Weekly Review
39 • 29.9.2017
BOFIT

Russia

BOFIT sees Russian economy continuing moderate growth in coming years. Lifted by higher oil prices, Russian GDP has returned to positive growth this year as anticipated. BOFIT's latest [Forecast for Russia] sees GDP rising by 1.5 % p.a. through 2019 on the assumption that oil prices remain roughly at their current levels.

Growth will be driven by domestic private demand, which has gradually recovered this year. Household consumption is supported by increasing real wages and reviving household borrowing. Fixed investment is also expected to continue moderate growth as Russian industry already operates near full capacity. Further growth of fixed investment is limited, however, especially by the difficult business environment and uncertain economic outlook.

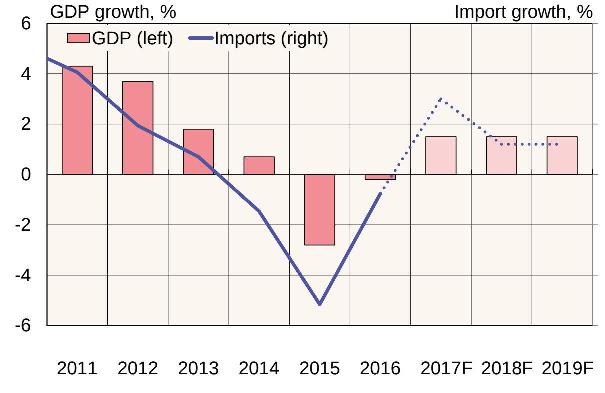
Government spending is not expected to increase in real terms this year and the preliminary budget framework anticipates even harsher spending discipline in coming years. Inflation has slowed down close to the Central Bank of Russia's 4 % target and the CBR has signalled that it will continue to cut interest rates if inflation pressures permit.

Despite brisk export growth, the volume of Russian export growth should slow as e.g. oil & gas export levels are already historically high. After three years of contraction, the volume of imports has increased strongly this year supported by recovering demand and appreciation of the ruble. This year's import growth forecast has been raised substantially, but growth should slow gradually in coming years.

Forecast uncertainty is caused by oil price trends, which impact the Russian economy rapidly. The approaching presidential election could add pressure to increase public spending and temporarily raise growth. Growth could also be helped this year if demand is oriented more towards domestic production than imports for the latter part of the year.

Russia's economy is expected to continue moderate 1,5 % growth in coming years. With the economy at near-capacity, higher sustainable growth would require structural reforms that are currently not in sight.

Forecast for Russian GDP and import volume for 2017–19



Sources: Rosstat and BOFIT.

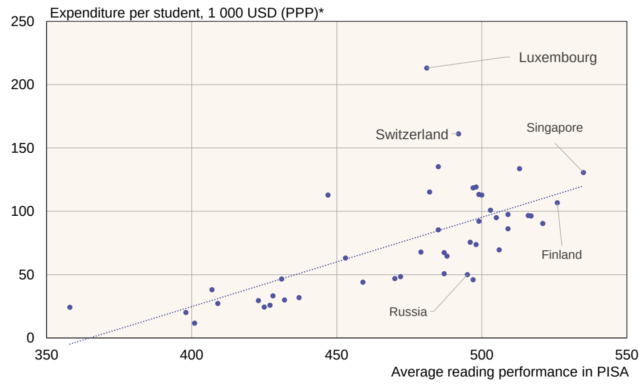
Russia has plenty of college graduates, but spends little on education. *Education at a Glance 2017*, the latest publication of the education database kept by the Organisation of Economic Cooperation and Development (OECD) broadly assesses the school systems of many countries, their spending on education and outcomes. The survey also covers several non-OECD members, including Russia and China.

Figures from 2015 show nearly 60 % of Russians in the 25–34 age group had completed tertiary (i.e. college-level) degrees, putting them on par with the South Koreans and the Japanese, but well above the OECD average of 42 %. Only 18 % of this age group in China had completed tertiary education, and just 14 % in India. Russia's high tertiary education figures partly reflect the fact that in the Russian system students enter and graduate university at relatively young ages. Most degree-holders have something less than a master's degree (short-cycle tertiary or bachelor's degree). The phenomenon is not new as also about 55 % of Russians between the ages of 25 and 64 have college degrees.

Tertiary education in Russia currently focuses heavily on business, administration and law. Some 38 % of degrees granted in 2015 went to students majoring in one of these three fields. The average for OECD countries was 24 %. In addition, 24 % of Russian students took degrees in natural sciences, engineering or math, compared to an OECD average of 20 %. The share in Germany was 32 %. Russia graduates relatively fewer professionals with degrees in education or healthcare than other OECD countries.

Russia currently devotes relatively few resources to education by international standards. In 2014, Russia's education spending was just 3.4 % of GDP, the lowest for any country in the report except Indonesia. The OECD average was 5.2 %. The picture is similar when comparing cumulative spending per student. Regional differences in education spending in Russia are, however, huge.

Education spending and PISA reading scores



** Cumulative education spending per student (ages 6 to 15) in purchasing power-adjusted (PPP) dollars.*
Sources: OECD and BOFIT.

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China

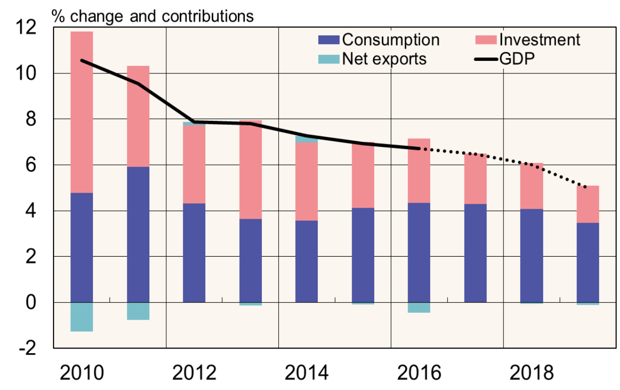
BOFIT expects China's growth to slow; financial market worries on the rise. China's GDP growth accelerated to 6.9 % p.a. in the first half of this year. The pick-up is not likely to last, however. BOFIT's latest [Forecast for China] sees growth slowing towards the end of the year, with GDP expected to grow by about 6.5 % this year, 6 % next year and 5 % in 2019. Even with lower growth, China's growth is high and closing the gap with advanced-world living standards. Growth will continue to be driven by the domestic market. Consumer demand and investment growth are supported by strong wage growth, urbanisation and productivity gains.

A growth slowdown in China is a natural development as major structural factors like the huge size of the economy, ageing population with fewer working-age people and environmental problems reduce growth. Moreover, the structure of the economy is changing as evidenced by lower fixed investment growth and the rising importance of domestic consumer demand and services. Productivity growth has slowed with the easy productivity-enhancing measures already taken and services account for an ever-increasing share of economic output.

In 2012, China set the goal of doubling its 2010 real GDP by 2020. The government has had to apply heavy stimulus to achieve the high GDP growth needed to hit that target. It also seems that officials have felt pressure to fudge their growth figures. At the same time, China's debt has soared. The experiences of other countries with extended episodes of rapid indebtedness end almost without exception in crisis. As a result, financial sector stability has become a major theme of China's leadership. Nevertheless, no significant measures to rein in credit growth have been implemented. The possibility of a financial market crisis and sharp reduction in economic growth during the forecast period cannot be ruled out.

The 19th Party Congress next month could be a turning point for policy, but the government's recent focus on excessive stability and increasing the role of the party in the economy have diminished hopes for serious market reform.

China's realised GDP growth and BOFIT forecast 2017–2019



Sources: China National Bureau of Statistics and BOFIT.

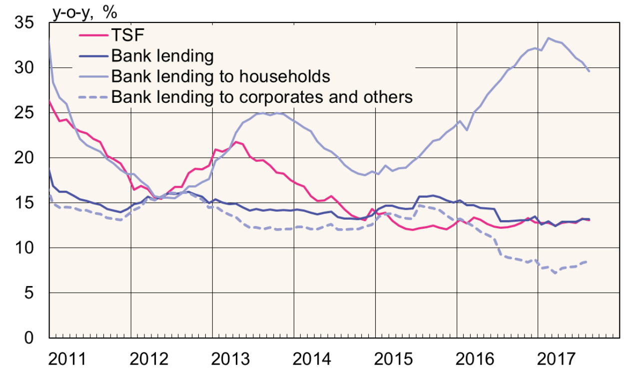
China's indebtedness still continues to rise. China's bank lending stock rose in August by 13 % y-o-y. While growth in lending to households has slowed slightly in recent months, the stock of household credit has increased faster than the credit stock overall (up 30 % y-o-y in August). In the first eight months of this year, over half of new lending went to households, mostly in the form of housing loans. The bank lending stock equals roughly 150 % of GDP, a quarter of which is household borrowing.

Bank lending to corporations, government and to non-bank financial companies has slowed this year to around 8 %, while non-traditional financing sources have become increasingly important for firms. Growth in China's broadly defined stock of total social financing (TSF) rose in August by 13 % y-o-y. Shadow bank lending has accelerated recently and firms have also resorted to new non-TSF financial arrangements.

Growth of M2, the broader measure of the money supply, has slowed this year, rising by just 9 % y-o-y in August. Slowdown reflects things such as faster pace of financial transactions rather than slower credit growth. In its latest monetary policy report, the People's Bank of China said it was reducing M2's role as a gauge of monetary policy due to its weakened link to economic development.

The rise in China's debt-to-GDP ratio has slowed. On-year growth of both TSF and the stock of bank lending averaged 13 % in the first eight months of the year, while nominal GDP grew by slightly over 11 % in January-June. BIS figures put China's debt-to-GDP ratio at 258 % at the end of March, an increase of over 7 percentage points from a year earlier.

Growth of China's credit stock and total social financing (TSF)



Sources: CEIC, PBoC and BOFIT.

S&P lowers China's credit rating. On September 20, China's sovereign credit rating was lowered one step from AA- to A+, S&P's fifth-highest rating category. China had held its AA- rating since 2010. S&P said the downgrade reflected China's rapidly increasing debt and the increased risk it imposed on the financial sector and economy. In May, Moody's lowered China's rating one notch to A1, its fifth-highest score. Fitch has maintained its fifth-highest rating, A+, for China since 2007. S&P also cut ratings for Hong Kong, several Chinese firms (including banks and state-owned enterprises), as well as some international banks operating in China.

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