BOFIT Weekly

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Russia

No changes expected in Russian corporate taxation in coming years. Last week, finance minister Anton Siluanov presented his ministry's proposed tax policy framework for 2016–2018. He promised that the tax burden on Russian corporations would not increase and that no major tax reforms were planned for the next few years. Siluanov noted that Russia's tax system is already largely in place, with nearly all of the major reforms of recent years now implemented. Big changes include revision of taxation of the oil sector (see BOFIT Weekly 48/2014), subjecting foreign-registered Russian firms to tax liability (BOFIT Weekly 48/2014), as well as laws on intra-group transfer pricing and conglomerate taxation (BOFIT Weekly 35/2012). In the future, attention will focus on improving the practical functioning of the tax system.

Under the released framework, the tax system would be developed over the coming years to support economic growth and increase tax fairness. The minister emphasized the need to immediately start the measures aiming at bolstering economic growth. Beyond traditional subsidies for capital investment, the ministry hopes to stimulate investment through e.g. lowering the tax burden on companies during the initial investment phase to when an investment becomes profitable. Companies will be allowed to deduct investment expenses from their profit tax and the government will try to speed up payment of value-added tax refunds of exports. In federal districts targeted for development (e.g. the Far East Federal District), companies will get additional benefits for investing. Special tax incentives will also be made available to encourage operation of small and medium-sized enterprises (SMEs).

To increase tax fairness, the ministry would make tax evasion harder and grant benefits to prudent taxpayers. To limit the extensive abuses of the VAT refund system, tax officials are moving increasingly to on-line services. The Duma this spring passed a law on tax amnesty for private individuals voluntarily declaring off-shore assets of to the tax authorities. The law took effect this week (June 8). The law grants tax amnesty to repatriated assets (except the fruits of criminal activity) if the declaration is filed by the end of this year (BOFIT Weekly 14/2015). It is hoped that the law will increase openness and in longer term broaden the tax base.

Loan stock growth stalls for Russian banking sector. The stocks of both corporate loans and loans granted to households contracted in the first four months of this year. SMEs, in particular, found it hard to get bank financing. At the end of April, SMEs accounted for 18 % of banks' corporate loan stocks, down from 22 % in April 2014.

In annual terms, the loan stock still increased, but the growth was lower than previously. In January-April, the stock of corporate loans was up 17 % y-o-y and the stock of loans granted to households up 4 %. Taking into account Russia's current inflation of around 16 %, the volume of corporate borrowing has practically not increased at all in real terms and household borrowing is down substantially.

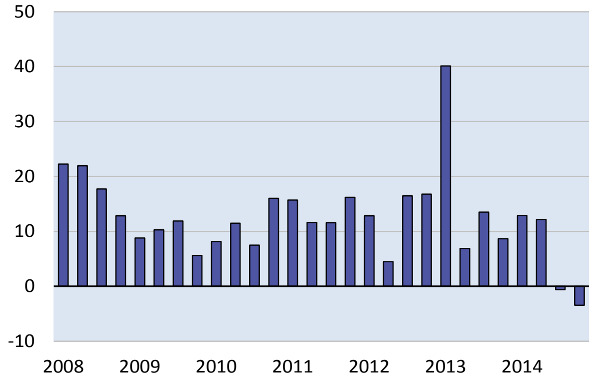
About half of corporate loans exceed three years, and about a third of corporate loans are denominated in foreign currency. The stock of non-performing corporate loans increased by a third in the first four months of this year, but the rate of increase has been lower than during the 2008-2009 financial crisis. Non-performing loans represented 6 % of the corporate loan stock at the end of April. The share of non-performing loans to households was 7 %.

Foreign direct investment inflow to Russia last year was lower than in 2009. Inbound foreign direct investment flow to Russia last year fell to $21 billion, down from an average of $55 billion a year during 2007–2013, and even well below the $37 billion registered during the crisis year of 2009. Supported by the early months, the FDI flow was still positive for the year as a whole, but in second-half net FDI flows turned negative, i.e. more investment flowed out of Russia than into Russia.

As usual, the largest inbound flows came from Cyprus, the Bahamas and the British Virgin Islands. Many large Russian firms are registered or have subsidiaries in these countries for e.g. tax purposes, and a large share of investment flows into Russia from these countries is apparently of Russian origin. Largest FDI flows went last year to the service sector, particularly finance and insurance and trade.

FDI outflows from Russia amounted to $56 billion last year, which was close to the annual average for 2007–2013. The flow of outbound FDI was about the same in all four quarters of 2014. Cyprus was the top destination, accounting for nearly half of outbound FDI (and tripling from a year earlier as the economic situation of Cyprus was more stable than in 2013). High growth was also seen in investment flows to other major destination markets. For example, Russian FDI flows doubled to the United States and quadrupled to Switzerland.

Quarterly flows of inbound FDI to Russia, USD billion



Source: Central Bank of Russia

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China

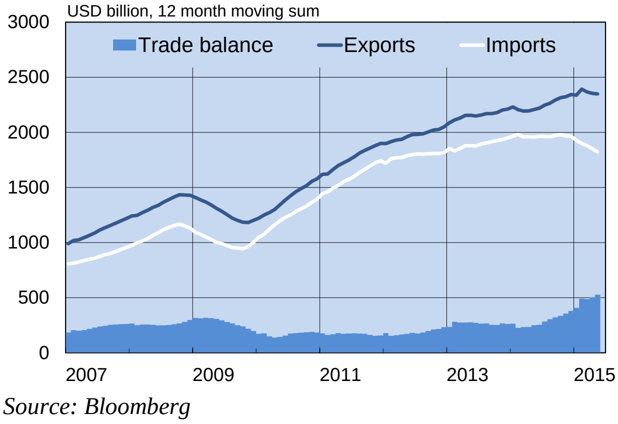
China's exports and imports continue to shrink. China's foreign trade statistics show that the value of exports compared to a year earlier contracted by 2 % in May, while the value of imports was down 18 %. The May trade surplus again approached the all-time monthly record of $60 billion. In the three-month March-May period, the value of exports declined 8 % and the value of imports was down 16 % from March-May 2014.

The sharp drop in the value of imports reflects falling global prices for energy and other commodities, but also lower import volumes, which in recent months have been running slightly below levels a year earlier. However, the volume of crude oil imported to China in March-May was up 4 % from the same time in 2014. Also export prices have been on a mild downward trend and export volumes have remained lower than a year earlier.

The decline in import volumes reinforces the wider view of a slowing Chinese economy. Export trends have been affected by growth in export markets and shifting foreign exchange rates. While the yuan-dollar exchange rate was relatively stable since last year, the yuan has appreciated against most of the currencies of its other main trading partners. This shift partly explains why China's exports to the US in recent months have continued to rise, while exports to the Eurozone and Japan have declined 10–15 %.

A notable trend is the significant decline in China's processing trade as a share of total goods exports. At the start of this decade, the processing and assembly activities in international production chains accounted for over 50 % of the total value of goods exports in China's foreign trade figures. Since then, the share of processing trade has gradually declined, and was about 40 % in January-May of this year. At the same time, the structure of imports has not undergone a similar shift. Imports reported as processing trade have held steady at around 30 %.

China's foreign trade, USD billion



Source: Bloomberg

Chinese inflation slows further. The 12-month rise in consumer prices slowed from 1.5 % in April to 1.2 % in May. The slowdown largely reflects the decline in food prices in recent months. Consumer price inflation for non-food goods and services, however, remained largely unchanged in April and May. May producer prices slid 4.6 % y-o-y. Chinese producer price have fallen since spring 2012, evidencing struggles with structural issues like overcapacity.

According to both official and private data sources, the drop in apartment prices on housing markets has ceased and prices may actually have started to rise a bit in most cities. Stock markets, on the other hand, face the risk of a price bubble due to market participants buying shares on margin. The overall trend in prices does not indicate a risk of deflation that would require easing of monetary policy.

Mainland China stock markets not quite ready for incorporation into global stock indexes. On Tuesday (June 9), the global stock index provider MSCI announced that China's yuan-denominated A-shares were still ineligible for inclusion in its Emerging Market (EM) stock index. Despite substantial liberalisation of China's capital markets during last year such as the stock connect of the Shanghai and Hong Kong exchanges, the extension of the RQFII (renminbi qualified foreign institutional investor) programme to several new cities, as well as specification of tax rules for capital gains, MSCI noted that making portfolio investment to China remains difficult. Investor roadblocks include the inflexibility, unpredictability and the lack of transparency of the current quota system, as well as limits on capital mobility and liquidity of many investment instruments. Suspicions also linger about protections for "beneficial owners" in the investment chain, despite efforts of the China Securities Regulatory Commission (CSRC) to clarify rules.

MSCI said that China is progressing at a good pace in resolving its accessibility issues, and that the ultimate inclusion of mainland A-shares into the MSCI EM index would happen gradually. The weighting of mainland Chinese H-shares listed in Hong Kong in the MSCI EM index is already about 25 %, and over the next year the index will incorporate shares listed elsewhere abroad. Adding mainland A-shares to the EM index starts after overcoming technical hurdles related to investing. The opening up of China's capital markets to the world and increasing A-shares to their full weight in the indexes could, by current estimates, lead to a weighting of Chinese shares in the MSCI EM index of as much as 44 %. Alternatively, MSCI could distinguish China with its own index as it does for several large developed economies.

Share indexes guide the actions of many investors. Changes in the weighting of indexes like the MSCI EM would force adjustments in stock markets and capital flows.

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