Weekly Review
12 • 24.3.2016
BOFIT

Russia

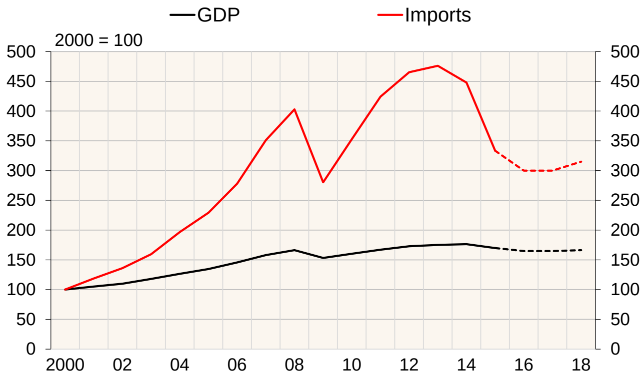
Latest BOFIT forecast for Russia sees economy and imports still contracting further this year. With the price of oil down by about 50 % in the second half of 2014, domestic demand, including private consumption, slid 10 % last year. Russian GDP contracted 3.7 %, even if oil sector exports displayed strong growth and defence spending rose at record pace. Imports fell by 25 % (down 6 % in 2014) on Russia's falling export earnings and the weak ruble.

The oil price slipped again in the second half of 2015. The latest BOFIT Forecast for Russia for 2016–2018 assumes the oil price recovering only slowly, to an average price this year slightly above $40 a barrel (23 % less than in 2015) and $49 a barrel in 2018. We assume no change in geopolitical tensions or economic sanctions. Due to the previous export price shocks and also the oil price assumption, we see Russian GDP contracting about 3 % this year and then remaining around zero in 2017 before returning to low growth. Russian growth should remain low thereafter due to uncertainties and the poor quality of the business environment.

Because the economy will contract and Russian export earnings fall, Russian imports are expected to contract this year yet another 10 %. The volume of imports would be about 37 % below their 2013 level. With recoveries in the economy and export earnings, we expect imports to return to modest growth towards the end of the forecast period. The ruble's real exchange rate will appreciate gradually as inflation remains higher in Russia than in its main trading partners.

The substantial further decrease in domestic demand this year will be driven by several factors, including still rather high inflation that continues to eat away at purchasing power in the private and public sectors. Private consumption will also be restrained by modest growth in private and public sector wages, as well as small pension hikes. Fixed investment is expected to continue to decline. The volume of exports will rise only slowly as growth in oil sector exports will fade.

Russian GDP and import volumes



Sources: Rosstat and BOFIT Forecast for 2016–2018.

Even without targeted cuts, real government spending is set to decline notably this year. The oil price drop has reduced the government's real revenues sharply, so the government also this year faces a rather large budget deficit.

The oil price is a central risk to the forecast, as it could go up or down from our assumption. Geopolitical tensions could change, and there is continuously the risk of other events that would increase capital flows from Russia and cause the ruble and imports to deteriorate further. Despite the government's aims to cut spending, the government could add to spending as the September 2016 Duma elections and March 2018 presidential election are approaching.

CBR keeps key rate at 11 %. The importance of pursuing cautious monetary policy was emphasised in the Central Bank of Russia's statements on the rate decision. Inflation has slowed in past months on e.g. weak domestic demand and recent ruble appreciation. In February, consumer prices were up 8 % y-o-y. The CBR still regards, however, inflation risks high and noted that moderately tight monetary policy could remain in place longer than previously planned. The CBR expects to reach its inflation target of 4 % in late 2017. Inflation risks include development of oil and other commodity prices, high inflation expectations caused by the ruble's previous collapse and uncertainty related to fiscal policy. The CBR noted that this year's planned budget deficit and its funding mostly out of the Reserve Fund can slightly ease monetary conditions. Loosening fiscal policy further could fuel inflation and decrease room for monetary easing.

Russian firms seek financing from China. In response to sanctions imposed on Russia by Western countries that have limited access to financing, Russian firms have stepped up talks with the Chinese to find new sources of financing. Progress has been stiff for the most part.

Chinese investors are interested in Russia's natural resources and local market potential, but they see also many weaknesses and risks in Russia. E.g. an Ernst & Young survey last year found that Chinese firms see Russia's regulatory environment and infrastructure as weaknesses. Biggest obstacles to investment relate to legislation, uncertain economy, the lack of investment guarantees and sanctions.

Some projects have moved forward recently. The Silk Road Fund has sealed the purchase of a 10 % stake in Novatek's LNG project on the Yamal peninsula (CNPC already owns a 20 % stake). Sinopec has agreed to purchase a 9.9 % stake in the petrochemical company Sibur. Both Russian firms are involved in major investment projects that have received funding also from Russia's National Welfare Fund. Gazprom has also taken sizable loans from Chinese banks. Gazprom needs funding for e.g. construction of the Power of Siberia natural gas pipeline to China and bringing gas production on stream in order to supply the pipeline. The Chinese have, however, also sold stakes in Russian enterprises (e.g. a stake in the Moscow stock exchange).

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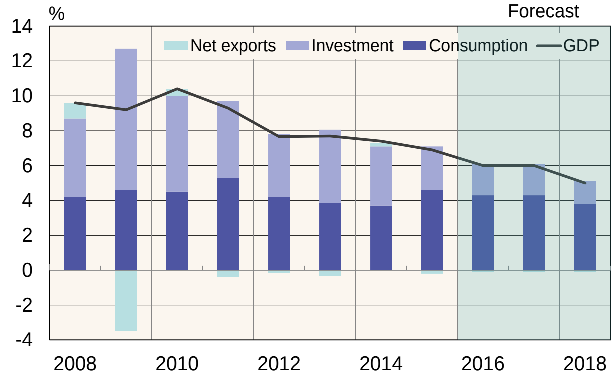
China

BOFIT sees continued modest slowdown in growth for China. Despite market fluctuations, our latest BOFIT Forecast for China sees China's development in coming years conforming largely to our earlier forecasts. Thus, we expect the Chinese economy to grow at around 6 % p.a. in 2016 and 2017, and then slow to around 5 % in 2018.

The rate of structural change accelerated last year and Chinese economy seems to be even more clearly following dual tracks. Growth in the service sector remains brisk, contributing to the relatively bright outlook for employment. In contrast, heavy industry production declines and branches suffering from overcapacity will be forced to reduce output. In coming years, growth in fixed investment will moderate and China's domestic consumption will increasingly drive economic growth.

A controlled slowdown in economic growth and a smooth progress in structural change is by no means a given. With the opening of China's markets to the world and an already high level of indebtedness, the economy is increasingly susceptible to a range of economic disruptors. China's overall debt-to-GDP ratio is estimated to be around 250 % of GDP, which is exceptionally high for countries at a similar level of development. If the high GDP growth targets under the current five-year plan are adhered to, China will be left with little room to work on reducing debt. The risk of allowing problems to build up is that progress in needed reforms will take a back seat as decision makers are tempted to increase regulation and leverage to prop up existing economic structures and non-competitive heavy industry, especially at the regional level. Indeed, some signs of tighter regulatory policies that are ill-suited to economic reform efforts have recently begun to appear.

Structure of China's economic growth and BOFIT forecast



Sources: China National Bureau of Statistics and BOFIT

The opening up of the Chinese economy brings with it new risks that will have to be met with well-defined policy measures and transparency. Deregulation of capital movements and the freeing of the yuan's exchange rate should proceed at a deliberate pace to take advantage of the relatively favourable conditions at the moment. Postponing reforms could leave policymakers in a position where they must push through tough reforms in the midst of a crisis.

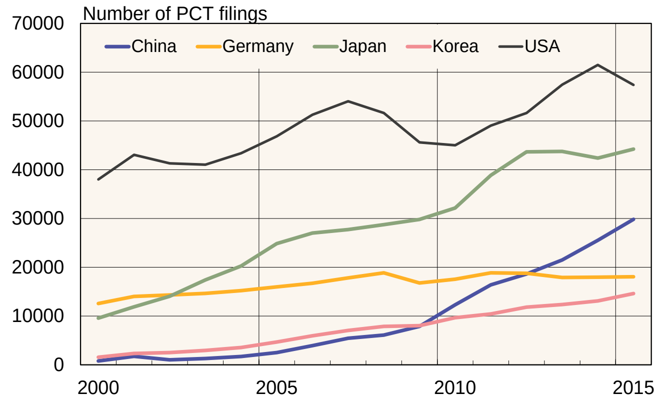
China's role in international patent activity continues to increase rapidly. The latest figures from the World Intellectual Property Organization (WIPO) show that the volume of patent applications filed under the international Patent Cooperation Treaty (PCT) increased by less than 2 % last year to 218,000. The number of patents filed by Chinese firms increased by 17 %. Chinese entities accounted for 14 % of all PCT patent filings, cementing China's position as the world's third-most-active international patent seeker. The United States led with most patents filed last year, accounting for over 25 % of all PCT filings. Japan's accounted for about a fifth of PCT filings. Most of the growth in the number of PCT patent applications came from China, Japan and Korea, indicating that the global centre of gravity in technological innovation continues to shift to Asia.

As in previous years, Chinese telecom giants Huawei and ZTE ranked number one and number three on the list of top filers of international patents. Second place went to the American electronics giant Qualcomm. The Top 50 list of patent filers included six Chinese firms, which together represented about a third of all Chinese PCT patent filings. China's innovation activity covers a broad front.

The large number of patent application does not tell the full story, however, as the quality and significance of the innovation of Chinese companies is often lower than that shown in the filings of companies in more advanced countries. Nevertheless, China's emergence as a technological powerhouse is indisputable. For example, China already accounts for 44 % of all high-tech exports from Asia.

Other BRIC countries lagged far behind China in patent activity. In 2015, India filed just over 1,400 patent applications (about the same as in 2014), Russia about 800 (-16 %) and Brazil about 550 (-6 %). Finnish firms in 2015 filed about 1,600 international patent applications, a drop of 12 % from 2014.

Countries filing the most PCT patent applications



Source: WIPO

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