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managing risk, enabling trade

market monitor

Adapting to the challenging economic environment

September 2010

Steering a steady course to recovery

While all of the countries featured in this month's Market Monitor are seeing an improvement in their economic performance, one of them – China – is in the enviable position of having to consciously steer its GDP growth downwards to avoid its economy overheating.

Not that it's all plain sailing for China. A sluggish export market is just one problem it still faces – in common with several of our featured countries while, for others, exports are proving the mainstay of their recovery.

For instance, while the Swedish economy is showing real signs of improvement, its high reliance on exports means that any moves to reduce budget deficits in the eurozone could blow it off course. By contrast, Italy's exports are definitely on the crest of a wave, not just to its EU partners, but to South America and Asia as well.

Elsewhere in this Market Monitor, there's a mixed outlook for France, with the automotive and transport industries under pressure while manufacturing and inventory restocking have boosted GDP. And, while France too is experiencing a deceleration of its external trade, Austria's recovery is led by a high tide of exports.

Finally to Russia, where exceptional weather conditions have cast a shadow over an improving economic performance. While other countries seek to increase their exports, the drought and wildfires of recent months have led Prime Minister Putin to introduce a ban on wheat exports until next year's harvest.

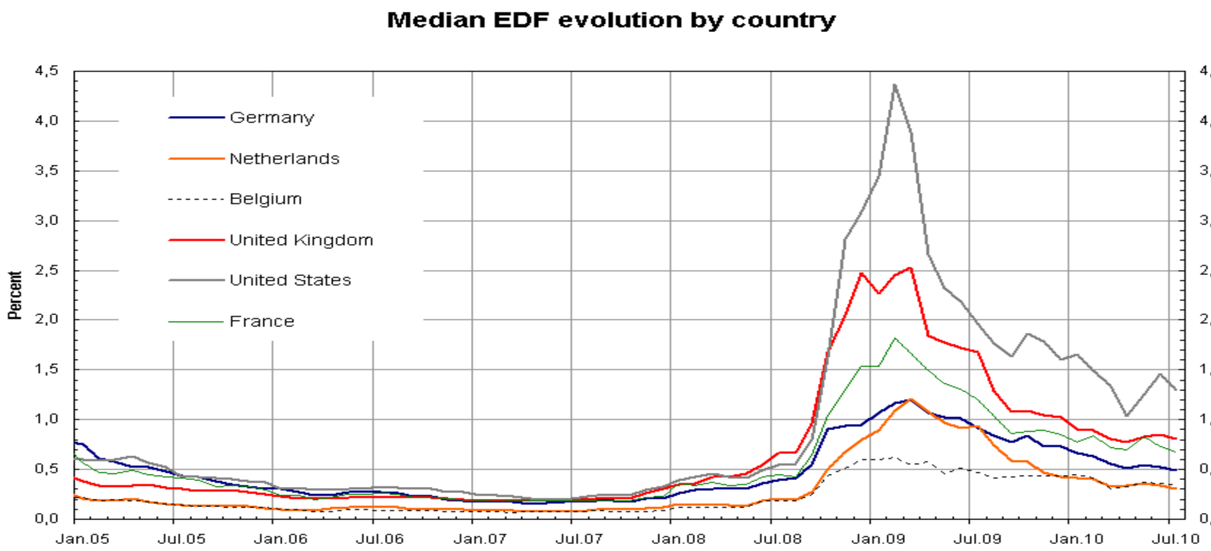
In this issue…

…we feature the following markets:

- Italy – with a spotlight on the agriculture/food and textile/clothing sectors
- Austria – with a spotlight on the chemicals and transport/logistics sectors
- France
- Sweden
- China
- Russia

Expected default in Western Europe and USA

One of the most important factors that any business needs to know is the trend in insolvencies in their markets. The following Expected Default Frequency (EDF) chart is based on listed companies in the markets referred to, and the likelihood of default across all sectors within the next year. In this context, default is defined as a failure to make a scheduled payment, or the initiation of bankruptcy proceedings. Probability of default is calculated from three factors: market value of a company's assets, its volatility and its current capital structure. As a guide, the probability of one firm in a hundred defaulting on payment is shown as 1%.



Source: KMV Credit Monitor and Atradius Economic Research

After an increase in May across all the economies surveyed, due to higher financial market volatility triggered by uncertainty over the global economic recovery and the eurozone's troubles, the situation has calmed down again. The July 2010 median EDFs for France, Germany and the Netherlands are the lowest since the beginning of 2010. At the same time Belgium and the UK recorded slight decreases, while the US median EDF dropped 16 basis points.

On the following pages, we assess the impact of expected default in key markets. As well as the expert view of our underwriters, we indicate the general outlook for each market and sector featured using these 'weather' symbols:

Excellent

Good

Fair

Gloomy

Bleak

Insolvencies will increase further this year

Italy continues on the path to recovery, albeit slowly, as GDP grew in Q2 of 2010 - by 0.4% on the previous quarter and 1.1% year-on-year. The largest contribution came from exports which, according to the Italian Statistics Office ISTAT, increased 12.6% year-on-year between January and June (a 12.2% increase in exports to EU countries and 13.2% to non-EU countries). Exports to Italy's main trading partners Germany and France increased 14% and 13.2% respectively, but the biggest boost came from outside the EU, with well above average increases to Turkey (54%), South America (28%), China (23%) and India (23.3%). In terms of products, in addition to the traditionally strong exports like food and furniture, electromechanical articles (wires, solar panels etc) performed well.

Industrial production, turnover and new orders all posted positive results in the first half of the year. According to ISTAT, manufacturing production (excluding construction and calendar adjusted) recorded a 2.2% increase in Q2 on the previous quarter and 5.5% year-on-year. Industrial orders rose 13.2% year-on-year between January and May. However, despite this industrial recovery, investment in machinery and equipment remains modest, suppressed by uncertainty about future demand and by continuing spare capacity.

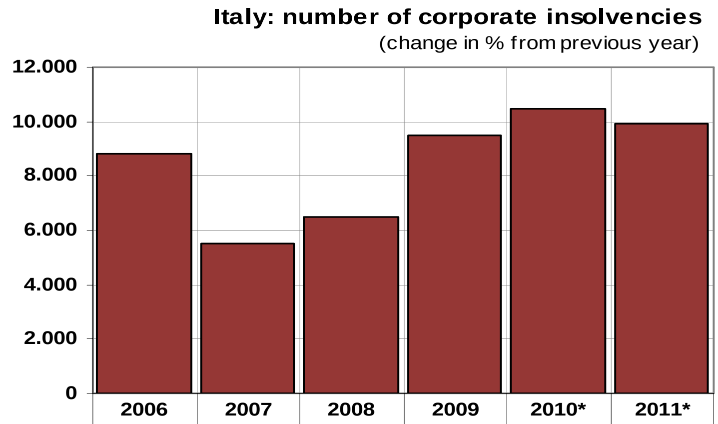
Internal demand is still weak, with household consumption sluggish. Unemployment remains high - at 8.5% in June 2010 - and, after a recovery during late 2009, consumer confidence has weakened again since the beginning of this year. Retail trade decreased 0.1% between March and May on the previous three months (non-food: -0.3%). Several domestic-oriented sectors like wholesale, hotels, construction and construction materials, metals, textiles and footwear show higher overdues (see chart below).

Chart 2	Bank Lines 05-2009	Bank Lines 05-2010	Overdues 05-2009	Overdues 05-2010	Overdues/lines 05-2009	Overdues/lines 05-2010
Agriculture	37.434	39.455	2.142	2.638	6%	7%
Construction materials	19.666	18.612	675	1.012	3%	5%
Metals	31.209	30.345	1.386	2.359	4%	8%
Industrial Machines	25.991	24.465	1.051	1.554	4%	6%
Food	29.874	29.055	1.543	1.879	5%	6%
Textile and Footwear	28.611	26.143	2.603	3.589	9%	14%
Industrial Products	22.301	22.352	1.508	2.009	7%	9%
Constructions	131.914	131.504	6.141	8.430	5%	6%
Wholesaler	135.298	135.309	6.536	9.055	5%	7%
Hotels	36.762	36.709	1.431	2.057	4%	6%

Source: Bank of Italy

Italy

After a massive 46.2% increase in 2009, we expect corporate insolvencies to rise further this year, but an improvement, albeit small, is expected in 2011 (see chart below).



	2006	2007	2008	2009	2010*	2011*
Total	8.827	5.518	6.498	9.500	10.450	9.928
% change	0,0%	-37,5%	17,8%	46,2%	10,0%	-5,0%

* forecast date 30 June 2010

Source: Atradius Economic Research

A moderately positive outlook

The Bank of Italy expects GDP to grow 1% in 2010 and 2011, and the overall perspective on the Italian economy is moderately positive for the coming 12 months, as export demand is likely to continue to drive the recovery. Nevertheless, there are still potential pitfalls in the coming months, as the phasing out of stimulus measures and the effects of fiscal consolidation will probably slow down the rebound. In the case of raw material prices and stock exchange performance, it is hard to predict if this signals a further slowdown or will develop into a new consolidation phase. Either way, many sectors will face a difficult second half of 2010, and so a prudent approach is still recommended. The spread on the Italian bonds in the market is still under control and further turmoil of sovereign debt in the eurozone hasn't been forecast. However, the currently unclear political situation in Italy could also have an impact in the months to come.

Agriculture/food

How has the agriculture/food sector performed in the last six months?

In Q2 of 2010, domestic agricultural production decreased 2%, due mainly to a lower output of crops (except in some segments like wine grapes, wheat and corn), while animal farming activity remained reasonably stable. Farmers' profitability is still under pressure this year as production prices, although recovering, are insufficient to generate real earnings. Breeders in particular have been affected: hit by both declining production prices and higher costs.

Food production saw a slight 0.5% contraction in Q2, although the total level of production is higher than the 2009 average and the sector has preserved its production capacity throughout the economic crisis without ever having to report a significant downturn.

It is worth noting, however, that large retailers, by concentrating on the sales of brand labels and higher value products while cutting prices to promote and preserve sales, have suffered a consequent pressure on their margins.

Looking at consumption of agriculture/food sector products in general, so far in the second half of 2010 there has been some stability in sales of agricultural products, though with some sales falling and others increasing. Sales of cereals, pork, salami and fruit are stable, while veal, wine, bread and pasta have fallen and dairy products, vegetables, olive oil and poultry sales have risen.

What is the current trend in payment delays and payment defaults?

The agriculture/food sector has shown a slight increase in late payments, but, with signs of a moderate overall improvement in the Italian economy, we expect a levelling-off or even better results in the second half of the year.

What is Atradius' short term outlook for the agriculture/food sector?

The agriculture/food industry is quite complex, made up as it is of very different subsectors: from animal breeding to meat production and sales, and from corn growing to pasta production, making a single forecast for the whole industry difficult. The continuing moderate decline in production suggests that we should be cautious about any upturn trend. Nevertheless some indicators, such as a recovery of orders and the reduction of stocks, have boosted the confidence of market operators. However, there is a potential negative outlook for the pasta subsector, due to the wheat exports ban in Russia and competition from other major producers in Eastern Europe.

Textile/clothing

How has the textiles and clothing sector performed in the last six months?

The whole Italian textile sector has been in crisis since as long ago as 2001, due mainly to low price competition from the Far East. The outsourcing to other countries of low value yarn and highly labour intensive production with small margins has reduced the range of the industry, with Italian companies instead adopting a niche strategy of high value products: typically fashion related. Thanks to their unique skills, some industrial areas have been able to survive.

In the first half of 2010, the main players in the sector have shown some positive results, compared to the very negative figures of 2009, with sales up 3.4% and profits slightly higher year-on-year. However, between January and June 2010 small- and medium-sized manufacturers suffered from the steep fall in end-user consumption. Consumers are focused more on primary goods than textile products, and this has hit many fashion brands.

What is the current trend in payment delays and payment defaults?

The textile sector still has the highest level of overdue bank debts (13% and, including footwear, 14%). Payment delays and defaults have increased steadily, and we are expecting a continuing negative trend, although some districts will perform better than others.

What is Atradius' short term outlook for the textile/clothing sector?

The feedback from the main Italian textile districts (Biella, Carpi, Como, Prato, Vicenza) is mixed. Any recovery will be very modest and slow in textiles and even more so in clothing. There are some positive signs coming from the Biella district; whereas Como, specializing in silk production, continues to face strong Asian competition. The Prato district has shown some export growth (10%).

On the whole, the forecasts for 2010 confirm a poor sector performance - production down 14% and turnover down 12% - with exports decreasing 9% and domestic orders declining 16%. (Source: SMI Sistema moda Italia).

Austria

Recovery driven by rising exports

Austria's GDP declined 3.4% in 2009, due mainly to a drop in economic activity in the first half of last year. However, recovery gained momentum in the second half of the year and in early 2010, thanks to improved stock investments and rejuvenated exports. According to the Austrian Statistics office, between January and May 2010 exports increased 9.8%, while imports rose 9.7%. Industrial production rose 7.6% year-on-year in June 2010. Private consumption has increased moderately in the first half of the year, with retail turnover up 2.9% year-on-year. In Q2 of 2010, GDP grew 0.9% on the previous quarter and 1.9% year-on-year.

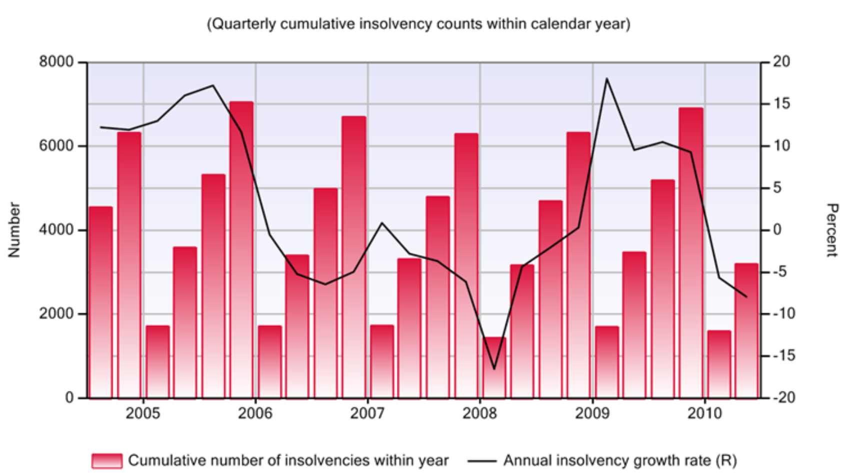
According to the Austrian National Bank, the difficult economic situation is still impairing the financing of Austrian companies, although the situation has eased slightly since autumn 2009. Bank lending has shown negative growth since the end of 2008, for two main reasons. On the one hand, the drop in investment activity has reduced demand for corporate financing and, on the other hand, with company ratings downgraded in the wake of the downturn, the banks' lending policies have remained cautious. However, in Q2 of 2010, Austrian banks have, for the first time since the onset of the crisis, eased credit conditions for business loans, at least for larger companies, which had been subject to much tighter loan conditions than smaller enterprises during the crisis. Interest rates for business loans have remained far below the eurozone average, and this should support further economic growth.

Corporate insolvencies have decreased

According to credit agency KSV, 3,196 corporate insolvencies have been registered in the first half of 2010, a 7.9% decrease year-on-year, after a 9.3% increase last year. Related outstanding receivables shrank 20% to €1.6 billion. Those most affected were companies already suffering from high debts and losses before the economic crisis.

Insolvency trends: Austria

(Quarterly cumulative insolvency counts within calendar year)



Sources: Global Insight; KSV Information GmbH; Atradius Economic Research.

Note: The insolvency counts displayed in the chart (at quarterly frequency) represent cumulative values within calendar years. This means that the Q1 values include the total number of insolvencies taking place in the first quarter, Q2 values represent the total number of insolvencies taking place in the first half of the year, and so forth. As only Q4 values represent an annual sum of insolvencies, the associated "annual" growth rate series should be treated as approximate.

Source: Global Insight, KSV Information GmbH, Atradius Economic Research

Textile (-18.9%), paper/printing (-26.7%), chemicals/pharmaceuticals (-17.1%), food (-14.4%), wood/furniture (-42.5%) and electronics (-19.1%) recorded very high decreases year-on-year in H1 of 2010. Lower decreases were seen in construction (-8.3%), metals/machines (-4.7%), while in the automotive sector business failures increased (2.9%). As the expected high unemployment rates and predicted slump in private consumption have not materialised, insolvencies in the consumer related sectors such as food, textiles and hospitality were much lower than forecast at the beginning of the year. Overall, we expect corporate insolvencies to level off in 2010.

The Austrian National Bank forecasts that Austria's growth will recover 1.6% in 2010 and 1.8% in 2011, after its 3.4% contraction last year. Gross fixed investments will remain weak for the whole of 2010 but exports will rebound in 2010 (4.6%) and 2011 (5.4%). Private consumption will sustain the recovery this year, but is expected to weaken in 2011 when austerity measures to stabilise public finances take effect.

Chemicals

How has the chemicals sector performed in the last six months?

2009 was an exceptionally bad year for the Austrian chemical industry which, with a relatively small domestic market, is heavily export dependent. According to Bank Austria, production in this sector decreased 11% and turnover dropped 17%. However, unlike many subsectors such as plastics, coating and agrochemicals, which all suffered from substantial declines, pharmaceuticals recorded a slight increase in turnover. The response of many companies in the sector to falling demand was to take harsh cost cutting measures, including factory closures and downsizing their workforce.

There have been signs of a recovery in 2010, as international demand increases, with production rebounding 5% throughout the whole industry between January and May. However, volatile price development and a continuing rise in unemployment (up 1.4% in the first half of 2010) reflect the persisting uncertainty in the market. The plastics sub-sector at least has rebounded quickly, with a sharp increase in product prices since the end of 2009, as producers and processing industries restock their inventories.

What is the current trend in payment delays and insolvencies?

According to KSV, insolvencies in the chemicals/pharmaceuticals sector decreased 17.1% in Q1 of 2010, to 34 cases, following the 50% year-on-year increase in 2009.

What is Atradius' short term outlook for the chemicals sector?

For the rest of 2010, production will continue to grow, rising at least 6% by the end of the year. But it will take until 2012 to compensate for the loss in revenues suffered in 2009, as the recovery of the Austrian chemical industry depends largely on government stimulus packages and global inventory restocking – both of which have short-term effects. In addition, the expected start of new chemical production in the Middle East next year and decreasing prices could adversely affect the industry.

Transport/logistics

How has the transport/logistics sector performed in the last six months?
Austrian forwarders were very badly affected by the economic crisis. According to Statistics Austria, the volume of railway freight transports decreased 18.7% in 2009, while road transport fell 8.9%. The sector has started to recover in the last couple of months, but now has to contend with cheaper competition from neighbouring countries, as truck fleets are increasingly being outsourced to Eastern Europe.

What is the current trend in payment delays and insolvencies?
After last year's difficulties, with a steep rise in insolvencies, business failures in the first half of this year fell 5.2% year-on-year. Even so, the transport/logistics industry still ranks third in the overall business insolvency statistics.

What is Atradius' short term outlook for the transport/logistics sector?
There are signs that the recovery will continue, with the sector profiting from the increase in the volume of shipments resulting from the economic rebound. But it is still too early to give the 'all clear', as many companies are still financially weak as a result of the losses and sharp drop in demand that they experienced at the height of the economic crisis. Moreover, a potential increase in fuel tax would lead to higher costs, probably triggering more insolvencies and further outsourcing of truck fleets to other countries.

The recovery gathers speed once more

After a disappointing growth rate in Q1 of 2010 (0.2%), the French Statistics Office INSEE recently reported that French GDP grew 0.6% in Q2 on the previous quarter, suggesting that it is on the way to a comprehensive economic recovery. After zero growth in the first quarter, household consumption again increased – 0.4% in Q2. The consumer confidence indicator stabilised in July, compared to June, though it is still fairly low. Manufacturing production accelerated 1.3% on the previous quarter (0.6%) and 7.1% year-on-year, while inventory restocking (up 0.6%) has contributed considerably to GDP growth. After eight quarters of contraction, gross fixed capital formation increased 0.8% in the second quarter. However, exports have decelerated (up only 2.7% compared to 4.2% in the first quarter) while imports increased, driven mainly by demand for energy and consumer products.

The business climate indicators have continued to improve slowly since our last report on France in June (see chart below), and are now 30 points above their lowest point in March 2009.

Business climate indicators

	Oct. 09	Nov. 09	Dec. 09	Jan. 10	Feb. 10	Mar. 10	Apr. 10	May 10	June 10	July 10
Business climates										
France	86	88	87	90	90	92	96	96	97	98
Industry	89	90	89	91	91	93	96	97	96	98
Wholesale trade	-	79	-	83	-	87		95		100
Building	93	93	93	93	93	91	92	93	92	94
Retail trade	97	104	100	103	100	98	105	103	102	100
Services	85	86	86	88	89	92	98	98	98	98

Source: INSEE, Business tendency surveys

In July, electrical goods and machinery again recorded dynamic production figures with a low level of inventory. However, orders are also low and forecasts are less optimistic, while in the food and chemicals industries, production remains healthy with a low level of inventory and a good long term outlook for orders. Automotive and transport are still under pressure with low production and little improvement in orders, although inventories are also very low. Forecasts for production remain negative, with a similar outlook for rubber and metals. Pharmaceuticals have deteriorated with below average production levels and depressed order books. Services have stabilised, but with only average forecasts and less than dynamic demand - in particular for the hotel & catering subsector. The trend for the retail industry has deteriorated in the past 3 months with pessimistic forecasts for both activity and orders. Building and construction improved slightly in July, but orders and backlogs remain below average.

Credit issuance for the private sector (excluding financial institutions) continued to rise in July 2010 - up 3% month-on-month (after a 2.8% increase in June) and 2.8% year-on-year. Credit issuance for companies increased 0.2% year-on-year, whereas erosion of short term credit issuance continues (-8.6%). Credit issuance for households grew 5.3%.

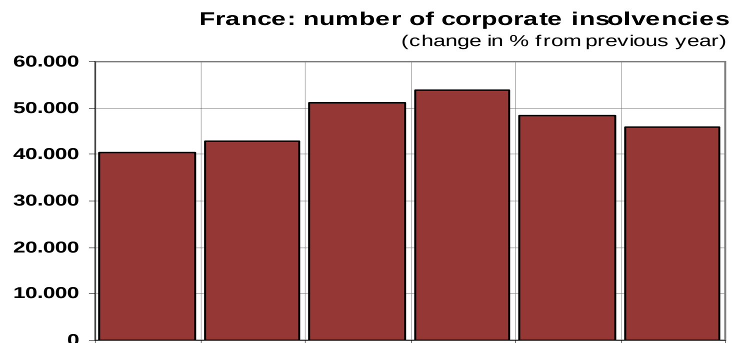
France

According to Altares, the number of defaulting companies decreased 5.2% year-on-year in Q2 of 2010 (13,200 defaulting companies), after a 2% decline in the first quarter. However, the situation remains sensitive for some companies and industries. While companies with less than 10 employees recorded a 4.8% decrease in defaults, they still constitute 92% of the total. Larger companies (between 50 and 200 employees) recorded a sizeable 29% drop in defaults, while newly established enterprises (less than 3 years old) continue to suffer: with a 14% increase in defaults in Q2 following a 20% increase in the first quarter.

In terms of sectors, manufacturing and real estate recorded significant improvements in default rates in Q2 – down 24% and 23% respectively. Building improved 5%, but the situation remains critical for finishing activities. Retail recorded a slight improvement (3.5%), transport and food a small increase - 2% and 5% respectively -while defaults in the service sector have risen sharply (+15.8%)

A 10% decrease in insolvencies in 2010?

Based on the positive trend recorded in the first months of 2010, we currently forecast a 10% decrease in business insolvencies this year, followed by a further 5% drop in 2011. In July 2010, the Expected Default Frequency (EDF)



	2006	2007	2008	2009	2010*	2011*
Total	40.407	42.840	51.254	53.743	48.369	45.950
% change	-6,3%	6,0%	19,6%	4,9%	-10,0%	-5,0%

* forecast date 30 June 2010

Source: Atradius Economic Research

indicator for listed companies in France fell 5 basis points - to 68 - reaching its lowest level since August 2008 (see chart page 2).

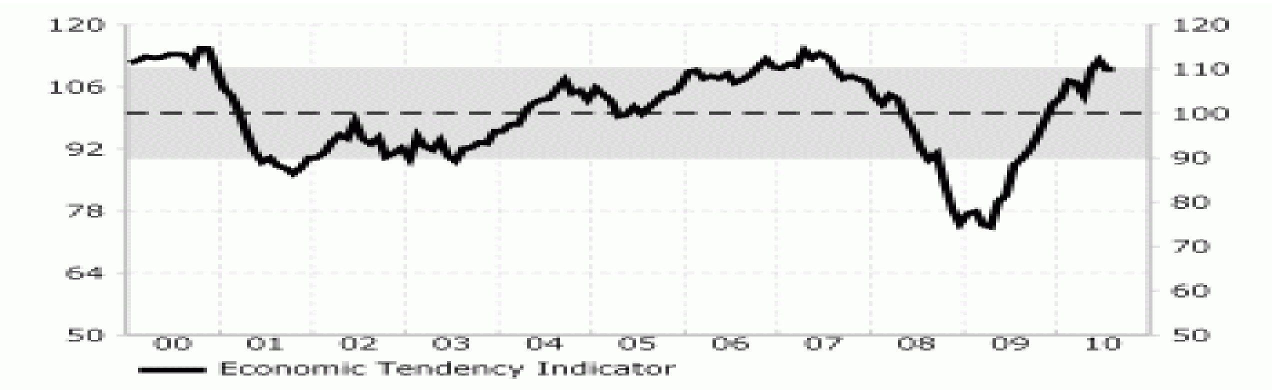
For the whole of 2010, the Economist Intelligence Unit forecasts French GDP to grow 1.4%. Corporate investments should increase 5% year-on-year while orders received will continue to benefit from foreign demand. Private consumption is expected to contribute positively to economic growth, but could be hampered by still high unemployment, despite the slight drop in the jobless rate (to 9.7%) in Q2 of 2010.

Sweden

On the road to recovery

According to Statistics Sweden, GDP increased 3.7% year-on-year in Q2 of 2010 and 1.2% on the previous quarter (seasonally adjusted). Inventories contributed very positively to this GDP growth, with industrial production increasing 5.2%, while exports and imports rose by 14% and 18% respectively. Total employment, measured as the number of hours worked, increased 0.6%.

According to the National Institute of Economic Research (NIER), the Economic Tendency Indicator remained unchanged in August, showing that both business and consumer sentiment are considerably stronger than normal (see chart below). Consumers have become increasingly optimistic and private consumption is rising. The Consumer Confidence Indicator (CCI), rose 1.9 points to 25.2 in August and, while the confidence indicator for the business sector fell three points in the same month, it remains considerably above its historic average, with the recent drop due mainly to a fall in the indicators for the retail trade and the private service sector.



Source: NIER

Automotive

Demand for new cars has improved further from last year's slump. BIL Sweden reports that 20,375 new cars were registered in July, up 40% year-on-year, and in the first half of the year registrations rose by 35%. Truck registrations increased 34.1% year-on-year in July and 22.9% in H1. The major players in the automotive sector in Sweden have all experienced a dramatic downturn in demand during the last couple of years, but it has recently been reported that the two truck manufacturers Scania and Volvo are re-hiring previously laid-off staff. Much of the new demand has come from South America and there are hopes that European demand will also increase. Both SAAB Automobile and Volvo Cars have new owners but the effects on the business and the companies' suppliers are not yet known.

Construction

Total construction investment decreased 10% in 2009, but is expected to rebound 3% in 2010 and 5% in 2011. This year, demand will be driven largely by public projects, while next year housing is expected to be the main driver. The industry is also helped by tax subsidies for home owners who choose to make improvements to their houses.

Wood/timber

Demand fell rapidly and steadily from autumn 2008 but recovered in the course of 2009, as production capacity decreased. From a domestic standpoint, this sector's performance is linked critically to the exchange rate of the Swedish Krona, as that determines the industry's competitiveness with foreign rivals such as the Finnish companies that are linked to the Euro. Unless the Swedish Krona appreciates rapidly, the industry should be able to remain competitive, especially in the light of the slimming down and restructuring of the sector that has taken place over the last couple of years.

Retail

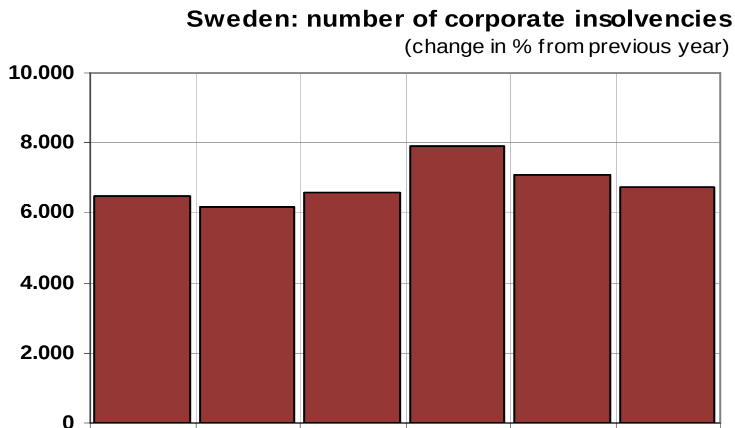
Sales volumes increased 2% year-on-year in July, with sales of convenience goods rising 1.2% and sales of shopping goods increasing 2.1%. With the positive movement of the Consumer Confidence Indicator, the retail industry will hopefully follow that positive trend.

Decreasing insolvencies in 2010 and 2011

According to Upplysningscentralen UC, corporate insolvencies decreased 14% year-on-year between January and July 2010 as business failures in the construction, retail, wholesale and corporate services sectors fell markedly. However, sectors with the highest prevalence of insolvencies measured as percentage of the total number of companies in that sector are currently restaurants & hotels, retail, transport, company services and motor vehicle sales.

To improve conditions for Swedish companies during the economic crisis, last year the Swedish government postponed some tax payments, giving temporary breathing space to the many companies facing liquidity problems, and probably reducing the number of insolvencies that would otherwise have resulted from the rapid downturn in demand. As the financial situation gradually improves for many companies the lenient tax regime will probably be phased out during the next year. Overall we currently expect corporate insolvencies to decrease 10% this year and 5% in 2011 (see chart overleaf). Despite this improvement, business failures remain higher than in the pre-crisis years.

Sweden



	2006	2007	2008	2009	2010*	2011*
Total	6.489	6.152	6.602	7.892	7.103	6.748
% change	-10,0%	-5,2%	7,3%	19,5%	-10,0%	-5,0%

* forecast date 30 June 2010

Source: Atradius Economic Research

The Swedish economy appears to be on the road to recovery. Currently the Economist Intelligence Unit (EIU) forecasts Swedish GDP to grow by 3.2% this year and 2.7% in 2011. However, some potential risks remain. Sweden, as a relatively small country, is heavily dependent on exports and so developments in the eurozone and in the world economy are of great importance. Many EU countries are expected to tighten their fiscal policy substantially to reduce their budget deficits. As well as dampening GDP growth in the euro area, this could, in the longer term, hold back economic growth in Sweden. Moreover, Sweden's national elections will be held this month and a possible shift in the ruling parties could also have an impact on the Swedish economy, making predictions even more complex.

China

Government measures to curb potential overheating continue

In mid 2010, China became the world's second largest economy, surpassing Japan and now second only to the United States according to figures released in August by National Bureau of Statistics. China's nominal GDP was valued at US$ 1.33 trillion, ahead of the US$ 1.28 trillion assessment of Japan's economy. China's real GDP grew 10.3% year-on-year in Q2 of 2010, down slightly on the 11.9% recorded in the first quarter, and reflecting the government's intention to avoid overheated economic growth.

This slowdown is likely to extend over the rest of the year as the government steers monetary and fiscal policy back to normal after the record credit surge designed to counter the global crisis. The government feared that overly rapid growth might inflate a housing bubble and compromise its environmental goals. It has therefore been gradually drawing back the enormous stimulus applied to the economy since late 2008, while also clamping down on property-market speculation and the expansion of polluting and energy-intensive industries.

In the first seven months of this year, the value of China's imports and exports jumped 40.9% year-on-year: to US$ 1.62 trillion. China exported US$ 850.49 billion worth of goods, up 35.6% year-on-year but, despite the rebound in exports witnessed since December 2009, in absolute terms they remain a long way below the levels seen in July 2008. We will need to see a full 12 months' trend of significant reversal before we can definitely conclude that exports have recovered.

China's government recently highlighted six key industries in which overcapacity was a problem: namely, iron and steel, cement, flat glass, coal chemical, poly-silicon and wind power equipment. To enable growth to be steadily maintained the government has taken a number of measures to control industrial overcapacity, which has a strong impact on companies at every stage of the supply chain and on end-users.

In the first half of 2010, the steel industry faced high production costs due to the failure to negotiate lower iron ore contract prices, coupled with massive oversupply. The steel market depends heavily on the performance of the international market, and in particular the stimulation of consumer demand. Troubles in the eurozone and the slow yet steady recovery in North America indicate that a strong revival in the Chinese flat steel industry is unlikely to occur until 2011.

The gradual recovery of the global economy and national policies supporting the textile and garment industry have seen China's clothing exports make a steady rise, but the textile and garment industry is still facing problems. External demand is still weak, trade protectionism is growing, and export costs are high, as regulation of the cotton market this year has led to higher overhead for China's domestic enterprises. As a result, textile and garment export competitiveness has been weakened.

But, besides these problematic sectors, there are also healthy industries such as the pharmaceuticals sector, which has recorded steady growth thanks to the stimulus of new medical system reform launched by the government in 2009. China's pharmaceutical industry is among the top five drug markets in the world in terms of overall size, with a large pool of highly skilled, low-cost scientists and general labour. The reform of regulations on foreign direct investment (FDI) has seen pharmaceutical regulation in particular undergoing considerable change in recent years. Many processes have become increasingly aligned with international norms, making the operating environment increasingly transparent for outside investors. Multinational drugmakers have recognised the opportunities in China's fast growing pharmaceutical market and are keen to establish a significant long-term presence in China.

Government support for SMEs

China is increasing its financial support to small and medium-sized enterprises (SMEs) with preferential tax policies and easier funding channels. The government has extended to the end of 2010 the implementation period for allowing troubled SMEs to defer payment of social security or pay a lower premium rate. Aside from this, the government also wants small banks to give more financial support to SMEs.

Over the past 6 months there has been no obvious increase in late payments. Overdue payments have been due mainly to the morality issue – so called Moral Hazard - rather than to financial difficulty.

2010 will be a crucial but complicated year for China's economy as the country continues to combat the after effects of the global financial crisis while maintaining a stable and comparatively fast economic growth, and adjusting its economic structure. The government is aware of the risks of rising inflation and overheating asset bubbles, and has therefore tightened its monetary policy, albeit moderately: with a credit supply of Yuan 7.5 trillion in 2010 down from Yuan 9.59 trillion lent by China banks throughout 2009 under a loose monetary policy. Slowing property prices, stress in the banking system, weaker global demand for Chinese exports, the formal ending of the Yuan/US$ peg, inflation and wage pressures all point to slower growth.

Massive state intervention to beef up the banking sector

Russia has managed to recover from its deep recession of 2009. According to the Federal State Statistics Service, the Russian economy grew 5.2% year-on-year in Q2 of 2010, up from 2.9% in Q1. The most significant factors behind this recovery are:

Higher oil prices

Average crude spot price (Urals Northwest Europe classification of crude oil) throughout Q2 stood at US$ 76.66 per barrel - the highest quarterly average since Q3 of 2008. Oil and gas contribute 30% of Russia's GDP, 50% of its budget and 65% of its exports.

Increasing consumer demand

Retail prices showed an increasing trend as a result of rising demand in Q2.

Lower unemployment

The jobless rate decreased to 6.8% at the end of June, from 9.2% in January.

There are still some concerns about the financial sector because of the number of non-performing loans, as both the corporate and the banking sector have accumulated excessive foreign debt obligations in the last few years. Illiquidity, falling asset prices and slowing domestic demand during the economic downturn caused cash flow problems in all sectors, especially for smaller companies and banks. In Russia, non-performing loans are calculated on different criteria to those normally used by Western financial institutions, and it is therefore difficult to ascertain the actual risk.

However, the Russian banking sector is gradually increasing its risk appetite, and we expect a steady but substantial increase in lending over the next 18 months. The banks' renewed risk appetite is reflected in markedly lower interest rates, as the Bank of Russia has lowered its refinancing rate several times since March 2009. Interest rates are expected to remain low in the short-term as a result of the overall recovery and better asset quality. At the same time, there has been strong political pressure, especially on the major banks, to increase their lending appetite to help ailing corporates and smaller banks. The government itself has spent a total of US$ 250 billion on various rescue measures, with almost US$ 100 billion of this dedicated to help struggling banks and companies.

Russia

No major consequences of the drought and fires

Russia's growth expectations for the medium and long term are good, but the recent drought and wildfires throw some doubt on whether the strong rebound seen in the first half of 2010 can be maintained for the rest of the year. The most important consequences identified are:

Agriculture

The drought was one of the worst for many years and the resultant wildfires left farmers with some big problems. As a way of securing stocks and easing domestic prices, Prime Minister Putin has introduced a ban on wheat exports that will remain in force until next year's harvest. It is estimated that this decision will cost Russia lost grain export revenues of around US$ 3 billion.

Industrial production

As a result of the heatwave in July to August, production output decreased to 5.9% (see chart below). Efforts will be made to compensate for this through increased production during the rest of the year, but this is unlikely to fully make up for lost production.

Retail sales

It is expected that retail sales will drop as a result of the wildfires, as heavy smoke spread to Moscow, deterring shoppers.

Source: TradingEconomics.com, Federal State Statistics Service

Therefore, we expect the repercussions for industrial production and retail sales to be only short term, while the agricultural sector may suffer in the medium term as well.

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