EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly

13 • 30.3.2012

Russia

Russian domestic demand weak in January and February. The pick-up in domestic demand in February failed to compensate for January's drop. The seasonally adjusted volume of retail sales in February was roughly on par with December, and preliminary figures show fixed investment was down from the final months of 2011. After spiking in December, real household incomes declined despite falling inflation.

In contrast, robust growth in industrial output continued throughout January and February in both manufacturing and energy production. Industrial output has recovered in several industrial branches, supported by e.g. revived exports of crude oil and higher government spending. Confidence indices for industrial firms were still fairly good in March.

Strategy 2020 emphasises economic cooperation with CIS countries and the EU. Among the biggest challenges facing Russia's economic relations are its dependence on oil and the rapidly increasing role of emerging economies (particularly China) in the global economy. In response to these challenges, Strategy 2020 calls for deeper and wider external trade relations, liberalisation of foreign trade and increased support to foreign investment.

Unlike many international assessments, Strategy 2020 sees a substantial risk that world prices could decline sharply due to a glut of energy products on the markets. Nevertheless, the oil price is expected to average above $70 a barrel throughout the current decade. But high oil prices could also be problematic for Russia as they could put appreciation pressure on the ruble and diminish the competitiveness of Russia's other exporting branches.

China's strengthening position could hamper Russia's plans to increase international use of the ruble and integration within CIS countries in Central Asia. The rising competitiveness of Chinese firms and their rapid technological advancement is also eroding the position of Russian firms on the domestic market and could threaten their possibilities to adopt high-tech manufacturing.

A regional priority of Strategy 2020 is development of the Russia-Belarus-Kazakhstan customs union into a Eurasian Union that shares a common economic space and currency. It also envisions development of other forms of cooperation with CIS members. CIS cooperation is seen as important both for political reasons and from the standpoint of expanding markets for Russian products. In technology cooperation, the EU is seen as a desirable partner.

Tighter cooperation with the EU is also recommended in other areas with an expanded free-trade agreement as a goal, including e.g. some further liberalisation of trade in services and implementation of better investor protection. EU technical standards should also be adopted by the customs union and mutual visa practices substantially relaxed. Despite deeper economic relations, Russian dependence on the EU should be reduced and export markets diversified, especially to Asia. China is seen as the most promising Asian export market, while Japan and South Korea are seen as offering the best possibilities for technology cooperation. They latter two are also seen as promising sources of investment.

Strategy 2020 proposes also measures to promote foreign trade and foreign investment, such as lowering customs duties, increasing export subsidies, reducing restrictions on foreign investment and increasing the number of special economic zones.

Russia needs highly skilled immigrants. Strategy 2020 declares that Russia needs immigrants to meet the needs of its labour markets. To date, Russia has not been an attractive destination for skilled migrant workers. Russia's Strategy 2020 working group on immigration policy concluded that current policies are limiting and geared to immigrants' temporary stay in Russia. It does not include measures to help immigrants adjust to society or, for example, take into account the implications of entire families immigrating.

Over 7 million people moved to Russia after the breakup of the Soviet Union. The lion's share of immigrants were Russians living in former Soviet republics, who moved back to Russia during the 1990s. Russia is still willing to take back its ethnic Russians, but their motivations for moving to Russia have diminished.

A large share of immigrants currently come from countries south of the Russian border in Central Asia and the Caucasus region. Most take low-skilled jobs. Such workers are likely to be found in menial jobs in big cities or doing farm work in the countryside.

The actual number of immigrants in Russia is unclear. According to the Federal Immigration Service, about 1.7 million migrants legally worked in the country in 2009. The immigration service estimates that 3–5 million immigrants work illegally in Russia. The official quota for migrant labour last year was 1.7 million people. Legal migrants make up about 2.5 % of the Russian workforce. Under Strategy 2020, the goal is to attract annually some 250,000–300,000 immigrants.

Strategy 2020 proposes replacement of the current general immigration quota system with special categories according to skills. Most-favoured immigrants would be highly educated experts and their families, entrepreneurs and investors and their families, as well as workers in branches suffering from manpower shortages. These groups' immigration should be eased by improving immigrants' legal protection, access to social security and the possibility of multi-year work permits. Several changes were made in the system in 2010 to encourage immigration of highly skilled experts, but the results so far have been fairly disappointing.

Editor-in-Chief Seija Lainela

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160 • FI-00101 Helsinki
Phone: +358 10 831 2268 • Email: bofit@bof.fi • Web: www.bof.fi/bofit

EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly
13 • 30.3.2012

China

European Commission competitiveness report notes pluses and minuses of China's competition policies. The report released in February shows a positive trend in the second half of 2011 in the opening up of public procurement to foreign competition. However, the EU said China had made little progress in lifting restrictions on foreign investment and issues related to standardisation, noting China had even added new restrictions on foreign investment under the guise of national security.

Friction in China-EU trade relations has also been generated by export subsidies given by China to high-tech firms. Green technologies, for example, have become an area where China seeks to dominate the world market using what critics see as unfair practices. Companies in the US and India that produce conventional solar panels have complained that the Chinese are engaging in price dumping to gain market share. The US Commerce Department last week announced it was imposing a countervailing duty on Chinese solar panels to offset unfair subsidies.

Trade policy disputes have also arisen in many other contexts. The *2012 Business Climate Survey* of exporting firms released by the American Chamber of Commerce in China last week found that China gives preferential treatment to domestic firms over foreign firms in the granting of business licences. The US, EU and Japan also filed complaints with the WTO over China's restrictions on exports of rare earth metals. The complaint follows on the heels of a January ruling by the WTO that China's restrictions on exports of several other critical metals violated China's WTO commitments. The US, EU and Japan in the latest filing seek a similar ruling on restrictions of rare earth metals, which were not covered in the January ruling. China produces over 90 % of the world's rare earth metals, and recently has imposed quotas on their export. China claims the restrictions reflect environmental needs.

China has brought out the heavy artillery in its dispute with EU airlines over CO_2 emissions. The dispute arose when EU incorporated airlines into its emissions trading scheme at the start of this year. The ruling requires airlines using European airports to purchase carbon emission offsets from an emission trading exchange. Chinese officials have responded by declaring that Chinese airlines will not participate in the EU emissions trading scheme. China has also threatened to cancel its aircraft purchase contracts with Airbus Industries. India has followed China's example by calling for its airlines to boycott the EU carbon tax.

China invests in military technology. During the People's National Congress this month, China announced that defence spending would increase 11 % this year to about 670 billion yuan ($106 billion), and that defence spending would account for about 6 % of the national budget. Defence spending covers the upkeep of the over 2.3 million members of the People's Liberation Army, the world's biggest standing army.

Observers note that China's actual defence spending is substantially higher than official figures; spending on research and development is partly outside the defence budget. The Stockholm International Peace Research Institute (SIPRI) estimates that China's actual 2010 defence spending exceeded over 2 % of Chinese GDP and in dollars terms was more than double the defence spending of Japan or Russia.

China is investing heavily in raising the technology level of arms production that includes e.g. an aircraft carrier project, development of a stealth fighter and military space applications. Although the rise in the sophistication of Chinese arms technology has been faster than many believed possible, China remains dependent on Russia for fighter aircraft engines and some key components made in Europe.

With the rise in its technological capabilities, China's dependence of others for arms imports has fallen and its export potential has grown. SIPRI's just-released 2011 report on international arms trade finds that over the last five years China has slipped from the top of the list as the world's biggest arms buyer to fourth place. During the period, Russia accounted for 78 % of China's traditional arms imports. China, in turn, accounted for a 16 % share of Russia's arms exports, making it the second-most important arms buyer after India (33 % share). Nevertheless, prior to last year, the volume of Russian arms going to China has been declining.

About 73 % of China's arms exports over the past five years went to countries elsewhere in Asia, 12 % to the Middle East, 9 % to Africa and 6 % to Latin America. Pakistan alone bought nearly 64 % of all Chinese arms exports. SIPRI actually noted that China so far has had trouble breaking into other markets.

Finland's trade deficit with China increases in 2011. Customs Finland reports that the value of goods exported to China in 2011 was €2.7 billion, a slight contraction from 2010. At the same time, the value of goods imported from China increased 16 % to €4.4 billion, raising Finland's trade deficit from about €1 billion in 2010 to €1.7 billion last year. However, the 2011 deficit was not particularly large; in the pre-crisis years 2006–2008, the annual deficit exceeded €2 billion. Finland's service trade balance with China in contrast has typically been in surplus.

China is Finland's seventh most important destination for its goods exports and the fourth largest source of goods imports. In terms of services exports, China ranked fourth in 2010 and was Finland's sixth largest provider of services.

Editor-in-Chief Seija Lainela

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160 • FI-00101 Helsinki
Phone: +358 10 831 2268 • Email: bofit@bof.fi • Web: www.bof.fi/bofit