

## ***Business Climate Reforms Missing from Russia's Growth Cocktail***

**On July 25, Russia's Minister for Economic Development presented the government with a plan for stimulating growth. Although many of the ingredients in the growth cocktail are welcome, absent from the mix is improving the quality of the country's business climate.**

### *Monthly Overview*

Russia's rate of growth has been a constant theme during the first seven months of this year. At the outset, Prime Minister Medvedev announced a target rate of growth of 5% per year. As months passed, however, forecasts for this year's growth have fallen well below this target rate and this has in part stimulated a much needed discussion over what could be done to boost growth. President Putin requested plans to be drawn in May. The most recent plan to boost growth in late July from the Ministry for Economic Development drew attention primarily to falling trade levels, corporate profits, and higher labor costs as reasons for lower than expected performance, but also cited infrastructure projects, support for small and medium sized enterprises, privatization and tax breaks as ways to give the country's economy the boost it needs.

While aspects of this stimulus, such as infrastructure improvements and privatization, may play roles in boosting performance as well as providing a signal for implementing changes, there are other mixed signals that suggest it might not be exactly what is on the menu. Earlier in the month, the World Bank revised its categories of economies based on GNI per capita and moved Russia from the "upper-middle income" category to the "high income" category. This, coupled with the country's rise in the ranks of economies based on nominal GDP to the top ten according to the IMF figures (see *Indicators* below) might suggest that the country has improved a lot and is now in a position for small changes. However, much of this rise has coincided with high resource prices, namely oil and gas, and this position is likely highly sensitive to changes in commodity prices. Further, the country has lagged other transition economies in terms of the quality of the business climate and/or competitiveness and when viewed in terms of GDP per capita, due to the country's large population, it would not rank even in the top 30 by 2018. Much more is likely needed to retain the advances made in addition to achieving a greater potential, both in terms of aggregate and per capita growth.

Also on July 25<sup>th</sup>, however, the country's Prime Minister drew attention to the slowdown in growth and cited outdated technology, red tape, poor transportation and infrastructure, but more broadly, the country's lack of competitiveness and weak quality of the investment climate. If these statements coupled with other aims to improve the country's rank in the World Bank's *Doing Business Index* represent a deeper level of support and desire to improve the country's business climate to boost performance, than there might still be hope that a better stimulus package may be on order.

**Improving Russia's business climate to boost growth was surprisingly absent from the Ministry for Economic Development's cocktail for growth announced in late July. Despite progress made in terms of Russia's ranking in GDP growth and moving from "upper middle" to a "high income" economy, business climate reforms need to be added to this mix to boost efficiency, labor productivity and help the country retain the progress made.**

## Monthly Highlights

BCDM's *Monthly 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 July, New Investment Announcement activity appeared stable overall. However, tourism-related announcements continue to be absent and outward announcements fell since last month.***

### Energy

- *LNG plants:* **Gazprom** intends to invest with a partner to build an LNG plant in the Leningrad Region to be launched in 2018 while **Rosneft** intends to invest in constructing an LNG plant in the Sakhalin Region estimated to cost \$15 bln;
- *Solar Power:* **Avelar** plans to invest RUR 11 bln to construct solar power facilities with a combined capacity of 100 MW in the republics of Altai and Bashkortostan in 2015-17;
- *Exploration:* **Rosneft** will invest RUR 4.391 bln into geological prospecting in the Republic of Chechnya over 2013-14, including RUR 3.863 on drilling;
- **Gazprom Neft** and **Total** are considering investing jointly up to \$ 10 mln in a joint venture to produce modified bitumen;
- **Lukoil** will invest in constructing 105 km of pipeline to transport gas from the Kokuisky field in the Perm Region with a capacity of 1 bcm of gas p.a.;
- **Gazprom Neft** will invest in developing 60 mln tons of difficult oil reserves by 2015 to achieve a target of 100 mln tons and refine 70 mln tons by 2020;
- **Rosneft** plans to invest RUR 52 bln in projects in the Magadan Region in 2013 and is expected to confirm about 14 bln tons of oil reserves there;
- **Gazprom** intends to invest RUR 8.8 bln in the gas distribution network in the Republic of Karelia and RUR 3.9 bln in local heat generation by 2015 involving four gas pipeline branches and 500 km of distribution networks;
- **MNPZ** intends to invest RUR 68.2 bln to construct an advanced oil refining complex to increase light oil production output 82%, oil processing depth to 98% and electric power by 40%.

### Autos and Aviation

- *Low-Cost Carrier:* **Aeroflot** is considering investing in launching a low-cost airline as soon as 2014 offering tickets 20-40% less than traditional carriers;
- *Natural Gas-based Engine:* **KAMAZ** intends to invest RUR 3 bln per year to develop a technology for transferring trucks to a natural gas-based engine fuel;
- *Car Parts:* **Sollers** will invest in establishing a Special Economic Zone near Vladivostok to produce car parts allowing for an increase in local manufacturing up to 30%;
- *Gas-fueling Stations:* **Gazprom** is planning to invest in designing gas fueling stations for agriculture aiming to re-equip trucks and buses to run on gas thereby reducing operating costs by 66.7%;
- Mexico's **Alfa's** Nemak unit intends to invest \$80 mln to construct a new plant to supply Volkswagen in Russia beginning in 2015;
- **UVZ** and **Caterpillar** plan to invest in launching a new plant producing locomotives running on both diesel fuel and LNG located in Chelyabinsk;

- **Transmashholding** and **Wartsila Corporation** will invest RUR 1.8 bln to launch a plant to produce multi-purpose diesels in central Russia with a capacity of 250-300 engines annually for both domestic and foreign markets.

### Metals, Minerals and Mining

- After receiving a license, it is expected that **Amur Prospectors Artel** will invest in developing the Norilsk-1 copper and nickel deposit in the Krasnoyarsk Region;
- **Khimprom** will invest \$87 mln to launch a hydrogen peroxide plant in 2015 aiming to reach a 55% share of Russian and CIS markets by 2018;
- **NLMK** is investing RUR 38 bln in an electrometallurgy plant in the Kaluga Region to produce re-bars and long products from ferrous metals scrap with a capacity of 1.5mln tons of steel;
- **Rusnano** and **Alcoa** are considering investing in producing technically advanced O&G aluminum drill pipe with anti-wear coating. Financial details have not been specified;
- **Lanxess** is investing EUR 5 mln in a plant to produce polymer additives for rubber in the Special Economic Zone in the Lipetsk Region and launch a line of car tire curtains in 2016 with a capacity of 80 000 units annually;
- **Mechal**, a Russian mining company, is investing \$715 mln in launching a universal rail and structural mill at the Chelyabinsk Metallurgical Plant with an expected capacity of 1.1 mln tons of metal products.

### Transportation and Infrastructure

- After a RUR 1.24 bln upgrade in Lenenergo, **Russian Grids** plans to invest in a 5-year program to modernize Lenenergo and also complete construction of a 330-KW power ring in St Petersburg and launch the Vasileostrovskaya substation by the end of 2014;
- **RZhD**, Russian Railways, will invest RUR 70 bln on upgrades and repairs in 2013, will be a minority shareholder in the RUR 928 bln investment in the country's first high speed railway from Moscow to Kazan expected to begin operating in 2018, and will invest a further RUR 15.5 on projects in the Moscow Region and RUR 16.2 bln on a rail stretch in Mezhdurechensk-Taishet in Siberia in 2013;
- **Stavropolenergo** plans to invest RUR 6.5 bln by 2018 and plans to launch a total of 234 power grid facilities by that time;
- **Su-155**, a Russian construction company, will invest RUR 2.6 bln to construct sewage treatment facilities in Moscow and the Moscow Region to be completed by 2015;
- **MTS** and **Nokia Siemens Networks** plan to invest to jointly develop telecom infrastructure and construct 4G networks in the Moscow Region and Russia's Central Federal District.

### Agriculture

- *Fishery*: Russia's PM, Dmitry Medvedev, approved investing RUR 32.22 to develop the fishing industry before 2015 and, according to the Agriculture Minister, the amount of total fishery support will stand at RUR 134 bln until 2020;
- **Agrokom** is planning to invest RUR 3.5 bln to develop Atlantis-Pak packaging production within five years;
- **Nefis Group** intends to invest RUR 2 bln to launch a silo in the Republic of Tatarstan on the Volga aiming to increase the group's total capacity for grain storage and oil crops to 375 000 m<sup>3</sup>;

- **Praxair** and **Kuibushev Azot** plan to invest in a joint venture in the Samara Region to produce on-site oxygen, nitrogen and compressed dry air for expanding caprolactam fertilization and ammonia production as well as liquid oxygen, nitrogen and argon;
- **Danone** will invest RUR 2.8 bln to reconstruct the Yalutorovsky plant in the Tyumen Region increasing capacity 40% in 2013-2015;
- **PhosAgro** will invest \$190 mln in a phosphorous fertilizers manufacturing facility with a capacity of 450 000 tons to be built in 2016;
- **Magnit** will invest over RUR 1 bln to construct an inter-regional agricultural wholesale center in the Penza Region to begin operations in 2015;
- **PhosAgro** will boost capital investment in Apatit to RUR 9.5 bln in 2013.

#### **Other Non-energy Sector Investment Activity**

- *Clothing:* **Uralvagonzavod** will invest RUR 20 mln to start production of men's, women's and children's clothes in addition to souvenirs and accessories under its own brand;
- **Svesa**, a Russian chip plate producer, will invest RUR 6 bln to construct a plant in the Urals to be launched in 2016 with a capacity of 500 000 m3 per year;
- **AFK Sistema** plans to invest \$ 1 bln to expand its medical business;
- **Nefis Group** will invest RUR 3.5 bln to upgrade its detergent plant in 2014 aiming to raise dry soap output 170% to 380 000 tons annually and account for 50% of the Russian market;
- **Vertex** will invest RUB 3.616 bln to construct a plant located in the St Petersburg SEZ
- **Orion** intends to invest \$ 100 mln to build a second line of a confectionary facility in the Tver Region with a capacity of up to 24 000 tons of confectionary products;
- *A number of investment plans in consumer retail were announced:*
  - **AFK Sistema** plans to invest in doubling the size of Detsky Mir Center before 2015;
  - **Tashir Group** will invest almost RUR 260 mln to restore the Aragvi restaurant in the center of Moscow
  - **IFC** will consider investing EUR 10 mln into Russia's largest online clothing store Lamoda;
  - **X5 Retail Group** is planning to invest over \$1 mln to rebrand its Karusel hypermarket chain;
  - **Burger King Russia** will invest in expanding its presence to 500 outlets by 2016;
  - **Fashion House Group** will invest EUR 70 mln to build an outlet in the Leningrad Region to be completed in 2014.

#### **Outward New Investment Announcements**

**Outward New Investment Announcements in July were noticeably down and focused primarily on commodity resources in energy and fertilizer in agriculture.**

- **Rosneft** is considering investing in taking part in Abserhon natural gas project on the Caspian Sea shelf and the possibility of seeking additional partnerships in Azerbaijan in addition to investing in new projects developing hydrocarbon blocks in Venezuela;
- *Fertilizer Plant in China:* **EuroChem** is planning to invest in a fertilizer plant with **Migao Corporation** in China in 2014 in the Yunnan province with the aim of expanding its

operations in the country and will invest an estimated \$1.5 bln to construct an ammonia plant in the USA (Louisiana) over four years;

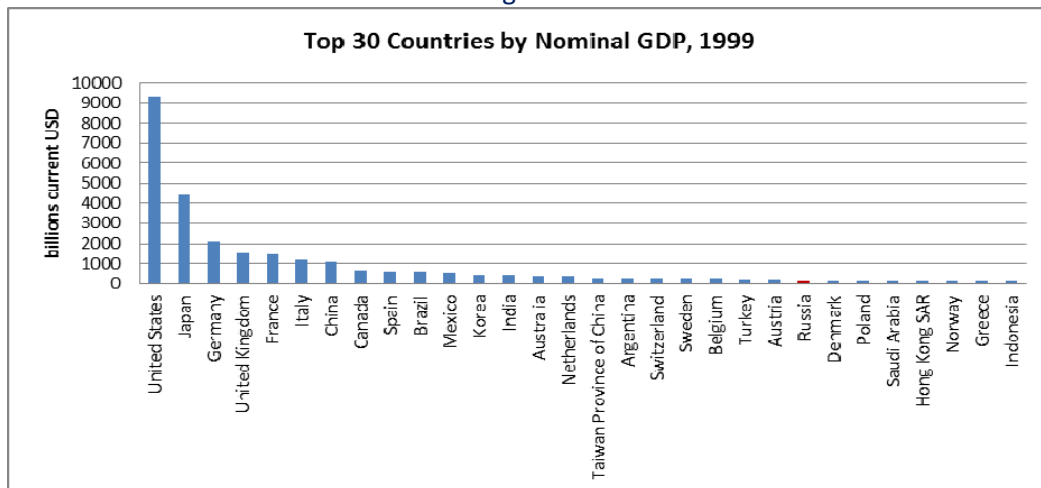
### Business Climate Indicators

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

**On July 1, 2013, in the World Bank's annually revised classifications of economies based on GNI per capita in the previous year, Russia was moved from an "upper middle" to a "high" income economy. The IMF's *World Economic Outlook* database also indicates dramatic improvement in Russia's GDP. Russia is forecast to become the 6<sup>th</sup> largest economy in terms of nominal GDP in USD by 2018. This same dataset placed Russia in the 35<sup>th</sup> spot in 1992, 23<sup>rd</sup> in 1999 and in the top ten in 8<sup>th</sup> position by 2012. However, even if Russia grew on target by 5% per year, a significant gap in GDP per capita would remain between Russia and other leading economies.**

- **Figure 1** below shows the top 30 countries by nominal GDP in 1999. Russia was within the bottom ten of the top thirty in 23<sup>rd</sup> place. This is roughly before the rapid growth in oil prices during the past 13 years and Russia's average growth of about 4.6% since then. However, it was still in a better position in 1999 than during the immediate aftermath of the collapse of the USSR in 1992 when it was in 32<sup>nd</sup> spot.

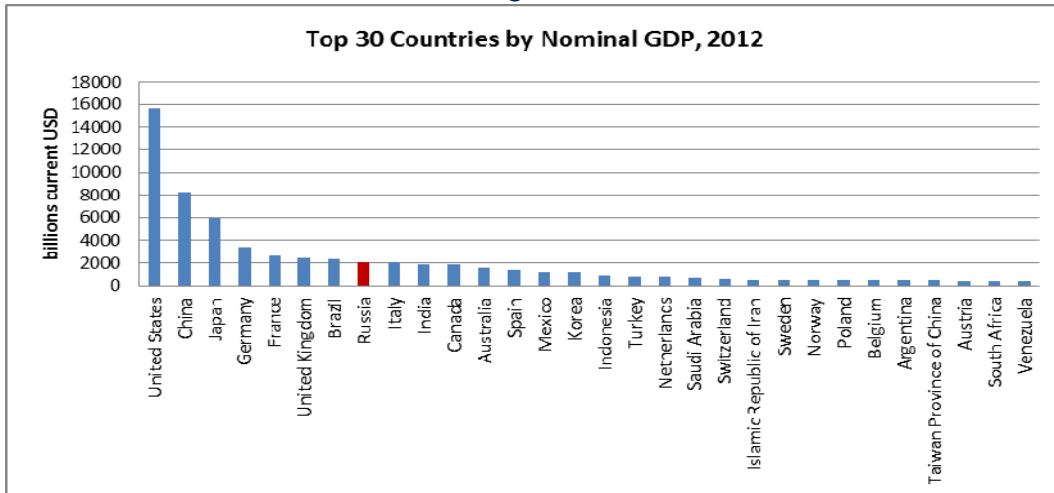
Figure 1



Source : IMF, World Economic Outlook Indicators, April, 2013

Figure 2 below shows the top 30 countries by nominal GDP in 2012. During 13 years, despite growth in the advanced countries, the financial crisis in 2008, and remaining well behind other transition economies in terms of rank in competitiveness and business climate indicators, Russia climbed to within the top ten economies to 8<sup>th</sup> position, not terribly far behind Germany, France or the UK (except for by GDP per capita). This places Russia currently among the group of largest economies in Europe.

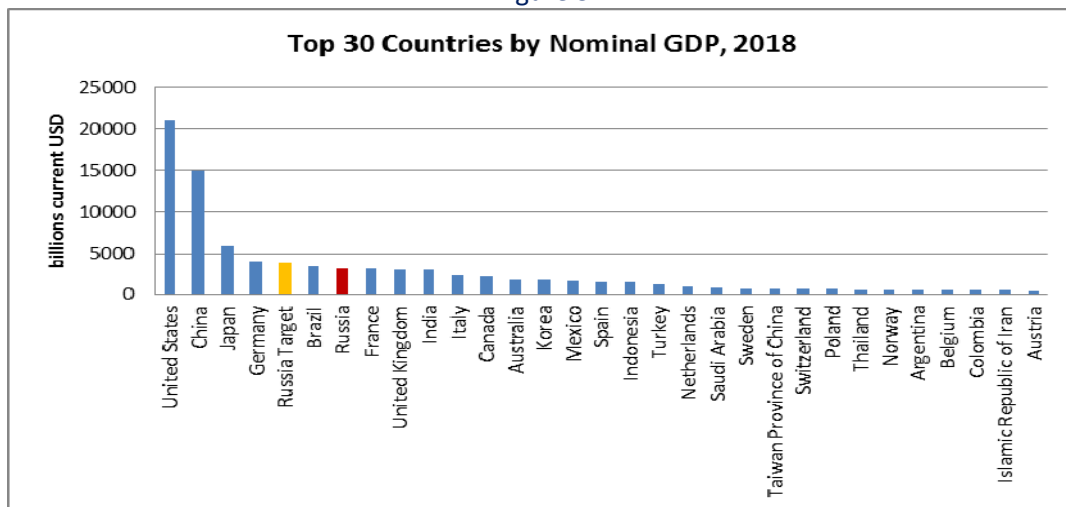
Figure 2



Source : World Economic Outlook Indicators, April, 2013

- Error! Reference source not found.** below shows the projected rank of the top 30 economies by nominal GDP by 2018. Russia (in red) in these projections climbs further, despite a slowdown in anticipated growth rates, to 6<sup>th</sup> spot overtaking France and the UK but remaining behind Germany. If Russia were to grow at the 5% rate target announced earlier this year by PM Medvedev, Russia would be in 5<sup>th</sup> place ( in yellow) by 2018, just behind Germany. Thus, the indication is that Russia is likely to retain and strengthen its position slightly as one of the largest economies in Europe over the next five years.

Figure 3



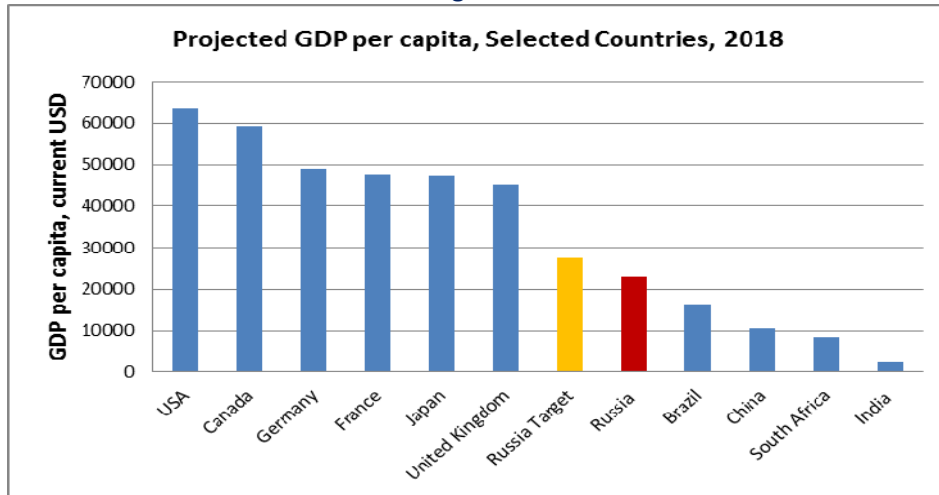
Source : World Economic Outlook Indicators, April, 2013

Figure 4 below shows the projected GDP per capita by 2018 for a select group of countries in Europe, the Americas, BRICS and Japan. Despite Russia's climb in the ranks above in terms of the size of its economy, a significant gap will remain in terms of GDP per capita. Russia (in red) remains well behind the USA, Germany, France, UK, Japan, and Canada while ahead of the remaining BRICS.

- Further, in yellow, Russia's forecast GDP per capita was adjusted to what it would be if the growth target of 5% were achieved. This would imply a GDP per capita by 2018, in current USD, of \$27 493 instead of the \$22 906 forecast.



Figure 4



Despite considerable progress in terms of the aggregate size of the economy, Russia is forecast to remain well behind other leading economies on a per capita basis, even if the 5% growth target set out by PM Medvedev were achieved. Further, much of the progress made was supported by high commodity prices (oil and gas) posing the risk that this rank may be tentative. Steps need to be taken to broaden growth, but also to improve efficiency and labor productivity to improve on a per capita basis. This would not only help to attract and retain investments, but also to attract and retain higher value added labor. Thus, setting a per capita growth target could further reinforce the need to place business climate reforms in the country’s growth cocktail.

### ***The First BCDM Semi - Annual Report***

*Our first Semi-Annual report, was released at the St Petersburg International Economic [Forum](#) in June, 2013 and provided a closer look at specific outcomes and targets beyond GDP growth to support improvements in Russia’s Business Climate.*