Weekly Review
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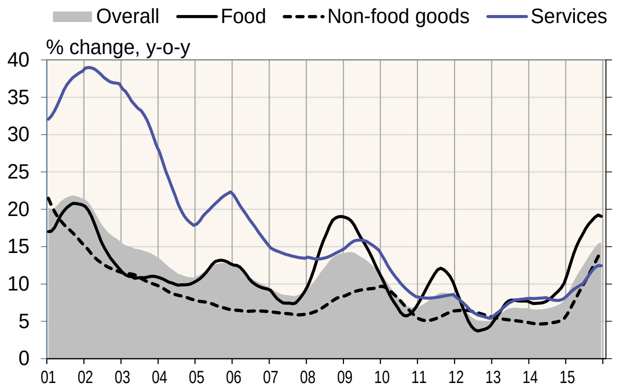
Russia

Russian inflation surged to heights last year. The on-month rise in consumer prices in December, as in November, outpaced the last significant rise in November-December 2010 – not counting the record inflation spike at the end of 2014, the biggest since the 1998 financial crisis. Leading the high inflation numbers was the continued increase in food prices, but the increase for non-food goods also went on. The ruble's slide, which worsened dramatically in December as the ruble lost 10 % of its external value, has been a crucial factor in fuelling inflation. Ruble's slide episodes readily create expectations in the import trade chain and among households of further exchange rate slide and continuing high inflation. Russian import restrictions on Turkish food items likely added to inflation pressures somewhat.

December 2015 consumer prices were up 12.9 % y-o-y (11.4 % at the end of 2014). Due to the inflation burst a year ago, for 2015 overall inflation was up on average 15.5 % over 2014. The high inflation tells about the extent of the loss of household purchasing power and reduced consumption. The annual average indicates that consumer prices rose faster than at any time since 2002. Episodes of high food price inflation as seen in 2015 were last experienced in 2008 and 2001. No similar episode of run-away non-food goods price inflation has been seen since 2001. The last similar rise in prices of services was in the early months of 2010.

Consumer prices, change of 12-month average



Source: Rosstat.

Russian stock market performance reflects low oil prices and ruble slide. Russia's main RTS share index, calculated in dollars, fell 4 % last year on the drop in oil prices and the ruble's weak exchange rate. The decline in the RTS index last year remained modest, however, as it had already fallen 45 % in 2014. The index largely follows the price of oil, as companies in the oil & gas sector account for about half of weight of the index. While the total market capitalisation of companies included in the RTS index has slumped about 50 % from peak years, it was still above $100 billion last year. That amount is about double the RTS market cap during the 2009 financial crisis.

In contrast, the Moscow exchange's MICEX index, calculated in rubles, rose 23 % last year. Although the price of oil has fallen below 2009 levels, the impact on the ruble-denominated index has been softened by the adjustment of the ruble's exchange rate. The ruble's weakening has supported the profitability of export firms despite falling prices for oil and other commodities. Revenues of export firms are mainly denominated in foreign currencies, while most of their spending is in rubles. Moreover, the sub-index for state-owned enterprises was up 31 % last year, beating the MICEX overall. Finance was an above-average-performing category, while metals clearly underperformed the MICEX average.

The year's trading volume on the Moscow stock exchange contracted slightly last year to 9.4 trillion rubles, about half the peak level of 2011, but still above the 2013 nadir.

Russia's main share indices and the oil price

Source: Macrobond.

Russia and Ukraine implement further trade sanctions against each other. With the entry into force of the free-trade agreement between Ukraine and the EU at the start of this year, Russia set its free-trade agreement with Ukraine to expire at the same time. Russia also took steps to expand earlier food import bans against the EU to include Ukraine, while significantly curtailing transhipment of Ukrainian goods via Russia. In response, Ukraine banned the import of various products from Russia, including certain foods, chemical products and locomotives. The value of such exports from Russia to Ukraine was about $200 million last year.

Russia has also clarified its new *Turkey* sanctions. From the start of this year, Turkish citizens and firms owned by Turkish citizens are prohibited from engaging in business in Russia in the following sectors: construction, architecture and engineering services, travel bureau services, hotels, wood processing and public procurements. The ban does not affect existing contracts, such as those for construction projects granted to Turkish firms involving the 2018 FIFA World Cup in Russia.

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China

Chinese markets remain restless. Just four days into the first week of trading this year, Chinese regulatory officials abandoned use of a new automatic circuit-breaker mechanism to deal with excessive intraday volatility after it was found to increase rather than decrease market volatility. In recent days, officials have resorted to older approaches such as limits on share trading to calm the markets. Such measures have done little, however, to dispel stock market uncertainty, and large daily gyrations in share prices can be expected to continue in the near future.

To calm forex markets and reduce depreciation pressure on the yuan, the People's Bank of China employed the fairly heavy-handed measure of squeezing the availability of offshore yuan (Hong Kong, CNH), thereby driving down the difference in offshore and onshore (Shanghai, CNY) yuan-dollar exchange rates. The measure initially caused offshore yuan market rates to soar at the start of this week (CNH Hibor7D reaching 33 %). While the CNH interest rate fell after Wednesday's session and the situation on forex markets calmed, China's slowing growth, deregulation of currency movements and shifting exchange rate policies will keep markets on edge.

New secretariat to coordinate administrative affairs of Chinese financial supervision bodies. Although volatility in China's stock and forex markets is to be expected as the country's massive systemic reforms continue, officials' interventions and poor communication have made matters worse than need be. The online economic news service *Caixin*, reported Thursday (Jan. 13) that the government plans to establish a new secretariat to coordinate the administrative actions and messaging among the central bank and the three authorities overseeing securities trading, banking and insurance markets. Many problems on China's financial markets and the creation of a new coordinating body indicate just how far reforms of China's markets have come and how difficult it is for officials accustomed to old regulatory system to change their approaches.

Foreign trade figures and price trends indicate no unusual weakness in the Chinese economy. The value of China's December exports in dollar terms was up 1 % from a year earlier. Imports contracted 8 % y-o-y on the fall in global commodity prices. As a result, the trade surplus continued to rise. For 2015 overall, the goods trade surplus rose to $595 billion. China's huge foreign trade surplus balance depreciation pressure on the yuan.

The December price trend was unremarkable: consumer price inflation held at 1.6 % y-o-y, while producer prices continued to decline nearly 6 % y-o-y. Although producer price inflation suggests persisting excess capacity problems and deflationary pressure, there was nothing immediately new or disconcerting in the latest data, making it hard to interpret or explain recent market uncertainty.

China seeks long-term economic growth through innovation processes. OECD estimates show China's R&D investment rose from $33 billion in 2000 to $336 billion in 2013. Innovation activity has focused on traditional industries and emerging IT branches. The Boston Consulting Group's 2015 list of the world's 50 most innovative companies includes three Chinese IT firms: Internet giant Tencent (12th), telecom network solutions provider Huawei (45th) and computer technology specialist Lenovo (50th).

Products of high-tech firms last year constituted the largest category of Chinese exports, accounting for about 30 % of China's industrial product exports. In 1990, over half of exports consisted of low-tech products. The rise of Chinese technology in Asia is stunning. China accounted for 9 % of Asian high-tech exports in 2000, but 44 % in 2015.

The Global Innovation Index (GII) 2015, published jointly by Cornell University, INSEAD and the World Intellectual Property Organization (WIPO), compares the innovation activities of 149 countries using several indicators. China was ranked 29th in the survey and the top performer among upper middle-income countries. China has invested heavily in innovation since the 2008 recession, and succeeded in improving the quality and efficiency of its innovations. In 2015, China ranked 18th for quality of innovations and 6th by innovation efficiency. To improve the efficiency of innovation activity, China needs particularly to improve its political, regulatory and business environments. The country's GII rankings could further rise in coming years as the 2016–2020 five-year plan sees innovation as a source of growth.

China's innovation policy, however, has been criticised for being protectionist. The US-based think tank, the Information Technology and Innovation Foundation (ITIF), reports that China's "innovation mercantilism" strengthened last year. The ITIF defines innovation mercantilism as a national strategy where technology exports are promoted through protectionist measures.

Other BRIC countries posted much lower GII scores than China. Russia ranked 48, followed by Brazil at 70th place and India at 81st. Even if Russia slightly boosted spending on innovation activity after the financial crisis, its ranking has been stable in recent years. The ITIF also accused Russia of engaging in innovation mercantilism. Brazil and India also climbed in the country rankings in 2011–2015, but not nearly as fast as China.

Finland ranked sixth in the 2015 GII, down two places from 2014. Finland's investment in innovation was particularly impressive (3rd out of 149), even if investment in innovation activity had not returned to the pre-2008-crisis levels. Finland came out on top in the survey in the "institutions" and "human capital and research" sub-categories. There was room for improvement in the innovation output (10th) and efficiency (41st) categories.

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