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BOFIT Weekly

40 • 4.10.2013

Russia

Low economic growth forces high-level debate on structural reform. Top government officials presented their insights on the economy and needed reforms recently at investment forums in Sochi and Moscow. Most attention was devoted to familiar themes such as Russia's poor business climate and how it impedes economic growth by scaring off investment.

President Vladimir Putin noted that progress in reforms to improve the business climate has been very modest so far and gave a time limit of two years for the reforms. He said that basing Russia's living standards on natural resource extraction is ultimately unsustainable. A big issue in Putin's view is the lack of efficiency in the Russian economy; labour productivity is substantially lower in Russia than in advanced economies.

Economy minister Alexei Ulyukayev reported that economic output contracted in the second and third quarters of this year. The economy ministry now forecasts yearly GDP growth of just over 3 % over the next few years.

Prime minister Dmitri Medvedev repeated his critique of the state's overblown role in the economy and the size of Russia's public sector. He said that the state plays too great a role in driving output growth. Medvedev's view is that public sector activity should be reduced and made more efficient. In the sphere of competition, Ulyukayev noted that ministries and government agencies may be too oriented to the public sector and do not always grasp the importance of the private sector.

Some less frequent topics also came up. Medvedev, in particular, called for greater efficiency in employment policy. In his view, efforts to support full employment at any cost now need to end, even if it means reduction of ineffective jobs. He called for special attention to restructuring of *monogorods,* towns built around a single enterprise or business. Medvedev added that possibly even a significant share of Russians might have to change jobs – and even their professions or where they live – if the structure of Russia's economy is to be reformed. Both Putin and Ulyukayev reiterated this theme.

Efficiency problems have received attention also in company level recently. For example, according to media reports, a draft of the new development strategy of the giant state-owned shipbuilder OSK recently revealed plans to possibly even close some of the company's inefficient shipyards.

Structural reforms are difficult to implement due to their negative short-term impacts, even if they are necessary to sustain economic growth of the Russian economy over the longer run. Many observers hoped that the 2008–2009 financial crisis would incentivise Russian decision-makers to move ahead with structural reforms of the economy. Instead the state moved to support large firms regardless of their inefficiencies. This was done to support household income development and prevent social unrest. The result was preservation of old inefficient production and reduction of state's oil revenue funds.

Partial freeze on regulated prices hoped to revive Russian economy. Regulated prices of goods and services produced by "natural monopolies" (e.g. gas, water, heating and rail transport) have been increased a pace higher than inflation in recent years to achieve cost recovery levels. Such rate hikes have been a major factor in keeping inflation high. For example, the rates households pay for gas were hiked by 15 % last year and again by the same amount this year, while rates for heating went up 10 %. Consumer price inflation last year was 6.6 %, and this year it is expected to moderate to 6 %.

The government wants to slow inflation in order to boost economic activity. To accomplish this, it will limit rate hikes of natural monopolies over the next few years. The measure reduces cost pressures on other sectors of the economy and shifts revenues from infrastructure monopolies to the manufacturing sector. This is hoped to encourage investment in diversification of production. Restraining rate hikes should also lead to a situation where infrastructure monopolies are forced to become more efficient.

In September, the government decided that rates of goods and services sold by monopolies to the corporate sector would not be raised at all next year. In 2015 and 2016, rates will only be increased to the extent of the previous year's inflation. Rates paid for household heating, water, electricity and gas will be increased during 2014–2016. The average increase is to match the inflation rate of the previous year minus 30 %. Using this formula, the average rate hike next year would amount to 4.2 %.

The downside of reduced rate hikes is that they lower the revenue projections of infrastructure monopolies and limit their investment possibilities in a situation where all investments would be important in order to accelerate economic growth.

The cabinet admits that there is a risk that infrastructure monopolies may cut back existing investment plans somewhat as their revenues will be smaller than earlier projected. This could negatively affect also sectors servicing infrastructure monopolies. According to the government, strategic development plans of monopolies need revision that takes into account the reduced income prospects. To support this, the government is seeking measures that lower the monopolies' operating and investment costs without harming their operations or reducing their investments. One of the ways of doing this would be the introduction of public control over infrastructure monopolies. The government is also considering partial financing of monopoly investments out of the federal budget, pension fund or oil tax revenues set aside in the National Welfare Fund.

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China

Game rules for Shanghai free-trade zone still unclear. At the end of September, China officially opened the Shanghai free-trade zone (FTZ) along with a list of reforms the government hopes to test in the 29-square-kilometre zone over the next 2–3 years. Most of the extra freedom to set up new companies and operate them will go to firms providing services. Financial services is the focus area with the highest profile, but other areas getting a chance to partake in the experiment include logistical services, trade, professional consulting services, entertainment, health care and training services. A small group of telecommunications services are also listed. The FTZ trials extend to 18 branches. At this week's launch, operating permits for the zone had already been granted to 36 companies. Two foreign banks, Citibank and DBS, are included among the dozen banks given berths in the FTZ.

Many practical questions remain open, however. Although fine-tuning and adjustments may come over the next three months, many of the pilot projects by nature require the laying of extensive groundwork. This applies particularly to the financial sector. The plan is to lift restrictions on bank operations, free up capital movements and yuan convertibility, which presumes officials should be able to monitor regulations are followed both in the FTZ and in the rest of China. The proposed deregulation of interest rates would create additional arbitrage position and moral hazard that could encourage some parties to exploit the different rules of the parallel systems and increase risk of abuse. While officials have experimented with e.g. monitoring money transfers between Hong Kong and mainland China, it will be a long time before financial supervision and financial market infrastructure in the FTZ reach the level of Hong Kong.

The decision to create the Shanghai FTZ is in itself a fascinating step in Chinese reform policy. It signals that the country's new leadership has committed to developing an advanced market based economic system. The experiment is being conducted under the direct supervision of the government, and Shanghai officials have been specifically tasked with implementation. The top-down arrangement is hoped to minimise inter-ministry turf battles and mis-communication.

A broader issue is whether regional experiments have lived their usefulness given China's current circumstances. In particular, given the nature and rapid evolution of financial markets, the FTZ experiment should not impede national reforms to the financial sector or on-going learning processes of firms and officials elsewhere. Indeed, with regard to the financial market, the Shanghai experiment may come a bit late and, consequently, may bring little in the way of added value. What China's financial market may need today is simply carrying on with reforms at the national level.

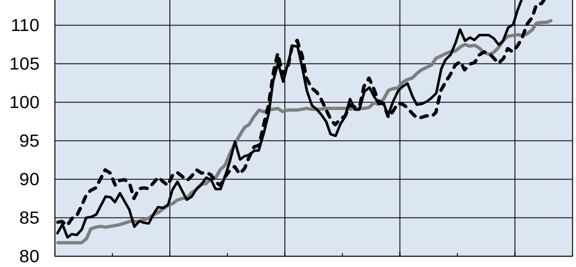
Yuan's real effective exchange rate has appreciated significantly. The real effective, or trade-weighted, exchange rate (REER), a measure of China's price competitiveness with its trading partners, has strengthened over 6 % this year. REER gains have been led by sharp yuan appreciation against the Japanese yen, although the yuan has also been appreciating rapidly against the currencies of many emerging economies. The yuan has appreciated less than 2 % against the dollar this year in nominal terms. On Thursday (Oct. 3), one dollar bought 6.12 yuan. The yuan has weakened slightly against the euro over the past nine months.

Despite the erosion of price competitiveness in the export sector, the volume of Chinese exports has grown around 10 % this year. Chinese export firms appear to have been bearing the costs of yuan appreciation. For example, prices of Chinese products shipped to the US have declined an average of about 1 % this year.

While economic growth has slowed significantly in recent years, authorities have refrained from re-pegging to the dollar to boost export growth, as occurred in 2008 when the financial crisis broke out. Central bank interventions in the foreign exchange market have become less frequent, suggesting that market forces are increasingly allowed to guide the yuan's exchange rate and that the yuan's exchange rate is closer to equilibrium than earlier. Indeed, an IMF assessment last summer found the yuan's exchange rate would be in equilibrium with an appreciation of just 5–10 %.

Guiding of the yuan's exchange rate is accomplished in practice with the central bank setting the yuan's reference exchange rate on the morning of each trading day. The central bank then refrains from intervention as long as the yuan appreciation or depreciation amounts to less than 1 % against the US dollar. If pressure for a bigger swing occurs, the central bank will begin to buy or sell currency. Although the official statement says the yuan's exchange rate is defined relative to a currency basket, yuan steering seems to be tracking the US dollar. Changes in the yuan's exchange rate against other currencies largely reflect their changes against the dollar.

Yuan-dollar exchange rate, REER and NEER (rising trend indicates yuan appreciation)



Sources: BIS and Reuters

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