Weekly Review
25 • 21.6.2018

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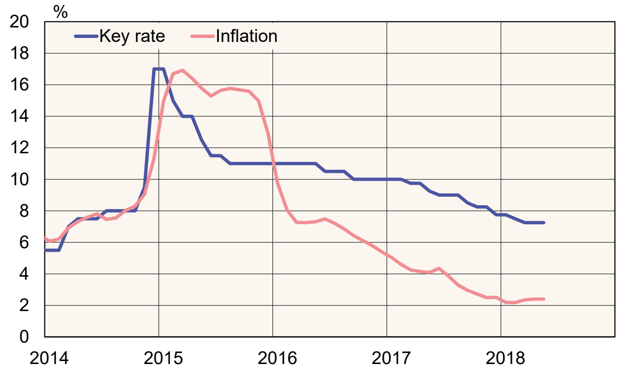
Russia

CBR keeps key rate unchanged, tightens guidance. The Central Bank of Russia decided last Friday (Jun. 15) to hold the key rate at 7.25 %. As the main reason for the decision was stated the proposed increase in the value-added tax (VAT) next year, which the CBR expects to add a percentage point to the inflation rate. The CBR also raised its inflation forecast to 3.5–4.0 % this year and 4.0–4.5 % next year.

For now, inflation has remained moderate, as consumer prices were up just 2.4 % y-o-y in May, the same as in April. Price trends are diverging by product groups, however. Food price inflation has nearly stopped in recent months, while the inflation of non-food goods has accelerated led by gasoline. The government has already decided to cut the excise tax on gasoline at the start of July to rein in the price growth.

The CBR's outlook for inflation and interest rate policy have shifted notably in recent months. As recently as March, the CBR was still lowering its key rate and gave guidance on a continuing trend to lower rates. Now the CBR observed that current circumstances require a slower transition to a neutral monetary policy stance. The change reflects increased inflation pressures caused by e.g. ruble depreciation and the planned tax increases.

Russia's key rate and consumer price inflation



Source: Macrobond.

Russian government submits proposals to the Duma on raising the retirement age and VAT hike. Last week the government finally agreed on a long-discussed move to raise the retirement age. As proposed, the retirement age would be increased annually in six-month increments until the new target ages were reached. Although certain groups would be exempted, the retirement age would generally rise from the current 60 to 65 for men and 55 to 63 for women.

Pension expenses already consume about a quarter of Russian public spending. They have increased due e.g. to higher life expectancy (currently 67 years for men and 77 for women), even if pensions have only increased modestly. Last year, the average monthly old-age pension was about 14,000 rubles (200 euros).

Last year just over 36 million Russians, or about a quarter of the population, received old-age pensions. Rosstat reports 24 % of them were also working. The number of such individuals, however, seems to have fallen dramatically in recent years with the elimination of annual cost-of-living adjustments for pensioners who choose to keep working.

The government also submitted to the Duma a proposal to raise the VAT rate from 18 % to 20 % from the start of 2019. Socially important items, like food and medicine, would continue enjoying reduced tax rates. The government estimates that the VAT increase will annually bring in an additional 620 billion rubles (9 billion euros) to the federal budget.

Most of the funds raised by the changes are set to go to funding expenditures for fulfilling president Putin's May decree. The cabinet discussed also several other measures to fund the May decree and compensate the tax hike, but they have so far not proceeded to the Duma.

While Russian economy experts have taken the proposed increase in the retirement age in general positively, they have criticized the VAT hike on its depressing effects for economic growth. In contrast, raising the retirement age goes down badly with average citizens. A recent survey found that 92 % of respondents were opposed to the government's proposed increase in the retirement age and an online petition by labour unions opposing the change has already gathered over one million signatures. Some political researchers believe the government deliberately came out with a harsh proposal to leave room for softening the conditions later.

Russian GDP forecasts cut after new US sanctions. Despite higher oil prices, Russian GDP forecasts have been revised down by many institutions lately. E.g. the World Bank's recent Russia forecast lowers its GDP growth outlook for this year by 0.2 percentage points. In addition to a weaker-than-expected growth in the early months of this year, the downward revision reflects the latest round of sanctions imposed by the US at the beginning of April. They are expected to increase uncertainty about the Russian economy.

Alexei Kudrin, chairman of Russia's Accounts Chamber and former finance minister, said in a recent interview that sanctions could impede growth by 0.2–0.3 percentage points. Several international banks also cut their 2018 Russian forecasts last month. The CBR's latest GDP growth forecast, however, was unchanged from March, even if the central bank slightly lowered its outlook for fixed investment growth.

Forecasts of Russian GDP growth, %

	2018	2019
Central Bank of Russia 6/18	1.5 – 2.0	1.5 – 2.0
World Bank 5/18	1.5	1.8
EBRD 5/18	1.5	1.5
OECD 5/18	1.8	1.5
Consensus Economics 6/18	1.8	1.9
IMF 4/18	1.7	1.5
BOFIT 3/18	1.8	1.6

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China

China and the United States back on the brink of a trade war. Last Friday (June 15), the United States released a list of 818 Chinese products to be slapped with a 25 % punitive import duty. Imports of affected products amount to about 34 billion dollars a year. The duties are scheduled to take effect on July 6. Following the public hearings process, the list could be expanded by another 284 products (16 billion dollars in imports annually). The duties target China's strategically important sectors such as information technology, industrial robotics and aerospace.

Immediately after the US announced the latest round of imports tariffs, China countered with its own 25 % import duties on US goods worth 34 billion dollars a year. Duties on China's 545-product list, including agricultural products, automobiles and seafood, would also go into effect on July 6. Another 16 billion dollars of additions to the list are planned, including imports of US coal, crude oil, and chemicals.

After promising to make good on its earlier threats to respond if China countered to new sanctions, president Donald Trump said on Monday (June 18) that he would hit China with a new round of 10 % duties on Chinese imports worth roughly 200 billion dollars a year. These duties take effect if China refuses to amend its practices in such areas as intellectual property protection and actually goes through with its threatened 25 % import duties. Trump's Monday evening threat on import duties on Chinese imports could add yet another 200 billion dollars in imports affected, amounting to nearly the entire value of China's goods exports to the US. China's goods exports to the US last year totalled about 500 billion dollars and goods imports 130 billion dollars.

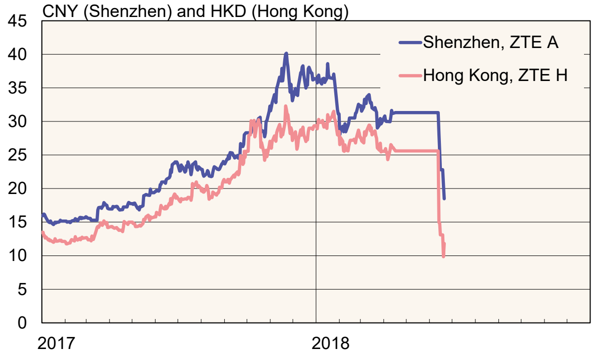
Rising opposition to ZTE's deal with the US. The problems of Chinese telecom giant ZTE began in March 2017, when it admitted to exporting US technology to Iran and North Korea in violation of US trade sanctions. ZTE is highly dependent on American technology. For example, over a quarter of its smartphone components are of US origin. ZTE was fined 1.2 billion dollars for violating trade sanctions. It got permission to continue working with US firms on condition that it punished employees who violated the sanctions. After it emerged that ZTE broke its promise, the US commerce department on April 16 imposed a seven-year ban sales of US components to ZTE.

Due to the ban on component sales, ZTE announced it was halting production. Trading in the company's shares was also halted on April 17. When trade negotiations at the beginning of May hit a favourable patch, president Trump announced that he was lifting the ban on component sales to ZTE. A deal was reached and ZTE announced on June 12 that it had agreed to the terms laid down by the US commerce department. ZTE would pay a one-billion-dollar fine and place 400 million dollars in escrow for possible future violations. Additionally, all board members must be replaced within a 30-day period that began on June 8 both in ZTE and in its wholly-owned subsidiary ZTE Kangxum Telecom.

The matter continues to simmer in the US, however. On Monday (Jun. 18) the US Senate, which is controlled by a Republican majority, passed the National Defence Authorization Act, which includes language repudiating the ZTE deal. For the NDAA to become law, it still requires reconciliation with the earlier-passed House version of the bill, which did not contain any reference to ZTE. Although trade relations between the US and China are less than optimal, the Trump administration seems determined to remove the ZTE language from the bill.

After trading of ZTE shares was restarted last Wednesday (June 13) prices nose-dived. Even after bouncing back slightly on the Hong Kong exchange on Wednesday (June 20) ahead of Trump's meeting with Republican senators, ZTE had lost over 50 % of its market capitalisation in Hong Kong and 40 % in Shenzhen.

Price of ZTE shares on Shenzhen and Hong Kong exchanges



Source: Macrobond.

New faces on the PBoC's monetary policy committee. In mid-June, central bank governor Yi Gang was named chairman of the 14-member policy panel. He replaces former PBoC governor, Zhou Xiaochuan, who retired in March. In addition to including the governor and two deputy governors of the PBoC, the committee comprises representatives from the government, the finance ministry, financial supervisory agencies, several other state agencies and China's banking association. The committee also includes three representatives from academia. The academics include Liu Shijin, deputy chairman of the government think tank China Development Research Foundation; Liu Wei, president of Renmin University; and Ma Jun, former PBoC chief economist and now a professor at Tsinghua University. The previous academic members were Fan Gang, Huang Yiping and Bai Chongen.

The PBoC's monetary policy committee meets every three months. It can offer recommendations, but has no real decision-making power over China's monetary policy directions. Even China's central bank lacks independence; all major monetary policy decisions have to be approved by the government.