Weekly Review
18 • 5.5.2017

BOFIT

Russia

Russian central bank lowers key rate again. At its regular meeting on April 28, the Central Bank of Russia Board decided to lower the key rate by 50 basis points to 9.25 %, effective May 2. The CBR justified the cut by pointing to a considerable slowing in inflation and lower inflation expectations. The CBR had earlier cut its key rate by 25 basis points on March 27.

The CBR added that its assessment of potential further rate cuts this year is unchanged. However, it did not note when the next cut might be possible. The CBR expects 12-month inflation to reach its 4 % target by the end of this year and remain close to the 4 % in 2018–19. The economy is expected to grow in 2017–19, even if the average oil price falls by $10–15 from its current level of around $50 a barrel. The next regularly scheduled CBR Board key rate meeting is set for June 16.

Change in the law pushes millions of Russians into Mir payment cards. At the start of the week, president Putin signed legislative amendments, whereby wages paid from government budgets and many social benefits like pensions must be paid to accounts linked to Mir payment cards (or no card whatsoever or a cash disbursement). The change goes into effect in full on July 1, 2018, but includes a longer transition for pension payments. Under the amendments, all banks must be able to accommodate Mir charge cards in e.g. their automatic tellers, and all businesses with net sales of more than 40 million rubles (about €650,000) must accept Mir cards.

The project to create a national payments system with payment cards was given a boost in spring 2014 after international sanctions were imposed on some Russian banks. The first Mir cards were introduced at the end of 2015. The CBR is currently the sole owner of the company administering the national payments system and Mir cards. The law specifies that the CBR must maintain a majority stake in the company. Over 70 Russian banks now issue Mir cards, and over 5 million Mir cards have already been issued. The use of Mir cards outside Russia remains limited. Currently Russian banks issue co-badging cards only with two foreign systems (Maestro and JCB), but Mir has announced it has reached deals with American Express and UnionPay, and is in talks with other majors such as Visa and Mastercard.

Russian defence spending has increased rapidly. The annual global military spending report from the Stockholm International Peace Research Institute (SIPRI) finds that the ratio of government defence spending to GDP in Russia reached 5.3 % last year. Fresh figures from the Russian Gaidar Institute for Economic Policy (IEP) indicate that defence spending rose to 5.7 % of GDP last year. Russia's finance ministry figures also show that the defence-spending-to-GDP ratio rose to 4.4 %, the highest level since the early 1990s.

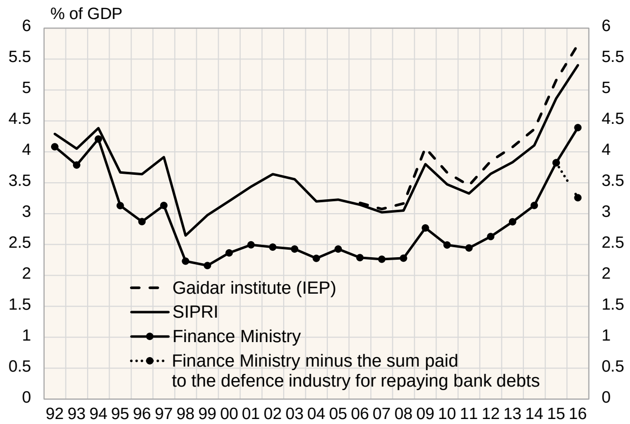
Notably, 2016 defence spending includes budget money given to the defence industry (OPK) intended for early repayment of bank loans granted from 2011 onwards to OPK with federal guarantees. The federal accounts chamber reports the amount paid from the budget for the repayment exceeded 1 % of GDP. If this amount is excluded, defence spending fell markedly last year even in nominal rubles. However, the to-be-paid-off OPK loans in fact earlier came on top of the rapid growth in defence spending, especially during 2013–14.

The differences in defence spending numbers reflect the fact that SIPRI and IEP include items in other budget spending categories outside the budget's defence category such as domestic security, the economy and social security. IEP figures also include e.g. budget spending on earlier defence activities such as weapons destruction costs, which SIPRI does not treat as defence spending.

In SIPRI's international comparisons, Russian defence spending has grown rapidly in recent years. Spending in 2016 hit $69 billion. China's defence spending has also climbed briskly, even if the spending growth slowed last year to below 5.5 %. SIPRI estimates Chinese spending last year at $215 billion and says that its estimates for recent years have been running at about 1.5 times China's official defence budget. Even so, SIPRI noted that Chinese defence spending relative to GDP was still less than 2 %. China recently launched the first Chinese-built aircraft carrier.

SIPRI reports global military spending in 2016 reached nearly $1.7 trillion. US spending alone amounted to $611 billion, an increase after several years of decline. The US defence-spending-to-GDP ratio was 3.3 %. Growth in India's annual defence spending leapt to 8.5 %, putting it together with France as regards the nominal dollar level of spending. Both countries spent about $56 billion last year on defence, giving both a defence-spending-to-GDP ratio of just under 2.5 %. SIPRI reports that nearly all countries of Central and Eastern Europe, the Baltics and Ukraine have increased their defence spending rapidly in recent years. Defence spending also rose briskly in all but a few countries in Western Europe.

Russian defence-spending-to-GDP ratio, %



Sources: Russian finance ministry, SIPRI, IEP, Rosstat and BOFIT.

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160, FI-00101 Helsinki
Phone: +358 9 183 2268 • Web: www.bofit.fi/en

Editor-in-Chief Jouko Rautava• Email: Jouko.Rautava@bof.fi

China

China announces tax cuts but corporate taxation overall remains high. China's tax code reforms last year involved bringing the remainder of service branches under the value-added tax (see BOFIT Weekly 18/2016). At the end of April, the State Council announced the elimination on July 1 of the 13 % VAT category, which includes agricultural products and natural gas. Both product groups shift to the 11 % VAT category, and just three VAT categories remain: 6 %, 11 % and 17 %.

Tax cuts on small firms were broadened at the start of the year and the tax-deductibility of R&D spending by certain scientific and technology firms has been extended for three years. Firms with taxable earnings of less than 500,000 yuan a year are now eligible for a tax break that allows them to pay a 20 % corporate tax on half of their earnings. The earlier ceiling for taxable annual earnings was 300,000 yuan. Some other temporary tax break programmes also continue.

The government estimates that its announced reforms will reduce the tax burden on firms and individuals this year by 380 billion yuan and reduce various payments by a total of 200 billion yuan. In March, premier Li Keqiang said that the move from the business tax to VAT reduced the tax burden on firms last year by a total of 570 billion yuan (€76 billion). However, combined VAT and business tax revenues increased last year by 4 % to 5.22 trillion yuan.

While China's 25 % corporate tax rate does not differ much from other countries, companies operating in China encounter other charges and fees that raise costs. The World Bank estimates that China's total tax rate of 68 % of commercial profits in 2016 (when mandatory contributions are factored in) is one of the world's highest. The World Economic Forum global competitiveness report finds China's rank near the bottom for indicators relating to business tax rates and the amount of red tape involved in starting a business. The problem has gotten traction lately and firms have begun to express dissatisfaction with the current situation. In February, the State Council directed government departments to examine their fees and other costs imposed on firms and eliminate those they find superfluous. The government hopes to have a nationwide list of fees levied on firms by the end of the year, as well as clear rules on when such fees are mandated.

China's business environment increasingly challenging to American firms. AmCham China, the American Chamber of Commerce in China, released its annual report on the business climate for US firms operating in China. AmCham finds the current conditions exceptionally challenging for firms: political tensions between the US and China have increased over the past year, China's economic growth has slowed, and the investment climate has deteriorated. AmCham estimates that the pace of reform and opening up of China to the outside world have slowed. In addition, domestic firms are being supported by several government programmes, eroding foreign firms' room to operate.

AmCham said that all parties benefit when trade is as free as possible, business is based on market principles and firms have easy access to markets. The Chamber of Commerce hopes that China would open its markets even more to foreign entities and move ahead with talks on bilateral investment treaty. The report noted that US firms see China's unclear laws and inconsistent regulatory interpretations as one of the largest challenges facing US firms. AmCham proposes improving the situation through better information distribution on e.g. court rulings and official investigation reports, as well as clarification of customs and tax regulations. It also noted room for improvement in allowing firms to comment on draft legislation and regulations.

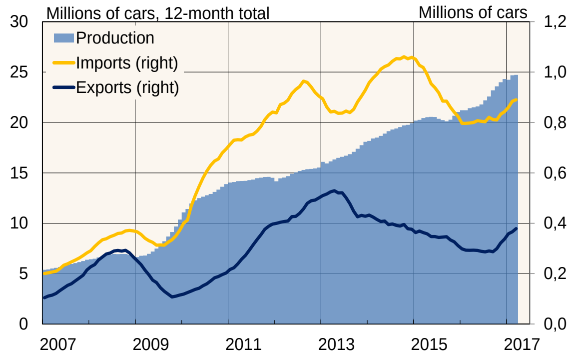
Lower growth of car production in China. In the first quarter of 2017, China produced 6.1 million passenger cars, an increase of about 7 % from 1Q16. The rate of production growth is slowing down, however. China last year produced nearly 25 million passenger cars and almost 4 million trucks and busses.

Car sales in the first quarter were up 5 % y-o-y. Chinese car sales and production go hand in hand as less than 2 % of production is exported and less than 4 % of cars sold in China are imports.

Part of the burst of growth in passenger car production and sales in the second half of 2016 reflected the known tax hike on January 1st 2017. As part of stimulus policies, small-engine car buyers were entitled to a tax break last year that meant they only paid a 5 % sales tax on the car. The sales tax is 7.5 % this year and 10 % next year.

Even if imported cars account for a tiny share of the Chinese market, foreign brands dominate the market. Less than half of cars sold in China are domestic makes. Foreign carmakers must engage in joint ventures with Chinese firm because foreign firms can only own up to 50 % of a production plant in China. Bloomberg reports that this limitation might be loosened as a part of efforts to make state-owned enterprises more efficient and response to pressures for open markets. The car industry's future is further affected by planned producer-specific minimum quotas for electric vehicles.

China's annual passenger car production and foreign trade



Source: CEIC.

Bank of Finland • Institute for Economies in Transition, BOFIT
P.O. Box 160, FI-00101 Helsinki
Phone: +358 9 183 2268 • Web: www.bofit.fi/en

Editor-in-Chief Jouko Rautava• Email: Jouko.Rautava@bof.fi