

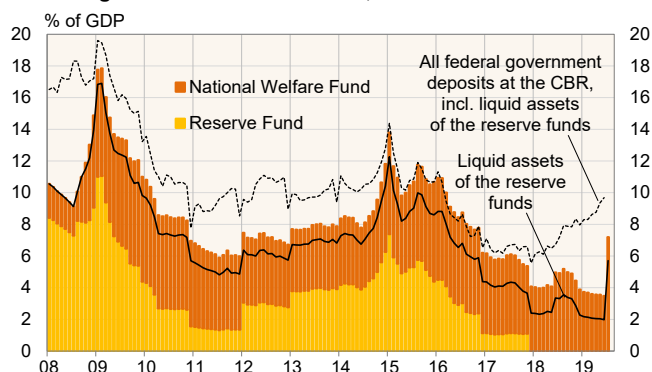
## Russia

**Russia moves its large excess oil tax revenues from 2018 into the reserve fund.** The finance ministry deposited over 65 billion dollars (equal to about 4 % of GDP) in the National Welfare Fund in July. As of August 1, the Fund's assets stood at 124 billion dollars (over 7 % of GDP). Of that, almost 99 billion dollars (5.7 % of GDP) were liquid assets that are held at the central bank in forex. The other assets of the Fund are tied up in e.g. investment project financing.

Each year, the excess oil tax revenues from the previous year must be transferred to the Fund by October 1. The federal budget rule defines that such excess revenues arise when the actual world market price for oil exceeds the rule's reference oil price for the year. The reference price for Urals-grade crude oil rises 2 % every year and was 40.8 dollars a barrel last year, while the actual outcome was almost 70 dollars. "Oil tax" revenues consist of taxes on oil and gas production, as well as export tariffs on oil, gas and petroleum products.

The Fund's reserves can be used on e.g. new investment projects when its liquid assets exceed 7 % of GDP. That sum has accrued because excess oil tax revenues in January-July this year amounted to well over 1.5 % of annual GDP. These excess funds will eventually be moved to the Fund but are until then waiting on other government accounts at the CBR.

### Russian government reserve funds, 2008–2019



Source: Russian Ministry of Finance.

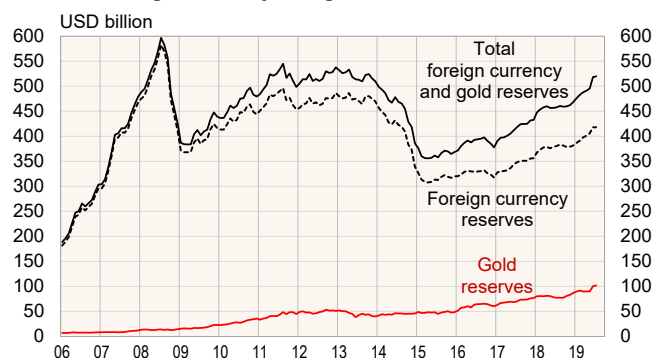
**Russia continues to accumulate foreign currency reserves.** The CBR's foreign currency and gold reserves have grown quickly this year. As of August 1, the reserves stood at about 520 billion dollars, an amount sufficient to cover about 18 months of imports of goods and services.

The increase in forex and gold reserves largely reflects the forex purchases that have continued from 2017 and 2018. The CBR makes them on the domestic currency market for the finance ministry. The finance ministry orders forex from the central bank at the pace that excess oil revenues flow to the federal budget.

The CBR's reserves have also been augmented by purchases of gold, which this year have nearly sustained the brisk pace of 2017 and 2018. The spike in gold prices in June gave

a notable increase to the value of the CBR's reserves. Gold makes up about 20 % of the reserves. The CBR holds the fifth largest gold reserves of any central bank in the world.

### Russia's foreign currency and gold reserves, 2006–2019



Source: Central Bank of Russia.

### Recent studies examine transport projects in Central Asia.

A recent [report](#) from the OECD's International Transport Forum (ITF) examines the potential for countries in Central Asia to become a major hub on the Eurasian continent. A World Bank [report](#) takes a different tack, considering the overall economic argument for China's Belt and Road Initiative. Both reports conclude that better land connections and logistics, while important, will not be transformative.

The geographic isolation of Central Asia (Kazakhstan, Kyrgyzstan, Uzbekistan, Tajikistan and Turkmenistan) is hard to overcome. Improved land connections would not necessarily transform economies based on commodity exports, but would widen the potential customer base for these countries. Even so, other factors such as unpredictable customs practices are likely to ward off international trade.

A recent [transition report](#) from the EBRD finds that if all planned transport corridors are built by 2040, it would increase real incomes in Uzbekistan by 6 % and in Kazakhstan by 4.5 %. These projects have a long journey from planning to implementation. The World Bank's assessment finds a direct impact on Central Asian real incomes of about 1 % after roads are built under China's Belt and Road plan. The biggest gains flow to the 300-km long Fergana Valley, which spans Uzbekistan, Kyrgyzstan and Tajikistan. The fewest benefits accrue to Turkmenistan. Streamlining of documentation and border inspection practices would deliver more benefits than Belt-and-Road connections per se.

Even with the challenges, Central Asian nations have come up with functional solutions. Rail freight transport between China and Europe moving through Kazakhstan usually keeps to schedule without unreasonable delays. Depending on destination, rail shipments from China to Europe only take about 15 days (transport by ship takes about 30 days). Despite the large investment, the value of goods freight moving by rail between China and Europe is worth only 2–3 % of the total value of goods flow. The sea and air freight dominate flows when measured in value of transported goods.

## China

### **Impasse as China-US economic relations take a turn for the worse.**

On August 1, in the wake of brief, unproductive trade talks, president Donald Trump announced a new round of tariffs. Chinese officials responded this week by forbidding Chinese firms from buying American agricultural products. Noting US protectionism and more tariffs hikes, the People's Bank of China on Monday (Aug. 5) let the yuan depreciate and pass the psychological limit of 7 yuan per dollar. On Tuesday (Aug. 6) the US officially designated China as a "currency manipulator." Global markets have reacted strongly to the increased uncertainty.

Trump unleashed the first round of punitive tariffs in the US-China trade war in July 2018. Since the start of June 2019, the US has applied additional 25 % tariffs to Chinese imports worth earlier about 250 billion dollars a year. The latest round of US tariff hikes, which go into effect on September 1, will add a 10 % tariff to all previously unaffected Chinese imports (worth earlier roughly 300 billion dollars a year). For its part, China has slapped (mostly 25 %) tariffs on American imports worth earlier about 110 billion dollars a year. US figures show that imports from China over the past 12 months were worth 509 billion dollars (down 4 % y-o-y), while US exports to China in the same period were worth 108 billion dollars (down 20 % y-o-y). The trade deficit, however, is about the same as a year earlier (400 billion dollars).

China's decision on Monday (Aug. 5) to allow the yuan to depreciate to a level of 7.05 to the dollar hardly came as a surprise, especially with few other forms of direct reprisal available given the massive trade imbalance between the two countries. The yuan has not broken the 7-yuan line since spring 2008, so the psychological impact on markets was huge (even if the yuan's drop was just 1.6 % from its Friday level). Besides the trade war, the downward pressure on the yuan's exchange rate from the slowing Chinese economy and rising indebtedness made it easier for the government to allow the yuan to weaken. Depreciation is by no means a cure-all; it drives capital flight, which, if it worsens, could force the government to tighten already strict currency controls. It also hits private consumption.

The US has inexplicably chosen to label China a "currency manipulator" for the first time since 1994. The move is especially odd given that it is very likely the yuan would have fallen further if it was allowed to float freely. In any case, the label is fairly meaningless as the US, under its own legislation, must engage a "currency manipulator" nation in talks. The US and China have already been in trade talks for over a year and half.

Thus, the US and China find themselves at an impasse from which it is impossible for either side to extricate themselves with current approaches. Continuing down this road only increases uncertainty in the markets and reduces economic growth for all.

**More cases of Chinese firms cooking their books.** Billions of dollars in fraudulent bookkeeping of Chinese firms has come to light this year. Many firms caught up in the revelations have been unable to repay their debts, even if their financial statements show excellent cash positions. Several accounting firms have been swept up in the scandals.

The latest round of accounting firm problems started when officials launched an investigation into the practices of the Chinese accounting firm GP in May. Last month, Ruihua, one of China's largest domestic accounting firms, was also targeted for investigation. That investigation implicated a number of Ruihua's clients as many of them have had to freeze their plans to get new funding.

At the end of May, the auditors of Jinzhou Bank, which is listed on the Hong Kong stock exchange, quit after the bank refused to provide additional information about its lending activities. To bail out the troubled bank, state-owned ICBC, Cinda and Great Wall announced in July that they would inject billions of yuan into the bank.

There is a long history of reporting on the bookkeeping problems and scandals surrounding Chinese firms, but slowing economic growth seems likely to expose more troubles. Chinese firms have long felt comfortable cooking the books as they faced only relatively small punishment if caught. Officials routinely threaten harsher punishments, but very little has actually happened.

**Hong Kong protests start to hit the economy.** The waves of demonstrations that began in June show no signs of abating. Indeed, the protests have been backed by strike action that has caused, for instance, stoppage of most of Hong Kong's public transport. A substantial deterioration in economic conditions would complicate resolution of the special administrative region's already messy political problems.

While the economic impacts from strikes and protests are hard to quantify, it is clear that strikes immediately affect production and add to political uncertainty and instability that drive away potential investors and tourists.

Hong Kong's on-year GDP growth fell to 0.6 % y-o-y already in the first and second quarters of this year. More recent data show Hong Kong's Hang Seng index fell by nearly 10 % last 30 days. There were no similar declines on any other major stock exchanges. Retail sales and real estate shares, which are highly dependent on condition of the Hong Kong economy, have been hit hardest. The share prices of Chinese firms listed on the Hong Kong stock exchange have also tanked. The slowdown in mainland China's economic growth is a major factor in Hong Kong slowing growth.

The Hong Kong Monetary Authority (HKMA) has pegged the Hong Kong dollar to the US dollar for decades with fixed exchange rate (currency board). Possible loss of confidence in the HK dollar would call the HKMA to intervene to prop up the HK dollar which would show up in the money market. So far, the situation seems to be stable and interest rates show no particular stress. The recent increase in forex reserves helps the HKMA defend the currency peg.