

Entrepreneurs Brought in From the Cold

Quarter in Brief: An issue brought consistently to the forefront during Q2 was the state of entrepreneurship in Russia. Earlier in the quarter, Prime Minister Medvedev restated the government’s intentions to continue with privatization and widen the role played by the private sector and entrepreneurs in the economy. Restrictions on foreign activity in “strategic Russian enterprises” would also be eased somewhat and by the end of the quarter, President Putin announced that he would, after all, agree to a newly amended version of an amnesty package for some of those previously convicted of economic crimes.

Quarterly Highlights

Legal changes signed in early April aim to make it easier for foreign investors to buy stakes in strategic Russia enterprises (Federal Law No. 57). This will partially be achieved by removing restrictions related to the use of subsoil assets if the state owns a controlling share and removing approval if the company already owns 75% in the company in addition to other changes.

In late April President Putin issued orders to his economic advisors to focus on economic growth and requested proposals to be submitted by mid-May, 2013. This draws attention to the importance of this policy objective as well as supporting a much needed discussion about what the country can do to boost growth in the midst of an apparent slowdown. Hopefully business climate reforms will play a crucial role going forward in this agenda although concrete steps and strategies remain to be seen.

Prime Minister Medvedev announced that the government will continue to reduce the state’s role in the economy making more space for private entrepreneurship in addition to highlighting the need for greater transparency in rules for companies with a state stake.

In the latest rankings from IMD’s *World Competitiveness Center* Russia’s position improved to 42nd out of 60 from last year’s at 47th out of 59.

In May Prime Minister Medvedev drew attention to the real risk of a recession facing the country and 5% cuts to the budgets of state agencies to deal with austerity measures while discussing his past year in office.

Also in May, President Putin signed into law a ban on specific categories of citizens from holding foreign bank accounts, such as those holding specific public offices and positions (i.e. deputy Ministers, Central Bank Board officials, etc.). Although this may aim to provide incentives to manage the economy more effectively as well as stemming corruption, it remains to be seen whether this tool will be effective or significant for dealing with one of the most cited concerns of investors: systematic corruption.

Forbes released its ranking of the *30 Best Cities for Business in Russia*. Focusing on the 40 largest cities by population and highest level of average incomes, the sample of cities were compared using data and information across a total of five categories: labor shortages, access to finance, inadequate infrastructure, problems with tax authorities, and closed cities. The top three in this year’s report were Kaliningrad, Ufa and Krasnodar.

Relying on a combination of surveys of business owners, experts, indicators of business well-being and arbitration data, The Public Opinion Laboratory (LIOM) published its ranking of the *Most Business-friendly Governors* in Russia. Sverdlovsk, the Khanty-Mansi Autonomous District, and the Republic of Tatarstan ranked in the top three positions respectively.

Moscow is considering the construction of four new rail stations to service high speed trains connecting St Petersburg, Adler and Ekaterinburg to Moscow. There are also plans to extend a high

speed rail link to Kazan which would involve an estimated infrastructure investment of nearly \$30 bln.

Cushman and Wakefield analysts have forecast that within two years Russia will likely be Europe's largest shopping center. Currently France and the UK have the most retail shopping space with 16.95 and 16.48 mln square meters respectively compared to Russia's 16.47 mln. Over a million new square meters of space is expected in Russia with 70% of shopping mall expansion forecast outside of Moscow relative to smaller expansions expected in the UK and France. This is in line with indications of Russia's consumer potential with rising disposable incomes and broadening of consumer demand regionally.

The *Annual Russia Business Forum* hosted by the Russo-British Chamber of Commerce was held this past June focusing in particular on investing in Russia's regions. Highlighted at the event was Russia's growing consumer market, especially for imported products, due in part to rising incomes and purchasing power, but also perceptions of the difficulty of expanding into Russia by British investors who have not yet entered the market versus those who have arrived and survived ("*The perception gap*"). This in part draws attention to the need for Russia to not only implement business climate reforms, but also to communicate the state of affairs accurately to potential investors.

The 17th *St Petersburg International Economic Forum* was held in late June focusing on "Finding the Resolve to Build a New Global Economy." A total of 7190 people took part in the event including various heads of states, ministerial representations, media outlets and 1992 foreign and Russian business people in addition to 102 agreements being reached worth an estimated \$9.6 trillion. Reforms to Russia's court system were announced as well as a shaking of Gazprom's monopoly.

After initially rejecting a bill granting amnesty to businesspeople previously convicted of economic crimes, President Putin announced at the *St Petersburg International Economic Forum* that an amended bill restricting the amnesty to avoid releasing some criminals convicted of some severe offenses such as weapons sales could be accepted and a new version is currently being rushed through the Duma before summer break. With the amendments the number of those expected to be covered by the amnesty has dropped from an estimated 100 000 to 3000 to 6000, although the precise applications remain unclear. Part of the stated aim was originally to release entrepreneurs who were convicted of offenses in the past that would no longer be considered criminal under current legislation today.

Also in June a group of about 20 of Russia's largest privately owned farms have announced the formation of the Union of Organic Farming citing as one of its aims as lobbying the government to create regulations for supporting "organic" farming in Russia since this is seen as a major obstacle in this activity for further growth and export to the EU. Some estimates by Euromonitor International and other experts value the size of Russia's organic market at \$ 148 mln in 2012 with growth potential of 30% by 2015.

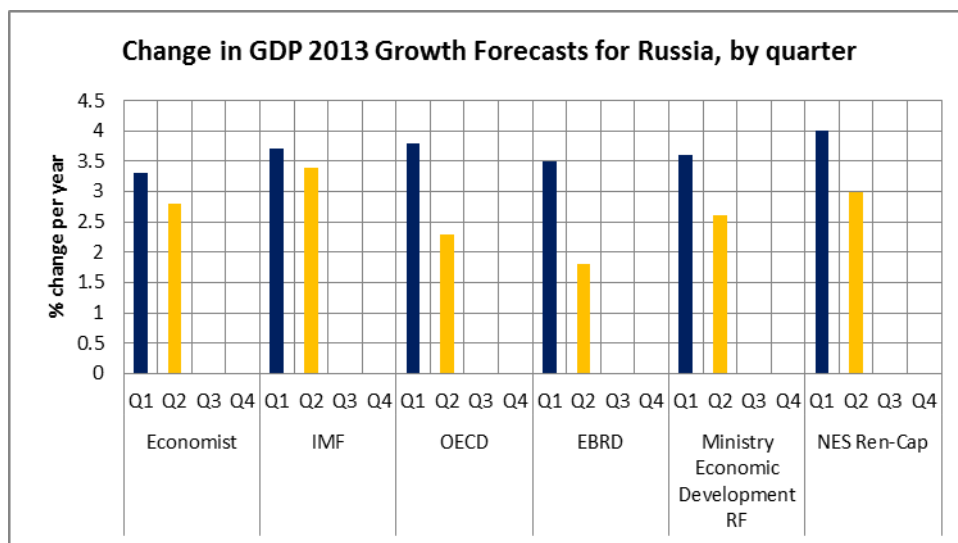
Ernst & Young released the *Russia Attractiveness Survey 2013* citing the importance of the country's large and growing consumer market, rising disposable incomes, growing middle class and low cost educated workforce for attracting investors. It drew, however, attention to the continuing dominance of the gas and oil sector as well as the perception gap between foreign investors already in the market versus those outside who remain relatively more cautious and key challenges which remain: political, legislative and administrative issues, corruption, and regional disparity as well as lack of knowledge about regional potential outside large, well known, centers.

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, particularly those that could be overlooked in less frequent or more aggregate reports.

Russia's Growth Outlook in the Near Term – Q2

Citing lower than previously expected investment levels, commodity prices, weakening consumer demand and government spending, forecasts across a sample of institutions for Russia's growth in 2013 have declined since the first quarter from a range of 3.3 to 4% to 1.8 to 3.4%. However, since the release of **BCDM's Semi-Annual Report** in June at the SPIEF, new short-term data indicate a slight improvement with Q1 growth coming in higher than expected and the Ministry for Economic Development considering a revision upwards from 2.4 to 2.6% for 2013 as a whole.



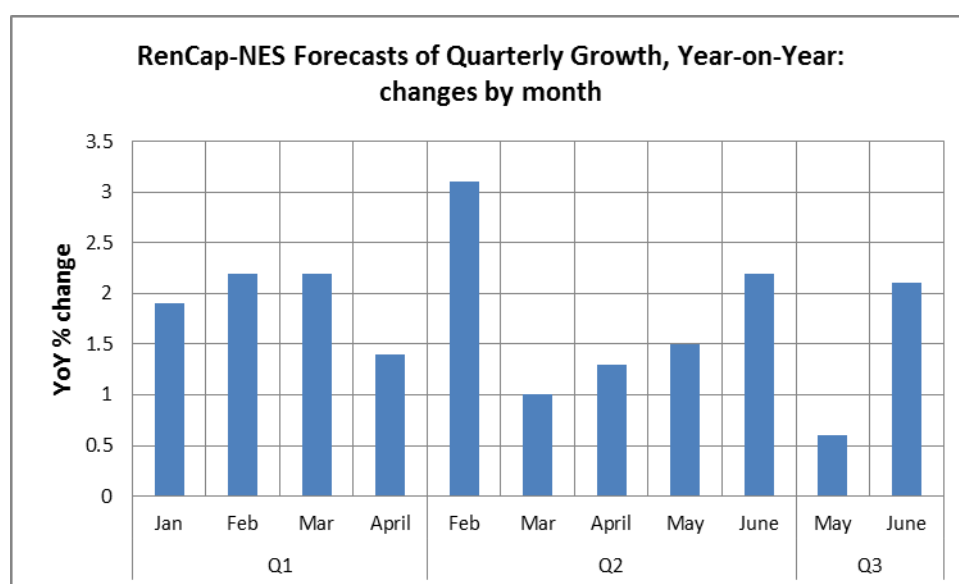
Note: Forecasts have been updated since BCDM's Semi-Annual Report in June to reflect Russia's MED's indication that they may raise their 2013 forecast to 2.6% in July.

- The Figure above provides forecasts for Russia's growth rate in 2013 across a sample of institutions and shows how these forecasts change from one quarter to the next helping to potentially identify conditions, including business climate conditions, which may account for changes in growth outcomes. The forecasts during the first quarter, shown in blue, were generally higher than those made during the second quarter, shown in yellow, and each of the institutions sampled have reduced their forecast for this year.
- As of going to print, however, the Ministry for Economic Development has cited higher than expected growth in Q1, 2013, of 1.6% YoY as part of the reason for their considering an improvement in their forecast for 2013 from 2.4% to 2.6%. This has already been incorporated into the figure.
- Previously Russia's Ministry of Economic Development cited lower than expected investment levels so far this year as part of the reason for their reduction from 3.6% in Q1 to 2.4% earlier in Q2. This stresses the important role that attracting and retaining investment activity could play in boosting growth, or at least in preventing further declines.

- The EBRD has cited a slowdown in Russia in its reduction of 2013's forecast from 3.5% in Q1 to 1.8% in Q2 stemming from a stagnation in commodity prices that is likely linked to weaker consumer demand in addition to a lack of investment growth and weaker confidence levels in terms of the quality of the investment climate (protection for foreign investors and lack of reform progress). Also highlighted was the impact that reduced government public spending may be having on the economy's level of performance.
- The OECD reduced its forecast from 3.8% to 2.3% citing weaker oil and gas prices as well as mentioning the tightening of budget spending. This serves to draw attention to the continuing important role gas and oil play both in the aggregate performance of the country as well as the impact they play on government budgets and social spending.
- [NES RenCap](#) forecasts have also cited a slowdown in key industries and weaker consumption levels in their forecast decline of 4% to 3%. *(Recent data on higher than expected Q1 growth has affected NES RenCap short term, quarterly, growth rates, but not the annual forecast as of the latest data to date)*

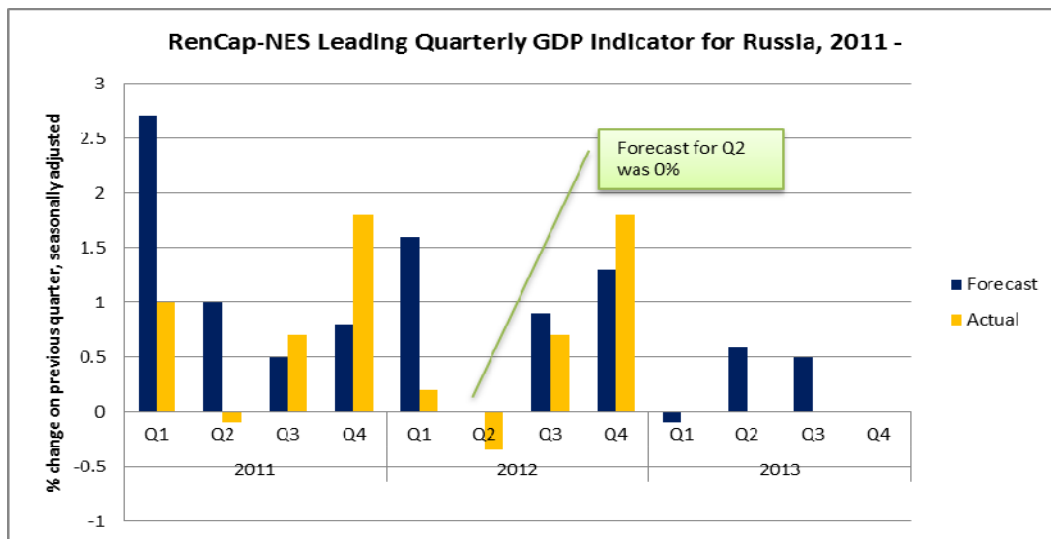
The decline in this year's annual forecasts continue to point to the important roles investment levels, gas and oil prices, and government spending have on Russia's growth performance. Further, these conditions point once again to the role business climate reforms that aim to attract and retain investments as well as improve non-energy sector performance could play in boosting Russia's growth rates in addition to reducing the risk of relying too heavily on any one sector or activity.

- The Figure below shows growth forecasts for the first three quarter of 2013 relative to the same quarter the previous year and how these forecasts have changed from month to month. These Year-on-Year (YoY) 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, monthly changes in these forecasts can help assess whether there are indications of a slowdown or pick up in performance and which conditions may be responsible.



Note: This data has been updated since the release of BCDM's Semi-Annual Report in June.

- During the first three months of 2013, estimates of YoY growth for Q1 increased until April when it fell from above 2% to 1.4% in part due to weaker than expected performance across key industrial sectors, indicating some concern about a slowdown.
- By the end of Q2, however, the first estimates by Rosstat for Q1's actual YoY growth came in at 1.6%, higher than this 1.4% forecast and better than the 1.1% expected by Russia's Ministry for Economic Development. This higher than expected performance will have some impact on short term forecasts going forward.
- Q2's YoY growth forecast has been revised upwards from 1.5% in May to 2.2% and Q3's YoY growth forecast has risen to 2.1% from 0.6%.
- In addition to the influence of higher than expected growth in Q1 on the forecasts for the remainder of the year, there are additional signs of an improvement in pace. The Ministry of Agriculture expects a better harvest this year than last (30% increase), rate cutting by the Central Bank is expected followed by lower inflation which should boost consumer purchasing power and stimulate demand.



- The figure above shows the RenCap-NES estimates of quarter on quarter growth from 2011 through to Q3, 2013, seasonally-adjusted. The figures have been updated since BCDM's Semi-Annual Report to reflect the latest estimates. Q2 has been revised upwards to 0.6% from 0.3% and Q3 to 0.5% from -0.2%.
- These upward revisions are also in part due to better than expected growth in Q1, but also indications that the pace of growth is beginning to pick up and showing signs that this trend should continue during the second half of the year. The Ministry for Economic Development's preliminary estimate of April's YoY growth is, for example, 2.6%.

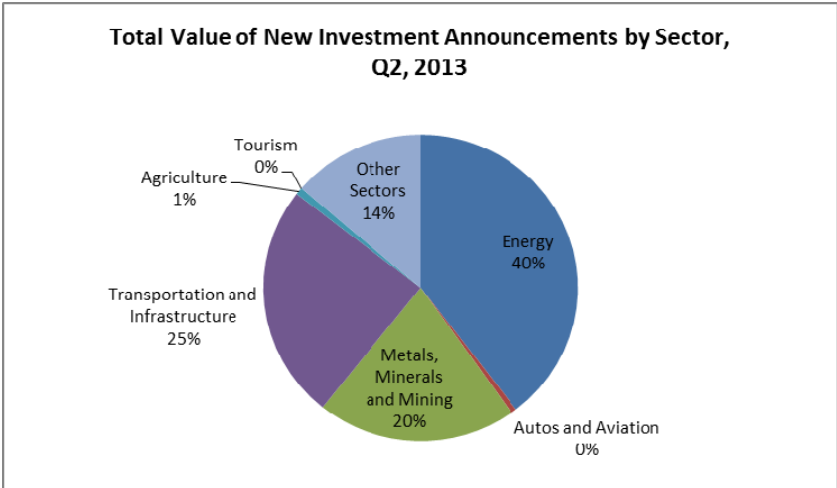
Although updated quarterly growth estimates for 2013 show some improvement in momentum, overall growth for the year remains weaker than previously expected due to larger concerns over commodity prices, the state of the European economy, stimulus spending and investment spending levels.

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.

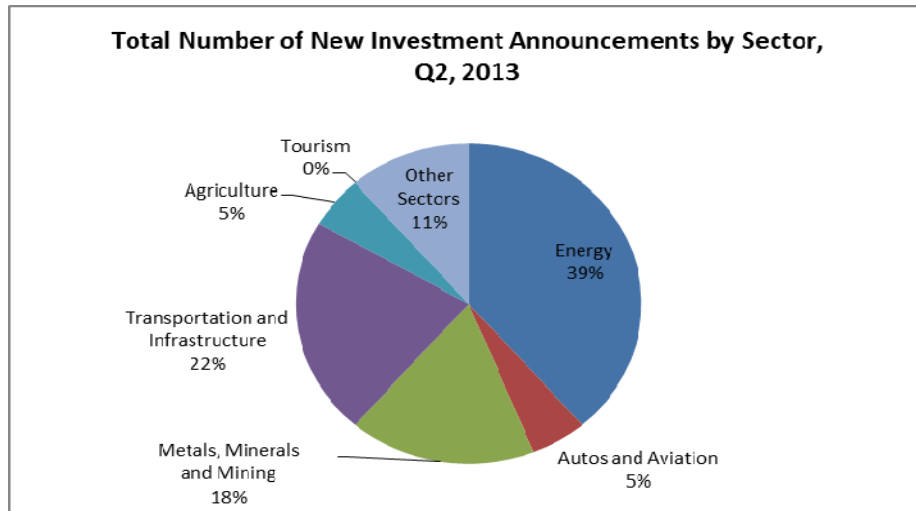
During Q2, there were 114 New Investment Announcements tracked totaling \$74.6 bln. This is down from 131 announcements in Q1 worth an estimated \$189.4 bln. A small number of large scale, multi-year, projects in the energy sector announced in Janaury, however, accounted for a significant portion (45%) of that quarter's total. Four announcements made at the beginning of Q1 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 **\$74.6 bln** during **Q2**. 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 40%, followed by Transportation and Infrastructure projects (25%) and Metals, Minerals and Mining (20%).

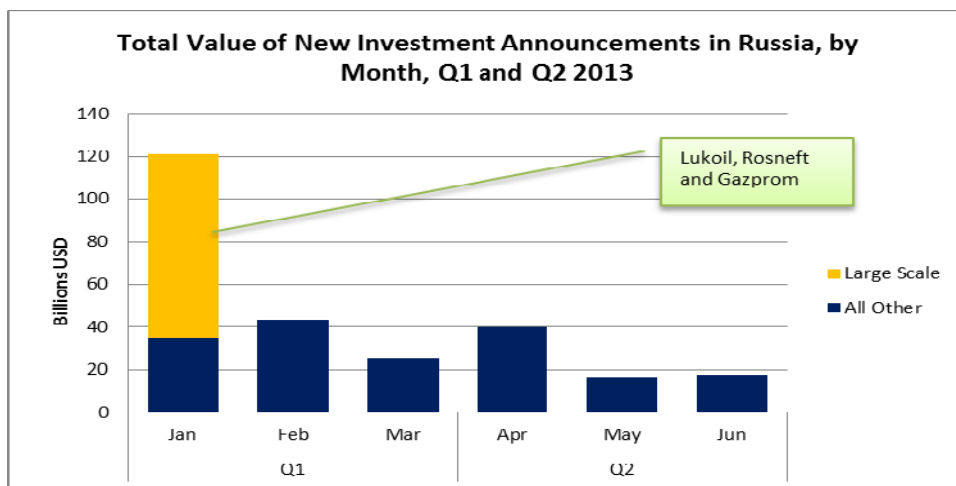


- The size and scope of large scale investments in the energy sector, however, can also overshadow investors' intentions to expand other sectors of Russia's economy. Relatively smaller projects in retail, tourism, or even infrastrure projects can be simply hidden in the aggregate data. Further, smaller 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 39% of the new investment announcements made while Other Sectors accounts for 11%, which is down significantly from the previous portion of 35%.

Typically during the past year and a half, the “Other” category, which is dominated by retail expansion announcements, dominate this chart and this marks a significant change from this trend, possibly indicating a slowdown in intentions to announce future investments in this type of activity. Further, these types of announcements often do not report the value of the investment to be made and are usually overshadowed in the value chart above.

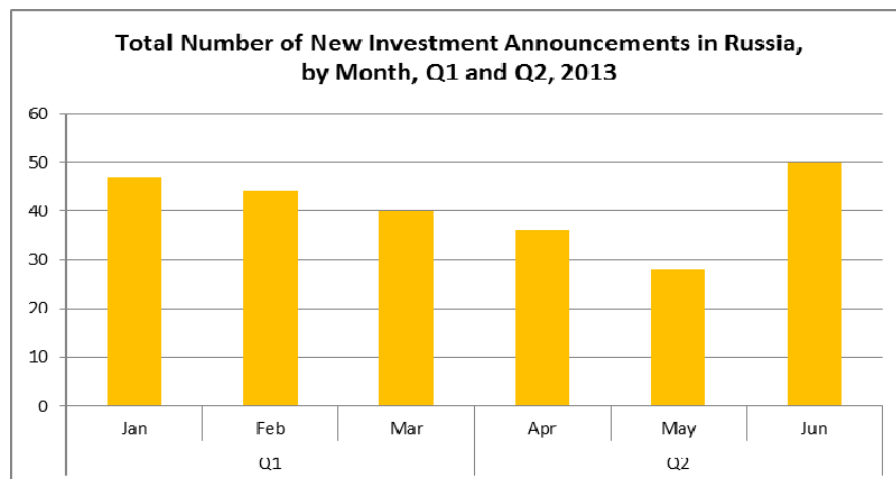


- The following figure shows the value of new investment announcements in Russia in Q1 and Q2 by month. It also makes an adjustment to the total to separate out four large scale multi-year investment announcements in the energy sector related to **Rosneft, Gazprom, and Lukoil** in January that accounted for \$86 bln, denoted in yellow. These four investment announcements would otherwise overshadow regular underlying trends in the data.

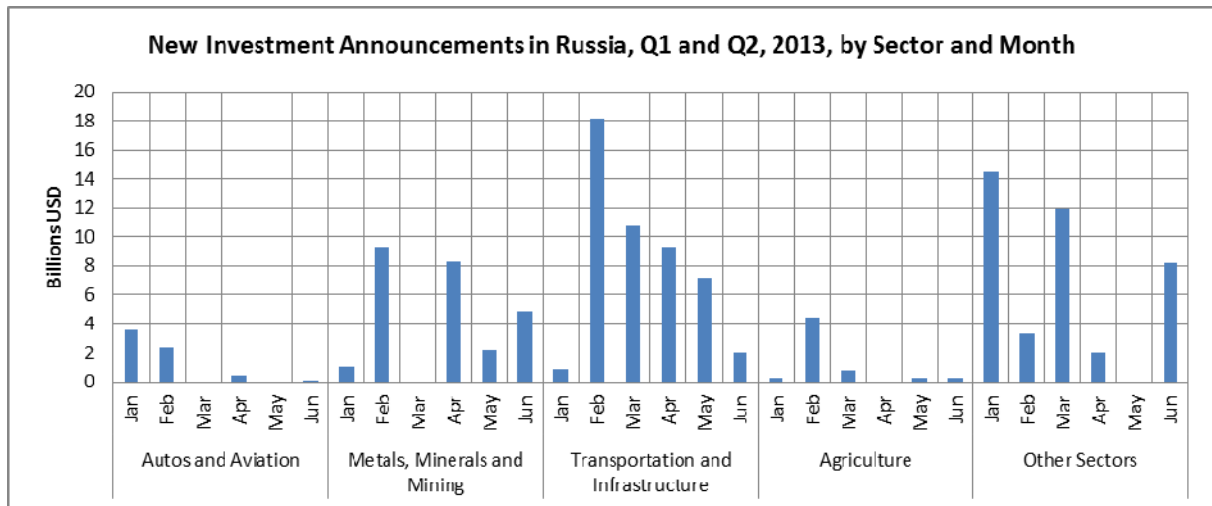


- While the overall trend during Q1 is downwards in terms of the total value of new investment announcements made, once adjusted for the extreme outliers in January, there appears to be a slight upward movement in February before falling more noticeably in March. After April, the value of New Announcements also fell noticeably.
- The following graph shows the number of new investment announcements during Q1 and Q2, 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 before raising again to 50 in June. This graph suggests that the number of activities may be seasonal, but also remain steady, and reflect the drawback of over relying on the values, especially when a large number of small investors do not disclose financial details.



- 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.
- 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, although the Ministry of Economic Development raised concerns over lower than expected investment activity in Russia during Q1 and lowered their growth forecast, there have been indicators of some improvement, including in consumer spending and commodity prices, in Q2 and some signs of a pick up in the number of investments have been noted.
- The following figure shows new investment announcement activity by month during Q1 and Q2 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 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.

- 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, which has been excluded from the chart due to a lack of activity.
- The general trend across sector is also downwards during the first six months although it is still too early to identify precise reasons for why this might be the case.

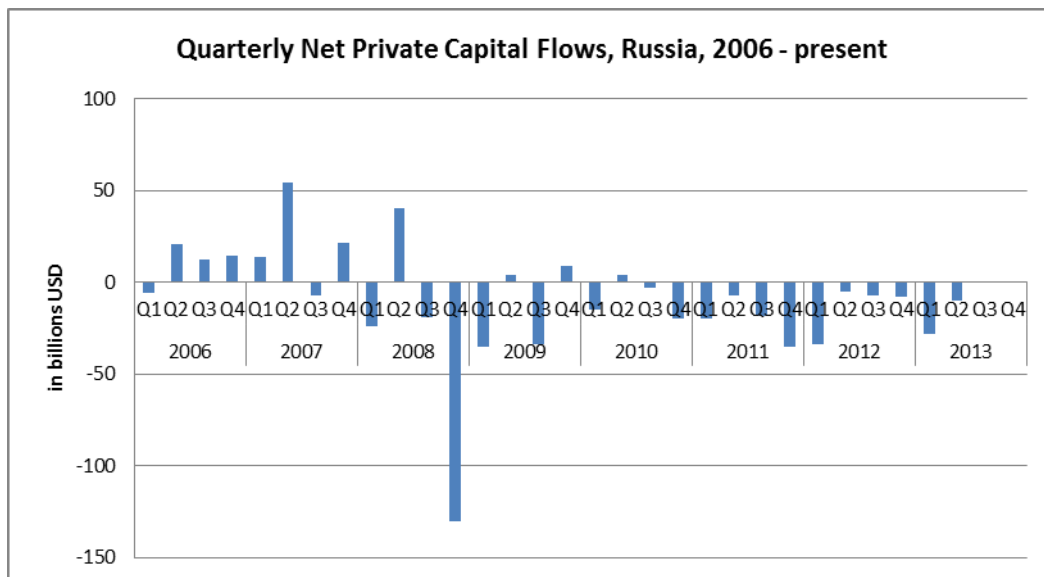
If New Investment Announcements accurately reflect future investment activity to take place in Russia, the latest quarterly data consistently shows that despite some activity in non-energy sectors, the country is likely to be dominated by a small number of large scale projects in energy. Further, because 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. There is also concern that the negative trend across other sectors during the first half of the year may indicate a lack of confidence to expand future production in these activities, further hindering future growth potential and stressing the need to address the country's non-energy potential.

Capital Flows and FDI

Net private capital flows for Q1 2013 have been revised to -\$28.4 bln from -\$25.8 bln since the first quarterly report. The Ministry for Economic Development has not yet revised its estimate of -\$30 bln for 2013, which would be lower than the -\$54 bln in 2012, but their preliminary estimates for the first six months of the year already total -\$38.4 bln. Although it is possible that some months may witness a net inflow of private capital, thereby slowing down or reversing this trend, an updated revision is expected in August.

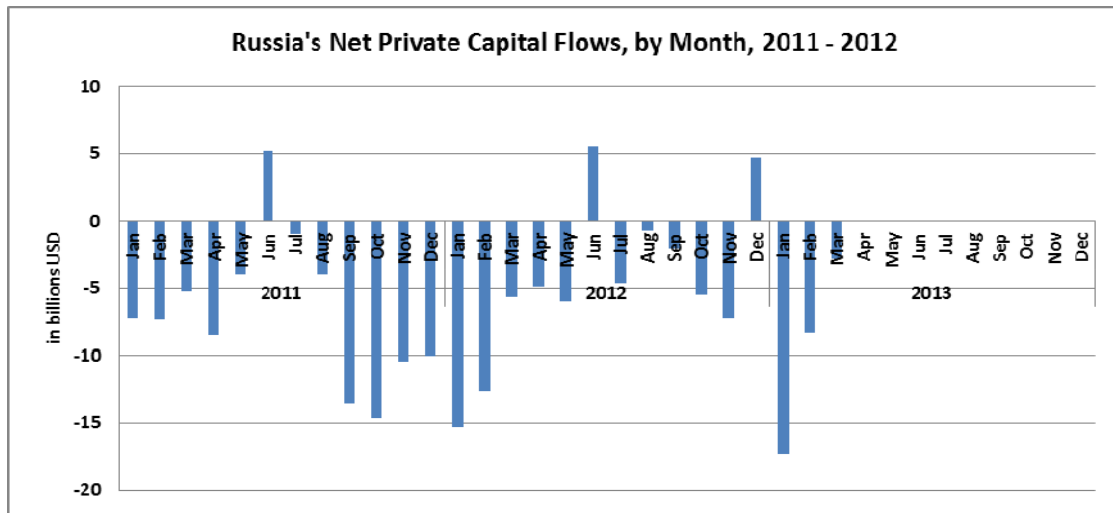
- The following figure shows net private capital flows per quarter since Q1, 2006, to the latest quarter for which an estimate is available, Q2, 2013. Data has also been updated due to revisions since the last quarterly and semi-annual reports, although overall trends remain unchanged as a result.

- The estimate of net private capital outflows for Q1, 2013, is at - \$28.4 bln, a 227% increase over the outflows of-\$ 7.9 bln in Q4 of 2012. However, net private capital outflows then dropped to an estimated -\$10 bln in Q2, or a 65% decrease since Q1.
- Part of the explanation for this sudden increase in Q1, 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)



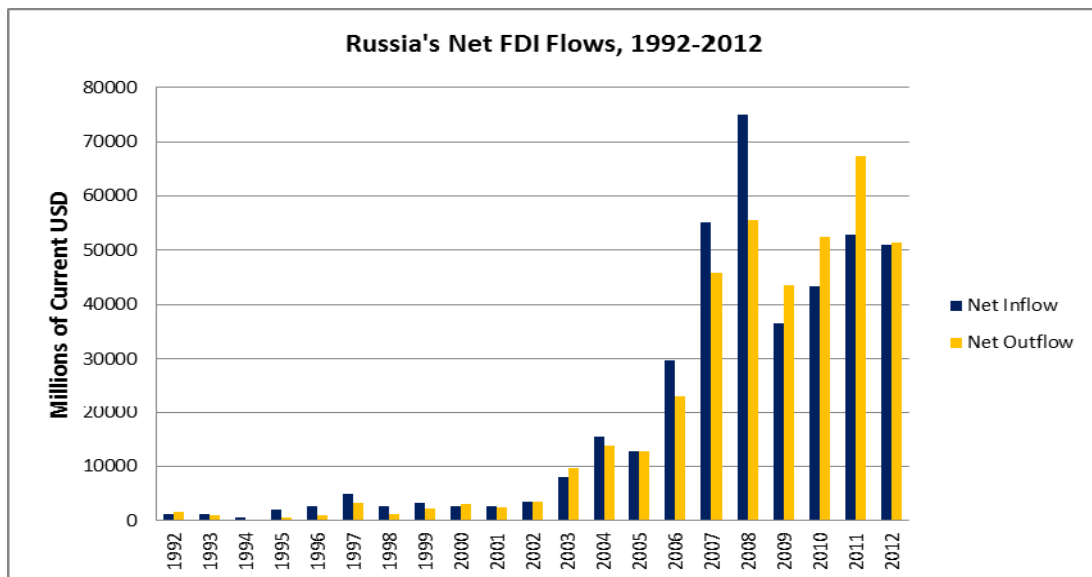
Source: Bank of Russia (figures have been updated since BCDM's Semi-Annual report in June to reflect date revisions and the latest estimates)

- The following figure provides a closer look at net private capital flows per month since January, 2011. The monthly figures for Q2, 2013, are not yet published on the Central Bank's website. One of the drawbacks of the quarterly data is that they can gloss over temporary reversals of net capital flows. In fact, the following figure shows that, although rarely occurring, net private inflows have been reported in three months and it therefore remains possible that in addition to the slowdown of net outflows, some future months of 2013 could see positive inflows or very low levels of outflows depending on economic circumstances and the choices investors actually make.



Although it remains to be seen whether this increase in net capital outflows will continue throughout the second half of the year or remain in line with previous Ministry for Economic development estimates of -\$ 30bln, the fact that they were higher than the -\$8 to -\$10 bln per quarter in Q1 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.

- The Figure below shows net inflows and outflows of FDI for Russia from 1992 to 2012. From 2003 onwards, there was a dramatic rise in both spiking just before the global financial crisis before dropping in 2009 and again growing until 2011.
- Since FDI flows grew globally during this period, it is possible that part of the explanation for this growth is due to the increase in FDI worldwide instead of Russia as an attractive location to invest. However, Russia’s share of inward flows has grown from about 0.2% in 2000 to as high as 4% in 2008 and currently sits around 3.4%. This means that net FDI inflows into Russia have outpaced the growth in worldwide FDI flows during this period.



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.

- Russia, however, shares this trend in particular with BRICS countries. UNCTAD's Global Investment Trends Monitor recently 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.
- So far for Q1 of 2013, total foreign investments into Russia have been estimated at \$60.436 bln, up 65.4% year on year. Of this, Foreign Direct Investment has been estimated at \$6.304 bln, up 63.2% year on year. The vast bulk of the total foreign investments has gone into manufacturing and, in particular, was concentrated in coke and petroleum production (\$34.482 bln).

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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