Weekly Review
13 • 29.3.2018

BOFIT

Russia

Latest BOFIT Russia forecast sees gradual economic recovery continuing. The economy recovered last year, with GDP rising 1.5 %. Relative to the swings in global oil prices, the recession was mild and recovery slow as the ruble's floating exchange rate significantly dampened the swings.

BOFIT Forecast for Russia expects GDP to rise by nearly 2 % this year and slightly exceed its 2014 peak. In 2019–2020, annual GDP growth should average about 1.5 % as long as the oil price remains near its current level and as proper reforms that would support growth are not in sight.

Household consumption continues its moderate recovery. General increases in government sector wages and pensions still this year are rather meagre in real terms, but should then increase. Corporate sector wages should rise reasonably compared to productivity gains. Consumption is supported by relatively low inflation.

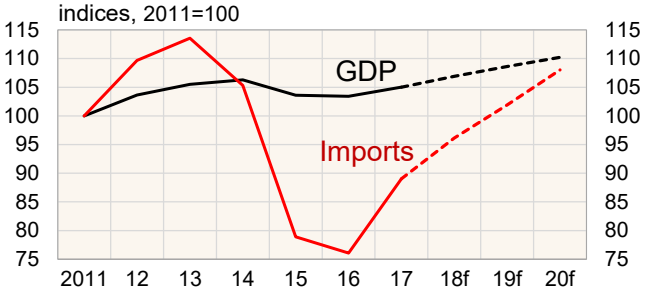
The revival in fixed investment will continue as the worn-out capital stock requires replacement and its high utilisation calls for investment in new capacity. High growth is not expected as the major investment phases of large projects are becoming past and appetite for new investment is limited, especially by the defective business environment.

Government expenditures are set to rise slowly as the new budget rule frames spending. It limits the deficit and defines computational oil & gas tax revenues. Other revenues should no longer increase rapidly with the projected GDP growth.

Growth in Russia's export volume should slow as the ruble is relatively strong and energy exports only rise slowly. The recovery in Russia's imports will slow this year from last year's big rebound and a bit further thereafter on fading growth of export earnings. Even so, imports will grow rather briskly, but only climb close to the 2012 level in 2020.

Risks to the forecast include possible deviations from the expected oil price, impairment of the good global economic growth outlook and developments in international incidents. The growth of Russia's export volume could exceed anticipations, although production capital could pose a tighter-than-expected constraint on exports and also more broadly on domestic production. A tax reform envisaged in Russia could slow consumption growth and support domestic production.

Russian GDP and import volumes, 2012–2020



Sources: Rosstat and BOFIT.

Muted market reaction in Russia to expulsion of Russian diplomats. Early this week, nearly 30 countries followed the UK in expelling over 100 Russian diplomats from their countries. Many countries assess Russia to be responsible for the nerve agent attack in England in early March. While the coordinated expulsion of diplomats sent a powerful political signal, Russian market reactions were limited. The ruble-dollar rate depreciated by 0.4 % in the beginning of this week and the Moscow exchange's RTS index fell by about 1 %. Despite the modest market reactions, heightened political tensions will elevate also economic uncertainty.

Central Bank of Russia lowers key rate by 0.25 % and signals plans to keep cutting. With the February 12-month inflation reading unchanged at 2.2 %, the CBR board decided to cut the key rate to 7.25 %. It said that it now considers the low-inflation environment sustainable and evaluated that inflation expectations have continued to fall. If the current environment prevails, it stated it will continue cutting the rate this year until reaching the level that is neutral with respect to inflation (which according to the current CBR estimate is 6–7 %). At the end of this year, the central bank expects inflation to be at 3–4 %, or near the CBR's official 4 % target. From inflation risks, the CBR now brought up for the first time a concern related to the tightening of labour market that might lead wages to rise faster than productivity.

Russian economy started to recover again in January-February. Following weaker performance at the end of last year, the Russian economy appeared to get back to the track of slow growth in the first two months of this year. The engine of recovery seems to have shifted from last year's primary production to a broader base, but the development is still shaky.

Retail sales rose by 2 % y-o-y in January-February. This represented a slight slowdown from the end of last year, even if real wages rose by over 10 % y-o-y. The spurt appears to have come largely from certain public sector wage hikes prescribed by president Putin back in 2012. Real incomes, however, still contracted by nearly 1 % y-o-y, although the last year's point of reference is raised by the 5,000 ruble one-time pay-outs to most pensioners (if the pay-out is ignored, real incomes rose by 2.5 % y-o-y).

In contrast, growth in industrial output accelerated in the first two months of the year, mainly thanks to support from manufacturing. Manufacturing recovered briskly in January-February, rising 3 % y-o-y. Metal fabrication and the car industry were among the main growth drivers. Growth in output of extractive industries slowed to under 1 %, with oil & gas production levels declining from a year earlier. Pipeline transmission volumes also fell, weighing on growth of the entire transport sector. Construction activity remained unchanged from a year earlier in January-February, mainly on strong growth in housing construction.

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China

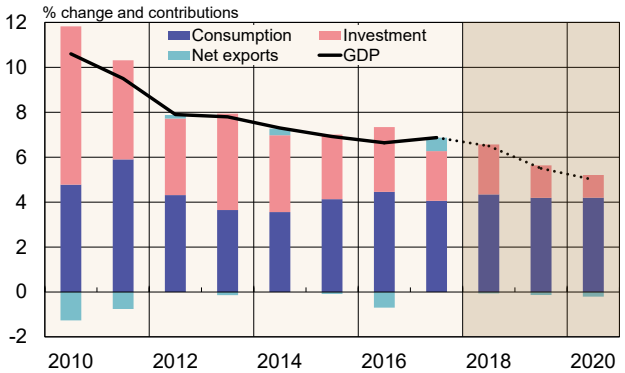
BOFIT China forecast sees lower GDP growth in coming years due to larger economic imbalances. Despite the upswing in the business cycle, our latest BOFIT Forecast for China is darker than the previous forecast six months ago. Expected market reforms in our previous forecasts have yet to be implemented and the government has failed to bring debt under control. As China's economic policy continues to rely on high numeric growth targets, we have slightly boosted our 2018 growth projection, putting it on par with the government's official target of 6.5 %.

However, sustained high growth is becoming ever harder to achieve. The government has to deal with financial market risks and the country's massive pollution problems in the years ahead, not to mention the impact of the ageing population and shift to a services-based economy on growth. We thus expect growth to slow to a more sustainable level of about 5.5 % in 2019 and around 5 % in 2020, which means the government will slightly undershoot its target of doubling real 2010 GDP by 2020. In any case, China's growth figures should be taken with a grain of salt; growth targets incentivise officials to manipulate the numbers, so official GDP figures are not trustworthy.

During the forecast period, China's monetary policy officials face the unenviable task of reconciling the goals of maintaining an accommodative stance to support economic growth while reining in debt and stemming the increase in financial market risk. The situation is further complicated by the general rise in interest rates globally. The PBoC responded to the US Federal Reserve's latest rate hike last week by raising its 7-day repo (open market operations) rate by 5 basis points. The hike was largely symbolic.

Rising debt levels have increased the risk of a serious disruption in financial markets that could lead to a rapid slowdown in economic growth. The risks of trade disputes have materialised with the US now threatening China with new import tariffs. The party's role in the economy has also increased worryingly. The concentration of power in fewer hands increases the likelihood of errors in policy planning.

China's realised GDP growth and BOFIT forecast 2018-20



Sources: China National Bureau of Statistics and BOFIT.

US takes hard line on China trade policy. The Trump administration announced plans last Thursday (Mar. 22) to impose a 25 % tariff on certain high-technology products from China in response to China's alleged intellectual property infringements. As part of the move, the US filed a complaint with the WTO against China's discriminatory technology licencing practices, which the Trump administration says prevents foreign firms from competing on Chinese markets.

The list of tech products subject to tariffs should be released by early April, after which begins a month-long series of hearings before the tariffs enter into force. Products under scrutiny are part of China's "Made in China 2025" industrial policy programme, which Western business organisations have criticised as protectionist. Imports of products subject to the new tariffs are estimated to be worth some 50–60 billion dollars, or about 10 % of US imports from China.

While the new tariffs raise the threat of a trade war, they also put pressure on the US and Chinese to get to the bargaining table to discuss opening up China's markets and improving conditions for American firms operating on Chinese markets. US negotiators seek faster liberalisation of financial markets, reduced subsidies to state-owned enterprises, lower duties on imported cars, a more transparent regulatory system and abolishing the practice of making American firms partner with a Chinese firm to conduct business in certain branches in the Chinese markets.

China has emphasised its desire for negotiated solutions and indicated a willingness to speed up implementation of certain reforms. But it has also stated its readiness to implement retaliatory measures. Immediately after Trump's tariff threat last week, China imposed retaliatory import duties on e.g. US pork products and fruits, as well as on steel pipe in response to the US announcement earlier this month to place new tariffs on steel and aluminium. US steel and aluminium tariffs, as well as China's just-announced retaliatory measures, only marginally impact US-China bilateral trade.

Guo Shuqing to head newly created banking and insurance regulator and serve as PBoC party secretary. The People's National Congress just approved merging China's banking and insurance regulatory agencies into the new China Banking and Insurance Regulatory Commission (CBIRC). It will be led by Guo Shuqing, former head of the banking regulatory commission. To the surprise of many, Guo was also appointed the central bank's party secretary. Former PBoC governor Zhou Xiaochuan, who retired this month, held both the governor and party secretary posts, so the new appointment aroused discussion about the extent of the authority of new governor Yi Gang. Guo is a member of the CPC's 205-member central committee; Yi is not.

The PBoC signals that governor Yi will manage "all aspects of work at the central bank" and that Yi and Guo will deputize each other for the governor and party secretary posts. Otherwise governor Yi is expected to focus on monetary policy, while party secretary Guo monitors administrative and strategic issues.

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