Russia's Growth Forecasts Below 5% Target

<u>Quarter in Brief</u>: Citing lower than previously expected gas exports and investment activity, Russia's Ministry of Economic Developed announced at the end of Q1 that it was lowering its growth forecast for 2013 from 3.6% to somewhere below 3%. The new forecast is to be released sometime in April (and as of going to print, has been lowered to 2.4%). While this stresses the important roles that energy exports and market conditions (in Europe for example) continue to play in Russia's economic performance, it also suggests that it will likely be even more difficult for the country to achieve the 5% growth per year target announced earlier this year by Prime Minister Medvedev. This growing gap between the forecasts and the target, however, could provide the type of stimulus needed to speed up and broaden business climate reforms across sectors and regions.

Quarterly Highlights

At the Gaidar Forum, which brings together government officials and independent experts, in Moscow in January, Prime Minister Medvedev announced a growth target of 5% p.a. and the need to stimulate small, medium and large enterprise growth as well as expanding the role of the private sector to achieve this outcome in the longer term. There is speculation, however, whether the country will achieve 5% in reality and if the government will stimulate the extra growth needed (1.5 to 2% on top of existing forecasts of 3% or so) through increased spending or through business climate reforms that will increase efficiency, attract investments and support growth.

In January Russia's Ministry of Economic Development indicated that it has taken the impact of cancelling the Shtokman Project into account in its forecast of the country's development to 2030. With an estimated gas reserve of 3.8 trillion cubic meters, Shtokman is one of the world's largest, but the estimated $15 bln investment relies on high prices to cover the intensive capital investment needed to make the project economically viable. Including this single project into the country's forecast highlights Russia's continued reliance on a small number of high value investments tied to the energy sector.

As part of a step for reducing red tape and bureaucratic procedures associated with investing in Russia, President Putin signed into law in January five-year visas for representatives or employees of foreign companies investing in Russia.

In March, Russia's Ministry of Economic Development raised its forecast of capital outflows in 2013 from the estimated $8 to $10 bln in January citing the crisis in Cyprus.

The 6th *Annual Russian Business Week* held at the London School of Economics highlighted Russia's need to develop non-energy sectors of the economy to achieve adequate growth rates while also drawing attention to the need to deal with the country's image to investors abroad citing that many UK investors seem concerned about corruption, arbitrary rule of law, and low cost sources of long term financing.

Late in Q1, the Russian government announced that it is considering a ban on cash transactions over $ 10 000 by 2015 (to be phased in with an initial level of $ 19 500 in 2014) in part to deal with the size of the shadow economy and tax revenues.

UNCTAD's latest *Global Investment Trends* *Monitor* (25.03.2013) highlighted growth in FDI flows to and from BRICS countries and Russia and China in particular. During the last decade, the amount of FDI going to BRICS countries more than tripled to $ 263 bln in 2012 (from 6% to 20% of global FDI flows), while FDI from BRICS grew to $126 bln (up to 9% from 1% of global flows). Since 2010, developing and transition economies have absorbed over half of global FDI flows and have been relatively more resilient to the crisis than developed countries.

In late March, the Ministry of Economic Development lowered its growth forecast for 2013 from 3.6% to somewhere below 3% citing a slowdown related to external market conditions, primarily weaker demand in Europe, and will release an updated forecast in April.

Business Climate Indicators

BCDM Quarterly's *Indicators* **aim to provide a brief look at statistics related to investment activity that can reflect changes in the quality of Russia's business climate from one quarter to the next that could be overlooked in less frequent or more aggregate reports.**

Russia's Growth Outlook in the Near Term – Q1

Across a sample of organizations, Russia's GDP is forecast to grow between 3.3 % and 4 % in 2013 after growing by an estimated 3.6% during 2012 (IMF, World Economic Outlook). However, during Q1, lower investment activity, changes in consumer habits (a move towards savings) and a lowering of expected energy exports are lowering expectations for this year and, as of the end of Q1, it looks as though forecasts for 2013 are likely to be reduced in Q2.

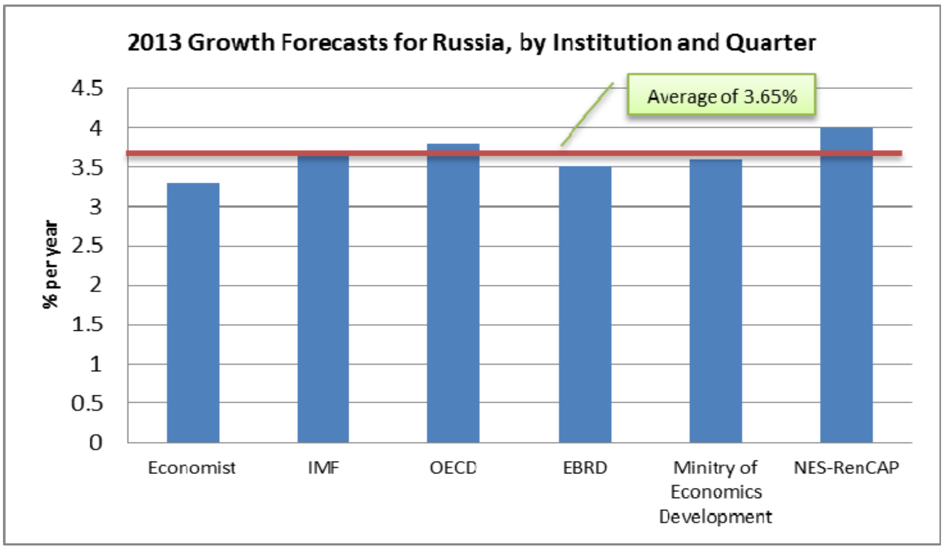
- The figure below shows forecasts for Russia's GDP growth for 2013 across a sample of organizations. Changes in the forecast for the year between quarters can help identify conditions that are thought to play a role in Russia's economic performance and help identify those that are relevant for qualitative changes in the country's Business Climate.

- By the end of 2012, Russia's real GDP had grown by an average annual compound rate of 4.7% since 2000 and in 2012, grew by an estimated 3.6%, just below a 3.9% average for the rest of the CIS. According to the IMF's latest *World Economic Outlook*, world output is forecast to grow by 3.5% and 4.1% in 2013 and 2014 respectively, while forecasts for Russia across organizations below range from a low of 3.3% to a high of 4% and are, on average, 3.65%.

- All of the forecasts in this figure are below the target rate of 5% per year announced by Prime Minister Medvedev at the beginning of 2013.

- The most recent RenCap-NES Monitor further indicates possible signs of a slowdown in Russia's economy at the beginning of this year due in part to declining commodity prices and a contraction across several industrial sectors, all of which serve to suggest that the 4% forecast is looking less realistic. The Ministry of Economic Development has also announced that it intends to revise downwards its 3.6% forecast for 2013 due to lower energy exports, investment activity, and signs of a slowdown while the EBRD includes the risks that Russia's forecast may worsen if the Eurozone crisis deteriorates further and from rapid domestic consumer credit expansion.

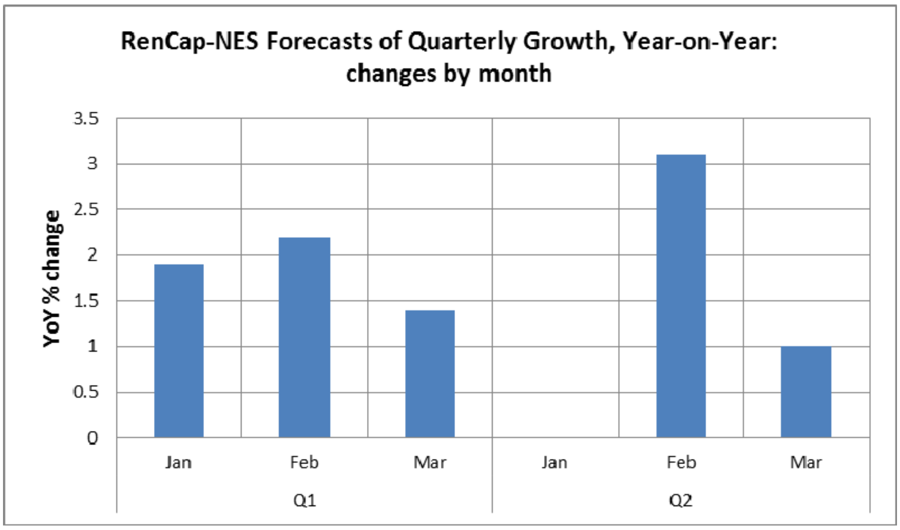
At the end of Q1, it looks as though forecasts for 2013 are likely to lower during Q2 depending on how these downside conditions continue to play out over the short term. ***(As of going to print, Russia's Ministry of Economic Development has lowered its forecast for 2013 to 2.4%)***



- The following figure shows growth forecasts for Q1 and Q2 of 2013 (RenCap-NES) relative to the same quarters last year. These year-on-year forecasts provide insight into how well the macroeconomy is performing relative to the same period last year without having to adjust for seasonal effects between quarters. Further, this graph shows how the forecasts for both quarters have changed monthly to use the latest statistics available to assess whether there are indications of a slowdown or pick up in performance.

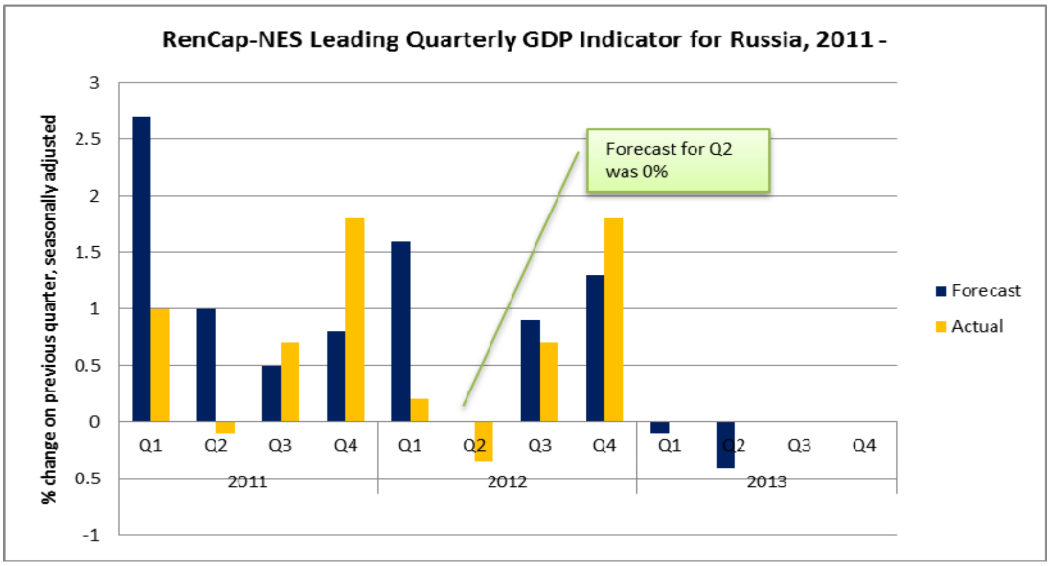
- Although the initial forcast for Q1 picked up from 1.9% over Q1 in 2012 to 2.2% by february, this forcast has since fallen to 1.4%. Further, forecasts for Q2 2013 over Q2 2012 have fallen significantly from 3.1% to 1%. This change in expectations is largely based on an observed slowdown in the economy and signs of stagnation that are more prolonged than previously expected (declining commodity prices and a drop in industrial output are cited as key factors in the forecast reductions).

- The first half of the year is expected to be weaker than previously thought and it looks more doubtful that the second half of the year will be strong enough to achieve the forecast RenCap-NES 4% for 2013 outlined above.



- The following figure shows RenCap-NES's quarter-on-quarter forecast, seasonally adjusted, and actual GDP growth figures starting from Q1, 2011. *(It is important to note that Russian state statistics, Rosstat, revised its methodology at the end of 2010 which partially accounts for changes in the accuracy of RenCap-NES's forecasts. Rosstat also occasionally changes its methodology in Q4 which can result in Q4 forecasts too high and Q1 of the following year being too low)*

- The latest forecasts for quarter on quarter growth, seasonally adjusted, for Q1, 2013, is -0.1% and for Q2, -0.4%. This slowdown in the economic activity following positive growth in Q3 and Q4 of 2012 is seen as in part due to a drop in commodity prices and a fall in key industrial activity such as mining, pulp and paper, and machines and equipment. As of Q1, a more positive outlook for the second half of the year depends on external economic conditions improving.



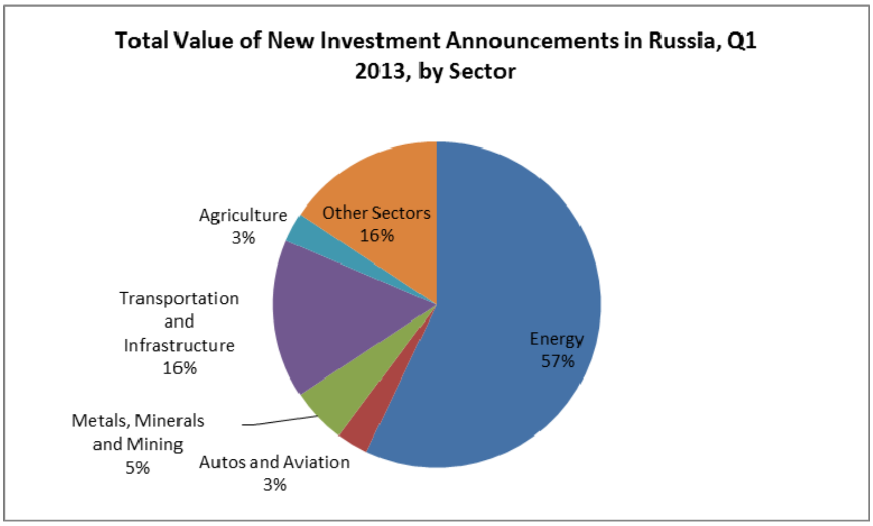
Although the forecasts for Russia's growth for 2013 are slightly higher, on average, than an IMF forecast for world output of 3.5% and advanced economies of 1.4%, both changes in the annual and quarterly forecasts suggest that the outlook for this year is likely to worsen depending on a mixture of external (the Eurozone crisis, commodity prices) and internal conditions (domestic consumer credit, lower investment spending). The gap between the forecasts and the government's target of 5% per year is therefore expected to grow and, as a result, make the target more difficult to achieve. This could provide an important stimulus for the country to embrace broader business climate reforms to improve efficiency and attract investments in other sectors and regions in part to compensate for worsening macroeconomic conditions.

New Investment Announcements

BCDM tracks new investment announcements monthly. A new investment announcement can reflect an intention to follow through with an investment in a particular activity over a future period and does not reflect an actual investment expenditure yet made or to be made. Tracking announcements monthly can help identify investors' intentions to make future investments in specific activities in Russia as well as important changes and trends that reflect, in part, changes in the quality of the Business Climate in the short term that may be missed or overlooked in less frequent or more aggregate reports.

During Q1, there were 131 New Investment Announcements tracked totaling $189.37 bln. A small number of large scale, multi-year, projects in the energy sector announced in Janaury, however, accounted for a significant portion (45%) of the quarter's total. Four announcements made at the beginning of the quarter by Rosneft ($40 bln), Gazprom (two projects totaling $36 bln) and Lukoil ($10 bln) continue to indicate that as far as public intentions are concerned over future investment activity, Russia is dominated by a small number of large scale energy projects.

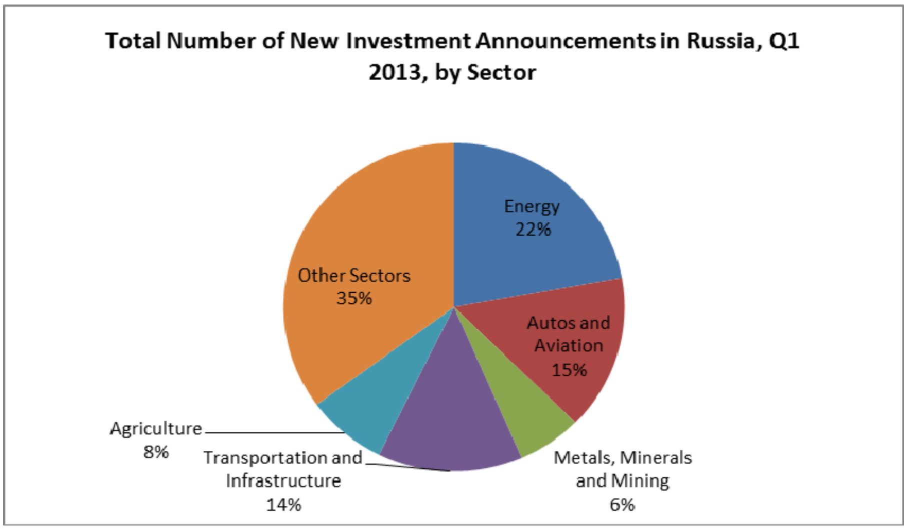
- Tracked new investment announcements (excluding outward), for which there were investment figures disclosed, totaled **$189.37 bln** during **Q1**. The figure below shows the breakdown of the value of new investment announcements by sector. Energy continues to dominate the overall value of new investment announcements with 57% (45% of the total represent only four announcements made in January alone), followed by Transportation and Infrastructure projects (16%) and Other Sectors (16%).



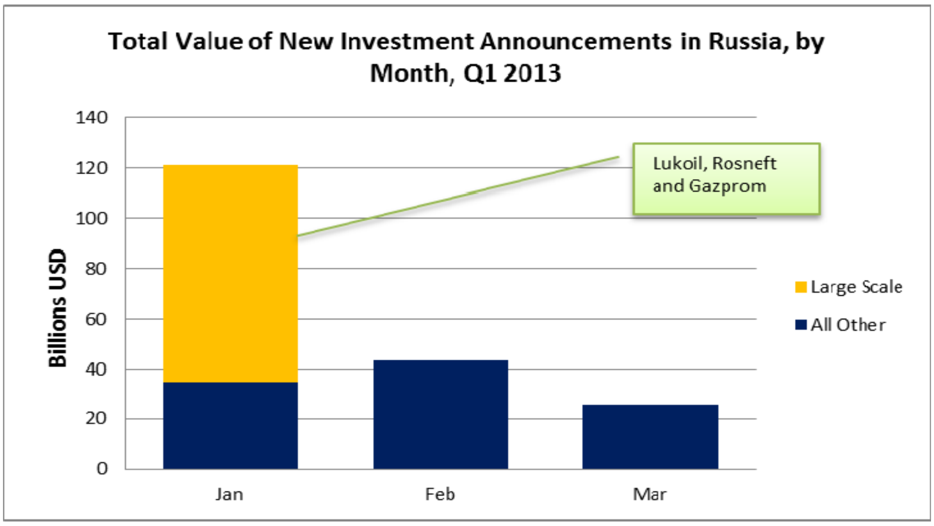
- The size and scope of large scale investments in the energy sector, however, can also overshadow investors' intentions to expand other sectors of Russia's economy. Relatively smaller projects in retail, tourism, or even infrastrure projects can be simply hidden in the aggregate data. Further, smaller investment announcements in other sectors often do not disclose the amount of the investment to be made which further exaggerates the role of energy investments.

- The following diagram shows, instead, the number of new invesmtnet announcements by sector to help overcome some of these drawbacks due to the relative differences in value and the failure to disclose values, which is a more significant problem outside the energy sector.

- By number, Energy accounts for only 22% of the new investment announcements made while Other Sectors accounts for the largest share at 35%. The "Other" category is dominated by retail expansion announcements which often do not report the value of the invesmtent to be made. This diagram helps to draw attention to the fact that investors are active outside of energy investments in Russia.

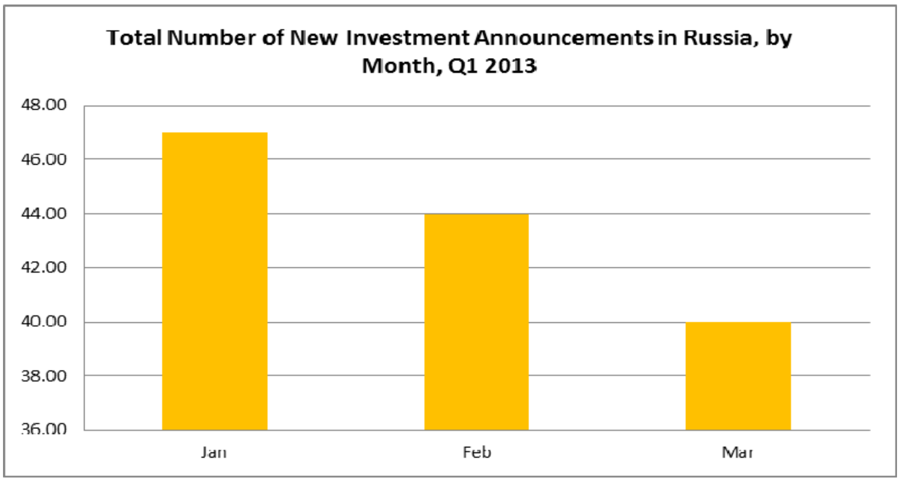


- The following figure shows the value of new investment announcements in Russia in Q1 by month. It also makes an adjustment to the total to separate out four large scale multi-year investment announcements in the energy sector related to **Rosneft, Gazprom, and Lukoil** in January that accounted for $86 bln, denoted in yellow. These four investment announcements would otherwise overshadow regular underlying trends in the data.



- While the overall trend during Q1 is downwards in terms of the total value of new investment announcements made, once adjusted for the extreme outliers in January, there appears to be a slight upward movement in February before falling more noticably in March.

- The following graph shows the number of new investment announcements during Q1, also by month, due to the fact that many announcements outside energy do not disclose financial figures and this downward trend, in value, may not reflect accurately investors' intentions. This graph, however, shows more clearly that after starting the year with 47 announcements in January (which is above the 38 average in 2012), the number dropped to 40 by March.

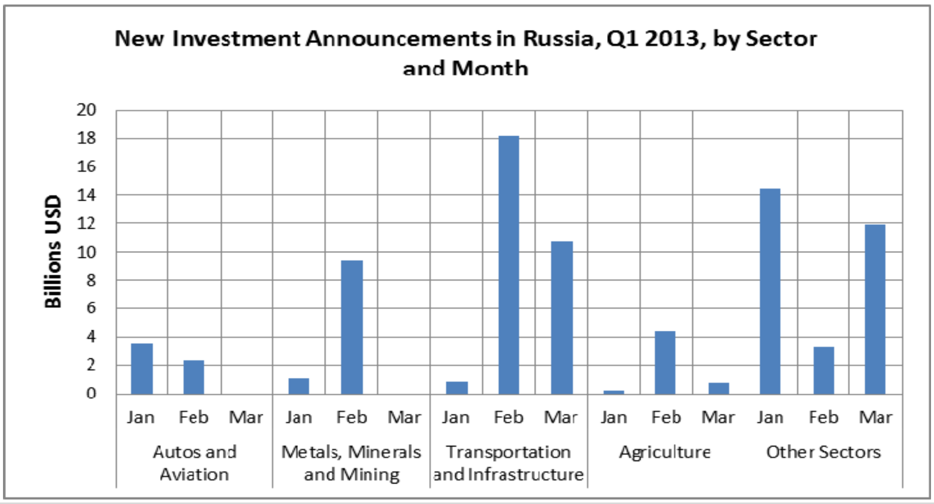


- Although it is still too early to tell whether this trend will continue and how much of a role announcements play or are tied to current investment activity in Russia, these trends are at least consistent with several trends noted elsewhere qualitatively (See Quarterly Highlights).

- First is the dominant role the energy sector continues to play in new investment announcements and that as far as indicated here, this role looks likely to continue in the overall level of investments in the country in the near future (other sectors are still overshadowed).

- Second, Russia's Minitry of Economic Development has raised concerns over lower than expeected investment activity in Russia during Q1 and these trends above so far show a decline in value and number. It remains to be seen whether these investments will actually be carried out, expanded or reduced, and whether the downward trend will continue. Another likely scenario is that investors may be holding off making their intentions publicly known until there is greater certainty over relative conditions for investing in Russia versus elsewhere.

- The following figure shows new investment announcement activity by month during Q1 in non-energy sectors. "Other Sectors" on the far right of the graph tend to be related primarily to retail investment announcements, many of which do not disclose investment figures and thus, the bars as represented tend to understate the true level of value activity.



***Note on Data** : New investment announcements are tracked monthly and totaled in USD only for those announcements for which figures were disclosed. The monthly edition of the BCDM discloses both announcements for which figures were and were not disclosed, but neverthless tracked. Disclosed sums in other currencies were converted for each month using European Central Bank figures for the last day of the month of the announcement. New investment announcements do not capture all investment intentions nor do they represent actual investment expenditures made.They represent only the total amount disclosed in the month of the announcement.*

- This graph shows that Other Sectors and Transportation and Infrastructure tend to dominate the value of new investment announcements month by month outside of energy. However, it also shows that relatively less has so far taken place in Agriculture and, unlike 2012, there were no investment announcements tracked so far this year related to tourism.

If *New Investment Announcements* accurately reflect future investment activity to take place in Russia, the latest quarterly data consistently shows that despite some activity in non-energy sectors, the country is likely to be dominated by a small number of large scale projects in energy. Further, because this single sector likely props up the rest of the economy, the underlying activity in sectors such as retail, autos and aviation, etc. are likely quite weak. These trends further highlight the need to address the country's non-energy potential sooner rather than later, particularly if reliance on energy alone is unlikely to help achieve the 5% target outlined by the government.

Capital Flows and FDI

Net private capitals flows for the first quarter of 2013 have been estimated to be -$ 25.8 bln, which is substantially higher than the forecasts outlined by Russia's Ministry of Economic Development of - $8 to 10 bln per quarter. While this is lower than the -$ 33.6 bln in Q1 of 2012, it is almost half of the total estimated outflows for 2012 of - $54.1 bln.

- The following figure shows net private capital flows per quarter since Q1, 2006, to the latest quarter for which an estimate is available, Q1, 2013. Data has also been updated due to revisions since the last quarterly report, although overall trends remain unchanged as a result.

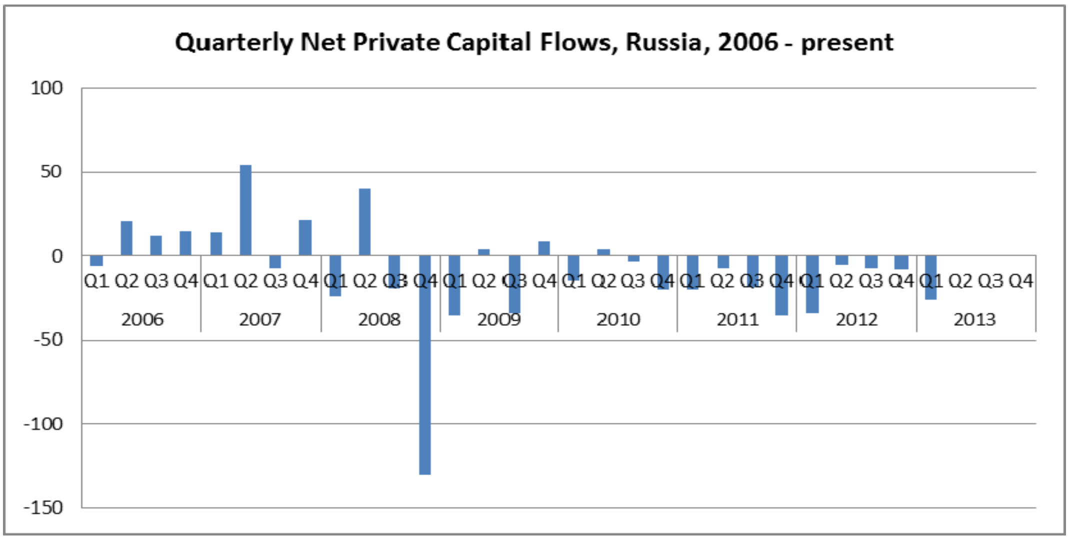
- The estimate of net private capital outflows for Q1, 2013, is at - $25.4 bln, a 227% increase over the outflows of-$ 7.9 bln in Q4 of 2012 and 243% over the -$ 7.4 in Q3, 2013.

- Part of the explanation for this sudden increase, however, is likely linked to the recent TNK-BP takeover by Rosneft announced in March, making Rosneft the largest listed oil producer in the world. The $55 bln deal involved a transfer of an estimated $16.7 bln to BP.

- After the 2008 crisis, the figure below shows that there was a dramatic increase in net outflows at the end of 2008 followed by several other larger quarterly outflows in 2009 (compared to the more recent quarterly outflows).

- Further, at the end of 2010 and beginning of 2011, there was another wave of outflows and this continued on a larger scale at the end of 2011 and beginning of 2012 (partially associated with political uncertainty in Russia coupled with the Eurozone crisis)

Although it remains to be seen whether this increase in net capital outflows will continue into Q2, the fact that they are higher than the -$8 to -$10 bln per quarter thought to be okay according to Ministry of Economic Development statements may provide an additional stimulus for discussing what steps need to be taken to enhance Russia's ability to attract and retain investments.



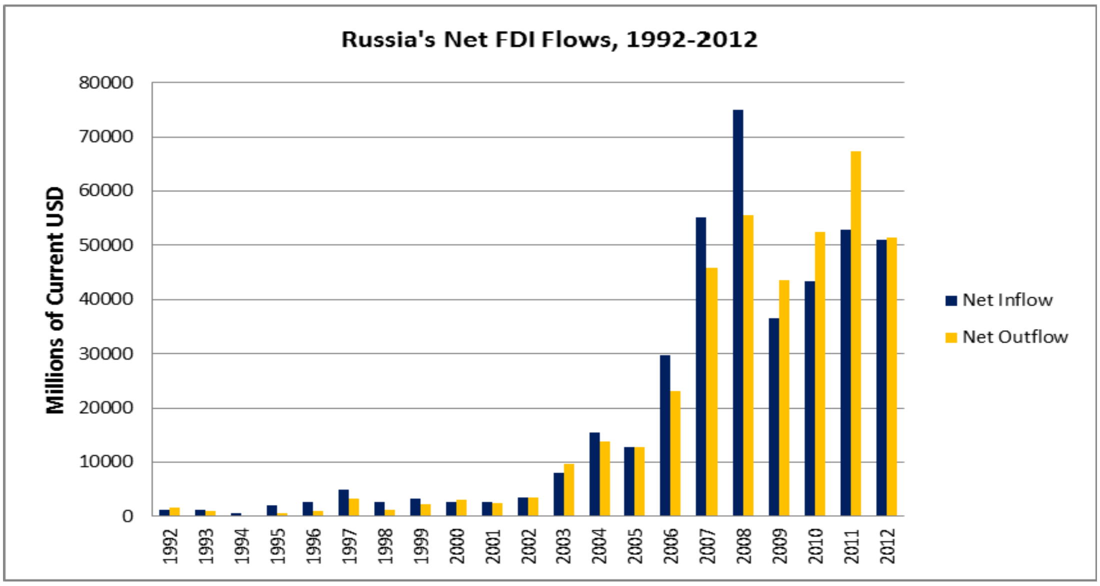
Source: Bank of Russia

- The following figure shows both net inflows and outflows of FDI since 1992. The graph has been updated since BCDM's last quarterly report to reflect the Bank of Russia's latest estimates for 2012.

- Beginning in the 1990s, FDI inflows and outflows began to grow although a more noticeable "take off" took place during the late 1990s and early 2000s. FDI flows in and out of Russia during this phase more than doubled worldwide FDI growth rates.

- As noted in the *Quarterly Highlights*, UNCTAD's latest *Global Investment Trends Monitor* (March) has highlighted the fact that just over half of FDI flows since 2010 have gone to transition and developing economies and, in particular, flows to and from Russia and China within the BRICS grouping have dramatically increased.

- According to the latest data available for 2012, net FDI inflows into Russia fell slightly to $51 bln from $52.8 bln in 2011 while outflows fell relatively more from $67.2 to $51.4. Although the graph shows a strong trend upwards in both flows since 2008, the levels of flows have not yet reached their peak pre-crisis levels.



Source: FDI figures are from Russia's Central Bank and were cross checked with those available from UNCTAD up to 2011, while those for 2012 are solely based on figures publicly provided by Russia's Central Bank.

It remains to be seen, however, what impact the evolving financial crisis will have on further FDI in Russia in 2013.

Readers' Business Climate Corner

BCDM quarterly's *Business Climate Corner* **provides readers with the opportunity to submit questions to relevant government authorities concerning the quality of the business climate.**

In order to provide relevant information to its readers on Business Climate issues in future editions, BCDM quarterly would like to invite its readers to submit questions and comments. Questions should address an issue concerning the quality of the business climate, current changes or challenges, which are important but all too often left out of large annual reports that cannot address specific issues in detail.

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