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Beijing tightens the screws on local government revenue

Policy changes are consistent with Beijing's priority to deleverage the economy and promote higher-quality growth

Regulations released by **China**'s central government in early June will require all local governments to transfer the power for collecting land sales revenue (worth some 8 trillion yuan or approx. US$1.25 trillion nationally) from their natural resources departments to tax authorities. Local tax authorities are overseen by the central government's State Taxation Administration and generally have advanced collection technology and complete taxpayer databases. One city and six provincial governments will join a pilot programme commencing at the beginning of July, with a view to rolling out the policy nationwide by the beginning of next year. This policy announcement gels with a policy announced in early 2018 requiring local government tax authorities to take responsibility for collecting non-tax revenue in their jurisdictions.

The overall intent of these policy changes is to increase central government oversight over how local governments spend their revenue, and allow for tighter control of debt levels. The evident goal is a shift away from (typically infrastructure) projects with questionable justification and towards higher-quality and greener projects supporting the energy transition. Beijing signalled its uprated willingness to intervene when in April it cancelled two high-speed rail projects worth US$20 billion in Shandong and Shaanxi province. Over time, Beijing's re-direction of capital flows could potentially reduce demand for foreign natural resources – particularly coal and iron ore. The quantum of this effect will depend on the extent to which unjustified large-scale projects are wound back. The policy may also be a precursor to more significant power shifts away from the provinces towards Beijing.

China courts Indonesia

Indonesia is reaching out to its northern neighbour whilst bulking up its naval defences

Indonesia's relationship with **China** appears to have gone from strength to strength since the bilateral relationship reached a nadir in late 2019 and early 2020. Persistent Chinese incursions into the Natuna Sea – located on the southern fringes of the South China Sea within Indonesia's territorial waters and exclusive economic zone – prompted Jakarta to dispatch warships and fighter jets. In the end, China backed down and the bulk of its South China Sea incursions have since been made into waters claimed by the **Philippines** and most recently **Malaysian** airspace.

The lull in tensions and some shrewd, opportunist diplomacy by Beijing has provided the impetus for a diplomatic reset. So-called vaccine diplomacy has been a big part of this. As of May, 90 percent of Indonesia's 76 million vaccine doses were provided by Chinese company Sinovac. The sinking of the Indonesian attack submarine KRI *Nanggala* in April provided another opportunity for China to show a more amicable side. Despite sensitivities over the Lombok Strait where the *Nanggala* sank, Jakarta has accepted China's offer to salvage the submarine – free of charge.

As is often the way in China's relationship with Southeast Asian countries, this is only part of the story. As it cosies up to Beijing diplomatically and economically, Jakarta is also increasing the frequency of naval patrols and has established a new military base at Natuna Besar – the region's largest island. Defence Minister Prabowo Subianto, previously persona non grata in much of the West, has been making major purchases from countries including **Italy**,

Denmark, **South Korea** and likely the **US**. Jakarta earlier in the year inked a defence pact with **Japan** and was also recently in discussions with **India** over joint-patrols of the Malacca Strait – a key chokepoint for China's energy imports. So, whilst relations with China are clearly on the mend, any talk of Indonesia firmly aligning with China as a "strategic bulwark" against countries like **Australia** is greatly overstated.

G7's democratic alternative to China's BRI faces challenges

The G7's Build Back Better initiative has been criticised by some as being scant on detail

The Build Back Better (B3W) World Partnership – announced by the G7 in Cornwall, **UK** last week – has been vaunted as a rival to **China**'s Belt and Road Initiative (BRI). The initiative has been presented as a "transparent" programme led by the **US** and other G7 nations, with support from others including **Australia**, to improve infrastructure in low- and middle-income countries. As yet, there is little detail on how the programme will be financed.

The B3W is firm on espousing "democratic values." It aims to mobilise investment to help tackle climate, health, digital technology and gender equality issues under loan terms more transparent than those of BRI. While one aim of the BRI is to shape global trade flows to suit China, other imperatives are more domestically focused. For example, the BRI aims to export excess domestic steel and cement production and secure preferential access to natural resources. Another potential point of difference between the BRI and B3W is the appetite for risk. China has offered loans to countries at high risk of debt distress and Chinese investors have shown little concern for ESG risks. B3W investment would presumably be attentive to both.

It is unclear how the B3W will finance the estimated US$40 trillion "infrastructure gap" in developing countries. The idea is that the B3W will mobilise private sector investment – perhaps with support from development banks, export credit agencies and the like. Any incentives must overcome the barriers that inhibit purely commercial financing. The B3W demonstrates – to some extent – a coalition that is united against China. However, strong government backing will be essential if B3W is to reduce reliance of developing countries on Chinese infrastructure investment.

Suga's political fortunes hinge on the Tokyo Olympics and vaccine rollout

The Prime Minister's approval ratings have plummeted

Japan's Prime Minister **Yoshihide Suga**'s popularity has declined sharply. This month, his Cabinet's approval rating fell to 33 percent – the lowest level since Suga was elected in September to head the ruling Liberal Democratic Party (LDP). On Tuesday, opposition parties submitted (an ultimately unsuccessful) vote of no confidence against Suga. In April, the LDP lost all three parliamentary by-elections. A slow vaccine rollout and broad public opposition to holding the Tokyo Olympics are contributing to his declining public approval. Suga must call a general election before October 21 and faces a party leadership poll in September.

Suga is wagering that a successful Olympic games and vaccine campaign will shift public sentiment. However, if the Olympics are held without domestic spectators, they will require what would be an unpopular public bailout of perhaps $US800million. Japan's fiscal firepower is already stretched. It has a debt to GDP ratio of 252 percent compared to the OECD average of around 86 percent. Organisers are expected to delay the decision on spectators to the last minute. With 5 percent of the population fully vaccinated – one of the slowest rollouts in the OECD – the Games are expected to worsen Japan's virus situation. Tokyo is recording around 370 COVID-19 cases per day and has extended its state of emergency. It is unclear whether the 60,000 Olympic volunteers will even be vaccinated by the Games' start. The stakes are high. Suga's party and allies may lose its two-thirds majority in the lower house at the elections. Or, Suga may yet be replaced in September, proving to be a mere seat warmer for Japan's next Prime Minister.

Iran heads to the polls

Raisi will likely seek to use electoral success as a springboard to the Supreme Leader position

Iranians will head to the polls today to elect the country's next president as the term of the incumbent **Hassan Rouhani** comes to an end. Even by Iranian standards, where candidates are tightly vetted by the Guardian Council (ultimately controlled by Supreme Leader **Ayatollah Khomeini**), there is a conspicuous lack of reformist candidates on the ballot sheet. Key prospective reformist candidates including Rouhani's first deputy Ishaq Jahangiri did not pass the vetting process. The only genuinely moderate candidate who made it on the list, former vice-president Mohsen Mehralizadeh pulled out of the race on Wednesday – likely to boost the chances of the next most moderate candidate remaining on the list, former Central Bank chief Abdolnasser Hemmati.

Though Iranian elections have a track record of surprising observers, Ebrahim Raisi looks firmly to be in the box seat. The hard-line cleric ran against Rouhani in the 2017 elections and has far better brand recognition than other candidates. The stringent and flagrantly biased vetting process applied by the Guardian Council has sparked speculation that Khomenei is seeking to engineer a Raisi victory. Even so, many ostensible successors to Khomenei have fallen by the wayside over the years. Legislative elections held early last year saw turnout decrease by 19 percentage points to just over 42 percent off the back of a similarly strict vetting process. A Raisi "victory" on Friday with low turnout may actually prove to be something of a poisoned chalice that delegitimises Raisi as a prospective Supreme Leader. The only certainty is that, ever since former **US** President Trump exited the JCPOA, Iran's political dynamics have shifted strongly in favour of the hardliner camp.