EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly

38 • 19.9.2014

Russia

BOFIT forecasts slow recovery for Russian economy. Russian economic growth slowed to a crawl in the first half of 2014, even if transient factors supported domestic output and consumption. Temporary factors included the sharp increase in defence spending and a jump in retail sales as households accelerated purchases in the late winter and spring in anticipation of higher inflation.

The latest BOFIT Forecast for Russia 2014–2016 sees virtually no GDP growth this year as the Ukraine crisis continues to stoke uncertainty that has been particularly hard on private investment. The Russian economy will begin to recover gradually as growth in global trade and the world economy picks up – even with the oil price falling slightly over the forecast period as we believe. This benign scenario of slow recovery assumes that financial market responses to the heightened uncertainty from the Ukraine crisis are limited and no further escalation or prolongation of sanctions takes place. If so, investment should start to recover at the end of the forecast period. Growth in private consumption will slow this year on e.g. relatively modest real gains in wages and pensions due to higher inflation. Overall export growth should be sluggish as energy exports decline slightly in coming years. The finance ministry expects zero real government spending growth.

Russian imports have already contracted substantially due to the depreciation of the ruble. Imports are expected to stabilise next year and then begin to recover as long as the ruble's exchange rate remains relatively steady. The ruble's real exchange rate will strengthen gradually as Russia's inflation rate is likely to remain higher than that of its main trading partners. Net capital exports from Russia will continue, but their influence on the ruble's nominal exchange rate will be offset to some extent by the current account surplus driven by reduced imports.

The downside risks associated with this forecast are quite substantial. They relate largely to the situation in Ukraine and Russian uncertainties, which, in turn, affect both Russian investment decisions and imports. Private investment could be postponed to a much greater extent than in our basic forecast. Net capital outflows could also well exceed expectations, in which caser the ruble's slide continues and imports drop even more than forecast. The limited possibilities for further employment gains and the lack of investment could impose surprisingly large constraints on Russian output growth.

Economic growth could also revive faster than we forecast if Russia decides to move ahead with a wider economic stimulus that involves higher government spending or channelling central bank money into the economy via the banking system. Russian leaders could also substantially increase the investment levels of large state enterprises.

Over the long term, the conditions for growth and development will be weakened as private investment projects are delayed and the government prioritises spending on defence over the next few years. Russia will also be hurt by the current push to increase self-sufficiency in production and to move further away from market reforms and promotion of open competition.

The EU and US step up economic sanctions against Russia. Last Friday (Sept. 12), the EU and US tightened last summer's sanctions on the financial sector. The new measures bar Russia's largest banks as well as oil and defence companies from receiving loans with maturities of more than 30 days, down from 90 days earlier.

Export restrictions were also widened. The EU forbid exports of dual-use military equipment to more Russian firms. European companies were now also banned from providing Russia with certain services in addition to previous restrictions on some technologies for deep-sea and Arctic oil exploration and production, as well as shale oil production. The US imposed similar oil-sector bans on state-owned Gazprom and privately held Lukoil.

Many Russian companies hit by financial sanctions are asking for state compensation. The restrictions on technology and services exports for the oil sector could limit the development of the sector in longer term.

Ruble down sharply. According to the Central Bank of Russia's official daily rate today (Sept. 19), one euro bought 49.5 rubles and one dollar 38.4 rubles. The ruble has this week been at an all-time low against the CBR's dual-currency basket. Nevertheless, the CBR has refrained from market interventions under its stated policy to intervene only when ruble goes outside its permitted fluctuation band relative to its currency basket rate.

The ruble's slide has been driven by increased uncertainty concerning the Russian economy, caused by the latest round of EU and US sanctions. In addition, the world market price for crude oil, a key number for the Russian economy, has declined since mid-summer. The export price of Urals-grade crude fell below $100 a barrel at the end of August, hovering in recent days at around $95 a barrel. The ruble's slide has been strongest against the dollar. The ruble, like the currencies of many emerging economies, has been hurt by expectations of monetary tightening in the US.

Russian financial markets have for some time suffered from foreign currency drought. To increase liquidity, the CBR announced Tuesday (Sept. 16) the start of foreign exchange (FX) swap auctions, whereby it sells dollars at a fixed interest rate to commercial banks and then buys them back the next day. The reverse FX swap (central bank sells rubles for dollars) is a standard CBR monetary policy tool.

The CBR decided to keep the key rate at 8.0 % at its monthly meeting on Tuesday. Interest rates will be revisited at the next meeting at the end of October.

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

Editor-in-Chief Seija Lainela • Email: Seija.Lainela@bof.fi
*The information is compiled and edited from a variety of sources.
The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.*

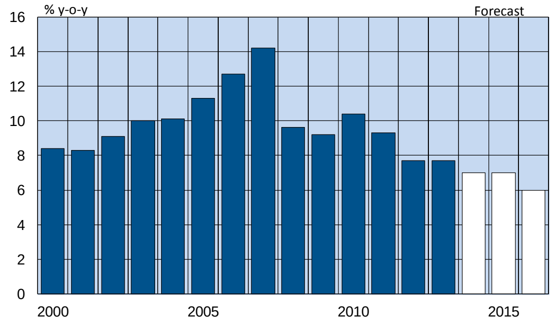
EUROJÄRJESTELMÄ
EUROSYSTEMET

BOFIT Weekly
38 • 19.9.2014

China

BOFIT forecast sees smooth slowdown in Chinese economy. On-year GDP growth slowed to 7.7 % in 2013, and to around 7.5 % in the first half of 2014. Our latest BOFIT Forecast for China predicts the slowdown in growth to continue. In line with our March forecast, we still see GDP growth of around 7 % this year and next, and then falling to around 6 % in 2016.

Realised GDP growth and BOFIT forecast 2014–2016



Sources: NBSC and BOFIT

The slowdown in growth is quite natural given the size of the Chinese economy, its resource demands and its increased level of development, but there are many other factors contributing to the slowdown. Following a decade-long investment boom, new investment no longer delivers the same "bang for the buck" as earlier. The aging population reduces labour input, and vast environmental degradation comes with hefty social costs that are already eroding growth. Short-term economic growth will also be subdued by the rapid rise the indebtedness of local governments and businesses that will limit the government's room to manoeuvre in the fiscal and monetary policy.

Perhaps the clearest signs of waning economic growth can be seen in fixed-asset investment in urban areas (FAI), which slowed from 20 % y-o-y in 1H2013 to 16 % in the first half of this year. The volumes of goods exports and imports faded in January-July to around 2–3 % (goods trade increased about 10 % last year in the same seven-month period). Figures for industrial output and credit growth in July and August confirm the view that growth continues to slow in the third quarter. Indicative data do not show any increase in unemployment (admitting, of course, the general difficulties in getting reliable employment data).

A controlled "soft landing" for economic growth is by no means a given at this point. Remaining on an appropriate glide path will require strong economic and reform policies. Rising indebtedness of firms and local governments remains a top challenge for China's multi-tiered economic policy matrix. Darkening the outlook further is an impending correction in the real estate sector. Reducing risk exposure and reinforcing new engines of growth will require far-reaching reforms of China's financial markets, state enterprises, the public sector and social security. China's eagerness to move ahead with reforms will be on display at the fourth plenum of the Communist Party next month.

Given the nature of China's challenges, comprehensive management of economic policy is becoming increasingly difficult. Consequently, there are significant downside risks associated with this forecast. Even in a best-case scenario, it is unlikely China avoids occasional market disruptions. The knock-on effects seen in recent years in financial markets offer a hint of things to come.

China's competitiveness still based on market size and favourable macroeconomic environment. This year's World Economic Forum (WEF) Global Competitiveness Report ranks China 28th out of the 144 countries surveyed. China was the most competitive of the BRICS, followed by Russia (53rd), South Africa (56th), Brazil (57th) and India (71st). Switzerland remained in the top spot for global competiveness, while Finland ranked fourth.

In the 12-category survey, China's competitiveness was sustained by the large size of its market (second out of 144) and a favourable macroeconomic environment (10th) that reflects e.g. a high savings rate and low state debt. A number of development indicators, however, still show China lagging far from the leader pack. Low marks that dragged down China's overall ranking include higher education and training (65th), efficiency of commodity markets (56th), financial market development (54th) and technological readiness (83rd). The WEF report noted that China is no longer a centre for cheap labour-intensive production. To retain its competitive advantage, the country must develop high value-added businesses.

Russia this year rose eleven places in the rankings to 53rd position. The improvement particularly reflects gains in commodity market efficiency (e.g. increased competition), innovation and business development. Russia outperforms China in the areas of higher education and training, infrastructure development and technological readiness. Russia's competitive weaknesses stem largely from its inefficient institutional environment (97th), and underdeveloped commodity (99th) and financial markets (110th). Data in the report are from last year. The escalation of the Ukraine crisis is seen as a risk to Russian competitiveness that rests largely on publicly funded education and innovation.

Chinese business leaders interviewed for the report identified difficulties in access to finance, corruption and tax regulation as the biggest barriers to doing business. The biggest barriers in Russia were corruption, high corporate taxation and poor access to financing.

Hong Kong ranked seventh and Taiwan 14th. Hong Kong's infrastructure and financial market sophistication put it among the world's best. It still had room for improvement in education, research and innovation.

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

Editor-in-Chief Seija Lainela • Email: Seija.Lainela@bof.fi
The information is compiled and edited from a variety of sources.
The Bank of Finland assumes no responsibility for the completeness or accuracy of the information, and opinions expressed do not necessarily reflect the views of the Bank of Finland.