EUROJÄRJESTELMÄ
EUROSYSTEMET

# BOFIT Weekly

**44 • 4.11.2011**

# Russia

**Is Russia finally on the brink of WTO membership?** Georgia and Russia have initially accepted a Swiss-moderated proposal to end Georgia's hold on Russia's WTO accession. Russia's acceptance was announced late Wednesday evening (Nov. 2) by the country's chief WTO negotiator Maxim Medvedkov. Georgia had been the sole holdout against Russia's WTO accession, taking a hard stance against what it saw as Russian occupation of Georgia's breakaway regions of South Ossetia and Abkhasia since 2008. Under the Swiss-mediated compromise, goods shipments crossing Russia's borders with South Ossetia and Abkhasia will be inspected by an international agency. Although Georgia failed to get its own inspectors, it hailed the compromise as acknowledgement of its true borders.

Russia last year resolved most of its bilateral discussions with the United States and the European Union. A few thorny matters were left unsolved, however, and Russia has been actively negotiating on them with the EU this autumn. Final resolution of these issues now seems at hand.

One of the most difficult issues has been a local-content requirement for foreign-make automobiles assembled in Russia. Russia boosted its local content requirement at the start of 2011. Last week the EU Commission announced that the EU and Russia had agreed on a compensation procedure that would enter into force if exports of European car parts to Russia decline as a result of Russia's new local-content requirement. Local content requirements designed to protect domestic producers are a direct violation of the WTO's Agreement on Trade Related Investment Measures (TRIMS). Russia has requested a TRIMS exemption to allow its domestic content rule to continue until 2020, an unusually long transition period by WTO standards.

The differences between the EU and Russia also extend to governing sanitary and phytosanitary (SPS) rules for imports of agricultural products. In the EU's opinion, Russia has used its SPS regulations to restrict food imports. The Commission announced it has now agreed with Russia on clearer SPS rules.

According to the Commission's announcement, the EU has obtained assurances from Russia that it will soon lower the overflight fees it charges European airlines. Overflight fees are seen as a violation of WTO rules as they are handed over to a competing domestic carrier, Aeroflot. According to Russian sources, the amount of the fee reduction has yet to be agreed.

The EU hopes all the above-mentioned issues will be resolved as swiftly as possible. If the necessary technical preparations are handled rapidly, too, Russia's membership could be approved in December at the WTO Ministerial Conference in Geneva. Russia's membership would enter in force in the first half of 2012 at earliest, after the ratification process has been concluded.

**Russia ready to help finance eurozone debtors.** Arkady Dvorkovich, president Medvedev's economic policy adviser, announced Monday (Oct. 31) that Russia could provide up to $10 billion (€7.3 billion) to help struggling European states. Russia prefers to channel the support via the IMF, which has a system in place for monitoring borrowers. Russia could also consider bilateral lending to specific EU countries, but still via the IMF. All loans assume the EU adopts a clear strategy to resolve its debt crisis.

Russia recently negotiated with Spain on purchasing its Eurobonds, but Dvorkovich says Russia has no further plans at the moment to expand sovereign bond-buying in the EU. Russia and Cyprus agreed last month on a loan to Cyprus, but Russia's finance ministry says it was one-off deal (described by the Cypriot government as a €2.5 billion four-and-a-half-year loan). The 4.5 % yield on the bond is well below current market rates. The loan would allow refinancing of debts coming due next year. Cyprus is the preferred tax haven of Russian corporations and the single largest source of FDI for Russia, thanks to repatriated Russian monies.

As of end-October, the Russian state held $118 billion in off-budget reserve funds. Part of these assets is held as deposits in Vneshekonombank and the rest is invested in high-grade bonds as part of Russia's foreign currency reserves. After China and Japan, Russia holds the third largest foreign currency reserves in the world. The current value of Russia's reserves is about $515 billion.

**Next year's regulated rate hikes to be postponed.** The Russian government typically adjusts rates for municipal services such as water supply, electricity, gas and heating at the start of the year. With the March 2012 presidential election approaching, it has decided to wait until July.

Heating rates will go up at least 6 % next July and regional authorities will be allowed to further increase rates if they deem necessary in September. Electricity rates for consumers will go up by a maximum of 6 % and natural gas rates 15 %. Larger rate hikes were earlier anticipated to allow for increased investment in municipal services and reduction in the subsidy burden that below-market rates place on municipalities providing such services. Last spring, prime minister Vladimir Putin said 2012 rate hikes could not exceed the year's forecast inflation, which is currently expected to run at 5–6 %.

Regions are free to set rates for municipal services as long as they stay within certain limits set at the federal level.

Editor-in-Chief Seija Lainela

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160 • FI-00101 Helsinki
Phone: +358 10 831 2268 • Email: bofit@bof.fi • Web: www.bof.fi/bofit

EUROJÄRJESTELMÄ
EUROSYSTEMET

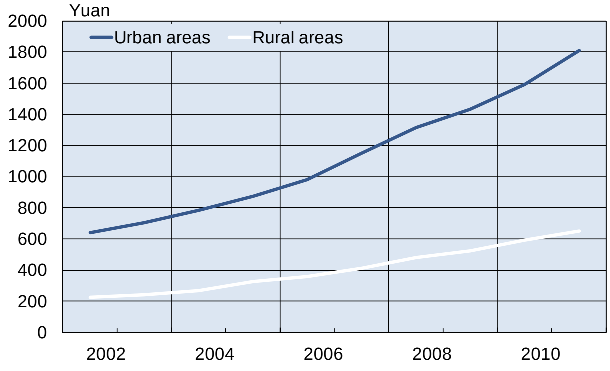
# BOFIT Weekly
**44 • 4.11.2011**

# China

**Income continues to climb.** China's National Bureau of Statistics reports per capita monthly disposable income of households in January-September reached 1,811 yuan (about €200), a 14 % increase from the same period in 2010. Income rose 8 % in real terms. The rise in wages was slightly lower than the increase in other forms of income. In the countryside, disposable incomes rose substantially faster than in urban areas. Soaring food prices have significantly boosted the income and wages of farm workers. Although still well below urban income levels, the average rural cash income in the period reached 653 yuan (€71) a month.

The long and steady rise in income (and wages) has begun to impact on the structure of the Chinese economy. At first glance, consumer purchasing power has risen, which is seen as a driver of private consumer demand. On the other hand, rising labour costs for firms and a stronger yuan mean that companies are seeing competitive advantage over foreign competitors erode to some extent. Previously, this was not much of a problem as rising costs could be dealt through productivity gains and offsetting smaller profit margins with higher volumes. This wiggle room has diminished and higher input costs force producers to raise their prices. Indeed, quoted dollar prices for Chinese goods delivered to the US have begun to rise. The increase not only reflects appreciation of the yuan's exchange rate, but also signals that the steady slide in yuan-denominated prices that began in 2003 has ended.

**Per capita income of households, 2002–2011 (Jan.–Sept.)**




*Sources: NBS and CEIC*

**China experiments with extending VAT to services.** Starting in January, Shanghai will introduce on a trial basis an extension of value-added tax to transport services and other yet-to-be-specified service branches. Two new VAT tax categories (6 % and 11 %) were introduced and those will probably be applied to services. If the pilot programme succeeds, VAT on services will be applied nationwide.

Rather than VAT, service providers currently pay a turnover tax, which is for example in transport services 3 %. Although the current tax rate for service providers is lower than the proposed VAT rates, the change should lower the tax burden on firms and reduce public tax revenues somewhat. VAT is a pass-through tax, which means firms can deduct the VAT taxes they have paid on production inputs. The turnover tax, in contrast, does not allow such deductions. The experiment will not alter the status of local administrations or the central government with respect to tax collection, because the value-added tax will be paid to local administrations just as the turnover tax is currently paid. The goal of the pilot programme is to reduce double taxation and clarify taxation practices.

**OECD gives Chinese higher education a mixed report card.** A new OECD report says China needs to significantly increase its number of universities and improve the quality of instruction. At the moment, only a fifth of young people attend university, and many of them never graduate. Exporting companies are distressed by the lack of highly educated employees; nearly two-thirds say the lack of university-educated staff prevents them from expanding their operations. By recent estimates, the Chinese state spends less than 2 % of GDP on higher education, far less than in advanced industrialised countries and even below the average of its Asian neighbours.

China must develop its university system if the country is to shift its economic emphasis to high-value fields based on demanding technologies and know-how. China's strength relative to other Asian countries is that it has state and university support systems to make higher education available to as many promising students as possible, regardless of their economic background or geographic origins. To raise the level of university education to the international forefront, universities have been granted considerable academic freedom and financial resources. The vanguard of Chinese universities has been separated from the regular university system. These top-tier universities stress research and receive preference in state funding.

Top-tier universities have seen such vast improvement that five of Asia's top ten universities are now in Hong Kong or mainland China. About 36,000 people took science or technology PhDs last year in China, which was about half of all PhDs granted in East Asia. The latest figures show that about a fifth of China's over 3,000 universities are privately operated. Tuition typically runs around $700 a semester. Over 400,000 Chinese study in universities abroad.

Editor-in-Chief Seija Lainela
Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160 • FI-00101 Helsinki
Phone: +358 10 831 2268 • Email: bofit@bof.fi • Web: www.bof.fi/bofit