Weekly Review
41 • 13.10.2017

BOFIT

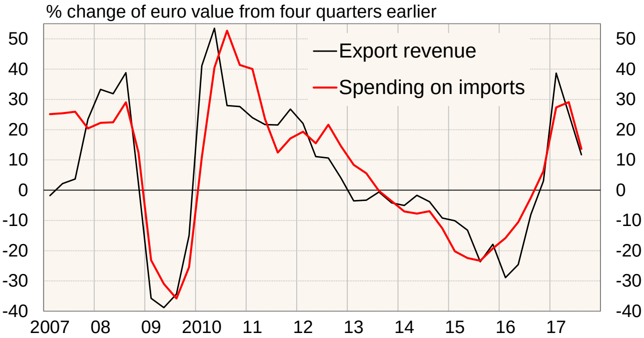
Russia

Russian export earnings and imports continue to recover rapidly, even if the fastest pace has slowed. Preliminary balance-of-payments figures for the third quarter show revenues from exports of goods and services rose by about 15 % y-o-y. For the first three quarters, on-year growth was about 25 %. The rise in oil prices has slowed from the first half of the year, however. Growth in the services exports also slowed.

Growth in Russian spending on imported goods and services slackened in the third quarter, but growth was still well above 15 % y-o-y. For the first three quarters growth was 23 % y-o-y. The slowdown in the very rapid recovery concerned imports of both goods and services, including spending abroad by Russian travellers. In euro terms, total third quarter spending on imports was about the same as in 2011.

The current account surplus for the first nine months of the year hit 27 billion dollars, which was more than last year in the same period but clearly smaller than in normal years. As usual, the goods trade surplus of 80 billion dollars was the element maintaining the overall current account surplus. The deficits in the services trade and other categories in the current account (mainly dividend and interest payments) were approximately the same as in the previous year or two.

Russian foreign trade (goods and services), 2007–17



Source: Central Bank of Russia.

Moderate net outflow of private capital from Russia. During the first three quarters of this year, the net outflow of private capital from Russia amounted to 21 billion dollars, which was more than in the same period last year, but less than in previous years. The outflow largely reflects repayments by banks of their foreign debts.

The net outflow of capital in the non-banking corporate sector was small in the three quarters. Capital flows consisted largely of direct investments, which flowed into Russia in a notable amount after a low of a couple of years. Russia's outbound direct investments rose by about the same amount, and possibly reflected a channelling of Russian investments via foreign countries back to Russia. Grey capital flows from Russia have raised their head for the first time since 2013.

Russian GDP forecasts increased in recent months. The IMF's latest *World Economic Outlook* (WEO) sees Russian GDP rising by 1.8 % this year and 1.6 % next year. Forecasts for both years were slightly higher compared to July. Most Russian and international forecasters expect Russian GDP to increase by 1.5–2 % p.a. in 2017 and 2018. At the start of the year, most forecasters only expected growth of 1–1.5 %.

There are much larger differences in the outlook for imports this year. Several international institutions, including the IMF, expect imports to rise by about 5 % this year, while Russian forecasters expect roughly double that and thus a considerably smaller current account surplus. For 2018, most forecasters expect import growth of a few per cent.

The longer-term outlook for Russia, however, remains largely unchanged. The IMF estimates that Russia's potential growth is still about 1.5 % a year. The Central Bank of Russia predicts that growth should be about 1.5–2% p.a. during 2019 and 2020, regardless whether the oil price averages 40 or 60 dollars a barrel. The base forecast of the economy ministry foresees growth slightly above 2 % in 2019–20. The ministry estimates that an increase of 5 dollars a barrel in the oil price adds 0.1–0.2 percentage points to economic growth.

Recent forecasts of Russian GDP growth (%)

	2017	2018
IMF WEO (10/17)	1.8	1.6
BOFIT (9/17)	1.5	1.5
OECD (9/17)	2.0	2.1
Consensus Economics (9/17)	1.7	1.8
Russian central bank (9/17)	1.7–2.2	1.0–1.5
Russian economy ministry (9/17)	2.1	2.1

Russian inflation hits historical lows. Consumer prices rose by 3 % y-o-y in September, which was Russia's smallest on-year increase in inflation in the entire post-Soviet era. Inflation expectations have also fallen to their lowest level ever. The continuing decline in Russian inflation this year reflects the current low-growth economic environment, the CBR's relatively tight monetary policy and ruble appreciation. The CBR estimates that a 1 % change in the ruble's exchange rate results in a change in the inflation rate of 0.1-0.15 percentage points within a few months.

For the first time, inflation has also fallen below the CBR's inflation target of 4 %, but the CBR views this to mainly reflect transitory factors. In recent months, inflation has been stemmed by a seasonal drop in prices for fruits and vegetables boosted by good crops this year. In September food prices rose by 2 % y-o-y, non-food goods by 3 % and services by 4 %.

Most forecasts see inflation hovering around 3–4 % this year and next. This should allow the CBR to continue to lower the key rate, which currently stands at 8.5 %. The CBR estimates that the longer-term level of key rate compatible with its 4 % inflation target is 6.5–7 %.

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China

Central bank governor wants to speed up the opening of Chinese economy. The business magazine *Caijing* this week published a wide-ranging interview with the outgoing governor of the People's Bank of China, Zhou Xiaochuan. Mr. Zhou made a strong case for China moving forward with reforms in order to open up its economy. Zhou hoped, in particular, for exchange rates set by the market and a reduction in capital account controls. He said that now is the appropriate time to move ahead with reforms as later it will be costlier.

The interview was released just days ahead of the National People's Congress. China's central bank, traditionally been a proponent of economic reforms, nevertheless lacks independence and must cope with the fact that reform policies are largely political matters. Progress in reforms has recently ground to a halt as Chinese officials have taken their pursuance of stability into extremes.

Zhou has been at the helm of the PBoC since December 2002. His 15-year term, exceptionally long for China, has witness the pushing through of major reforms on the monetary policy front. Interest-rate regulation ended, the yuan's peg to the US dollar loosened and capital movements deregulated. Indeed, reform progress was so substantial that the IMF last year decided to include it in its SDR basket. Unlike the experiences of many emerging economies, Chinese inflation has remained stable over the last decade and a half. Zhou is expected to retire in the near future.

China to lower bank reserve requirements in January. The People's Bank of China announced on September 29 a 50 to 150 basis-point reduction in the reserve requirement ratio (RRR) for commercial banks from January 1 next year. The PBoC said the requirement cuts were based on how well banks meet needed requirements. Nearly all commercial banks are eligible for a 50 basis-point cut, but only a small group of banks are entitled to larger reductions. The PBoC hopes the reduction of RRR will encourage lending to small firms and farming operations, but it is difficult to see how the measure works without other incentives or actions.

The RRR defines the portion of a bank's customer deposits it must keep at the central bank. The money cannot be lent ahead and the PBoC only pays marginal interest on it. After the cut, the average reserve ratio in China will be about 16 %, which is still high by international standards.

It is exceptional for the PBoC to announce a reserve requirement ratio adjustment three months in advance. The typical heads-up has been about a week. Consequently, some market participants speculate that the move has more to do with the upcoming changes in macro-prudential assessment of commercial banks at the start of next year than a change in lending policy or monetary easing. The PBoC itself noted that the lowering of the RRR does not signal a change in monetary policy.

IMF raises its growth forecast for China, but warns of rising debt problems. In its *World Economic Outlook* (WEO) released this month, the IMF has slightly raised its projected growth for the Chinese economy. IMF analysts now expect China's GDP to grow by 6.8 % this year and 6.5 % next year. The revised forecast reflects higher-than-expected growth in the first half of this year and strength in China's export markets. The 2018 forecast assumes that the Chinese government will continue to support economic growth, especially through public investment in order to meet the government's target of doubling real GDP between 2010–2020. Achieving of the GDP growth target, which was set by the party leadership in 2012, requires that GDP growth average about 6.5 % p.a. in coming years.

The increase in the IMF's growth prognosis is not so much an indication of strong economic conditions, but a foreshadowing of increased economic problems in coming years. Debt-fuelled stimulus policies partly account China's recent high growth. This has eroded room to manoeuvre in the fiscal policy sphere and slowed progress in structural reform of the economy. In conjunction with the WEO's release, the IMF issued a longer-term projection that sees Chinese GDP growth slowing very gradually while public-sector debt as a share of GDP rises from the current level of 48 % to over 60 % in 2022. However, China's public-sector liabilities are actually even greater than that.

The IMF would like to see China shift its policy focus from annual GDP growth targets to reforms that support sustainable growth and tuning of fiscal policy so that the broadly defined budget deficit (about 10 % of GDP) is gradually reduced to stabilise the debt-to-GDP ratio. The monetary stance should be gradually tightened. Monetary policy could be made more effective by phasing out monetary targets, increasing exchange rate flexibility and improving communications. China could also strengthen its financial market supervision and impose measures to make banks deal with non-performing loans. Expanding the role of markets in the economy should be a central priority. This means, for example, opening of China's tightly closed service sector and allowing state-owned enterprises to face harder budget constraints.

As earlier, the IMF warned of postponing efforts to restrain mounting indebtedness and structural reforms as it could lead to a sharp slowdown in the economy. A crisis could be triggered by a sudden drying up of access to financing on the interbank market or the wealth management product market, barriers to trade imposed by trading partners or increased pressure to move capital out of the country due e.g. to a faster-than-expected rise in US interest rates.

A rapid slowdown in Chinese economic growth would also be reflected in the volume of trade with other nations, a drop in global commodity prices and uncertainty over global growth prospects. The latest WEO notes that China accounts for over half of the world demand for metals. A tightening of China's lending policies or a substantial reduction its overcapacity in metals production could have profound downward or upward price implications in global commodity markets.

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