

## ***From Russia, but Without Love: Capital Flight Soars in 2011***

**In early January, Russia's Central Bank estimated that net capital outflows reached \$84 billion in 2011, up 150% from 2010's \$33.6 billion, drawing attention to the quality of the country's business climate and the integrity of reforms and progress already made.**

### *Monthly Overview*

For many investors willing to look beyond the headlines and business climate rankings (the country currently ranks 120 in the World Bank's Doing Business Survey), Russia is a potentially attractive place to invest. With world demand for energy and food forecast to grow over the next decade while traditional global suppliers have little room for further expansion, Russia is well positioned with abundant energy and natural resource supplies and room for further expansion in agricultural output. The country also has a large, educated, population that can provide valuable labour resources as well as consumer markets with growing disposable income especially hungry for commodities after decades of suppressed demand due to the hardships associated with transition. Inflows of investments have grown significantly from a low of \$1.9 bln in 1999 to as high as \$214 bln in 2007 and although the 2011 figure was lower at \$65.8 bln, it was still 54% higher than in 2010.

For other investors, however, Russia remains too great a risk despite this potential. Business climate conditions such as fair treatment, red tape and administrative barriers, corruption and insecure property rights continue to be cited, for example, as increasing the risk and costs of doing business in the country relative to other destinations, even those with less potential for growth. While inflows have grown dramatically over the past 12 years, so too have outflows. They rose from \$11.8 bln in 2001 to as high as \$229 bln in 2008. In 2011, outflows were lower at \$136 bln, but were nevertheless nearly 100% higher than they were in 2010 (see Figure 1 in Indicators).

Concern over capital flight is not a new issue for Russia. Since 1994 capital outflows have generally been higher than inflows and net outflows have averaged about 4.6% of the country's GDP (Figure 2). The estimate for 2011's net capital outflow according to the Central Bank is \$84 bln, up nearly 150% over 2010, but still well below the \$133.7 bln in 2008. Further, net outflows are likely in large part due to a favourable current account balance, strong rouble, increased lending abroad and international investors re-allocating funds to deal with asset issues at home and sheltering investments in lower risk environments as well as successful Russian investors taking advantage of opportunities elsewhere.

The real concern related to the quality of the business climate is not so much that net capital outflows exist, but that they are sensitive to political uncertainty. Towards the end of 2011, especially in the fourth quarter, they rose by \$36 bln. Large and consistent net outflows which intensify during periods of political instability draw attention to two core business climate issues. First, that the potential of the Russian economy is not enough to attract and retain investment flows. Second, that many investors worrying about the outcome of an election and responding by withdrawing capital indicates that much of the progress that has been made in reforming the business climate lack integrity; they depend more on the specific people in charge rather than a guarantee that these changes are here to stay, regardless of who is in power.

Aiming to improve Russia's business climate is one thing, making the reforms stick is another and appears to remain a significant challenge ahead.

### *Monthly Highlights*

BCDM's highlights aim to provide a brief summary of announcements related to new investment activity that can reflect changes in the quality of Russia's business climate from one month to the next that could be overlooked in less frequent or more aggregate reports.

***Announcements related to new investment activity continued to be dominated by the energy sector in January followed by the auto sector, transportation, tourism along with some activity across other sectors.***

### **Energy**

- **South Stream:** President Medvedev expressed hope that the **South Stream Project** would get a new breath after Turkey gave its final approval while PM Putin announced intentions to speed up the construction of the pipeline to begin at the end of 2012 instead of 2013.
- **The Global Environment Facility** intends to invest up to \$2.5 mln to develop pilot energy savings projects in Russia in 2012.
- **New Investment:**
  - **Gazprom** announced its intention to expand in the German market to not only supply gas, but also start energy business and along with **Royal Dutch Shell PLC** and **Mitsui & Co** (partners in the Sakhalin-2 project) may invest between \$ 5 and 7 bln to expand the joint venture's liquefied natural gas plant off Russia's Pacific coast and will make a decision this year whether to add a third train to the LNG plant which would allow start up between 2016 and 2018;
  - **LUKoil** expects to invest about \$ 1.3 bln between 2012 and 2022 in its Arctic venture with **Bashneft**;
  - **Novatek**, Russia's largest independent gas company, and **Gazprom** are considering a joint venture to produce liquefied natural gas at the Yamal peninsula and are considering increasing LNG production near Sabetta port;
  - **Zarubneft** intends to invest about EUR 1 bln in Croatia over the next five years and implement three joint projects with Croatia's **Jadranski Naftovod**;
  - **Alliance Oil** company plans to invest \$ 380 to 450 mln in oil production in 2012 and another \$490 to 540 mln in the refining industry;
  - **Intertekhelectro** and Germany's **SoWiTec International GmbH** agreed to set up a joint venture to build the first wind power plant in Russia's Urals Federal District in Shumikhinsky in the Kurgan region with a capacity of 50 megawatts;
  - **Kazan Motor Production Association** agreed to create a joint venture with Uzbekistan's gas company **Uzbekneftegaz** to produce gas pumping facilities in the first half of 2012.

### **Autos**

- With Russia expected to become Europe's largest car market by 2014, **GM** announced that it expects to invest \$ 1 bln within the next five years to double its car output by 2015. GM intends to increase production from 232 000 cars (2010) to 520 000 by 2015. **Ford** expects car sales in Russia to rise potentially to 140 000 in 2012 and plans to increase output by 20% this year to 119 000 at its joint venture plant with **Sollers** in Vsevolozhsk in the Leningrad region.

- Although no investment sum has yet been disclosed, the German **Johnson Controls** is considering constructing an auto-chairs plant in Nizhni Novgorod once an appropriate site is found.

### Transportation

- The Russian Railways Monopoly **RZhD** announced that it plans to invest RUR 11 bln in railway infrastructure to prepare to the 2013 Summer Universiade in Kazan. RUR 700 mln is planned for the reconstruction of Kazan's main railway station and another RUR 2 bln for a link with the airport terminal and a further RUR 6 bln to reconstruct two links. **RZhD Logistika**, a unit of the company, also announced its intention to establish a joint venture, **EuroRail Trans**, with Latvia's **Transtrade Riga** to transport cargo.
- Japan's **Mitsui&Co** and Russia's **ICT Group** have agreed to invest an initial estimated \$ 100 mln to establish a joint venture with headquarters in Moscow to lease freight cars with a prospective launch in April 2012.

### Tourism

- *North Caucasian Tourism Cluster*: tourism is expected to grow in resorts in the North Caucasus to 40 000 people per day by 2018, which is expected to require modernization of existing airports and the construction of four new ones in Zelenchukaskaya village (Karachai-Circassian Republic), Mamison (North Osetia), Matlas and Derbent (Dagestan). The resorts' territory has also been expanded to include the Caspian shore of Dagestan and Ingushetia's mountain ranges into the cluster. The **Nafta-Moskva** company plans to invest RUR 40 bln in Dagestan while **Akropol** investment company will invest a total of RUR 27 bln to develop two resorts in Ingushetia ( RUR 18 bln and RUR 9 bln, respectively).
- **Sberbank Capital** plans to invest RUR 1.43 bln in the Republic of Altai's Manzherok ski resort to finance a project that the owners hope to complete by 2015.

### Agriculture

- Dairy Farming: Russia's **Rusmolco** and Singapore's **Olam International** are planning to invest up to \$700 or 800 mln to develop a joint venture in dairy farming in Russia. Denmark's **Arla Foods** and Russia's **Molvest** have agreed to establish a joint venture in cheese production in the Voronezh region under the Arla Natura brand which is expected to be launched in early 2013 and reach an annual cheese production level of 6000 tonnes per year in 2014 with future production to grow to 12000 tonnes. The investment is estimated at RUR 500 mln.

### Non-energy sector investment activity

- *Several investment plans in consumer retail were announced:*
  - **X5 Retail Group** has decided to change the format of its **Karusel chain**. Stores cannot exceed 4500 m2. Stores above this limit will be sold. The company also plans to invest upto \$ 2bln to construct 1mln m2 of new storage facilities and is seeking partners for construction of distribution centers;
  - **OOO Pavlovskaya Sloboda**(trademark Velkom) has launched a chain of fast food restaurants and plans to open at least 5 cafes in 2012;
  - **OAo Magnit's ZAO Tander** plans to develop a Magnit cosmetics chain and open 550 cosmetic stores in 2012;
  - **Finn Flare**, a Finnish clothing brand, plans to open 40 new stores in Russia, Kazakhstan and Ukraine in 2012 to increase the size of the network to 411 outlets;

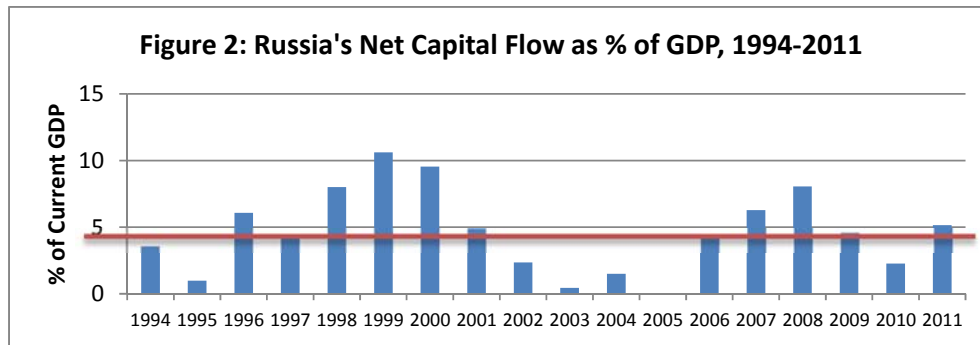
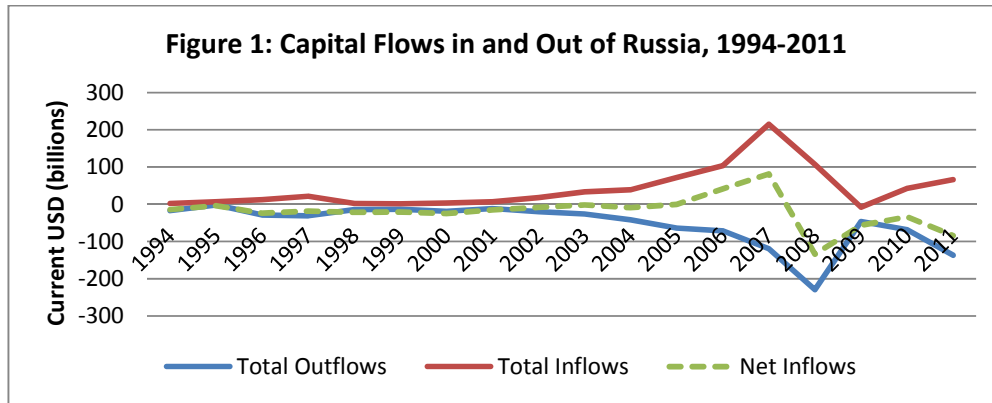
- **Subway**, a fast food chain, doubled the number of outlets in 2011 to 322 after opening 155 new ones and plans to open 210 more in 2012;
- **Igor Yakovlev**, a Russian businessman who founded electronics and household appliances chain Eldorado, plans to invest \$ 150 mln to create a new chain of shoe stores in Russia, Poland, Ukraine and Kazakhstan featuring “affordable shoes” and expects to open 150 stores by the end of 2012. Stores are projected to be 300 m2 on average.
- **Pepsi Co** will restore construction of non-alcoholic drinks plant in Novosibirsk region in 2012.
- **RR Donnelley**, a global provider of integrated communications, plans to construct a printing plant worth RUR 500 mln in a special economic zone in Alabuga (Republic of Tatarstan, RF).
- **Severstal** plans to construct a \$ 600 mln iron plant in Trinidad and Tobago with local partners.

### *Business Climate Indicators*

BCM’s indicators aim to provide a monthly snapshot reflecting important trends and changes in Russia’s business climate. This second issue provides a glance at capital flows.

**Despite the fact that net capital outflows from Russia have not increased much in 2011 relative to GDP, the sensitivity of investment flows to political uncertainty indicates investors’ concerns over the strength of business climate progress already made and whether conditions will continue to improve.**

- Both capital inflows and outflows grew in size roughly from 2001 to 2007 and 2008 before contracting significantly following the recent financial crisis (Figure 1).
- Net outflows of capital have been normal for Russia except for a brief period between 2005 and 2007 (Figure 1) and have averaged 4.6% of GDP (Figure 2).
- The recent increase in net capital outflows to \$ 84 billion is in part likely due to current account surpluses (net exports), developed countries re-allocating funds to deal with asset crises at home and/or seeking less risky investments, as well as Russian businesses and funds taking advantage of a relatively strong rouble and opportunities abroad.
- However, the intensification of net outflows in the fourth quarter of 2011 have also been associated with political instability with some investors holding off until after the 2012 elections and domestic investors sending funds abroad for safety reasons until after the election outcome is known.
- This extra effect is an important robustness indicator, or stress test, raising concern over how secure the business climate really is; investors are concerned about who is in power rather than trusting the fundamental government institution’s integrity itself to protect the business climate regardless of who rules.
- There is a need to address the integrity of government institutions such that the quality of the business climate depends less on political outcomes.



*BCDM's Next Issue*

**The next issue will focus on Russia's Outlook. Issue 3 will also add monthly highlights summarizing the treatment of investors and questions from readers.**