Weekly Review
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BOFIT

Russia

BOFIT forecasts low growth for the Russian economy in coming years. Our latest BOFIT forecast for Russia, which covers the 2018–2020 period, sees GDP growth this year remaining below 2 %, with growth slowing next year to around 1.5 % as long as the oil price (Brent crude) stays reasonably close to its current level of about $75 a barrel. Growth will remain slow in coming years as there is little indication that Russia will move ahead with market-friendly systemic reforms that are necessary to foster higher growth.

The recovery of Russian imports from a deep slump in 2014–2016 slowed this spring, dragged down by ruble depreciation (first-half import growth this year was 6 % y-o-y). Imports are expected to recover at roughly 5 % pace in the next few years as the ruble's real effective exchange rate (REER) is assumed to remain rather stable. The rapid growth in Russian export volumes (mainly non-energy goods and services) is expected to slow, even if the relatively low REER supports export growth. The outlook for growth in Russian energy exports is tame.

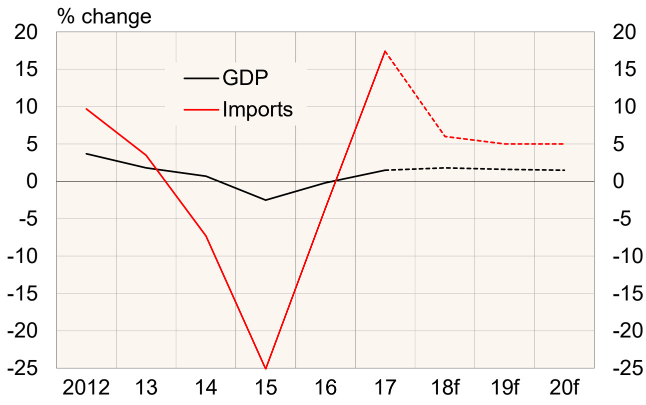
The recovery in household consumption should remain rather slow. The increase in the value-added tax from 18 % to 20 % at the start of January 2019 will lift up consumer prices and bite purchasing power. Real pensions will rise slowly, and the state has not promised increases in government budget sector wages. Recently increases in corporate wages have been higher than productivity gains. The gradual increase in retirement ages starting next year means slightly fewer people than expected will be leaving their workplaces.

Fixed investment will continue to recover slowly, even with aging and worn existing capital and peak utilisation of industrial capacity. The state has started guiding investments made by state-owned and large private firms to the national programmes and projects listed in Putin's inaugural decree on May 7 this year. While implementation of the projects is currently expected to get underway closer to next summer, it is unclear how much the guidance of corporate investment will increase corporate investment overall. Besides the state's growing role in the economy, uncertainties in the business environment have increased due to new foreign sanctions and threats of further sanctions.

Government sector spending will increase in real terms this year, and will continue to rise next year to implement projects in Putin's May Decree. Higher inflation will reduce real spending growth. The added spending will be funded by the VAT hike and by lowering the federal budget surplus. Even so, the federal budget, which assumes the Urals oil price at about $60 a barrel, and the entire consolidated budget are expected to show notable surpluses in the next few years.

Important risks to the forecast continuously include a large shift in oil prices and weaker-than-expected developments in the global economy and international relations. Increased government spending could drive higher-than-expected GDP growth in the forecast period.

Real Russian GDP and import growth, 2012–2020



Sources: Rosstat and BOFIT.

Russian oil production hits peak in September. Russia's energy ministry reports that Russian crude oil production in September exceeded by a small margin its previous peak in the post-Soviet era. Russia's average daily production in August rose by 1.3 % y-o-y to 11.4 million barrels. Russia and OPEC agreed in 2016 on voluntary limits to oil production, a scheme that since succeeded in substantially raising oil prices. For example, the price of Urals-grade oil, slightly over $50 a barrel at the start of 2017, now stands at over $80 a barrel. Russia and OPEC agreed in June to get rid of production ceilings. Russian oil output currently exceeds the former agreed ceiling by 400,000 barrels a day. OPEC countries have also boosted their production.

Russian oil production at present is already higher than the economy ministry's latest forecast for 2019 (see BOFIT Weekly 37/2018). The ministry expects production to rise further in 2020–21 by about 1 % a year, and then ease into a slow decline. It is therefore unclear how long the current production level can be sustained without new investment.

Retirement age hike approved in Russia. On September 27, the Duma, the lower house of the parliament, approved the third reading of a bill to raise the general retirement age by five years. After approval by the Federation Council, the upper house, president Putin signed the bill into law on October 3. Starting January 1, 2019, the retirement age will rise by six months every year, from 60 to 65 for men and from 55 to 60 for women. Numerous special groups will still be entitled to lower retirement ages.

Russia's current retirement age is low by international standards and an increase in the expected lifespan makes financing of pension obligations increasingly difficult. OECD figures show that over the past ten years the average life expectancy for Russian men at 65 has risen by two years to 13.4 years. The average life expectancy for Russian women at 65 is 17.7 years. Spending on pensions represents about a quarter of all consolidated government budget spending. The law does not change the principles for determining labour pension benefits or their financing basis.

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China

Latest BOFIT forecast sees China's slowing growth exacerbating economic problems. The outlook for China's economy has become increasingly uncertain this year. As in our March 2018–2020 forecast, the baseline forecast in our latest [BOFIT Forecast for China] sees growth remaining strong, but slowing to around 5 % p.a. in 2020. The risk of lower growth, however, has increased.

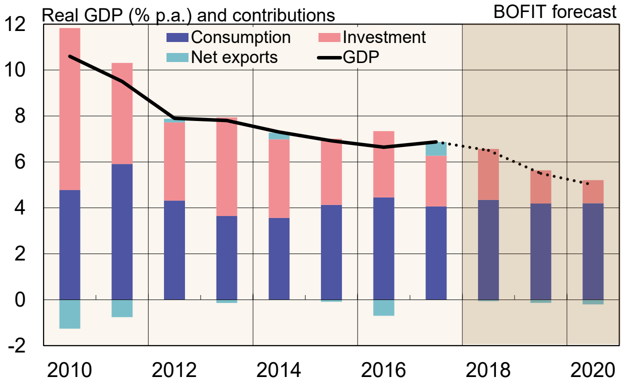
An external driver of uncertainty has been the intensifying trade war with the United States already manifested in plunging share prices on Chinese stock exchanges and yuan depreciation. The main cause of China's deteriorating situation, however, stems from its own problems, particularly the economic slowdown and rising indebtedness.

Over the longer term, China's growth will be drawn down by demographic trends, environmental issues and the rise of a services-based economy. Unreliability of official figures makes clear assessment of current economic conditions difficult, but many indicators suggest growth is weakening. The slowdown in growth is also evidenced by the government's robust stimulus policies designed to blunt the effects of the trade war and help the country meet official growth targets.

China's current official GDP growth targets and accompanying stimulus policies stand in stark contrast to the country's worsening indebtedness. Stimulus policies sustain old structures and unprofitable activities which, along with the lack of serious economic reforms, are an important source of the current trade policy battles. The credibility of reform policies has been further eroded by the heightened emphasis on the Communist Party of China's importance and campaigns related to increasing the CPC's power.

Market disturbances this year should be seen as a natural part of China's economic evolution. We should also acknowledge the country's significant buffers for handling problems. Nevertheless, the economic situation has been shifting in a disconcerting direction. The number of market disturbances could increase and China could see a much more abrupt slowdown than in our baseline scenario.

China's real GDP growth and main components of growth



Sources: China National Bureau of Statistics, BOFIT.

Chinese indebtedness relatively higher than in the Euro Area or the United States. New figures released by the Bank for International Settlements (BIS) show that China's total debt-to-GDP ratio rose by 5 percentage points in the first quarter of this year to 261 % of GDP. China's debt ratio, is slightly higher than that of the US or the Euro Area, and significantly higher than that of other emerging market economies tracked by the BIS.

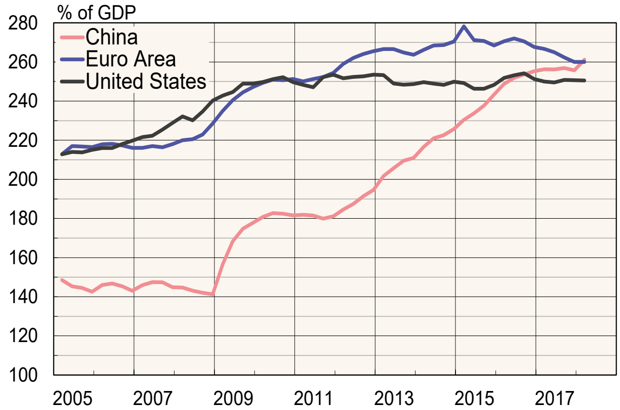
Total debt includes debt of public-sector entities, household and firms (excl. banks). Unlike most other countries, Chinese debt is concentrated with firms (164 % of GDP). The indebtedness of households (49 % of GDP) and public-sector entities (48 % of GDP) are relatively small. On the other hand, the distinction between firm and public-sector entity is blurred in China, making them hard to tell apart. The IMF puts public-sector entity debt at almost 70 % of GDP.

The monthly reporting of the People's Bank of China of total domestic lending to the private sector suggests that the rising debt-to-GDP ratio continued in the second and third quarters. Although on-year growth in the stock of total lending slowed in August to 10 % (down from an average of 13 % last year), growth has still outstripped the pace of nominal GDP growth. The shadow banking sector is largely responsible for the slowdown in the rise in overall lending. Tighter regulation has reduced the stock of financing provided via the shadow banking sector in recent months. Growth in the stock of bank loans has continued at about the same pace as last year.

Most of China's debt is domestically held. While foreign debt has grown rapidly for more than a year, it was still just 14 % of GDP at the end of June. About half of foreign debt is denominated in dollars and about a third in yuan.

Years of soaring debt have raised fears in many quarters. Debt explosions like China's have, almost without exception, led to lower growth and crisis. Chinese authorities understand the problem and have managed to rein in it partly, but escalation of trade disputes has again shifted the emphasis of economic policy in a more stimulatory direction.

Debt-to-GDP ratios for China, Euro Area and the US (% of GDP)



Sources: BIS, Macrobond.

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