Weekly Review
40 • 4.10.2019
BOFIT

# Russia

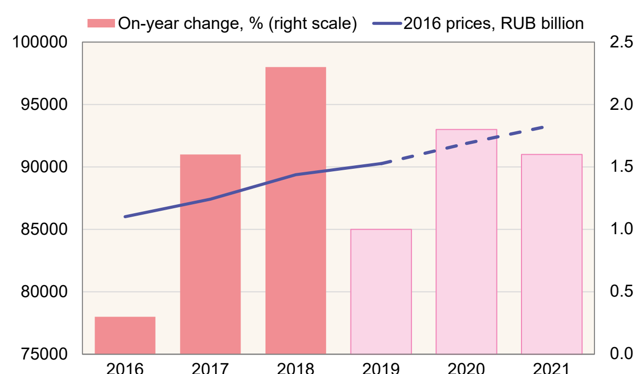
**BOFIT's latest forecast sees Russian economic growth falling to 1 % this year.** The acceleration of Russian economic growth to 2.3 % last year was largely driven by transient factors. Growth was expected to subside to a lower level this year. Rosstat's first-round estimate of growth in the first half of this year (0.7 %) suggests the slowdown has been more rapid than expected.

Rosstat's just-released figures for the second quarter show growth in private consumption remained fairly brisk, while the performance in exports was exceptionally weak. Following episodes of very strong growth in export volumes since 2016 and a plateauing of growth towards the end of 2018, the volume in exports contracted in the first half of 2019. While a lower rate of export growth was largely expected, the actual declines in volumes in many core export industries came as a surprise. Part of the decline in export volumes can be attributed to last year's poor grain harvest compared to 2017, the agreement among OPEC+ countries to limit crude oil production and the contamination and interruption in operations of the Druzhba pipeline (one of Russian's main oil export pipelines) last spring. Underpinning these developments are slowing global economic growth and a bleaker outlook for global growth.

Fixed investment growth is also expected to remain very modest this year. In the first half of 2019, the volume of fixed investment was smaller than in the same period in 2018. Growth in government-sector spending may slightly raise the economy's growth rate in the second half, but overall the GDP growth is expected to stay at around 1 % this year.

The fresh BOFIT Forecast for Russia sees the economy's growth rising slightly next year on higher public consumption and government-sector investment. The state's growing role and meagreness of market-friendly reforms, however, will limit growth in private investment. While private consumption remains important to economic growth, negligible growth in real household incomes and slower growth of household borrowing will dampen consumption growth.

**Realised Russian GDP growth and BOFIT forecast 2019–2021**




*Source: BOFIT Forecast for Russia 2019–2021.*

**Stimulus included in Russia's 2020–2022 government sector budget framework.** The finance ministry's three-year fiscal framework covers the entire consolidated budget. That includes the federal budget and the budgets of the state's three social funds, for which (all four) the government has just submitted drafts to the Duma, and also projections for regional and municipal budgets.

In nominal terms, government-sector revenues are expected to increase annually by 4–5 % this year and in the next coming years. The role of the government budget sector in the economy overall is stimulative. The estimated growth in spending could still accelerate this year to a degree that growth for the entire year would reach about 8 %. Growth will average around 6 % a year in the closest years ahead, i.e. about two percentage points above the projected inflation rate. The consolidated budget surplus, which was almost 3 % of GDP in 2018, is expected to fall below 2 % of GDP this year and go down to 0.7 % of GDP next year.

The consolidated budget revenues are constrained by the assumption of a moderate drop in the price of Urals crude oil from its current level to around 56 dollars a barrel for the next few years. In that case, oil & gas tax revenues would decline substantially this year and next year before levelling off in 2021. On the other hand, the estimate of the budget's other revenues is based on the economy ministry's forecast that GDP growth accelerates from about 1.5 % this year and next year to over 3 % from 2021 onwards. Thus, the growth of other revenues, which has remained high for the past two years, will continue in the next few years at 6–7 % a year.

Other revenues are expected to increase at about that pace for the federal, regional and social fund budgets. VAT revenues to the federal budget will rise well, and dividend payouts from state-owned companies are expected to increase notably. The flow of money to social funds will be due to revenue increases from mandated social taxes from wages. Regional budget revenue estimates are not broken out.

Consolidated budget spending on healthcare and public order and domestic security will grow this year and next by over 10 %. Public administration will also receive tangible increases. After increases this year, the various branches of the economy and the housing sector must wait at least a year for new budget impulses. The education sector will have to wait longer. Increases of spending on social benefits and defence are to slightly outpace inflation in the next coming years. General increases in government-sector wages are scheduled roughly in line with inflation. Pension increases are to exceed 6 % a year based on the decision of summer 2018.

As the base oil price set under the federal budget rule is low compared to the oil price assumption of the revenue calculations in the federal budget, the National Welfare Fund (NWF), which serves as the government's reserve fund, is expected to swell by the end of next year to a level corresponding to 10 % of GDP. The finance ministry's technical assumption is that NWF assets will not be invested in anything other than central bank accounts. Thus, the NWF's liquid assets at the end of next year would amount to 8.5 % of GDP.

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# China

**BOFIT forecast sees Chinese growth slowing at about one percentage point a year from 2019 to 2021.** Growth of over 6 % p.a. is required for China to meet its declared goal of doubling 2010 real GDP by 2020. Like before, our latest BOFIT Forecast for China, however, expects growth to fall faster than official projections perhaps to around 4 % p.a. at the end of the forecast period in 2021.

Unreliable official figures that fail to capture economic trends make it more challenging than ever to get an accurate picture of China's economic situation, let alone to produce solid forecasts. Official figures report an extremely modest drop in growth, but a review of a broad range of economic indicators and anecdotal evidence suggest that the current economic situation is clearly worse than in early 2018.

Domestic factors are largely the cause of the economic slowdown, and structural factors alone already pose a significant drag on the economy. Escalation of trade tensions has made matters worse. Several institutions (including the Bank of Finland, IMF and OECD) estimate that the tariff increases reduce China's growth by about one percentage point a year if 25 % additional customs tariffs are applied to all trade between the US and China. As the causes of the trade war are deeply rooted in China's current system, we expect tensions to continue. Their resolution requires China to address system-level issues.

Productivity-enhancing reforms would be essential to sustaining growth potential, but major reforms have been postponed years. Capital allocation is increasingly inefficient as an ever-larger share of financing goes to low- or negative-profitability state-owned enterprises and role of the Party in the economy surges. The concentration of power in the hands of a party leadership reluctant to move ahead with reforms increases the danger of economic policy missteps.

China has increased fiscal stimulus to support growth, even as the room for stimulus has become more limited. The actual public-sector deficit is rising rapidly. The IMF estimates that general government debt is approaching 80 % of GDP. If the current policy to support unsustainable pace of growth continues, it will distinctly erode government finances during the forecast period.

As growth is sustained by debt-fuelled stimulus, China's debt ratio has soared to a disturbing level of around 260 % of GDP. Banking crises are often associated with countries that experience such rapid increases in their debt-to-GDP ratios. Corporate access to financing has become tighter, which, in combination with the slowdown in domestic growth, has severely reduced outward FDI flows of Chinese firms.

The relentless pursuit of economic stability through stimulus in the current, still relatively benign, economic conditions diminishes economic buffers and further delays the implementation of reforms crucial to locking in long-term growth. This, along with the weakening of corporate finances and increased financial market risk, heighten the danger of a serious recession.

**China's fiscal revenues reduced by tax cuts.** Tax cuts implemented over the past twelve months (i.e. cuts in the income tax, value-added tax, as well as larger tax refunds for exporters) have hurt growth in budget revenues. The finance ministry reports that the combined budget revenues of the central and local governments increased by 3 % y-o-y in the first eight months of 2019. Revenue growth was the lowest since 2009, a period marked by the international financial crisis and roll-out of a massive economic stimulus.

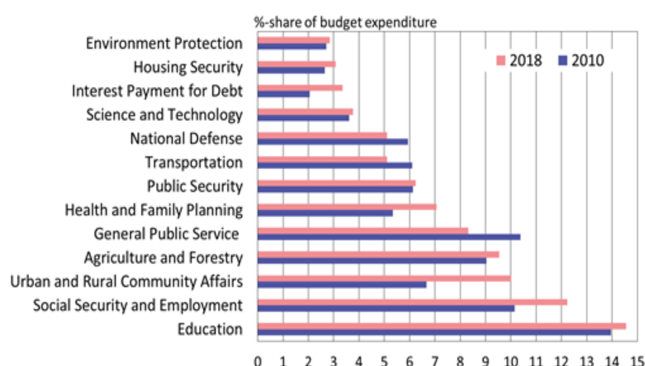
The slow increase in revenues, however, was anticipated in the budget released last spring. In January-August, received revenues were running at 71 % of the forecast revenues for the year, about the same level as in previous years. Last year's budget revenue totalled 18.3 trillion yuan (2.35 trillion euros or 20 % of GDP), of which 85 % came from taxes and 15 % from other revenue streams. The biggest source of tax revenues was the VAT (40 % of total tax revenues) and the corporate tax (23 %).

Public-sector spending in the first eight months of this year increased by 9 % y-o-y, slightly below the budget forecast. It is unclear whether spending is timed for later in the year or whether financial difficulties are involved. Less debt was issued in the first eight months of this year to fill in budget cracks than in 2018. Last year's budget spending amounted to 21 trillion yuan (2.7 trillion euros or 23 % of GDP). The official budget deficit was about 3 % of GDP.

Revenue collection last year divided roughly equally between the central government and provincial and local governments. The central government then distributed most of its revenues to provinces and cities. Last year, about 85 % of all public spending occurred at the local and provincial levels.

A major obstacle to analysis of China's public sector is that a considerable amount of spending takes place off-budget. China's budget fails to mention various social security funds or the amounts of money made from sale of land-use rights. Adding in funds, sales of land-use rights and investment projects funded by local government bonds and local government financing vehicles (LGFVs), the IMF puts public-sector spending in 2018 at 43 % of GDP, revenues at 32 % of GDP and the budget deficit at 11 % of GDP.

**China's largest public-sector spending categories (central and local governments) in 2010 and 2018**




*Sources: China's finance ministry, CEIC and BOFIT.*

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