BOFIT Weekly
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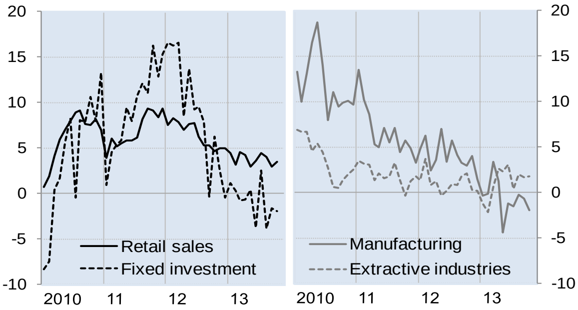
Russia

Latest figures show persistent low growth for Russia. Fixed capital investment fell in October about 2 % y-o-y. The contraction in fixed investment has continued at roughly the same pace for several months now. Construction activity, in particular, was down 3 % y-o-y. Retail sales, in contrast, continue to grow. Over the last six months, the sales growth has stayed in the range of 3–4 % y-o-y.

Industrial output growth has remained flat for quite a while. Over the last six months, on-year industrial output growth has been at or just below zero. The weak performance mainly reflects the struggles of manufacturing, the output of which has over the last six months been about 1 % less than a year earlier. Production drops have been especially evident in the categories of machinery & equipment, metallurgy and pulp & paper. Mineral extraction industries, which include mining as well as oil & gas, recovered after a poor performance in the first quarter of the year. Since last spring, these industries have experienced growth averaging almost 2 % y-o-y. Much of this comes from the rebound in natural gas production, which climbed at an on-year rate of over 10 % during the last three months.

The decline in imports to Russia continued. Imports from non-CIS countries over the last six months were down about 5 % y-o-y, with the rate of contraction increasing to about 7% in October. The contraction concerns nearly all major goods categories, including machinery & equipment.

12-month change (%) in domestic demand and industrial output



Source: Rosstat

Russia raises corporate property tax. Under tax code amendments approved at the beginning of November, the method for determining the property tax paid on commercial space based on book value can be replaced with the valuation indicated in the property register that more closely reflects the actual market value of the property. Officials say the current tax paid on commercial properties is too low relative to the huge profits they generate. The Duma took up and passed the amendments to the tax code with exceptional speed. They enter into force next January.

According to the amendments, the new method can be applied to commercial and office space only. The tax on other types of space (e.g. industrial facilities) will still be determined according to book value. To be eligible for the new method, at least 20 % of a property's floorspace must be dedicated to commercial purposes.

Property tax is collected by regional governments, which can decide the details of the tax within a framework set forth under the federal law. Only a few regions will introduce the new tax practice immediately next year. This is because the majority of regions are unlikely to be able to make the requisite legislative amendments to their own tax codes before the end of this year.

The federal law establishes different ceilings for the tax rate during a transition period (1.5 % in 2014 and 1.7 % in 2015 for Moscow; 1 % in 2014 and 1.5 % in 2015 everywhere else). Starting in 2016, the ceiling will be 2 % nationwide. Although the current ceiling is actually higher (2.2 %), revenues are likely to rise sharply as the taxable values of properties are adjusted up. The change profoundly affects the taxes paid on large, old properties that today carry miniscule book values. These properties will likely see vastly higher tax appraisals under the new method.

The City of Moscow has been the biggest proponent of the reform. Moscow saw a substantial drop in tax revenues last year after changes were made in laws governing transfer pricing and conglomerate taxation. Taxes collected from conglomerates such as large energy companies are now shared among all regions where the business group has operations. Earlier, the lion's share of taxes went to the region where company headquarters were located.

The City of Moscow this week decided to introduce the new tax arrangement from the start of next year. The new method applies to buildings with floorspace of at least 5,000 m^2. In practice, this means large commercial centres such as shopping malls and office buildings are affected. In response to an initiative from business lobbies, the tax rate next year will be cut to 0.9 %, which is below the minimum set by federal law for Moscow. Under the change, Moscow's tax revenues will increase next year by about 17 billion rubles (€390 million), or about 1 % of Moscow's budget revenues.

The Moscow region will also adopt a new tax scheme at the start of next year. The Moscow region's new tax rate will be 1 % and the new method will only apply to commercial space, not offices. In St. Petersburg the reform enters into force in 2015.

Over the past two years, Russian regions have made a massive effort to assess property values and list them in property registers. However, property owners often dispute valuations as unrealistic, and in some cases, these valuation disputes end up in court. Given the extensive uncertainty over property values, business lobbies argue the new taxation method has been introduced prematurely.

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EUROJÄRJESTELMÄ
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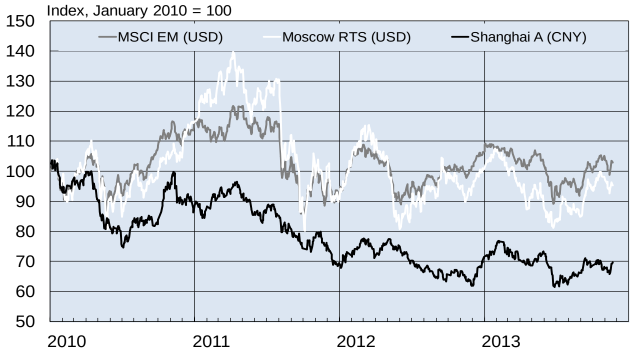
China

China reveals further details on reform plans. Last Friday (Nov. 15), China released blueprint on how decisions reached at the Third Plenary Session of the Central Committee will be implemented. The markets reacted positively to the revealed plans and share prices rose sharply. Many of the reforms mentioned in the plan, however, have been under preparation for a long time or are already in use as pilot programmes. Indeed, the reforms are largely driven by realities facing China and there is probably little leeway for authorities to manage the situation without bold reforms. No schedule for the reforms has been released, but it is expected most will be implemented by 2020.

Moscow RTS, Shanghai A and Morgan Stanley Emerging Markets (MSCI EM) indexes



Source: Bloomberg

The government remains committed to continue reforms of the financial sector, which have been underway for years. Market forces will play an increasing role in determining the yuan's value, capital controls will be further relaxed and the interest rate liberalisation will continue. Establishing private financial institutions will also become easier.

Standardised budgeting processes will be introduced to improve public sector transparency. Local administrations will be permitted to issue their own bonds and their notoriously complex financial structures will be simplified and made more transparent. Some taxes such as property tax and the value-added tax on services that are currently in the trial phase will be rolled out nationally. Various environmental taxes and fees will also be increased.

Administratively set rates for e.g. water, gas, electricity, fuel, telecommunications and transport prices will be freed and for municipal utilities and services the rate-setting mechanism will be reviewed.

The *hukou* household registration system will be modified so that anybody will be free to move to a small city and restriction on moving to mid-sized cities will gradually be lifted. The restrictions on moving to large cities, however, will remain in place. The reform is intended to promote further urbanisation in China. In addition, rural residents will be granted the possibility to sell or rent their personal share of land owned by the farm collective.

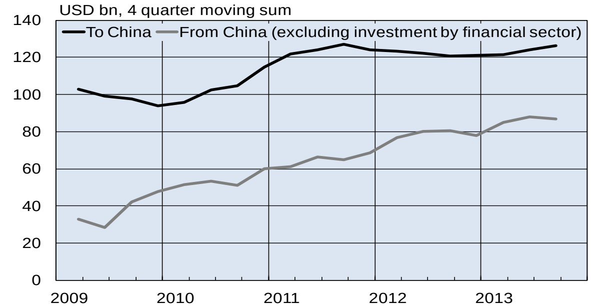
As expected, the one-child policy will be fine-tuned so that couples can have two children if at least one of the parents is an only child. Earlier both parents had to be only children for the couple to be eligible for a second child. Some demographic estimates see the birth rate rising about 10 % a year, or 1.5 million more children than would be born without the change. Such estimation is difficult, however, as lifestyles tend to change with growing prosperity. There are already many couples that do not want any children.

Chinese firms' investments abroad are getting more diverse. China's foreign direct investment abroad (excluding investments by the financial sector) in January-October amounted to $70 billion, a fifth more than in the same period in 2012. About two-thirds of investment has gone to Asia in recent years, but Chinese firms have also been active globally. Last year, 8 % of China's FDI went to Europe, 7 % to Latin America, 6 % to North America, 3% to Africa and 3 % to the Pacific region.

Looking at the current stock of Chinese investment, the focus seems to be on various types of business services, the financial sector, retail and wholesale trade, and the mining industry. The investment activities of Chinese firms, however, have become more diversified, and the share of investment in manufacturing has increased. Recently, Chinese companies have been making headlines in the United States and Great Britain for their real estate investments, as well as investment in oil production and the banking sector in Latin America.

After a brief dip, FDI inflows into China are rising again. In the January-October period, $97 billion in FDI flowed into China, a 6 % increase from the same period in 2012. Most FDI came from countries neighbouring China.

China's FDI inflows and outflows



Source: CEIC

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