

Policy Directions More Clear, But Uncertainty Remains

President Putin was sworn into office on May 7 and immediately signed 11 decrees outlining ambitious social, economic and military policy goals and priorities for his third term as President largely reflecting statements he made during the election campaign. Although this should ease some investors' concerns over policy directions, uncertainty remains over whether the objectives can be achieved and what might need to be done to reach them.

Monthly Overview

Since the middle of last year, there has been concern over what was happening in Russia as protest movements grew and it remained unclear what Putin would do during his third term in terms of policy priorities, reforms and who would be appointed to various posts in government. Net capital outflows started to grow in the summer of 2011 reaching \$ 35 bln in the fourth quarter alone while continuing at a similar rate in 2012 and reaching an estimated \$ 8 bln in April. Although part of this drop in investment activity is due to the financial crisis in developed economies as investors restructure their portfolios and avoid risks in foreign emerging markets, part of it is also likely due to concern over what would be in store for investors in the Russian market after the political dust settled and a new government formed.

Some of this political uncertainty that has hung over Russia for the past year was reduced in May. After being sworn in, Putin immediately signed 11 decrees outlining ambitious policy priorities and objectives broadly covering social, economic and military spheres during his new 6-year term in office with implications beyond. By the end of the month, his new cabinet had been announced and appointments made. These two factors largely remove questions over what his intentions are and who will be in charge of government Ministries.

Although the goals and priorities are ambitious, they delivered more than expected in terms of being logically connected. The social goals ranged from improving real wages, increasing salaries for teachers and professors to better health outcomes in terms of life expectancy. However, the country's ability to make good on these promises depends significantly on achieving higher levels of economic performance in terms of efficiency and growth. The economic goals ranged from improving the business climate (to climb from 120th to 20th place in six years in the World Bank's *Doing Business Survey* – and to 50th place in three years) to expanding privatization of non-raw material companies in competitive sectors before 2016. This represents an important shift for the country in terms of recognizing that Russia cannot rely much longer on gas and oil prices to finance socio-economic improvement. Instead, these reforms rely more strongly on outlining ways to improve private sector performance and attract foreign investments to support growth and development.

Although these steps go some way in reducing some of the political uncertainty, other sources of uncertainty nevertheless remain. The first concerns the reforms and actions to be taken to attempt to achieve these goals. Questions remain about which steps will be taken, whether they are the most efficient ones, and how much they will cost and benefit. This is uncertainty related to implementation and it can be reduced partially through openness, transparency, and private-public dialogue. Second, the type of political uncertainty that has caused some concern during this past year is likely to return again towards the end of the term as people wonder who will be in power and what policy directions they will take.

This last issue of the integrity of the government to withstand changes in personnel can be postponed in the short term, but it will remain a future source of uncertainty and risk unless steps are also taken to improve the strength of reforms and their directions to live past those who put them in place.

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.

Compared to the first three months of 2012, there was a noticeable decline in the number of new investment announcements in April and activity appeared to remain sluggish in May, especially for announcements related to expansion plans in the retail sector.

Energy

- **Exploration: Gazprom** announced its plans to invest RUR 61.4 bln in geological exploration, most of which (RUR 52.2 bln) will go to projects primarily concentrated in Russia's Far East with 27.3 bln dedicated to land-based projects and 24.9 on shelf projects while Russia's **Rosneft** entered an agreement with Norway's **Statoil** for shelf exploration in Russia that would also involve exchanging access between the companies' domestic shelf projects. Investment by the two companies in geological prospecting in four deposits (one in the Barents Sea and three others in the Sea of Okhost) is estimated at \$ 2.5 bln;
- After spending RUR 76.08 bln on modernization and repairs of pipeline infrastructure in 2011, **Transneft** plans to invest an additional RUR 100 bln on similar projects annually until 2017. The company's total investments planned for 2012 are RUR 107.6 bln, down from 152.5 in 2011;
- **Gazprom Neft** plans to invest RUR 8 bln into the development of its gasoline and filling stations in 2012 involving the construction and reconstruction of filling stations and acquisition of existing new chains from independent companies;
- After investing RUR 650 mln into the development of the Omsk Region's gas system during the last 7 years, **Gazprom** intends to invest another RUR 5 bln into gas supplies and distribution in the region by 2015;
- Russia's **Transoil** will invest an estimated \$ 300 to 400 mln to buy 10 000 tanks to expand its rolling stock.

Autos

- **Nissan** cited fast-growing demand for its cars when it announced its intention to invest EUR 167 mln to double its capacity from 50 000 vehicles per year to 100 000 at its plant in St Petersburg by 2014. The company wants to triple its sales in Russia by 2016 from 161 000 in 2011;
- **Mitsubishi Motors** and **Peugeot Citroen Group** are planning to invest EUR 320 mln to triple their joint venture's annual production capacity in Russia from 40 000 units to 125 000;
- **GAZ Group**, a Russian automaker, plans to invest RUR 16 bln over the next 18 months to produce Gazel Next commercial vehicles, cars under contracts with Volkswagen and General Motors, construction of a paint booth and production of Unimax buses and cars under contract with Daimler.

Metals, Minerals and Mining

- **Rusnano's** portfolio company **Russian Quartz** is investing in a new production line for high purity quartz enrichment, which is used as a basic material for electronics and solar industries. The project will take place at the existing Kyshtym Mining Production site in the Ural region and the total investment is estimated at RUR 2.3 bln;

- **Evrax** plans to invest \$ 37 mln to develop its two coal assets in Russia's constituent Republic of Tuvan in 2012. The Mezhegeisky deposit's coal output is expected to begin in 2013 while the Vostochny field in the Ulug coal basin is scheduled to start in 2021;

Transportation and Infrastructure

- *SeaPort*: **Gazprom Neft Shelf** announced that the construction of a Seaport for the Shtokman Project in Teriberka, Murmansk Region, set to begin in 2013, will require at least \$ 2 bln in investments.
- *Fiber-optics lines*: **Rostelecom, Megafon, MTS, and Vimpelcom**, four of Russia's major wireline and mobile operators, have agreed to invest RUR 2 bln for constructing underwater fiber-optic lines connecting Sakhalin, Kamchatka and Magadan;
- **RZhD**, Russian railways, has plans to invest RUR 112.6 bln into development of railroad infrastructure in the Krasnodar Region in 2012-2014;
- **Russian Machines** and **Terex Corporation** have formed a joint venture to manufacture construction and road-building equipment in Russia;
- Russia's **TNK-BP** plans to invest \$ 40.4 mln by 2014 to modernize racks for loading light oil products into railway tanks at the Saratov Oil Refinery's Uvtek oil depot which will involve fully automated gasoline and diesel loading systems;
- **RusHydro** has announced the beginning of joint construction of a hydropower equipment manufacturing facility with Alstom in the Republic of Bashkortostan. The total investment in the plant is estimated at EUR 125 mln;
- *Airports*: Russia's **Vnukovo Invest** has submitted an offer to the Russian Government to invest RUR 12 bln to build a second runway at Domodedovo Airport as part of a larger deal involving the exchange of a land plot at the airport to build a passenger terminal and fuel service complex while Yekaterinburg's **Koltsovo Airport** plans to invest RUR 2.7 bln to modernize over the next ten years.

Agriculture

- **Cherkizovo Group**, a Russian meat processor, will create a RUR 4.5 bln joint venture to produce turkey meat with Spain's **Grupo Fuertes** which it intends to start building in 2014 and reach a projected capacity of 25 000 to 30 000 tons in 2015;
- Scandanavia's **Arla Foods** will invest RUR 500 mln with Russia's **Voronezh Dairy**, part of Molvest Holding, in a cheese producing plant in the Voronezh region with production scheduled to commence in early 2013.

Non-energy sector investment activity

- *High-Tech Start-ups*: **Qualcomm**, the US smartphone chip maker, announced it is now prepared to invest in Russian high-tech start-ups, however, to date investment projects and sums have not been specified;
- *Housing*: The **Korean SsangYong Engineering Construction Co** has launched the construction of its first housing estate in the Kaluga Region comprised of 2000 flats. The investment is estimated to be \$ 500 mln;
- Russia's **Uralkhimplast** and US SI Group have agreed to form a joint venture in Nizhni Tagil that will produce and distribute synthetic resins for industrial purposes to be launched in 2012, the sum of the investment was not disclosed;
- **Ingosstrakh**, a Russian insurance company, plans to create a countrywide chain of 24 clinics. The investment required is estimated at \$ 170 mln;

- **Techstroy**, a Tatarstan-based polyethylene piping manufacturer, plans to invest RUR 400 to 500 mln to build a plant in Novosibirsk;
- **Sangri**, a Russian investment company, plans to invest RUR 5.2 bln to build an alcohol plant near Novosibirsk with a projected launch in 2014-2015 that will be able to process about 250 000 tons of grain annually;
- Russia's **Eurochem** has launched a melamine plant in Stavropol Region worth RUR 10.08 bln with a production capacity of 50 000 per year which will completely meet domestic demand for melamine;
- **RDIF**, the Russian Direct Investment Fund, as entered an agreement with the Republic of Tatarstan and the Strategic Initiatives Agency to co-invest in hydrocarbon-related industrial machinery, IT and nanotech projects in the Republic of Tatarstan;
- After launching a chain of medium-sized stores under the "Magnit family" brand, **Magnit**, Russia's largest retailer, plans to open another 8 or ten by the end of 2012;

Outward New Investment Announcements

In May, no new outward investment announcements for Russia were made, down from four in April.

Business Climate Indicators

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

By Presidential decree in 2010, an Investment Ombudsman office was created on the basis of the Ministry for Economic Development in Russia to investigate complaints by Foreign Investors. Between now and the beginning of operations in August, 2010, the office has received 87 applications related to problems encountered by foreign companies, of which 67 have been successfully resolved while another 20 remain under consideration.

- Evidence from the types of complaints filed can reveal which areas remain problematic for foreign investors in Russia as well as how widespread each of the types of problems is. This information is not only valuable for retaining those investors already operating in the country, but can also be a valuable resource to compliment existing surveys and studies and help prioritise where reforms are most needed to generate the greatest impact.
- **Figure 1** shows that the most prominent forms of complaints submitted to the Ombudsman's office by foreign companies are related to administrative barriers (red-tape issues), followed by discrimination against foreign companies relative to Russian companies when trying to resolve disputes, and abuse of power by government authorities.
- Further detail about the specific companies involved or experiencing specific problems is not possible to report. The Ombudsman's Office does not disclose the identities of companies because the companies themselves are not interested in such disclosure. However, in terms of effectiveness to date, the introduction of this office has been viewed as successful and this is why Putin announced the creation of a similar office for domestic entrepreneurs.

Although this type of information can be highly useful in helping to identify common problems faced by foreign investors operating in Russia, and more transparency is welcomed and needed to facilitate reforms aiming to improve the Business Climate, it should be noted that these data need to be accompanied by an impact assessment in order to prioritise which reforms will generate the greatest impact. It is possible that a less widely reported problem is more costly to ignore than a widely reported, but small or relatively unimportant, complaint.

