Setting the Target Beyond Growth

Early in 2013, Russian Prime Minister Medvedev announced a target of 5% GDP growth per year. While this ambitious target can help stimulate a much needed discussion about how the country can achieve this target, there is a need to go beyond simple growth targets to stimulate, identify, prioritize and implement business climate reforms.

Monthly Overview

Between 2000 and 2012, Russia's economy grew on average by 4.7% per year (in real terms at constant 2008 prices, see Figure 1 in ***Indicators*** below). Earlier this year, Prime Minister Medvedev, announced a target future growth rate of 5% per year. This target, however, looks increasingly more difficult to achieve. The previous growth of 4.7% was during a period of high resource prices coupled with the country's bountiful resource endowments, better market conditions in the developed economies, and rapid growth in global FDI flows, of which Russia took a growing share (from 0.25% in 2000 to almost 4% by 2011). With a slowdown in the EU, lower investment inflows, lower commodity prices, Russia is still forecast to grow, but well below target at just over 2% or so (again, see Figure 1 below).

This growing gap between the ambitious target announced by Russia's PM and forecasts by the IMF, among others, and Russia's own Ministry of Economic Development (most recently, 2.4% in 2013) could, however, have a silver lining. The setting of a target above forecasts could stimulate a much needed discussion about the levers of economic growth and what Russia needs to do to improve performance. Given that the past growth rate of 4.7 % was achieved during high energy prices while the business climate continued to rank among the bottom across indexes, such as in the World Bank's *Doing Business Index* and the World Economic Forum's *Global Competitiveness Index* out of the transition economies, this context might finally direct attention to reforms that are needed to improve efficiency, attract and retain investments and, overall, support growth and development if this target is to be realistically achieved. This is especially true given the lack of alternatives in a situation where the country has potential outside of energy, raw resource prices are unlikely to continue to provide the growth stimulus they once did, and the government's budget, reliant as it is on energy rents, needs to look elsewhere for financial sources.

The silver lining in this 5% target comes with a downside, however. Setting a simple target of 5% growth is not enough to support business climate reforms. Just as past performance has relied on conditions well outside the country's control, such as global energy prices and investment flows, getting close to target could happen "by accident" if these conditions were to improve. This could provide the government with yet another opportunity to avoid making the tough decisions it needs to when it comes to improving the country's business climate - much as it has done in the past. In other words, the setting of this target comes with a *risk of complacency* should the GDP forecasts improve for reasons other than policy reforms.

To ensure that the country remains focused on business climate reforms, setting targets has to move beyond simple growth and involve other outcomes. Improving the business climate should aim, for example, to improve employment prospects, attract and retain FDI, diversify the economy beyond energy, improve labor productivity across sectors and regions, reduce poverty, diversify government revenues, in addition to many others (see BCDM's upcoming *Semi-Annual Report* for more details). Being explicit about the desirable targets the country should aim for should not only reduce the risk of complacency involved with GDP growth targets, but it should also help to identify and prioritize reforms across sectors, activities and regions as well as monitor and evaluate progress. It should also support recognizing successful reforms and policies where and when they happen as well as sorting out successful approaches from the less successful where policy experiments are underway.

Although setting an ambitious growth target of 5% could help stimulate much needed business climate reforms, a broad, well-designed, extensive list of desirable outcomes is also needed to avoid the risk of complacency, should growth prospects improve, as well as identify and support specific reforms across sectors and regions if the country is to achieve its fuller potential.

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.

In April, New Investment Announcement activity as noticeably down particularly with no new announcements in Agriculture and a noticeable decrease in Retail. Outward announcement activity, however, was up.

Energy

- *Exploration*: **Gazprom** and **Shell** intend to invest in jointly exploring the Russian Arctic shelf and work on two blocks, one where the Chukhotka and East –Siberian Seas meet and the second in the Pechora Sea while **Lukoil** plans to invest $ 3 bln to drill the Filanovsky deposit on the Caspian Sea with a recoverable deposit estimated at 153.1 mln tons of oil and 32.2 bcm of gas;
- *Power Plants*: **Verkhne-Volzhskaya Generating Co.** plans to invest RUR 28.68 bln to construct a combined cycle gas turbine thermal power plant in the Nizhni Novgorod Region's Kstovsky district with a capacity of 900 MW with first and second stages to be launched in 2016 and 2018;
- *Liquefied Natural Gas (LNG):* **Rosneft** and **Marubeni Corp** intend to invest in the construction of an LNG plant in the Far East as well as the exploration and development of oil and gas fields, **Exxon Mobil Corp** and **Rosneft** are considering investing $ 15 bln to construct an LNG plant on Russia's Pacific Coast while **Yamal LNG** along with France's **Technip** and Japan's **JGC** are planning to invest in building an LNG plant on the Yamal peninsula with a capacity of 16.5 mln tons;
- *Gas supply*: **Gazprom** will invest RUR 1.9 bln in developing a gas supply network in the Tambov Region in 2013 and will invest a total of RUR 4.5 bln by 2015 to reach the demand of all the regional customers;
- After acquiring the company for $2 bln to stabilize and increase production, **Lukoil** will invest $ 1 bln in Samara-Nafta to increase oil production between 5 and 7 % during the next five years from 2.5 mln tons per year;
- **Mitsui** and **Rosneft** intend to invest in developing the Eastern Petrochemical Company and its complex to process about 3.4 mln tons of hydrocarbons and 2 mln tons of ethylene and propylene per year in the Far Eastern city of Nakhodka to be launched in 2017;
- **Kuzbass Fuel Company** has increased its investment program for 2013 by RUR 456 mln to RUR 956 mln in part due to changes in the global steam coal market;
- **Rushydro** will invest in creating four companies for power construction projects in the Far East (a thermal power plant in the Khabarovsk Region's city of Sovetskaya Gavan, Sakhalinskaya GRES–2 plant, Yakutskaya GRES-2 plant, and Blagoveshchenskaya thermal plant);
- **Rostec** and **Royal DSM** are exploring investing in the production of biofuels and bio-based products such as bioethanol, biogas and organic acids.

Autos and Aviation

- *Tires*: **Bridgestone** will invest RUR 12.5 bln to build a tire plant in the Zavolzhye industrial zone in the Ulyanovsk Region to start operations in 2016 and reach a capacity of 4.4 mln winter tires in 2018 while **Rosneft** and **Pirelli** will invest in the construction of a Pirelli's Premium tire store in Sochi to be completed in Q4 of 2013;
- **RUSAL** and **Omen High Pressure Die Casting** plan to invest in a joint venture to produce aluminum auto components to be located in one of RUSAL's Aluminum West Division smelters.

Metals, Minerals and Mining

- **Tuva Energy Industrial Corp**. plans to invest in developing the Elegest coal deposit after acquiring a license for a starting price of RUR 547.835 mln;
- **Uralkali** will invest $ 5.8 in capacity upgrades to reach 19 mln tons by 2021;
- **Danieli** is planning to invest RUR 3.1 bln into launching a metallurgy equipment production plant in Nizhni Novgorod Region during the summer of 2013;
- **RUSAL** and **Chalco** are considering investing in an aluminum smelter in Siberia;
- **KuibyshevAzot** and **Commercium Immobilien und Beteiligungs** are planning to invest an estimated EUR 200 mln to establish a joint venture, Linde Azot Toliatti, for the production of ammonia and hydrogen facilities with a capacity of 120 000 Nm3/h of hydrogen and 1 340 t/d of ammonia;
- South Korea's **SeAH Group** and **En+ Group** plan to invest in the development of the Agasky copper and Molybdenum deposit in the Republic of Khakasia;
- **Intergeo** intends to invest an estimated RUR 47 bln to launch operations at the Kingash cobalt, copper and nickel deposit in the Krasnoyarsk Region in 2016;
- South Korea's **KOWEP** and Russia's **Rosengineering** plans to invest RUR 18 bln to build a coal terminal in the Primorsk Region port with an annual capacity of 20 mln tons of coal with federal development infrastructure investments estimated at RUR 3 bln.

Transportation and Infrastructure

- *Rail Cars*: Canada's **Bombardier** and **Uralvagonzavod** are considering investing in producing high-speed streetcars, **Transmashholding** and **Alstom** plan to invest in a joint venture to produce electric trains for the Moscow Ring Road, **Kirovsky Zavod** and **Scoda Transportation** plan to invest about RUR 600 mln in a joint venture to produce metro cars, trams, and suburban trains while **Russian Railways**, **Sinara Group** and **Siemens** and planning to invest in manufacturing locomotives at the joint venture Urals Locomotives plant;
- **MTS** will invest RUR 1.7 bln in infrastructure development in the Republic of Bashkortostan in 2013-14 with upgrades to its 3G networks and expansion of fiber-optic communication lines with plans to launch a 4G LTE wireless network in the region in 2013;
- **AFK Sistema** plans to invest $ 415 mln to restructure **Shyam TeleServices Ltd**. in 2013 and under $ 250 mln per year into SSTL in 2014-15;
- The **German Energy Agency** and **Integrated Energy Systems** plan to invest in developing a heat supply system in Yekaterinburg;
- **Sistema** intends to invest in a joint venture focusing on the transportation of LPG by the end of June with Financial Alliance;

- The **Russian Government** intends to invest RUR 260 bln into RZhD, Russian Railways, to upgrade the Trans-Siberian Railway and Baikal-Amur mainline in 2013-17;
- **Voronezh Logistic Company** will invest RUR 6.5 bln in a logistics complex in the city of Voronezh beginning construction in 2013-14 to reach capacity in 2016.

Agriculture

- *No New Investment Announcements tracked in agriculture for April*

Other Non-energy Sector Investment Activity

- **Shvabe**, an optical device holding company, plans to invest RUR 60 bln in its development by 2020 and expects its revenue to triple to RUR 90 bln in 2013;
- *A number of investment plans in consumer retail were announced*:
    - **Vseinstrumenti.ru**, a Russian online tools retailer, plans to invest $ 100 mln to expand its regional footprint and improve its IT and marketing strategy;
    - **Detsky Mir** plans to invest in opening 45 new stores in 2013 and another 40 each year until 2015.

Outward New Investment Announcements

Outward New Investment Announcements in April were noticeably up as well as diverse (including outside energy) including in retail, infrastructure projects and communications.

- ***Gazprom*****:** plans to invest RUR 32.6 bln during the next three years to develop Iraq's Badra oil field, plans to invest with EuRoPol Gaz to construct a second line of the Yamal-Europe pipeline through Poland to Slovakia and Hungary to be completed in 2018-19, is considering investing with Egyptian energy companies to expand LNG supplied to international markets, conduct geological research and development of hydrocarbon fields, is prepared to invest in a regasification plant and pipelines in Japan, and, pending the reaching of an agreement, the company may invest an estimated $ 631.6 mln to modernize, develop, and take over Kyrgyzstan's gas network;
- *Retail*: **Gloria Jeans** is considering investment in expansion into markets in the US, China, Turkey and Iran and plans to expand its chain from 550 outlets to 1000 by 2017 while Melon Fashion Group is planning to invest in opening an additional 10 stores in Kazakhstan after investing $ 100 000 in its first one.
- *LNG*: **Rosneft** plans to invest in **Exxon Mobile's** construction of an LNG plant in Alaska,
- *Diamonds*: **ALROSA** intends to invest in a joint venture for prospecting and geological exploration in African countries, and in particular, with one JV with ENDIAMA E.P. for projects in Angola;
- Rails: **The Federal Passenger Company**, a unit of Russian Railways (RZhD), plans to invest in a joint venture with Germany's **Deutsche Bahn** and France's **SNCF** to develop its business in Europe and expects to launch 200 new RIC class rail cars by the end of 2014 while **RZhD** plans to invest an estimated $ 800 mln in upgrading projects in Serbia;
- *Fuel and Gas Stations*: **Rosneft** plans to invest in opening an office in Kyrgyzstan and supply fuel to the Manas airport as well as developing construction plans for fueling stations there and at the Osh airport;
- *Nuclear Power*: **Russia** may take part in an estimated $ 20 bln investment to construct a nuclear power plant in Turkey in 2015 pending receiving a license with a capacity of 4.8 GW;
- **Rusal** plans to invest in the re-opening of two plants in Jamaica within three years;

- **Akado Group**, a broadband internet access and cable TV services provider, plans to expand its business to South Africa and Mozambique in partnership with **Afritel**;
- **Rushydro** and **Kyrgyz Hydro** may invest $ 425 mln to construct a hydro complex over two and a half to three years;
- **RAO ES Vostoka** plans to participate in a RUR 5.6 bln investment to construct a bridge that would connect the Khabarovsk Region with Japan;
- **Rosneft** will invest in the creation of a joint venture in Armenia with **Oil Tekhno** to operate in the field of oil product marketing and supply with expectations that this will include jet fuel, gasoline, diesel fuel, all much needed in the country;
- **Zarubezhneft** will invest with **Petrovietnam** to develop the '42' gas block on the Vietnamese shelf through their joint venture, Vietsovpetro.

Business Climate Indicators

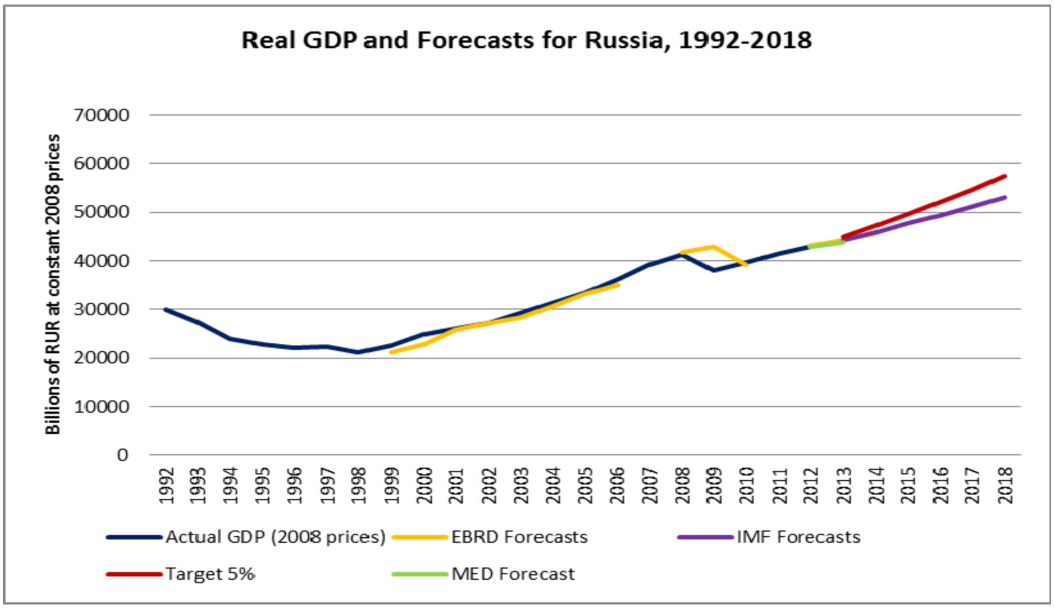
BCDM's indicators aim to provide a monthly snapshot reflecting important trends, challenges, and changes related to Russia's business climate.

Russia is generally forecast to grow through to 2018, however, the forecasts are lower than the 5% target announced by Prime Minister Medvedev earlier this year. Although this could provide the context to consider business climate reforms as a lever to achieve these targets, there is a considerable risk of complacency if growth is achieved due to changes in global market conditions.

- Figure 1 below shows Russia's real GDP from 1992 through to 2012 (in dark blue); at constant 2008 prices. It also shows the one year forecasts for the country's real GDP from the EBRD for 1999 to 2014 (in yellow), the IMF's latest forecasts for 2013-2018 (in purple), and the latest forecast from Russia's Ministry of Economic Development for 2013 (in light green).
- The target of 5% growth per year announced at the beginning of 2013 by Prime Minister Medvedev is represented by the bright red line from 2013 through to 2018. It shows where Russia's GDP should be each year if the target were to be achieved.
- One of the first striking features of this graph is that although growth is forecast to be positive to 2018, the gap between the target of 5% announced by the government and the mid-term forecast by the IMF appear to widen over time. This suggests that it is anticipated that it will be increasingly more difficult for Russia to achieve this target level of GDP as time goes on. The forecast for 2013 by Russia's Ministry of Economic Development appears even less optimistic and thus, suggests that this target will be even more difficult to achieve than the IMF foresees.
- The second feature is the affect of the global financial crisis on Russia's economy. After the severe downturn in the 1990s, Russia grew at a strong pace up to 2008 and before the crisis, was forecast to continue at this high pace; achieving roughly 2011's level of output in 2008. Note that the EBRD's forecasts, for 2009, made in 2008 showed that they expected Russia to grow even further when the country experienced, in fact, a decline. This is highlighted by the yellow line going above real GDP for that year.

- Likewise, before oil prices rose significantly, the EBRD's forecasts, the yellow line, were below actual GDP in 1999 and 2000. The growth potential was underestimated due to unforeseen oil price increases.

Figure 1



Sources: Real GDP in Rubles at constant 2008 prices from 1992 to 2012 were obtained from the IMF's World Economic Outlook database as well as forecasts to 2018, EBRD forecasts were obtained from the EBRD's Transition Reports when available (except 2007 and 2011) and the Ministry of Economic Development of the Russian Federation for the 2013 forecast as of April, 2013.

- The third noted feature is the forecast for 2013 from Russia's Ministry of Economic Development. It is even lower than the IMF's forecast and likely indicates a growing awareness of the need to look closely at where the country's levers for growth might be hidden (where performance could be improved!) if the country is to aim, realistically, to achieve the 5% growth target.

- Although setting ambitious targets can provide the type of stimulus needed for identifying and implementing reforms, getting the target(s) right is also crucial. Russia's GDP performance has been influenced by several major factors in this graph since 1992: namely, the severe pains of early transition followed by high resource prices coupled with the country's resource endowments through to the downturn in the West. Differences in forecasts also highlight many factors outside of the country's control, such as volatility in energy and agricultural prices, investment flows, and the state of the EU's economy.

- In other words, Russia's GDP performance has depended on many factors beyond the country's control and it will continue to be influenced by global market conditions. There is a chance that the growth target could be achieved, or close to being achieved, by accident rather than through policies supporting growth, or vice versa. If global market conditions improve, there is a risk of compacency in that Russia could ignore the issue of the quality of its business climate and continue to rank among the worst performers out of the transition economies across indexes much as it has during period of high energy prices for the past 12 or so years.

Although the gap between expected performance and the 5% target could provide Russia with a stimulus to implement much needed business climate reforms as an important lever to support growth, the concern here is that other conditions could change for the better, such as energy prices, allowing the country to close in on its target and, at the same time, generate complacency when it comes to the reform agenda. Being more specific about a wider array of desirable outcomes (targets) such as productivity, employment, diversification, investment inflows, exports, across sectors and regions will help to counter this risk of complacency at the same time as providing a stimulus to identify, prioritize, monitor and evaluate progress over time when it comes to business climate reforms.

The First BCDM Semi - Annual Report

Our first Semi-Annual report, to be released at the St Petersburg International Economic Forum in June, will look more closely at specific outcomes and targets beyond GDP growth to support improvements in Russia's Business Climate.