Weekly Review
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Russia

Russia's central bank lowers key rate and revises forecasts downwards. On September 6, the Central Bank of Russia's board of directors again lowered the key rate by 0.25 percentage points. It was the third cut since mid-June. The move was expected by the markets, and from Monday (Sept. 9) onwards the key rate is 7 %.

The CBR noted that inflation had slowed to 4.3 % p.a. at the end of August. Moreover, economic growth was continuously lower than the CBR had expected. The Bank said it would consider whether further rate cuts will be necessary if its baseline forecasts for inflation and economic growth materialise. The CBR currently estimates that the targeted neutral level of its key rate is in a range of 6–7 % in nominal terms and 2–3 % in real terms.

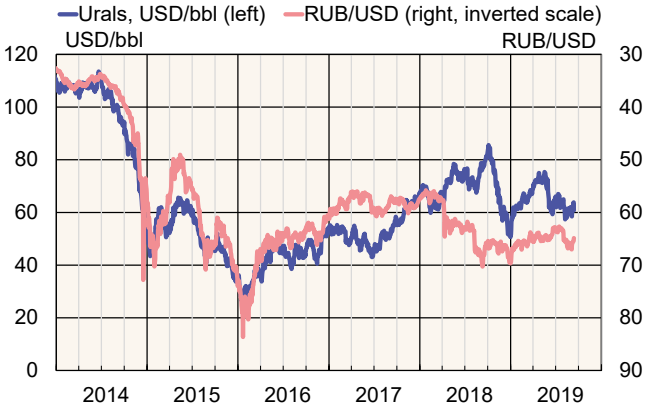
The CBR lowered its inflation forecast and expects inflation at the end of this year to be running in the range of 4–4.5 % before settling to close to 4 %. It also lowered the economic growth outlook. The CBR expects GDP growth of 0.8–1.3 % this year and 1.5–2 % next year if the price of Urals crude oil falls so that next year's average is 55 dollars a barrel. In accordance with its June forecast, the CBR continues to expect the real volume of household consumption to grow this year by 1–1.5 %. At the same time, the outlook for fixed investment growth was lowered to 0–1 %, while the outlook for growth in export and import volumes fell to around zero.

Ruble rate and oil prices weaker after strong performance early in the year. The ruble's exchange rate and oil prices strengthened in the early part of 2019. While both have been on a downward track in recent months, the ruble-dollar rate is still up 6 % from the start of the year and the dollar price of Urals oil up by 23 %.

As in previous years, developments in the ruble's exchange rate has occasionally diverged from the oil price. The price of Urals crude in dollars around the end of May was up by slightly over 40 % since the start of the year, while the ruble was up only about 7 % against the dollar. Despite the large drop in oil prices in June on market concerns about slowing global growth, the ruble held its value. It only dropped to its current level (around 65 rubles to the dollar) in early August on the US announcement of more sanctions against Russia. The price of a barrel of Urals crude also dropped slightly when the sanctions were announced, but has now recovered to its late July level of around 63 dollars a barrel.

Foreign investors supported the ruble's exchange rate in the first five months of this year by increasing their share of ruble-denominated treasury bonds (OFZs) from 25 % to 30 %. The government's rather tight fiscal policies have also supported the ruble. CBR forex purchases under the finance ministry's fiscal rule are not expected to cause much weakening of the ruble's exchange rate as the purchases are a small part of market activity (on September 13, the dollar-ruble rate was 64.8 and the euro-ruble rate 71.7).

Ruble's exchange rate and Urals oil



Source: Reuters.

Russian and Indian leaders meet to discuss economic relations. Russian president Putin hosted the leaders of India, Japan, Mongolia and Malaysia at the Eastern Economic Forum on September 4–6 in Vladivostok on Russia's Pacific coast. The bilateral discussions of Russian host Vladimir Putin and Indian Prime Minister Narendra Modi focused on increased economic cooperation. A number of bilateral agreements were signed.

The countries already cooperate on a few strategic and technical fronts. There are a few Russian nuclear reactors in India, and more may be built. For years, Russia has been supplying arms and other military equipment to India, but recently Russian companies have made efforts to start producing them in India as well. India is a partner in the Sakhalin-1 project to exploit oil and gas fields in the Sakhalin Island. The American Exxon holds a 30 % stake in the venture, the Japanese Sodeco 30 %, the Russian Rosneft 20 % and India's state-owned oil company ONGC Videsh 20 %. Rosneft CEO Igor Sechin announced at the economic forum in Vladivostok that the venture partners had agreed on construction of a gas liquefaction plant at Russia's De-Kastri seaport on the coast of the Sea of Japan. Oil and gas are already flowing through pipelines from Sakhalin Island to the mainland.

Despite these ventures, Russia-India trade is fairly modest. Russian customs values last year's Russian goods exports to India at around 7 billion dollars, while goods imports from India were worth about 3 billion dollars. India accounts for just 1.7 % of Russian goods exports and 1.4 % of goods imports. Russian exports to India include oil, fertilizers, paper, diamonds, machinery and sea vessels. The Stockholm International Peace Research Institute (SIPRI) reports that Russia last year exported at least $1 billion in military equipment to India. Russia imports pharmaceuticals, tea, electrical equipment and clothing from India. The statements released in the context of Putin-Modi meeting envision a manifold increase in Russia-India trade in coming years. However, there is no free-trade agreement between the Eurasian Economic Union and India at the moment.

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China

IMF sees rapid decay in China's government finances. The IMF last month released its annual Article IV consultation on trends in the Chinese economy. China's public sector deficit and indebtedness continue to rise when borrowing by off-budget local governments and other debt is included (augmented debt). This year's fiscal policy stimulus through tax cuts and investment by local governments in infrastructure projects will boost the augmented deficit by 1.5 percentage points to 13 % of GDP (11 % in 2018). Stimulus measures should support growth this year by 0.8 percentage point.

Both public debt and China's total debt-to-GDP ratio are expected to rise until 2024. China's augmented public sector debt should rise from 73 % last year to over 80 % this year (official public sector debt 38 % of GDP in 2018) and exceed 100 % of GDP in 2024. China's overall debt-to-GDP ratio is expected to rise this year by nearly 10 percentage points to 266 %.

Rising public sector debt poses a threat to the sustainability of China's indebtedness. To lower public sector debt, the IMF recommends limiting off-budget borrowing by local governments to finance infrastructure investment, as well as a shift to progressive and pro-rebalancing taxation that rewards structural adjustments (e.g. carbon tax). The credit growth of state-owned enterprises (SOEs) is of particular concern as debt ratios are rising, productivity remains generally weak and about a third of SOEs now operate at a loss. SOE debt represents as fast-growing share of total debt, highlighting how state firms are favoured by banks at the expense of private firms.

The state's extensive involvement in the economy interferes with efficient allocation of resources. The situation will only worsen if China continues to pile on debt to hit official growth targets. Administration of an ever-more complex economy requires an overhaul of policy, improvements in governance and a shift to more market-based and transparent frameworks. Rather than focus on rigid growth targets, fiscal policy resources should be used to mitigate the problems arising from critical structural reforms.

At the time of the consultation, roughly half of US imports from China were subject to punitive tariffs. Under the adverse scenario proposed by the IMF, whereby the US applies a 25 % tariff to all remaining Chinese imports, China's growth would slow by about 0.8 percentage point over the next 12 months relative to the baseline scenario. With the increased tensions in the trade war in August, the assumptions of the adverse scenario have largely come to pass.

The IMF recommended increasing fiscal stimulus to mitigate some of the impacts of the current trade war, noting that funding for such stimulus has to come from central government budget funds, that the stimulus must support structural reforms of the economy and be targeted at low-income households to amplify the impacts of stimulus as much as possible. These include hikes in pensions and unemployment benefits, as well as increased spending on education and health care. At the same time, however, public debt is rising faster than in the report's baseline scenario. The IMF does not recommend monetary stimulus; monetary policy should be focused on inflation.

With regards to exchange rate policy, the IMF encouraged China to move to a freer exchange-rate formation regime as it would help soften the impacts of external shocks on the economy. China also should work to improve the quality of its statistical data and eliminate gaps in its data.

After strong growth from 2009 to 2015, the shadow banking sector now appears to be shrinking. Shadow banking in China got its start after the partial deregulation of financial markets and restrictions on bank lending. Recently, however, the size of the shadow banking sector has shrunk.

In its latest Article IV report (see above), the IMF notes that regulatory measures to curb shadow banking have largely succeeded, with sector assets shrinking to just over 20 trillion yuan (2.8 trillion dollars). The IMF, however, wants further measures to force informal financing into the formal banking sector. Unlike in the US and Europe, in China the shadow banking sector is focused on lending to firms rather than households for e.g. housing.

Chinese shadow banking features several different contractual and lending arrangements. All involve marshalling investor assets for lending while avoiding the need for a bank to stand formally as creditor, serving instead as a mere intermediary (a role non-banks can also perform). While there is no precise definition of shadow banking, certain modes of financing deserve mention.

Wealth management products are based on agreements, whereby the investor agrees to place assets in an uninsured account and allow the bank to lend or invest those assets on behalf of the client in the hope of a high return. The assets are not included on the bank's balance sheet and the bank is not otherwise obligated to the investor. Typically, the money is not invested in securities, but loaned to debtors under a standard lending contract. Such investments are often thought to have the bank's implicit guarantee, so they are considered safe investments. Officials are currently promulgating new rules banning such implicit guarantees. These rules should be fully in force by the end of 2020.

Entrusted loans also rely on an agent bank relationship. The bank negotiates and intermediates the loan between two parties, handing the loan documents, but not assuming liability for failed performance of the loan parties. The parties are typically firms, but the bank has occasionally later purchased the debt note for itself. The firm placing the assets to be lent has some say at to whom their money is lent.

Trust loans are arranged by various trust companies, which also take in investments from banks. Such loans are granted to debtors with lower creditworthiness that may disqualify them from eligibility for a regular bank loan.

Peer-to-peer lending (P2P) typically is done online. It allows private individuals to lend to each other via a platform provided by a third party. With the collapse of several platforms, officials have sought to restrict growth of P2P lending.

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