Business Climate Development Monitor 2012

Signs of Thaw in Russia's Business Climate

1st Annual Report

NES New Economic School

FOREIGN INVESTMENT ADVISORY COUNCIL

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Preface

Improving the quality of Russia's business climate remains a critical objective for securing the country's future prosperity. Russia is well positioned with large tracts of arable land and abundant natural resources at a time when global demand for food and energy is forecast to grow. The country also has Europe's largest consumer market in terms of population with rapidly rising disposable incomes and a well-educated workforce. These favorable conditions are, however, not enough by themselves.

Despite ten to twelve years of progress in terms of growth, attracting investments, and better employment outcomes, the quality of Russia's business climate ranks consistently low across Indexes worldwide and behind almost all other transition economies in the Former USSR and Eastern Europe. Concerns over dealing with corruption, administrative barriers, among others, remain real constraints that make the country relatively less attractive for economic activity and serve to prevent Russia from reaching her full potential. Further reforms are needed to help the country make better use of the resources it has available and make it a better place to produce, work and live.

The title chosen for this report is "*Signs of Thaw*" to capture an apparent recognition by Russia's government that it is high time to deal with the quality of the country's business climate. After years of delay, Russia finally joined the WTO at the end of 2011. Accession is expected to stimulate much needed reforms as Russia agrees to adhere to WTO standards and norms as well as permit greater access to its domestic market in exchange for access to foreign markets. However, this also likely indicates a change of heart within the Kremlin since effort and commitment were required to finally agree to the terms of accession and bring about its fruition. This, coupled with other announcements, seem to suggest an even wider recognition that the country's recent progress has been overly dependent on energy prices and resources and broader reforms are needed to help the country attract and diversify investments to avoid risk as well as making better use of other assets Russia has to offer.

Further words and actions provide additional welcome signs of this overall "thaw". Russia's President has publicly committed to the aim of improving Russia's rank in the World Bank's *Doing Business Index* by 100 positions, from 120th in 2011, to 20th within six years before, during, and after his election campaign. The government has also created an Agency for Strategic Initiatives (www.asi.ru) with one of its assignments being to identify and support reforms for improving the business climate. The creation of an Ombudsman's office for hearing complaints and problems from foreign investors and expansion of this type of institution for domestic investors also engaging with entrepreneurs are also noteworthy steps in this direction. Future reforms, however, are easy to promise and remain to be seen.

This annual report on Russia's Business Climate is the result of a joint project between the New Economic School's (NES) Center for Economic and Financial Research (CEFIR), Ernst & Young, and FIAC during 2012. The primary focus of this project has been to monitor changes, positive or negative, in the quality of Russia's business climate on a monthly and quarterly basis. Since many qualities of a country's business climate do not change much from month to month, such as the education, knowledge and skills of the working age population, or infrastructure, our approach has been to track issues and indicators as they arose, particularly those which might be overlooked in more aggregate, less frequent, reports. One of the central issues during late 2011 and the first half of 2012, for example, is whether or not investors, both domestic and foreign, considered the country politically risky; waiting for the results of the elections and government appointments before committing to further investment activity in Russia. To help address this type of issue, as well as other important trends reflecting the quality of the business climate, we have assembled data on new investment announcements (Appendix 1) to help gauge potential changes in investors' intentions.

The content of this report has benefitted from contributions from each of the partner organizations involved in this project, namely Ernst & Young, the New Economic School (NES), The Center for Financial and Economic Research (CEFIR), and the Foreign Investment Advisory Committee (FIAC). BCDM's monthly, quarterly and annual reports also benefitted from editorial and research support from Sergei Guriev, Rector of NES and Natalya Volchkova, ExxonMobile Professor of Economics at NES. The lead author and economic researcher for this project was Barrie Hebb.

We hope this report, in addition to the monthly and quarterly issues, will support and stimulate a much needed discussion on what Russia needs to do to secure a better future,

Sincerely,

Sergei Guriev,
Rector of New Economic School

Executive Summary

The Business Climate generally refers to those conditions outside a firm, whether large or small, that can play a role in a firm's performance. Conditions such as access to a workforce with relevant skills, a police force that is able to lower the risk of theft or burglary, infrastructure that provides stable, low cost, access to other markets, or a legal system that ensures that contracts are likely to be well enforced, all serve to lower the costs of operating in a particular location. This further means that those who operate in locations with better conditions have a competitive advantage over those located in areas where these external costs are higher.

The quality of a region or country's business climate is an important policy issue first because many aspects of the business climate, such as the quality of policing, education and infrastructure, can be changed, for the better through in investments and effort, or for the worse through neglect and disinvestments. Second, regions who fail to improve or at least maintain the quality of their business climate face the risk not only of failing to attract new economic activity, but also of losing those they have to regions with relatively better, suitable, conditions. Third, and related, there is a link between the business climate and prosperity. Regions that improve the quality of the business climate are able to use their scarce resources more efficiently essentially freeing up more for both private and public use. Better conditions further support a region's ability to attract and retain investments, improve productivity and should aim, ultimately, towards better production, working and living conditions.

The quality of Russia's Business Climate prevents the country from achieving its full potential. The country has the world's largest natural gas reserves as well as other energy resources, minerals, forests and a vast amount of arable land. Further, forecasts indicate growth in global food and energy demand and the quality of Russia's business climate will be a key ingredient in how effectively the country is able to respond to this growth and make the most of what this potential opportunity presents. Further, the country has a large and growing consumer population with rising disposable incomes and a well-educated workforce. Despite a little over a decade of progress in terms of growth, development, employment outcomes and investment attraction, however, the country's business climate ranks consistently low worldwide and behind almost every other transition economy in the Former USSR and Eastern Europe.

Further, new investment announcement data suggest the country needs to do more to deal with political risk and make better use of non-energy related assets. A new investment announcement takes place when an investor makes his or her intention to invest in a new income generating activity publicly known. Although the investment expenditure may not take place, it is indicative of an intention over the direction and scope of a future investment. The vast majority of these types of announcements in 2012 was in the energy sector and primarily related to large scale, multi-year investments. Trends in the announcement data are also generally consistent with investors holding off until after the political dust related to the elections settled and a new government was announced. This further suggests that unless the integrity of political institutions is strengthened, this risk will simply return at a future date.

List of Figures

Annual Highlights

BCDM's *Annual Highlights* **provide a brief overview of major events and issues related to the quality of Russia's Business Climate that took place during the past year.**

At the end of 2011, after 18 years of negotiations, an agreement was finally reached for Russia's entry into the World Trade Organization (WTO). In addition to certain reductions in tariff and non-tariff barriers, membership will also involve granting wider access to domestic markets in exchange for foreign market access and is expected to provide an important stimulus for business climate reforms that will improve efficiency, enhance the country's ability to attract investments, improve trade flows and support growth.

The OECD released an economic survey of the Russian Federation at the beginning of the year citing a poor business environment as a key factor constraining the country's growth given its population's skill levels and rich natural resource endowments.

Russia's Central Bank estimated at the beginning of 2012 that net capital outflows for 2011 reached $ 80.5 billion, up nearly 150% from 2010's 33.6 billion and in the 4th quarter of 2011 may have been as high as $36 billion. Although net capital outflows have been the norm for the past two decades, the sudden dramatic rise and estimate that they may continue to be in the $35 billion range for Q1 of 2012 indicate that political risk might have be a serious issue facing Russia; one that will not be resolved until after the Parliamentary and Presidential elections are known and a new government and its aims appointed and announced with greater clarity.

The World Economic Forum in late January highlighted Russia's need to further modernize and diversify, ease administrative barriers while also strengthening state institutions.

The 5th consecutive Russia Forum took place from January 30 to February 4. Highlights included Russia's potential to provide a counterbalance to a lack of growth in developed economies due to the current crisis and that despite relatively high growth rates forecast for the next few years, Russia could be performing even better given its natural resources and skilled labor supply if it addresses weak private sector performance due to a poor business climate.

After serving two previous terms as Russia's President and one term as Prime Minister, the March 4th election returned Vladimir Putin for a third term. If his speech at the Russia Forum, held only a month prior to the election, is an indication of what is on his agenda, Russia's Business Climate should improve. Putin said Russia's current rank in 120th place on the World Bank's *Ease of Doing Business Survey* was unacceptable as he announced an ambitious goal of climbing 100 places. In later speeches, he clarified that this would probably take 8 years.

In April, Russia's Ministry of Economic Development lowered its growth forecast for 2012 from 3.7% to 3.4% citing a downgrade in expected investment growth for the year from 7.8% to 6.6%. This not only highlights the important role attracting investments will play in securing the country's economic performance in terms of GDP growth, but also the influence the global financial crisis and political risk have likely recently had on investment levels in Russia. The Ministry subsequently revised 2012's growth forecast to a range of 3.7 to 4% in June.

In early April, *Bloomberg's Best Countries for Business* ranked Russia in 48th place out of 160 countries covered. The ranking focused on conditions for attracting more foreign investment and the results stand in stark contrast to the World Bank's *Doing Business* ranking of 120th out of 183.

On May 7, President Putin was sworn into office and immediately signed 11 decrees outlining ambitious social, economic and military policy goals and priorities for his third term as President.

Many of the economic goals focused on growth and efficiency such as by expanding privatization and aiming to improve the business climate by climbing from 120th in the World Bank's *Doing Business Survey* to 20th place within six years.

In June, the World Bank produced its second subnational *Doing Business in Russia* report providing rankings for 30 cities across Russia in four dimensions of operating a business: starting a business, property registration, dealing with construction permits, and accessing electricity. Although the average start-up cost of 2.3% of income per capita is relatively low and puts Russia among the 30 lowest cost economies to start a business, the report highlights that the ease of business operations varies within the country and helps identify some of the specific challenges some cities face to attract and retain business activities.

Additional reports on the quality of Russia's Business Climate at the sub-national level have also appeared after the World Bank's first report in 2009. The World Economic Form produced a Competitiveness Report in Russia in 2011 and Business Enterprise and Environment Performance Surveys (BEEPS) were carried out beyond Moscow over the past year, with an analytical report soon due by NES.

In April and June, three large scale multi-year new investment announcements took place in the energy sector related to Rosneft and partners, totaling some $720 bln to take place roughly over the next decade. This has represented some 57% of the new investment announcement activity tracked during 2012 and highlights the risk the country faces in terms of its potential reliance on a small number of large scale investments at the expense of other activities.

In late June, the 16th St Petersburg International Economic Forum took place bringing together over 5000 people from 87 countries to discuss key challenges facing Russia's economy, emerging markets and the rest of the world as well as facilitating a dialogue on frameworks to deal with these challenges. One month after taking office, President Putin used this opportunity to restate a commitment to improve Russia's business climate by announcing a new business ombudsman, state withdraw from a variety of industries and assets, a privatization scheme that would be open to competition, fair and equitable as well as avoiding the errors of the 1990s schemes, and that no new restrictions on investment flows would be introduced.

In July, UNCTAD released its latest *World Investment Report*. In 2011, Russia managed to attract $52.9 bln in net FDI inflows, up 22% from $43.2 bln in 2010. Although FDI flows worldwide have increased dramatically during the past 12 years, Russia has managed to attract a growing share of these worldwide flows, from 0.2% in 2000 to 3.4% by 2011, a trend reflected in UNCTAD's *Inward FDI Attraction Index*, which ranks countries by the amount of inward FDI relative to the size of their economies. Russia has gone from 95th place in 2002 to 19th in 2011 out of 176 countries.

In early August, the powers of Russia's Business Ombudsman, Boris Titov, were expanded to include a new Commission for Entrepreneur's Rights with representatives from both the public and private sector as well as with offices in several of Russia's regions. The Commission will help to provide entrepreneurs with easier access to information on issues such as taxation as well as provide public input into the state's enforcement and legislative processes. This expansion also indicates recognition by the state of the importance of entrepreneurs to Russia's future development and the possibility for introducing effective Business Climate Reforms as well as resolving disputes.

In August, Shtokman, one of the largest scale energy sector projects, was abandoned, highlighting a significant challenge facing Russia in terms of reliance on a small number of high value projects in this natural resource sector as well as a need to embrace broader business climate reforms to attract activity in other sectors thereby avoiding risk and enhancing longer term, more stable, economic performance.

In Vladivostok in early September, Russia hosted for its first time the Asia-Pacific Economic Cooperation (APEC) summit, which includes 21 Asia-Pacific region nations signaling in part Russia's commitment to invest in new infrastructure and policies aiming to improve trade, transport and investment ties with countries outside the EU, its current largest partner.

In September, the World Economic Forum released its latest *Global Competitiveness Report 2012-2013* ranking Russia in 67th place, just one spot below Iran (66th) and slightly ahead of Ukraine (73rd) and Georgia (77th) out of 144 economies, and down one spot from 66th last year.

1 A Brief Look at Russia's Potential

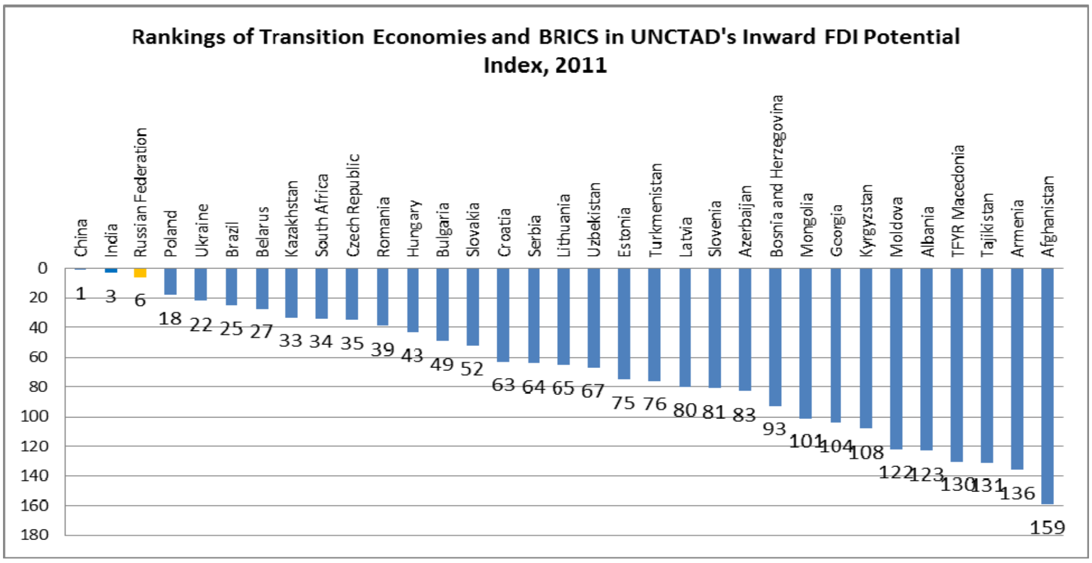
One of the central arguments for improving a business climate is that it can help a country approach its full potential. Although Russia is already well known for its abundant energy resources, the country also has a well-educated workforce, Europe's largest, as well as a consumer population with rising disposable incomes, infrastructure, and arable land resources with room for both expansion and productivity growth. This chapter briefly highlights some of these key qualities in Russia's potential and the country's most recent performance before turning attention to Business Climate rankings in Chapter 2.

1.1 Russia's Potential

The United Nations Conference on Trade and Development's (UNCTAD) *Inward Foreign Direct Investment Potential Index*[1] uses 15 different indicators to assess a country's potential to attract foreign direct investors. Although not directly meant to assess a country's full potential, the indicators are nevertheless broad and of interest beyond FDI and can shed some light on Russia's economic potential relative to other countries. For instance, the indicators are grouped into four categories reflecting the conditions that different kinds of FDI seek out worldwide: market conditions for market seeking FDI, low-cost skilled labor for efficiency seeking FDI, the presence of natural resources for resource seeking FDI and FDI enabling infrastructure. All of these conditions are generally relevant for assessing a country's broader economic potential.

Figure 1 below shows the latest overall rankings of transition and BRICS economies in the Index across these four categories. Out of 177 countries, Russia ranks 6 worldwide in terms of its potential to attract inward FDI just behind China (1st place) and India (3rd). Relative to other former Soviet Republics and transition economies in Eastern Europe, Russia ranks considerably higher.

Figure 1 – Russia Relative to BRICS and Other Transition Economies in Overall Rank in UNCTAD's Inward FDI Potential Index, 2011



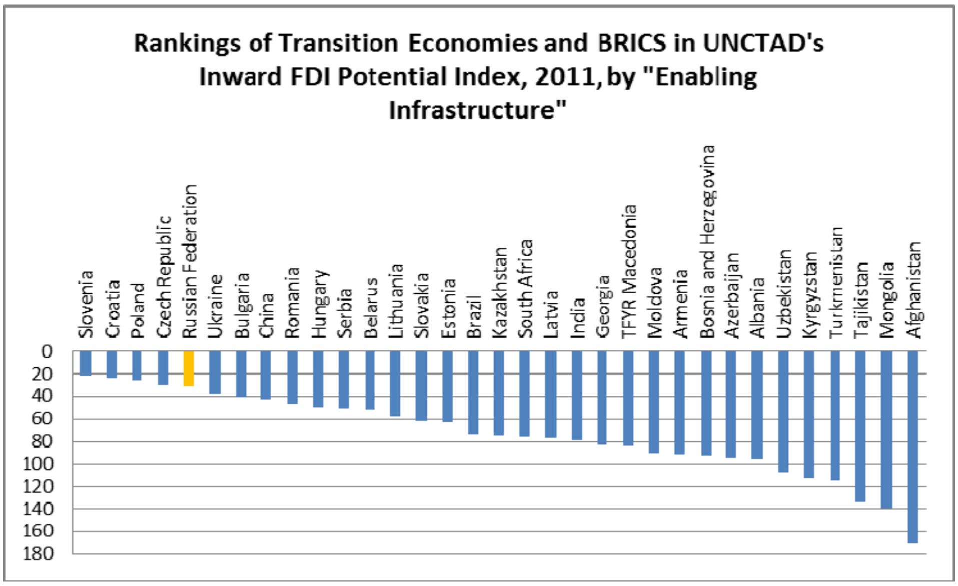
Source: (UNCTAD, 2012), Inward FDI Potential Index, Web-table 32a

Figure 2 below shows how Russia ranks relative to this same group of economies in terms of enabling infrastructure. This broad category includes indicators for assessing basic items such as road density, rail lines, connectivity, energy infrastructure (electricity), and telecommunications. Out of

[1] See (UNCTAD, 2012), Box 1.3 on page 30 for greater detail on the composition and use of this Index.

177 countries, Russia ranks 31st, ahead of the remaining BRICS economies and only behind four transition economies in Eastern Europe (Slovenia, Croatia, Poland, and Czec Republic).

Figure 2 - Russia Relative to BRICS and Other Transition Economies in Enabling Infrastructure



Source : (UNCTAD, 2012), Inward FDI Potential Index, Web-table 32a

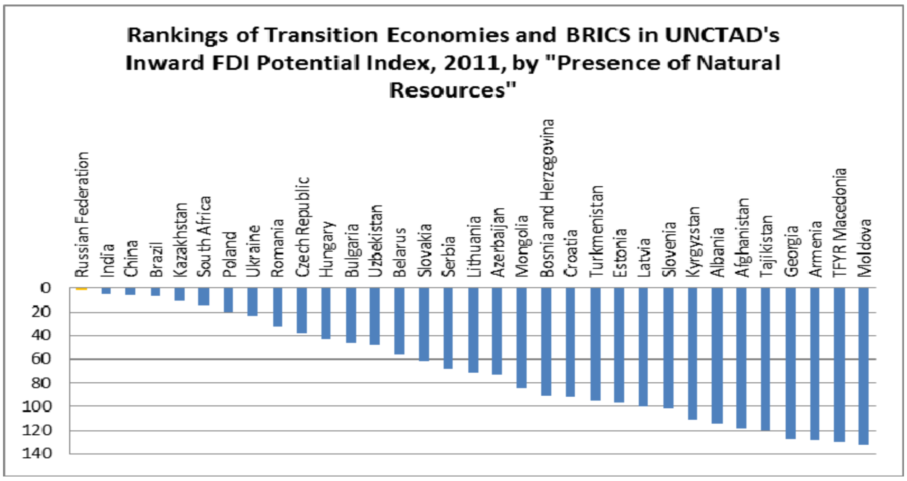
The remainder of this section provides additional highlights in terms of Russia's abundant natural resources and workforce.

1.1.1 Natural Resources

According to UNCTAD's *Inward Potential FDI Attraction Index*, Russia ranks 2nd place out of 177 countries in terms of the presence of natural resources, behind only the USA (1st). This section briefly highlights some of the key characteristics of Russia's natural resource endowments in terms of oil and natural gas reserves as well as agricultural land.

Figure 3 below presents the rankings of 177 countries in UNCTAD's *Inward FDI Potential Index* in terms of the presence of natural resources. Russia ranks 2nd worldwide, well ahead of the remaining BRICS and transition economies in terms of its potential ability to attract Foreign Direct Investors due solely to its natural resource endowments. This type of result is not likely surprising given the vast size of the country and its wealth in terms of oil, gas, minerals, forests and arable land relative to virtually all other countries in the world.

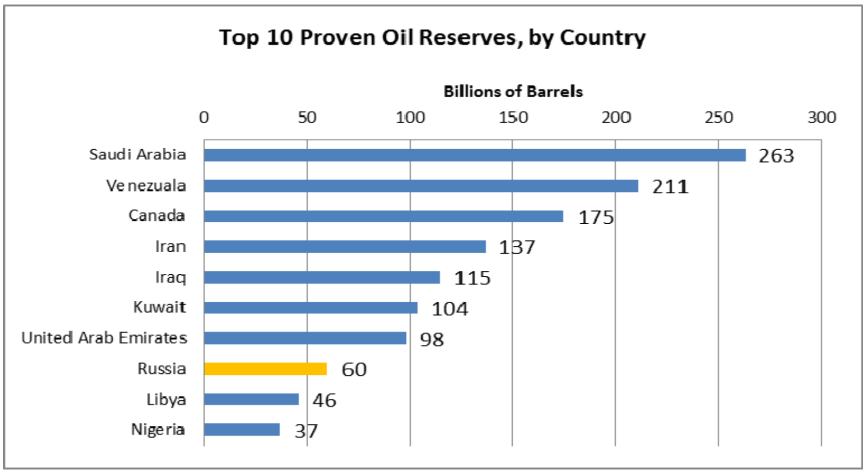
Figure 3 - Russia Relative to BRICS and Other Transition Economies in Presence of Natural Resources



Source : (UNCTAD, 2012) Web-table 32a

In Figure 4 below, the top ten countries are listed in terms of proven oil reserves from the largest to smallest. Saudi Arabia ranks in 1st place with 263 billion barrels of known reserves, while Russia ranks in 8th place with 60 billion barrels.

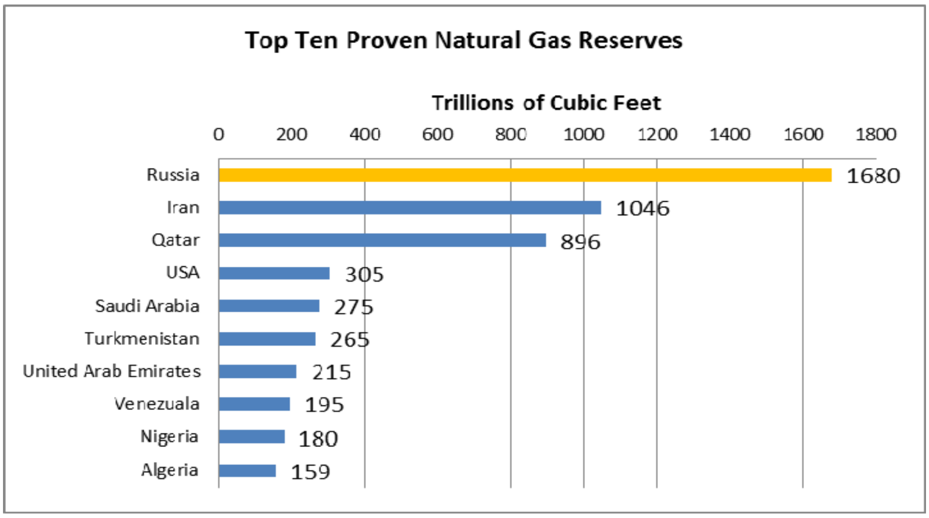
Figure 4 – Russia's Proven Oil Reserves



Source : (IEA, 2012) Internation Energy Agency, Country Profiles

Figure 5 below shows the top ten countries worldwide in terms of proven natural gas reserves. Russia ranks in 1st place with 1680 trillion cubic feet of natural gas reserves, considerably ahead of Iran (1046) and the USA, 4th place, with 305.

Figure 5 – Russia's Proven Natural Gas Reserves



Source: (IEA, 2012), International Energy Agency, Country Profiles

In terms of coal reserves, Russia ranks second in the world with 173 billion short tons, behind the USA with 263 billion short tons. Over the period up to 2035, global demand for energy is expected to rise by about 1/3 with 60% of this increase generated by India, China and the Middle East (OECD, 2012). Russia, with considerable conventional reserves as well as greater potential for hydropower production, is well positioned to potentially respond to this forecast growth in demand.

Beyond its well-established reputation in terms of energy resources, Russia is also well positioned for future growth in agricultural production and to seize new opportunities in export markets. According to the latest joint OECD-FAO *Agricultural Outlook 2012-2021*, demand for agricultural products is expected to grow to 2021 due to rising incomes, population growth, urbanization, and, more specifically, the growth in demand for processed foods and animal proteins (the latter will further generate an increase for feeder crops in addition to higher quality grains for human consumption). While part of this demand can be met by production growth in the developed world (forecast to grow by 1.2% per year), the remainder is expected to come from expansion in the developing world (and emerging markets), which are forecast to expand production by 1.9% per year during the same period.

While some of the increase in production can be met through expanding productivity on already existing land, it is also believed that expansion onto previously unused lands could also provide an important source for meeting future food supply needs in global markets. Although much of this surplus land is believed to exist outside the CIS, Russia, Kazakhstan and Ukraine are forecast to become much more important suppliers in world export markets, in particular for wheat exports.

Part of the reason for this has to do with excess land capacity and future room left for expansion to respond to rising prices and output demand. Between 1990 and 2007, for example, it has been estimated that the total amount of land under cultivation in Russia alone fell from 117.7 million hectares to 76.4 million[2]. Forecasts of Russia's potential due to expanding land under cultivation and growth in productivity by the United States Department of Agriculture (USDA, 2012)[3]indicate that Russia may represent a similar share of world wheat exports by 2021 compared to the USA, at 23.8 million metric tons and 24.5 (15.6% of world exports) respectively[4].

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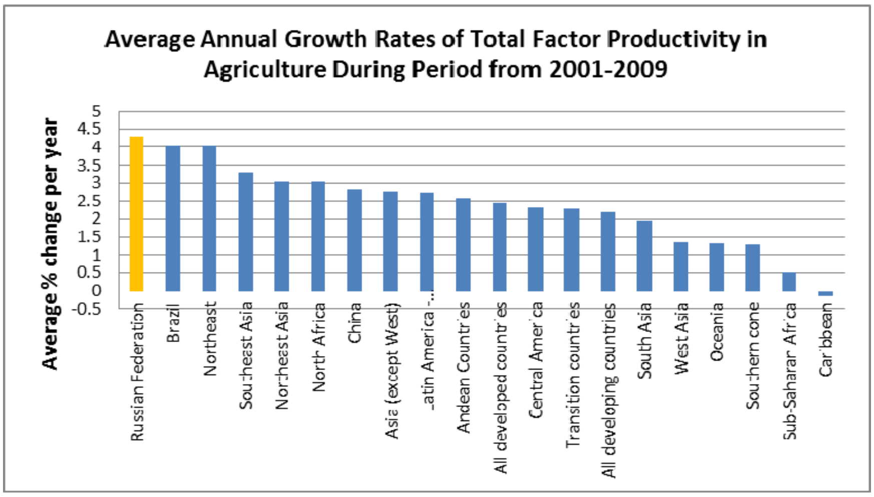
[2] See (OECD, 2009), page 57

[3] See Table 8, pg 48, of the cited report

[4] A previous USDA projection to 2019 has Russia's wheat exports in that year forecast to be 28.7 million metric tons relative to the USA's 24.5, representing approximately 18% to 16.4% of world wheat exports respectively (USDA, 2010), Table 8, pg 49.

In addition to these forecasts and some estimates cited concerning the availability of land for further expansion, Figure 6 presents estimates of productivity growth in agriculture across a selection of regions between 2001 and 2009. Russia is highlighted in yellow and had the highest rate of agricultural productivity growth, 4.29 % per year on average, among the regions selected during this period. Although this in part is likely due to a wide gap in how land was previously used relative to more modern practices, it does lend support to the idea that the country is potentially able to respond to changes in market forces.

Figure 6 – Total Factor Productivity Growth in Agriculture in Russia, 2001-2009



Source: (OECD, 2012), Table 2.2, page 55

Thus, with forecasts for demand growth for natural resources in global markets, namely energy and food presented here, Russia ranks high in terms of growth potential due to its abundant resources and room for expansion.

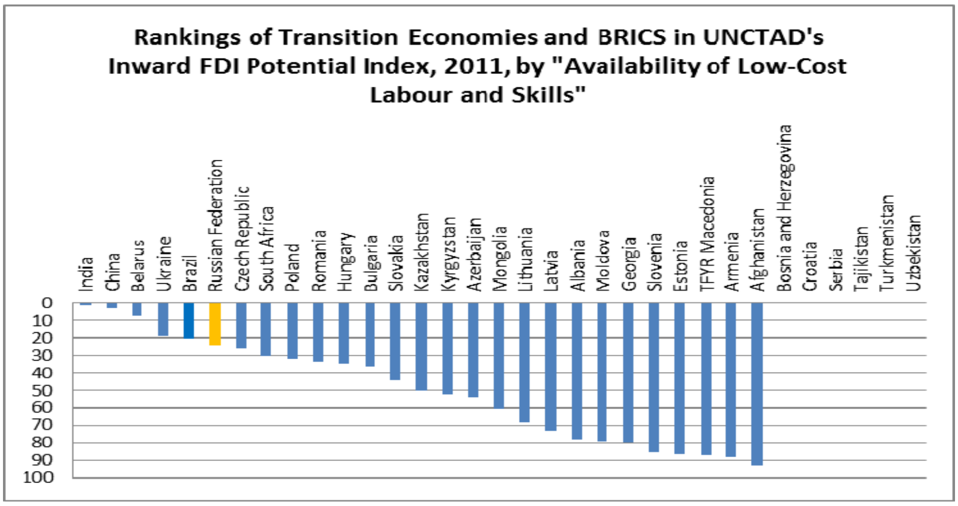
1.1.2 Labor Supply

Russia has a large, well-educated workforce and despite the challenges of transition, has managed to increase investment in education substantially since 2000[5], currently spending about 5.5% of GDP on educational institutions in 2009, below the OECD average of 6.3%, and ranks 24th out of 177 countries in UNCTAD's *Inward Potential FDI Attraction Index* **in terms of low-cost labor and skills. This section briefly highlights some of the key qualities of Russia's workforce in terms of relative literacy rates, levels of schooling and higher education.**

Figure 7 below shows how Russia ranks relative to other BRICS and Transition economies in UNCTAD's *Inward Potential FDI Attraction Index* out of 177 countries in terms of the availability of low cost labor and skills. Russia ranks in 24th place, behind India (1st), China (3rd) and Brazil (20th), but ahead of South Africa (30th) in terms of BRICS and only behind Belarus (7th) and Ukraine (19th) when compared to other transition economies.

[5] According to the OECD's *Education at a Glance 2012: OECD Indicators, Russia - Country Note*, between 2000 and 2009, "Public Expenditure on education more than doubled for all levels of education combined, and more than tripled at the tertiary level." (OECD, 2012), pg.4.

Figure 7 - Russia Relative to BRICS and Other Transition Economies in Availability of Low-Cost Labor and Skills



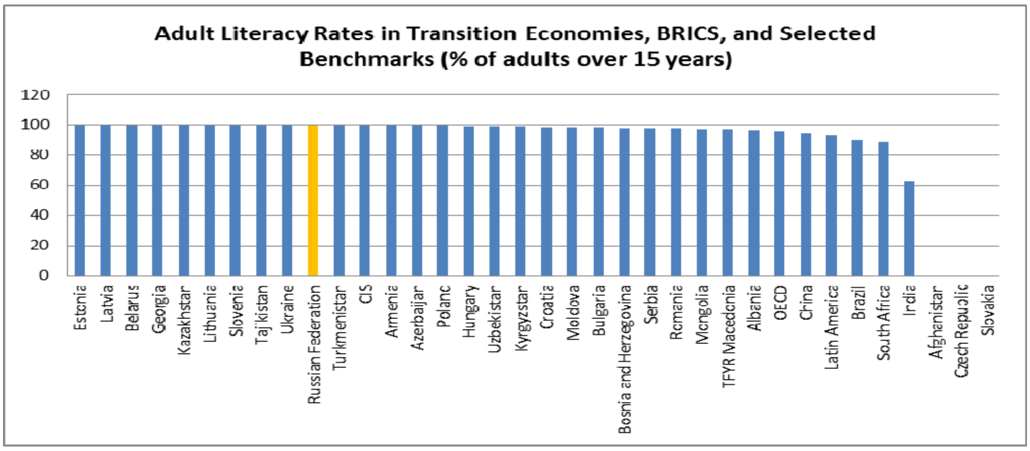
Source : (UNCTAD, 2012), webtable 32a

One of the fundamental ingredients for success in terms of attracting and retaining high-skilled, high value-added economic activity is an educated adult population; one that can respond to changes and needs in the workplace as well as offer creative solutions to production problems (OECD, 2012). In addition to adults who can read and write with basic numeracy skills, higher levels of basic educational attainment in addition to some form of tertiary education that supports the development of higher skills, knowledge and an ability to adapt and respond are fundamental.

Basic literacy is not a concern or challenge facing Russia compared to other economies. Figure 8 below shows that Russia has a high level of literacy in line with other transition economies and ahead of BRICS, as well as slightly above OECD average. These rates are generally high enough that they do not appear to pose a problem with the exception of three issues. These rates need to be maintained, firstly, and secondly, they do not capture how well adults retain their literacy levels throughout adult life, which is a considerable challenge currently facing some developed countries[6]. Third, literacy rates also do not capture deeper qualities of skills in the workforce or how well people can function across languages, all of which might be relevant for Russia in the 21st century to achieve a greater potential.

[6] According to The Conference Board of Canada and results from an International Adult Literacy Survey (IALS), four in ten Canadian adults do not have the literacy skills required to be fully competent in most modern economy jobs (The Conference Board of Canada, 2010).

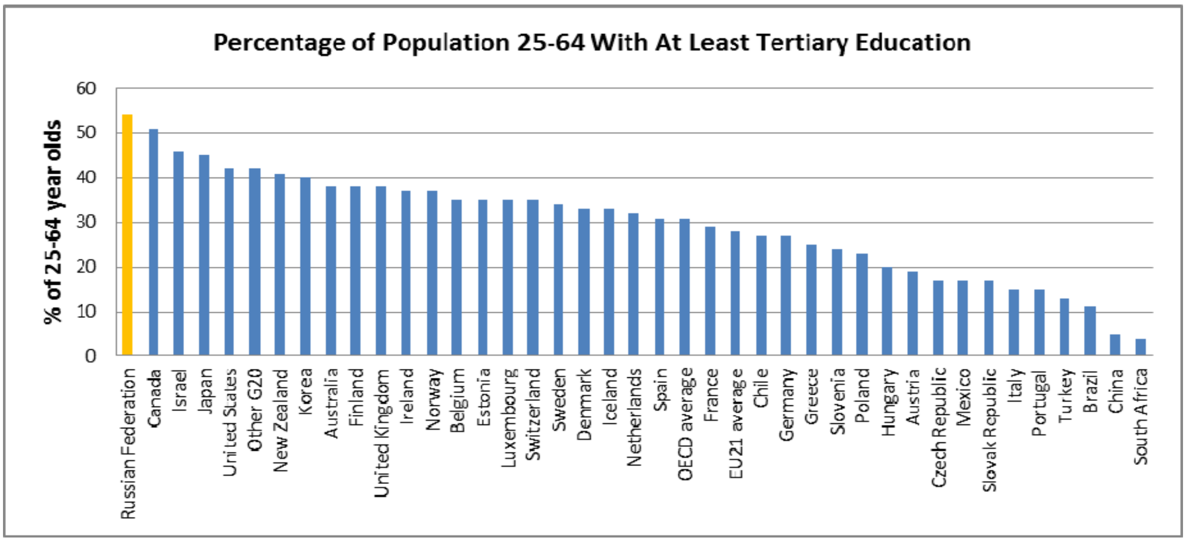
Figure 8 – Literacy Rates for Those 15 and Over



Source: United Nations Human Development Index. Percentages were not shown for Afghanistan, Czech Republic and Slovakia for this indicator.

Figure 9 shows that relative to advanced, industrial, economies, the OECD, and most of the BRICS (India's data was not included in this indicator), Russia is well positioned with the highest percentage (54%) of its adult population aged 25 to 64 with at least a tertiary education. Although there might be a need for closer examination of the quality of primary, secondary, and higher education Russian citizens receive relative to other countries, and whether the skills and knowledge are appropriate for the market's needs, this high level indicates that the country has managed to support access to a wide portion of its population, especially considering the difficulties with public education finance during the early years of transition and recent growth in educational expenditures since 2000[7].

Figure 9 - Percentage of Adults With Tertiary Education



Source: OECD Education at a Glance, 2012, Indicators

Figure 10, for example, shows a slightly different picture when younger adults, aged 25-34, are considered separately out of the general working age population over 25. This is roughly the age when many young people expect to enter the workforce after completing additional levels of higher education and training after completing secondary school. Korea has the highest portion of these adults with at least a tertiary education, at 65% of those aged 25-34, compared to Japan, in 2nd place,

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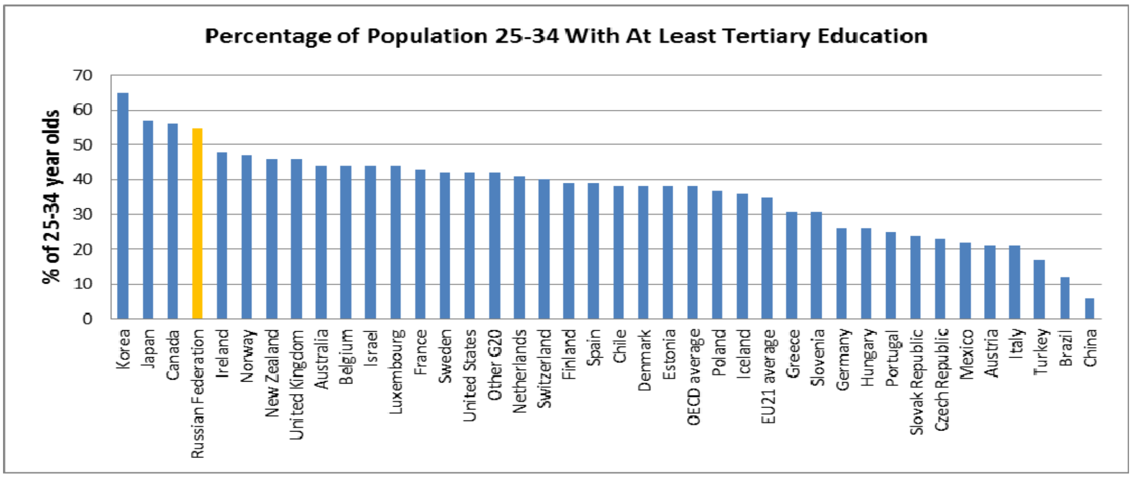
[7] See (OECD, 2012) Education at a Glance, PISA scores and related country reports for more detail about how the quality of Russia's education system compares to other countries as well as key challenges moving forward.

with 57% and Canada in 3rd with 56%, slightly above Russia's 55%. What this data appears to reflect is Russia's commitment to provide access to higher educational institutions, and the populations desire to enter some form of tertiary education, despite the turmoil associated with transition. In addition, it signals that this characteristic of a well-educated workforce is likely to remain an important feature for Russia in the foreseeable future.

Figure 10 – Percentage of Adults Aged 25-34 With Tertiary Education



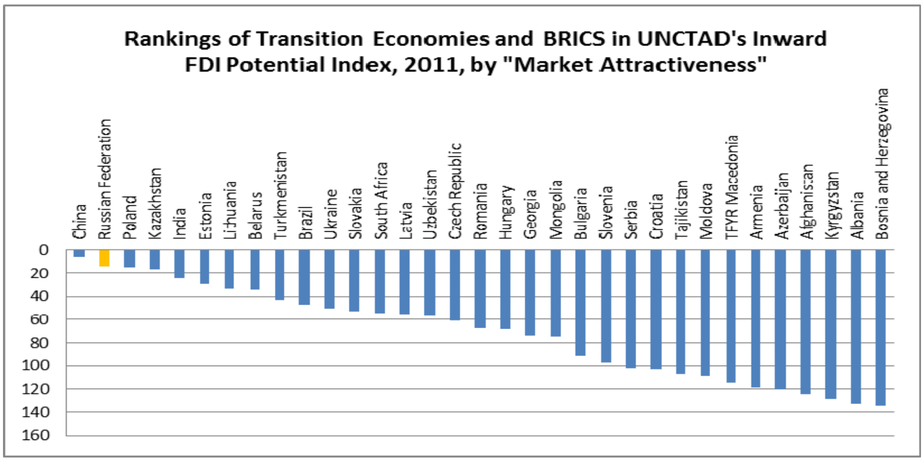
Source: OECD Education at a Glance, 2012, Indicators

One of Russia's most important assets is its large, well-educated, workforce and this does not appear to be changing any time soon. Out of 142.865 million people, the country has 75 million economically active people, 69.5 million of who are employed (about 7.1% unemployed). An estimated 54% of those over 15 have at least a tertiary level of education, the highest share in the world, and some 6.5 million people are currently enrolled in the country's 1080 higher educational institutions (Rosstat, 2012).

1.1.3 Consumer Market

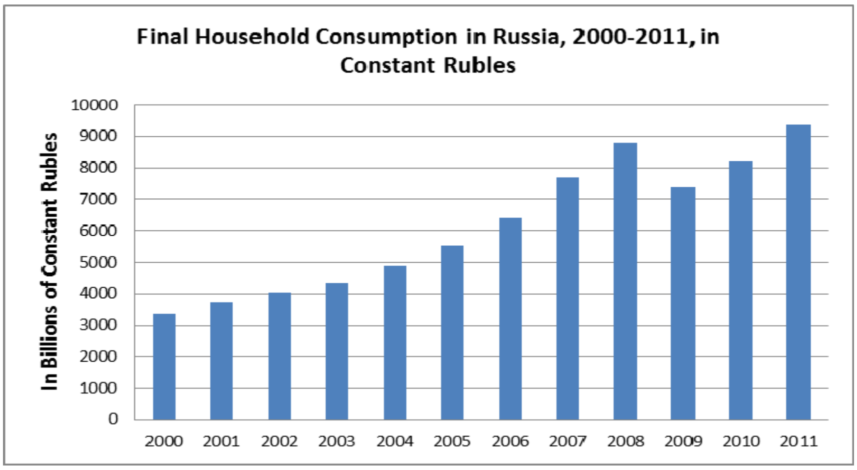
Figure 11 below shows how Russia ranks relative to other BRICS and transition economies in terms of "market attractiveness" in UNCTAD's *Inward FDI Potential Index*. Russia ranks in 14th place worldwide, just behind China (6th) and ahead of all other BRICS and transition economies in the Former USSR and Eastern Europe.

Figure 11 - Russia Relative to BRICS and Other Transition Economies in Market Attractiveness



With a population of 142.865 million people, Russia is Europe's largest market by population size. After a severe downturn during the 1990s associated with the collapse of the USSR and the early stages of transition, the country began to experience a strong turnaround in consumer spending and growth in disposable household incomes beginning around the year 2000. Figure 12 below shows the growth in final household consumption, adjusted for inflation, between 2000 and 2011. Despite the recent negative growth in 2009, this level of spending grew on average by 9.7% per year during the past 11 years.

Figure 12 – Growth in Final Household Consumption in Russia, 2000-2011



Source: (World Bank, 2013) World Development Indicators, #497 Final Household Consumption in Constant LCU.

Russia's average growth in household consumption between 2000 and 2011 of 9.7% has outpaced general economic growth of 4.8% during the same period. With a forecast of an average future growth rate of 3.9% to 2017, outlined in the next section, Russia's rapidly growing consumer markets present opportunities for domestic and international investors alike, whether it is for automobile production, repairs and sales, large ticket consumer items, or financial and other services[8].

1.2 Recent Performance

Given Russia's high potential in terms of growing domestic consumer markets, natural resource endowments, and well-educated workforce, this section looks briefly at how well Russia has recently performed. More specifically, the focus in this section is on three broad areas (Macroeconomic Growth, FDI and Capital Flows) since improving the quality of a country's Business Climate generally aims to improve these types of outcomes and was the focus of BCDM's annual project.

1.2.1 Macroeconomic Growth

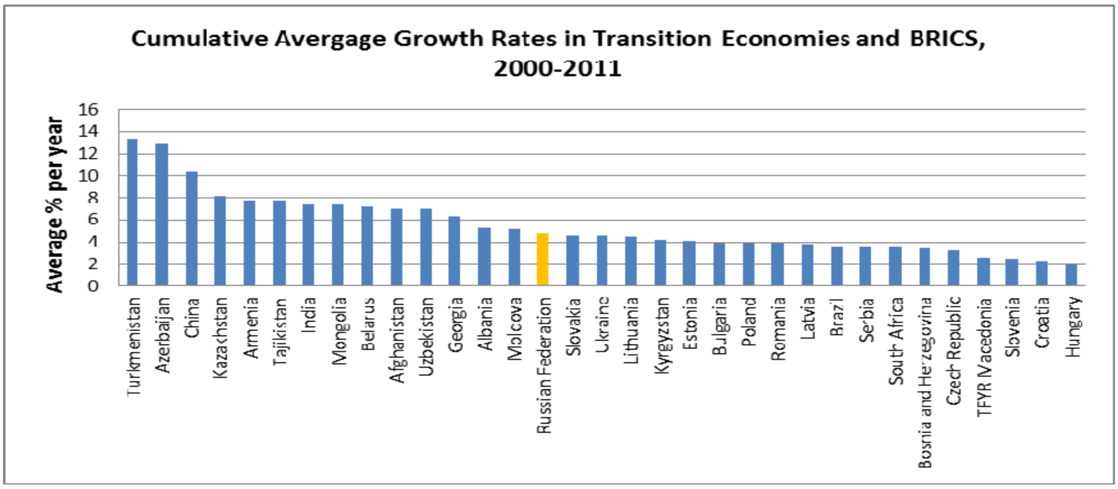
After a severe downturn during the 1990s associated with the collapse of the USSR and early stages of transition, Russia's economy began a turnaround roughly beginning in 2000 in terms of macroeconomic growth and has grown, on average, by 4.8% during this period, including the negative growth as a result of the impact of the financial crisis.

Figure 13 below shows Russia's average growth over this period relative to other BRICS and transition economies. The three former Soviet Republics within the top four positions, Turkmenistan, Azerbaijan and Kazakhstan, all have, like Russia, energy resources and have benefitted from expansion during a period of high oil and gas prices. In terms of BRICS, China and India have also had

[8] For greater detail on the potential of Russia's consumer markets and specific areas of growth and opportunities, see (BNP Paribas, 2011).

higher growth rates than Russia on average during this period. This graph suggests that Russia's high growth rate, when put in this perspective, has been moderately high.

Figure 13 – Average Growth Rates in Transition and BRICS Economies, 2000-2011



Source: (IMF, 2012), World Economic Outlook Indicator Database, calculated based on GDP in national currencies at constant prices using CAGR average growth rate formula.

Growth rates, however, must be used with a high level of caution. First, the data is not always directly comparable and there is a high degree of uncertainty about the accuracy of GDP and inflation figures, especially when comparing countries, and even of greater concern when comparisons are being made during stages of transition or development. Second, growth rates are base sensitive. Countries that are poorer, or have just emerged from conflict, often have higher growth rates due to a low starting position. Third, and no less important for interpreting data, countries have differing potentials, produce different goods, services and inputs, and face different conditions and prices in global markets, all partially explaining why GDP may differ during a specific period of time. In other words, not all countries can be expected to grow by the same rate during the same years[9].

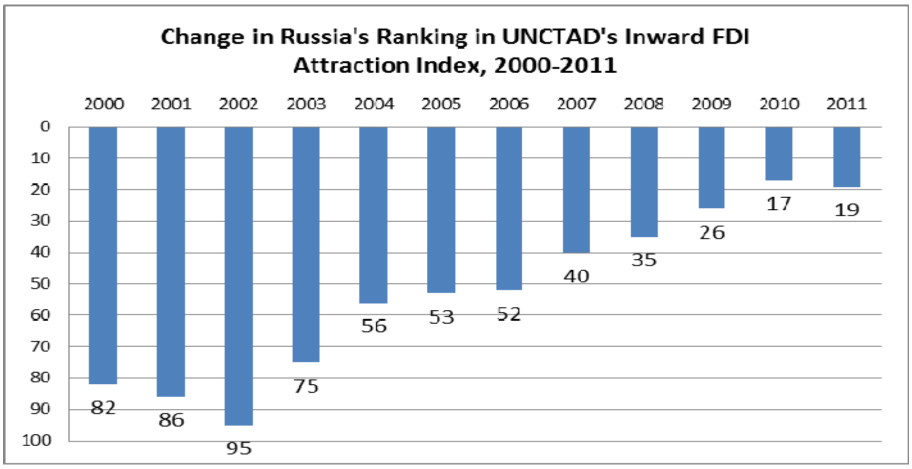
1.2.2 Capital Flows and Foreign Direct Investment

Since the early 2000s, Russia has managed to attract a growing share of worldwide FDI flows and capital inflows, however, there is no guarantee that this trend will continue and net capital outflows appear to be a serious issue facing the country.

The United Nations Conference on Trade and Development's (UNCTAD) *Inward FDI Attraction Index* looks at how much FDI countries manage to attract relative to their size. Figure 14 below shows how Russia has ranked in this index since 2000 out of 182 countries. This Index shows that for its size, Russia has managed to attract a growing share of inward FDI flows since 2000 and has, as a result, improved in rank from 82nd place in 2000, a low of 95th in 2002, to, most recently, 19th place.

[9] See (Pomfret, 2003) for more detail on using GDP statistics in the case of transition.

Figure 14 – Change in Russia’s Rank in FDI Attraction, 2000 - 2011



Source: (UNCTAD, 2012), Web-Table 31

Figure 15 shows by how many rank positions the BRICS and transition economies changed during this period of time in this Index. Caution must be used since the difference between rank positions are not necessarily, or even likely, equal. This means that it is possible that a country which climbed 50 ranks may have improved less in reality than a country which climbed 42 ranks. However, bearing this detail in mind, it is possible to see that as a general trend Russia has improved its rank position in this Index significantly during this period compared to many of these other countries.

Figure 15 – Russia’s Change in Rank on FDI Attraction Index Relative to BRICS and Other Transition Economies

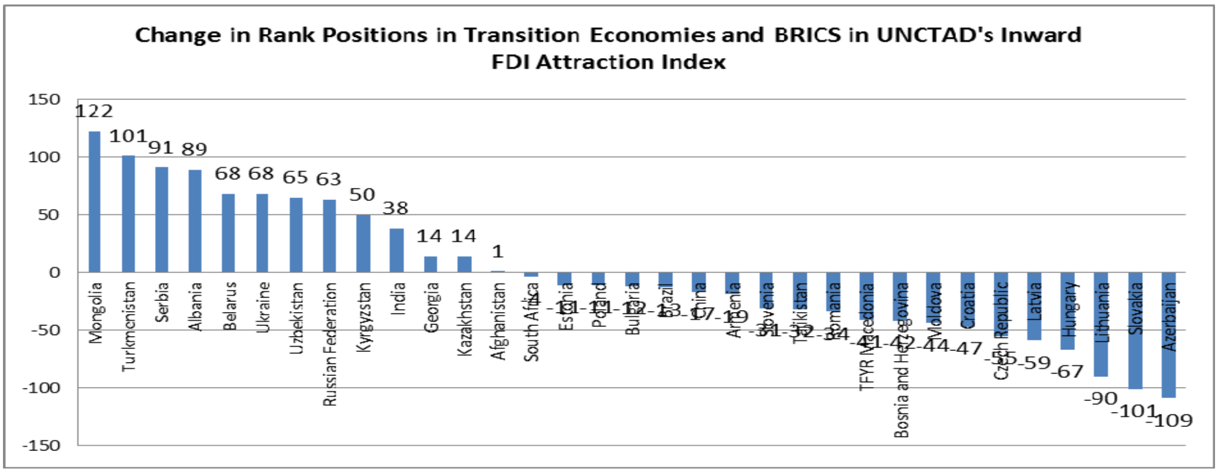
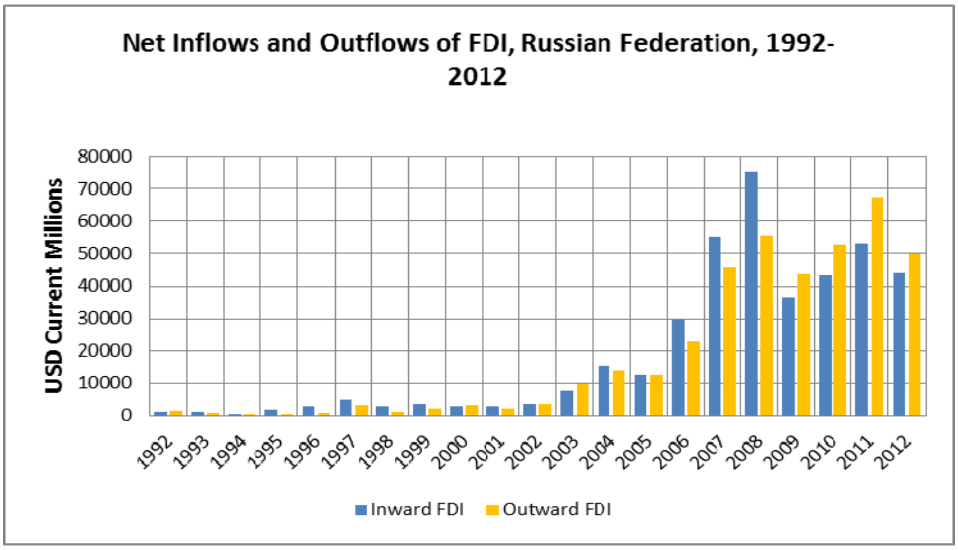


Figure 16 shows both net inflows and outflows of FDI for Russia from 1992 to 2012. While both were present during the 1990s, they were very low relative to the strong upward trend which began in the early 2000s. While world stocks of FDI grew on average by about 12.4% per year during the decade (2000-2010), Russia’s stock grew by 25% on average per year. This means that the inflows into Russia, as well as outflows, are not simply due to the growth trend in FDI flows worldwide. In fact, in 2000 Russia was only able to capture about 0.2% of worldwide FDI flows. By 2011, however, the country was able to capture 3.4%; a larger share of a considerably larger pool of FDI.

Figure 16 – Russia's Net Inflows and Outflows of FDI, 1992-2012



Source: Figures for 1992 to 2011 are based on (UNCTAD, 2012) World Investment Report data. Estimates for 2012 are based on Bank of Russia estimates for the first three quarters annualized.

This Figure 16 also indicates that not only has Russia managed to attract more FDI during the past 12 years, but it has become a more active player in global markets. Foreign investors are able to invest in Russia and take advantage of many of the benefits the Russian market has to offer, but also Russian investors have gained access to foreign markets and are investing abroad[10].

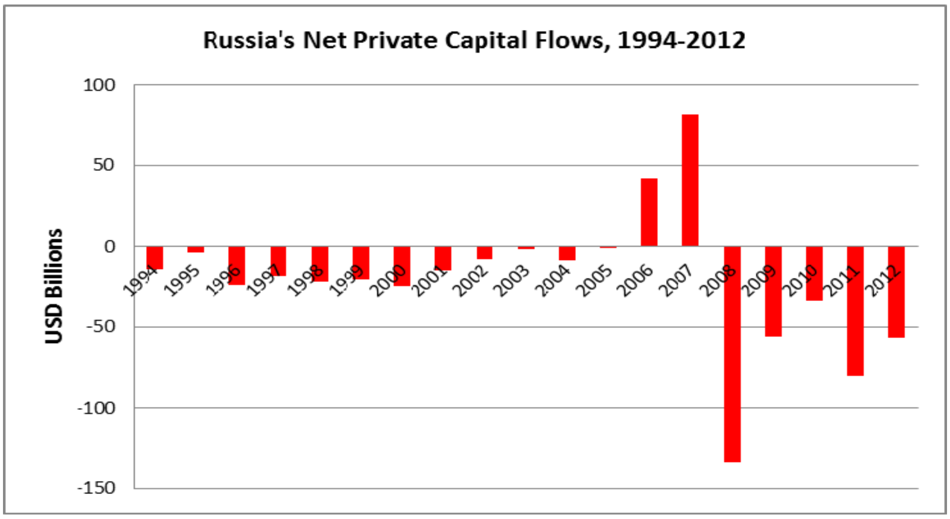
In addition to general concerns about whether this recent wave reflects primarily investments in the energy sector, one time privatization schemes, or the impact the recent financial crisis may have on hindering future growth in both FDI and capital flows more generally, one of the central issues that arose in 2012 concerned political uncertainty. Due to protests surrounding the Parliamentary elections in December, 2011, and the Presidential election in 2012, investors may have decided to hold off on investing in Russia until the outcomes of the election were announced, a government with a clearer mandate or direction appointed and the political dust somewhat settled. Further, domestic investors may have moved investments abroad and this political risk, as a result, could affect genuine economic outcomes in terms of the country's growth and development.

Figure 17 presents data on net capital flows for Russia from 1994 to 2012. It shows, in general, that net capital outflows are by no means a new occurrence. With the exception of 2006 and 2007, Russia has generally experienced annually net capital outflows. After the financial crisis, however, these flows began to decrease until 2010 before increasing again in 2011 and slowing down again in 2012. The recent estimate by the Bank of Russia for net capital outflows in 2011 was -$80.5 bln[11], almost 140% higher than 2010's $33.6 bln, and the estimate for 2012 is -$56.8 bln.

[10] This conclusion is partially simplistic since it avoids the issue of round tripping and other flows which might not truly represent FDI inflows and outflows, thus distorting the accuracy of the data. However, as far as overall trends are concerned, the data is a reliable indicator.

[11] This number is lower than the $84.2 bln previously reported in BCDM's Monthly and Quarterly Newsletters. This is simply due to updates in estimates provided by the Bank of Russia since then.

Figure 17 – Russia's Net Private Capital Flows, 1994-2012

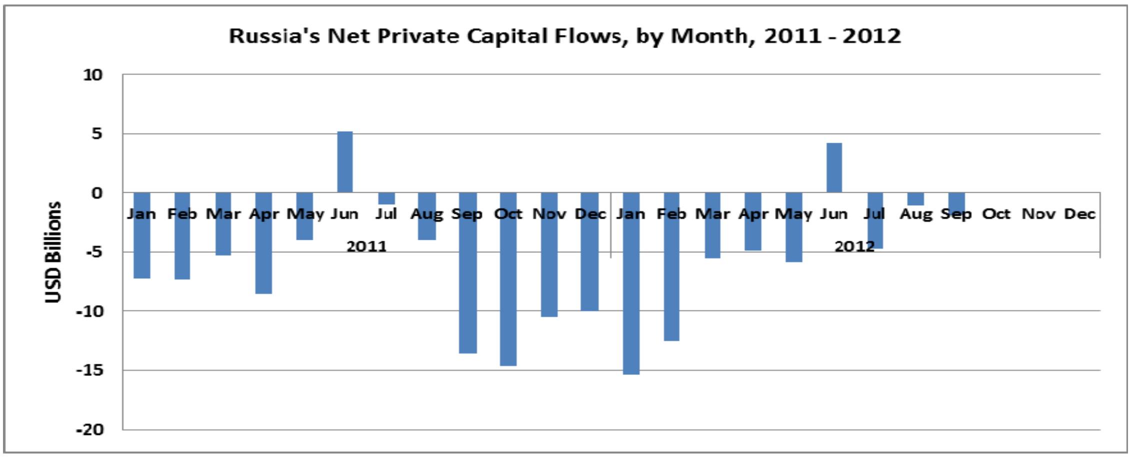


Source: Bank of Russia

It will likely be some time before a more detailed analysis can be carried out to determine how likely the element of political risk may have influenced, or to what degree, net capital flows and overall investment activity in Russia in 2011, 2012, and potentially thereafter. Figure 18, however, shows estimates of net private capital flows by month from the Bank of Russia. This view shows a jump in net private capital outflows starting just after the summer of 2011 leading up to and during the Parliamentary elections in December of that year and continuing, albeit at a slower pace, in spring before dropping significantly during the summer of 2012.

This observable trend is at least consistent with the idea that political risk may have returned to Russia and remains an underlying, fundamental issue, concerning the integrity of the country's political institutions. It further suggests that looking more deeply into this issue is warranted in terms of improving the business climate, especially since this issue is likely to return and have a real impact on economic performance, including social welfare.

Figure 18 – Russia's Net Private Capital Flows by Month, 2011 and 2012



Source: Bank of Russia

According to UNCTAD's Inward FDI Potential Index, Russia ranks high in terms of natural resource abundance, consumer markets, low-cost labor and skills, and enabling infrastructure. During the past 12 years, the country has managed to attract a significant amount of FDI, from 0.2% of worldwide FDI flows in 2000 to 3.4% of an even larger pool of flows by 2011. However, preliminary

data suggest that the country may be impacted by the financial crisis in Europe as well as potential outflows due to Russian investors taking advantage of foreign market access. There is also concern that political risk has returned to Russia in late 2011 and 2012, generating investment instability and potentially contributing to significant net private capital outflows. This indicates that steps should also be taken in terms of the integrity of Russia's political institutions to mitigate this risk in the future since it may be a serious underlying problem.

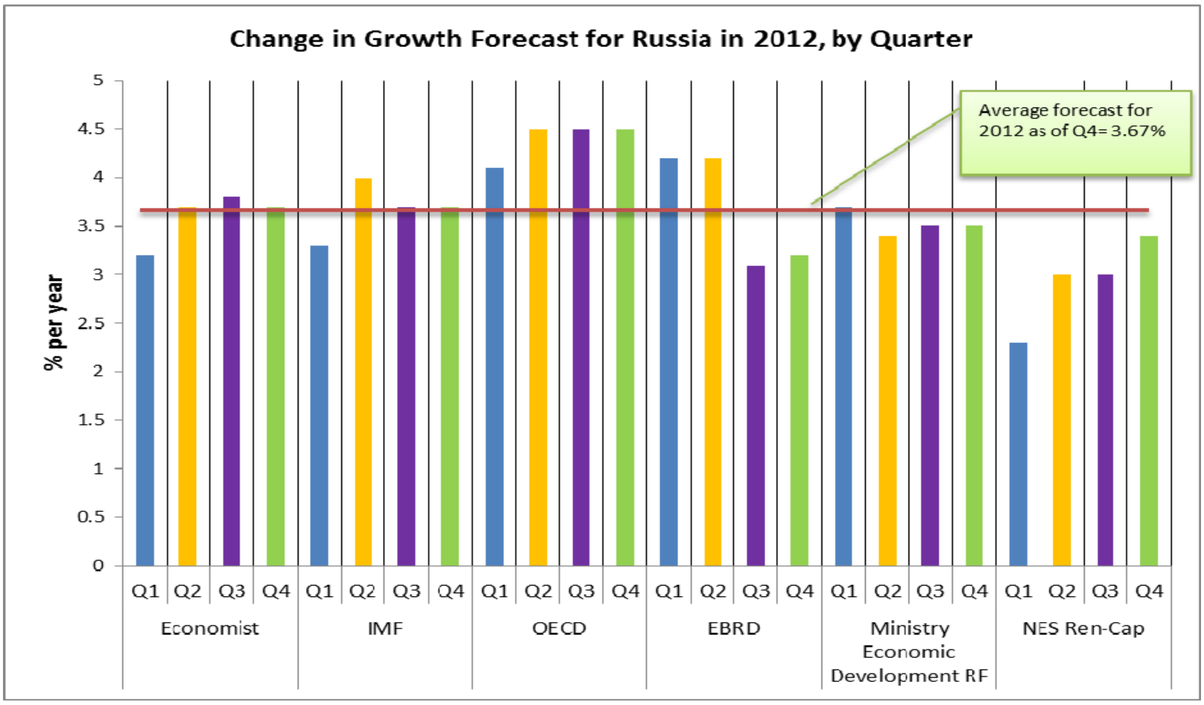
1.3 Looking Ahead

After growing by 4.8% per year on average between 2000 and 2011, forecasts of Russia's growth rate for 2012 range, as of the fourth quarter, from a low of 3.2% to a high of 4.5%. This is above IMF forecasts for Central and Eastern Europe, 2% on average, and in line with the CIS, 4.0% on average. The IMF has also forecast that Russia will continue to grow by 3.9% on average over the following five years to the end of 2017.

Figure 19 shows various forecasts of Russia's GDP growth rate for 2012 broken down by quarter and organization. By the end of the fourth quarter, the latest estimates of Russia's annual growth rate ranged from a low of 3.2% to a high of 4.5%, and were, on average, 3.67%, down from a previous high of 3.8% during the year.

Changes in the forecast during the year can highlight differences between what organizations think are important factors in determining Russia's growth rates, but also which changing conditions they see as relevant for changing their overall forecast for the year.

Figure 19 – Growth Forecasts for Russia's 2012 GDP by Organization and Quarter

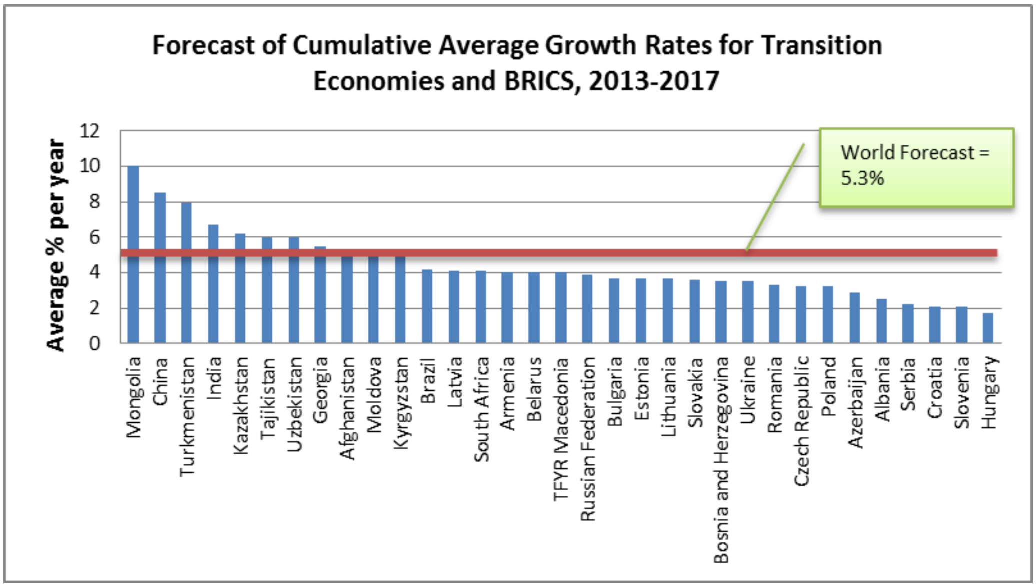


Over the year, these forecasts general changed for several reasons. First, Russia's Ministry for Economic Development downgraded their estimate for 2012 early in Q2 citing lower than expected investment levels. Revisions upwards during the second quarter were based on the easing of Euro tensions, greater political certainty, and higher resource prices. The IMF later reversed its upward revision due to a gloomier than expected outlook for 2012 and the EBRD cited a spillover of the Eurozone crisis into the transition economies[12].

Although many of these factors suggest conditions other than the quality of Russia's business climate as important factors affecting the country's macro performance, on the one hand, on the other they highlight the value in improving the business climate. This would allow for greater efficiency, help diversify economic activity and investments, and overall help mitigate the exposure and risk these conditions present.

Figure 20 below shows the IMF's forecasts for Russia, BRICS, and the other Transition economies in the Former USSD and Eastern Europe over the following five years (2013 to the end of 2017). The red line in the figure denotes that World GDP is forecast to grow by 5.3% on average per year during this period. Russia is forecast to grow by 3.9%, in line with many of the other economies in Eastern Europe and transition, but well below India (6.7%), China (8.5%), and other resource rich transition economies such as Turkmenistan (7.9%), Kazakhstan (6.2%) and Uzbekistan (6%).

Figure 20 – Russia in the near term



Source : (IMF, 2012), WEO Indicators, CAGRs based on difference in levels of GDP in constant LCU for each country between 2013 and 2017

Changes in forecasts for Russia's GDP growth in 2012 in addition to moderate forecasts during the next five years highlight the importance of Business Climate reforms to improve efficiency, avoid risk, as well as unlock potential alternative sources of growth.

1.4 General Conclusions

Russia is generally well positioned relative to other countries in the world, and BRICS and transition economies in particular, in terms of its economic potential. With abundant resources, more specifically in energy and food, coupled with a well-educated workforce, growing consumer base, especially when other developed economies are experiencing consumer slumps, and infrastructure, the country has key assets that can be used to grow, develop, attract investments, and more generally, offer a wide range of opportunities for income-generating activities.

[12] More specific details of changes during the year can be found in BCDM's quarterly newsletters.

During the past ten to twelve years, the country has further managed to attract a growing share of investments, grow at a moderate pace, and disposable incomes have expanded significantly.

However, there are some warning signs. Some aspects of Russia's potential can be improved or at least need to be maintained. While ranking high in terms of natural resources, there is room for improvement in terms of infrastructure and low-cost labor and skills. Further, there is suggestive evidence that political risk has returned and may have affected investment levels in the country, which will have a real impact on growth, development, productivity, and ultimately prosperity. Worse still, if left unaddressed, this issue is likely to return and pose a barrier to investment and expansion activity that prevents the country from using its assets to their full potential. Lastly, changes in forecasts highlight an additional need for business climate reforms to improve efficiency and support expansion in other activities to mitigate risk and exposure to external conditions as far as possible, such as Euro tensions, the recent financial crisis, and gloomier worldwide outlooks.

2 Russia's Business Climate

This section of BCDM's Annual Report aims to provide a brief overview of how Russia's Business Climate ranks relative to other countries across Indexes released during the past year and where the indicators used suggest reforms are needed to improve both the quality and ranking of the Business Climate.

During the past year, Russia's Business Climate has been assessed by several organizations. Although the approaches, data, and objectives differ across Indexes, often significantly, Russia generally ranks consistently low and behind most other transition economies. Given the country's potential in terms of natural resources, a well-educated labor force, infrastructure and a growing consumer market, improving the quality of the business climate should foster improvements in efficiency (lower production costs) thereby improving its ability to attract and retain economic activity and investments. It also means that recent performance could have likely been better had the country sought to improve the business climate earlier.

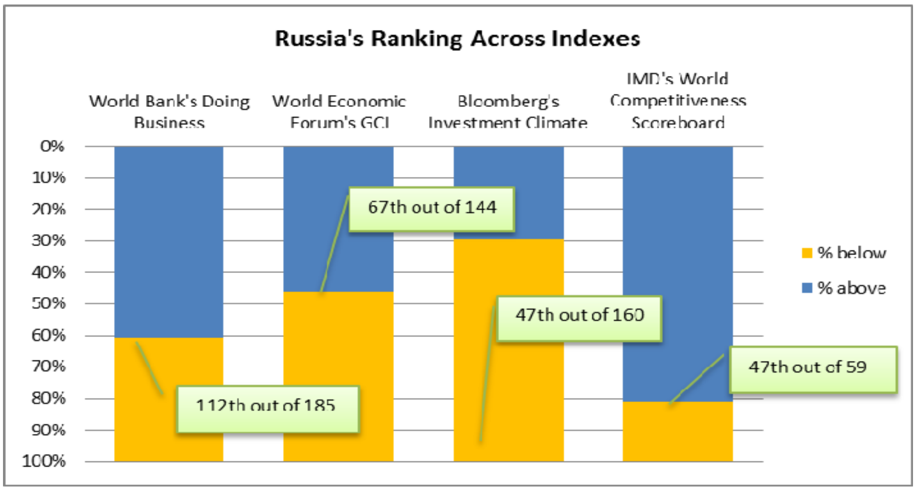
2.1 An Overview of the Quality of Russia's Business Climate

Error! Reference source not found. below shows how Russia ranks across four Indexes related to the quality of its Business Climate[13]. Each bar shows the percentage of countries included in each index that rank above Russia (in blue, representing a higher level of overall quality) compared to the percentage of countries which rank below Russia (in yellow, representing a lower level of overall quality). The captions for each bar specify where Russia ranks out of the actual number of countries covered.

Generally, Russia ranks low relative to other countries covered in these Indexes across indicators that aim to assess various qualities of countries' operating environments (factors external to the firm that can have an impact on firm performance) such as access to finance, an educated and skilled labor force, corruption, red tape and regulations, and infrastructure, to name but a few. In the World Bank's most recent annual *Doing Business Index 2013*, Russia ranked 112th out of 185 countries covered, up from 120 in the previous year. In the World Economic Forum's most recent *Global Competitiveness Index*, Russia ranked 67th out of 144 and 47th out of 160 in Bloomberg's *Investment Climate Index*. IMD's *World Competitiveness Scoreboard* placed Russia in 47th place out of 59 countries covered.

[13] Although different organizations may use different definitions, such as Investment Climate (Bloomberg), Competitiveness (OECD and WEF), Business Climate (OECD), Enterprise Environments (EBRD) or Doing Business (WB), they share an important common feature; they focus on factors external to the firm that, if improved, can lower the costs of production/improve efficiency. See (Krugman, 1994) for a broader discussion on this general topic as well as critiqcue.

Figure 21 – Russia's Business Climate Across Indexes



Although these organizations have different aims, objectives, and methodologies and use different data combined in different ways to assess characteristics of a country's operating environment, they nevertheless highlight several overall important features concerning the quality of Russia's Business Climate. First, they consistently show that Russia ranks low, generally in the lower half of countries covered (except in the WEF's GCI where it is just on the borderline of the lower half) and in one case (IMD) near the very bottom.

Overall, there is evidence that the quality of Russia's Business Climate is an issue. Second, given the breadth and depth of the indicators used generally across Indexes, a significant effort would need to be made on a wide range of issues to improve overall rankings; a piecemeal approach would not likely generate much observable change over a short number of years.

Third, and perhaps most important for providing a stimulus for the type of reform efforts required, Russia has made progress during the past 12 years after a severe downturn in the 1990s in terms of growth, employment, investment activity, and integration with other markets; despite the low quality of its Business Climate. This suggests that Russia could do even better, and could have done even better, if the Business Climate were improved.

2.2 A Comparison of Russia's Rankings Across Indexes With Other Transition and BRICS Economies

The following figures show where Russia ranks in each of these Indexes relative to other Transition and BRICS economies[14].

Figure 22 below shows how Russia ranks in the World Bank's *Doing Business Index 2013* relative to other transition and BRICS economies. Not only does Russia rank generally low, in 112th place, out of 185 countries covered in this year's Index, but it ranks significantly behind the vast majority of other transition economies which have also shared many common challenges associated with moving towards a market-oriented economy. The comparisons are even more revealing in the case of the Former Soviet economies which experienced transition challenges during the past two decades. Kazakhstan and Azerbaijan, which have considerable energy endowments, have managed to improve their rankings in the *Doing Business Index* during the past several years and now rank 49th and 67th

[14] Data for IMD's Index are not presented in greater detail throughout the rest of this section. The primary reason for this is that the rankings and indicators used are not publicly available online, only a sub-sample are freely available.

respectively. Georgia now ranks in 9th place (in the top ten) and other considerably poorer countries such as Armenia (32nd), the Kyrgyz Republic (70th) and Albania (85th) rank higher.

While most of the other transition economies have advanced during the past several years in terms of those characteristics covered by the *Doing Business Index*, Russia has remained far behind and only ahead of Ukraine, Tajikistan, and Uzbekistan in terms of Former Soviet economies, and Brazil and India in terms of BRICS.

If other economies which are lower income, or have energy endowments, can improve operating conditions for businesses, this comparison suggests that Russia could have as well. In other words, the challenges of transition itself are not enough to explain why Russia has been unable to improve operating conditions and, second, the progress made in other economies facing similar conditions indicates that it is possible for Russia to improve.

Figure 22 – Transition and BRICS Economies in Doing Business 2013 Index

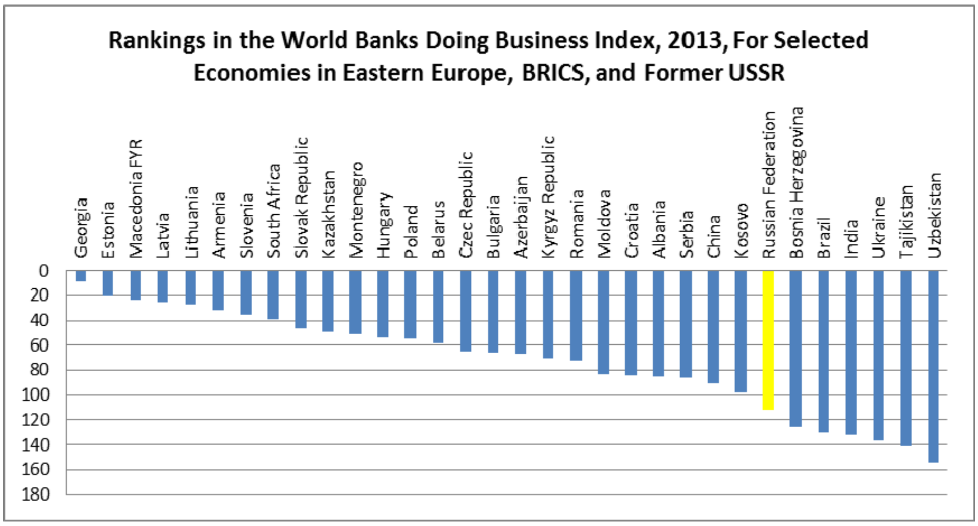
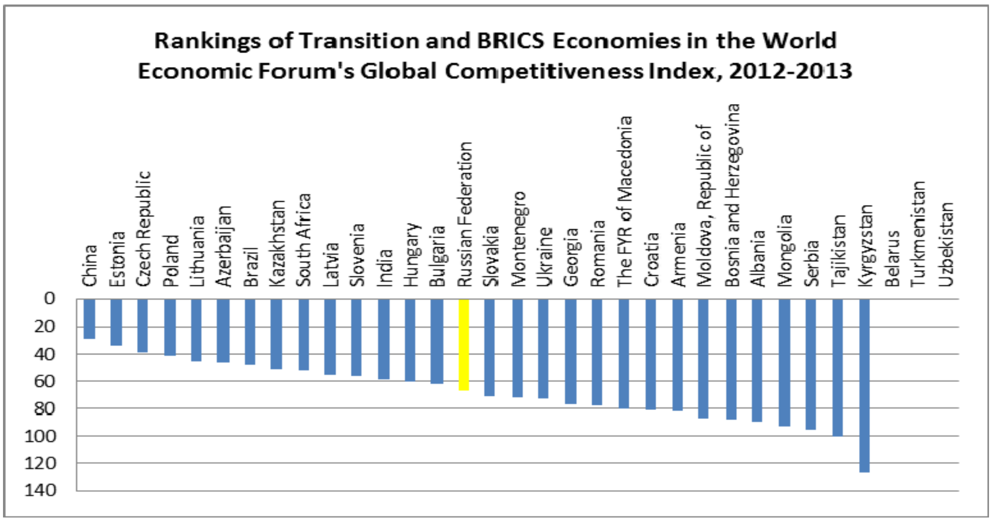


Figure 23 shows Russia's position relative to other BRICS and transition economies in the World Economic Forum's *Global Competitiveness Index*. Russia ranks 67th, behind India (59th) and China (29th) in terms of BRICS countries, as well as considerably behind transition economies such as Estonia (34th), Azerbaijan (46th), Kazakhstan (51st) and Bulgaria (62nd), but ahead of others, such as Georgia (77th).

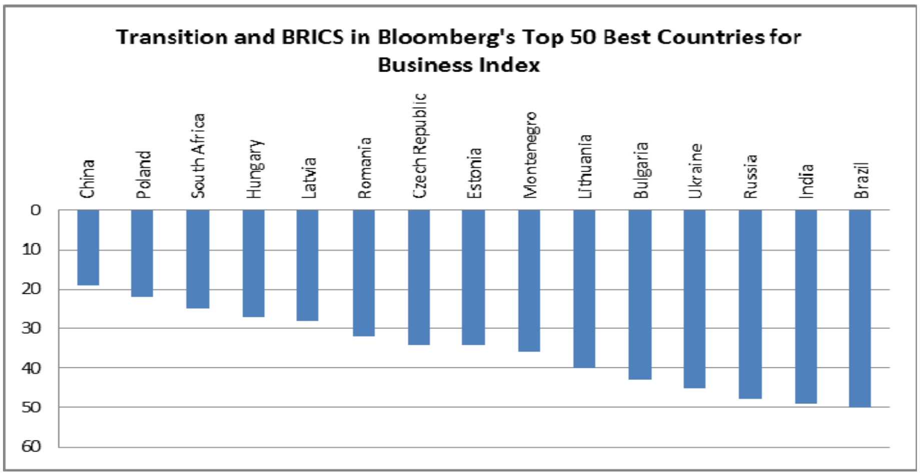
Figure 23 – Transition and BRICS Economies in the Global Competitiveness Index, 2012-2013



Source : (World Economic Forum, 2012), Global Competitiveness Index

Figure 24 shows the Transition and BRICS countries which ranked among the top 50 out of 160 in Bloomberg's *Best Countries for Business Index*[15]. In terms of BRICS, Russia ranks ahead of India (49th) and China (50th), but behind China (19th) South Africa (25th). Russia also ranks below 10 other transition countries covered in the top 50 in this index.

Figure 24 – Transition and BRICS Countries in Bloomberg's Top 50 Best Countries for Business Index



Source: Bloomberg.com

Generally, across each of these Indexes, Russia ranks behind many other transition and BRICS economies, or in close proximity. The changes in ordering of countries across Indexes, however, merits some explanation. Each of the Indexes differ in their overall aims and objectives and they combine different indicators together, as well as weighting them differently, and rely on different qualities of data sources. In addition to the difficulty, generally, in measuring the overall quality of a country's business or investment climate, or competitiveness, these signficant differences in approaches can partially explain inconsistencies in rankings and the order of countries.

15 Only a listing for the top 50 out of 160 was publicly available online.

However, Indexes, when used with caution, can provide important insights and be useful for helping to identify where reforms are needed. First, they can help raise awareness of the issue of the quality of a country's business climate. Second, they often rely on surveys of existing businesses and they can help to identify and prioritize barriers that enterprises actually face in terms of their operating costs and performance. Third, they can provide a tool for monitoring and evaluating progress that can be an important component in stimulating and maintaining domestic reform efforts as well as recognizing change when and where it happens.

The remainder of this section takes a closer look at the broad areas where these Indexes indicate Russia needs greater attention for further improvements in her Business Climate.

2.3 A Look at Russia's Strengths and Weaknesses Across Indexes and Other Sources

A closer look beyond the overall rankings across indexes at specific pillars and indicators can provide an important first step for identifying where attention is potentially most needed to improve Russia's rankings and potentially also the quality of the country's Business Climate. As mentioned at the outset of this section, some caution is needed in using information from Indexes to specify where exactly a country should devote effort and resources to improve its Business Climate.

Additional reasons for this are, first, that even reforms in those areas where the country ranks high already could still generate improvements in quality. It is also possible, depending on the specific case and conditions in a country that for very little extra cost and effort, better outcomes might be achieved despite little change in rank, in terms of investment attraction, employment, or development, for example. Second, and relatedly, the cost of implementing a reform in a specific area, as well as the benefits, are likely to differ across countries, within a country, as well as over time. It might appear that Russia, for example, should devote a lot of time and energy to deal with trading across borders. However, improving this area will not necessarily generate the same outcomes for this country as it has elsewhere since trade conditions differ signficantly across countries and the experience of one cannot expect to be repeated for another. It might also cost a lot of resources to improve the ranking, for little outcome and these resources might have been used more effectively and efficiently further developing credit institutions, or in some other area.

In summary, improving the quality of a country's Business Climate requires more country specific information about the costs and benefits of reforms to identify where attention is *actually* most needed and there is no reason to expect that a rankings or scores in an Index necessarily correspond to net benefits.

2.3.1 Russia in the World Bank's Doing Business Index

Each year the World Bank produces an Index ranking countries in terms of the ease of operating a business. The Index is comprised of a number of indicators across the lifecycle of a business from opening, operating to closing an enterprise. The primary forcus is on those conditions external to the firm, in the business environment, which generally affect the cost of operating in a location, typically the capital city of each country included in the index, such as the number of days it takes to get a permit, to issues related to enforcing contracts, getting electricity, filing and paying taxes, among others. Although caution must be used in using this Index, like any other, it can provide valuable insight into where a country's Business Climate strengths and weakenesses are.

In the latest World Bank *Doing Business 2013* report released this year, Russia climbed to 112th place from 120th last year. Further, one of the Russian President's stated commitments during the recent parliamentary and presidential election campaigns, as well as during key speeches, is to take Russia to the 20th position in this Index within 6 years[16], making this chart perhaps more relevent for identifying where current reforms are needed and likely to take place if the government follows through with this aim, which remains t be seen.

Figure 25 below shows Russia's rankings across the *Doing Business Index* pillars for both 2012 (in blue) and 2013 (in green), the most recent, while the axis represents where the country ranks out of 185 countries covered in this year's survey (up from 183 last year). This means that the further the bar stretches down the graph, the lower the country ranks in this particular pillar. This figure shows that Russia performs relatively well (above its 112th rank) in such areas as enforcing contracts, registering property, resolving insolvency, paying taxes and starting a business, while getting electricity, dealing with construction permits, trading and protecting investors are all trouble areas. Second, the figure also shows that there has been little change in Russia's ranking across most pillars during the past year relative to other countries, except most notably in the area of paying taxes.

This improvement in one pillar, albeit a welcome one in terms of the quality of the Business Climate, likely explains most of the change in the country's ranking over the past year. It also indicates that *if Russia is to climb to the 20th position over the remaining five years, the pace will have to be picked up considerably across pillars*. Not only will Russia have to improve in areas such as potecting investors and getting electricity, but it would also have to this improvement in a way where the change is relatively greater than other countries in order to climb ranks. In addition, the country would have to take steps to at least maintain its relative position in those areas where it performs well already.

Figure 25 - Change in Russia's Performance Across Pillars in World Bank's Ease of Doing Business Index, 2012-2013

Source : (World Bank, 2012)

With the exception of a couple of pillars, the World Bank's Doing Business Index shows that pace, depth and breadth of business climate reforms needs to pick up in order to achieve further progress in the rankings, especially to achieve a climb to 20th position within 6 years.

2.3.2 Russia in the World Economic Forum's Global Competitiveness Index

The World Economic Forum produces an annual index that ranks countries in terms of their national competitiveness. This Index is comprised of a number of indicators across 12 basic pillars that are used to assess a country's institutions, policies and other conditions in terms of how well they

[16] He later stated that it may take 8 years to achieve this outcome.

support productivity. In other words, the focus is primarily on conditions external to the firm that can play an important role in how efficiently that firm can produce goods and services. More competitive environments allow firms the possibility of producing in a certain location at lower real cost than those firms located in less competitive environments. More broadly, countries that have more competitive conditions allow scarce resources to be combined at lower cost (more producitively) than countries with less competitive conditions.

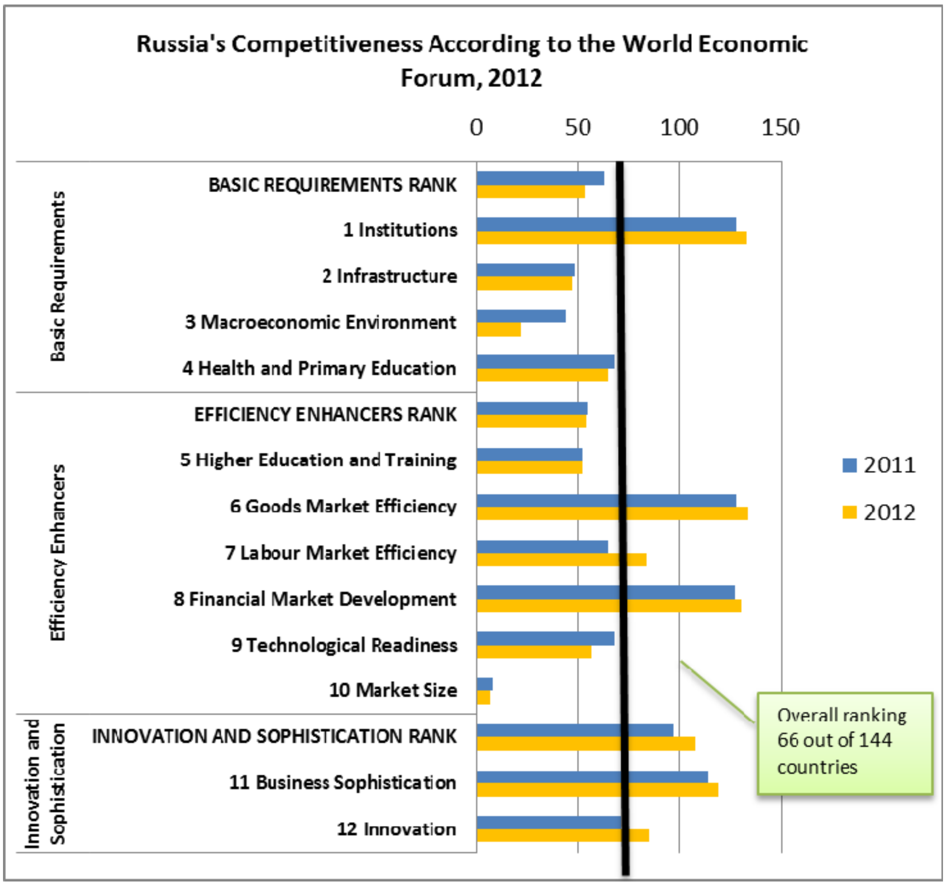
The types of indicators used for this exercise are broad and diverse, and generally cover conditions related to the health and education level of the population, macroeconomic conditions, the quality of a country's infrastructure, the state of financial market development, among others, since these types of conditions have been well established in terms of affecting economic performance, particularly in the long term, and ultimately prosperity. This type of Index can provide useful information on where a country's business climate stregnths and weaknesses are since these conditions are also well linked to qualities external to the firm that can also influence firm performance.

In the latest World Economic Forum's Global Competitiveness Index, Russia ranked 67th out of 144 countries covered. Figure 26 below shows how well Russia performed across the Index's 12 pillars both this year, in yellow, and last year, in blue. The black line represents the overall rank and helps to divide those conditions which improve the countries ranks, to the left of the line, and those that harm the countries rank, broadly to the right of the line.

In this Index, Russia does relatively better in terms of infrastructure, its overall macroeconomic environment and education and training. It also ranks very high in terms of market size. However, problem areas include the quality of its institutions, goods and financial market efficiency and development, as well as business sophisication and innovation.

Generally, across the two years, Russia's rank only fell slightly from 66 to 67th place, and across the majority of pillars, little *relative* change can be observed.

Figure 26 – Change in Russia's Rankings According to the World Economic Forum's Global Competitiveness Index by Pillar



Source: (World Economic Forum, 2012)

This Index highlights that with the exceptions of market size, macroeconomic environment and plausibly infrastructure, improving the quality of Russia's business climate would require broad reforms across virtually every other pillar. The pace of reforms would also need to be picked up considerably if the current administration is committed to improving not only rank, but the general quality of the business climate.

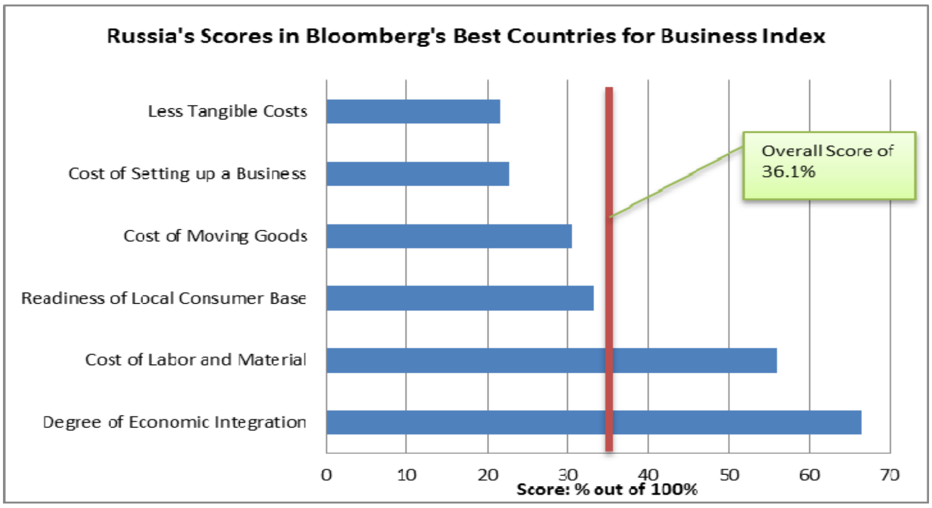
2.3.3 Russia in Bloomberg's Best Countries for Business Index

This year's Bloomberg *Investment Climate Index* ranked 160 countries in terms of the best places to do business across six areas covering business climate qualities such as the readiness of the local consumer base and the cost of moving goods. In each of these six categories countries were scored from 0% to 100%, with a higher score representing a higher quality. The scores in each of the six areas were then weighted to generate an overall score and used to rank countries from the highest score to the lowest.

In this year's *Investment Climate Index*, Russia ranked 47th out of the top 50 countries covered in terms of the "Best Country for Business." Figure 27 below shows each of the six areas covered in the Index and how Russia scored in each of those areas, ranked from lowest score to the highest. The red line indicates Russia's score or 36.1%, which resulted in the country's rank of 48th.

Russia received the lowest of its scores in the "Less Tangible Costs" category, which includes items such as the perception of corruption, property rights problems, inflation, taxes, and the adaptability of accounting practices. Russia also received a low score in terms of the costs of setting up a business, which covers the costs and time associated with taking the time to open and finance a business or carry out a foreign direct investment. This Index also draws attention to the cost of moving goods, which includes import and export costs, logistics and infrastructure efficiency.

Figure 27 – Russia in Bloomberg's Best Countries for Business Index



Source: Bloomberg.com

However, this Index must also be used with some specific caution in addition to the other issues raised at the outset of this section. The Bloomberg Index relies on other Indexes for some of its indicators, such as scores in the Corruption Perception Index, International Property Rights Index, as well as data from other sources, such as UNCTAD and the WTO. This means that some correlation in terms of identifying similar areas of problems in the relative quality of Russia's Business Climate can be expected and this does not indicate the type of robustness test that it could if these results were simply confirmed by using a completely independent alternative set of sources or tests.

This Index highlights many of the common problems cited elsewhere, such as the issue of corruption, red tape and regulations associated with opening a business, as well as logistical efficiency, all of which need to be dealt with to improve efficiency, the quality of the Business Climate, and ultimately the rank.

2.3.4 The Quality of Russia's Business Climate in Other Sources

In addition to the Indexes available from the World Bank (WB), the World Economic Forum (WEF), Bloomberg and the International Institution for Management Development (IMD), there are several other sources for information on the quality of Russia's Business Climate. This section briefly highlights some of the additional aggregate sources and, more specifically, information from Russia's Foreign Investor Ombudsman's office.

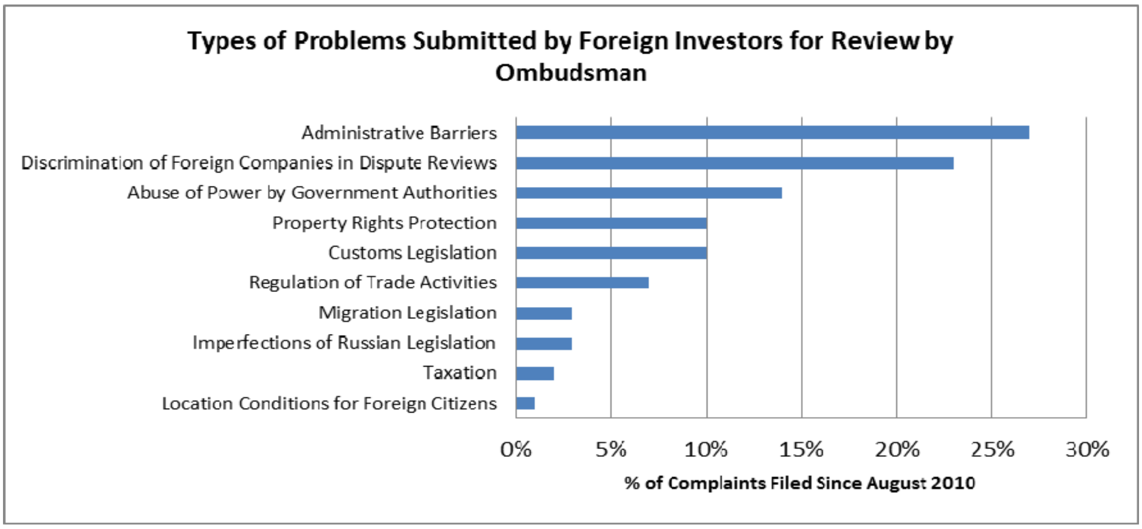
During this past year, an additional survey of 208 executives was conducted by Ernst & Young (Ernst & Young, 2012). The *Russia Attractiveness Survey* covers their opinions on those qualities that represent both opportunities for investors as well as business climate conditions.

An additional source of information on the quality of the business climate comes from the types of complaints and problems submitted to the Federal office of Russia's Foreign Investment Ombudsman. This office was created by Presidential decree in 2010 on the basis of the Ministry for Economic Development to investigate complaints by Foreign Investors. Figure 28 shows the breakdown of the types of problems foreign investors have brought to the ombudsman's attention as well as by percent. Since the beginning of operations, the latest data indicates that 87 applications related to problems by foreign companies have been received and 67 of these have been successfully resolved.

Similar to other Indexes and sources, the largest problems appear to be administrative barriers, discrimination and abuse of power. Taxation does not appear to be a dominant concern.

This type of data, however, must also be used with caution, first, since it is not necessarily representative of the types of problems investors are concerned about most. It only represents those problems about which some investors have registered complaints. Second, the number of problems submitted does not necessarily reflect the relative economic impact a problem has. Resolving a small number of tax problems might generate greater benefit to the economy than the removal of one barrier that many people complained about. Equating costs and benefits by the percentage of complaints in a category is not really possible without knowing more about the specific conditions, etc.

Figure 28 – Types of Problems Submitted to Russia's Foreign Investors Ombudsman



Source : Office of Foreign Investors' Ombudsman of the Russian Federation

Additional sources of information are generally consistent with the view that administrative barriers and other qualities of Russia's institutions are barriers in terms of the quality of the country's business climate.

2.4 Russia's Business Climate at the Sub-national level

In a country as vast as Russia, it is even more challenging to summarize the quality of the business climate as well as economic potential since conditions are likely to vary considerably across the country. It is also possible that various reforms are underway to different degrees within the country and these dynamics are not well reflected in the more aggregate reports mentioned above. This section briefly highlights some of the information this past year on conditions within Russia.

One of the major drawbacks of the World Bank's *Doing Business Index* is that it is based on conditions in capital cities, and in Russia's case, Moscow. Many other indexes also survey foreign executives or enterprises which may or may not be evenly distributed throughout a country or which may fail to capture important differences at the sub national level or even across economic activities. This poses a problem, first, for assessing the overall quality of a country's business climate. Second, it also prevents the identification, evaluation and recognition that qualities may be higher in various regions within a country or that important reform efforts might be underway. Third, failing to capture information at the sub-national level also misses a great opportunity to collect valuable information on potential solutions to business climate issues and identify better or worse practices from already existing in-country experience.

During this past year, the World Bank produced its *Doing Business in Russia 2012*, its second report dedicated to examining conditions at the sub-national level. This report ranks 30 of Russia's cities across four of the ten usual dimensions in terms of opening, operating and closing a business that were thought to be relatively more within the domain of regional control and could actually vary: *starting a business, dealing with construction permits, getting electricity and registering property*.

Figure 29 below shows the ranking of the 30 cities covered in this year's survey. The results show that within Russia across these four dimensions of indicators, Ulyanovsk ranks considerably ahead of Moscow, in 30th place. St Petersburg is also within the bottom 10 (22nd place) of these 30 cities.

Figure 29 – Ranking of 30 of Russia's Cities in Doing Business 2013

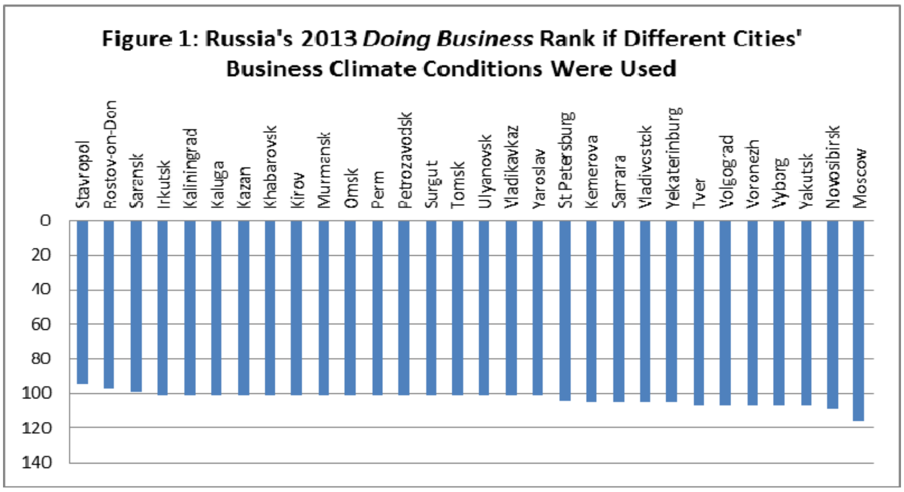
Source: (World Bank, 2012), Sub-national Report on Russia

The sub-national report indicates that there are differences across these 30 cities, and likely beyond, in terms of these four dimensions, and likely beyond these as well. In addition, the report highlights a key drawback of the annual country level report. Each year, Russia's overall ranking in the *Doing Business Index* is based on conditions in Moscow, which may not reflect very accurately the quality of the business climate, or reforms underway, elsewhere within the country. For a country as large as Russia, this is a serious drawback in that the country's ranking may change considerably simply by selecting a different city as the benchmark for the annual ranking.

A simulation was conducted to see how Russia's rank in the *Doing Business Index* would change in this year's report if the conditions across these four dimensions were used for each of the 30 cities. The World Bank's reform simulator program was used and the conditions were simply inserted for each city to see how the country's overall rank would change, while the remaining conditions remained the same within Russia and across all other countries.

Figure 30 shows the results of this simulation. The country's overall rank is shown as if each city were selected in Moscow's place. It shows that if Stavropol, for example, had been used instead of Moscow, Russia would have ranked in 95th position rather than 112th and 101st place if many of the other 30 cities had been used. (Moscow, in this simulation, ranks in last place out of the 30 cities and Russia would have been in 116th place in this case since the data used in this simulation reflect the cities conditions for these four pillars from a previous year, while the other six pillars remain unchanged. Note also that the rankings of the 30 cities in this case differ slightly from the Subnational Report rankings above. This is likely due to slightly different weights used across these four pillars between the Annual Report and Subnational Report.)

Figure 30 – Simulated Changes in Russia's Doing Business Index, 2013, Ranking if Different Cities Were Used



This figure highlights several key issues. First, that business climate conditions within a country can vary and annual indexes based on conditions in any one city, especially in a large diverse country such as Russia, may not paint an accurate picture. Second, the conditions in Moscow underrepresent conditions in 29 other cities surveyed and this suggests Russia may, in fact, be doing much better across indicators than the annual index would suggest. Third, carrying out successful reforms across just four pillars of indicators, as has taken place in many of Russia's cities, can improve a country's overall rank. Fourth, it suggests that if Moscow were able to replicate some of the conditions in Stavropol or other cities, Russia's rank should improve and this further draws attention to the fact that reforms are well underway within Russia and there is much to possibly draw upon from domestic sources in addition to cross country comparisons.

Sub-national data suggest that there may be considerable differences in qualities of the business climate within Russia, which is not surprising given the vastness of the territory. However, sub-national differences also suggest that the quality of the country's overall climate may be understated by too much focus on conditions in Moscow and, further, that reforms may be underway and national efforts are likely to have to take into consideration regional differences in conditions and priorities to help the country make the most of what it has to offer.

3 New Investment Announcements

New Investment Announcement data can be useful to gauge investors' intentions to make future investments in expanding production. This section presents data tracked and collected between December 1 2011 and December 1, 2012, to highlight key trends, issues and challenges related to the quality of Russia's Business Climate.

Between December 1, 2011 and December 1, 2012, a total of 459 New Investment Announcements were tracked for a total value for those which disclosed financial details of $1256 bln. 146 (31.8%) of these announcements were in "Other" activities, predominantly related to retail sector expansion followed by 102 (22.2%) related to "Energy". By value, however, new investment announcements were overwhelmingly related to the energy sector accounting for $998 bln (79.4%) of the total, and in particular a small number (3) of large scale, multi-year, energy investments announcements totaling $720 bln (57%) in April and June.

Although there are signs of intentions to invest beyond the energy sector, this data suggests that future investment intentions and activity will remain dominated by energy-related activity in a small number of high valued projects and that broader based business climate reforms are needed to unlock Russia's potential in other sectors.

A New Investment Announcement takes place when an investor makes his or her intention to invest in a new income generating activity publicly known, typically in the media. This type of "investment" differs from popular use of the term in newspapers or the financial press. The focus here is on an investment that expands production beyond its current level, whether it is for the production of a final good, service, or input into making goods or services (i.e. such as auto parts). This focus on new income-generating activity is in part due to the relationship between improving the business climate on the one hand, and the attraction of new activity on the other (increased growth and development). Many financial investments represent a purchase of an existing firm or assets and this type of "financial investment" is simply a transfer of ownership; representing an investment by one person or group at the same time as a disinvestment by another person or group. It does not represent an overall net sacrifice of resources to expand a country's production since this adds up to a zero change in overall net investment activity. Second, the only type of new investment activity included in this data set are those that are publicly announced (See Appendix 1 for a more detailed explanation of this dataset).

New investment announcement data can provide a useful tool for gaining insight into business climate issues, especially when used in conjunction with other datasets. First, they can help gauge investors' intentions to make future investments in productive activities in an economy. This data can provide some idea about the level of overall future investment activity currently planned as well as which specific areas investors are currently making public commitments in. Second, changes in trends of these intentions can be used to help identify challenges and issues more directly related to the quality of the business climate. An investor can hold off making an intention to commit to an investment on very short notice, for example, while waiting to find out about specific policy discussions or outcomes, or changes as a result of election campaigns. Unlike many other business climate indicators, this type of data is much more likely to be sensitive during the year since a public announcement can be held off by weeks or months. Third, this data can highlight important differences between which sectors have investment potential and where investors are willing to publicly commit to future investments. A strong potential in tourism that shows few, if any, people to commit could highlight a need to address which bottlenecks or barriers may be preventing higher levels of performance, growth and development in that sector.

This data, however, have to be used with caution. They do not represent actual investment levels since they have not necessarily taken place yet and it is possible for an investor to backtrack on commitments made in response to unforeseen changes in conditions. Second, not all intentions to invest are made public and not all announcements disclose full financial details. These types of issues, however, are present to some extent in all datasets and they only require caution and proper use to overcome. Third, these data are not broken down by time units and only represent a total amount to be invested in the future, not necessarily a certain amount per year or other specific time period. This makes it more difficult to align intentions to invest with actual future investment levels.

3.1 New Investment Announcement Trends, December 1, 2011 to December 1, 2012

This section presents the data collected over the past year in aggregate as well as broken down by type of economic activity and month with the aim of identifying specific issues and challenges related to the quality of Russia's Business Climate. The actual specific announcements are available in ***BCDM's Monthly*** *reports.*

3.1.1 Aggregate Value and Number of New Investment Announcements by Sector

Over the 12 month period beginning on December 1, 2011 and ending on December 1, 2012, 459 new investment announcements were tracked and collected. The total value of these investment announcements was $1256 bln for those which included financial figures.

Figure 31 shows the breakdown of the value of investments by type of economic activity. Some caution must be used since not all investment announcements disclosed financial figures and there is no reason to suspect that this tendency was shared evenly across activity. In fact, retail sector investment announcements, captured in the "Other" category, regularly failed to disclose investment sums whereas this was nearly always the case in the "Energy" related activity.

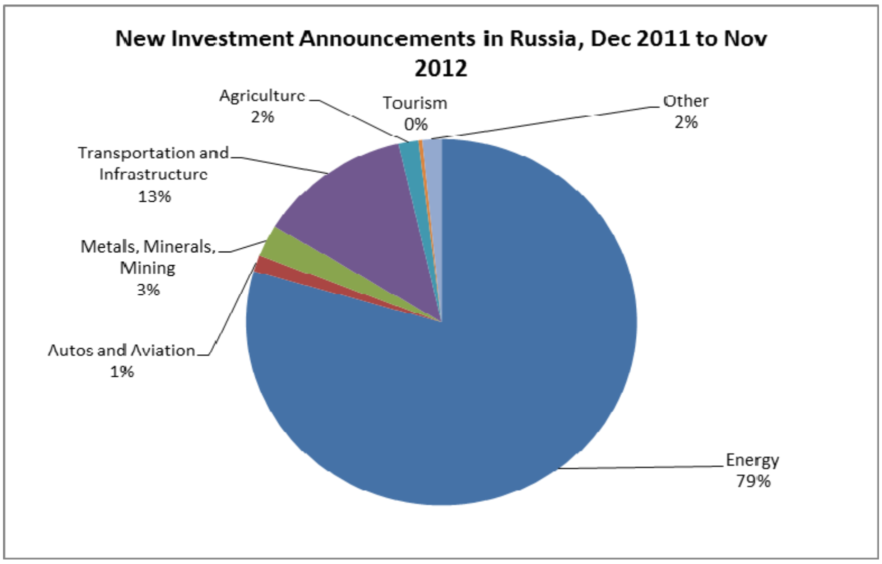
Of the total value, the vast majority, $998 bln (79%), were related to energy, followed by Transportation and Infrastructure. This, in part, is not surprising given Russia's well-established reputation for abundant energy resources and the size of the country requiring infrastructure investment and upgrade related activities.

These figures indicate an intention to invest heavily in energy in the future followed by infrastructure with very little, in terms of value, allocated to other areas of Russia's economy despite there being significant potential outside of these two activities.

Also noteworthy is that three large scale, multi-year, investments in the energy sector in April and June totaled $720 bln (Rosneft/Exxon: $500 bln, Rosneft/Eni: $100 bln, and Rosneft: $120 bln), which represent 57% of the total tracked new investment announcements.

Although this data does indicate that there are intentions to invest in activities broadly in Russia across activities, they also indicate a powerful dominance of a small number of large scale energy sector investments.

Figure 31 - Shares of Value of New Investment Announcements in Russia, by Sector

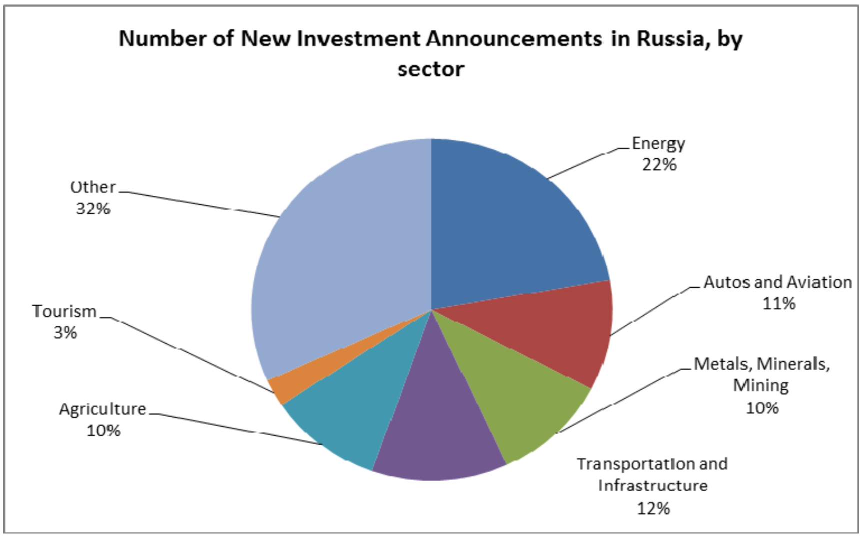


Due to the sheer size of these large scale energy sector investments and the fact that many announcements in other activities do no always disclose financial figures, or they are small due to the relative scale differences, it is also necessary to look at the number of new investment announcements by activity. Figure 32 shows the breakdown of how many announcements were made in each of the same categories as in Figure 31 above.

By number, the largest share is in the "Other" category, 32%, followed by "Energy" with 22%. Most other activities, such as "Agriculture" and "Autos and Aviation" show up more clearly when value differences are placed aside. The "Other" category includes a wide range of new investment announcement activity not covered by the other categories, such as pharmaceuticals or R and D. The vast majority of activity in this category, however, is related to expansion activity in consumer retail and services.

By number, activity such as consumer retail and services appears to be far more important in terms of investors' intentions to expand their activities in these areas. This is consistent with the potential generally outlined in Chapter 1.

Figure 32 - Shares of Number of New Investment Announcements in Russia, By Sector



3.1.2 Aggregate Value and Number of New Investment Announcements by Month

This section highlights changes in the value and number of new investment activity in each of these categories during the year (by month).

Figure 33 below shows the total value of new investment announcements between December 1, 2011 and December 1, 2012, by month. April and June are exceptions and distort the picture of the year due to three large scale multi-year announcements related to energy sector investment by Rosneft and its partners. These three announcements over these two months totaled $720 bln. Beyond these three data points, generally, the trend has been that the remaining value of new investment announcements was higher during the second half of the year relative to the first half.

Figure 33 – Total Value of New Investment Announcements, by Month

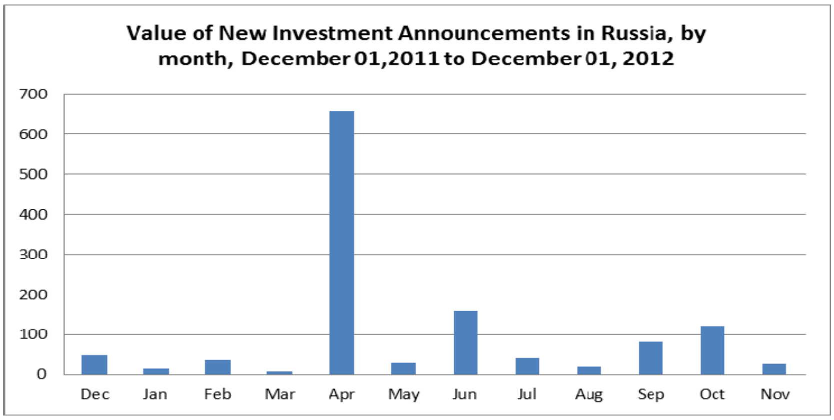
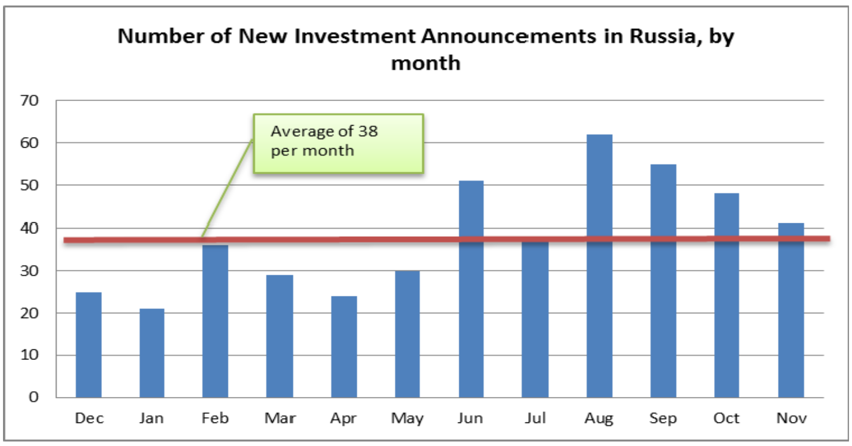


Figure 34 shows, by contrast, the total number of new investment announcements during the same period by month. This helps to reduce the problems associated with three large-scale multi-year investments overshadowing other fundamental trends. The figure also shows that the average number of investment announcements per month was 38 and that, generally, the first six months of were below this average while the second half of the year were above, or at least on, average. This trend is consistent with the concern that many investors may have been holding off making public commitments concerning their future intentions until after the political dust settled in May when a new government with clearer aims was finally announced.

Figure 34 – Total Number of New Investment Announcements, by Month



The remainder of this section looks more closely at trends, by month, for each of the categories of new investment announcements.

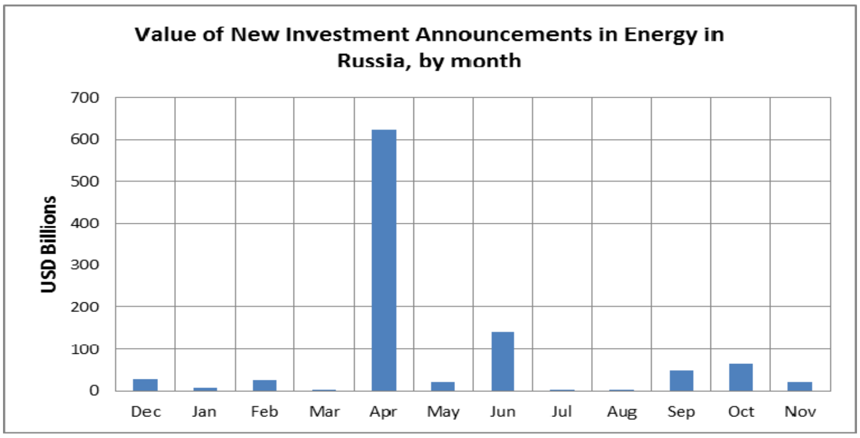
3.1.3 Energy Sector by Month

The Energy category generally covers those investment activities related to exploration for new energy sources, expansion of energy production, or the development of new energy supplies, whether they are in green sources or more traditional oil, coal, and natural gas.

During the past year, 102 new investment announcements in this category were tracked for a total value of $998 bln. This represents 22.2% of the total number of new investment announcements tracked and 79% of the total value. Russia, however, is well known for its abundant energy resources and ranks high in the world in terms of proven oil (8th), natural gas (1st), and coal reserves (2nd), as well as having a significant potential for renewable energy production, such as in hydropower. Further, investments in this sector tend to be in very large scale, multi-year, projects that can easily overshadow activity in other areas of the economy.

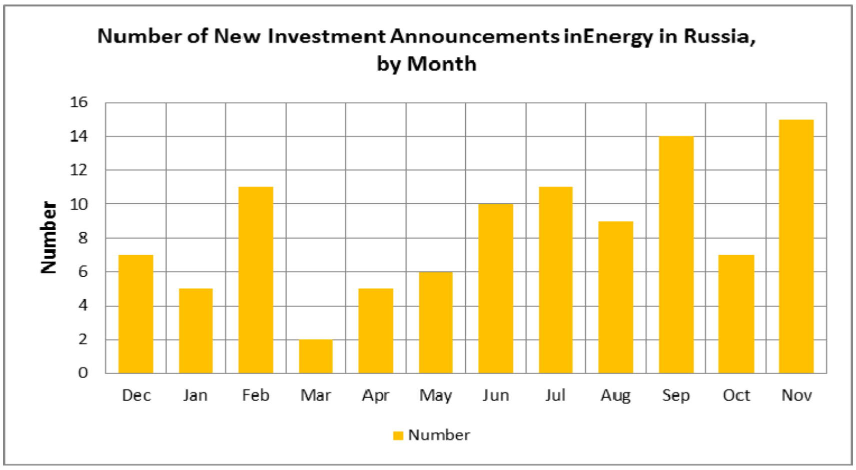
In fact, three large scale, multi-year, new investment announcements tracked during this past year in April and June, related to Rosneft and its partners, totaled $720 bln. These two months show up easily in Figure 35 which shows the value of new investment activity in this category during the past year by month. These three investment announcements alone account for 57% of the total announcement activity tracked over the year.

Figure 35 – Energy – Value of New Investment Announcements, by Month



Due to the problem of scale in this category, it was important to seperate out the number of investment announcements by month. This is shown in Figure 36 below. Despite the large share of the value of new investments announcements in April and June due to these three observations, this figure shows that the underlying trend is similar to other categories in that investment announcement activity appears more heavily concentrated in the second half of the year than in the first.

Figure 36 – Energy – Number of New Investment Announcements, by Month



Trends in energy related new investment announcement activity show that there is an intention to invest heavily in a small number of large scale multi-year projects in Russia in the near future. Second, this data indicates the reliance of the country on this type of activity and the risk Russia is exposed to should energy prices fall, or conditions related to any one of these projects change for the worse. This sector's activity also tends to overshadow other areas where Russia also has potential to expand and diversify away from the risk and exposure this sector presents.

3.1.4 Automobiles and Aviation by Month

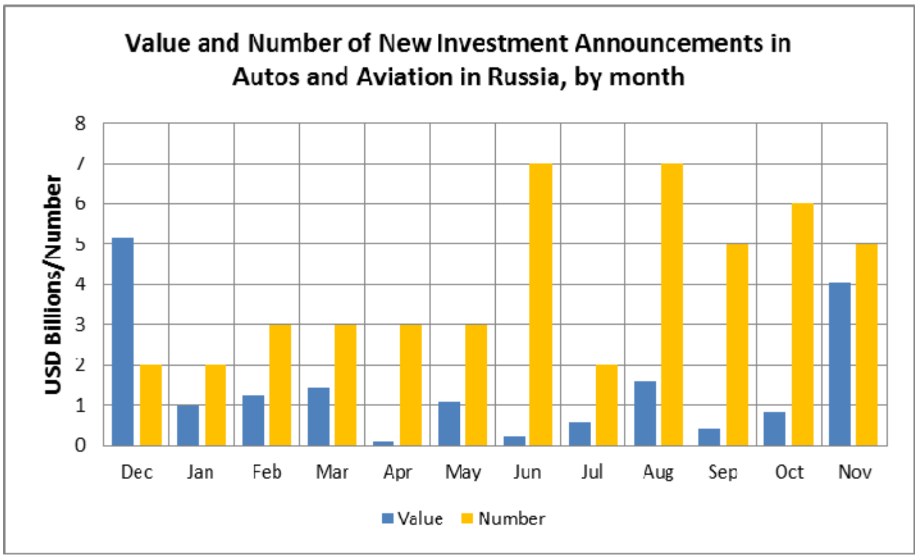
The Autos and Aviation category generally covers investment activity in creating new automobile or aviation factories, or factories for auto or aviation parts, as well as expanding them, as well as other related investment activity.

In this category, 48 new investment announcements were tracked during the past year worth a total of $ 17 bln. This represents 10.5% of new investment announcement activity and 1.4% of the value.

Figure 37 below shows the total number and value of new investment announcement activity in this category by month. Although there seems to be more activity during the second half of the year, in general, there also appears to be a more consistent level throughout the year. Unlike other sectors, this sector does not appear to be as obviously lower during the first half of the year during the months of political uncertainty. This might also be due to the prospects of auto expansion in Russia relative to decline in developed economies, particularly as a result of the recent financial crisis. Russia has been widely forecast to expand rapidly in production and sales of autos due to growing consumer disposable incomes, consumer desire, access to credit, and a low number of autos per person relative to other, relatively more, saturated markets such as in Europe[17].

[17] See (Babushkin, 2012) for brief highlights of this market.

Figure 37 – Autos and Aviation – Value and Number of New Investment Announcements, by Month



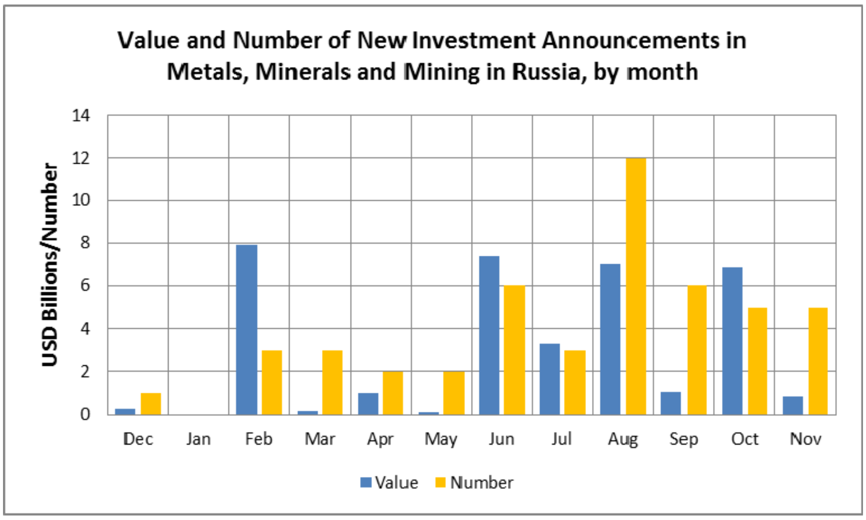
3.1.5 Metals, Mining and Minerals, by Month

This category generally covers investment activity related to expanding mining operations, constructing or expanding metal production or processing facilities, as well as other minerals and related activities.

During the year, 48 new investment announcements were tracked in this sector with a total of $35 bln. This represents 10.5% of the total number of new investment announcements and 2.8% of their value.

Figure 38 below shows the number and value of new investment announcements during the year broken down by month. The overall trend during the year is consistent with other sectors and shows the vast bulk of activity, in both value and number, taking place in the second half of the year.

Figure 38 – Metals, Mining and Minerals – Value and Number of New Investment Announcements, by Month



In addition to energy and agricultural resources, Russia is also widely cited as having great potential in this field due to vast metal, mineral and other mining related resources. The trend here also suggests that like other sectors, investors may have held off until after the months of political uncertainty ended since activity appears to have picked up signficantly in June.

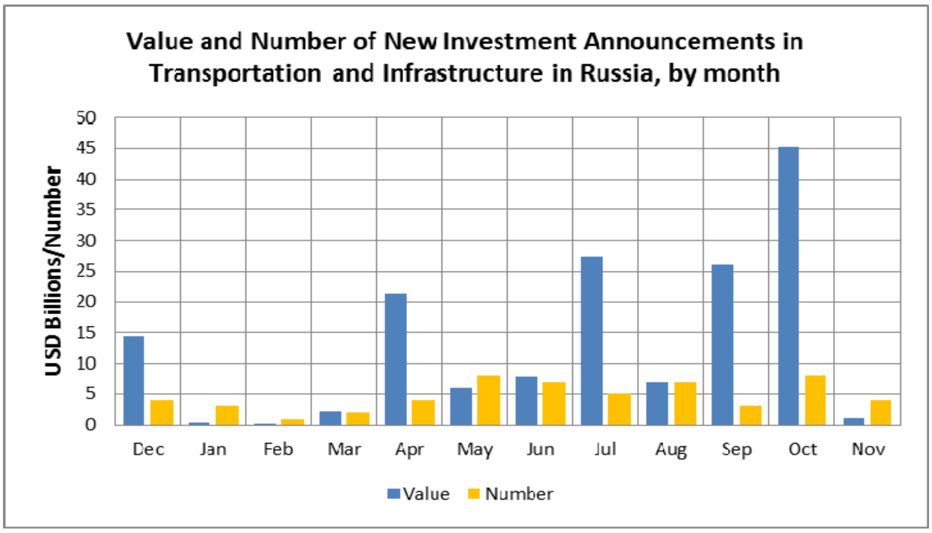
3.1.6 Transportation and Infrastructure, by Month

This category of new investment announcement activity generally covers investments in creating new infrastructure, such as rail connections, lines, of ports, as well as expanding existing facilities. It also involves passenger services and connections as well as commercial investments.

During the 12 months covered in this dataset, 56 new investment announcements were tracked in this category for a total value of $158 bln. This represents 12.2% in terms of its share of the total number of announcements and 12.6% in terms of total value.

Figure 39 shows the total number and value in this category during the year by each month. Generally, the upward trend in value is quite visible and the number of investment announcements is weighted more towards the second half than in the first. This is consistent with trends observed in other sectors.

Figure 39 – Transportation and Infrastructure – Value and Number of New Investment Announcements, by Month



One of the areas where Russia ranked relatively lower in terms of potential, and within medium range in terms of business climate qualities, is related to its infrastructure. Although the share of activity in this sector appears to reflect investors intentions to publicly commit to expanding operations in this line of activity, there are signs of worry that announcements were very low throughout the first half of the year during the months of political uncertainty.

3.1.7 Agriculture, By Month

New Investment Announcement activity in this category general refers to expanding production capacity of the country's agricultural sector, such as the creation of new livestock facilities, food processing facilities, or equipment to enhance agricultural productivity.

During the 12 months covered in this dataset, 47 new investment announcements were tracked in this activity for a total of $20 bln. This represents 10.2% of the number of new investment announcements and 1.6% of the total value.

Figure 40 – Agriculture – Value and Number of New Investment Announcements, by Month

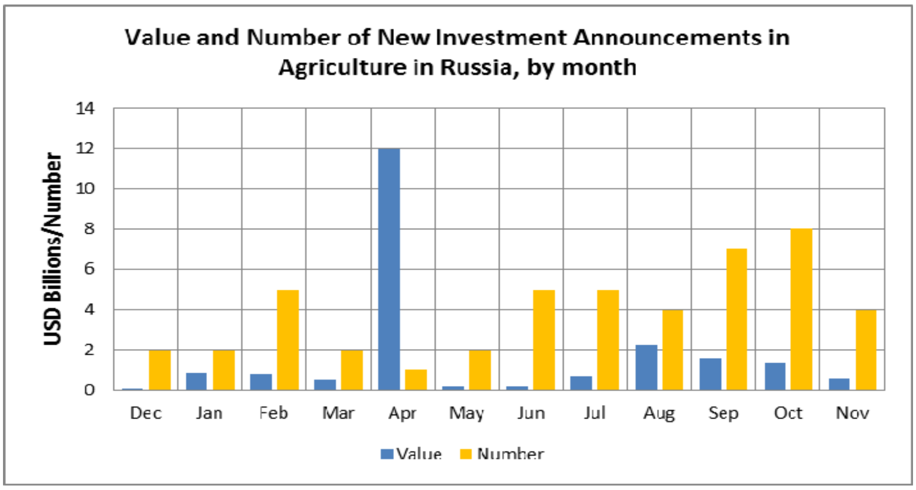


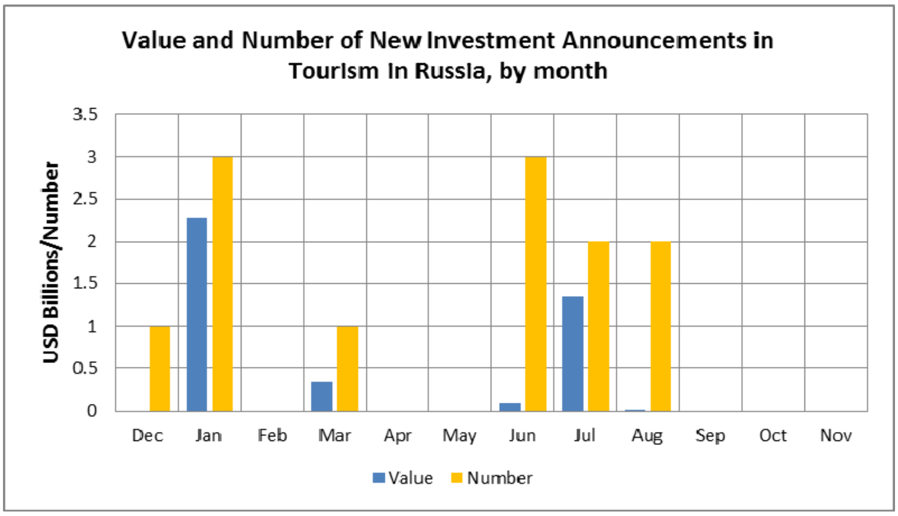
Figure 40 above shows the value and number of new investment announcements tracked in this activity over the year. With the exception of April in terms of value, the general trend highlights that both the value and number of investments were generally higher in the second half of the year than in the first. Second, despite the country's potential and recent productivity growth in agriculture, there appears to be a relatively small amount of activity in this sector, or at least investors willing to publicly commit to making investments to expand this activity in the near future. This would suggest, much like tourism below, that the country might need to look more deeply into specific business climate issues that may be holding this sector back from attracting more investment activity.

3.1.8 Tourism, by Month

The Tourism category of New Investment Announcement activity captures investments made in Russia's tourism service sector, such as the construction of new hotels, resorts, or expansion of existing ones. If foreigners travel to Russia to use these services, they are generally considered "export" activity while use by domestic residents would not be.

During the 12 months covered in this data set, 12 new investment announcements were tracked in this activity for a total of $4 bln. This represents 2.6% of the number of investment announcements and 0.3% of the total value. Figure 41 below shows the value and number of new investment announcements in this activity during the year, by month.

Figure 41 – Tourism - Value and Number of New Investment Announcements, by Month



Although the value per announcement suggests that many of these were not small investments, their comparison to other investment announcement activity suggests that few investors are publicly announcing intentions to expand tourism services in Russia in the near future. This further highlights that a country as large as Russia with tourism potential, specific barriers and characteristics of the business climate might need to be identified to unlock further expansion in this activity.

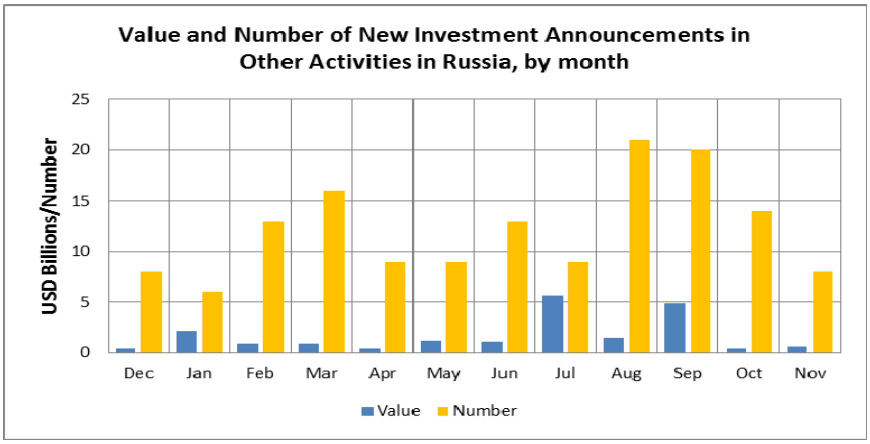
3.1.9 Other New Investment Announcements, by Month

The "Other" category of New Investment Announcement activity captures those investments announcements made in new income generating activity outside the energy sector and other sectors covered above. Although this category sometimes includes investments made in areas such as pharmaceuticals or technology, the vast majority of activity captured monthly is related to retail sector expansion[18].

During the 12 months covered from December, 2011 to December, 2012, a total of 146 new investment announcements were tracked in this category for a total value of $19 bln. Figure 42 shows both the value and number of announcements tracked per month. In particular, many of the new investment announcements in this category are typically small in value relative to those in infrastructure projects, automobile production, or energy. Second, many of the announcements do not disclose financial figures in this category. Both of these factors tend to overshadow activity in this sector and the number of announcements is relatively more important to look at underlying trends.

[18] BCDM's *Monthly Reports* contain a list of the specific investment announcements in this category. It was necessary throughout the year to subdivide this category into retail and non-retail investments due to the volume of activity. However, space limited the number of categories selected at the outset of the year and it was not foreseen that a separate category would be practical.

Figure 42 – Other - Value and Number of New Investment Announcements, by Month



The general trends shown in this figure suggest that announcement activity picked up during the early part of the year before dropping during April and May, with stronger performance during the remaining part of the year. This suggests further that there are quite strong intentions to make future investments particularly in Russia's retail sector. This is in line with evidence that shows that the country has strong potential for further growth in terms of household consumption demand, and the kinds of opportunities this potential presents to investors, both domestic and foreign.

4 Key Findings

This section briefly highlights the key conclusions drawn from reviewing Russia's potential, its rankings across indexes and trends and issues related to New Investment Announcement data collected during the past year.

Diversification

Despite Russia's progress over the past 12 years in terms of attracting capital inflows, inward FDI, and overall growth performance, New Investment Announcement activity has been dominated by the energy sector, which accounted for 79% of all new investment announcements tracked during this past year. This highlights, in particular, that Russia's reliance on a small number of large scale, multi-year, projects in the energy sector and the risk the country faces in terms of energy price changes that may affect the viability of any one of these projects, such as the Shtockman Project, this past August.

The lack of investment diversification also indicates that Russia has not benefitted as much from other areas where it ranks high in terms of potential, such as a large and growing consumer retail market and educated population, as well as suggesting that the country could have done perhaps even better had the quality of its business climate been higher during these same years.

Political Risk

New Investment Announcement trends and monthly changes in net private capital outflows are generally consistent with the view that investors held off on making public commitments to invest in Russia until after the political dust settled and a new government with greater clarity over direction was appointed in May. The number and value of new investment activity was generally below the annual average until June and noticeably increased thereafter and remained above the annual average for the remainder of the year.

In addition to improving qualities indicated by other Indexes, such as the World Bank's Doing Business or the World Economic Forum's Global Competitiveness Index, this trend suggests that Russia needs to also improve the integrity of its political institutions such that a change in personnel does not raise such looming questions over the direction of the country. This element of political risk, which can have a direct impact on the quality of the business climate, has fallen below the surface for now, but the issue remains and needs to be dealt with well before the next presidential elections if this type of scenario is to be avoided.

Potential Outside Energy

Although Russia is well known for its vast resource endowments and should take advantage of these assets in terms of generating income from them, it is not the only type of activity that the country is capable of. Russia has vast agricultural potential performing below its potential as well as an auto sector forecast to expand while many other producing countries are facing decline in these sectors or have already reached capacity. A growing large consumer base with rising incomes coupled with a highly educated workforce should also provide greater potential for other production activities and expansion in retail goods and services. While the value of new investment announcements have been overwhelmingly dominated by energy activities, the number of new investment announcements indicates that there is expansion activity in these other areas. Energy accounted for only 22% of the number of announcements compared to 32% in other activities, which largely involve retail expansion. Automobiles and Aviation accounted for half as many announcements as energy (11% versus 22%) and was closely followed by Metals, Minerals and Mining at 10%.

This view suggests that if the quality of the business climate were to further improve, these sectors, in which activity is already taking place, would likely perform even better given that they are likely hindered by an inefficient business climate and have greater potential.

Activity Beyond St Petersburg and Moscow

A noticeable portion of both the value and volume of new investment announcements involved activities and expansion plans beyond Moscow and St Petersburg during the past year. This was not only due to the location of Russia's resources, such as gas, oil, metals and minerals, but also new production plants for automotive parts, pharmaceuticals, and a noted expansion in retail goods and services into other cities and regions, which is consistent with a growing consumer base. Because the business climate conditions vary as well as the potential across the country, as shown in the sub-national data in Chapter 2, these trends indicate a significant need to identify, prioritise, and implement improvements in the quality of Russia's business climate at a sub-national level as well as taking into consideration differences in priorities across activities. This type of tailored approach will be needed to efficiently allocate resources to where they are needed most to allow the country as a whole to reach its full potential.

Pace and Breadth of Reforms

Despite progress in terms of growth, development, employment, and disposable income over the past 10 t 12 years, Russia's future is not written in stone and much remains to be done. In particular, this past progress was made while the business climate remained of poor quality relative to other countries. In fact, Russia has generally remained behind most other transition economies in Eastern Europe and the Former USSR. There is also a strong need for the country to begin to rely on other assets, such as its workforce, large market, or agriculture, it has to offer outside energy, to help the country achieve a greater potential as well as avoid excessive risk on a small number of large scale multi-year investments in energy exploitation.

Further, Business Climate Indexes generally show that Russia has a need to improve virtually in most pillars and indicators covered and the speed of reforms needs to be picked up substantially if the aim to achieve a climb of 100 positions in the World Bank's Doing Business Index is to be achieved.

Further, the pace and breadth of reforms needs to be picked up if the country is to secure a higher level of prosperity than it has now.

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A1 Appendix – New Investment Announcements

This appendix outlines what a *New Investment Announcement* is and how the data was derived for the purposes of this report as well as BCDM's monthly and quarterly reports and newsletters.

A1.1 The Definition of a New Investment Announcement

A New Investment Announcement takes place when an investor makes it publicly known that he or she intends to invest in a new income generating activity, whether it is in the production of a good or service (new retail outlets, the expansion of a retail outlet, or a new car factory or expansion of one), or in the production of inputs used for private (for example a rubber plant that will eventually be used to produce tires for cars) or public purposes (for example, new infrastructure, or an upgrade or expansion of existing infrastructure).

The first key characteristic of a New Investment Announcement is that it is an investment in *expanding production*. This distinguishes this type of investment from more popular or conventional investments mentioned in magazines, newspapers, or financial media, such as Company X has invested Y dollars in stocks, bonds, or acquiring a firm. Although this type of popular use of the word investment might make sense from the perspective that the specific investor in this case is engaging in investing and hopes to gain income from it, it does not change the overall total amount of production in the country or region. Instead, it represents primarily an investment by one person and a disinvestment by someone else. An already existing investment is simply changing ownership from one person to another and although one person might run the investment more effectively or efficiently thereby generating more production in the future, for our purposes it is not an investment in expanding overall production in something new; something that does not already exist.

For the purposes of monitoring the quality of the Business Climate, with the aim of future growth and development of Russia, we are interested in new investment activity. The central idea focused on is that improving the Business Climate should attract and retain economic activity; generating an expansion. The typical switch in ownership, albeit important for other purposes, goals, or aims, in excluded from this exercise primarily for this reason. Thus, a new investment announcement first and foremost refers to an expansion in economic production and excludes announcements where investors simply buy or sell already existing assets, whether they be physical or financial (derivatives).

The second key definition of a New Investment Announcement is the public aspect. Investors may be making investments in expanding production, but fail to tell the public. In this case, a new investment activity has taken place, but it has not been announced publicly, and therefore would not be captured as an announcement in a new investment. A new investment announcement only takes place when a person makes their intention to invest in a new activity known publicly.

A1.2 The Use of New Investment Announcement Data

New Investment Announcements data must be used with caution. Like all data, they can be useful when their limitations and technical definitions are known and clearly established. In addition to the technical definition mentioned above, New Investment Announcements have several key characteristics:

- **Intention to Invest** – they only represent an intention to invest and do not necessarily refer to any actual expenditure actually made. They may not correspond to actual investment levels that take place in GDP accounting, for example, during a specified period of time. Investors may also change their mind and cancel the investment, reduce it, or expand it in the future.

- **The Total Value and Time Horizon**– of the investment announcement may be disclosed or not disclosed, and it may represent an actual investment total that will or won't take place, similar to the limitation mentioned above in terms of intention. However, the total value also represents the total amount the investor intends to invest in a new activity and the amount may be spread over different time intervals. Large scale, multi-year projects, will tend to overshadow smaller scale new investment announcements that are over shorter time horizons.
- **Public Availability** – only those new investments that are publicly announced are included and it is possible that substantial changes in new investment activity are taking place that are not captured by this data set.

Despite these limitations, New Investment Announcements can provide valuable insight, if used cautiously. For the purposes of monitoring changes in the quality of the business climate, this data set can be used to compliment already existing data and analysis. First, an investor, over a short period of time, can hold off making their new investment announcement publicly known while awaiting for news about elections, policy discussions and votes, or for changes in market trends. Changes in new investment announcements could provide insight into whether key qualities of the business climate matter. This is especially true if other, more aggregate or less frequent data sets fail to capture changes in investors' intentions and responses to changes in Business Climate characteristics. Second, new investment announcements can indicate future intentions in investment activity. If tracked, and investment activity is lower, higher, or equal to those intentions, this information can provide further insight into whether progress is being made in the quality of the overall Business or Investment climate. Third, they can further highlight trends in various types of economic activities or sectors and be used to indicate a lack of investor comfort in those areas that are underperforming or sectors that are overshadowing others. Finally, the data, which is provided in micro detail in BCDM's Monthly Monitor newsletters, can provide those public and private interests with specific information about people's intentions to engage in specific economic activities, how much they are publicly willing to announce in their invest, for what purposes and where.

A1.3 The Source and Collection of the Data

New Investment Announcement data are derived ultimately from daily summaries of business news in Russia. Each day, Ernst & Young produces a summary of business news announcements. This news source is broad and typically includes information on new CEO appointments, decisions by government departments and Ministries that are relevant for the private sector, mergers and acquisitions, initial public offerings, and asset purchases and sales as well as intentions to invest in new economic activity. Each month, there are approximately 35 standard pages of brief announcements covering this range of activity.

In

Figure 43 below, the process for sorting out this information into a New Investment Announcement dataset is outlined in greater detail. These general daily summaries are at the top of the figure.

The first step in generating the data set on New Investment Announcements involves filtering out all of those announcements that do not reflect a genuine investment in a new production activity. This is represented by the next division in the figure where the daily summaries are divided into new investment activity and everything else. For most of the cases, this is a straightforward filtering process, while in others, there is some grey area. Some firms announce, for example, the amount of an investment already made, or in progress, and have decided to expand their previous intentions by a certain amount. In these cases, the preference is to include only that portion that represents the new expansion and exclude that portion that was publicly announced in the past. In some cases, an interval is used, such as an investment between two amounts, such as an intention to invest between 2 and 3 million dollars. In this case the upper amount is used since it represents the maximum amount the investor has publicly announced as his or her intention to invest. In other cases, financial details are not disclosed. The announcement is still, however, collected, and the intention registered in the dataset, but the total value of New Investment Announcements will not be affected and will unfortunately be underrepresented in this case. Thus, if the undisclosed effect dominates, the total value of this data typically represents the lower boundary of what investors have announced in terms of a public intention to invest in a new activity.

The second step involves dividing these new investment announcements into two further broad categories; those that will expand production capacity in Russia, and those which represent outward investment intentions. [19]This step is usually straightforward, but also involves some grey area where an investment may be announced in total sum, but involve bother domestic and expansion activities abroad. It might also not be clear which portions of the announcement to allocate to each category, but in the end, this problem does not take place often enough to make the dataset unreliable or pose many serious limits. For these few cases, BCDM's Monthly Monitor names the specific investment activity in any case.

The third step involves dividing the New Investment Announcements into various economic activities, such as those related to Energy, Minerals and Mining, Retail, etc. Generally, dividing up New Investment Announcements in this way is partially conventional and partially arbitrary. Many investments can be easily categorized as being in retail expansion versus energy production. The choice of which categories to include, however, depends in part on their usefulness. If no new activity takes place in a sector in Russia all year, it makes little sense to include this category. If only one announcement takes place, but it is small, it might make sense to place it in another category so that it can be included while avoiding wasting space with its own separate category. In the case of tourism, for example, enough announcements took place at the beginning of the year that a category was created, but later in the year, few announcements took place. Decisions were made essentially based on what was deemed likely useful for the readership in these "grey area" cases and the announcements were divided into the seven categories shown in the figure. The final category is a catch all. Most of the activities in this category were in consumer retail, but sometimes pharmaceutical announcements were made among some other activities. It has been possible to generally divide this category on a monthly basis to capture and draw attention to developments in areas outside the above mentioned six categories.

The fourth step, not shown in the figure, involved converting investment sums into a single currency for use in BCDM's quarterly and annual reports. At the end of each month, for those announcements with disclosed financial figures, the sums were converted into USD using the closing rates provided by the (Bank) European Central Bank on the last day of each month.

[19] Inward and outward investment intentions can both play an important role in reflecting qualitative changes in a country's business climate. While part of a healthy development process should result in domestic companies and investors taking advantage of investment opportunities abroad, as well as at home, sudden shifts of preferences for foreign markets could also represent better relative conditions abroad. Which of these two cases is true is often difficult to determine, but at this stage, the data on outward investment announcement activity has been too sparse to draw any conclusions; in this respect, this dataset would not be as useful as examining trends in capital and FDI inflows and outflows, etc.

Figure 43 – Filtering Process to Generate New Investment Announcement Dataset