SUOMEN PANKKI FINLANDS BANK EUROSYSTEM 18 11

Weekly Review
33 • 16.8.2019

BOFIT

Russia

US imposes new sanctions on Russia. At the beginning of August, president Donald Trump signed an executive order preventing United States financial institutions from participating in new issues of Russian sovereign foreign currency bonds, effective August 26. The executive order also calls the US Treasury to oppose any new lending to Russia by international financial institutions (such as the World Bank). The actions are based on US code pertaining to international violations in the use of chemical and biological weapons. Russia is alleged to have poisoned several persons with Novichok nerve agent in Salisbury, England in March 2018.

The impacts from the latest round of sanctions are likely to be minor as the Russian government has little need to borrow on international markets at the moment. Virtually all of its new bond issues are in rubles. At the end of July, foreign investors held about 30 % of government-issued ruble-denominated paper and slightly over half of Russia's euro-denominated government bonds.

Kremlin imposes strict economic targets on regional leaders. Under a new rule introduced this spring, regional leaders are now evaluated according to 14 different criteria. The main measures of regional economic performance are private-sector job creation, number of small and medium-sized enterprises in the regions and labour productivity.

Russia has a total of 85 federal regions (including the unlawfully annexed territories of Crimea and Sevastopol). Most are led by regional governors. Every region now has specific targets they should meet. The targets are intended to supplement the national investment projects. For example, the annual volume of investment in Moscow and St. Petersburg needs to grow at over 6 % to achieve the national target of a 25 % investment ratio (fixed investment to GDP) by 2024. Regions are also expected by then to halve the number of people living below the poverty line and increase labour productivity by 5 %. Observers have criticised the evaluation criteria released in July for their narrow perspective. Rather than strive for general improvement of economic conditions, leaders must concentrate on boosting readings of specific metrics.

The target regime places trust in the central government (including the president) as the core metric, which shows that political stability and loyalty to central power remain most important. Constitutionally Russia is a federation, but its power structure is actually centralised. Since elections of regional governors were restored in 2012, the Kremlin has effectively diminished regional authority by removing unfavourable governors from office prior to elections and replacing them with favoured candidates whose victory is effectively guaranteed.

IMF Article IV consultation reiterates calls for Russia to maintain economic stability and move on reforms. The International Monetary Fund (IMF) reports that Russian GDP grew by 0.5 % a year during 2014–2018, while in the same period other emerging economies in the G20 and eleven EU new member countries on the averages of the two groups saw growth exceeding 3 % a year. The IMF estimates that foreign sanctions reduced Russian GDP growth in those years by 0.2 percentage points a year, while the fall in oil prices knocked off 0.6 percentage points a year.

The IMF expects Russia's 13 national projects to lift GDP growth in the next few years to 2 % a year through increased government spending. The projects focus on such areas as transport infrastructure, education and health care. The IMF also estimates that the national projects, if properly targeted and effectively implemented, could together with a gradual increase in the retirement age increase Russia's potential economic growth from the earlier-estimated 1.5 % a year to 1.6–2 % by 2024 that marks the end of the period reviewed.

The IMF recommended that the central bank stays the course with its policy of gradual relaxation of the monetary stance. Improving communications on factors affecting monetary policy will also help, which should focus on the central bank's view of the outlook for the economy and inflation.

The IMF encouraged Russia to keep to its fiscal rule (e.g. refrain from measures like the relaxation already made as regards the deficit limit for the 2019–2024 budgets). In the IMF's view, the assets of the National Welfare Fund (NWF) should not be used in a quasi-fiscal manner of e.g. lending for such purposes as project financing even after the liquid assets in the NWF reach the required level of 7 % of GDP, which is likely to happen next year.

Regarding government finances, the IMF also recommended lowering the high wage-based social taxes, which could then be offset by cutting back on various tax benefits. Oil taxation needs to be simplified, especially given that after a promising start of the reform in this area the taxation became more complex. Subsidisation of domestic oil consumption should be phased out gradually, and the classification of budget spending as secret should decrease. Due to the lack of reform, early retirement provisions remain overly generous, and social support policies have not been overhauled to better meet the needs of people and reduce poverty.

The IMF offered several recommendations for the banking sector, including the introduction of regulations to prevent a bank's related parties from receiving more favourable treatment from the bank, as well as reaffirming the independence and professional competency of external auditors. The Duma remains reluctant to pass legislation that would give central bank supervisors the necessary legal protection when exercising professional judgement in supervision tasks.

Looking at broader economic reforms, the IMF noted that the lack of competition and the related government's involvement in the economy remain core problems for Russia. Oversight of state-owned enterprises needs to improve, which in turn requires proper standardised economic reporting. Regarding barriers to trade, the IMF noted that the domestic content requirements applied in Russia are the third highest among the G20 countries.

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China

Third Chinese bank rescue of the summer gets underway. *Caixin* business media reports that Hengfeng Bank, headquartered in Shandong province, is on track to receive funding of 30 billion yuan (4.3 billion dollars) from the provincial government. In addition, the state-owned Central Huijin Investment is expected to acquire a stake in the bank.

The capitalisation of the bank is unsurprising given that Hengfeng Bank's troubles have been long recognised. The bank has not released a financial statement since 2016. Based on the latest available information, Hengfeng is somewhere in the neighbourhood of China's 20th largest bank in terms of total assets, or roughly the same size as the combined assets of the Baoshang and Jinzhou banks recued earlier this summer. One of the largest banks in Southeast Asia, Singapore-based UOB, holds a 13 % stake in Hengfeng Bank. UOB has tried to divest its stake in recent years, but has found no buyers.

Regulators have taken a different approach in the rescue operations of Hengfeng Bank and Jinzhou Bank announced in late July than they used in the Baoshang Bank case in May. In the Baoshang takeover, officials announced that large stakeholders would have to accept some of the bank's losses. This measure lead to a reassessment of counterparty risk on the interbank market and made access to funding for small and medium-sized banks more challenging. In contrast, when the government decided to recapitalise Hengfeng and Jinzhou with public funds, the market reactions have been fairly subdued. Of course, simply pumping money into a troubled bank is a temporary solution that can only be effective if the bank changes its practices.

China wants to speed up transfer assets of state-owned enterprises to pension funds. China decided in 2017 to transfer a handful of 10 % stakes in state-owned enterprises to pension funds. Later, the list of enterprises was broadened to 600.

Lou Jiwei, head of the national social security fund, said in spring that the 10 % stakes of just five state firms had been transferred in full to the pension funds. In July, the government announced it wanted to accelerate the transfers and further broaden the list of firms.

Pension funds are in dire need of additional assets as their current levels are inadequate to meet future obligations. China's population is ageing rapidly, while the number of pensioners is growing and the dependency ratio is soaring. The China Academy of Social Sciences (CASS) estimated last spring that the pension funds will be exhausted around 2035 without reform. The government has given assurances that pensions will be paid in full also in future.

Raising the retirement age is seen as a critical reform. Men currently retire at 60 and women at 55 or 50 depending on the nature of their work. At the same time, the average life expectancy in China has risen to 76 years. While authorities have from time to time called for raising the pension age, lately the subject has largely fallen pretty much off the radar.

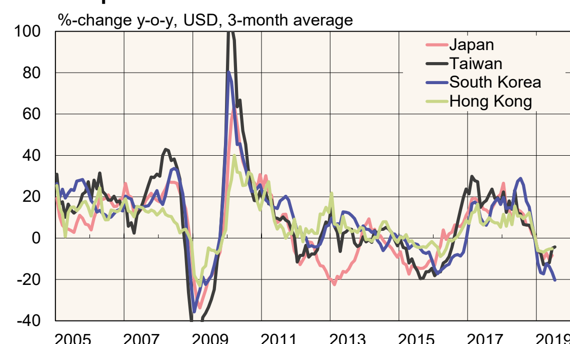
China's pension system needs reform. Presently, provinces have their own funds. The pensions of migrant workers are paid into the provincial fund where the worker is employed. Pensions must be paid out, however, from the migrant labourer's home province if the worker has not worked long enough in another province. As a result, there are huge differences across provincial funds. Provinces in Northeast China in particular have seen their pension funds drained, while provinces that attract migrant labour enjoy burgeoning pension funds and have even granted companies reductions in their mandatory pension contributions.

For years, China has been expanding the number of persons covered by the pension system. Officials say that as of the end of 2018 about 940 million people were covered under some kind of pension scheme. Some pension, however, are rather meagre. China's finance ministry says that the average monthly pension was just 120 yuan (16 euros) in 2016 for rural residents and individuals in cities who had not worked at a wage-paying job. This system covers over 520 million Chinese. Persons who have performed wage labour for their entire career in a firm or as a bureaucrat were paid on average just under 2,400 yuan (325 euros) a month in 2016. The government has sought to encourage citizens to participate in various private pension savings plans geared to the individual, but participation has been modest. Children have traditionally provided for their elderly parents in China.

China's goods imports continued to fall in July. China Customs reports that goods imports in July fell by 6 % y-o-y in dollar terms, the same rate of contraction as in previous months. The biggest drop was seen in imports from the United States, but there were also major declines in imports from East Asian economies. The value of imports from the EU, Southeast Asia and Africa has risen slightly this year.

China's goods exports are running at the same level this year as in 2018. With contracting imports and stable export levels, the goods trade surplus increased by 60 billion dollars from year earlier to 226 billion dollars for the January-July period.

Goods exports of East Asian economies to China



Sources: Macrobond, national customs and statistics authorities, and BOFIT.

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