

Missing from the Ballot: Russia's Business Climate Reforms

If President-elect Putin's speech at the Russia Forum this past February is an indication of what's to come after the election in March, improvements in Russia's Business Climate are on the agenda.

Monthly Overview

Since 1999, Russia has made significant advances in terms of economic growth and attracting investment flows, FDI in particular. After nearly a decade of decline and attracting well below 1% of world FDI flows (except for 1% in 1997), Russia's economy has grown on average by a compound annual rate of 5.3% during the past 12 years and now manages to attract just over 3% of world FDI flows annually.

Russia's December 2011 parliamentary elections, however, shed considerable doubt about the integrity of Business Climate reforms already made. Despite an abundance of natural resources, growing consumer markets, and a well-educated labor force, net capital outflows were estimated to have increased significantly during the fourth quarter (- \$36 bln) in part due to political uncertainty. That investors, both domestic and foreign, would choose to invest in other relatively less attractive countries based on who was in power rather than relying on government institutions already in place indicates that much more needs to be done to increase trust in the quality of the system.

The March 4th presidential election returned Putin to the presidency for an additional 6 year term, having served already from 2000 to 2008 and then as Prime Minister during the past 4 years. Although this removes the question of who will be in charge in the near term, pending unforeseen changes or protests, it raised another about the reform agenda moving forward and, in particular, what is on it when it comes to Russia's business and investment climate.

During the Russia Forum, held between February 2nd and 4th only the month before the election, Putin gave a speech that provided some clues. Russia currently ranks 120 out of 183 countries surveyed in the World Bank's Ease of Doing Business Index, up from 123 a year before, but still remaining one of the lowest ranking transition countries amongst those in Eastern Europe and Eurasia in terms of opening and operating a business locally. Only Bosnia and Herzegovina (125th), Tajikistan (147th), Ukraine (152nd), and Uzbekistan (166th) ranked lower. Putin, PM at the time, stated that this was unacceptable for a country like Russia and set an ambitious goal of climbing 100 spots to 20th place while mentioning several steps underway to help achieve this goal ranging from establishing an institution to defend businesspeople to harmonizing simplifying legislation. This follows almost a year after the creation of the Agency for Strategic Initiatives, one of whose tasks is to support improving the business climate in Russia.

There are recent examples that this ambitious target is within reach. Georgia ranked 100 in 2006, but in the most recent Index, climbed to 16th place. The FYR of Macedonia currently ranks 22nd, up from 34th only the year before, and the Baltic countries, Latvia (22nd), Estonia (24th) and Lithuania (27th) are in similar positions. Although the conditions, costs and benefits of reform packages needed to improve ranks are specific to each country and time period, these examples suggest that a country like Russia could and should be doing better.

Although introducing reforms to improve Russia's Business Climate will require a sustained commitment from the government, the Kremlin in particular, and will involve energy, time, effort and resources to identify, prioritize and implement reforms, *staying* in 120th place is also costly. It would mean Russia's continuing to perform below its potential, attracting and retaining less investments, continued inefficiencies, poorer labor market outcomes, lower growth, and ultimately prosperity.

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.

After being dominated by the energy sector during the first two months of 2012, new investment activity announcements in March were more concentrated in Russia's retail sector.

Energy

- **Green Energy:** Russia's largest electrical engineering manufacturer, **JSC Energovypryamitel**, has signed a memorandum with German **REFUSol** to construct a JV plant in Saransk that will produce solar power modules although no investment sum was disclosed;
- **LUKoil** plans to invest \$ 125 bln within 10 years in exploration and production;
- **Enel**, an Italian energy company, plans to invest about EUR 1.2 bln by 2017 focusing on modernizing existing facilities in Russia although it also sees potential in building a new gas vapor unit in Russia.

Autos

- **Fiat-Chrysler** is considering investing RUR 32 bln to construct a car plant in St Petersburg with a capacity of up to 120 000 Jeep cars p.a.;
- In order to increase sales figures in Russia, **Nissan** plans to re-launch its low budget Datsun model assembly line and expects to sell about 100 000 Datsun cars p.a. by 2016;
- **Sberbank** and **ZIL** car manufacturer plan to set up a joint venture in Moscow to produce some 200 000 cars and light trucks annually with possible partners, such as Fiat, Kia and Hyundai. The value of the investment has been estimated at \$350 mln.

Metals and Mining

- **Danieli**, an Italian industrial company, is planning to construct a plant in the Nizhni Novgorod region with a launch in May, 2013, to produce equipment for the metals industry in two stages, the first estimated at EUR 35 mln;
- China's **Zijin** is going to invest RUR 3 bln to extract metal ores in the Tuva region between 2012 and 2014;
- France's **Imerys Group** is planning to invest EUR 10 mln to construct a mineral substances plant in the Rostov region.

Transportation and Infrastructure

- **Smart City:** Russia's constituent Republic of Tatarstan plans to invest up to \$1 bln to construct a 350 hectare exhibition and business center near Kazan, called Smart City, with an initial government injection of RUR 50 to 100 mln;
- **NCSP**, Russia's Novorossiisk Commercial Sea Port, plans to allocate \$1.2 bln for investment projects by 2020, of which \$350 mln would be used to construct a container terminal and another \$250-290 mln for an iron-ore and coal handling terminal.

Agriculture

- **Milkiland**, a dairy producer operating in both Ukraine and Russia, plans to invest up to EUR 15 mln to construct two dairy farms with a capacity of 3000 heads of cattle each in 2012;

- **VTB Capital** is planning to invest \$ 500 mln to develop new agribusiness projects.

Non-energy sector investment activity

- *Pharmaceuticals:* **Rusnano** and **Domain Associates** intend to invest \$380mln each into development, production and promotion of drugs and medical devices, of which \$95mln each will go into production in Russia and the remaining share into 20 American biotechnical companies;
- *Financial Services:* After receiving its banking license, **Merrill Lynch** plans expand its Russian operations to cover banking services, no investment sums have been disclosed;
- *Logistics:* **Lenta**, a Russian supermarket chain based in St Petersburg, plans to invest \$50 mln to build a logistics center in the Moscow region with plans to open its first supermarket in the region;
- Tourism: **Grinn**, a Russian multi-industry corporation, plans to invest RUR 10 bln into multifunctional tourist resort in Oryol;
- *A number of investment plans in consumer retail were announced:*
 - **Samsung** will open retail sections in 2000 MTS stores in 2012 while the two companies plan to jointly open 10 official Samsung stores in Russia
 - **Euroset**, Russia's largest cell-phone retailer, currently operates 5260 stores in Russia and plans to open 800 more in the country in 2012;
 - **Billa**, a food retailer, currently operates 73 supermarkets in Russia and plans to open 20 more in 2012, up from the 7 new openings in 2011;
 - Spanish clothing retailer **Mango** plans to increase the number of its outlets to 125 in Russia in 2012 by opening 25 to 30 new stores;
 - **Leroy Merlen**, a French retailer, plans to open 6 new malls in Russia in 2012, the investment sum has not been disclosed;
 - **OBI**, a German retailer, plans to open on average 4 new malls in Russia p.a.;
 - Russia's third largest food retailer **Dixi** plans to open 250-300 new shops in 2012 with future plans of 400-500 new shops annually from 2013 onwards, depending on favorable financial conditions.
 - Russia's **36,6** pharmacy retailer launched a new chain of low cost pharmacies under the LEKO brand;
 - Russia's **Ideas4retail** firm received a license from U.K.'s Hamley's Toys to open its first Hamley's outlet in Russia in Moscow in May with plans to open 6 more Hamley's in major Russian cities as well as plans to invest RUR 300mln to open 50 toy stores in Russia by 2014.
 - Within 2-3 years, **McDonald's** is considering opening over 20 restaurants in Novosibirsk, Omsk, and Tomsk and further plans to open a production and logistic center by 2014 in the Novosibirsk region.
 - **KupiVIP.ru** is going to invest \$50 mln in a new internet store, ShopTime.
 - Pending the Moscow region's government's construction approval, **Alye Parusa** intends to open 30 stores in the region within 2 years.
 - **Megafon**, a major Russian mobile operator, plans to increase its own monobrand cell phone stores by 450 to 2000 in 2012.

Outward FDI

Announcements related to Russia's investments outside the country in March were focused on railways, the energy sector and metals and mining.

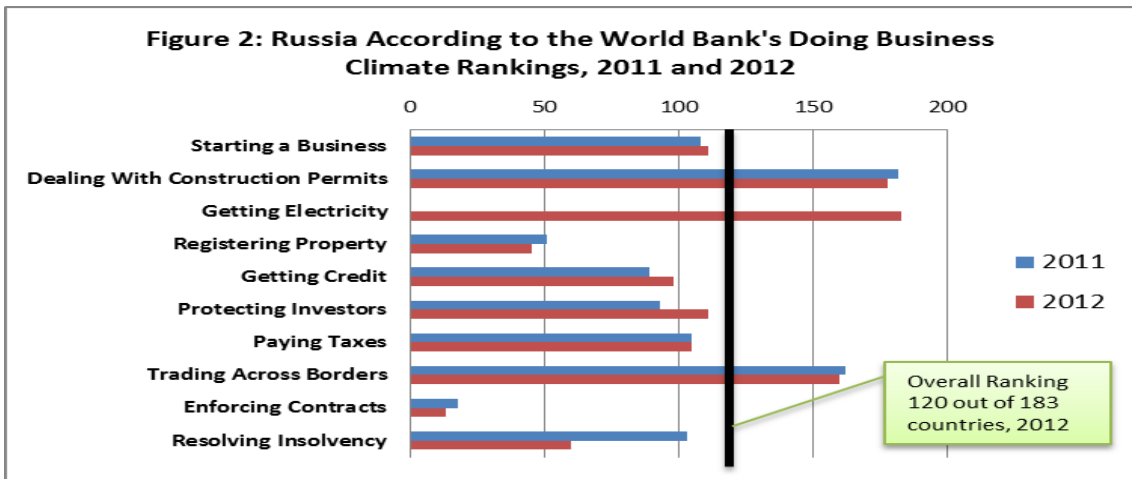
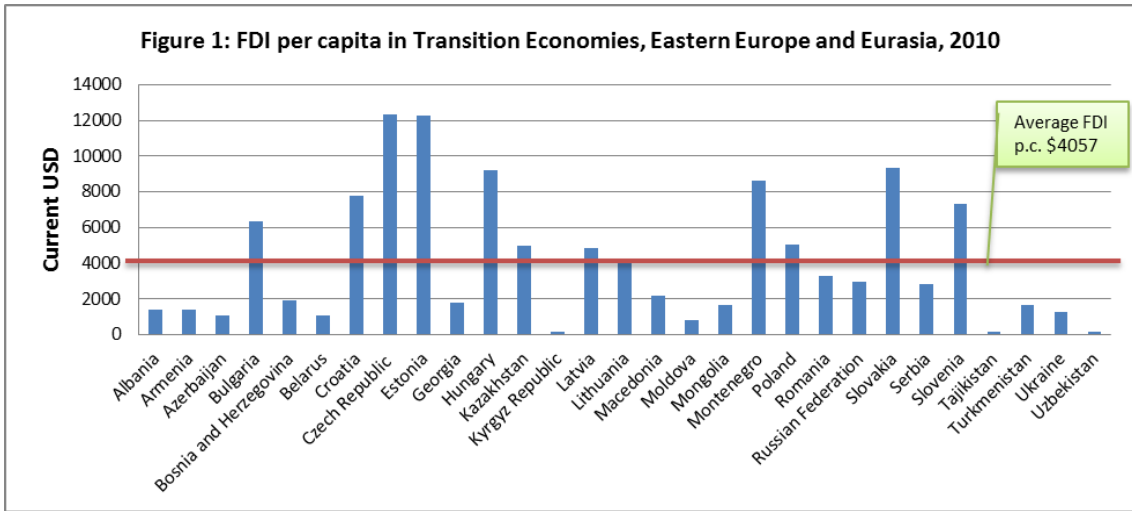
- **RZhD**, Russian railways, plans to invest \$920 mln to construct 81 km, and reconstruction of another 311 km, of railways in Serbia in 2012.
- **OMK** may invest up to \$150-200 mln to construct a pipe plant in the USA.
- Although no sum has been disclosed, **GAZ Group** plans to create a JV for production and distribution of its products in Turkey in 2012.
- Russia's **RUSAL** has signed a memorandum with Canada's **Orbite Aluminae** with plants to create a JV for developing a clay deposit and construction of an alumina refinery in Canada.

Business Climate Indicators

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

Despite Russia's great investment potential in terms of natural resources, large and growing consumer markets, educated population and proximity to Europe, the country only managed to attract 0.5% of FDI flows in 2002. Despite its relatively poor rankings in Business Climate Indexes (World Bank and WEF), by 2010 this figure grew significantly to 3.5%. This means that not only that Russia could have likely performed even better, but that even more could likely be achieved by investing in further improvements in the country's Business Climate.

- After missing out on world FDI and capital flows during the 1990s, Russia's stock of inward FDI grew at an impressive compound rate of 25% per annum between 2002 and 2010, roughly double the rate of growth of FDI stocks worldwide of 12.4% during the same period.
- Despite this recent progress, the actual amount of FDI stock per capita remains very low relative to other transition economies in Eastern Europe and Eurasia (**Figure 1**), especially when Russia's relative size and investment potential are taken into consideration.
- Remarkably, Russia managed to attract FDI at the same time that its Business Climate in terms of the ease of opening and operating local businesses ranked poorly relative to other countries worldwide. In **Figure 2**, Russia ranked 120 out of 183 economies in the World Bank's Ease of Doing Business Index, up from 123 in 2010, but well below most other transition economies (except)
- Although some aspects of the business operating environment improved while others worsened slightly during the year, Russia ranks relatively well in terms of contract enforcement and very poorly when it comes to dealing with construction permits, obtaining electricity, trading across borders, taxes and protecting investors.



Data Sources: FDI stocks per capita were derived from population statistics from the World Bank Indicators and UNCTAD's FDI database. Russia's Doing Business Rankings were derived from the World Bank's Doing Business Survey Reports in 2011-12 and 2010-11.