

Political Uncertainty Pushed to the Background – For Now

Quarter in Brief: Political uncertainty returned to Russia late last year with large scale protests following the Parliamentary elections in December and leading up to the Presidential election in 2012. With the appointment of a new government with a clear agenda, the political uncertainty appears to have faded into the background during the second quarter, although it remains in principle unresolved for the longer term.

Quarterly Highlights

At the beginning of the second quarter, 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, but also the influence the global financial crisis and political risk have recently had on investment levels in Russia. By the end of the second quarter the Ministry had revised upwards 2012's growth forecast to a range of 3.7 to 4%.

In early April, *Bloomberg's Best Countries for Business* ranked Russia within its top 50 coming 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.

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. During the preconstruction phase, for example, Moscow has 21 requirements that need to be fulfilled compared to 6 in Murmansk.

New investment announcements increased by 400% (by 23% excluding one large scale multi-year announcement by Rosneft) in terms of value in June and 77% in terms of number since May. Rather than indicating new investments moving forward, part of this increase in value and number was likely due to investors holding off investment decisions until after the political dust settled in May and a new government and its agenda were announced. Although political risk seems to be lower in the aftermath of the elections and announcements, political risk remains an issue that will need to be addressed to improve Russia's business climate in the long term.

The 16th St Petersburg International Economic Forum took place from June 21 to 23 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.

Business Climate Indicators

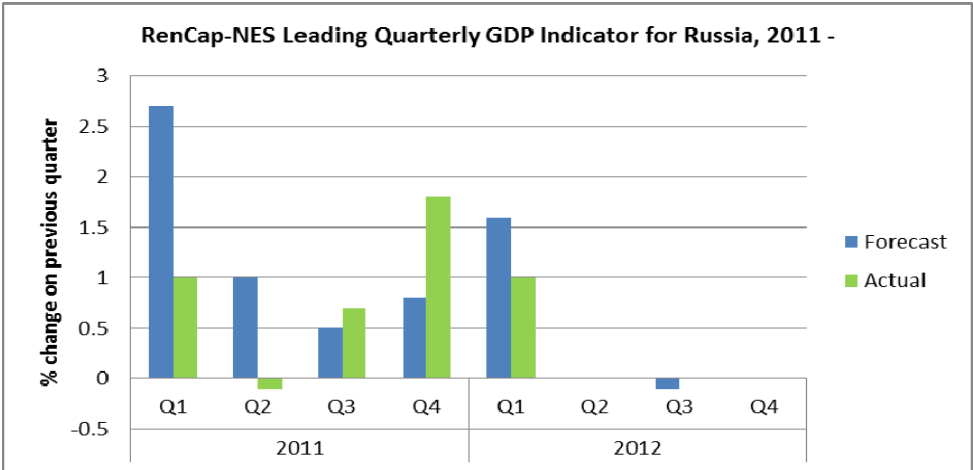
BCDM quarterly's indicators aim to provide a brief look at statistics related to investment activity that can reflect changes in the quality of Russia's business climate from one quarter to the next that could be overlooked in less frequent or more aggregate reports.

Russia's Growth Outlook in the Near Term – Q2

Russia's GDP has grown at an average annual compound rate of 5.1% during the last 12 years. Growth forecasts for 2012 during the first quarter were on average 3.5% across a sample of organizations cited below and ranged from a low of 2.3% to a high of 4.2%. By the end of the second quarter, however, most forecasts have been revised upwards for 2012 to an average of 3.8% and ranging from 3 % to 4.5%.

The second quarter was marked by concern that annual forecasts might need to be revised downwards, primarily due to weaker than expected investment levels. Since last summer, net capital outflows had continued to grow reaching -\$ 35 bln by Q4 in 2011 and continuing apace at an estimated -\$ 35.1 bln during Q1 in 2012 (recently revised downwards to -\$ 33.9 bln). Citing a downgrade in expected investment growth from 7.8% to 6.6% for 2012, Russia's Ministry of Economic Development lowered its GDP growth forecast from 3.7% to 3.4% earlier in the quarter before raising it to an even higher range of 3.7 to 4%. Further, new investment announcements appeared sluggish until June, and RenCap-NES's quarterly growth forecasts have been lowered for Q2 and Q3. Some, such as the OECD, have cited, however, higher oil prices and an easing of Euro tensions in their upward revisions for the year.

- The following figure shows [RenCap-NES's](#) quarter-on-quarter forecast 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.
- Actual growth estimated for the first quarter of 2012 was lower at 1% versus the 1.6% originally estimated.
- Forecasts for growth for Q2 and Q3 have been lowered since the first quarter from 1.1 and 1% to 0 and -0.1% respectively. According to these quarterly forecasts, it is expected that the economy slowed down during the first quarter and plateaued during the second and will contract slightly during the third.



- The quarterly forecast above stands in contrast with more optimistic revisions upward of annual forecasts shown below. The following figure shows the annual growth rate forecast for Russia in 2012 by a sample of organizations and compares their forecasts made in the first quarter with their revised forecasts in the second quarter.
- The average forecast for this year's growth rose from 3.5% to 3.8% since the last quarter and in general, each organization has revised their forecast upwards for Russia. After revising its forecast downwards at the beginning of the second quarter citing a downgrade in expected investment levels in 2012, by the end of the second quarter, the Ministry of Economic Development has also revised its forecast upwards to a range of 3.7 to 4% (not reflected in the figure).

Although there are indications in the short term (quarterly growth) forecasts that Russia might be experiencing a slowdown since Q1, there has also been a revision upwards of annual forecast growth since the first quarter citing a variety of factors, such as greater political certainty, higher resource prices, and an easing of Eurozone tensions.



New Investment Announcements

BCDM tracks new investment announcements monthly. A new investment announcement usually reflects an intention to follow through with an investment in a particular activity over a future period and does not reflect an actual investment expenditure made. Tracked announcements monthly can help identify 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.

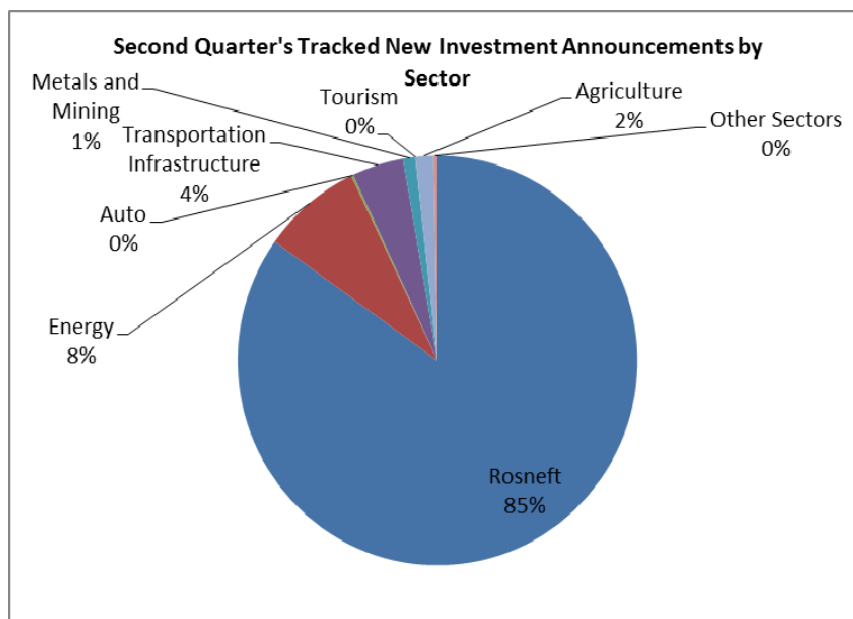
With the exception of several large multi-year investment announcements in the energy sector in April, the number and value of investment announcements appeared to slow down at the beginning of the second quarter before picking up significantly in June.

- Tracked new investment announcements (excluding outward), for which there were investment figures disclosed, totaled **\$848.6 bln** during Q2. This was up significantly from \$60.7 bln¹ during Q1, primarily due to three large multi-year investment announcements

¹ This figure has been revised since the first quarterly report to exclude tracked outward investment announcements. Similarly, adjustments have been made in the graphs presented throughout the Q2 report to allow for consistent comparisons.

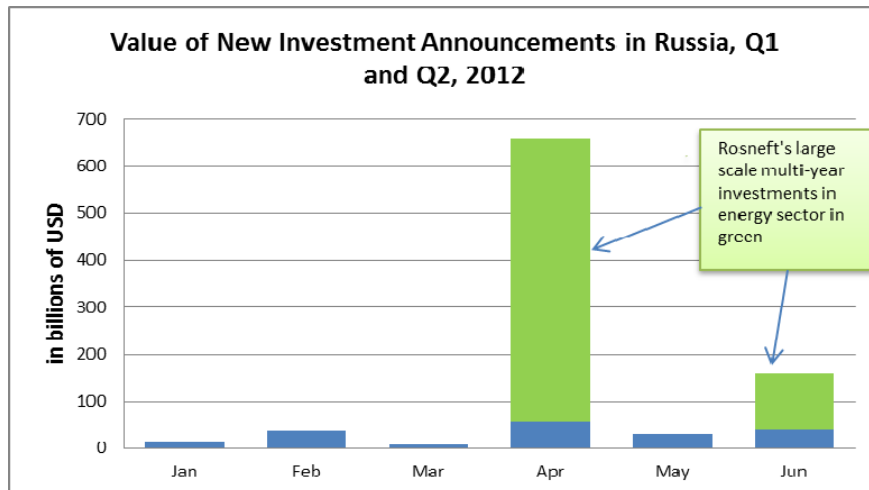
made in April and June in energy exploration by **Rosneft-Exxon** and **Rosneft-Eni**, accounting for \$720 bln.

- A clear trend that emerges from the data on new investment announcements is a strong dominance by energy sector announcements. The following figure shows that the energy sector accounted for 93% (Energy, 8%, + Rosneft, 85%) of new investment announcements during Q2, up from 72% in Q1. This is primarily due to three large scale investment announcements, two in April (\$600 bln) and one in June (\$120 bln) by Rosneft and its investment partners and these three alone account for 85% of the value of all new investment announcements for which figures were disclosed.
- A small number of multi-year large scale investment commitments in energy sector activities, such as exploration and related energy infrastructure construction, tend to overshadow activities in other sectors as a result. Additionally, many smaller investment announcements do not disclose investment figures. As a result, it is necessary to make adjustments in the value of new investment announcements for large scale activities to identify underlying trends as well as track the number of announcements since many smaller scale investments do not disclose the value of the investments.



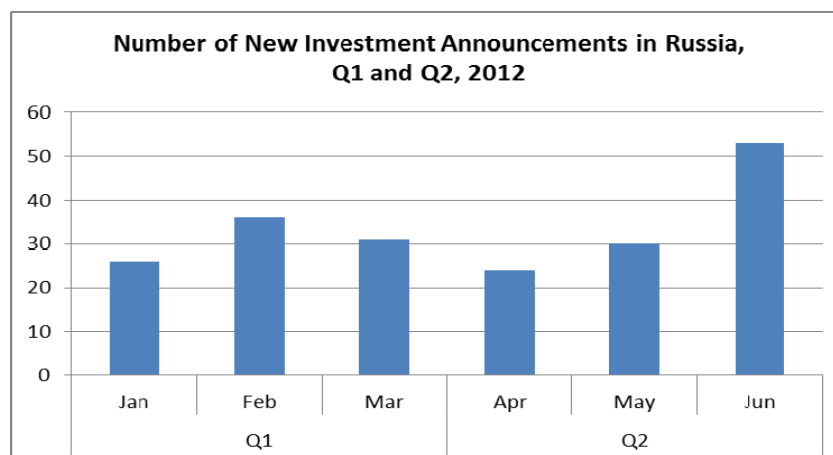
- Adjusting for these three large scale investments, there was still a noted increase in Q2 primarily due to an upswing in investment announcements in April and June. The following figure below shows the value of new investment announcements by month and quarter. The values for the three large energy deals by Rosneft and its investment partners are shown in April and June in light green to show primarily by how much three such deals can distort the general trend.
- The increase in new investment announcements June was 400% over May. Most of this substantial increase was accounted for by one large investment deal by Rosneft alone. However, excluding this deal new investment announcements still increased by 23% in June since May and both April's and June's other new investment announcement activity was higher than in the beginning of the year.

- June's increase is likely in part due to delayed investment commitments during the past year. Due to political uncertainty, many investors likely held off making investment commitments until the political dust settled in May with the inauguration of Putin, government appointments, and greater clarity over the new government's agenda with a strong focus on improving Russia's business climate during the next several years.



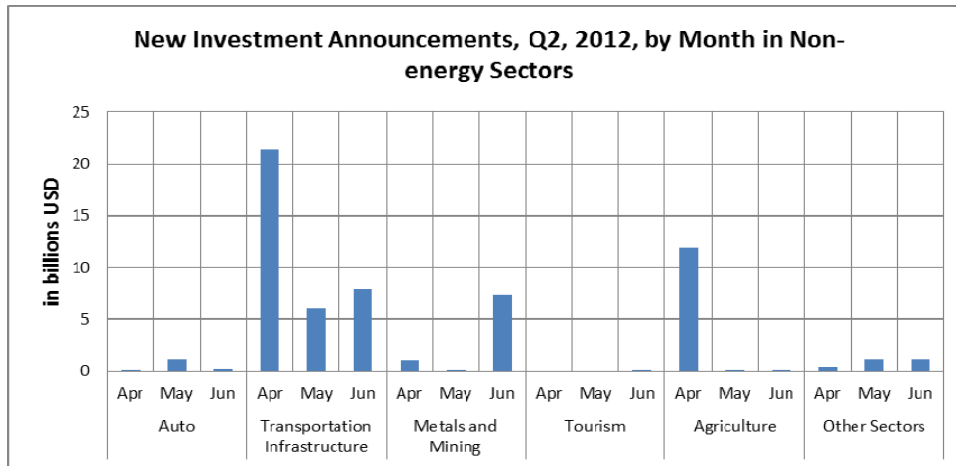
- This is more clear by examining the number of investment announcements. The following figure shows the number of investment announcements by month and quarter (regardless of value) and indicates a low and generally declining trend leading up to June. June's number was the highest all year, and even higher than April's. Many investment announcements do not disclose the investment amount and this serves to underestimate, potentially, the upward trend in activity in June.

This trend is consistent with the scenario that many investors may have decided to wait until after the new government was formed in May before announcing or making investment commitments publicly.



- The following figure shows the value of new investment announcements by month in Q2 in non-energy sectors. This provides further detail on some of the activities overshadowed by the scale of energy sector investment activity. During the second quarter, there was generally a lot of activity in **Transportation and Infrastructure** followed by **Agriculture** and **Metals and Mining**. The **Auto**, **Tourism** and **Other** sectors' announcements were less active

than in Q1 although there was a noted increase in retail activity (Other Sector) in May and June.

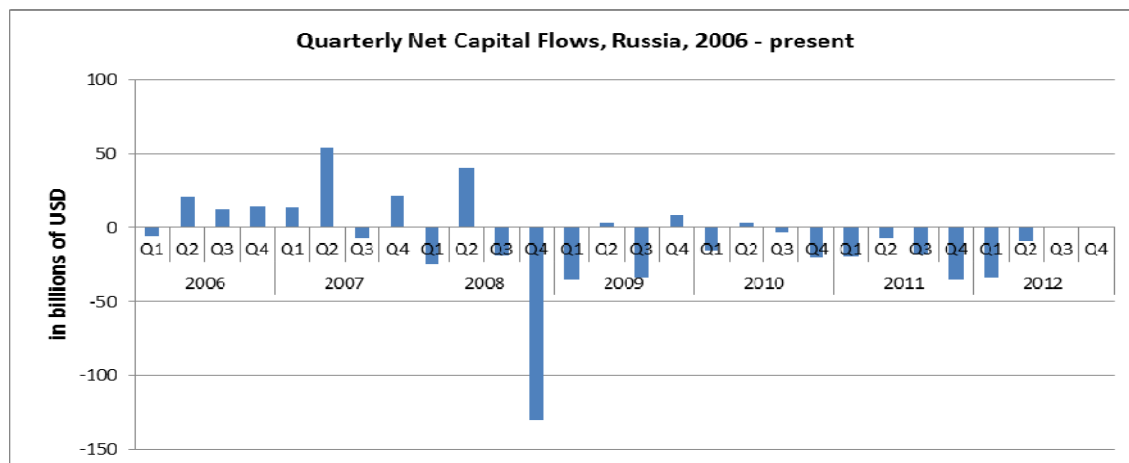


Note on Data : New investment announcements are tracked monthly and totaled in USD only for those announcements for which figures were disclosed. The monthly edition of the BCDM discloses both announcements for which figures were and were not disclosed, but nevertheless tracked. Disclosed sums in other 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.

Capital Flows and FDI

Estimates of net private capital flows for the fourth quarter of 2011 and the first two quarters of 2012 indicate that significantly more capital continues to leave Russia than enter. Net inflows of Foreign Direct Investment for 2011 indicate that net inflows were up over 2010. At the same time, Russia continues to directly invest abroad in greater volume.

- The following figure shows net capital flows for Russia by quarter since Q1, 2006, to the latest quarter for which data was available, Q2, 2012. The estimate of net capital outflows was reduced for Q1, 2012, from -\$ 35.1 bln to -\$ 33.9 bln since the last Quarterly Report. The latest estimate for Q2, 2012, is that net capital outflows slowed down to -\$ 9.5 bln.

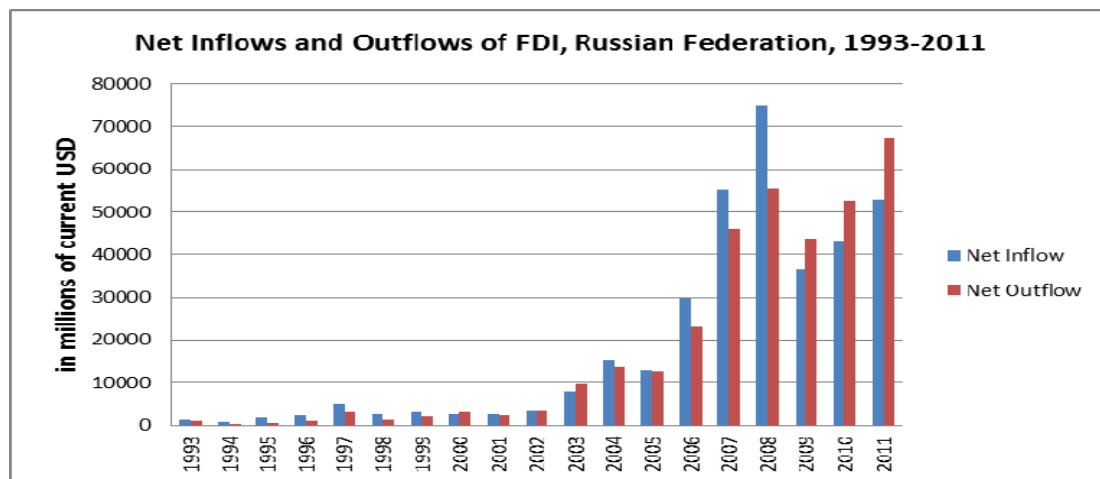


Source: Bank of Russia

- The following figure shows both net inflows and outflows of FDI since 1993. Starting in the late 1990s, both flows grew rapidly and Russia's stocks of FDI were double worldwide growth rates. Since the onset of the global financial crisis in 2008, both flows have grown each year with net outflows generally higher than inflows as Russia acquired more assets abroad.

- This graph remains unchanged since the first quarter since not further estimates of FDI have become available.

It remains to be seen, however, what impact the financial crisis will have on further FDI in Russia in 2012 coupled with the outcome of political uncertainty during the past year and how much progress is made in the near future in terms of improving Russia's business climate.



Source: FDI figures are from Russia's Central Bank and were cross checked with those available from UNCTAD up to 2010. Figures for 2011 are solely based on estimates from the Bank of Russia.

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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