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BOFIT Weekly

37 • 12.9.2014

Russia

Food prices in Russia up sharply. Although August consumer price inflation only picked up slightly from July to 7.6 % y-o-y, food prices climbed 10.3 %. Prices of non-food goods were up just 5.5 % y-o-y and services 6.7 %.

Prices of most food items rose, and in some cases extremely fast. Indeed, the surge in food prices was only constrained by the seasonal drop in prices of fruits and vegetables. The largest price gains were posted for meat and fish. Meat prices were up 2.5 % y-o-y and fish 1.4 %. Meat and fish prices have risen rapidly for some months already. The rise in meat prises is due in part to Russia's ban in January on pork products of EU origin. The reduced supply on the Russian market has driven up pork prices, as well as other meat alternatives such as chicken. There was also a sharp rise in prices of milk and dairy products in August.

The ban on food imports imposed last month has yet to cause shortages of products in the banned categories, with the exception of unprocessed fish. Therefore, the direct effect of the ban on inflation has been limited. The ban has, however, boosted inflation indirectly by e.g. encouraging domestic producers, merchants and foreign supplies unaffected by the ban to raise their prices. In the future, the ban is expected have a bigger inflationary impact. There were already signs in the first week of September that inflation was running significantly higher than in August.

Officials regularly review retail prices to prevent price gouging. The Federal Antimonopoly Service (FAS) has opened a hot line that allows people to report on food prices. The FAS is currently investigating sharp hikes in fish and poultry prices.

Experts weigh in on 2015 budget options. The government is currently reviewing next year's federal budget draft. Although the basic budget framework has been agreed upon in principle, the challenges of matching revenues with ever-increasing spending needs has fostered conflict. Prime minister Dmitri Medvedev last week summoned together Russia's leading economists and cabinet ministers involved with economic issues to discuss the available fiscal policy options.

The prime minister wanted to hear the economists' take on the economy ministry's assertion that fiscal policy needs to be relaxed under the current circumstances. The proposal would require the government to abandon its budget rule, which places a ceiling on the federal budget deficit of 1 % of GDP. The economy ministry says that allowing a larger budget deficit would make available budget assets that could be spent on stimulating economic activity. Nearly all experts present said it would be better to stick to the budget rule as it forms the basis of public sector stability.

The invited experts were divided on Medvedev's question as to whether tax hikes were in order. One group felt that taxes should not be raised, noting that the government has committed publicly to holding the line on the overall tax burden. Others felt that tax hikes were necessary in the current situation to cover rising expenditures, but the tax hikes should be smaller than the government initially proposed. The economists were united in their opposition to the proposed new sales tax. They said it would be wiser to slightly raise the value-added tax.

A number of experts said the preferred option would be to keep the budget rule and tax rates in place, and instead make efforts to rationalise budget spending. Savings could be garnered, for example, by making public-sector operations more efficient, including reducing fringe benefits and wage hikes and improving administration of public procurements. The cabinet is currently preparing plans to make investments especially in food production and weapons development in order to enhance domestic production to substitute for imports. The experts warned that such investment should not raise budget spending, but should be funded though redirected spending.

CBR and economy ministry divided over monetary policy. The economy ministry's criticism of the central bank intensified this summer after the CBR raised its key rate in July by a half percentage point to 8 %. Hackles were further raised by the fact that the CBR raised rates without first consulting the government. The CBR justified the rate hike, citing the inflationary pressures created by e.g. the tense international climate and the government's planned tax hikes next year.

CBR first deputy chairman Ksenia Yudayeva remarked that the government should pay attention to the inflationary impacts of any decisions regarding taxes. Yudayeva said that if the government decision on taxes leads to higher inflation, the CBR would have to assume a tighter monetary stance, even if it negatively impacted economic growth.

The economy ministry responded that a more relaxed monetary stance is needed to promote economic recovery. Economy minister Alexei Ulyukayev proposed to president Putin that the economy ministry, finance ministry and CBR jointly decide the inflation target. Putin accepted Ulyukayev's proposal at the end of August. The economy ministry and finance ministry are already heard by the central bank when it prepares its policies as both ministries have consultative representation at the CBR board.

It remains to be seen whether the new approach will influence CBR monetary policy. The CBR has a fixed medium-term inflation target of 4 % with a 1.5 percentage point deviation up and down. The economy ministry wants the inflation target to be adjusted in response to changes in economic circumstances.

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China

China further relaxes capital controls. China's commerce ministry has announced an easing of the rules for Chinese firms investing abroad from the beginning of October. Capital investment projects of $100 million or more will be freed altogether from the permitting process, and the ministry will only require permits for investments in countries subject to UN export restrictions or from companies involved in businesses subject to government export restrictions.

Both the commerce ministry and the influential National Development and Reform Commission (NDRC) regulate foreign investment of Chinese firms. Under new NDRC rules set forth last April, foreign investments of under $1 billion only need to be declared, while investments of $1–2 billion require NDRC clearance and all investment above $2 billion must be approved by the Chinese government.

The volume of capital flows in October will be further boosted by "Shanghai Hong Kong Connect," an arrangement that lets foreign investors trade in yuan-denominated A-shares on the Shanghai stock exchange via the Hong Kong stock exchange. The mechanism also permits investors in mainland China to trade in H-shares of Chinese companies denominated in Hong Kong dollars (HKD) on the Hong Kong exchange. It provides a new channel for investment in parallel with current qualified institutional investor programmes (QFII, RQFII, QDII), even if share-trading under the arrangement is restricted by quotas.

Growth of China's foreign trade slowed in August on falling commodity imports. Goods imports declined in August by 2 % y-o-y to $159 billion. Imports from Japan fell 5 %, while imports from the US were off 3 %. Imports from EU countries rose by 4 %. Imports from Germany, in particular, remained strong (up 11 %).

The value of August exports exceeded $208 billion. Although export growth slowed in July, they were still up 9 % y-o-y. As a result of declining imports and rising exports, China's trade surplus hit a monthly record of nearly $50 billion. Exports remained robust for the EU (up 12 % y-o-y) and the US (up 11 %). Exports to Russia were also up 27 % y-o-y in August, although exports to Russia still only accounted for 3 % of China's goods exports overall.

The slowdown in investment (e.g. lower housing construction activity) depressed domestic demand. Commodity imports fell in August. Import volumes of coal declined 27 % y-o-y, copper 12 % and aluminium 38 %. The drop in world market prices further lowered the value of commodity imports.

Falling commodity prices, overcapacity in some industries and the slow rise in housing costs all contributed to August's lower inflation figure. 12-month consumer price inflation fell from 2.3 % in July to 2 % in August, while producer price *deflation* accelerated from 0.9 % in July to 1.2 %.

Modernisation of China's railways moves ahead. Railways were jammed last weekend as people travelled to their home districts for the mid-autumn festival holiday on Monday (Sept. 8). On average, there are over six million train journeys taken every day in China, accounting for 10 % of all passenger traffic. China massively invests in its railway network, particularly bullet train corridors in eastern and central China. No other country comes close to matching China's 11,000-km high-speed rail (HSR) network – and HSR projects in progress should double the length of track in service. HSR lines presently account for about 10 % of the whole railway network.

Rail projects will play an important role in sustaining investment levels if activity in the real estate sector continues to drag. The China Railways Corporation (CRC) plans this year to invest at total of 800 billion yuan (€110 billion), of which about half had been spent by the end of August. The investment target has been raised by 170 billion yuan this year. The measures are used to boost GDP growth to its target level this year.

CRC has funded most of its investments by borrowing. As a result, the company is currently carrying over 3 trillion yuan (€360 billion) in debt. CRC operations were deeply in the red in the first half of this year. Premier Li Keqiang wants to see more private capital going to rail investment. The NDRC announced this summer that it was opening investment in rail projects to private investors. The central government is also looking into ways to support profitability of the rail companies.

A World Bank report released in July found that the Chinese take a fairly cost-effective approach to construction of high-speed rail connections. A kilometre of HSR in China can be built on average for about $20 million, when the same kilometre costs over $30 million in Europe. The World Bank said the keys to Chinese cost-efficiency were standardisation of railway components and processes. The massive projects also enjoy scale advantages.

Cost-efficiency is a key feature of China's competiveness for international rail projects. CRC currently has projects under construction in Africa, Latin America and Southeast Asia. Last month, Thailand approved a partnership of a $20 billion project to build a transnational railway linking Singapore to China's rail network.

China has gone head-to-head with Japan in competing for major projects (e.g. in India). Chinese companies have won bids for major infrastructure projects internationally by demonstrating technical proficiency and offering sufficient capital.

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