BOFIT Weekly

13 • 27.3.2015

Russia

Latest BOFIT forecast sees further contraction of Russian GDP and imports this year, with slow recovery thereafter. The Russian economy slowed for the third consecutive year with growth coming nearly to a standstill in 2014. With the price of oil down by nearly half (from last year's average price), the economy has entered a contractionary phase.

In our latest Forecast for Russia, we see Russian GDP contracting this year by over 4 % as long as the oil price does not rise much above $55 a barrel. Further, the Ukraine situation, financial and trade sanctions from the West, along with counter-sanctions from Russia and the slide in the oil price, have increased uncertainty surrounding the Russian economy. Sanctions are expected to remain in place for a considerable while and access to foreign financing will remain challenging. Government spending is expected to contract in real terms.

The volume of imports fell 7 % last year. We estimate that weak domestic demand, the frail ruble and Russia's reduced export earnings will cause imports to contract this year by approximately 20 %.

For 2016 and 2017, the average oil price will rise to around $65 a barrel. Russian export earnings will recover. The economic contraction and drop in imports shall gradually end and then begin slow recoveries in 2017. The real exchange rate of the ruble should also appreciate as inflation in Russia is significantly higher than in its main trading partners (the gap has widened to over 10 %).

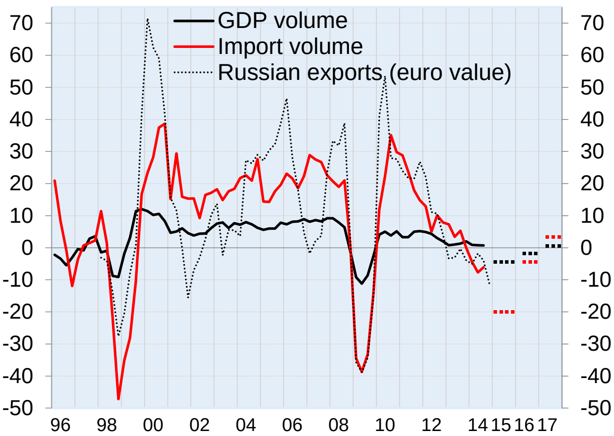
High inflation will cause private consumption this year to decline significantly. The outlook for wage increases is slim and recovery in consumption will take time. Investment is expected to contract substantially this year and also next. Private investment, in particular, has been stifled by uncertainty arising from the continuous tensions in eastern Ukraine, the unclear sanctions outlook and the possibility of more sanctions. The picture is further clouded by the unpredictability of Russia's economic and trade responses in a looming recession. Volumes of exports will increase quite slowly, due in part to hardly any growth in energy exports.

Russia's leadership has responded actively to the onset of recession. However, even if government spending cuts have now become policy, the 2015 federal budget deficit will amount to around 3.5 % of GDP (at an assumed oil price of slightly over $55) and may force the government to use about half of the Reserve Fund. Russia's reliance on the Central Bank of Russia to cover (via banks) the budget deficit and provide financing to firms for paying off foreign debt has for its part increased the CBR's receivables from banks to unprecedented levels. Besides providing state financing, the leadership has increased "manual steering" of parts of imports and exports of capital as the country has come to the brink of recession.

Our forecast sees large risks associated especially with fixed capital investment and imports. Various uncertainty factors could further erode the motivation of private firms in the real economy to invest, while increasing outflows of private capital from Russia. Changes in capital outflows and the oil price are rapidly reflected in the ruble's exchange rate, Russia's export earnings and imports.

Conditions that would foster economic growth and development continue to degrade as private investment declines and government spending focuses increasingly on defence and pensions. Subsidies and restrictive measures to stave off a recession are likely to reduce competition and choke off what little incentive remained for reforms.

Russian GDP, imports and earnings from exports of goods and services, % change y-o-y



Sources: Rosstat, CBR, BOFIT

Transit shipments through Finland to Russia contracted sharply last year, while transit freight from Russia rose. The value of transit freight to Russia via Finland contracted last year by over a fifth to €14 billion, even less than in the crisis year 2009. Transit shipments fell last year for the third year in a row. Although roughly a third of all Russian imports passed through Finland in the first half of the 2000s, last year just 8 % of Russia's total imports passed through Finland. This has been partly caused by Russia's weak economic development but also by improving transport infrastructure in Russia, particularly development of the Port of Ust Luga. Transport freight moving through Finland has also been hurt by increased competition from other transit routes, particularly the Baltic countries.

In contrast, transit freight moving from Russia via Finland to third countries rose last year for the second year in a row to a record level. This transit freight constituted 7 % of Finland's international sea transport volume. It largely consisted of ore concentrates and chemical products.

The most recent estimate of Finland's Ministry of Transport and Communications from 2012 put the Finnish economy's annual value-added from transit freight at around €90 million and job generation at about 1,200 jobs.

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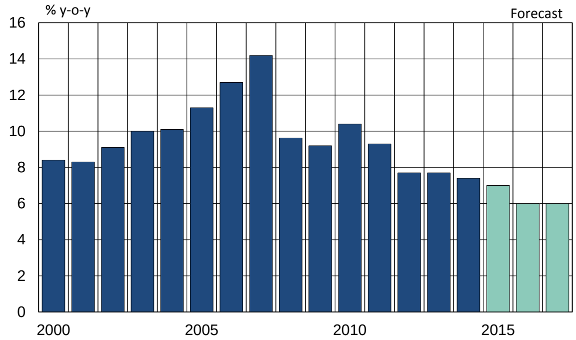
China

BOFIT 2015–2017 forecast sees further slowdown in China's growth without certainty of a soft landing. The latest BOFIT Forecast for China came out this week. We expect Chinese economic growth this year to come in at around 7 % and then slow to around 6 % in 2016. The new forecast largely matches our forecast of September 2014. Our forecast is based on the assumption that China continues to move ahead with bold reform policies and avoids large economic shocks. In this case China could also achieve GDP growth of around 6 % in 2017. A controlled "soft landing" of the economy is by no means set in stone, however, as risks to the economy have continued to grow.

Realised GDP growth and BOFIT forecast for 2015–2017



Sources: NBSC and BOFIT

Lower growth is by and large a good thing for China as it allows structural changes in the economy to continue, and increases the roles of private consumption and services in the economy. Excessive investment resulting from e.g. broad stimulus measures has exacerbated environmental harms, fuelled indebtedness, allowed assets to be squandered on unprofitable ventures and created excess supply in many branches. China's high-growth paradigm emphasising massive investment has reached the end of the road.

The slowdown in growth also highlights the importance of achieving deliberate progress in economic reforms. With the employment situation relatively strong and inflation running at modest levels, it seems an auspicious moment to move ahead with reforms. Indeed, reforms should be expanded to take on the thorniest issues such as reform of state-owned enterprises. Reforms of financial markets are at the moment proceeding for the most part as planned.

Risks to the economy have increased since our last forecast. The biggest risks are growing debt problems and increased challenges in the real estate sector. Dealing with the growing debt problems will be harder midst the lower economic growth. China's domestic credit stock now exceeds 200 % of GDP. The growth of credit has been especially high in the shadow banking sector, which is much less regulated and supervised than the regular banking sector. Low inflation has also driven up real interest costs. The debt problem limits monetary policy, and the central bank must carefully consider whether and how much monetary easing is appropriate, especially if labour conditions remain stable.

China strengthens its status as world's third most active patent-seeker. Latest figures from the World Intellectual Property Organization (WIPO) show the volume of international patents filed under the Patent Cooperation Treaty (PCT) in 2014 rose by nearly 5 % to around 215,000 applications. The United States and Japan together accounted for nearly half of PCT patent applications. The share of China, which is in third place, increased to 12 %. The number of patent applications from China increased nearly 19 %.

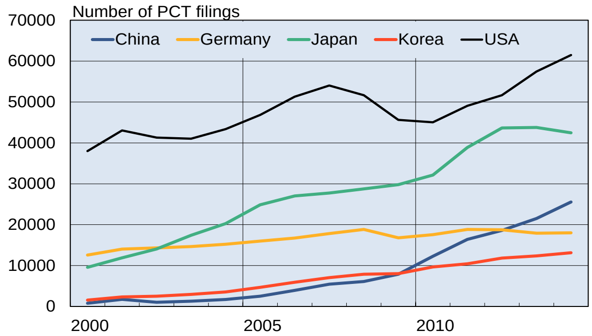
China's rising intellectual property strength was led by its flagship telecom companies Huawei and ZTE, which ranked first and third among large firms globally in terms of PCT applications submitted. US electronics giant Qualcomm occupied the number-two spot.

The number of Chinese applications in itself may overstate China's current innovation capabilities, however, because the quality and value of innovations of Chinese firms tends to be lower than that of firms in advanced economies. Even so, the double-digit growth in international patent activity provides an indication of Chinese ambitions in the technology branch. Here again China seems to be following the development strategy pioneered by Japan and South Korea. The technology-driven growth strategy of East Asia is further evidenced by China surpassing Japan in 2013 as the world's largest buyer of industrial robots.

China's filing of over 25,500 patents last year dwarfs the patent activity of other BRIC countries. India last year produced fewer than 1,400 patent applications, while Brazil fewer than 600. The volume of patent applications from Russia shrank by a quarter to below 900 applications.

Finnish firms last year submitted just over 1,800 PCT applications, a drop of 13 % from 2013. The top PCT filer was the Nokia Group with 630 applications. Nokia ranked 30th globally among large patent-seeking firms.

PCT patent activity of leading technology countries



Source: WIPO

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