**,** and may cause substantial damage to buildings, roads, airports and electrical power grids. Over 30 % of Russian oil deposits and 60 % of natural gas deposits are situated in the north, mainly in permafrost areas. Heavier rain patterns would also increase flood risk**.** Floods are already incurring most of the damages caused by dangerous weather phenomena, which according to the World Bank estimates annually amount to about 60 billion roubles (€1.6 billion).

The negative impacts of climate change on Russian agriculture are substantially lower than e.g. in China or Central Asia. Warming to date in many parts of Russia has increased the vegetation period for five to ten days, has reduced devastation by winter frost and made it possible to grow certain crops in higher latitudes. At the same time, however, pests, diseases and droughts become more commonplace. The increased risk of droughts posed by global warming is seen as a significant threat e.g. to grain production, which could fall more than 10 % by 2015. Climate change is not expected to have as large an impact on growing conditions of forests in the short term. However, forest fire risk will increase and snowless winters that make it difficult to remove cut timber will become more common.

In the event the rise in the average global temperature is held to about 1–1.5 °C, the net effect of climate change for Russia could be positive. The largest single positive impact would be the reduction in heating costs. By 2025, this could reduce fuel demand by 5 to 10 %. Energy consumption, however, might be boosted by increasingly violent weather that brings heat waves, cold spells and storms. Oil and gas leaks could also become more common as pipelines are often located on soil sensitive to climate change impacts.

Russia is the world's third largest carbon dioxide emitter after the US and China. The WWF/Oxfam report calls for Russia to make significant emissions reductions, including increasing energy efficiency. Among the signatories to the Kyoto treaty, Russia is the largest greenhouse gas emitter. The treaty binds signatory countries to reduce emissions by an average of 5 % below 1990 levels. Russia retains its 1990 emission level as its target value until 2012. Thereafter, Russia's limits are expected to tighten. Russia's emissions are currently about a third below their Kyoto obligations, which means Russia can sell or save its surplus carbon dioxide rights.

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China

China's new anti-monopoly law enters into force today. The anti-monopoly law forbids anti-competitive monopoly agreements and mergers and acquisitions, as well as abuse of dominant market position. The government can get involved in company acquisitions if at least one of three thresholds set forth in the new law are exceeded: combined turnover of the transacting parties is at least 9 billion yuan (about €0.8 billion), turnover exceeds 300 million yuan in Mainland China (about €26 million), or the acquisition results in an arrangement that takes at least 25 % of market share. Many mergers and acquisitions can meet the first two criteria rather easily. To date, Chinese antitrust regulation has been inconsistent and based on variety of laws with the result that unfettered competition and protection of consumer rights have not had a safe harbour.

At present, it is still unclear how the law will be implemented and what type of supervision companies should be prepared for. Three bodies are expected to be responsible for antitrust regulation. The Ministry of Trade will supervise acquisitions, the State Administration for Industry and Commerce (SAIC) will investigate abuses of market position, and the Nation Development and Reform Commission (NDRC) will study and identify pricing monopolies. Dividing responsibility could be problematic for the three bodies, as the tasks overlap to some extent. There are concerns that interpretation of the law is case-specific and decision rules are inconsistent. Some foreign firms suspect China will use the regulations as a means of evading liability for violations of industrial and intellectual property rights.

By optimistic estimates, the legal reform means that China will reduce the special benefits of state-owned companies in order to create a level playing field with the private sector. However, many suspect that the new law has practically no impact on the operations of state-owned firms. The law, which enters into force today is based largely on principles laid out in European competition legislation and is an important step towards a market-based economic system in China. The law retains a number of Chinese features, such as the goal of balanced development of China's socialist market economy. The law also provides an opportunity for special breaks to unidentified industries that are important to the Chinese economy or national security.

Summer's electricity supply problems worst in years. China's main grid operator reports that electricity is being rationed in seven provinces. This summer's power shortages have been made worse by problems of coal fired plants to get fuel. Some coal-burning plants have even had to close down due to the shortage of coal. Coal producers have been unwilling to sell their coal to power plants, when the spot price for coal has doubled since the start of the year and is distinctly higher than the price originally agreed with power plants.

To assure electrical power production, officials have introduced measures designed to improve the availability of coal for the plants. Last month, the government capped the ex mine price of coal. This week, the spot price was frozen at the June 19 level for three main coal markets. Coal producers have also been pressured to keep their agreements with coal-fired plants. These measures, however, may only make things worse as they fail to encourage companies to produce more coal. The actions are also seen as directing the coal trading to smaller local markets and the black market. In recent years, officials have closed down several small coal mines due to inadequate safety measures. Although the central administration has requested that smaller mines be reopened, local administrators so far have been reluctant to do so as they are liable for any accident in these mines.

The main problem underlying the power shortages is the state's rigorously regulated rates for electricity. Even if electricity rates were slightly raised at the beginning of July, the hike was insufficient to cover the rise in production costs. Currently, the rate paid by industry for electricity in e.g. Guangzhou in South China is 0.84 yuan/kWh (0.08 euro/kWh). The electricity shortage has been exacerbated by China's weak electricity transmission grid, which is sometimes unable to shift power to areas of need from surplus areas.

In China, the electricity consumption of both industry and households peaks on hot summer days, when all air conditioners are on. In July-August, 2007, the Chinese used 14 % more electricity than in an average month. Industry uses 75 % of the electricity, while households account for slightly over 10 %. Prime minister Wen Jiabao has encouraged the reduction of air conditioner use to reduce power consumption.

Official figures show no indication of a slowing in growth of electricity production. Last year China's electricity production grew 16 % y-o-y and growth has continued just as fast this year. Coal-fired plants produce over 80 % of China's electricity, followed by hydropower which accounts for over 10 %.

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Russia

CBR raises reserve requirements and key reference rates for the fourth time this year. At the beginning of September, the Central Bank of Russia will increase mandatory reserve requirements on banks by 0.5–1.5 percentage points. The highest requirement, 8.5 %, applies to bank liabilities to foreign banks. In mid-July the CBR boosted all interest rates by 0.25 percentage points. The CBR also raised interest rates in June. The purpose of these hikes is to reduce liquidity in the markets and stem inflationary pressure.

Inflation slowed a bit in July, mainly in response to lower growth in food prices. July's 12-month inflation figure was 14.7 % (15.1 % in June).

Sustained banking sector growth. Growth in deposits accelerated in the second quarter after lower growth at the start of the year. Household deposits increased 32 % y-o-y in the first six months of the year, while corporate deposits climbed 35 %. Real growth, however, was cannibalised by prevailing high inflation. Although deposit rates have risen along with inflation, real interest rates remain negative. State savings bank Sberbank, Russia's largest bank, continues to dominate household deposits, but its share of the market has fallen to 50 %.

Growth in lending to firms and households continued brisk in the first half of the year with an annual rate of increase of more than 50 %.

At the end of June, 1,125 banks operated in Russia. The fastest growing banks by profit growth were the state-owned VTB24 (Vneshtorgbank) and the private banks Uralsib, Alfa Bank and ING Bank.

The five largest banks held some 42 % of total sector assets, while the 20 largest banks had a combined share of 65 % of assets. Russia's large banks are today significant by international standards. According to *The Banker,* 35 Russian banks now rank among the world's 1,000 largest banks, a net gain of eight from last year. Sberbank ranks an impressive 33rd in the world. Moreover, Sberbank, VTB and Gazprombank are the largest banks in Central and Eastern Europe. The *Financial Times* list of the world's 500 largest companies puts Sberbank in 91st position.

Although corporate borrowing has increased rapidly, Russian banks have been unable to keep up with the demand for long-term financing driven by strong economic growth. This situation has forced Russian companies to borrow from abroad – usually in the form of syndicated loans (i.e. several banks jointly arrange the loan). Due to unease prevailing on international financial markets, several firms have either cancelled or delayed their IPO plans.

The Reuters Loan Pricing Corporation (RLPC) reports that Russian firms took some $39 billion in syndicated loans in the first half of 2008, an 8 % increase from the same period a year earlier. Russia is currently Europe's third largest syndicated borrower. Elsewhere in Europe, amount of syndicated loans has fallen significantly. Russia's rapid growth in borrowing has been driven by a number of factors, including several major mergers and acquisitions (by e.g. aluminium producer RusAl and steelmakers Mechel and Severstal) and refinancing of earlier loans. Russian banks joined industrial borrowers in taking syndicated loans in the second quarter.

President Medvedev approves national anti-corruption plan. The plan calls for enactment of a new anti-corruption law. An earlier version of the law stalled in the Duma in 2000 after its first reading. The new law will define e.g. the concept of corruption and measures to prevent corruption. Changes in several existing laws will be made, including how sentences are set for various acts of corruption as well as specification of rules governing the conduct of public officials. Investigation into the sources of income and property of public officials will also be allowed.

Measures aimed at improving state management include, among others, the transfer of some authority from the federal level to the regional. The right of citizens to reliable information will be improved through increased media independence. Citizens' role to monitor the actions of public officials will be increased. The plan also provides incentives for law-abiding behaviour and improvement in the skill sets of court clerks.

The legislative initiatives are set to go before the Duma sometime this autumn. By the beginning of October, official agencies and regional administrations ought to prepare their own anti-corruption programs. The agency responsible for leading the fight against corruption should be resolved by the end of the year. It currently appears the job will go to the Prosecutor General's office.

President Medvedev, who made it clear where he stands on corruption before the election, is engaged in a high-profile anti-corruption campaign at the moment. Medvedev appointed his own anti-corruption council in May.

Few observers believe the measures will provide a quick remedy to Russia's corruption situation. By some indicators, economic growth has actually contributed to bribe-taking.

The latest report from Transparency International says that anti-corruption efforts are unlikely to be effective as long as political corruption remains unchecked. In this respect, the most recent Duma and presidential elections have failed to improve the situation from four years ago.

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China

Beijing Olympics expected to have minor impact on Chinese economy. The Beijing 2008 Olympics are expected to draw 2.5 million Chinese spectators and 600,000 foreign tourists. All of the 9 million tickets were already sold by the end of July. Since China won its bid for the 2008 Olympics seven years ago, the country has been busy constructing infrastructure for the games. Events will be held in Beijing, Hong Kong and five other cities in mainland China. China's National Bureau of Statistics reports preparation for the Olympic Games added about 2.5 percentage points a year to Beijing's annual economic growth since 2002. The city's economy has grown on average about 12 % a year in real terms over the past six years. For the Chinese economy overall, however, the Olympic impact is relatively minor. Beijing accounts for only about 4 % of Chinese GDP, and all mainland China cities sponsoring competitions only about 15 %.

Official figures for China's spending on the games run on the order of $43 billion, or about 1.5 times more than what was spent on the previous five Olympics combined. Most of the money, however, has gone to development of the national infrastructure, and is actually quite reasonable given Chinese circumstances. Investment in real estate construction in games cities in 2006 amounted to $56 billion. China's investment in Olympics infrastructure includes upgrading of data communications, improvement of the transportation infrastructure in Olympic Games cities (mainly Beijing) and construction of 37 stadiums and practice centres.

Beijing, which ranks among the most polluted cities on earth, has been plagued by its terrible air quality prior to the games. Officials have struggled to reduce pollution by increasing the use of natural gas instead of coal, limiting private car use and closing down heavily polluting industrial activities or moving them far from competition sites. During July, a total of 300 steel mills, coking coal plants and electrical power plants were temporarily shut down in the Hebei province and the industrial city of Tianjin. Even so, the closed plants are relatively small and produce only a fraction of the steel in the area. Their closure will also have little economic impact.

Higher credit ratings for China and Russia. At the end of July, the international credit rating agency Standard & Poor's boosted China's long-term sovereign rating one notch from A to A+. At the same time, the creditworthiness of the Hong Kong special administrative region was raised to AA+.

In upgrading mainland China's rating, S&P noted the good condition of state finances, the country's huge foreign currency reserves and the economy's potential for continued high growth. S&P stated further increases were possible if operating conditions continue to improve for businesses, particularly financial institutions, through ongoing structural reforms. The agency warned of a risk, however, that difficulties in the banking sector could hurt economic growth over the long term and cause the condition of state finances to deteriorate.

China's $374 billion foreign debt as of end-2007 was 11.5 % of GDP; the ratio of short-term debt to foreign currency reserves was 14.4 % – both low by international standards. S&P's sovereign rating for China is in line with the other major agencies (Moody's A1, Fitch A+). S&P's rating for India is five notches lower (BBB-).

Moody's raised Russia's sovereign credit rating in mid-July from Baa2 to Baa1. The upgrade was justified by robust fiscal health, good economic prospects and declining political risk. Investment outside the commodity sectors and strong domestic demand are contributing to diversification of the economy. Moody's noted that the smooth transition of power in March and continuity in economic policies have reduced risks associated with Russia. Challenges, however, are posed by high inflation and the business environment. Moody's rating of Russian sovereign debt is three notches lower than its rating for China.

Economic cooperation between mainland China and Hong Kong deepens; CEPA VI signed. Hong Kong and mainland China last week signed the sixth version of their Closer Economic Partnership Agreement (Supplement V). Agreement was reached on removing limits on mining and research activities as well as the service branches related to them. The latest agreement also continues to reduce trading restrictions in fields such as accounting, architecture, medical science and personnel management. CEPA VI enters into force at the beginning of next year, when it will expand to cover about 40 service industries.

Since the first CEPA was negotiated in 2003, the pact has been expanded every year. The agreement puts Hong Kong in a privileged position ahead of foreign countries. Mainland China has eliminated barriers to trade with Hong Kong to a far greater extent than under its WTO commitments. The ultimate goal of the CEPA framework is to eliminate all trade barriers between Hong Kong and mainland China.

The current agreement covers almost all goods trade. In the previous agreement (Supplement IV), the emphasis was on liberalisation of trade in services. Hong Kong estimates that CEPA brought $650 million in investment and 36,000 new jobs to the special administrative region during 2004–2006.

Last week, China signed a similar agreement (Supplement V) with Macao.

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Russia

Russian economy not expected to suffer significant impacts from Russia-Georgia conflict. Russian troops last week moved into the breakaway province of South Ossetia in Georgia, demanding that Georgian troops withdraw from the province. Moscow's money and foreign exchange markets reacted to the military operations with an immediate outflow of foreign capital from Russia. The panic was short-lived, however, with share prices and exchange rates returning close to pre-conflict levels by mid-week. Tighter bank liquidity, however, is manifested in persistently higher interest rates. Intra-bank rates have climbed a couple percentage points from July levels. Faced with a tighter liquidity situation, the Central Bank of Russia has responded by increasing the amount of credit available to the banking sector.

If the conflict becomes protracted, it may affect operation of two strategically significant pipelines running through Georgia (the Baku-Tbilisi-Ceyhan oil pipeline and the Baku-Tbilisi-Erzurum gas pipeline). It is also possible that a lengthy conflict could diminish Georgia's willingness to approve Russia's admission into the WTO. WTO accession requires approval of all member countries (which include Georgia and Ukraine).

Relations between Russia and Georgia have been poor for several years. Trade between the countries is fairly minor at present. Russia has imposed import bans on many of Georgia's key export products and interrupted postal deliveries between the two countries for months at a time.

High oil prices boost foreign trade to record levels. The CBR reports the value of exports in the first half of the year reached $238 billion, while the value of imports rose to $135 billion. The value of exports grew over 50 % and imports over 40 % from the same period a year earlier. The trade surplus ballooned over 70 % as average world oil prices in the first half were nearly 80 % higher than in 1H07.

Trends in commodity prices and trade policy measures slightly altered the structure of Russian exports. Oil, oil products and gas made up a slightly larger share of exports, while metals accounted for a smaller share than a year earlier.

In volume terms, crude oil exports contracted 7 % y-o-y during the first half. Some of the contraction in exports reflected stagnation in output. On the other hand, exports of oil products grew 5 %, as Russia continued to boost oil refining activity domestically and increase export volumes of refined petroleum products.

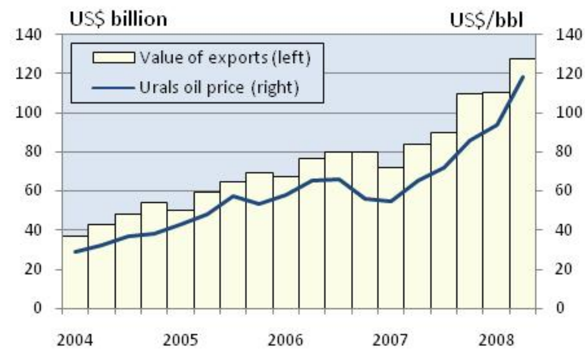
Gas exports increased by a fifth from a year earlier, mainly due to last year's temporary decrease in export demand caused by an unusually mild winter.

The hikes in raw wood export tariffs in July 2007 and April 2008 have impacted raw wood export volumes. In January-June, Russia exported about one-fifth less raw wood than in the same period in 2007. Russia also imposed temporary export tariffs on grains to control the spike in domestic food prices. This reduced the amount of grain exports substantially; e.g. wheat exports were down over 70 % from a year earlier.

Half of imports continued to consist of machinery and equipment. Foods and chemical products both represented a 13 % share of imports.

EU countries' share of Russian trade grew slightly from the 1H07 level to 53 %. The share of CIS countries in Russia's trade shrank a bit to 15 %. Russia's top trading partners continued to be Germany, the Netherlands and China. Ukraine remained Russia's most important trade partner in the CIS.

Value of Russian exports (US$ billion) and average price of Urals-grade oil on world market (US$/bbl) by quarter



Sources: CBR, Bloomberg

New law restricts access to continental shelf drilling and production. Under a new law signed by president Medvedev in July, access to gas and oil deposits located on Russia's continental shelf areas will be limited to energy companies that are majority-owned by the Russian state and have at least five years of experience in off-shore exploration and production. In effect, there are only two companies that fulfil the requirements: Gazprom and Rosneft. In place of competitive bidding for off-shore leases, the government will simply dole out drilling rights to the two qualified companies.

The limits on exploitation of oil and gas deposits on Russia's continental shelf are stricter than for exploitation of Russia's other natural resources. The law on foreign investment in strategic sectors, which was approved in May, requires foreign investors to petition a special commission under the cabinet if they seek to acquire a 10 % or greater stake in a mineral extraction enterprise considered federally important.

The new law applies to the continental shelf areas of the Barents Sea, Russian arctic waters, as well as the Azov Sea, the Black Sea and the Caspian Sea.

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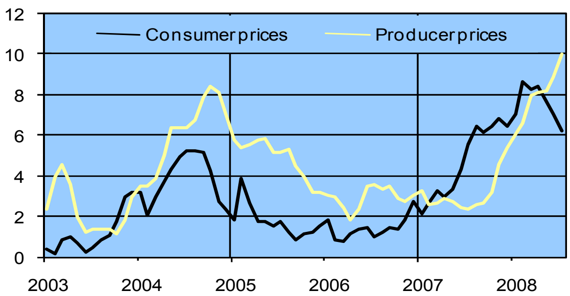
China

July producer price inflation rises to highest level in over a decade. Producer prices were up 10 % y-o-y in July, driven largely by higher prices for crude oil, coal and steel. The rise in consumer prices slowed, however, in July to 6.3 % y-o-y (June prices were up 7.1 % and February 8.7 %). The eased consumer price inflation largely reflected decelerating growth in food prices, which in July rose the slowest in over 12 months. Soaring prices for pork and cooking oil over the past two years have also moderated in recent months. About a third of the basket of consumer goods used to measure price trends in China consists of food items. Thus, changes in food prices have a profound impact on the CPI. The rise in prices of non-food consumer goods accelerated in July to 2.1 % y-o-y.

Despite the slight reduction in consumer price inflation, higher producer prices curtail the central bank's flexibility in monetary policy. However, some officials note that increases in producer prices do not feed through immediately to consumer prices because manufacturers must deal with tough competition and regulated prices that make it difficult to pass on higher costs simply by raising prices. This makes assessment of impact of producer prices on Chinese consumer price trends difficult – especially given the fact officials do not release exact data on the weighting of various goods categories in the price indexes. In general, however, one can assume higher production costs eventually translate into higher consumer prices.

Trends in consumer and producer prices, % change y-o-y



Source: China National Bureau of Statistics

Housing price development varies from city to city, but overall trend is to slower increase in prices. Real estate prices in China's 70 largest cities were up 7 % y-o-y in July, over a percentage point less than in June. Price development, however, varied significantly among cities. In 17 cities, prices in July fell from the previous month. The decline in prices is not geographically limited to a single area. For example, declines were noted for new apartment prices in southwestern China's economic hub of Chengdu, the Pearl River Delta giants Shenzhen and Guangzhou, as well as the Hunan provincial capital of Changsha. In Shenzhen, the on-month change in new housing prices was consistently negative from January to May (with March prices declining nearly 5 % from February).

Chinese officials remain concerned about trends in housing prices. Recent credit restrictions and other official measures have calmed the exuberance of the real estate sector. Lower growth in real estate is further evidenced by the decline of sale volumes this year measured in terms of floorspace. As of June, total sold floorspace was down more than 7 % from a year earlier. Even with declining sales, there seems to be no significant slowdown in the pace of new construction. Thus, market-clearing prices for new apartments may witness further declines if demand continues to dry up. Over the longer term, of course, China's ongoing migration to cities will likely support the demand for housing. The consulting firm McKinsey estimates that China's urban populations will rise from 570 million people in 2005 to over 920 million in 2025.

Increased export subsidies for clothing manufacturers. At the beginning of August, officials increased the refund on export taxes on clothing and textile exports by two percentage points to 13 %. Firms get refunds on value-added taxes they have paid. Not only is competition in the sector extremely stiff, but the international price competitiveness of manufacturers has been eroded by higher production costs and appreciation of yuan against the dollar. The China National Garment Association claims the sector employs about 10 million people, a figure that does not include workers indirectly employed by the sector.

China's exports of clothing and textiles have grown rapidly since early 2005, when international restrictions on textile and clothing trade were lifted under WTO rules. At that time some countries, including the EU and United States, responded with temporary restrictions on certain Chinese products. During January-June of this year, China's clothing exports increased just 3 % from a year earlier. China's textiles and clothing exports make up slightly over 10 % of China's total exports and represents about 30 % of the entire world garment and textile trade. China is the world's biggest exporter of clothes and textiles.

In recent years, Chinese officials have tried to wean manufacturers off export subsidies in an effort to balance foreign trade. Last year, for example, subsidies were cut or eliminated altogether for nearly 3,000 products. The reinstatement of higher textile and clothing subsidies rolls back the situation to the same level as at the start of 2007. It was the first increase in export tax refunds in a long while.

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Russia

Federal economy remains in good shape. According to preliminary figures, the realised federal budget in the first half showed a surplus of 1,331 billion roubles (€37 billion). That compared to 7 % of first-half estimated GDP and was essentially unchanged from the share in 1H07.

Budget revenues in the first half amounted to 4,369 billion roubles, or slightly over 23 % of the first half's GDP. Expenditures reached 3,038 billion roubles, the equivalent of 16 % of GDP. Higher-than-forecast inflation, economic growth and oil prices drove tax revenues well above budget targets. The original 2008 budget cautiously predicted the price of Urals-grade crude oil would average somewhat above $50 a barrel in 2008. In fact, the average in the first half was $105.50 a barrel. In 2007, the price of Urals averaged $69.50 a barrel.

Duma approved the second supplemental budget this year. The supplemental budget is an acknowledgement of the government's higher revenues, and has provided opportunities for hikes in certain spending areas. The supplemental budget, approved at the end of the Duma's spring session in July, assumes a nominal increase in revenues of 35 % from the original budget. This takes revenues from the original forecast of 19 % to well above 21 % of GDP. Tax income from crude oil and natural gas is to increase 78 %. Other budget revenue categories rise 11 %.

The government remains quite restrained on its spending increases. Expenditures will only rise 7 % in nominal terms, well below nominal growth in GDP. Spending as a share of GDP declines to below 19 %, or two percentage points less than the original budget. In relative terms, the biggest hikes come in transfers to social funds and regional budgets from which come pension payments and the lion's share of social entitlements. Housing and culture also will receive larger-than-average boosts.

Part of the new spending goes to increasing pensions to offset the unexpected pick-up in inflation. Other areas receiving large increases included agricultural subsidies and preparations of the Sochi winter Olympics in 2014.

Several international bodies have warned against Russia increasing budget spending in the current high-inflation environment. The pressures to spend more, however, are intense, because revenues keep rising. Although the budget hikes are small this time, further supplemental budgets this year are conceivable.

Under the supplemental budget, the budget surplus at the end of this year will reach 4.6 % of GDP. Last year, the surplus was just over 5 % of GDP.

The finance ministry is presently preparing a long-range plan for federal finances. Cabinet discussions, however, have been postponed due to the Georgian crisis. Russia's armed forces are asking for higher defence spending to pay for new equipment.

Even with new SME legislative support, running a small business in Russia remains challenging. One of president Medvedev first acts in office was to sign a decree on eliminating excessive barriers on business. The president wants special attention to be paid to development of small and medium-sized enterprises (SMEs). Last month, the government commission of SME development, which is led by first deputy prime minister Igor Shuvalov, released package of legislative proposals that includes measures to make registration of a business easier and limits the number of inspections carried out by the state officials. After discussion and approval in the cabinet, the proposals will be submitted to the Duma. At the end of the spring session, the Duma already approved a law simplifying taxation of SMEs.

Despite Russia's rapid economic growth, the SME sector's development has been spotty. Experts say the biggest problems facing small business are red tape, corruption and capricious inspection practices of state agencies.

SMEs represent about a third of Russian businesses, employ about a quarter of the workforce and generate nearly 20 % of GDP. Nearly half of small firms operate in the retail and wholesale trade sector.

Under the economic development ministry's draft plan on the Russian economy that runs through 2020, SMEs share of all firms will rise to 80 % over the next twelve years (to about 6 million firms). At that time, they will employ 60–70 % of all workers. Already by 2015, the contribution of SMEs to GDP should reach the European average – around 50 %. The government would particularly like to see business creation in the healthcare, IT, wood-processing and research sectors. SMEs are expected to participate in innovation and increase the selection and quality of domestic products, which, in turn, will reduce dependence on imports.

According to the economic development ministry, these goals can be reached with state development aid in forms that include loans to small businesses and training programmes. The government also wants to support the establishment of enterprise incubators and export-oriented businesses. The government recently established new criteria concerning the amount of net sales and number of employees for a company to qualify as an SME.

Although in recent years Russia has approved a number of reforms to make it easier for small businesses to operate, the setting up and running of a small company remains problematic. In particular, needed legal reforms have not been implemented as planned.

It also remains expensive to set up a company in Russia: By some estimates, the costs of setting up a small company in Russia are higher than in the US, where the cost averages around $1,200.

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China

Spending on children's education represents a substantial share of Chinese household spending. According to the figures released by UNESCO, 93 % of China's adult population have attained literacy, up from slightly under 80 % in the early 1990s. The literacy gains largely reflect an emphasis on education of girls and a rise in the average number of years people spend in school. At the beginning of the 1990s, one woman in three and one man in ten was illiterate in China. Today, 90 % of Chinese women and over 95 % of men can read and write. Nearly all Chinese children now receive a comprehensive school education, but only 70 % of youths continue on to secondary school. A quarter of students attend universities or colleges. The UNESCO figures show that in OECD countries and many mid-income countries nearly 60 % of persons with university degrees are women. In China, the share is 40 %.

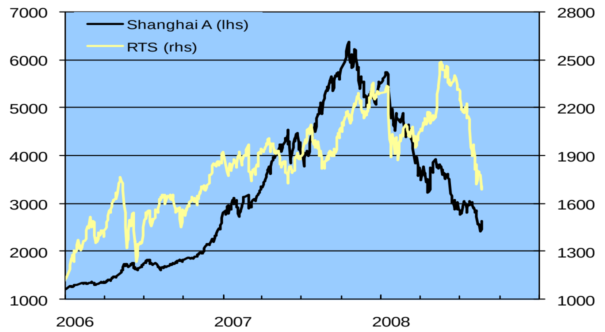
A 2005 survey of Chinese households identified spending on children's education as the top family spending item for the first time ever. The survey found that city-dwellers plow a quarter of their household incomes into education, while in rural areas families spend about a third. The trend reflects both the rise in the social prestige attached to education and the rising costs of schooling. In 2005, families in China had to spend an average of 3,500 yuan (€320) a year on the comprehensive school education of the children. Last year, the tuition for a semester at most state universities ranged between 5,000 and 10,000 yuan (€460–920).

During 2002–2006, budget figures show China invested about 2.2 % of GDP in education, or about half of the average in Latin America. The corresponding shares for 2006 were about 3.8 % for Russia and 7.1 % for Finland. China's central administration has boosted spending on education from 30 billion to 160 billion yuan (€15 billion) over the past two years and it has set a target for education spending at 4 % of GDP. Local administrations currently contribute about 90 % of education spending. Since no local spending figures are available after 2006, however, it is hard to say how much China has spent on education recently. According to some estimates, education spending rose slightly last year to nearly 3 % of GDP.

The statistics on education system and its finance are deficient in many respects. For example, a significant share of general operating costs and construction investment are not shown in budget figures, but the finance ministry considers them as investments to education in other contexts. Moreover, the Chinese officials and international organizations release different, often contradictory, figures on education spending.

Stock market decline continues; IPO enthusiasm wanes. The Shanghai and Shenzhen A-share indexes have fallen over 50 % since the start of the year, which in percentage terms represents one of the largest drops of any major exchanges in the world during the period. The money raised in IPOs on Chinese bourses in the first half of this year was about 40 % less than in 1H07. The approximately 100 listings in the first half of this year on the Shanghai and Shenzhen exchanges raised a total of about $13 billion for the firms concerned. PricewaterhouseCoopers estimates that IPOs on Chinese exchanges will only reach a value of about $37 billion in 2008 (the value of IPOs last year was about $65 billion). A large number of major state-owned companies held IPOs on Chinese stock exchanges in 2007.

Shanghai A-share index and Moscow RTS index



Source: Bloomberg

Sharp slowdown in Hong Kong's economic growth. In the second quarter of the year, Hong Kong's GDP grew 4.2 % y-o-y in real terms. The size of the economy, however, shrank 1.4 % from the first quarter – the first quarterly decline since the SARS crisis in 2002–2003. Slowdowns were most apparent in private consumption, investment and goods trade. Exports of services, vital to the Hong Kong economy, continued to rise rapidly, while there was a clear decline in the growth of service imports. Consumer prices in the special administrative region were up 6.1 % y-o-y in June. Hong Kong's economic growth is not expected to slow significantly further in second half of the year and real GDP growth is expected to hover in the range of 4–5 %.

It is feared that the downturn in Hong Kong's economic growth reflects weaker export prospects for mainland China as a significant share of mainland China's foreign trade moves through Hong Kong. However, statistics do not support this view and there have been no signs of a substantial slowing in mainland China's exports, despite the overall slowdown in the global economy. A recent survey for major industrial enterprises by the People's Bank of China found that most companies still see a positive outlook for export.

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Russia

Government goes with plan for relatively modest growth in public spending in coming years. On August 21, the government approved a detailed budget proposal for 2009 and preliminary budgets for the following two years. The proposals, which are more detailed versions of the budget framework approved by the cabinet at the beginning of July, are essentially the original proposals of the finance ministry. Proposed additional spending by other ministries was apparently rejected.

Thus, the view of the finance ministry, which sees fighting inflation as the top priority in economic policy, seems to prevail at present and also enjoy the support of prime minister Vladimir Putin. The economy ministry, the chief opponent to the finance ministry's position, has called for substantial increases in public sector investment in order to diminish the gap between Russia and the countries with more advanced production technologies.

The proposed budget for next year features large increases in spending on pensions, health care and education as well as a rise in investment in infrastructure. Spending on health care will increase 35 % in nominal terms, while spending on education will go up 26 %. The budget surplus for next year is supposed to be 3.7 % of GDP.

During the budget discussions, finance minister Alexei Kudrin proposed that, beginning in 2010, all federal oil-related revenues collected in the national prosperity fund be applied to pensions as pension fund assets will be inadequate to cover rising expenditure levels. Since even these resources will still be inadequate to meet the growing pension obligations, direct budget support will also be required. Transfers from the federal budget to the pension fund over the next three years should be the fastest growing expenditure category.

Because of the large spending required for, e.g. pensions, the finance ministry opposes persistent demands for a lowering of the value-added tax. A lower VAT has been pushed by the economy ministry and the business community, and it was also promised by candidate Dmitri Medvedev in a speech during the presidential campaign. The VAT reduction now appears unlikely any time soon, as it is not included in the cabinet's approved draft budget.

The budget proposals are next considered by the Duma.

Cabinet approves CBR's monetary policy proposal for 2009–2011. The Central Bank of Russia's monetary policy programme and the government's budget proposal for 2009–2011 together form the basis for medium term economic policy. Both documents use the same assumptions on economic trends.

According to media reports the monetary policy framework sets fighting inflation as the major objective of the central bank. The CBR will target 12-month inflation rates in the range of 7.5–8.5 % next year, 5.5–7.0 % in 2010 and 5.0–6.8 % in 2011.

By 2011, the plan is that CBR monetary policy implementation will be largely based on inflation targeting. For the first time, the monetary policy framework did not set any concrete limits on rouble appreciation. The CBR will gradually reduce currency market interventions and allow the rouble's exchange rate form more freely. During the transition, the CBR will continue to use a dollar-euro currency basket as its operative indicator of its rouble exchange rate policy.

Lower pressures for appreciation of the rouble's nominal exchange rate should ease the shift to a free-floating currency regime. The CBR says Russia could be running current account deficits within a few years. To sustain a current account surplus in 2010 and 2011, for example, the price of crude oil must stay well above $100/bbl.

Foreign companies investing in strategic branches now required to submit detailed business plans. The Federal Antimonopoly Service (FAS), which now administers applications of foreign companies seeking to invest in companies operating in Russia's strategic branches, has published more detailed instructions on what an application should contain. A foreign investor seeking a majority stake in a company in a strategic branch needs to submit a detailed business plan to officials. The plan should include an overview of the investment project, describe the goods or services produced, give industrial and risk analyses, sales projections, plans for marketing, production and financing as well as a profitability estimate. These categories include, among others, an estimate of the value of the project and the project's implementation schedule. They should note product pricing principles and cost structures, as well as the impacts of the project on employment and the environment.

The law, which entered into force in May, requires that foreign investors first apply to qualify as an investor when they intend to acquire a majority stake in an enterprise in a strategic branch (see *BOFIT Weekly 19/2008* and *29/2008*). To date, three companies have submitted application to the FAS. One application has been returned for lack of specificity. Once the FAS and other responsible agencies (e.g. Federal Security Service) have reviewed the applications, they will be forwarded to a cabinet commission led by prime minister Putin for approval or rejection. The commission is expected to meet for the first time in mid-September. Its first decisions should indicate how the new law will be applied.

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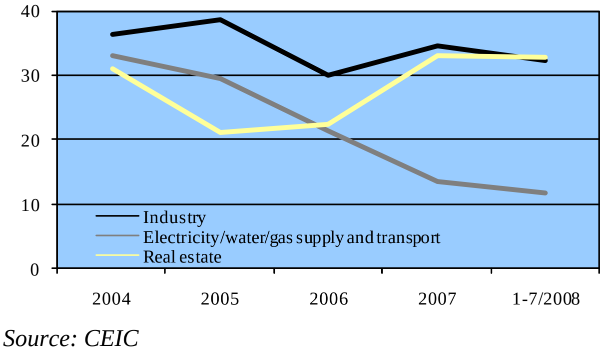
China

Investment rising fastest in China's interior provinces. Media reports that suggest companies are moving their operations inland in response to rising cost levels in coastal provinces have been bolstered by official data that show fixed capital investment has grown fastest this year in interior provinces. Most notably, purchases of machinery and equipment have been intense throughout Central China. For example, in Jiangxi province, which lies inland between the traditional growth centres of Shanghai and Guangzhou, purchases of machinery and equipment nearly doubled in January-July from the same period a year earlier.

For all of China, the monthly data show real on-year growth in investment slowed during January-July to 15 %, down from over 20 % in the same period in 2007. While nominal growth in investment is still very high, the rise in building costs has eroded investment volumes. There are also faint signs that the credit restrictions imposed at the end of last year have dampened investment. The share of credit-financed investment projects of overall investment has fallen slightly, while the shares of out-of-pocket and state financing have increased. Although the ongoing restructuring of China's economy and continuing migration from the countryside to cities will increase China's investment needs, corporate enthusiasm for investment is likely to be limited somewhat in coming months by lower growth in company profits and a weakened outlook for exports. Anecdotal evidence from the real estate sector suggests falling apartment prices and longer selling times for new apartments, a situation that may lead to lower growth in housing construction. The growth outlooks, however, vary widely from province to province and city to city. The volume of public projects in contrast is expected to increase if China's leaders start actively pursuing policies to fight flagging economic growth.

Nominal growth in fixed capital investment in selected sectors, % change from a year earlier



Source: CEIC

In urban areas, about a third of investment went to industry and another quarter to the real estate sector. Growth of investment in the transport sector as well as in energy and water supply has slowed this year; their combined share is now about 15 % of total investment. Growth in industrial investment has slowed most in branches where export prospects have dimmed (e.g. manufacture of textiles, footwear and sport equipment). Investment growth has accelerated this year in manufacture of machinery and equipment, and metals and fuel industries.

Corporate profits continue to make robust gains. Rapid economic growth and a lowering of the corporate income tax for domestic firms at the start of the year have helped sustain brisk profitability growth of Chinese firms (even if the rate of growth in profits was below last year's rate). The National Bureau of Statistics reports that profits of large companies in January-May grew an average of 21 % y-o-y to 1,100 billion yuan (about €100 billion). Growth in the profits of China's state-owned firms stagnated, however. Profits of foreign-owned companies and joint ventures grew at the average rate.

Corporate profits rose fastest in those fields where the end-product prices have risen sharply over the past 12 months. For example, profits of producers of coal, iron ore, oil and foodstuffs climbed 40–220 % y-o-y. On the other hand, losses in industrial branches were largely concentrated in fields where prices of raw material inputs have risen rapidly and prices of end-products are strictly regulated. For example, oil refiners posted record losses and the large electrical power producers have declared billions of yuan in losses.

China's banking sector, which saw a higher-than-expected rise in profits in 1H08, seems somewhat immune to the malaise afflicting international financial markets. Some mid-sized banks saw profits over double, while large, mostly state-owned, banks experienced profit gains of 40–70 % y-o-y. According to media reports, China's largest bank, the Industrial and Commercial Bank of China (ICBC), posted the largest profits of any bank in the world during the first half of this year (65 billion yuan or €6 billion). Among the large state banks, the Bank of China has yet to publish its first-half financial results.

Although the official profitability figures put out by Chinese companies are notoriously opaque, the fact that companies are making more money is backed up by the central bank's quarterly survey of firms. Chinese companies need strong profitability as most companies still finance most of their investments out of pocket.

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Russia

Georgia conflict reflected on Russian financial markets. The markets reacted to the start of the Georgia conflict and Russia's decision to recognise the independence of the South Ossetia and Abkhasia breakaway regions, although also other factors have increased uncertainty on the markets. Moscow's RTS index this week dipped below 1,600 points, down over a third from its all-time high in May. The decline in Russian stock markets began last May as it did on most emerging markets. Uncertainty about the Russian stock market has increased also with the global drop in oil prices and the problems of Russian metals giant Mechel and TNK-BP.

Central Bank of Russia chairman Sergei Ignatiev preliminarily estimates the outflow of capital in August was $5 billion. Analysts have, however, presented significantly higher estimates. The rouble has lost nearly 5 % of its value against the dollar since the start of the conflict with Georgia, but in recent weeks many other major currencies have also been dropping against the dollar. Interbank rates are still a couple percentage points higher than earlier this year.

To date, the Georgian conflict has had no impact on Russia's budget policies. Over the longer term, the conflict could affect Russia's integration into the global economy, including prolonging Russia's WTO negotiations. The EU decided at the beginning of the week to postpone negotiations of the new partnership and cooperation agreement until Russia pulls its troops out of Georgia. In addition, the conflict could influence the influx of immigrants into Russia and thus worker availability in an already rather tight labour market. According to media reports, Russia has announced it would cease granting visas to Georgians, as Georgia has severed diplomatic relations with Russia.

Russia reconsiders its WTO commitments. Prime minister Vladimir Putin last week called for Russia to abandon some commitments made in its WTO membership talks. He noted Russia already bears the economic consequences of its commitments without enjoying any of the benefits. Putin said Russia wants to continue WTO talks, but at its own pace and without further impairing the country's competitive advantages. Putin's statement was seen as a counterpunch to the US announcement that it wants to delay Russian WTO membership due to the Georgia conflict.

A working group appointed by first deputy prime minister Igor Shuvalov, who is responsible for foreign economic relations, is currently putting together a list of agreements already signed as part of the WTO accession process that Russia can repudiate as long as membership talks continue. Russia has been engaged in WTO membership talks for 15 years.

Agriculture minister Alexei Gordeyev said the meat import quotas it agreed to three years ago in WTO discussions could be reduced, while import tariffs on milk products could be increased. According to media reports, other agreements affected could include grain export tariffs, aviation technology import tariffs, and intellectual property rights. Agreements concerning banking and insurance sectors are also under review. Shuvalov announced Russia would begin talks with its most important trading partners on suspending agreements it sees as detrimental to the Russian economy until such time as Russia is admitted as a WTO member.

At the start of the week, Igor Shuvalov tasked various ministries to prepare measures to protect the Russian market against goods entering via Ukraine. Ukraine joined the WTO in May, and it is possible Russia will end or cut back the scope of its free-trade agreement with Ukraine.

Georgia's critical role as a channel for energy exporters. Although Georgia is poor in terms of energy resources, it has become a major transit country for oil and gas, especially Azeri output. In 2006, the Baku-Tbilisi-Ceyhan (BTC) oil pipeline was opened. It carries up to a million barrels a day of Caspian Sea oil to the Turkish port of Ceyhan on the shore of the Mediterranean Sea. In 2007, the Baku-Tbilisi-Erzurum gas pipeline (South Caucasus Gas Pipeline, SCP) was opened. It can potentially supply up to 20 billion cubic metres of gas a year to the Georgian and Turkish markets. International energy giant BP operates both pipelines.

Georgia has three major ports on the Black Sea: Supsa, Batumi and Poti. The BP-led consortium also administers the Baku-Supsa oil pipeline (Western Route Export Pipeline), which has been undergoing maintenance since 2006. In addition to pipeline transmission, an increasing amount of oil is being transported by rail from Baku to Supsa, Batumi and Poti. Some Kazakh oil is also exported to the world market via the Port of Batumi.

Military activities in Georgia have not affected pipeline transmission through Georgia. BP shut down the BTC pipeline already in July due to an explosion on the Turkish leg. The Georgia leg was unaffected and continues to operate at full capacity. However, a bridge critical to rail shipment was badly damaged in mid-August. The ongoing repair work should take several weeks. It will take months to restore sea shipments to the pre-conflict level.

For years a consortium of European gas companies has planned construction of the Nabucco gas pipeline from Georgia through Turkey to Austria. The goal of the EU-supported project is to reduce dependence of EU countries on gas imports coming from or through Russia. The consortium's management has given assurances that the project is moving ahead on schedule despite the Georgia conflict.

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China

Grain production keeps rising; new hikes on fertiliser export tariffs. Chinese officials now expect grain production overall to rise this year by 10 million tons to over 510 million tons. It will be the fifth year in a row that grain output has risen. Growth in production is expected in rice, wheat, corn and beans.

Officials also announced higher export tariffs on certain fertilizers. A large export tariff on fertiliser was already imposed earlier to assure availability on the domestic market. In early September, the export tariff on certain fertilisers was increased to 150 %, and officials announced that the export tariff on other fertilisers would remain at the 100 % level until the end of this year.

Chinese officials have actively sought to support domestic food production and keep prices of staple foods under control. China continues to hold to its principle of self-sufficiency in grain production. While the country still exports more grain than it imports, the net balances for certain grains and cereals have decreased in recent years.

Tracking the progress of China's gas and oil pipeline projects. Construction of a 7,000-kilometre natural gas pipeline running from Turkmenistan, Central Asia's largest gas producer, to China's eastern coast is underway. The pipeline travels through Uzbekistan and Kazakhstan to join up with China's natural gas grid in the Xinjiang province. While the part of the pipeline situated on Chinese territory is already completed, work on the Uzbekistan leg began just this summer. The first phase of the pipeline should be operational by the end of next year and full capacity reached by the end of 2011. The pipeline's annual capacity is 40 billion cubic metres of natural gas.

China and Turkmenistan recently agreed that the pipeline will supply gas at full capacity, instead of the previously agreed 30 billion cubic metres annually. Turkmenistan's ability to meet its end of the deal, however, is suspect; Turkmen domestic gas consumption and supply contracts with China and Russia far exceed its annual production capacity.

An oil pipeline with annual capacity of 10 million tons running from Kazakhstan to China was commissioned at the end of 2005. The pipeline can carry up to 5 million tons of Russian oil to China every year. The first phase of another oil pipeline, running to Russia's Pacific coast, should be completed before the end of next year. The pipeline has been under planning and construction for years. Its first phase extends to the city of Skovorodino near the Chinese border.

China and Myanmar are currently preparing a profitability analysis on a gas pipeline from the Bay of Bengal to the Yunnan province. China wants to get at Myanmar's natural gas reserves. Also under study is a plan to build an oil pipeline between China and Myanmar to speed up oil imports to China from Africa and the Middle East and avoid the problems of shipping oil by tanker through the Strait of Malacca.

In recent years, Chinese officials have promoted the use of natural gas. China last year produced 44 billion cubic metres of natural gas. The import of natural gas is still minimal, however. Last year less than 4 billion cubic metres of gas in the form of LNG was imported, mostly from Australia, with which China has long-term supply contracts. Preparation of import agreements with other countries has been complicated by China's strictly regulated gas retail prices, which have not been raised as quickly as the price of gas on the world market. Early this summer, however, China reached an agreement with Qatar that will assure China of 5 billion cubic metres in annual supplies over the next 25 years.

In January-July, China imported 100 million tons of crude oil. China's domestic oil production slightly exceeded imports. About 40 % of China's oil imports come from the Middle East, 27 % from Africa and 13 % from Russia and Kazakhstan combined.

National audit office again finds widespread mismanagement of public funds. In its 2007 audit, the national audit office found 117 cases of misused, embezzled or mismanaged state funds totaling billions of dollars. Nearly 90 persons have already been charged or convicted of embezzlement or misuse of funds. The abuses include falsification of budget accounts and under- and over-reporting of revenues and expenditures. Media reports claim problems were detected in e.g. the ministries of education and commerce, the National Bureau of Statistics and the State Administration of Taxation.

The auditors also detected misuse of 258 million yuan meant for disaster relief. In the 13 provinces examined, the audit office found funds were used to cover other public spending and construction of state offices. The extent of corruption in the Chinese economy is not captured in the audit office's report, as e.g. bribery of public officials is not included in abuse of public funds.

China's government treats the abuse of public funds and corruption as undermining the position and legitimacy of the communist party. The party has proposed an internal monitoring and called for increased supervision to avoid future abuses and misapplication of public funds. In the absence of an independent judiciary, however, there is no effective mechanism to pursue abuse cases. In Transparency International's 2007 Corruption Perception Index, China ranked 72 out of the 179 countries surveyed, putting it on par with India and Brazil. Finland topped the CPI as the world's least corrupt nation. Russia ranked 143rd.

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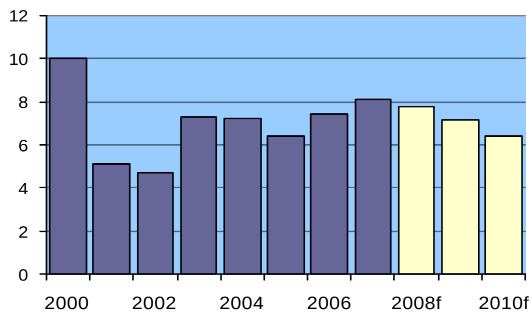
Russia

BOFIT forecast sees strong economic growth to continue in Russia. In our latest forecast, we see the Russian economy growing at a nearly 8 % annual rate this year and then gradually slowing to around 6 % in 2010. We expect rapid economic growth to be supported by oil prices substantially higher than last year. Although growth does not come directly from the oil sector, oil earnings stimulate growth in other branches.

Rising domestic demand remains the driver of economic growth. Growth in consumption and investment, while remaining brisk, is projected to slow gradually. Export growth will continue to decelerate somewhat, while import growth will remain robust in coming years.

Economic growth could be impaired if oil prices continue to decline from present levels. Moreover, ongoing high inflation and capacity constraints could also potentially limit growth. Uncertainty on Russian financial markets has been heightened recently due to the Georgian conflict and other negative factors.

Realised and forecast real GDP growth 2000–2010, %



Sources: Rosstat, BOFIT forecasts 2008–2010

Inflation remains high; monopoly pricing under investigation. In August consumer prices were up 15 % from a year earlier. The inflation rate has remained at approximately the same level since May. Inflation was expected to decline a bit in August with the seasonal drop in prices of fruits and vegetables, but a sharp rise in meat prices sustained inflation.

Industrial producer prices have been rising faster than consumer prices (the 12-month rise in July was 34 %). The sharpest (over 50 % y-o-y) increases were seen in producer prices for coking coal and oil products. Producer prices in the chemical industry were up over 40 % and in the metal industry over 20 %.

Prime minister Vladimir Putin and his government have implemented measures to rein in soaring prices. Last month, Putin condemned Russian metals and coal-mining giant Mechel for its high prices. Last week, the company was fined 790 million roubles (€22 million) by the Federal Antimonopoly Service for abuse of its dominant market position. Mechel was also required to lower its prices for coking coal by 15 %. At the government's direction, producers of coal and metals have begun to sign longer-term supply contracts. The government hopes this will eliminate some of the prevailing price volatility.

In response to first deputy prime minister Viktor Zubkov's August threat that the government would double or triple the export tariffs, producers of mineral fertilisers agreed to freeze the domestic prices until the end of the year. Up next on the government agenda is an investigation into price formation of building materials and oil products.

This summer, the government focused its attention on Gazprom's monopoly on pipeline transmission. As a result, the Federal Antimonopoly Service imposed its first fine on Gazprom for preventing other gas producers from using the pipeline grid to transport their gas.

Tightness in money market continues. The rouble lost another 2 % of its value in the past week against the Central Bank of Russia's euro-dollar currency basket. The CBR continues to intervene in the markets to prop up the rouble. Analysts estimate a net capital outflow of $20 billion from Russia since the start of the Georgia conflict. The CBR puts the figure for capital flight in August at just $5 billion and expects the net capital flow in September to approach zero. The CBR has announced it has no plans to further expand the rouble's fluctuation band relative to the currency basket. Rouble support purchases decreased the CBR's currency reserves by $24 billion, leaving the balance at $574 billion in the first week of September.

Investor jitters have also been reflected in interest rates. The overnight and 1-week Mosibor rates have been running about two percentage points above their pre-crisis levels. As it has become harder for banks and companies to borrow from abroad, demand for credit from the central bank has increased. The average rate at the CBR money market auction on Monday was 8.35 %, a level substantially higher than the 7 % repo rate, which sets the starting bid at auction. On Wednesday, the CBR injected over $10 billion more into the banking system in a response to deteriorating liquidity. Higher-than-usual demand has also been seen at finance ministry auctions this month.

The RTS index fell below the 1,400-mark for the first time in over two years, plummeting about 15 % over the week. The decline was so large, that even president Medvedev has tried to calm the market.

In addition to the Georgian conflict, Russia's financial markets have been rocked by the drop in oil prices and the problems experienced by Mechel. The price of Urals oil this week fell for the first time since spring to a level under $100 a barrel.

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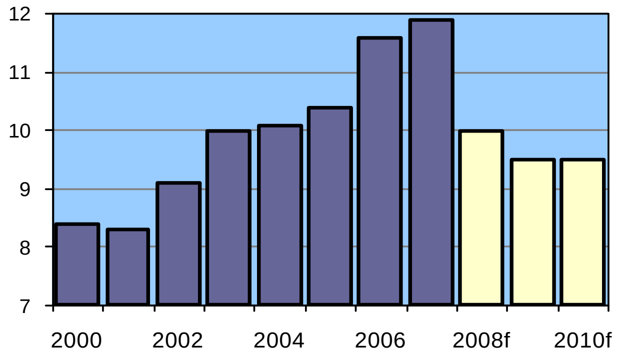
China

BOFIT forecast sees China's high GDP growth continuing. In our latest forecast for the Chinese economy, BOFIT economists have lowered the overall GDP growth projection for this year from an earlier 10.3 % to 10 % in recognition of deterioration of the global economic outlook. Growth will decline slightly next year to 9.5 % (previous forecast 10 %). The growth outlook for 2010 remains unchanged at 9.5 %. The slight deceleration in China's economic growth conforms to our earlier expectations, and the overall picture does not diverge significantly from previous BOFIT forecast.

Realised real GDP growth from 2000, forecasts to 2010



Sources: National Bureau of Statistics and BOFIT

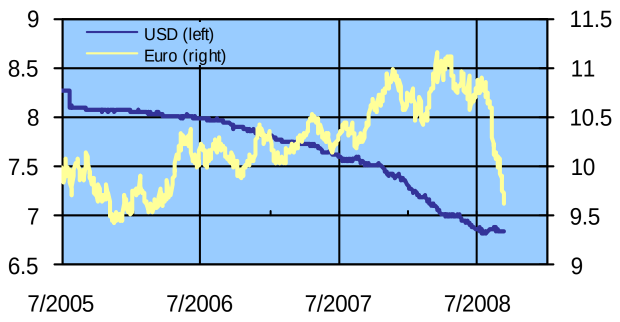
Since last year, lower growth in many countries has reduced growth in demand for Chinese products, so the contribution of foreign trade to China's economic growth has been reduced. As the government hoped, its tighter monetary stance has slowed real growth in investment. During the forecast period (2008–2010), the incentive for Chinese firms to invest may somewhat weaken as profitability recedes and export prospects decline. Domestic consumption demand is expected to remain strong, implying its importance as an engine of economic growth will increase in coming years. Employment and higher wage levels in cities, as well as larger farm incomes are expected to sustain consumer demand. Public consumption is also expected to pick up.

Implementing successful economic policies in the forecast period will be a challenge given the slowing in economic growth and rather high inflation. During the past two years, rising inflation forced China's leadership to tighten its monetary stance. It now appears the policy emphasis is shifting from fighting inflation to sustain economic growth and employment. One of the biggest risks in the coming three years is that rising uncertainty and soaring costs curtail investment and depress household consumption more than expected at a time when the danger of stoking inflation prohibits the use of economic stimulus policies.

Yuan continues to climb against euro. Although the yuan's decline against the euro halted last April, strong appreciation against the euro has only occurred in the last five weeks with the rapid readjustment of the euro-dollar exchange rate. The yuan has appreciated against the dollar at a more modest rate. Since early August, the value of the yuan relative to the dollar has been unchanged, while the yuan has appreciated about 10 % against the euro. Since the start of the year, the yuan has strengthened less than 8 % against the dollar and 12 % against the euro.

The People's Bank of China tightly controls the yuan-dollar exchange rate. When the dollar strengthens against the euro, the yuan inevitably follows suit. China's officials have increasingly expressed the view that excessively rapid appreciation of the yuan against the dollar needs to be avoided. The top concerns facing policymakers at the moment are how to sustain economic growth in environment of declining export prospects. Inflation has slightly receded as a major policy concern.

Yuan-dollar and yuan-euro exchange rates



Source: Reuters

While rise in consumer prices slows, producer price inflation is high. The rise in consumer prices slowed in August to 4.9 % y-o-y. The slowdown could be short-lived, however, as the rise in producer prices has continued to accelerate in recent months. August producer prices were up slightly over 10 % y-o-y. Over the last twelve months, producer prices for crude oil, refined oil products, coal and ferrous metals have risen 30–40 %.

A slowing rise in consumer prices and the decline of crude oil prices in recent weeks on international markets has increased calls for gradual relaxing of China's strictly regulated energy prices. Oil refiners and coal-fired power plant operators have been forced to take huge losses this year as increases in regulated electricity and fuel prices have failed to keep up with soaring prices for inputs.

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Russia

Government supports the finance sector. The troubles roiling international financial markets have increased uncertainty across all emerging markets, so unsurprisingly the liquidity situation in Russia's financial markets has been tight in recent days. The overnight interbank rate now exceeds 10 %, up from less than 6 % just a month ago.

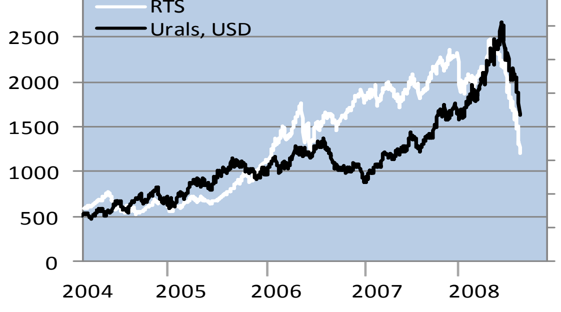
To ease the liquidity crunch, the finance ministry and the central bank have coordinated efforts to add liquidity to the banking system. On Wednesday (Sept. 17), the finance ministry announced it was depositing 1,126 billion roubles (€31 billion) of budget funds in Russia's three largest banks: Sberbank, VTB Bank and Gazprombank (the state holds a majority stake in all three banks). The idea is that these banks, in turn, will distribute liquidity among smaller banks via the interbank market.

On Thursday (Sept. 18), the CBR lowered its key reference rates. The CBR also reduced bank reserve requirements by four percentage points temporarily until next February. President Medvedev also announced a further €14 billion would be made available to allow the stock exchange to reopen today (Sept. 19).

Russia has an on-going discussion on where to invest money from the national prosperity fund (money derived from taxes on oil and gas earnings). Recently, the debate has focused on whether assets should be used to buy domestic shares to prop up the stock market. Finance minister Alexei Kudrin indicated a proposal on expanding fund investment policies will be ready this month, and that some money could be invested in shares of foreign firms once international financial markets calm down. There are no plans at the moment to invest in domestic shares.

Russian stock market plunges as crude oil price tanks. The dollar-denominated RTS index lost about 15 % of its value during the week. Trading was halted Wednesday and again on Thursday, when the index was down about 50 % from its all-time high of May 2008.

RTS index and Urals oil price



Sources: RTS, Bloomberg

The stock market decline has been driven in part by the drop in crude oil prices. The average price of oil has fallen from above $140 a barrel this summer to below $90 a barrel this week (about the same level as in January 2008). The sensitivity of the RTS index to oil prices reflects the fact that over half of the index consists of oil companies or other raw commodity producers.

The trend on other emerging markets has been similar. For example, the Shanghai stock exchange A-share index this week was off about 60 % from its recent all-time high.

Record grain harvest expected; state grain export company to be established. The agriculture ministry estimates this year's grain harvest will reach about 95 million tons, 13 million tons more than in 2007. By some estimates, the harvest could exceed 100 million tons.

About 71 million tons of grain will be used domestically, while exports are estimated to amount to about 18 million tons (valued at $5 billion). Russia initiated grain exports in 2002 and has quickly risen to become the world's third largest grain exporter. In recent years, about 15 % of Russia's grain harvest has gone to exports.

The government has decided to establish a major state cereals trading company under the Agency for the Regulation of Food Markets. The new corporation will take over the state ownership stakes in 28 companies (including a Novosibirsk baked goods group and a harbour export terminal). The plan would make the company Russia's largest cereal exporter. The company is expected to account for 40–50 % of Russian grain export by 2011. The plan has yet to be approved by the Federal Antimonopoly Service.

Finnish-Russian trade continued to expand rapidly in 1H08. The value of Finnish exports to Russia increased 23 % y-o-y and imports 35 %. Finland's total exports increased 4 % in 1H08 and all imports 6 %.

The rapid growth in Finnish imports from Russia was due largely to the first-half rise in oil prices. The value of raw wood imports also climbed nearly 50 %, although the volume was up just 3 %. Russia accounted for 17 % of Finnish imports in the first half.

The growth in Finnish exports to Russia has accelerated sharply from last year. The rapid growth in Russian investment demand is reflected in Finnish exports, which consist mainly of investment goods. Growth in exports of passenger cars also accelerated notably, but they are actually imported from elsewhere and then re-exported to Russia.

Transit freight moving through Finland to Russia increased about 10 % y-o-y in the first half of this year – both in terms of value and tonnage. The combined value of Finnish exports to Russia and transit freight amounts to over a fifth of Russia's total imports.

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China

China's central bank relaxes its monetary stance. On Monday (Sept. 15), the People's Bank of China announced it was lowering its benchmark lending rates, while keeping the benchmark deposit rates unchanged. The rate cut, the first since 2002, went into effect the following day making the benchmark rate on one-year loan 7.20 % (previously 7.47 %). The rate cut coincided with efforts of central banks across Asia to boost money market liquidity in the face of market jitters caused by the problems at US investment banks.

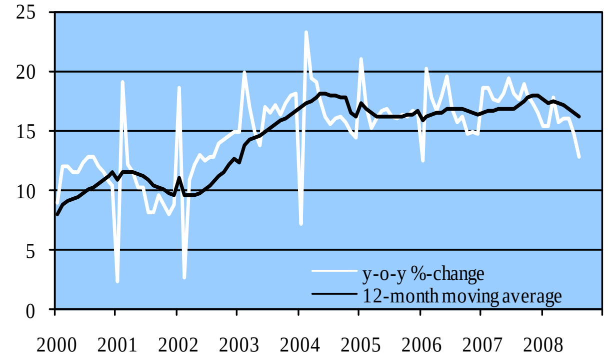
The PBoC also relaxed its monetary stance by lowering reserve requirements for small and mid-sized banks by one percentage point to 16.5 %. The change in the reserve requirement does not apply to the four large state banks, the Bank of Communications or the Postal Savings Bank of China. The reserve requirements of small banks in areas affected by the May earthquake were reduced an extra percentage point. In recent years, the central bank has relied on the reserve requirement as a key monetary tool, raising the reserve requirement 16 times since the beginning of 2007.

The loosening of the monetary policy reflects the view of Chinese policymakers that high inflation is a smaller issue relative to the challenge of sustaining economic growth. In fact, consumer price inflation (y-o-y) has fallen since peaking at nearly 9 % in February to below 5 % in August. Producer price inflation, however, continues to run at about 10 %. A slowing in expansion of the broad money supply (M2) in recent months suggests future inflationary pressures may be waning. August M2 growth was 16 % y-o-y.

Industrial output growth slows. According to China's National Bureau of Statistics, industrial output rose 12.8 % y-o-y in August – a further decline from the 14.7 % July figure. Real growth has been slowing for months. Moreover, there have been indications real growth in fixed capital investment is slowing. Changes in industrial inventories in the latest second-quarter figures give a muddled picture. January-August figures show growth in China's exports, especially to the United States, slowed from a year earlier, which may be further reinforced by the deterioration in the global economy. Retail sales figures (which give an idea of Chinese consumer demand) for August, revealed no evidence of faltering domestic demand; real growth in retail sales actually accelerated.

The lower figures for late summer include a period of production restrictions imposed during the Beijing Olympics and track events in a period of unusually high economic uncertainty. In any case, it is clears industrial output growth has been slowing for months. The weaker key indicators for real economy performance have increased government discussions on the need for fiscal policy measures to stimulate the economy.

Industrial output growth in 2000s, %



Sources: NBS and BOFIT own calculations

China continues to favour domestic carmakers. At the beginning of September, China increased the import tariff on cars with large engines (volumes of 3.0 litres and above) by 10–20 percentage points. The tariff on cars with small engines (volumes under 1.0 litre) was reduced by two percentage points. A third of imported cars last year had large engines, while imported cars with small engines were very rare. According to officials, the changes were made to reduce energy consumption and environmental impact. The actual environmental benefits, however, will be negligible as foreign imports accounted for only 3 % of the passenger cars sold in China last year. Due to rapid market growth and incentives from Chinese officials, nearly all large international carmakers have production in China where they operate through joint ventures.

In spring 2006, the EU, Canada, and the US filed a complaint with the WTO on China's interpretation of the import duty rules for car parts. China says it will appeal the WTO's July ruling that its rules for imported car parts violate China's WTO obligations. When imported car parts account for 60 % or more of the value of a car assembled in China, China taxes the car parts at the same tax rate as it does for a finished foreign import. The tax on car parts, when interpreted at the whole-car rate, is 15 percentage points higher than for normal imported car parts. A final ruling on the matter is expected by next spring at latest.

In China, slightly over 3 million passenger cars were produced during January-July. The pace of car sales, however, has fallen off slightly in recent months. Lower figures for late summer were likely affected by the Beijing Olympics, which were closely followed by most Chinese, and a near 20 % hike in fuel prices.

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Russia

Financial markets calmer this week. As of Thursday (Sept. 25), the RTS index had recovered 23 % from its lows last week. Interbank rates were also down and on Thursday the overnight lending rate stood above 5 % – a level last recorded at the beginning of September.

The cabinet decided last week to buy up, as needed, shares in domestic (mainly majority state-owned) companies this year and next year to prop up the stock market. Up to 500 billion roubles (€14 billion) will be made available for share purchases. The idea is to only hold the shares until the market improves.

Bank health varies. Russia's banking sector still breaks down into a core of large, financially sound banks at the top, and hundreds of small banks at the bottom, most offering a limited range of banking services. In between these, operate a tier of about thirty mid-sized banks, along with some smaller regional banks that have local significance as banking providers. The sector suffers from banks' basic distrust of each other and the inability of the interbank markets to distribute liquidity efficiently. As a result, small banks are often shut out from access to finance and thus are the first to experience tight liquidity in times of economic stress. Due to the prevailing mistrust, banks are little connected to each other, which ironically reduces the danger of contagion when a bank gets into trouble.

Last week, for example, small banks were completely shut out of the interbank market and even mid-sized banks found themselves being charged about 20 % for overnight borrowing. The situation eased towards the end of the week, due in part to the fact that the central bank lowered reserve requirements. The finance ministry this week arranged three auctions, in which it offered 1.1 billion roubles in the form of 1-week to 3-month deposits with the 28 largest banks. The government's ceiling for this kind of operations is 1.5 billion roubles (€40 billion). The banks receiving money are supposed to make the money available on the interbank market. Demand for money at the auctions, however, was tepid, and the third auction was cancelled when no bids were submitted.

The maximum deposit insurance on retail deposits is to be increased from 400,000 to 700,000 roubles (€19,000). An amendment to this effect of the deposit insurance law was submitted last week to the Duma. The aim of the amendment is to lessen possible worries among depositors about deposits' safety. Beginning next month, Russia's Deposit Insurance Agency will lower the mandatory payments of banks to the deposit insurance fund to help boost bank liquidity.

The sale of two private banks is in progress. Investment bank KIT Finance and Sviaz-Bank got into trouble last week when the value of shares that they had used as collateral for loans collapsed during the stock market downturn. In terms of total assets, KIT Finance is Russia's 25th largest bank and Sviaz-Bank is number 20. State development bank VEB will buy Sviaz-Bank, while the sale of KIT Finance is still under discussion.

Further changes in taxation under consideration. The government has decided to change the value-added tax payment schedule from the beginning of October. Under the new arrangement, companies will pay VAT monthly rather than quarterly. The idea is to spread out payments in order to avoid liquidity crunches on the markets caused by large payments. One of the special features of the Russian financial sector is that money tightens and interest rates rise when tax or other major payments are due.

Prime minister Vladimir Putin announced that the current state of the financing market has taken any plans of lowering the VAT from 18 % to 12 % off the table until next year. Both the prime minister and the president support VAT reduction in principle. In place of the VAT cut, changes in corporate taxation are planned for 2010, including an easing of depreciation rules. In addition, the tax-exempt status of dividends paid by subsidiaries and rules on belated tax payments will be simplified.

Further tax incentives to boost oil production in addition to tax breaks implemented this spring and last week are under consideration. The government is currently working to resolve the differences of the finance ministry and the energy ministry on these issues.

Fairly rapid growth continues. Retail sales growth, a reflection of consumer demand, was up 15 % y-o-y in January-August. The pace of growth was about the same as last year. Growth was supported by accelerating wage growth in late summer. Real wages climbed nearly 16 % y-o-y in August. Consumption was also supported by a robust employment situation. According to preliminary estimates, the unemployment rate was at end-August just above 5 %.

Growth in fixed capital investment has clearly slowed, however. In January-August, fixed capital investment increased 13 % (growth in the same period a year earlier was 23 %). The slowing appears to reflect lower growth in housing construction, which, despite a modest revival in recent months, only grew in January-August at a rate of 5 % y-o-y. Overall growth in the construction sector, however, remained at 18 %, or nearly the same level as during the same period a year ago.

Growth in industrial output revived slightly from June's bottom. Growth in January-August amounted to more than 5 % y-o-y. Manufacturing, which rose nearly 8 % y-o-y, was the main driver of growth. Highest growth in manufacturing was seen in production of transport vehicles, as well as rubber and plastic products.

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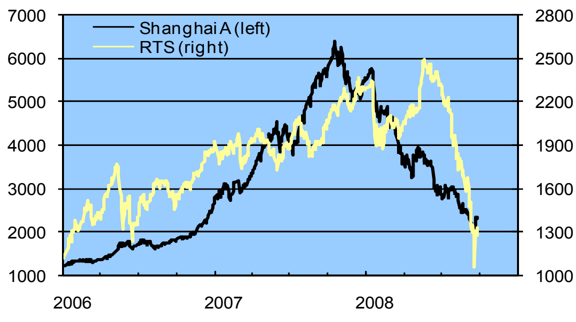
China

Officials move to prop up China's share markets. The long decline in Chinese share prices, which began last October, continued last week as Chinese shares reacted to uncertainty in international financial markets. In order to support share prices, Chinese authorities announced last week that they were eliminating the requirement that buyers pay a stamp tax on share trades. The stamp tax was already lowered in April from 0.3 % to 0.1 %. Officials also announced the Central Huijin Investment Company, which is part of China's sovereign wealth fund CIC, will purchase shares in three of the large state-majority-owned banks (China Construction Bank, Bank of China and Industrial and Commercial Bank of China).

Chinese share prices shot up on information of the official measures and plans of the US bailout package that would allow the US treasury to purchase troubled assets from financial institutions. Earlier official measures have mainly had only short-term effects on Chinese share prices. The stock markets may also have received a shot in the arm from the central bank's announcement at the beginning of last week that it would loosen its monetary stance. The Shanghai A-share index is still down more than 60 % from its all-time high of October 2007. Declining share prices have had little impact on real economy performance, and most notably consumer demand.

Share prices in Shanghai and Moscow



Source: Bloomberg

Seven Chinese banks announced they hold a total of $721 million on bonds or other receivables in the bankrupt Lehman Brothers investment bank. Hardest hit is China Construction Bank, whose exposure exceeds $190 million. Even so, the bonds only correspond to less than 0.02 % of the bank's total assets. Although the losses of China's commercial banks in investments in subprime paper are expected to be minor considering the size of the sector, the Bank of China, for example, said at the end of August that it had suffered losses of $1.9 billion from subprime-based securities. The Bank of China's first-half profits were up nearly 43 % y-o-y.

World Bank survey finds China more business-friendly; TI corruption ranking unchanged. According to the annual *Doing Business* survey of the World Bank Group and the International Finance Corporation, China's ranking as a pro-business reformer continues to rise. The latest survey puts China at 83rd (last year 90th) out of the 181 countries surveyed. Russia ranked 120 (112 last year). The top business-friendly country continued to be Singapore, while Hong Kong was in fourth place.

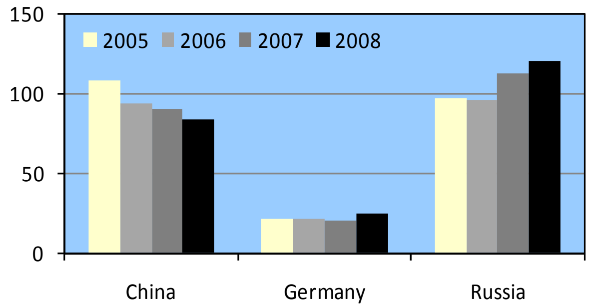
The survey compares the amounts of time and money consumed by firms in performing basic corporate functions such as employing workers and applying permits. China's ranking was lifted this year by reforms that give firms easier access to credit, reduce spending on contract enforcement and simplify taxation.

Despite the gains of China's business reform, there is still plenty of room for improvement. Setting up a business still requires an inordinate amount of permitting and capital by international standards, and permitting processes related to construction are extremely time-consuming. Small firms, in particular, still have difficulty obtaining credit, and officials are poor at providing information. In addition, officials' practices fluctuate widely across China's large cities.

Two weeks ago, the World Economic Forum published its first international *Financial Development Report*. China ranked 24th out of the 52 countries on the list. China won praise for the stability of its financial system, while special criticism was reserved for the institutional environment. Ironically in the current situation, the US was seen to have the world's most developed financial sector.

In its just-released 2008 *Corruption Perception Index* rankings, Transparency International puts China again in 72nd place, sharing that ranking with e.g. Mexico. This year's TI ranking included 180 countries. Denmark, New Zealand and Sweden tied for least corrupt, while Russia fell from 143rd to 147th place.

Business environment openness, rankings



Sources: World Bank and International Finance Corporation

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Russia

International uncertainty begins to hurt Russian economic growth. Finance minister Alexei Kudrin now expects the current international economic turmoil to lop off at least one percentage point from Russia's current GDP growth projections. Thus, GDP would grow at under 6 % in 2009 (official forecast still 6.7 %). Kudrin said further calculations would be needed to give a move accurate assessment of the situation. Arkady Dvorkovich, presidential advisor on economic policy, said that in the worst case Russian economic growth would slow to 5 % a year. This assumes a substantial drop in Chinese economic growth, which would sharply reduce demand for raw material inputs and energy on international markets.

Under the official government estimate, GDP should increase 7.8 % this year. Economy ministry figures for January-August show GDP rose at 7.7 % y-o-y in the first eight months of this year.

Several research institutions have cut their forecasts for Russian economic growth in lieu of the current international credit crunch. The IMF revised its 2008 GDP growth forecast downwards to 7.1 % (previously 7.8 %) and to 6.0–6.5 % for 2009 (previously 7.3 %). The IMF welcomed slowing growth as the Russian economy has shown clear signs of overheating.

Finance minister Kudrin said the budget should run a surplus as long as the price of oil remains above $70 a barrel.

CBR currency reserves down slightly. The foreign currency and gold reserves of the Central Bank of Russia were depleted by $35 billion or 6 % since their record peak in early August. At the end of last week, reserves stood at $563 billion, or about a third of Russian GDP. Russia has the world's third largest foreign currency and gold reserves after China and Japan.

CBR deputy chairman Alexei Ulyukayev said capital outflows in September were essentially unchanged from August, when the CBR valued capital outflows at $4.6 billion. The drop in crude oil prices has reduced the flow of foreign currency into the country. In addition to capital and trade flows, the size of the reserves has been influenced by swings in exchange rates, as Russia's reserves are composed mainly of two currencies, dollars and euros. The euro declined more than 2 % against the dollar in September.

New government measures to support the finance sector. On Monday (Sept. 29), prime minister Vladimir Putin announced new measures to support banks and other private businesses in the event they run into difficulties.

He said the state is prepared to loan up to $50 billion of the country's foreign currency reserves to the private sector to help in the refinancing of their foreign borrowing. The money will be lent out via the state development bank Vnesheconombank. According to the CBR, debt-servicing costs to the private sector in the final quarter of this year will reach about $40 billion, of which a third will be shouldered by the banking sector and two-thirds by other corporations. In addition to the $50 tranche, 75 billion roubles ($3 billion) of the government's earlier-announced 250-billion-rouble ($10 billion) 2008 stock market support package will be dedicated to bolstering Vnesheconombank's capital.

The CBR is preparing regulatory changes that would make central bank financing available to commercial banks without collateral. Central bank deputy chairman Alexei Ulyukaev said the number of banks eligible for central bank funds could be raised from the current 28 to 116. The CBR is also prepared to cover risk in Russia's interbank markets. News media reports say that the central bank would guarantee the losses of at least the three largest state controlled banks in the event of defaults by counterparty banks on the interbank market.

Finance ministry prepares principles on investment and use of assets in the National Welfare Fund. President Dmitri Medvedev last May asked the finance ministry to prepare a policy proposal on managing National Welfare Fund asset. The Fund is financed with federal tax and resource fee income from oil and gas production, as well as export tariffs.

According to preliminary information, the finance ministry is proposing diversification of Fund investments into riskier assets: 50 % in publicly traded shares and 30 % in bonds. 5 % of assets could even be invested directly to gain a greater say in company affairs than simple portfolio investment. Investments would target G-7 countries and certain emerging markets. Invested assets would be handled by a state company, which in turn would select asset management companies. Currently, most Fund assets are invested by the central bank like the rest of its foreign currency reserves, i.e. in highly liquid, low-risk, low-yield treasuries.

Asset investment evidently would not have extremely long horizons as the finance ministry has proposed that Fund capital will be used in coming years to fund Russia pension system.

At the end of September, the value of the National Welfare Fund was 1,229 billion roubles ($49 billion). The pace of asset transfers into the Fund increases towards the end of the year. The finance ministry currently expects the Fund value will climb to nearly $100 billion by the end of this year. The state's other stabilisation fund, the Reserve Fund, currently holds assets of 3,559 billion roubles ($141 billion). Money in the Reserve Fund is available for covering budget expenditure during times when tax revenues drop significantly.

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China

China embarks on second major economic census of business activity. Between October and December, China will implement its second major economic census. The census is planned to take place every five years. An estimated 8 million manufacturing companies and altogether over 30 million private enterprises will participate in the census. The census mainly focuses on obtaining information about smaller firms involved in industry, construction, and the service sector, because these play a significant role in overall employment. It has been discussed in public that tighter monetary policy and a decaying export outlook have hit small and medium-sized businesses harder than large firms. Besides employment, the census also looks at e.g. company production and capacity, energy consumption and financial condition. The census data are used to verify the reliability of other macroeconomic data and in setting economic policy.

The results of the first census were published at the end of 2005. The results led to an upward revision of China's GDP figures by 17 % after the discovery that the official estimate of the size of the service sector had been too small. The service sector (tertiary industry) was found to contribute a ten-percentage-point larger share of GDP than before the census, while industry's share of GDP was revised down seven percentage points.

There has been a wide discussion of China's GDP revisions in the literature. It has been noted that the first census provided support for the provincial GDP figures whose sum had previously often exceeded the reported national total. Prior to the first census the provincial figures had mainly been claimed to be exaggerated by Chinese officials.

EU-China Joint Economic and Trade Committee meets to discuss trade and investment issues. EU trade commissioner Peter Mandelson and Chinese trade minister Chen Deming met last week in Beijing for the annual EU-China Joint Economic and Trade Committee meeting. The parties agreed on some specific issues related to technology transfer, agricultural trade, intellectual property rights, China's cosmetics regulatory standards and import of active pharmaceutical ingredients into China. They also discussed an initiative concerning sustainable development policies. Mandelson expressed concern about declining direct investment in China by European firms. The EU Commission claims that European firms operating in China have been subject to theft of their intellectual property, capricious oversight of corporate acquisitions, high licensing fees and practices that force European companies to enter into joint ventures with Chinese parties.

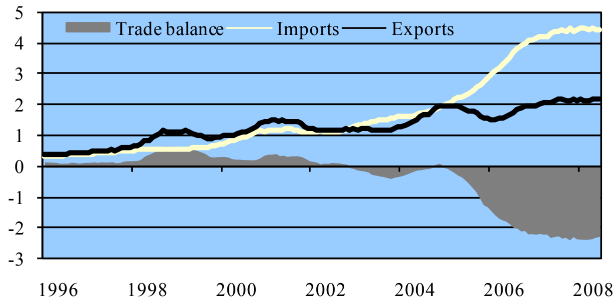
While the EU remains China's largest trade partner, the EU's share of China's FDI inflows has declined from 11 % at the start of the decade to 5 % in the first eight months of this year. Last year, China was the EU's largest import provider and fourth largest export market after the US, Switzerland and Russia.

Slowing growth in Finnish-Chinese goods trade. Customs Finland valued January-June Finnish exports to China at €1.1 billion, an increase of 3.7 % from 1H07. Import growth effectively ceased with a value of imports in 1H08 of €2.1 billion, down about 2 % from 1H07. The slowdown in trade growth was already evident in late 2007. Finland has run a trade deficit with China for several years now; in the first half of this year, the deficit was about €1 billion. The trade deficit contracted nearly 8 % from 1H07.

Machinery and equipment remains the top export category, accounting for nearly 66 % of the total value of Finnish exports to China. Machinery and equipment constituted a similar share of Finland's imports from China (68 %). The second largest goods import category was clothing (10 %). The value of both categories was up slightly from the first half of last year. No Chinese milk products are sold in Finland, as the EU has banned the import of Chinese milk products since 2002. Last week, the EU decided to limit imports of products containing any milk from China (notably prohibiting products for children containing any milk). Finland imports very little food from China (less than 0.5 % of the value of total China imports).

China is Finland's most important Asian trade partner. Chinese products account for 6.6 % of Finland's total imports and China ranks as Finland's fourth largest source of imports. Some 3.3 % of Finnish exports go to China. January-June figures show China dropped two places among Finnish export destinations to tenth place.

Finland's goods trade with China, 12-month moving average, € billion



Source: Customs Finland

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Russia

Share price swings on Moscow stock exchanges give new meaning to the term "volatility." The dollar-denominated RTS index blew off about 25 % of its value over the past week, putting it down over 60 % from the start of the year. The stock exchange has been closed several times recently as share prices rollercoastered above and below trading limits.

The hardest hit branches have been the metal and extractive industries, both down about 65 % since January. Retail sales have fared best, losing about 50 % of their value. Share prices have also declined sharply on other emerging markets.

Government announces further measures to support Russian finance sector. President Dmitri Medvedev announced more aid for the banking sector on Tuesday (Oct. 7). The government committed to providing long-term subordinated loans of at least five years of maturity. The value of the aid is 950 billion roubles (€26.7 billion), corresponding to roughly a third of Russia's entire banking-sector capital. Finance minister Alexei Kudrin says part of the rescue package may be covered with money from the National Welfare Fund.

Under the plan, Sberbank will get 500 billion roubles in direct financing from the central bank. 200 billion roubles will be transferred to VTB and 25 billion roubles to Rosselhozbank via Vnesheconombank. The remaining 225 billion roubles will go to other rated banks. For these other banks, the state capital infusion is limited to 15 % of the bank's total capital. Bank owners must also pony up a sum equal to at least 30 % of the bank's capital. Drafts of the proposed legislation are to go to the Duma today.

The Duma approved the first reading of bills on the financial sector aid announced last week by the government. The second reading is today (Oct. 10).

Russia lending $4 billion to Iceland? Iceland's prime minister announced on Tuesday (Oct. 7) that his country will start negotiations with Russia next week on borrowing $4 billion from Russia. Russian finance minister Alexei Kudrin noted that Russia is open in principle to providing credit to Iceland.

High inflation continued in September. Consumer prices were up 15 % y-o-y last month. 12-month inflation has remained at the 15 % level since last spring, and food prices continue to soar. Prices on grain products are up 25–40 % y-o-y and milk products 25–30 %.

While prices have risen nearly 11 % since January, inflation is expected to slow towards the end of the year. The Central Bank of Russia expects 12-month inflation to fall to around 12 % by December.

The CBR says state-provided liquidity infusions to the financial markets may drive up the inflation rate by two percentage points over the current 2009 forecast. The government's 2009 budget plan targets a consumer inflation rate of 7.5–8.5 %.

Hefty current account surplus persists, capital account in balance. Preliminary balance-of-payments data from the CBR show a current account surplus for January-September of $91 billion, or about 8 % of GDP. This was nearly 80 % more than in the same period in 2007.

The capital account surplus, in contrast, fell to a mere $500 million from $59 billion in the same period last year. The capital account deficit in 3Q08 was $17 billion, compared to a deficit of $4 billion in 3Q07. Last year was, however, quite exceptional in terms of capital flows. Also, in the first quarter of 2008 the capital account was in deficit by as much as $19 billion.

Capital inflows from abroad to the banking sector fell 35 % y-o-y, and capital inflows to other branches of business were off 9 %. The decline for other business branches mainly reflected a reduction in credits from abroad. The problems in financial markets were most clearly visible in portfolio investments, but their volume is rather small compared to other items. About $6 billion in portfolio investment was taken out from Russia according to the preliminary b-o-p figures. FDI in the corporate sector (excluding banks), in contrast, was up nearly 60 % y-o-y.

Russia's foreign currency reserves increased $86 billion during January-September, about a fifth less than in the same period a year earlier.

Cabinet comes together on reform of pension system financing. One of the stickiest economic policy questions recently has been funding the rising shortfall to the pension system. Under a government decision last week, the current regressive social tax will be replaced in 2010 by an insurance premium scheme. The size of the premium will rise from 26 % to 34 % of an enterprise's total wage bill.

The average burden of the current social tax is about 22 % of the wage bill. Preliminary calculations suggest this will rise to 26 % in the new system. The payment will be made by the employer as at present. Prime minister Putin promised that the total tax burden on companies will not increase with the change, as the state will compensate for the tax increase, possibly with money from the National Welfare Fund.

One of the aims of the reform is to raise the pension level gradually to 40 % of the wage. The current average pension is 23 % of the average wage.

The cabinet hopes to submit its plan for pension system reform to the Duma no later than January 2009.

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China

China's central bank relaxes monetary stance. On Wednesday (Oct. 8), six central banks around the world announced half-percentage-point reductions in key interest rates to support the financial markets. Also the People's Bank of China lowered its references rates for both deposits and lending. The one-year deposit rate was cut from 4.14 % to 3.87 % and the one-year lending rate from 7.20 % to 6.93 %. Bank reserve requirements will also go down a half percentage point next Wednesday (Oct. 15). China's officials further announced that they are eliminating the 5 % tax on income from deposit interest. In mid-September, the PBoC relaxed its stance by dropping the reference 12-month lending rate by 0.27 of a percentage point and cutting the reserve requirements for small and medium-sized banks by one percentage point. The rate cuts have generally been seen more as measures to boost domestic economic growth than an indication of financial market problems in China.

China's financial markets were closed last week for the National Day holidays. When markets reopened this week, the yuan strengthened against the dollar and the euro. As the dollar has recently appreciated against the euro, the yuan has also strengthened by about 15 % against euro since the start of the year. On Thursday (Oct. 9) a dollar bought 6.82 yuan and a euro 9.33 yuan.

Share prices on China's stock market fell again this week. The country's second largest insurance company Ping An reported over $2 billion in losses on its investment in the Europe-based Fortis financial company, which has been partly nationalised and partly sold off to the French BNP Paribas.

IMF forecasts slowing economic growth in both China and Russia. The IMF's latest *World Economic Outlook* finds that growth prospects for China and other emerging Asian economies have deteriorated with falling export demand. Capital flows into China have remained strong and the yuan's exchange rate has appreciated in real terms. The IMF now forecasts real growth of the Chinese economy will decelerate this year to 9.7 % and next year to 9.3 %. The IMF left untouched its July forecast of China's 2008 economic growth, but lowered its forecast for 2009 by 0.5 percentage points. Consumer price inflation is expected to rise to 6.4 % this year and then slow next year to 4.3 %. China's current account surplus should contract this year to 9.5 % of GDP and further next year to 9.2 % of GDP.

There are mainly downside risks to growth in emerging Asia. If the risks to international financial markets strengthen and growth slows in export markets even more than expected, growth in China and other Asian countries could be lower than forecasted. Economic policymakers must walk the tight-wire between stimulating growth and keeping inflation in check. China, which has a central government budget surplus, has the option of using fiscal policy to support growth. On the other hand, domestic demand may prove to be stronger than expected.

In the case of Russia, the international finance crisis of confidence has been manifested as capital flight. Weaker demand from Russia's main trade partners is expected to add to the impact of the crisis on the Russian economy. Higher food and fuel prices combined with strong domestic demand and capacity constraints, caused inflation to flare up in the first half of 2008. The IMF forecasts Russian 12-month inflation will average 14 % this year and slow to 12 % next year. The IMF report also expresses a concern that CIS economies are overheating as a result of loose monetary and fiscal policies. Given slowing export demand, the IMF predicts real growth for Russia of 7 % this year and 5.5 % in 2009. Compared to its July forecast, Russia's growth forecast was lowered from the IMF's July forecast by 0.7 of a percentage point this year and 1.8 percentage points next year. Russia's current account surplus is expected to reach to 6.5 % of GDP this year and then fall to 3.4 % of GDP next year.

For Russia and the other CIS countries, the IMF emphasised that their forecast numbers are subject to the downside risks of the current international financial turmoil. Over the long term, however, these countries should reduce their sensitivity to changes in commodity prices by diversifying their production structures.

EU continues sanctions on Chinese footwear – for the time being. The European Commission announced at the beginning of October that the anti-dumping tariffs imposed on Chinese and Vietnamese leather shoes will remain in place until a new investigation into the matter is completed. The dumping investigation will attempt to determine whether Chinese shoe producers are still selling shoes in Europe at prices below actual production cost. The current anti-dumping tariff, which was imposed two years ago, is 16.5 % of the import price of a Chinese shoe. This adds on average about one euro to the price of a pair of shoes imported from China. EU customs officials will continue to collect the tariff, despite the fact that the majority of EU members oppose it. Indeed, because of the broad opposition to the anti-dumping tariff, the EU Commission is expediting its investigation of the dumping charges. Normally an investigation takes 12–15 months. The anti-dumping tariffs are most passionately supported by Italian shoe manufacturers.

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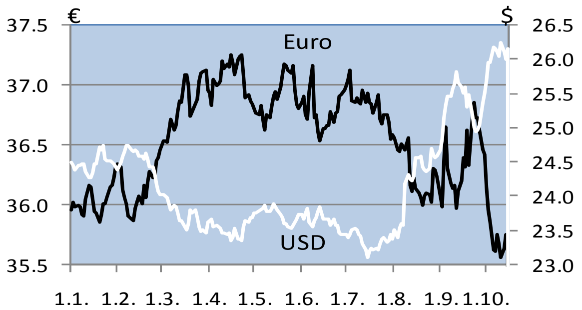
Russia

Rouble's exchange rate stays relatively stable. The strengthening of the US dollar against the euro since September has pulled up the rouble's value against the euro more than 3 %, even as the rouble has lost value against the dollar. The Central Bank of Russia steers the rouble's external value within a set fluctuation band for its dollar-euro currency basket. The CBR has recently had to buy roubles to maintain the Russian currency's value as it approached the limit of its fluctuation band.

During the week ending October 10, Russia's foreign currency reserves were depleted by $15.5 billion to $530.6 billion. Since hitting a peak in early August, the reserves have fallen by $66.9 billion. Because currency reserves are measured in dollars, valuation changes reflect both currency flows and exchange rate shifts.

Rouble-dollar, rouble-euro exchange rates in 2008



Source: Central Bank of Russia

Duma quickly approves measures to stabilise financial markets. Including earlier approved measures, the Russian state now has at its disposal about €120 billion (or just over 10 % of Russian GDP) in assets available to prop up the financial sector. Although the money is now allocated under the law, there are still a few days needed to specify guidelines on how the funds will be made available and under what conditions. The markets are generally satisfied with the quick response of the government and the central bank in the fashioning of support measures.

Under the current plan, the CBR will loan up to $50 billion (€37 billion) to state development bank VEB, which will then use the money to provide financing for companies servicing foreign loans. Top priority will go to investment projects important for the economy. One of the aims is to prevent Russian assets put up as collateral from falling into foreign hands in the event of payment defaults.

The CBR will assure liquidity of the financial markets by increasing the number of banks eligible to participate in its repo auctions. The CBR will also offer money to rated banks for up to six months without requiring collateral. The CBR will further share the risk of larger banks operating in the interbank market by providing partial compensation in the event of a default caused by the de-licensing of a counterparty bank. This measure will remain in force until the end of 2009.

The CBR and state will invest a total of 950 billion roubles (€27 billion) as ten-year subordinated loans to banks. Sberbank will receive an infusion from the CBR of 500 billion roubles (€14 billion); the remaining 450 billion roubles will be directed from the National Welfare Fund via VEB to other major banks. As a condition of financing, bank owners must match the state-provided capital contribution. The assets of National Welfare Fund, generated from taxes on oil and gas earnings, have earlier only been invested in low-risk, low-yield foreign securities.

The guarantee on individuals' bank deposits was raised on October 1 from 400,000 roubles to 700,000 roubles (€20,000). The deductible requirement for depositors was also eliminated, so the deposit insurance scheme now covers deposits in full up to 700,000 roubles.

To boost market liquidity, the CBR on Wednesday (Oct. 15) dropped all reserve requirements to 0.5 % of liabilities. Reserve requirements were last cut in September. The low reserve requirements will be in place until February 1, 2009, when they will be raised incrementally.

First foreign investments in strategic industries approved. The new commission on foreign investment in strategic industries, headed by prime minister Putin, convened last week for the first time. It approved stakes of two foreign investors in strategic firms. The Swiss World's Wing, a firm indirectly controlled by the Italian state, can now acquire a 25 %-plus-one-share stake in aircraft manufacturer Sukhoi. The Russian subsidiary of South African diamond giant De Beers can buy 49.99 % of Arkhangelsk-Geologodobycha, the diamond mining subsidiary of Lukoil. A condition of the deal is that diamonds mined in Russia will be cut there.

The commission, which still must review a dozen of applications, plans to meet again at least once this year. Commission member and head of the Federal Antimonopoly Service, Igor Artemiev, stated that foreign investors do not need commission approval for acquiring companies operating in the banking sector. In principle, companies using encryption technology are strategic industries under the law.

Low voter turnout for regional and local elections. Regional and local elections were held last Sunday (Oct. 12) in 74 of Russia's 85 regions. In the five regional elections, the dominant party United Russia took on average 77 % of the vote; the Communists and Just Russia each won about 6 % of the vote. Turnout varied from 95 % in Chechnya to under 40 % in Irkutsk.

Local elections were held in 73 regions, and involved the election of 2,038 local leaders and over 30,000 deputies. Voter turnout in local elections was below 40 %.

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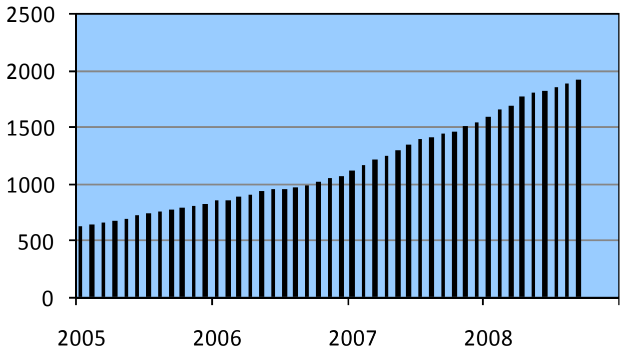
China

China's foreign currency reserves climb to $1.9 trillion. China's foreign currency reserves increased in the third quarter this year by $97 billion ($30 billion less than in the second quarter). The trade surplus and foreign direct investment in China in September exceeded growth in the currency reserves by nearly $15 billion, indicating an outflow of capital from China to other countries. The worldwide financial crises may have forced international companies operating in China to free up liquidity for use outside China. In addition, the rate of yuan appreciation against the dollar has clearly slowed, which in turn has weakened the attractiveness of China for speculative capital.

According to media reports, China's securities market regulators are pushing fund management firms to provide information about financial condition of their foreign partners. The officials are apparently worried that the weakened financial health of foreign partners could affect the operations of fund management firms. Otherwise, restrictions on cross-border capital movements have largely insulated China's financial markets from the direct effects of the international financial meltdown. The prestigious China Academy of Social Sciences (CASS) forecasted this week that real economic growth – despite global problems – will reach 10 % this year and 9.5 % next year. The vibrant growth figures are in line with the forecast of the International Monetary Fund released last week.

China foreign currency reserves, US$ billion

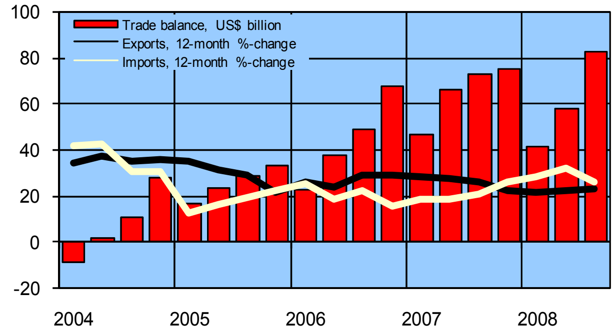


Source: CEIC

Record foreign trade surplus in September. China's foreign trade surplus reached $29.4 billion last month, up 22.8 % y-o-y. In September, the value of exports reached $136 billion and the value of imports was $107 billion. Both imports and exports grew 21% y-o-y. 12-month import growth slowed from earlier months, a reflection of recent declines in commodity prices on world markets.

The EU remains China's top export destination. In September, China exported goods to the EU worth $27 billion. In addition, China exported goods worth $25 billion to the United States and $11 billion to Japan. Chinese exports to these countries have continued to grow steadily despite the global financial crises. If the global financial crisis deepens and China's export growth slows, however, the government will face increased pressure to implement expansive fiscal policies. At the moment, it is anticipated that the government will reduce taxes on firms and workers, while increasing public consumption and investment.

China's trade development quarterly



Source: China Customs

Communist party central committee lays out policy goals at its autumn meeting. The approximately 300-member central committee of China's Communist Party (CCP) gathered at the end of last week for their fall session. At a central committee meeting thirty years ago, the party made its landmark decision to move ahead with economic reforms in China.

This time the central committee dealt with problems of the rural population, who have clearly been left behind in terms of economic development when compared to their urban counterparts. The party retained preservation of self-sufficiency in key food crops as a national objective.

The theme of tackling the poor condition of rural infrastructure and development of public services in the countryside was given a high profile at the meeting. The CCP central committee also committed to doubling the disposable income of rural residents between 2008 and 2020. This goal appears quite doable as real incomes in the countryside have grown at over 10 % y-o-y in recent years.

The central committee adopted changes in rules on management of land use rights. This is seen by many observers as a move to facilitate commercial exchange of land use rights for rural housing, which has been under trial in some areas.

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Russia

Rouble exchange rate weakens suddenly at bureaux de change. As a devaluation scare spread late last week, the rouble's exchange rate weakened to above 27 roubles to the dollar at Moscow bureaux de change. At the same time, the Central Bank of Russia's official rate was 26.4 roubles to the dollar. To put an end to the speculation, the CBR limited rouble sales through its foreign exchange swap facility. On Monday (Oct. 20), the facility was limited to 50 billion roubles (€1.4 billion), and in following days it was further reduced. The CBR provides banks with roubles through swap operations. The roubles are exchanged for foreign currencies and later bought back by the banks. Limiting the amount of roubles available at the swap window prevents banks from speculating on expected rouble devaluation.

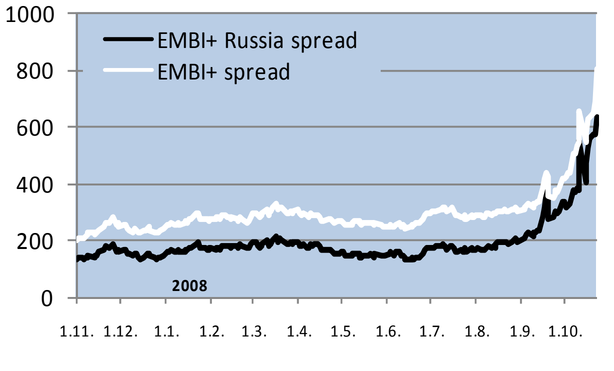
The CBR move caused market rates to surge. The overnight rate rose from below 10 % last week to a high of 20 % before retreating again. The CBR also drove up the rouble's value nearly 1 % against a strengthening dollar.

Finance minister Alexei Kudrin said that, while Russia should be wary about dipping into its currency reserves, assuring exchange rate stability takes top priority.

Russian credit risk rising. The current international financial crisis has increased the risk of lending to Russia. Russia's sovereign credit risk, however, has increased less than in other emerging market countries.

J. P. Morgan's Emerging Market Bond Index Plus (EMBI+) rates the yield on sovereign bonds relative to the US, a first-tier issuer. The interest rate spread on Russian bonds has widened to about 630 points; the average for emerging markets now exceeds 800 points.

2008 EMBI+ spreads: emerging markets overall and Russia



Source: C-Bonds

State development bank VEB and Deposit Insurance Agency support banks. Four of Russia's mid-sized banks have recently been restructured and taken over by the state. Majority stakes in Russia's 20th largest bank, Svyaz-bank, as well as 35th largest Globex bank have been taken by state development bank VEB. Russian railways and diamond mining company Alrosa teamed up to purchase a majority stake in KIT Finance (29th largest). Gazprom subsidiary Gazenergoprombank (41st largest) acquired its slightly larger rival Sobinbank.

Globex ran into liquidity troubles after a large number of customers rushed last month to withdraw their deposits and transfer them to the safety of state banks. The challenge facing Russia's financial sector is how to maintain the trust of depositors in banks. The environment is extremely susceptible to rumours due to the lack of transparency and information asymmetry.

The Duma this week swept aside other business to discuss a bill giving the Deposit Insurance Agency (DIA) power to restructure ailing banks. DIA's predecessor ARKO, created after the 1998 financial crisis, carried out these tasks for several years after the crisis. To accomplish the task, DIA has been budgeted this year additional capital of 200 billion roubles (€5.6 billion). The agency's mandate of helping banks extends only to Russia's 100 largest banks.

September data reveal no evidence of slowing economic growth. Preliminary Rosstat figures indicate that brisk growth persisted in nearly all branches of the economy throughout September. One reason for the apparently buoyant growth figures, however, seems to be the exceptionally weak comparison point of September 2007.

Retail sales, a reliable indicator of consumption trends, continued to soar. During January-September, growth was 15 % y-o-y, while real wages rose 13 %. Investment growth, which had been fading since last spring, revived slightly in September. Investment was up 13 % in the first nine months, although the increase was substantially lower than last year. Construction continued to revive slightly from its summer dip, up 17 % y-o-y overall for January-September. Housing construction grew only 4 %.

Industrial output overall rose over 5 % in the first nine months of this year. For the mineral extractive industries, however, oil production shrank by 0.6 % y-o-y and gas production increased by just 1.5 %. Manufacturing, in contrast, rose nearly 8 %.

Given the gloomy outlook ahead, many Russian firms have lately warned that they are considering reducing production levels, postponing planned investments and laying off workers. Among large metal producers, Severstal and MMK have announced plans to cut production. Norilsk Nickel has indefinitely shuttered its Cawse mine in Australia and announced intentions to sell its operations in the United States. Carmakers GAZ and Kamaz have made production cuts and warned of impending layoffs. Several projects in the construction sector have been abandoned, and many firms in the financial sector have announced layoffs or staff reductions.

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China

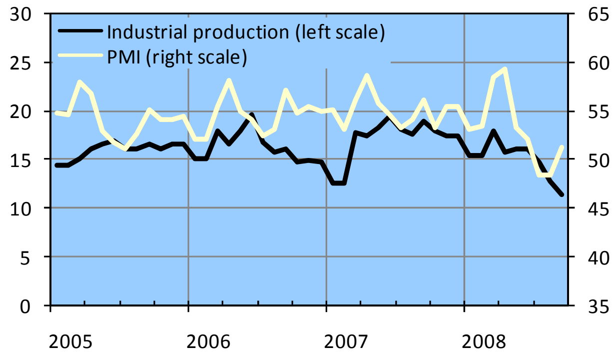
China's economic growth slows more than expected in July-September. China's total economic output rose 9.0 % y-o-y in the third quarter, a rate surprisingly below forecasts. For the first nine months of the year, 12-month growth in GDP slowed to 9.9 % (compared to 11.9 % GDP growth in 2007). The lower pace of GDP growth reflects slower growth in both industrial output and services. Although China's lower growth conforms well with the slowdown in the global economy, various indicators give a conflicting picture of the situation.

Real growth in industrial output was 11.4 % y-o-y in September, the third consecutive month of slowing on-year growth (see graph). The fact that growth was lower in September than August was something of a surprise as industrial output was expected to revive in September after the production restrictions from the August Olympics were lifted. Also perplexing was the fact that China's Purchasing Managers' Index (PMI) recovered to above the 50-point mark in September after spending two months below the critical half-way point. The PMI is a diffusion index where index values above 50 indicate that the majority of responding firms see the current business climate as improved from the previous month. Correspondingly, a value below 50 indicates the majority of surveyed firms see the business environment as deteriorated from the previous month. China has released PMI figures since the start of 2005.

Other available indicators show no signs of a significant drop in Chinese economic growth. Fixed capital investment climbed nearly 27 % in nominal terms in January-September, i.e. growth accelerated slightly from August. Retail sales were up 23 % in nominal terms. Using available price data, real investment growth did not fall from the previous quarter and real retail sales growth even accelerated. Foreign trade figures released last week further provide no evidence of a significant slowdown; both exports and imports were up over 20 % y-o-y in September.

During September and October, China's government cut key interest rates and bank reserve requirements slightly, and lending restrictions regarding small and medium-sized enterprises were relaxed. Chinese officials also worked to keep the yuan's exchange rate steady relative to the US dollar. Since the beginning of July, the dollar-yuan rate has hovered around 6.8. In addition, tax refunds to clothing and textile exporters were increased at the beginning of August. Economic stimulus measures to date have been quite restrained as officials have feared stoking inflation and remained uncertain over lower growth. China still has more potent monetary and fiscal arrows in its policy quiver it can use if needed.

On-year growth in industrial production and China's Purchasing Managers' Index (PMI), %



Sources: CEIC and BOFIT

Rise in consumer prices continued to slow in September. China's National Bureau of Statistics reports consumer prices in September were 4.6 % higher than a year ago. Inflation peaked this year in February at 8.7 % y-o-y. In particular, the rise in food prices slowed from the run-up in prices in the beginning of the year. Producer prices, however, continued to rise briskly throughout September (up 9.1 % y-o-y in September, 10.1 % in August) and thereby may continue to add to consumer price inflation pressures. On the other hand, recent declines of commodity prices on international markets may further slow the rise of producer prices in coming months.

The average price of apartments in China's 70 largest cities in September was up 3.5 % y-o-y. The rise in housing prices has generally slowed significantly in recent months, and in some areas, housing prices are already in decline. Officials this week approved a raft of measures to support housing prices, including elimination of some taxes related to apartment sales and a ten-percentage-point reduction in the down-payment requirement for first-time apartment buyers to 20 % of the apartment price. Officials are worried banks will incur credit losses in a collapse in housing prices.

The easing in the rise in consumer prices has given China's leaders increased room to manoeuvre in fiscal and monetary policy. The People's Bank of China has recently moved its policy focus from fighting inflation toward sustaining economic growth. The broad measure of money supply (M2) was up 15.3 % y-o-y as of end-September. Moreover, the drop in the inflation rate provides the authorities with possibilities to further deregulate prices. China still actively regulates prices for fuel, gas and electricity.

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Russia

Seesaw trend continues on Russia's financial markets. Russia last week burned through $31 billion of its currency reserves, which fell to $484.7 billion as of October 24. Russia's currency reserves have declined rather steadily since early August, when they stood at $597.5 billion. Changes in the reserves, which are stated in dollars, are influenced beside trade and capital flows also by fluctuations in exchange rates.

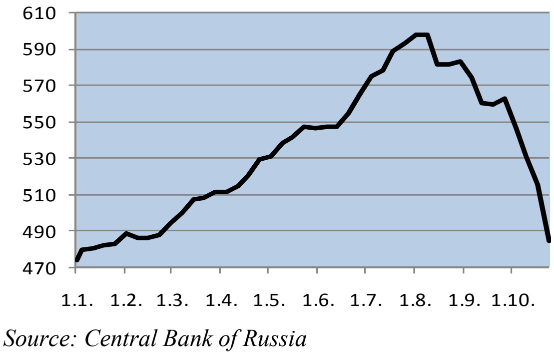
Despite the approximately $113 billion drop, Russia's reserves are still sufficient to cover over 18 months worth of imports. In relative terms, that makes Russia's reserve position about equal to China's. As a general rule, countries should have currency reserves equivalent to at least three-month's worth of imports to provide a safety buffer against major external shocks.

The Moscow stock exchange has recently experienced high volatility that has driven violent swings in the RTS index. The MICEX was closed again on Monday after trading ranges were exceeded. The exchange reopened on Tuesday and the RTS was up over 30 % by closing on Thursday. Over the longer term, prices of Russian shares have been losing ground. The RTS index touched the 560-mark this week, about the same level as in late 2004. Still down some 70 % from its all-time high last summer, the RTS ended Thursday at 759.

Market interest rates typically rise near the end of the month with the approach of corporate tax payment deadlines. The CBR again this week boosted liquidity through repo auctions to meet the increased money demand.

Rumours of an impending devaluation a couple weeks ago have now subsided. Although the rouble weakened against the dollar over the last week, the price of roubles at bureaux de change returned to near official CBR rates. A couple weeks ago, the rouble lost substantial value against the dollar at bureaux de change, putting its value considerably below the official CBR rate.

Russia's currency reserves Jan. 1–Oct. 24, 2008, US$ billion (weekly observations)



Source: Central Bank of Russia

Russia's foreign debt relatively small by international standards. CBR figures show Russia's gross foreign debt was $530 billion at the end of June. Public administrations accounted for less than $40 billion of the total sum, but companies that are either state owned or controlled by the state held additional foreign debt of more than $150 billion. In combination, the total foreign debt of the widely defined public sector was about $200 billion. About 90 % of the debt is long term (over one year).

Private sector foreign debt defined narrowly (i.e. excluding state-controlled firms) stood at $330 billion as of end-June. Although 75 % of the debt was long-term, less than 60 % of the private banking sector's $115 billion foreign debt was long term.

Russia has substantial foreign receivables, and its gold and foreign currency reserves exceed its net foreign debt. Even with the recent decline in its foreign currency reserves, Russia remains a net lender.

Distribution of financial sector support commences. On October 21, the government decided that part of the money from oil tax revenues collected in the National Welfare Fund can be invested in domestic securities. The measure is hoped to support development of Russia's stock exchanges. Previously, Fund assets could only be invested in high-grade, low-yield and low-risk foreign bonds. As of end-September, the National Welfare Fund had assets of about 1.2 trillion roubles (€35 billion). By the end of this year, Fund assets are expected to rise to 2.5 trillion roubles. The state development bank VEB, which handles Fund investment, received 175 billion roubles (€5 billion) of Fund assets to put in listed shares and bonds.

The CBR began to hold unsecured loan auctions for about 120 of Russia's banks with strong credit ratings. At the first auction, banks purchased about 388 billion roubles (€11 billion). Investment banker Renaissance Group took €200 million in unsecured loans, which it used to avoid the sale of its consumer credit services unit Renaissance Credit to Vneshtorgbank.

Under a change in the law, the CBR will also have the right to use corporate bonds in its open market operations as of November 1. The CBR was earlier limited to using state-issued securities. The change is expected to lift market liquidity.

Despite the manifold operations of the CBR and the government, interbank markets remain essentially frozen. Small and medium-sized banks, in particular, are suffering from the lack of access to finance. Instead of loaning money forward to smaller banks or firms, big banks that have received government cash infusions have preferred to sit on the money and change it into dollars or euros. As a result, in part CBR efforts to increase domestic liquidity have simply increased demand for foreign currency and put downward pressure on the rouble's exchange rate.

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China

More measures to ease monetary policy. The People's Bank of China announced a further cut in key reference rates this week. Effective Thursday (Oct. 30), the reference one-year lending rate is 6.66 % (down from 6.93 %) and the one-year deposit rate 3.60 % (previously 3.87 %). Since the beginning of September, the one-year lending rate has been lowered by 0.81 percentage point and the deposit rate by 0.54 percentage point. Other measures to relax the monetary stance include lowering reserve requirements for commercial banks.

Commercial bank profits show slightly lower growth; new opportunities sought abroad. China's largest commercial bank Industrial and Commercial Bank of China (ICBC) announced its profit growth slowed to 26 % y-o-y in the third quarter. ICBC's profits were still up 77 % in the first quarter. China Construction Bank also announced lower profitability growth. Growth in bank profits is still high despite a decline of certain asset prices in China and stringent lending restrictions imposed during the first half of the year. Share prices of large banks have followed the Shanghai A-share index's declining trend.

Details on the recapitalisation of state-owned Agricultural Bank of China (ABC) were released recently. ABC is the last of China's four large state banks yet to be stock-exchange listed. The Chinese state dipped into its massive currency reserves to boost the balance sheets of its large banks and prepare them for exchange listings a few years back. Central Huijin Investment Company, a part of China's state sovereign wealth fund, is in the process of injecting nearly $20 billion into ABC, China's leading rural bank. A part of ABC's non-performing loans will be moved from the bank's balance sheet into a separate fund.

Some of China's large commercial banks are actively working to expand their operations internationally. In mid-October, ICBC opened a branch office in New York. It recently also opened a subsidiary bank in the Middle East (Dubai). China Merchants Bank opened a branch office in New York in September.

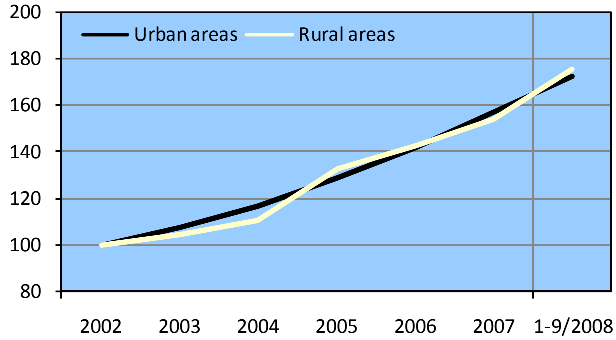
Rapid rise in disposable income continues. According to China's National Bureau of Statistics, real incomes rose 11 % y-o-y in the countryside and nearly 8 % in cities during the first nine months of 2008. The average disposable income in urban areas climbed to over 1,300 yuan a month (€122), when the corresponding figure for the countryside was still less than 500 yuan (€47).

Real incomes of rural dwellers increased slightly faster than their urban counterparts during January-September. The developments in average rural and urban disposable incomes from 2002 appear in the chart below. Real disposable incomes have risen in both urban and rural areas more than 70 % over the past six years.

Income disparity within the country remains huge. The World Bank's most recent (2004) Gini coefficient calculation is 0.47. The Gini coefficient, an indicator of income disparity, suggests China's income disparity is among the highest in transition economies (e.g. Estonia 0.36 or Hungary 0.31). The figures for income disparity, however, do not take into account the money Chinese working in cities send home to their relatives in the countryside.

According to the World Bank's most recent estimate (2005), about 208 million Chinese live in absolute poverty (less than $1.25 a day). About half live on less than a dollar a day (the classic definition of absolute poverty). However, the number of poor persons in China has fallen steadily since the early 1990s and the amount of people living in absolute poverty has been reduced by about two-thirds. China's rapid economic growth has lifted over 400 million people from poverty.

Growth in disposable income, 2002=100



Sources: China's National Bureau of Statistics and BOFIT

China increases export subsidies. China's ministry of finance and tax administration announced last week plans to increase the value-added-tax rebates on nearly 3,500 export articles, effective November 1. The increases are mostly in the range of 1–4 percentage points. The VAT rebate on export goods can amount to up to 17 % of the VAT paid by the company.

The increased subsidies will go mainly to labour-intensive industries such as manufactures of textiles, clothing and toys. The margins in these industries are small and their profitability has been hit by the weakening global outlook, and caused a raft of layoffs and corporate bankruptcies. It is difficult to assess nationwide impact of the layoffs, as there are no reliable statistical data on Chinese unemployment rates. The VAT rebates on export goods were reduced for nearly 3,000 export items last year. At that time, officials hoped the measure would slow down sizzling export growth, but the impact was minor.

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Russia

First decisions reached on distribution of refinancing loans. Last week state development bank VEB gave a green light to the first wave of companies qualifying for assistance with their foreign debt repayment problems. So far, a total of $7.8 billion in credit has been extended to ailing companies. VEB will distribute the money among companies in the fields of energy, metallurgy and metal fabrication, construction, transport and telecommunications.

The CBR has given VEB $50 billion to use in loan assistance. VEB is permitted to provide financing at rates of LIBOR + 5 % or higher.

Many Russian firms took on foreign debt to finance corporate acquisitions. Now, with liquidity tight, they need help in paying back their debts. The provision of credit for loan refinancing is hoped to prevent the surrendering of Russian firms' shares pledged as collateral to foreign entities in the event of default.

Russian aluminium giant RusAl, in which Russian oligarch Oleg Deripaska holds the majority stake, announced it has received a $4.5 billion refinancing loan from VEB. RusAl used the money to pay off a syndicated bridge loan it took last spring to finance the acquisition of a 25 % + 2 share stake in Norilsk Nickel. Norilsk Nickel shares are used as collateral for the refinancing loan. The Russian government will also get a seat on the Norilsk Nickel board and two seats in the management group.

According to media reports, other recipients of refinancing include the state oil company Rosneft, state railways RZD, as well as the Alfa Group, a conglomerate involved e.g. in the banking sector.

Cabinet prepares to support real sector of the economy. Prime minister Vladimir Putin announced support plans for the production sector suffering from the international financial crisis. Assistance includes access to financing, interest subsidies, tax breaks and revised tariff policies. Putin also issued a strong caveat to bailed-out companies against converting their aid into foreign currency and taking it out of the country.

Most support will go to firms in the construction, machinery, and defence sectors, as well as those involved in agriculture, raw material extraction and retail sales. The total amount of support has yet to be announced.

State banks will issue low-interest loans to help companies shore up their capital base. Money from the national housing fund will be provided to finance the purchase of unsold apartments to help e.g. military personnel. The state will accelerate planned military procurements from Russian defence firms. In addition, the state strives for boosting employment with new orders in e.g. the shipbuilding, aerospace and metal industries.

Further reduction in oil export duty. To support oil production, the cabinet lowered the export duty on crude oil from $372 to $287 a ton, or $39 a barrel, effective November 1. The export duty on oil was previously lowered at the start of October.

The lower export duty is in force until the end of November. The formula for determining the export duty was revised at the beginning of October to dampen the impacts of the financial crisis. The duty is now based on the average world market price over the previous 17 days. Under the new arrangement, the formula better reflects rapidly declining price levels and the duty is clearly lower. The earlier formula was calculated from the average of world market price over the previous two months.

Export firms and the economy ministry wanted an even lower duty, but were rebuffed by the finance ministry, which argued that the federal budget could not sustain a larger drop in revenues and was adamant that budget balance be maintained in the midst of a financial crisis.

Investment of oil tax revenues transferred to special state agency. The finance ministry announced the establishment at the beginning of next year of a separate state agency to administer resources of the Reserve Fund (planned to be used for covering budget shortfalls) and the National Welfare Fund (aimed at financing the pension system). The agency can employ private investment firms to handle investment of fund assets.

Currently, the assets in the Reserve Fund are held in foreign currencies and invested under principles generally applied to investment of central bank currency reserves. The central bank also handles investment of 60 % of the National Welfare Fund, while the remaining 40 % has been transferred to VEB for investment in domestic securities with a view to supporting the stock market.

President Medvedev delivers his first major policy speech. In the section of the speech dealing with the economy, Medvedev stated that in the near future Russia would manage to construct an independent modern financial system capable of reacting to external pressures and support balanced economic development of the country.

The international financial crisis has given Russia a chance to pursue new market niches in the global economy, for which it has to build new production at the top of world technology development. Medvedev reiterated Russia's plans to become a high-tech leader. He noted that not even difficult economic times should interfere with pursuit of state and private-sector efforts to develop the country's technological advantages.

President Medvedev warned the business community against exploiting the current downturn to abuse their competition positions and officials against malfeasance. He also spoke widely about the challenges of fighting corruption in Russia.

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China

Central bank further relaxes monetary stance. Last weekend, the People's Bank of China announced it was scrapping limits on commercial bank lending. The PBoC has sought to reduce bank lending to certain sectors since summer 2006 and generally since last November by issuing strict restrictions for lending. The lending restrictions were intended to combat inflation and prevent overheating in certain sectors. Under current circumstances, however, growth of the broad money supply (M2) is slowing (15.3 % y-o-y as of end-September) and the risks of economic overheating are on the wane. Press reports say the construction sector has been hit especially hard by credit restrictions.

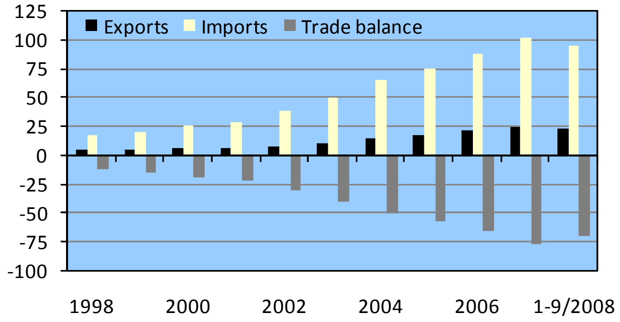
The PBoC has moved to support flagging growth in recent months with such measures as lowering key interest rates and reducing the reserve requirements for commercial banks. Further monetary policy measures to help the economy are expected in coming months.

China and Taiwan agree to allow direct sea cargo and flights. At the start of the week, talks between China and Taiwan were held first time on Taiwanese soil. Agreement was reached on direct cargo shipping and airline connections across the Taiwan Strait. Earlier, connections required a stopover in for example Hong Kong or Macau. Initially, direct flights will serve Shanghai and Taipei. Other routes are already under discussion. It was also agreed to triple the number of charter flights per week from 36 to 108. In addition, up to 60 cargo flights will be permitted each month. Although increasing the number of flights had been hoped to boost the number of Mainland Chinese tourists visiting Taiwan, the impact to date has been marginal. China is now expected to modify its rigid regulations concerning travel to Taiwan.

The negotiation also produced agreement on speeding up the postal transport. Cooperation on preventing the impacts of the international financial crisis and issues on food safety were also discussed. The next meeting will be held in mainland China in early 2009, where the agenda will include fighting crime, improving legal protection of Taiwanese investments in China, increasing cooperation in food safety and coordination of measures to deal with the fallout from the current financial crisis. The possibility of Chinese banks establishing branch offices in Taiwan will also be discussed next year.

The meeting signalled a significant thawing after decades of brusque relations between Taiwan and China. Since his election last spring, the popularity of Taiwan president Ma Ying-Jeou has faded with the faltering economy. Protests were held in Taipei against the president's China-friendly policies last month. The Ma administration sees the bilateral meetings as a means to restore popular support.

China's trade with Taiwan, US$ billion
Source: China Customs



China and Russia pen deal on Siberian oil pipeline. During the visit of Chinese prime minister Wen Jiabao to Russia last week China's state oil company CNPC and Russian oil pipeline grid operator Transneft signed a deal on the principles of construction and use of a branch pipeline from the Eastern Siberia–Pacific Ocean (ESPO) trunk pipeline currently under construction. Press reports indicate the parties also discussed financial arrangements related to the pipeline project and oil trading; China would extend credit to Transneft and Rosneft (total $20–25 billion) against future oil deliveries.

Plans to build a pipeline to China have been on the drawing board for years, but the final go-ahead has been frustrated by a range of economic, technical and political difficulties. The branch on the China side will run from Skovorodino in the Amur region to the city of Daqing in northeastern China. The pipeline will span about 1,000 km and have a transmission capacity of 15 million tons of oil per year. The ESPO project has two phases. The first phase extends from Taishet on the western shores of Lake Baikal to Skovorodino. This 2,700 km leg will have an initial capacity of 30 million tons a year and should be completed by the end of 2009. The second phase (2,100 km) of the trunk pipeline will reach from Skovorodino to Nakhodka on the Sea of Japan.

At a China-Russia economic forum taking place after prime minister meeting, agreements were signed on a raft of small joint bilateral projects. A Chinese and a Russian commercial banks agreed on an arrangement to allow Russian firms to list on the Hong Kong stock exchange. After departing Russia, Wen journeyed to Kazakhstan for seventh gathering of Shanghai Cooperation Organization (SCO) prime ministers.

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Russia

Rouble's fluctuation band widened, interest rates increased. The Central Bank of Russia announced Tuesday (Nov. 11), that it was widening the rouble's fluctuation band by 30 kopecks in both directions. The external value of the rouble relative to its binary currency basket (0.55 dollar + 0.45 euro) weakened on the same day from 30.4 roubles to 30.7 roubles. The CBR last widened the rouble's fluctuation band last summer as part of its longer term plans to shift to a floating exchange-rate regime with monetary policy based on inflation targeting.

The CBR also increased its key monetary steering rates by a percentage point. The markets did not expect a hike in current tight liquidity situation. The central bank stated as reasons for its decision the need to fight inflation and prevent capital flight. On-year inflation slowed in October, but was still 14.2 %, i.e. real interest rates remain negative.

CBR chairman Sergei Ignatyev estimated that net capital export by the private sector in October was about $50 billion. Russia's foreign currency reserves contracted last month by $72 billion. The rapid depletion of reserves over the last two weeks has now slowed. As of November 7, Russia's currency reserves stood at $475 billion.

Some of the money channeled by the state to the banking sector is suspected to have been exported abroad. The government is currently planning to improve oversight of how the money is used. According to the plans, special inspectors named by the CBR would be put to banks receiving public funds.

Duma approves 2009 federal budget. The budget act approved by the Duma at end-October is based on the government's August proposal and thus does not reflect the recent slide in oil prices or weakened economic prospects. The budget act sees federal revenues next year reaching 10.9 trillion roubles or €315 billion (21 % of GDP) and expenditures of 9 trillion roubles or €260 billion (17.5 % of GDP), leaving a surplus of 1.9 trillion roubles.

Some 43 % of budget revenues next year will derive from oil and gas tariffs, down from about 50 % this year. The steep hike in spending (up over 18 % y-o-y in real terms), breaks from the general trend in this decade of moderate spending increases. The higher spending will go to improving housing and community services, healthcare, and public administration (which includes, among others, the investment fund for nationally important investment projects carried out jointly with the private sector, as well as basic scientific research). The policy emphasis on social issues and economic development was formulated before the financial crisis emerged. Growth in defense spending will lag the budget average, with its share of budget expenditures remaining at about 14 %, or about 2.5 % of GDP. In conjunction to the 2009 budget, the Duma approved framework budgets for 2010 and 2011 in which real growth of total spending slows to 3–7 % per year.

The 2009 budget assumes real GDP will increase 6 % next year and Urals-grade crude oil will average $95 a barrel. According to the finance ministry, the budget will be adjusted to reflect the deterioration of economic conditions. The revisiting of budget numbers likely means reductions in revenue assumptions, spending cuts and reallocation of funds. The ministry said the budget will be in the red if the average price of crude oil falls below $50–60 a barrel next year.

While considering the proposed budget, the Duma approved a law giving the government the option of shifting expenditures between budget categories and within the three-year budget framework. The measure is designed to give greater flexibility to budget spending in dealing with the troubled finance sector and reduce spending if economic conditions dictate. The special law expires at the end of 2009.

Banking sector performance reflects crisis in international financial markets. All basic indicators for the CBR's figures on the banking sector suggest growth slowed in the third quarter, particularly in September. Even so, the January-September figures showed the banking sector was still profitable as a whole, despite huge losses from the collapse of securities' prices in September.

Nominal growth in household deposits in January-September fell to 14 %, a growth pace substantially below the same period a year earlier. During September, the deposit stock contracted about 2 %. In addition, growth in corporate deposits slowed to 27 % in the January-September period. Corporate and household deposits are the most important funding source for banks. They form about 60 % of the sector's balance sheet.

Growth of the stock of loans to households slowed to 35 % in January-September, while growth in the stock of corporate loans declined to 29 %. The share of non-performing loans in the total loan stock of banks remains relatively insignificant (about 1.5 %). The amount of troubled loans, however, grew slightly. In September, new non-performing loans appeared particularly in the interbank lending market.

Total assets held by the banking sector at end-September amounted to 24,600 billion roubles, up 35 % from a year earlier. The rate of growth slowed, however, from last year. Highest growth was seen in the balance sheets of Russia's biggest banks. The five largest banks' share of all banking in Russia rose in September by nearly a percentage point to 43 %.

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China

China announces massive economic stimulus package. Coinciding with a meeting of G-20 finance ministers and central bank governors in Brazil, China announced last weekend its long-awaited stimulus package. The economic injection, initially announced at an eye-popping 4 trillion yuan ($586 billion), amounts to about 15 % of China's 2007 GDP. The stimulus measures, to be rolled out over the coming two years, will focus on encouraging household consumption and promoting public and private investment. The government's ten-point stimulus programme targets include building infrastructure and housing, environmental protection and improving social conditions through e.g. spending on health care and education. A reduction in the value-added tax is also hoped to fuel investment. On Wednesday (Nov. 12), China announced plans to increase export subsidies, construct a new nuclear power plant in the Guangdong province and launch water-saving projects in drought-stricken regions.

Ahead of the main G-20 leaders' summit in Washington DC this weekend, China's leaders took the opportunity to flex their economic muscles by dealing with flagging economic growth domestically and abroad. China alone accounted for about 27 % of all global economic growth last year, so the international impact of the spending package could be considerable. Details of the stimulus package, including its precise scope and timing, remain unclear. Observers note some projects targeted for stimulus funds have apparently already been implemented or are covered under the current five-year plan (2006–2010). According to some estimates, new spending targets make up only about a sixth of the stimulus objectives.

IMF lowers its economic outlook for China; NBS and China Customs October figures inconclusive on trends. The International Monetary Fund revised downward its forecast for Chinese 2009 economic growth by nearly a percentage point to 8.5 %. The IMF now expects the staggering global economy to affect Chinese growth more than originally anticipated. The IMF forecast was released before the Chinese government announced its stimulus package.

NBS economic figures for October released this week show real growth in industrial output fell to 8.2 % y-o-y, or about half of the pace earlier this year and the lowest growth level since 2001. Some other NBS figures, however, were surprisingly positive. For example, retail sales, an indicator reflecting individual consumer demand, witnessed nominal growth of 22 % y-o-y. China Customs also reported a slight slowing in export growth to 19 % y-o-y. As import growth fell to 16 % y-o-y, the foreign trade surplus swelled to a record level in October. Export growth is expected to slow more sharply in coming months.

In any case, the October decline in consumer price inflation to 4 % y-o-y has granted China's central administration greater room to manoeuvre in economic policy. The rise in producer prices is also moderating.

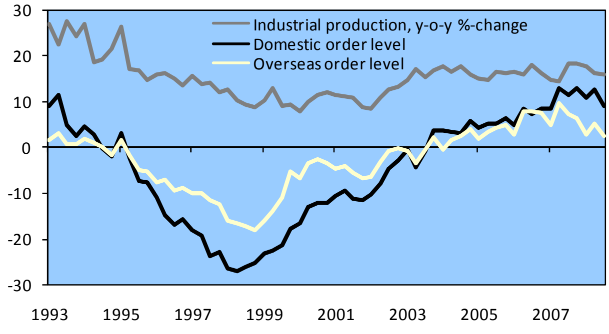
Business barometers hint at slowdown in industrial output growth. The latest reading of the People's Bank of China's (PBoC) business survey of industrial producers, weakened slightly in the third quarter. The indexes, that consider booked domestic and foreign orders and corporate profitability, fell in the third quarter. Even so, most industrial firms remain optimistic, as the diffusion index remained in positive territory (see chart below).

This year's GDP and industrial output figures indicate a slowdown of the Chinese economy, but the index figures are still substantially higher than during the Asian financial crisis in the late 1990s, when indexes measuring domestic and foreign demand plunged far into negative territory. Although some real economy variables indicate deteriorating growth, the lack of negative economic news in Chinese media is notable.

A noteworthy aspect of the PBoC's business barometer is that business conditions may have already deteriorated substantially from the third quarter. The purchasing managers' index (PMI), published once a month, again fell well below the critical 50 percent level after recovering just a month earlier. A PMI value below 50 indicates the majority of purchasing managers surveyed are experiencing worse business conditions than in the previous month.

Researchers find that the PBoC's index contains useful information about development of the real economy. According to the economic model of BOFIT that utilizes business survey data, China's inflation rate is expected to subside in coming months.

Business survey of order books and industrial output development quarterly



Sources: People's Bank of China, National Bureau of Statistics and BOFIT

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Russia

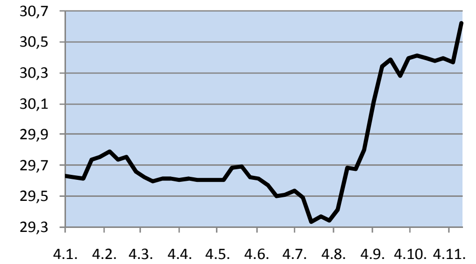
Market rates surge. MosPrime, which is based on the interbank rates of eight large contributor banks, hit all-time highs in excess of 20 % across all maturities early this week. Short-term liquidity loans granted earlier this autumn by the finance ministry and the central bank are coming due over the next few days, which is increasing demand for roubles. Observers value the amount of short-term loans coming due at about 800 billion roubles. End-month tax payments will also push rouble demand.

Russia's binary dollar-euro currency basket stabilised at around 30.7 roubles after the CBR last week widened the fluctuation band for the rouble's external value. The rouble remained steady or strengthened slightly against the reference currency basket up to early August, then went into decline. Central bank chairman Sergei Ignatiev reported that CBR burned through nearly $60 billion of its currency reserves during September and October defending the rouble.

Trading on the Moscow stock exchange shut down sporadically this week, mainly on large declines in share indices. Under RTS trading rules, trading must be suspended if the index value fluctuates over 5 %. The RTS index dipped below the 600-point mark for the second time during the past month, and currently is down about 75 % from its all-time high last May. A major factor in the sharp decline has been the drop in the price of Urals-grade crude oil to below $50 a barrel this week.

Russia's gold and currency reserves contracted by $22 billion, and stood at $454 billion as of November 14. It was the second largest one-week drop in CBR reserves ever. Russia's currency reserves have shrunk by $144 billion since the beginning of August.

Rouble value against dollar-euro currency basket (roubles)



Source: Central Bank of Russia

World Bank lowers economic outlook for Russia. The World Bank's *Russian Economic Report* released this week lowers the 2009 forecast for Russian economic growth from 6.5 % to 3 %. World Bank forecasters expect Russian inflation to remain brisk next year and economic surpluses to fall substantially.

The report notes that Russia is much better positioned than many emerging economies to deal with the global financial crisis, and that it has responded to the new circumstances with appropriate policies. Nevertheless, the World Bank warned against excessive increases in public spending and hoped Russia would redouble efforts at economic diversification, strengthening its financial sector and integration with the world economy.

The IMF lowered its 2009 forecast for the Russian economy from 5.5 % to 3.5 % at the beginning of November. Several investment banks have also reduced their outlooks for Russia in recent months.

First three quarters show brisk foreign trade growth. The value of Russian exports in January-September rose over 50 % and the value of imports over 40 % y-o-y, i.e. the same pace as in September. The trade surplus was again well over 10 % of GDP.

The rapid growth in exports is explained largely by the run-up in oil prices. During the third quarter, the average price of Urals was still $114 a barrel (nearly 60 % higher than a year earlier). In January-September, some 70 % of the value of Russian exports came from oil, oil products and natural gas. Metals accounted for another 12 % of exports. Raw wood, valued at about $3 billion for the first nine months of the year, represented about 1 % of exports.

Slightly over half of all imports consisted of machinery, equipment and vehicles. Food and chemical products each had about 13 % shares of imports.

Putin and Medvedev participate in international talks. Prime minister Vladimir Putin and Finnish counterpart Matti Vanhanen met in Moscow last week to discuss, among other things, Russia's raw wood export tariffs and the Nordstream gas pipeline project. Putin announced during the talks that the planned hikes in raw wood export tariffs at the beginning of next year would be delayed by 9-12 months.

President Dmitri Medvedev participated in the EU-Russia summit, where discussions on a new partnership and cooperation agreement were restarted. The EU broke off talks at the beginning of September in the wake of the Georgia conflict. Medvedev stated in conjunction with the meeting that Russia still desires WTO membership, but it wants to do so by normal, not humiliating conditions. The EU reiterated its support for Russian WTO membership.

G-20 leaders met last weekend in Washington DC to discuss the international financial crisis and fixing the international financial system. Medvedev joined other leaders in signing the declaration, stating e.g. to refrain from new measures restricting trade or investment during the next 12 months. However, the package of measures to deal with the financial crisis approved by the Russian government includes also corrections to several import duties and reduced quota on pork and chicken products next year. At a session of the government's presidium early this week, prime minister Putin said Russia would hold to its obligations, but added that several decisions made earlier should be implemented to protect national interests.

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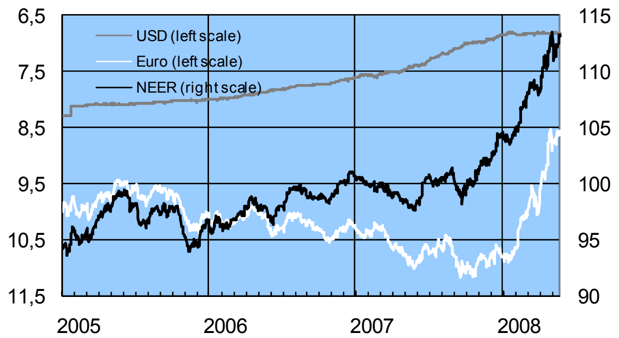
China

Yuan exchange rate stabilises against the dollar. The yuan's exchange rate against the dollar has fluctuated only slightly in recent months since it reached 6.83 yuan to the dollar in early August. While the People's Bank of China has not announced changes in its exchange rate policy, it has in practice put on hold its policy of letting the yuan gain gradually against the dollar. The yuan has strengthened in relation to the euro as it has tracked the rising dollar. The yuan has gained about 24 % this year against the euro but only about 7 % against the dollar. On Thursday (Nov. 20), one dollar bought 6.83 yuan and one euro 8.57 yuan.

On the other hand, both the nominal and real trade-weighted exchange rates have strengthened significantly to record heights. In particular, China's price competitiveness with its most important trade partners has been degraded by real exchange rate strengthening. This has yet to affect China's exports, which have continued to grow at an astonishing rate in the midst of the international financial crisis.

Yuan-dollar, yuan-euro, and nominal effective exchange rates (rising trend line means yuan appreciation)

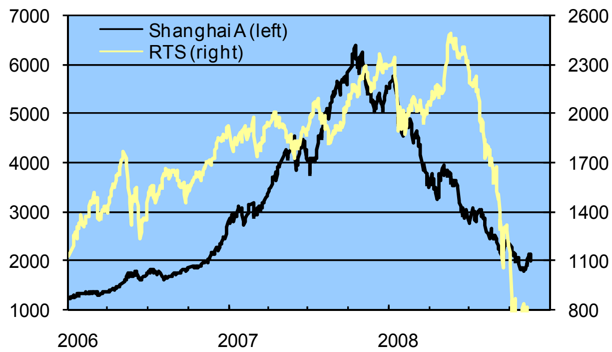


Sources: Reuters and JP Morgan

Share prices on China's stock exchanges in full retreat. The Shanghai A-index has currently fallen to around the 2,000-point level, which is about where it was two years ago. The decline has been as precipitous as the increase before since the peak at the end of 2007 at 6,396 points was reached after a year-long rapid increase in value, while the stock exchange has lost two-thirds of its value during the past 12-months.

Since the stock market index hit its nadir at the start of the month, the exchange appears to have recovered slightly in the wake of the government's announcement of a major stimulus package two weeks ago. While there is no clear sign the worst is over, share trading volumes have revived significantly in November, although the trade levels are still below the record levels at year and half ago.

Trends on key Moscow and Shanghai share indices



Source: Bloomberg

G-20 policy shift signals larger role for China. G-20 leaders gathered last weekend in Washington DC to consider solutions to the world's economic woes. The heads of state issued a joint declaration reaffirming the IMF's role in helping to solve the financial problems of countries hit by the crisis. However, IMF badly needs more funding to cover the massive increase in demand for its credit facilities.

Japan, among the wealthiest Asian countries, promised last weekend to set aside extra $100 billion in emergency funds for the IMF. China also announced support for IMF actions and committed to shouldering its share of the burden. While China has not specified how much emergency money it planned to make available to the IMF, the commitment seems to include a condition that China would have a greater say in IMF decisions in the future.

China's leadership says the biggest boost China can give the world will come from stimulating its own domestic economy; the Chinese economy has accounted for more than a quarter of all global economic growth. China has also promised direct financial support to select troubled economies. Hungary became the first candidate for Chinese funding after state policy bank China Development Bank entered into a joint agreement with Hungary at the beginning of November. The amount of support provided has yet to be announced. It is also clear that China has boosted its support for the United States since summer by significantly increasing purchases of US treasuries. Two months ago, China surpassed Japan as the largest single holder of US debt securities.

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Russia

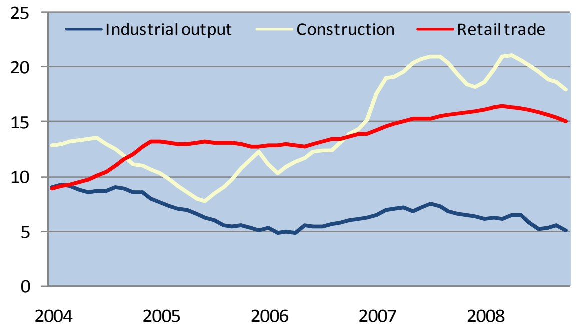
Economic growth cools in October. The economic slowdown was seen most clearly in drops of growth in investment, industrial output and construction. Rosstat preliminary figures indicate that investment growth slowed in October to 7 % y-o-y. Industrial output growth came to a near halt, rising just 0.6 %. While food production, wood processing and the chemicals industry, among others, contracted in October, manufacturing of rubber and plastic products climbed to nearly 16 % y-o-y. Oil production fell by nearly 1 %, while natural gas production grew marginally. Growth in electricity production was just under 3 %. Growth in construction output continued to decline, falling to 6 % y-o-y in October. Despite the poor development of the housing sector through the year, in October there was a sudden growth spurt of 15 % y-o-y.

Agricultural output growth continued to pick up, reaching 18 % y-o-y in October. Preliminary data suggest the 2008 grain harvest will be nearly a third larger than last year. Forestry production shrank about a fifth in October.

Consumer spending has held up remarkably well under the circumstances. Growth in retail sales slowed to around 12 % y-o-y in October. Growth in retail sales of food dipped slightly to below 9 %, while growth in non-food retail sales reached 15 %. Russia's consumption growth has been supported by a rapid rise in wages; although wage growth, too, has been slowing. Wages climbed nearly 12 % in real terms in October. The unemployment rate has risen gradually since summer, climbing to 6 % at end-October.

Preliminary economy ministry figures show 12-month GDP growth fell to 6 % in October, and during January–October, GDP grew 7.5 % y-o-y.

Monthly growth in core production sectors, % (12-month moving average)



Source: Rosstat

Further widening of the rouble fluctuation band. On Monday (Nov. 24), the Central Bank of Russia expanded the rouble's trading band by 30 kopeks in both directions. The rouble's external value is determined relative to a dollar-euro currency basket. The CBR also widened the trading band by 30 kopecks on November 11. While the CBR does not explicitly announce the limits on the trading band, it appears the effective ceiling under the new regime is 31.0 roubles per currency basket unit.

With the change, the rouble weakened to near the 31-rouble level. On Friday (Nov. 28), the rouble-dollar rate was 27.4 and the rouble-euro exchange rate 35.4.

CBR discloses allocation of currency reserves. CBR chairman Sergei Ignatyev reported that during September and October, $98 billion of Russia foreign currency reserves were consumed. About $58 billion of the sum went to propping up the rouble. The currency reserves were also used to provide liquidity to distressed banks and businesses. For example, the central bank loaned $14 billion to state development bank VEB, so that VEB could then further lend the money to other banks and firms to pay down foreign debts.

Exchange rate shifts also explain the downward valuation of the currency reserves. The current breakdown of reserves stands at 45 % US dollars, 44 % euros, 10 % British pounds and 1 % yen. Thus, the value of the currency reserves in dollars has fallen as the values of other major currencies have dropped relative to the dollar.

As of November 20, Russia's currency reserves stood at $450 billion. The rate of reserves depletion slowed however last week to below $4 billion for the week.

Finance minister Alexei Kudrin announced that, as of mid-November, about 18 %, or 315 billion roubles ($11 billion) in oil tax money set aside in the National Welfare Fund had been invested in domestic financial instruments. The Fund assets are on deposit with VEB, which then invests the money in domestic securities or lends it to other banks to help boost liquidity in the financial sector.

Financial market regulators in Russia and Cyprus agree to exchange information. Russia's Federal Financial Market Service and the Commission on Securities and Stock Operations of Cyprus have signed a memorandum of understanding, under which the FFMS can get information e.g. on the ultimate owners of Russian firms registered in Cyprus. The change is expected to improve oversight of off-shore companies.

Many of Russia's financial firms registered in Cyprus have large holdings in Russia's largest companies. Media reports indicate significant Cypriot holdings in companies such as coal giant SUEK, energy producer Itera, base metals producer Norilsk Nickel and Rostelekom.

FDI figures show Cyprus is Russia's largest FDI destination and the largest foreign investor in Russia.

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China

China substantially eases monetary stance. On Wednesday (Nov. 26), the People's Bank of China dropped its key reference rates by 1.08 percentage points. Following the cut, the new reference rate for one-year loans granted by commercial banks is 5.58 % and the deposit rate 2.52 %. The PBoC also announced on Wednesday that, effective December 5, the reserve requirements for large banks will fall a percentage point to 16 % and for small and mid-sized banks will decline two percentage points to 14 %.

China's decision-makers, alarmed about the diminished economic prospects, have moved swiftly to support growth. Besides relaxing monetary policy, China two weeks ago announced a $586 billion economic stimulus package.

Under the World Bank forecast released this week, China's economic growth is set to fall from 9.4 % this year to 7.5 % in 2009.

China posts huge current account surplus again. During January-June, China's current account reached $192 billion (10.4 % of GDP), up 18 % y-o-y. Growth, however, seems to be cooling. A booming trade surplus contributed $132 billion to the six-month current account surplus. The services balance continued to be negative as the value of service imports exceeded service exports by $3 billion. The contribution of goods trade to the current account surplus, however, has been declining in recent years, while income and current transfers (e.g. remittances, dividends, interest payments) from abroad comprise a growing share of the current account surplus.

The financial account, which tracks investment flows, contracted overall in the first half of this year compared to 1H07. Direct investment abroad by Chinese firms climbed from $7 billion to $33 billion, while direct investment of foreign firms into China rose from $58 billion to $74 billion. Total net portfolio investment, which had been negative (–$5 billion) in 1H07 returned to surplus ($20 billion). Foreigners' net portfolio investment to China fell from $10 billion to $5 billion and Chinese repatriated more investment from abroad ($28 billion) than their amount of new investment abroad ($13 billion). Other capital investment inflows in 1H08 amounted to just $10 billion, or about a quarter of such investment a year earlier. The net impact of foreign borrowing and trade credits diminished in the first half. The changes in investment flows reflect uncertainty in international financial markets, where it has become harder to get foreign loans.

The slowing growth in the current account surplus and the shrinking of the financial account surplus inhibited the growth of foreign currency reserves in the first half. As of end-June, China's foreign currency reserve stood at $1,809 billion. During the third-quarter, foreign reserves have increased by an additional $100 billion.

China's key first-half balance-of-payments figures and foreign currency reserves, US$ billion

January-June	2006	2007	2008
Current account	91	163	192
Capital account	2	1	2
Financial account	29	89	70
Net errors & omissions	0	13	17
Increase in currency reserves	122	266	280
Currency reserves on June 30	941	1,333	1,809

Source: SAFE

Hong Kong economy falls into recession. Hong Kong's economy contracted in both the second and third quarters of this year, which under the technical definition puts the economy officially in recession. The global economic crisis caused Hong Kong's second-quarter growth to shrink 1.4 % from the previous quarter; 3Q08 growth was down 0.5 % from the previous quarter. On-year, however, the Hong Kong economy still grew 1.7 % in the third quarter. While growth in Hong Kong services exports has slowed substantially in the past year, signs of fading economic growth have yet to appear in the unemployment rate, which, according to preliminary figures, stood at 3.5 % in August-October 2008.

Hong Kong, with its economic freedom and transparent regulation, serves as an important global financial hub critical to firms in mainland China. In recent years, Hong Kong has benefited from the rapid economic growth on the mainland. However, Hong Kong share prices this year have lost about half their value since the beginning of January. This negative wealth effect is partly responsible for holding private consumption growth to just 0.2 % y-o-y in the third quarter (down from 3.2 % y-o-y in the second quarter).

As Hong Kong's exchange rate is pegged to the US dollar, the special administrative region is closely bound to US monetary policy moves. In recent months, Hong Kong's monetary authority has made a series of interest rate cuts and moved to increase liquidity in the interbank market. The government also committed to guaranteeing all Hong Kong bank deposits.

Compared to the Asian financial crisis in the late 1990s, the current contraction is still quite modest. The Hong Kong economy shrank 6 % in 1998, and over the following years experienced an episode of painful consumer price deflation. The dollar peg to some extent limited the ability of officials to implement more relaxed monetary policies.

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Russia

Further widening of rouble trading band accompanied by interest rate hike. Over the past week, the Central Bank of Russia twice broadened the rouble's fluctuation band relative to its binary dollar-euro currency basket. The latest change was made today (Dec. 5). The CBR widened the band by a total of 0.6 roubles, 0.3 roubles each time. The new trading band is now 28.1–31.6 roubles. The familiar pattern of the rouble weakening to the upper limit of the trading band after the change was announced was again repeated. The CBR has now widened the trading band four times in a less than four weeks.

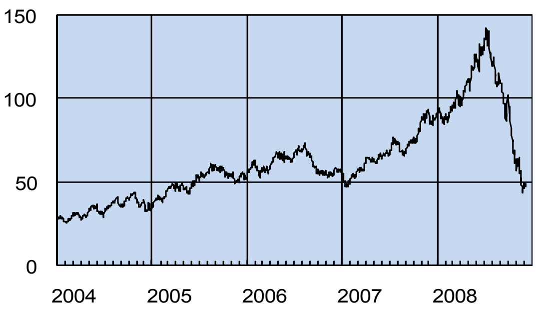
On November 28, the CBR raised its key reference rates with effect on Monday (Dec. 1). For example, the one- and ten-day repo rates were raised one percentage point to 10 %. Key rates were last raised on November 11.

Finance minister Alexei Kudrin said that raising interest rates was part of government efforts to get banks to raise deposit rates to levels that will encourage savers to keep their deposits in roubles and reduce flight to other currencies.

Unrelenting decline in oil prices defies budget assumptions. The spot price of Urals-grade crude oil this week fell below $40 a barrel, the lowest it has been since 2005. The price of Urals crude in the first half of this year averaged over $105 a barrel.

The Russian economy generates 65–70 % of its export earnings from energy, so it remains highly dependent on oil, the largest source of those earnings. Moreover, tax revenues from energy account for about a half of all federal budget revenues. The 2009 budget will be in balance as long as the average price of Urals oil stays around $60 a barrel next year. The CBR's monetary policy programme announced in August assumes that Russia's remarkable streak of current account surpluses posted throughout this decade will come to an end if the average crude oil price falls below $66 next year.

Urals-grade crude oil, US$/bbl



Source: Bloomberg

Currency reserves rise. After falling for two months in a row, Russia's foreign currency reserves rebounded in the last week of November. For the week, the reserves rose by $5 billion and stood at $455 billion as of November 28.

Russia's currency reserves peaked in early August at $598 billion.

State moves ahead with tax relief measures. Working on an accelerated scheduled, the Russian Duma last week approved amendments to the tax code that lower the corporate profit tax next year from 24 % to 20 %. Companies will also get relief from e.g. faster amortisation, possibilities to reschedule tax payments in special cases, and allowing regional authorities to lower the tax rate on small firms from the current 15 % to as low as 5 %.

The amendments included a rule change that will protect firms from overly invasive treatment during on-site tax inspections, which earlier could be time-consuming and interfere significantly with a company's normal operations.

The government also last week lowered the export duties on crude oil and oil products, effective December 1. The export duty on crude oil was lowered from $39 a barrel to $26. While oil export duties still lag the current market prices, the export duty is currently reviewed once a month, and based on the average world market price during the previous month. Previously, the duty was reviewed every two months and determined according to prices from the two previous months. The change to a shorter reviewing period was made this autumn in order to enhance the reduction in the tax when oil prices go down.

Financial crisis also reflected in corporate profits. The total profits of corporations (excluding the financial sector) declined slightly in the third quarter of the year, especially in September compared to a year earlier. 3Q08 profit growth slowed in all branches, and most in the construction sector. The profitability of real estate companies was down sharply from a year earlier.

Firms have found it harder in recent months to raise prices at the same pace as earlier. As a result, the rise in producer prices slowed sharply this autumn, especially for companies involved in hydrocarbon extraction. In October, however, producer prices were still rising 18 % y-o-y, beating out the rise in consumer prices. In mineral extraction industries, prices rose just 3 %, while manufacturing saw price growth of 23 % y-o-y.

The sharp rise in labour costs continued in October; nominal wages were up 28 % y-o-y.

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China

November PMI figure drops below 40. On Monday (Dec. 1), the Federation of Logistics and Purchasing released its monthly Purchasing Managers' Index (PMI) for the manufacturing sector. The November index value of 38.8 %, the lowest since the PMI was first published in 2005, confirms the perception that industrial output growth is generally slowing. Values below the 50 % mark indicate a perception among purchasing managers of weaker economic conditions relative to the previous month. The PMI figure is in line with data from the National Bureau of Statistics showing a slowdown in industrial output growth this year.

The record-low PMI reading for input prices signals that the cost pressures seen earlier are likely to abate quickly.

China considers easing controls on retail pricing of gasoline and other oil products. With the sharp decline in world oil prices and a low inflation environment, Chinese officials are seizing the opportunity to reform pricing policies for gasoline and diesel fuels. A proposal from China's National Development and Reform Commission (NDRC) seeks to deregulate retail pricing of fuels and introduce a fuel consumption tax. Reform has been under discussion for almost ten years and it would help to reduce China's dependence on foreign energy suppliers, increase energy efficiency and protect the environment. The shift would also represent a significant step towards a market-based fuel pricing mechanism. Regulated prices have led to fuel shortages and hoarding episodes across the country in recent years.

With pump prices for gasoline and diesel fuels already about 50 % higher than in the United States, decision-makers are taking advantage of the current declines in oil prices to push through the reforms and introduce the new fuel consumption tax. Consumers should be amenable to the change if, as the NDRC claims, the fuel consumption tax will be offset by elimination of road tolls. Local administrators oppose changes in retail pricing and tax structure for fuels, as they benefit directly from road tolls. Moreover, farmers and the military also oppose the fuel consumption tax as they are exempt from road tolls.

The reformed pricing regime would benefit Chinese oil companies, which presently pay prevailing world prices for crude oil and then have to sell their refined products at regulated prices. As world energy prices spiked over the last two years, refiners suffered massive financial losses that the state eventually had to make up through subsidies. The market-based pricing scheme should also clarify relations between the state and state-owned oil companies.

This week, China announced it was eliminating price controls imposed last January on certain food products. The price controls were intended to subdue inflation, which has now fallen with the global collapse of commodity prices.

Fiscal policy takes aim at the countryside. Chinese officials have announced a stimulus package designed specifically to help the rural population. Farmers in 14 provinces will be granted a 13 % discount on the purchase of some home appliances such as televisions, refrigerators and mobile phones. The support package is said to be 920 billion yuan (€105 billion) spread over the next four years. The programme is planned to be extended to all provinces in February 2009.

Boosting rural consumption supports manufacturing and domestic employment. Plans to provide subsidies for improving rural conditions and developing infrastructure were already mentioned as part of the giant 4 trillion yuan ($586 billion) stimulus package announced at the beginning of November. Stoking domestic demand in China is seen as a necessary approach to preserving robust economic growth and healthy employment during the global economic downturn. Real retail sales figures suggest that domestic demand growth has remained strong this year.

In conjunction with the stimulus package, officials also approved plans to build 550 kilometres of new motorways. Money has already been committed for the end of this year to improving transportation infrastructure, including railways, the road system and airports. The projects should boost demand for steel and cement, as well as create employment.

Chinese firm takes over container handling operations at the port of Piraeus in Greece. One of the world's largest shipping companies, China's Cosco, has acquired a 35-year concession to handle container cargoes at the Port of Piraeus near Athens. In addition to paying the concession fee of nearly €900 million, Cosco further committed to investing over €200 million in pier area upgrades. According to Greece's maritime ministry, the Greek state will benefit a total of €3.4 billion from the deal if the taxes and other revenues generated by the project over three-and-a-half decades are included. Piraeus is the world's largest passenger port and ranks among the world's 50 largest cargo ports. Greece's dock employee union aggressively opposes the deal. Cosco has concession to handle containers for example in Antwerp, Belgium.

Although Chinese foreign direct investment outflows have expanded rapidly in recent years, China's FDI stock abroad is modest. Most investments have focused on the commodity sector. China's balance of payments figures show that in January-June, China's foreign direct investment abroad was $33 billion.

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Russia

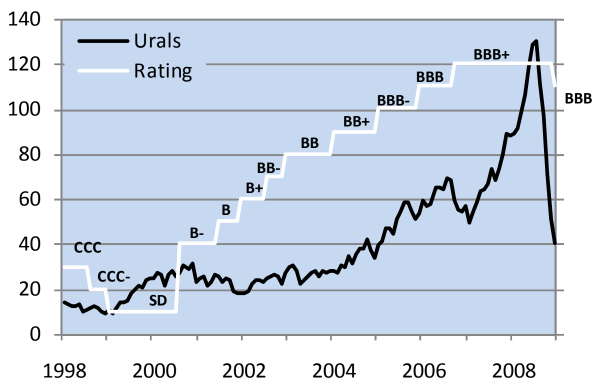
Rouble trading band widened again. The rouble's trading limits were widened twice in the past week against its euro-dollar currency basket. The latest move widened the upper and lower trading bands another 30 kopecks. The range now stands at 27.8–31.9 roubles. The band was widened by 30 kopecks on each of five occasions since November 11.

Russia's foreign currency reserves declined $18 billion in the latest reported week, and stood at $437 billion last Friday (Dec. 5).

S&P lowers Russia's sovereign credit ratings. On Monday (Dec. 8), the international credit rating agency Standard & Poor's dropped its rating of Russia's foreign currency sovereign borrowing from BBB+ to BBB. Rouble sovereign debt was also lowered from A- to BBB+. The ratings downgrade was stated to reflect risks related to the reversal in Russia's investment flows. This has increased the cost of and reduced the access to external financing. S&P expects Russia's current account balance and budget will both go into the red sometime next year. Russia will have to make up for its possible 2009 and 2010 budget deficits, as well as pay for the recapitalisation of its banking sector, with money from the Reserve Fund and the National Welfare Fund if oil prices remain depressed. S&P expects Russia's GDP growth to slow sharply next year.

S&P also declared a negative outlook on the rating. The credit rating is an opinion of the creditworthiness of an obligor and in turn affects the access to credit and price at which money is available. A rating of BBB- is the lowest investment-grade rating (issuer expected to still perform on its obligations).

S&P foreign currency borrowing rating and Urals oil price



Sources: Standard & Poor's, Bloomberg

Deposit stock continued to shrink in October. Central Bank of Russia figures show that the decline in the deposit stock of banks accelerated in October. The decline most affected rouble deposits, which account for about 80 % of all Russian bank deposits.

The stock of household deposits in October contracted 6 % m-o-m. Household deposits at the end of October amounted to 4.1 trillion roubles (€117 billion), or 16 % of total banking sector assets. Household rouble deposits fell 9 % in October; foreign currency deposits rose 11 %.

The October corporate deposit stock contracted nearly 1 % from September. Corporate deposits are important for banks as they represent about 35 % of banking sector total assets. Corporate rouble deposits fell 4 %, while foreign currency deposits increased 10 %. Foreign currency deposits represented about a quarter of total corporate deposits.

Even with the CBR's latest rate hikes, real interest rates for household rouble deposits remain negative, as on-year inflation was near 14 % still in November.

Government plans to dip into the Reserve Fund. Finance minister Alexei Kudrin announced that the state plans next year to withdraw at least a trillion roubles (€28 billion) from the Reserve Fund to support the public economy. As of end-November, there were 3.7 trillion roubles (€103 billion) in the Reserve Fund and 2.1 trillion roubles (€58 billion) in the second oil-tax earnings fund, the National Welfare Fund.

It will be the first time the government dips into the Reserve Fund since it was established in 2004. Fund money will be used to cover federal and regional budget deficits. Budget deficits can arise from lower energy prices that reduce export tariff revenues, as well as lower tax revenues after the tax cuts approved at the end of November take effect in January (the loss is expected to be around 400 billion roubles). For example, the corporate profit tax will decline by four percentage points, which will cut especially into regional budget revenues. Kudrin maintains that the tax cuts will not affect current budget spending plans.

Federal budget remains in surplus. Due to the historically high oil prices earlier this year, the 2008 federal budget is still substantially in surplus. Preliminary finance ministry figures show the January-October surplus amounted to 2.6 trillion roubles (€72 billion), or more than 8 % of estimated GDP for the period. However, budget spending has traditionally grown at the end of the year, which will somewhat cut into the surplus for the entire year. The accumulated surplus this year will be shifted at the beginning of next year to the off-budget Reserve Fund.

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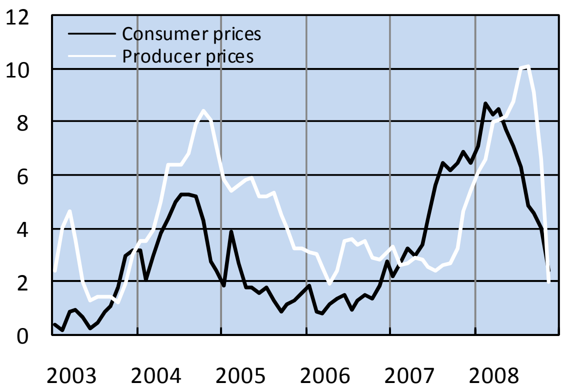
China

Both consumer- and producer-price inflation slow sharply. The National Bureau of Statistics reports that the rise in consumer prices fell to a pace of just 2.4 % y-o-y in November – the lowest figure in almost two years. It was the ninth month in a row that China's inflation fell since hitting a high of 8.7 % last February. A third of China's consumer shopping basket consists of food items, the prices of which are now increasing much more slowly than before. The price rise for non-food items also decreased from 1.6 % y-o-y in October to 0.6 % last month. The rise in producer prices declined to 2 % y-o-y. The lower producer price inflation partly reflects the global slide in commodity prices.

The calming of inflation was expected, even if the realised drop was larger than the consensus forecast. Indeed, the fact that the drop in inflation was so severe is now stoking fears of possible deflation. Nevertheless, lower inflation gives the government greater latitude in its use of fiscal and monetary stimulus measures. Lower inflation has also turned real interest rates positive.

Consumer- and producer-price inflation, % y-o-y

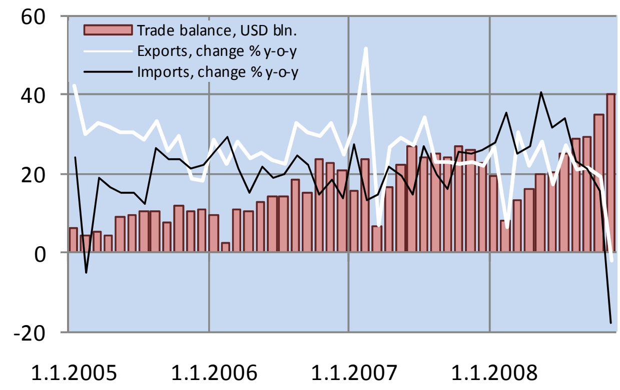


Source: China's National Bureau of Statistics

China's export growth turned slightly negative in November, imports nosedive. Data released this week show that Chinese exports contracted over 2 % y-o-y in November. Imports fell by nearly 18 %, causing the trade surplus to climb from $35 billion in October to $40 billion in November. The lower growth in exports was particularly dramatic, given that in October exports were still *rising* at a pace of 19 % y-o-y. The shift was anticipated, however; company surveys began to indicate a sharp weakening in export orders earlier than the official statistics came out.

International organizations see economic growth in many countries in developing Asia remaining positive next year. The World Bank, for example, released a forecast this week that expects economic growth in East Asia (excluding Japan and the Indian subcontinent) to exceed 5 % next year. Although a substantial share of Chinese exports are initially shipped to Asia for further processing, the ultimate markets for value-added export goods are typically in Europe or North America – regions now struggling with economic recession.

China's foreign trade



Source: China Customs

Paulson holds final round of talks in China. United States treasury secretary Henry Paulson went to Beijing last week for his last appearance as delegation head at the US-China semi-annual "strategic dialogue" meetings he helped establish. Top ministers of both countries have met under the dialogue arrangement since 2006 to discuss various economic topics. As earlier, China's foreign exchange rate policy topped the agenda. This time, the valuation of the yuan has special significance, given the decline in growth in China that is increasing speculation about yuan devaluation to help export industries. Officially, at least, China appears hesitant to abandon the present foreign exchange rate policy, because the decaying export prospects stem from a collapse in demand rather than erosion of the competitiveness of Chinese exporters. A substantial depreciation of the yuan against the dollar would also chill relations with the incoming US administration. During his campaign, Barack Obama and his economic advisers argued that China should allow faster appreciation of the yuan against the dollar. It is not known if the Obama administration plans to continue the strategic dialogues that have so far benefited both countries.

China sharply criticised the EU, currently headed by France, after French president Nicolas Sarkozy met last weekend with Tibet's spiritual leader, the Dalai Lama. To protest the meeting, China scrubbed a scheduled EU-China summit at the beginning of this month.

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EUROJÄRJESTELMÄ
EUROSYSTEMET

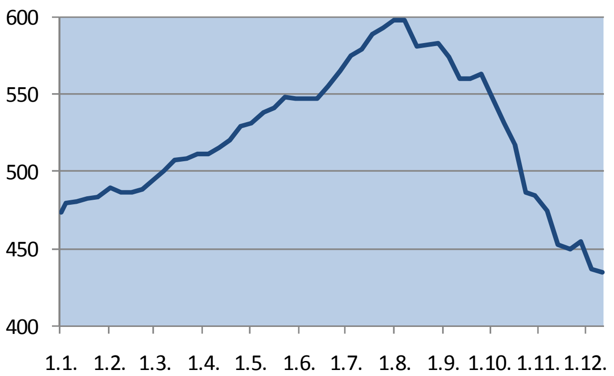
BOFIT Weekly
51-52 • 19.12.2008

Russia

Further widening of the rouble's trading band. The Central Bank of Russia widened the rouble's trading band three times this week. The new fluctuation range for the rouble against its dollar-euro currency basket is 26.4–33.1 roubles. It was the eighth widening of the trading band since November 11, when this series of sustained actions began. In earlier adjustments, the limits of the trading band were shifted in 30-kopeck increments. This week's moves were more substantial. The moves amount in total to a shift of 2.7 roubles since November 11. The rouble has weakened over 8 % against the currency basket since November 11.

Russia's gold and foreign currency reserves declined by $1.6 billion last week and stood at $435 billion as of last Friday (Dec. 12). Russia's reserves have contracted a total of $163 billion since peaking at $598 billion in early August.

Russia's foreign currency reserves in 2008, US$ billion



Source: CBR

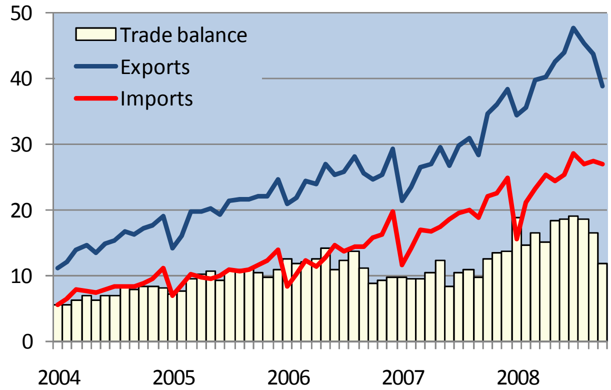
Industrial output contracted in November. Preliminary Rosstat figures show that industrial output contracted in November at a rate of nearly 9 % y-o-y. Manufacturing, as well as production of electricity, gas and water, declined about 10 %, while production of mineral extraction industries was down 2 %. During the autumn, many large companies, including metals producers and car companies, have warned that they have to slash production and close plants temporarily. These warnings came to pass last month, as the production of many goods in these sectors, along with construction materials and chemicals reduced sharply.

Preliminary Rosstat figures indicate Russian GDP rose 7.3 % y-o-y in the first nine months of the year. Last week the economy ministry stated that Russian economic growth will slow substantially in the last quarter of the year. Hence the ministry expects overall GDP growth for 2008 to come in at 6 %.

Lower foreign trade growth emerged in October. Although the value of Russian exports still grew 12 % y-o-y in October, it was quite a drop from the September figure of over 50 %. The soaring trend in import growth also slowed down significantly. September growth was still 47 % y-o-y, but October was just 21 %. Lower growth was most apparent in imports from CIS countries, which saw growth decline from 45 % y-o-y in September to 6 % in October. Imports from non-CIS countries increased 23 % in October.

Russia is also turning to trade policy measures to protect its domestic industries. For example, import tariffs on automobiles, poultry and pork will be increased temporarily from the start of next year.

Russian monthly foreign trade, US$ billion



Source: CBR

Economic downturn hurts employment and increases wage arrears. Many large Russian companies have announced layoffs and downsizing of personnel in recent months. Social services and health minister Tatyana Golikova said new work has been found for about 40 % of the approximately 30,000 people who have lost their jobs since the start of October. Golikova expects less than 10 % of Russia's labour force to be laid off next year. The unemployment rate was 6 % at the end of October.

The monthly unemployment benefit is planned to be increased to 4,900 roubles (€130), an amount corresponding to less than a third of an average wage. Prime minister Putin has proposed improving the labour situation by reducing significantly the amount of work permits granted to foreign workers.

Layoffs are especially problematic regionally as Russia has hundreds of towns with a single large employer.

Due to financial problems, many firms have begun to delay wage payments. The level of wage arrears has risen clearly over the past two months. Wage arrears at the start of December doubled from just a month earlier. Over half of wage arrears come from the manufacturing and construction industries.

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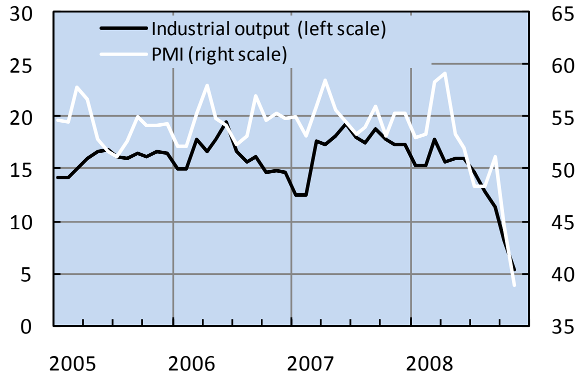
China

China's industrial output growth collapses to record low. Hopes that China would provide a safe harbour and act as an engine of global economic growth during the current financial crisis evaporated last week after China's National Bureau of Statistics released its industrial output figures for November. Real growth in industrial output fell to 5.4 % y-o-y, down from 8.2 % in October (see chart). Industrial output growth has been on the wane in recent months; November's on-year growth was nearly 12 percentage points lower than a year earlier. Car manufacturing fell 16 %. Industries such as steel, iron and other commodity producers, as well as electrical power production fell sharply relative to November 2007. The Manufacturing Purchasing Managers' Index released at the beginning of December showed a general expectation that production would continue to decline; the November figure, the lowest on record, reflected shrinking order books and lower sales expectations.

China's export growth flamed out in November, plunging to just 2 % y-o-y in dollar terms. In October, export growth was still 19 % y-o-y. The situation for domestic demand, however, is not so clear. Fixed investment in urban areas continued to surge with nominal growth in November at 27 % y-o-y – a remarkable number considering it includes apartment construction and real estate investment, both of which are at zero growth. November retail sales figures also indicated nominal growth of almost 21 % y-o-y (or real CPI-deflated growth of about 18% a year).

Chinese 12-month industrial output growth (%) and manufacturing purchasing managers' index (PMI)



Sources: NBS and CEIC

Officials move to support flat housing market. A barometer compiled from five sub-indices shows building construction activity has declined 7.6 % in January-November from the same period a year earlier. Measured in terms of completed floorspace, construction activity continued to rise through January-November, even as land sales, which foreshadow future construction, decline 6 % y-o-y in the same period. Housing starts overall increased in January-November by just 5 %, and the trend to lower growth persisted throughout the period. The unsold share of the total building stock, measured in floorspace, rose, while the aggregate value of sales of building space fell by nearly 20 % y-o-y in January-November.

Investment in the real estate sector is equivalent to about 10 % of China's GDP, so the chill in real estate has large implications for the national economy. The severity of the downturn in the housing market and elsewhere in the economy stems in part from official policies intended to stave off a housing bubble. Housing market continues to receive special attention from the government. For example, the requirement that first-time apartment buyers put down 30 % of the purchase price has been lowered to 20 %. The government also announced support for construction of affordable housing for low-income city-dwellers. The government also wants local administrations to offer land and financing to stimulate housing construction in the countryside and cities.

The government's plans to provide direct support to the construction sector include increasing investment in construction of reservoirs and canals to bring water to regions suffering from drought. Construction schedules for motorways and railways will be accelerated, investments in waste water treatment and waste processing will be boosted and money will be allocated for refurbishing schools.

China's fuel pricing reforms set to take effect. The Chinese government has confirmed that on January 1 it will raise the consumption tax on gasoline and diesel fuel, as well as begin to deregulate fuel prices. According to preliminary information, the consumption tax on gasoline will rise from the current 0.2 yuan to 1.0 yuan and the diesel tax from 0.1 yuan to 0.8 yuan per litre. The higher consumption tax revenues replace earlier revenue sources such as road tolls.

Although the details of deregulated fuel pricing are yet to be announced, it is clear that fuel prices in the future will be more closely aligned to world oil prices. Currently, retail gas stations can only adjust their pump prices up to 8 % from the official reference price. Although the government decided to cut gasoline prices already this week, the price reform will be implemented without price increases at the beginning of 2009.The pump price of gasoline in China is currently just under €0.60 per litre. The corresponding price is just over €0.30 in the US and €1.10 in Finland.

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Central Bank of Russia / Exchange rates 2008
Source: http://www.cbr.ru/eng/currency_base/dynamics.asp

Date	USD	Euro
10.1.2008	24.4387	35.9762
11.1.2008	24.4796	35.9214
12.1.2008	24.3671	36.0389
15.1.2008	24.2913	36.1212
16.1.2008	24.2858	36.113
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24.1.2008	24.6325	35.9832
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9.2.2008	24.7813	35.8585
12.2.2008	24.6715	35.9316
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18.3.2008	23.5126	37.1123
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20.3.2008	23.5581	37.0216
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1.4.2008	23.5027	37.0873
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