Weekly Review
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BOFIT

# Russia

**EU and Russia extend sanctions.** The EU Commission decided on June 28 to keep economic sanctions targeting specific sectors in place until January 31, 2018. The sanctions, imposed on Russia for its actions in the Ukraine conflict, were extended for the lack of full implementation of the Minsk agreements. The EU sanctions limit the access of certain Russian firms to financing and restrict exports of technology related to oil production and dual-use goods from EU to Russia. In addition, the sanctions prohibit arms trade with Russia.

On June 30, president Putin signed a decree extending Russian countersanctions on certain Western foods to the end of 2018.

**Russia's finance ministry proposes continuing the pension funding practice of last years.** Russia has planned for years to reform its chronically underfunded pension scheme. Pensions have accounted for over 20 % of public sector spending in Russia in recent years. Over 60 % of pension spending has been covered from the pension insurance contributions of the current workers. The rest (about 2.4 trillion rubles) has come mostly out of the federal budget.

Under the current model applying to most employees, a mandatory pension contribution of 22 % of the worker's pay is paid by the employer. Of that, 16 percentage points goes to the pay-as-you-go system, i.e. for pension payments to current retirees, while the remaining 6 percentage points is set aside to fund future pension obligations. With the tightening fiscal situation in recent years, however, the government has used the funded part for covering running costs (including pensions). The finance ministry recently gave the government a proposal that in principle formalises the practices of recent years. Under the proposal, the entire 22 % mandatory contribution would be channelled to the pay-as-you-go pension system. In addition, workers could choose their level of voluntary contribution for personal pension savings, which would range from 0 to 6 % of their wages. The voluntary pension savings would be encouraged with e.g. tax breaks.

The shift, which would relieve immediate budget pressures, is feared to further undermine the long-term sustainability of the pension scheme. Only 7 % of workers participated in voluntary pension savings plans last year. Funding the pensions entirely from the current contributions is becoming even more difficult with Russia's aging population and rising dependency ratio. The finance ministry has also proposed raising the retirement age, but no decisions are expected at least until next spring's presidential election.

Critics of the financing model reform fear that it will also gut the pension funds. One of the reasons for the shift to a partly funded scheme in 2002 was the ability of pension funds to provide long-term financing for the markets. Pension funds last year held a total of 5.2 trillion rubles (6 % of GDP). 40 % of that was under the control of state development bank VEB, with rest held by private pension funds.

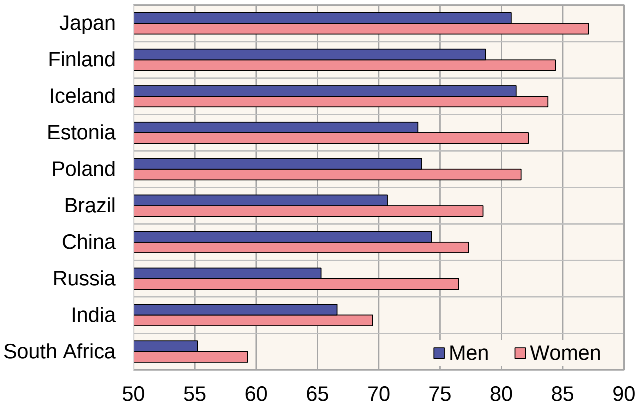
Russia last year had about 45 million people receiving pension benefits. The average monthly pension payment was 12,400 rubles (185 dollars), or about a third of the average monthly wage. About a third of people receiving pensions were still working.

**Life expectancies in Russia up sharply, but gap between men and women remains huge.** Rosstat reports that the life expectancy of girls born in Russia last year rose to 77.1 years, while that for boys rose to 66.5 years. Life expectancies of Russians have increased notably from the late-1990s, when the life expectancy for men was still well below 60. Life expectancies have increased with improvements in healthcare resources and lifestyle changes. Cardiovascular disease, however, remains a major cause of death in Russia.

OECD countries and many middle-income countries boast longer life expectancies than Russian men. In addition, in Russia the difference in life expectancy is particularly pronounced between men and women. In 2015, Japanese women had the longest life expectancies for OECD countries – 87.1 years. Iceland boasted the longest expected lifespan for men – 81.1 years. Numerous countries poorer than Russia had higher life expectancies, highlighting the generally poor condition of Russia's national healthcare system. For example, the average expected lifespan in China was 77.3 years for women and 74.3 years for men. The life expectancies of men were also higher than in Russia in Brazil (70.7 years) and India (66.6 years).

The life expectancies especially for men in Russia are expected to rise further in coming years, tracking trends in most developed countries. Therefore, Rosstat's latest demographic forecast expects the number of pensioners to increase significantly. The middle variant of Rosstat's three forecast scenarios sees the number of working age people falling by the end of 2035 by slightly over 4 % to 78.7 million people. In the UN's latest demographic forecast, the number of Russians between the ages of 15 and 60 will decline slightly more between 2020 and 2035 (about 5 %). In Rosstat's forecast the labour force will be bolstered by net immigration adding 300,000 people a year to the workforce through 2035.

**Life expectancies in selected countries in 2015**




*Sources: Rosstat and OECD.*

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# China

**20th anniversary of Hong Kong's handover to China; integration with mainland continues.** July 1 marked the 20th anniversary of Great Britain's return of the Hong Kong special administrative region (SAR) to China. Since then, the Hong Kong economy has become increasingly intertwined with the mainland economy. Territory's importance has diminished, however, as China has an increasing number of cities with over one million that now compete with Hong Kong. In 1997, Hong Kong's GDP was equivalent to about 20 % of China's GDP. It is just 3 % today.

Nevertheless, Hong Kong remains the main economic link between mainland China and the rest of the world. The Hong Kong economy is dominated by logistics and finance, and in both areas mainland is the main counterpart. A quarter of all China's exports went through Hong Kong 20 years ago, and today still over 10 % of Chinese exports pass through Hong Kong. The territory's role with China increasingly involves provision of financial services. Hong Kong provides foreign entities controlled access to mainland China's financial markets and China uses Hong Kong as a test lab for economic reforms and to encourage international use of the yuan. China has tightened capital controls in recent years, causing yuan deposits in Hong Kong to fall by 50 % between January 2015 and March 2017. The share of the yuan in bilateral trade payments between mainland and the SAR has also declined.

The integration of Hong Kong with China continues. Credit ratings giant Moody's characterises Hong Kong's economic, financial and political connections with the mainland as "close and tightening." Not surprisingly, China's credit downgrade in May led to a similar downgrade in Hong Kong's credit rating immediately. The Hong Kong Monetary Authority estimated in March 2017 that 28 % of Hong Kong borrowing originated from China and 26 % of loans granted by Hong Kong banks to foreigners went to mainland Chinese entities. Shares listed on the Shanghai or Shenzhen stocks exchanges can now be traded via the Hong Kong stock exchange as part of the Stock Connect arrangement.

The business environment for foreign firms in Hong Kong has recently suffered from political uncertainty, particularly China's efforts to interfere with its politically independent judiciary. The Heritage Foundation has continuously listed Hong Kong as the freest place in the world to do business after the SAR return to China. The erosion of judicial independence, however, has made firms wary. Young people in Hong Kong also have become more hostile in their views of mainland China, which is reflected in the growing popularity of democracy and independence movements.

**Foreign institutional investors can now invest in mainland China bond markets via Hong Kong.** This week's anniversary celebrations of the UK's return of Hong Kong to China included the launch of the Bond Connect programme on Monday (July 3) that was approved in May (BOFIT Weekly 22/2017). The programme permits foreign institutional investors to invest in bonds traded on China's interbank market. China last year broadened opportunities for these investors to trade in the interbank bond market from mainland China. The Bond Connect now eliminates the requirement that investors hold a separate Chinese trading account, allowing investments to be made using Hong Kong accounts without quotas or preapprovals.

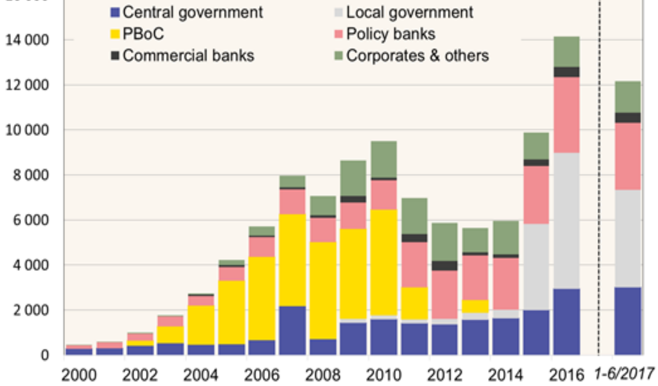
Roughly 130 institutional investors had registered with the Bond Connect as of Monday, the first trading day, when the value of trading under the programme totalled 7 billion yuan. As the trading rules are not fully clear, it seems unlikely that the Bond Connect will significantly increase foreign holdings in China's bond markets in the short term. Citigroup and Bloomberg this year introduced mainland China debt securities into some of their narrower indices. Mainland Chinese bonds, however, are not yet included in the major international indices.

Despite recent efforts to restrict capital outflows from China, the bond programme is a step forward in the opening up of China's capital markets to the world. The Bond Connect differs from the Stock Connect programmes in that Chinese investors are still denied access to Hong Kong's bond markets. The central bank says that this policy is not yet ripe for review.

About 90 % of China's bond trade is conducted on the interbank market, where Chinese commercial banks and investment firms account for most of the trading. Bonds can also be traded on China's stock exchanges. The interbank bond market was valued at around 46 trillion yuan (about USD 7 trillion) at the end of June, when China's total bond market was worth close to 70 trillion yuan. Foreigners hold less than 2 % of bonds traded on the interbank market.

With the start of the Bond Connect, the People's Bank of China announced rules to allow foreign credit rating agencies to operate in China. From the foreign investor's perspective, the allowing of international credit ratings agencies to rate Chinese firms is an important step in getting beyond China's tendency to overrate corporate creditworthiness. Currently, it is difficult for foreign investors to evaluate actual corporate risk, so nearly all foreign investments have been made to government bonds or policy bank bonds.

**Interbank bond issues by issuer class**




*Source: CEIC.*

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