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BOFIT Weekly

13 • 28.3.2013

Russia

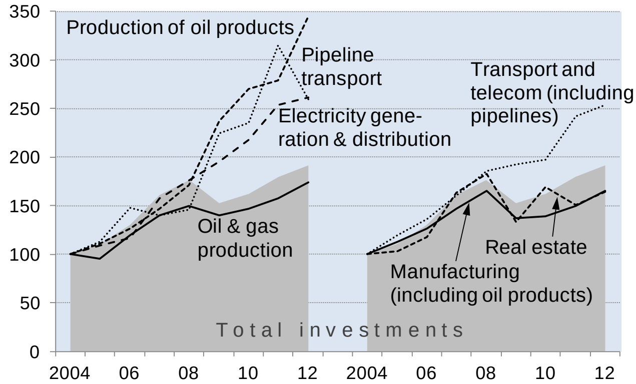
Russian economic growth slowed in the first two months of the year. The economy ministry has estimated that seasonal, work-day adjusted GDP contracted slightly on-month in January and February, and that GDP was up only about 1 % over the past 12 months. Industrial output fell on-month in the first two months of this year and was down slightly from a year earlier. Most of the decline was due to reduced production and exports of oil & gas. Manufacturing output was unchanged from a year ago. However, industrial firms are still quite optimistic about their outlook for the coming months.

Growth in domestic demand was quite slow. Retail sales grew 3 % y-o-y while consumer expectations cooled. Growth in retail sales slowed mainly because household borrowing is no longer growing. Fixed capital investments were up slightly from a year ago. Imports continued to grow moderately.

Forecasts expect weak growth in the first half of 2013 with a recovery in the second half as growth of the global economy picks up. Most forecasts expect GDP to rise 3–3.5 % this year (GDP grew 3.4 % last year).

Small shift in investment structure last year. The volume of fixed capital investments increased nearly 7 % overall last year, although growth slowed sharply over the year. Investments in the energy sector (production and pipeline transport of oil, gas and oil products, as well as investments in electricity generation and distribution), continued to account for well over 30 % of all investments, even if that share was slightly lower than in 2011. The reduction was due to a drop in investments in pipelines as the pipeline building boom of the past couple of years abated (7–8 % of total investments). Investments in oil refining, in contrast, continued their strong rise of several earlier years. Growth of investments in oil and gas production picked up (12 % of investments).

Volume of investments in key sectors (2004 = 100)



Source: Rosstat

Looking at other areas attracting major investments, manufacturing (excluding oil products) again accounted for nearly 11 % of total investments and was up again less than 10 % as in the previous year. Investments in the transport sector not including pipeline transport (share about 20%) continued to grow at an over 15 % pace. Investments in the real estate branch (13 % share) saw a considerable uptick. Housing construction activity continued to rise.

New government budget administration programmes strive to maintain balance. This month the government approved two budget programmes: one focused on the federal budget and one on regional and municipal budgets.

The federal budget programme is aimed at securing budget balance. The programme stresses the new budget rule that ties federal spending to the average oil price in previous years. The programme notes that by following the budget rule the non-oil budget deficit (i.e. the difference between budget revenues other than revenues from taxes on production and exports of oil, gas and oil products and total budget expenditures) would be reduced from over 10 % in 2012 to around 7.5 % by 2018 based on a roughly stable oil price. This would keep the budget in balance. Federal government debt is not expected to grow larger than 15–20 % of GDP in the period, even if domestic borrowing is planned to continue in order to increase the state reserve funds. The biggest risks noted include a decline in the oil price and scheduling spending e.g. in economic development programmes so that it outstrips budget revenues.

The background to the programmes includes projections by the finance ministry, presented in last autumn's budget frame, of budget revenues from oil & gas which all go to the federal budget (they stood for half of federal budget revenues and 28 % of all government budget revenues in 2012). In the policy frame, the size of budget revenues from oil & gas relative to GDP will shrink considerably as the export price of oil is assumed to remain broadly unchanged and meagre development is expected in oil and gas output and exports (in line with the economy ministry forecast).

Other objectives of the federal budget programme are to improve Russia's international creditworthiness via budget balance and sufficient reserve funds, develop budget administration in various ways, e.g. by simplifying tax payments, and further raising Russia's already rather good ranking in international budget transparency comparisons.

The programme for regional and municipal budgets seeks to increase tax revenues to regions and reduce dependence on transfers from the federal budget. The transfers represented about a fifth of all regional and municipal budget revenues in 2012. Regional governments and the finance ministry are set to sign agreements on enhancing revenues in the regions and effective use of funds. The programme notes it could lead to cuts in the public sector workforce in such areas as education and health care. The programme also seeks to improve the reduction of economic disparities across regions.

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China

OECD recommends that China improve status of internal migrants and push ahead with market-based solutions to environmental problems. The latest OECD [Economic Survey of China] deals extensively with the economic challenges facing China. The OECD asserts China can sustain high economic growth in the future as its development path in many respects seems to follow that of Japan and Korea in earlier decades. China still has plenty of room to grow. Adjusted for purchasing power, the Chinese economy will surpass the US as the world's largest economy around 2016. Even then, however, Chinese per capita GDP will only be about a quarter of the US level.

China's economy faces multiple challenges. Many stem from a wave of loans, unproductive investments and other imbalances that occurred after China's massive stimulus programme in 2009–2010. China also has to take on accelerating inflation. One solution to rising housing prices might be to zone more land for residential purposes. The OECD wants to see greater transparency for local borrowing and other off-budget financial actions by local administrations that became common during the stimulus. Financial market reforms should be continued. Commercial banks should be given greater latitude in setting interest rates, and more foreign investment should be permitted in China's financial markets.

China has experienced one of the fastest and largest scale urbanisation in human history, yet its administrative structures have failed to keep up with the development. In particular, China's *hukou* household registration system must be reformed in order to give internal migrants to cities access to standard public services such as schooling and healthcare. Due to the *hukou* system, such services are presently not available to migrant workers outside their home district. Urban planners should also focus more on public transport, which has failed to keep up with rapidly growing cities.

China's growth model has resulted in a vast increase in energy consumption, which, in turn, has boosted emissions of greenhouse gases and other pollutants and led to serious environmental degradation. So far China has largely relied on regulation to deal with its environmental messes. The OECD suggests China employ market-based solutions. For example, regulated pricing of coal and other fuels, as well as electricity, could be abolished. Because regulated prices are so low in China, they fail to provide consumers with a price signal that would make them aware of actual production costs and thus encourage them to save energy. The price of water should also be raised to reduce waste. Emissions reductions could also be achieved by raising various taxes and fees on polluters.

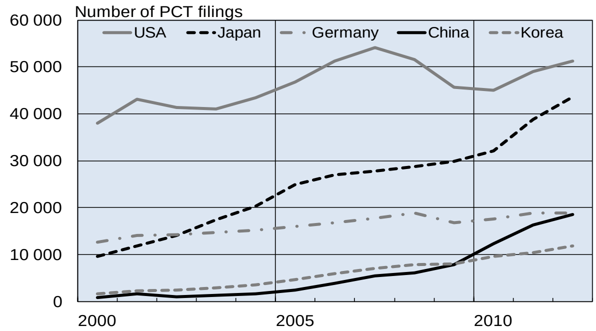
China matches Germany in international patent activity. The World Intellectual Property Organization (WIPO) reports that the number of patent applications submitted under the international Patent Cooperation Treaty (PCT) exceeded 194,000 last year, an increase of nearly 7 % from 2011. The most patent applications were filed by companies in the United States and Japan, which together accounted for nearly half of all applications. Although growth in patent applications from Chinese firms slowed to 14 % last year, applications from China reached around 19,000, putting it on par with Germany in patent submissions. Germany and China each accounted for about 10 % of total PCT applications. South Korea ranked fifth in PCT filings.

Asia's strong emphasis on product development can be seen in the 12–14 % increases in patent filings from Japan, China and South Korea. However, in protecting designs and trademarks, Asian firms still lagged well behind their European and North American counterparts.

The most PCT patent submissions were made by Chinese telecom giant ZTE, followed by the Japanese Panasonic and Sharp, and China's other big telecom equipment maker Huawei. ZTE and Huawei accounted for about a third of all applications submitted by Chinese firms. Only a couple of other Chinese institutes made it into the top 100 organisations applying for patents globally. However, there were over 100 Chinese firms and research institutes that filed at least ten applications, suggesting that Chinese patent activity is wide-ranging. The overall quality of Chinese patent applications and patents is low compared to Western companies, so simply counting the number of applications overstates the abilities of Chinese firms to come up with true innovations. Nevertheless, there is no reason to belittle Chinese firms as they are increasingly displaying an ability to come up with novel solutions and have shown that they can follow the lead of Japan and South Korea in this area.

Measured in PCT patent applications, China is a far bigger player than India or Russia. India last year filed 1,200 patents and Russia less than 1,000. Finnish firms, in contrast, filed nearly 2,400 applications, putting Finland 13th in patent-seeking activity. Nokia and Nokia-Siemens accounted for over 40 % of Finnish patent applications.

Leading countries filing international patents (PCT)



Source: www.wipo.org

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