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BOFIT Weekly

27 • 6.7.2012

Russia

Cabinet confronts realities of tighter budget discipline. President Vladimir Putin delivered on June 28 the annual presidential budget plan, laying out the basic framework of fiscal policy for the next three years. The budget talk acts as a starting point for drafting of the 2013 budget.

Putin noted that the room to manoeuvre for those drafting the federal budget depends largely on revenues from energy taxation and set spending on social entitlements. Thus, any opportunities for increasing spending are limited at the moment, even if economic development requires more spending – especially in such areas as research, education and infrastructure. As a way out of this conundrum, Putin suggested that the cabinet focus on finding the most effective use for budget outlays through a total revamp of the budget system. Under the system currently in development, budget expenditures would be allocated to 41 sectors in the form of special "state programmes." The reforms would take effect in 2014.

In response to uncertainty over trends in the global economy, the government next year will restart the regular funding of off-budget reserve funds that halted during the 2009 financial crisis. The cabinet and presidential administration have revisited the rules for reserve funding that determine how much of oil revenues should go to the reserves and how much should be used to finance budget spending. The basic principle is that the budget should be protected from the short-term swing in oil prices by using longer-term price trends as a basis for drawing up the budget.

In his budget address, Putin announced the crude oil price assumption used in calculating budget spending next year would be based on the average world oil price over the past five years. The number of years used in the average would be increased incrementally so that in 2018 a ten-year average would be used. If the oil price exceeds the average price, the excess in revenues to the state would be set aside in reserve funds. It the oil price undershoots the average, budget funding would be supplemented from reserve funds.

Under the above-mentioned framework, next year's budget would assume a Urals crude price of about $92 a barrel, down from $100 a barrel this year. The lower revenue target calls for a tighter fiscal stance and slashed spending.

According to experts, meeting budget targets will be challenging with the announced spending increases. Putin e.g. promised hikes in social spending as part of his presidential campaign platform. There is also a new spending category running from 2013 to 2020 that allocates a total of 20.7 trillion rubles (over €500 billion) for development of Russia's defence forces. Putin reaffirmed the military spending timetable on Monday.

Special agency to handle state loans and investments. As part of his budget speech, president Putin tasked his cabinet with establishing a special organisation to manage the government's international borrowing and productively invest off-budget reserve funds. Putin noted that management of state debt and investments demands particular expertise in the currently volatile international financial markets.

The need for an organisation to manage state investments has been discussed for years. The current goal is to launch the new organisation by the beginning of 2013.

Rates for municipal services hiked on July 1. Annual adjustments in administratively regulated prices of municipal services are normally implemented at the start of the year. This year, however, due in part to the presidential election in the spring, rate hikes were postponed. As a result, inflation in the first part of the year was exceptionally low by Russian standards. At the end of June, consumer price inflation was running at a mere 4.3 % p.a.

From the start of this month, municipalities have raised regulated rates an average of 9–12 % for e.g. district heating, water supply, natural gas, electricity and waste handling. A second round of rate hikes is scheduled for early September. As in the past couple of years, the annual ceiling on any rate hikes of municipal services remains at 15 %.

Prices of alcoholic beverages hiked on July 1. The excise tax on alcoholic beverages is typically adjusted each year in January. This year, however, the hikes were split in two, with the bigger hike occurring on July 1. At the same time, the lowest permitted retail prices for alcoholic beverages were increased. Today, for example, the lowest price on a half-litre of vodka has been increased by 27 % to 125 rubles (about €3). The use of minimum allowed retail pricing of alcoholic beverages was introduced in 2010 as part of efforts to reduce sales of cheap illegal alcohol. Retail prices on alcoholic beverages have been raised regularly since then. The government seeks to reduce alcohol consumption overall, and prices have continued to climb ever since 2010, when then-president Dmitri Medvedev focused attention on the social impacts of alcohol use.

A change in the law on alcoholic beverages reclassifying beer as an alcoholic beverage entered into force at the start of this month. The law itself was passed by the Duma in summer 2011. The change means that restrictions on alcohol sales also apply to beer. Now retailers are only allowed to sell beer in shops and licensed pubs and restaurants. Sales of beer from kiosks, the traditional beer vendor in Russia, is forbidden, and shop sales are limited to the hours of 8.00–23.00. It is prohibited to drink beer on the street, in parks or other public spaces, and beer advertising on radio, TV and public transport is forbidden.

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China

China experiments with further liberalisation of capital movements. During president Hu Jintao's visit last weekend to Hong Kong, China's central bank announced the introduction of a new experiment in freeing up capital movements between the mainland and Hong Kong. The trial only affects capital movements between Hong Kong and Shenzhen's newly created Qianhai special financial zone. While details of the trial are yet unavailable, companies operating in Qianhai will apparently have easier access to financing from Hong Kong. Moreover, investment funds to be established in Qianhai can accept investments from Hong Kong.

Although China has introduced a variety of measures to increase the use of the yuan internationally (particularly in Hong Kong), it still strictly regulates capital movements. The only allowed capital movements are direct investment, and even then, special permission is required in certain cases. Purchase of an apartment from abroad is also permitted. Other capital transfers are completely banned or subject to strict quotas and approval processes.

Despite its modest scale, the Qianhai experiment represents a step towards what observers expect to be the extensive lifting of capital movements by 2015. Ending of capital controls is a necessary part of making the yuan a widely used international currency.

Economic cooperation between Hong Kong and Mainland China deepens further. As part of the 15th anniversary celebrations of the Hong Kong special administrative region, the government announced reforms aimed at increasing economic cooperation between Hong Kong and mainland China and stimulating Hong Kong's economic growth. Many of the new reforms were written into the ninth expansion of the Closer Economic Partnership Agreement (CEPA) between mainland China and Hong Kong. The 9th round additions enter into force at the start of 2013. Although the agreement is between the mainland and Hong Kong, it also offers foreign firms access to the Chinese market as long as they are registered in Hong Kong and meet the conditions promulgated last year.

The latest CEPA round offers service-sector firms freer access to the mainland market. Educational services are an entirely new branch included in the agreement. Of the 47 service branches already enjoying access of varying degree, 21 saw their restrictions lifted further. Service providers will now find it easier to work in China as they can expand the scope of operations geographically (e.g. tourism), engage in broader cooperation with a mainland Chinese firm (e.g. legal services), increase their holdings and operate more independently (e.g. telecommunications) or offer a wider palette of services (e.g. social services).

Some of the rule-easing involves companies in the fields of information technology services, accounting services, and printing introduced on a trial basis in Shenzhen's newly created Qianhai special financial zone. As part of efforts to attract Hong-Kong-based firms and workers to the special zone, companies are being offered low corporate and income tax rates (e.g. the corporate tax rate is 15 %) and an environment with a strong legal regime, i.e. the same approach used in Hong Kong.

CEPA's 9th round expansion also includes aims to increase co-operation between Hong Kong and mainland China's financial sectors. Under the Qualified Foreign Institutional Investor (QFII) programme, the threshold qualification criteria will be lowered to allow a greater number of Hong Kong financial institutions to buy and sell securities in mainland China. In addition, the listing of mainland Chinese enterprises on the Hong Kong stock exchange will be supported by easing mainland's listing requirements on foreign exchanges.

Developers still waiting for official actions to stimulate construction activity. Chinese officials remain reluctant to ease up on the strict measures implemented in 2010 and 2011 to deal with overheating in the construction sector. Even with the slowdown in economic growth, officials continue to press with the measures. Economic experts and representatives of the construction sector are now calling for a lifting of restrictions. Some local and provincial administrations have even moved ahead with their own measures to revive their flagging building sectors. Construction activity is especially important for local administrations as it allows them to raise money from the sale of land use rights.

Apartment prices continue to decline. Official figures show that May prices for both new and old apartments were about 1 % cheaper than at the start of this year. Official figures for apartment prices indicate the changes are quite modest, and the statistical data is believed to be somewhat sketchy. Builders themselves claim prices have dropped substantially more than the official numbers and say they expect the decline to extend through this year. Falling prices translate into fewer apartment sales.

Several corporate surveys indicate builders remain broadly pessimistic about the outlook for their industry. Builders have purchased fewer land use rights this year than earlier. In the January-May period, new housing starts were down nearly 10 % y-o-y. Differences across provinces are large, however. For example, housing starts in Beijing are down by a third from last year, but in some interior provinces starts on new apartment construction are still climbing rapidly.

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