Weekly Review
18 • 4.5.2016
BOFIT

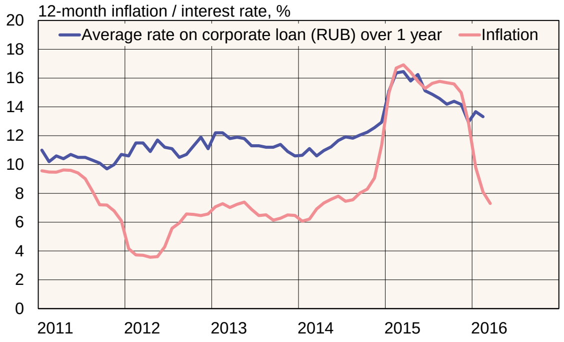
# Russia

**CBR keeps key rate unchanged at 11 %.** The Central Bank of Russia stated that inflation has slowed down in recent months, but inflation risks remain elevated. Hence, the CBR board of directors decided to keep the key rate at 11 %. The CBR estimates that 12-month inflation at the end of April was 7.3 %, unchanged from the March reading. The board said it expects to reach its declared 4 % inflation target in late 2017.

The CBR noted that uncertainty associated with government budgets was among the biggest inflation risks. In addition, it expects market interest rates to fall even without a cut in the key rate as the budget deficit and financing the shortfall out of the Reserve fund will increase liquidity in the banking sector. Lending rates have been falling gradually during the past year, but real interest rates have turned clearly positive this year due to the significant drop in inflation.

The CBR said it will resume a gradual lowering of the key rate in the near future if inflation risks subside sufficiently. The board's next meeting on rates is set for June 10.

**Average interest rate on corporate loans and inflation in Russia**




*Source: Macrobond.*

**Russia's defence industry still enjoying strong growth.** Information collected from multiple sources indicates that Russia's defence industry production rose about 13 % in 2012 and nearly 20 % a year in 2014 and 2015. While precise figures on how much the defence industry contributes to total Russian industrial output is unavailable, experts estimate defence industry accounts for around 5 % of total industrial output and about a third of Russian machine building. Defence ministry procurements also represent a large share in the production of transport vehicles and electrical devices.

The goal of Russia's 2011–2020 state armament programme approved in 2010 was to substantially upgrade weaponry and capabilities of all branches of the military and special forces under the defence ministry. While programme details remain classified, a number of sources have put total planned spending on the programme at around 20 trillion rubles, or 2 trillion rubles a year. Media reports indicate the programme has been fully implemented in recent years, and defence spending has soared since 2011. Federal budget spending on defence in 2015 rose 28 % to around 3.1 trillion rubles (€46 billion, slightly over 4 % of GDP).

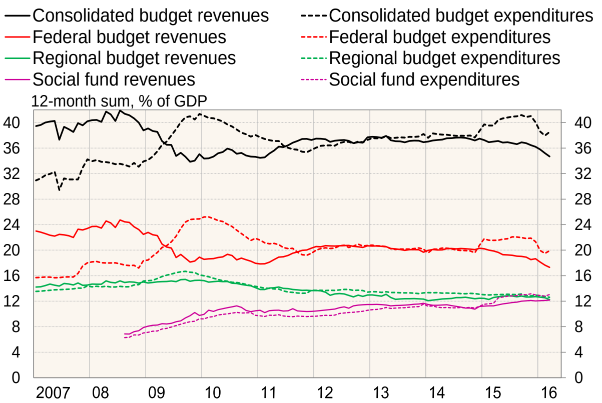
Russian industrial output contracted about 5 % last year. Without the demand spike from the military build-up, however, it appears industrial output would have already begun to fall in 2013. According to the approved federal budget, total defence spending will not grow this year. If the armament programme stays to schedule, large acquisitions still lie ahead in the 2016–2018 period, after which demand for government defence procurements goes flat. Defence contractors and suppliers have been encouraged to develop products for the civilian market and to seek new export markets abroad.

**Pressure on Russian government finances continues to increase.** First-quarter revenues to the consolidated budget (federal, regional and municipal budgets plus state social funds) were down about 3 % from 1Q15. As inflation remained fairly high, the contraction in government revenues in real terms that began in 2015 persisted.

As in 2015, the revenue drop reflected lower oil & gas tax revenues, which were down 36 % y-o-y in the first quarter (down over 20 % for 2015 overall). Other revenues increased 8.5 % in nominal terms, basically matching the pace of inflation. Nominal spending declined slightly. The government deficit amounted to 2.8 % of GDP.

Federal budget revenues fell 15 % y-o-y even in nominal terms on the lower oil & gas tax revenues and weakness in other revenue streams. As regional budget revenues were essentially unchanged on-year in nominal terms, the real fall in revenues continued. Asset transfers from the federal level to regions continued to dwindle, while other regional revenues performed weakly. Federal budget expenditures fell sharply, due in part to a spending spree in early 2015. Regional budget spending has fallen in real terms since 2013, while growth of revenues of state social funds and their expenditures accelerated to over 20 % y-o-y in nominal terms.

**Government revenues and expenditures**




*Source: Ministry of Finance.*

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# China

**China shifts main service branches into VAT sphere as key tax reform proceeds.** China further expanded its value-added taxation (VAT) reform on May 1 to major service branches, including construction, real estate, finance, insurance and a variety of consumer services. These industries were earlier subject to the Business Tax (BT), a tax based on each firm's gross revenues. The shift to VAT in service branches began in 2012. Initially, the pilot programmes only involved certain cities and branches. The VAT trial has been expanded nationally since 2013 to include e.g. logistics, postal and telecommunication services.

Most financial services are now subject to a 6 % VAT rate. These include income from interest on consumer and business loans; gains made from trading equities, debt securities and foreign currency; fees for financial services and insurance premia. VAT exemptions will include deposit interest, interest commercial banks pay to the central bank, interbank loans and public and local government debt.

The basic VAT rate for real estate services and construction is 11 %. Small businesses are eligible for a simplified tax scheme with a lower tax rate, but are then not entitled to tax deductions. VAT applies in real estate deals and the sale, purchase or rental of properties by firms or private individuals. VAT generally will not be collected from private individuals selling an apartment that they have owned for over two years, but sales of expensive apartments in big cities will still involve some amount of VAT. A reduced 5 % tax rate of the sale price is applied to other private apartment sales.

The basic VAT rate is 6 % for consumer services such as tourism, hotels, the hospitality, food & beverage branch, training, healthcare, cultural events and entertainment. There are exceptions, however. Tax exemptions have been granted e.g. to healthcare services, elder care, child care and training provided by approved agencies and up to certain levels of accreditation.

Companies have had only a short time to prepare for the tax reform as premier Li Keqiang announced only at the National People's Congress in March that the expanded VAT reform would enter into force at the beginning of May. VAT revenues will be shared between the central government and local governments. BT revenues earlier went directly to the local government and accounted for about 40 % of local government revenues. Officials say the tax reform this year will reduce the overall tax burden on companies by more than 500 billion yuan (€70 billion), which, in turn, will reduce revenues to local governments. The shortfall has been factored into this year's central government budget.

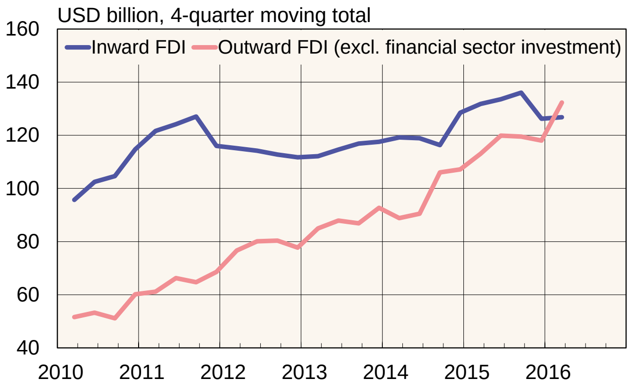
VAT was already applied before the extension to manufacturing and trade. The newly implemented tax reform harmonises tax practices for goods and services and allows tax deduction for semi-finished goods and procurement of services across branches. Several VAT rates are currently applied in China and the Chinese tax system is still quite complicated. VAT rates typically range between 3 % and 17 %. In 2014, for example, the average VAT rate in OECD countries was 19 %. China's VAT system is set for further reforms until in practice there are only two tax rates in use.

**Chinese direct investment on the rise also in Finland.** Foreign direct investment outflows from China have enjoyed strong growth for over ten years, but the investment pace this year seems to have kicked into high gear. China's commerce ministry reports that outward FDI flow in the first quarter of 2016 was up over 50 % y-o-y. Media coverage of planned acquisitions indicates that the trend will continue. China's government supports companies through such measures as providing financing for acquisition of foreign firms.

Chinese investors earlier generally paid little attention to Finland, but over the past year interest in Finnish companies has soared. The Chinese National Silicon Industry Group is acquiring the Finnish silicon wafer maker Okmetic for about €150 million. JOT Automation, a company focused on production automation and testing, was bought by the Chinese Wuxi Lead Intelligent Equipment for €74 million. The Chinese HNA Tourism Group announced last week it was purchasing Carlson Hotels and the deal includes the multinational Radisson Hotel chain, which operates in Finland. The Chinese Kaidi, which is specialised in environmentally friendly power facilities, is designing the Kemi biofuel power plant, currently contemplated as a €1 billion project.

Earlier large investment projects that remain active include Huawei's Finnish research and development centre for mobile device technologies and Finnish commercial ship designer Deltamarin, which has been Chinese-owned since 2012. Both investments are on the order of tens of millions of euros. The Chinese companies have also made many smaller investments and Chinese representative offices have been opened in Finland.

**China's inward and outward FDI flows**




*Source: China Ministry of Commerce*

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