SUOMEN PANKKI FINLANDS BANK
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Russia

BOFIT forecast sees Russian economic growth reviving. The slowdown in Russian economic growth in the first half of 2013 to less than 1.5 % p.a. was significantly sharper than predicted. This was mainly due to a reduction in investment of state-owned enterprises and the public sector. In our latest BOFIT Forecast for Russia 2013–2015, we expect the Russian economy to pick up in the second half of this year as the global economy revives. GDP growth for all of 2013 is now forecast to reach nearly 2 %.

Growth should be restrained somewhat by a slight decline in the oil price. In 2014 and 2015, nevertheless, GDP growth should exceed 3 % p.a., supported in part by the recovery in world trade that should gradually increase Russian exports and end the contraction in fixed capital investment. Russian import growth should pick up slightly to around 5 % p.a.

Growth in exports will remain low due to a slight deterioration in the outlook for energy exports. Growth in household incomes will also slow as room for granting wage hikes has narrowed. On the other hand, the decline in inflation should give a slight boost to household purchasing power. Also, household borrowing should recover. Driving factors behind revived capital investment include the facts that production capacity utilisation levels are high and the state will begin to grant long-term loans to finance a number of massive transport infrastructure projects. Other stimulus measures in the government's current plan are somewhat scattered and seem likely to have limited impact. The increase in state spending will slow as growth in state revenues has decreased sharply and the goal, at least for the moment, is to keep the budget deficit small.

Russian GDP and import volumes, realised and BOFIT forecast 2013–2015, %

	2008	2009	2010	2011	2012	2013f	2014f	2015f
GDP	5,2	-7,8	4,5	4,3	3,4	1,8	3,3	3,2
Imports	15	-30	26	20	9	4	5	6

Sources: Rosstat, BOFIT

Economic growth will be weaker than forecast if the recovery of the global economy is delayed, the oil price falls, growth in household incomes and state expenditure slows more than predicted or if uncertainty about demand and the business environment limits investment. Russia's high employment rate could also constrain growth.

Over time, economic growth will gradually head towards its long-term trend as long as the oil price does not rise. Our calculated long-term trend has moved to a distinctly lower level since the 2009 recession. The trend hovers around 2 % unless Russia accelerates its efforts to improve its business climate and attract more investment.

CBR names new deputy chairwoman and streamlines its monetary policy instruments. Presidential economic policy adviser Ksenia Yudaeva (43) was named Central Bank of Russia first deputy chairwoman on September 11. Yudaeva, who took her PhD at MIT in the US, will be in charge of CBR monetary policy.

The CBR board decided last Friday (Sept. 13) to eliminate many of its financing instruments. The goal of a smaller toolbox is to increase monetary policy transparency to better signal monetary moves to the markets. The CBR also expects the change to promote development of the interbank market

Russia's central bank has had at its disposal a wide array of interest rate tools, due in part to the heterogeneity of Russia's banking sector. Interest rates have been inconsistent and they have been changed at different times, which has diminished the effectiveness of monetary policy. The new system is structured along the lines of e.g. the European Central Bank (ECB).

The 7-day repo auction credit rate was announced as the main monetary policy tool, the "key rate." These credits have even to date been the most important form of central bank financing to banks. The rate currently stands at 5.5 %.

The standing facilities consist of the overnight credit rate (6.5 %) and overnight deposit rate (4.5 %). A change in the key rate will cause a corresponding shift in these rates, which in principle form the upper and lower limits for short-term interbank rates.

Starting in February 2014, the bank will no longer grant e.g. one-day and 7-day repo credits. On the other hand, the CBR is introducing the possibility of fine-tuning operations in the same manner as the ECB to adjust market liquidity.

The CBR in July introduced a new longer-term financing facility, the three-month adjustable-rate credit. Non-marketable assets will be approved as collateral to secure the loans so that marketable assets are available for use as collateral in the interbank market. The interest rate is tied to the central bank's key open-market rate.

The CBR's refinancing rate, currently at 8.25 %, serves no role in monetary policy, but instead provides a legal reference rate for many types of payments. By the end of 2015, the CBR hopes to have gradually cut the refinancing rate to a level matching the key rate so it can be phased out altogether. A transition period is needed to enact amendments to legislation that refers to the refinancing rate.

Main CBR financial instruments and their interest rates, %

Liquidity boosting	Overnight credit		6.50
	3-month credit	minimum	5.75
	7-day repo credit	minimum	5.50
Liquidity reducing	7-day deposit rate	maximum	5.50
	Overnight deposit		4.50

Source: Central Bank of Russia

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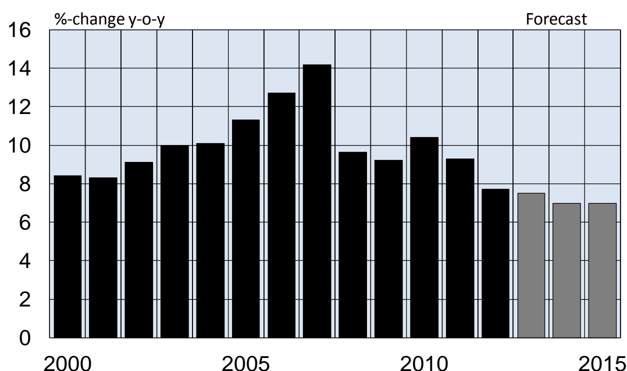
China

BOFIT sees China's economy growth slowing in 2013–2015. This week, we released our latest BOFIT Forecast for China 2013–2015. China's economy slowed slightly more that expected in the first half of this year, motivating us to lower our March forecast of 8 % p.a. in 2013 to 7.5 %. Otherwise, however, growth over the forecast period conforms to our earlier long-term outlook that sees economic growth moderating to around 7 % p.a. in 2014 and 2015. Annual growth in export volumes is expected to reach 5–6 % during the forecast period. Because economic growth in China is higher than in its trading partners, imports are expected to rise slightly faster than exports. Depending on the development of foreign trade prices, the current account surplus could slide over the next two years from about 2.5 % of GDP at present to around 2 % of GDP.

Realised GDP growth and BOFIT forecast 2013–2015



Sources: China National Bureau of Statistics and BOFIT

The immediate causes of China's economic slowdown are lower export growth, rising debt problems and overcapacity in many sectors that reduce capital investment possibilities. China's growth is still quite robust even with the slowing, so China's decision-makers apparently see no need at present to support growth as earlier with a flood of credit. Instead, they emphasise targeted fiscal spending measures e.g. in the form of tax breaks to small businesses and accelerating the pace of investment in railway projects. The authorities are forced to this partly due to mountains of debt held by local administrations and firms that resulted from easy access to credit under the previous stimulus package.

Over the longer term, rapid urbanisation and the following increase in demand for services will gradually change the structure of economy. Consequently, also the economic growth will slow down. As this shift to a more consumption-driven model can be promoted through structural reforms, China's new leadership later this year is expected to announce, among other things, reforms to the *hukou* household registration system, as well as changes in public sector administration and budget systems. Officials this summer ended regulation of bank lending rates and incremental reforms of the financial market will continue as before. International use of the yuan should continue to rise and currency controls will be relaxed.

If debt problems worsen and expose vulnerabilities in the financial and real estate sectors, economic performance would likely fall below our basic outlook. Despite significant troubles brewing, the near-term risks appear quite manageable overall in relation to projected economic growth. The new leadership's commitment to reform shown this year portends less hardship down the road, even if reforms are difficult to implement and may come with surprises.

EU Chamber of Commerce in China wants to see more space for market forces to operate. The European Chamber of Commerce in China last week released its annual business climate assessment Position Paper 2013–2014. The Chamber argues current economic conditions call for extensive reforms if the government hopes to sustain high economic growth in the future.

The Chamber sees that the state currently plays too big role in the corporate sector. Reforms reducing the role are critical for the economy as they would reduce market distortions and promote better use of resources. This applies in particular to the financial markets, where state-owned enterprises (SOEs) and local administrations have access to low-interest loans that they often use on unprofitable projects. SOEs are also shielded from competition though various industrial policy measures such as subsidies, which allow inefficient businesses to survive. The Chamber would like to see domestic and foreign firms treated equally in terms of access to state support. Moreover, the red tape encountered by firms could be reduced by clarifying the responsibilities of ministries and the various levels of government that currently overlap and occasionally conflict with each other. The Chamber would also like to see enhanced enforcement of patent and copyrights.

The Chamber was particularly concerned about the increase in recent years of actions taken in the name of China's innovation policy. According to the position paper, many innovation measures do not strengthen China's innovation capacity, and can be seen as masked attempts to grow market share of a particular domestic firm. The state has taken on the role of picking winners and losers, i.e. deciding the future branches and technologies with the best possibilities, and then lavishing them with support. The Chamber notes that such prioritisation is hard for firms themselves, let alone the state, and such picking up is likely to tie up large amounts of capital in unprofitable ventures. The Chamber also states that favouring domestic innovation in public procurement does not actually promote innovation, but it merely protects Chinese firms from competition.

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