

Some Signs of a Thaw in Russia's Business Climate

Quarter in Brief: Russia's rank fell slightly to 67th from 66th in the World Economic Forum's latest Global Competitiveness Index, released towards the end of Q3, out of 144 countries. New investment announcements, despite downgrades in Russia's growth forecasts due to the Eurozone crisis and commodity prices, however, have increased during Q3 especially when compared to Q1. This upward trend coupled with more clarity over the Kremlin's announced commitments to improve the Business Climate during and after the recent elections indicate possible signs of a thaw.

Quarterly Highlights

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 (See *Indicators below for further details*).

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.

One of the largest scale energy sector projects, Shtokman, was abandoned in August. This highlights a significant challenge facing Russia in terms of the country's reliance on a small number of high value projects in the energy sector along with a need to embrace broader business climate reforms to attract and retain investments in other sectors to avoid excessive risk and enhance longer term 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 (See *Indicators below for more details*).

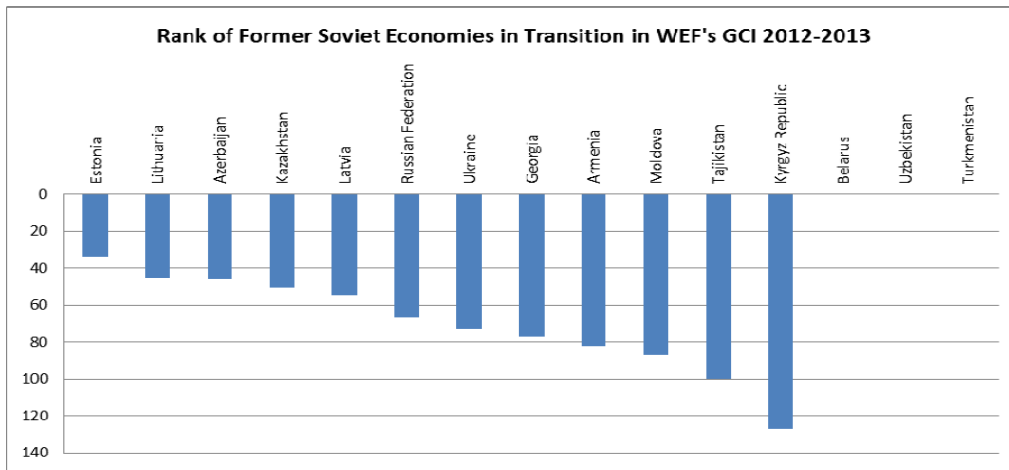
Business Climate Indicators

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 in the Rankings

Towards the end of Q3, the World Economic Forum released its latest *Global Competitiveness Report, 2012-2013*. In the Forum's *Global Competitiveness Index (GCI)*, Russia's rank this year fell one place to 67th from 66 last year. This is one position below Iran in 66th place and slightly ahead of Ukraine in 73rd.

- The following graph shows Russia's position in this year's ranking relative to other transition economies facing fundamentally similar challenges in moving from a centrally planned economy towards a market oriented one following the collapse of the Soviet Union in 1991.



- Russia ranks relatively higher in this year's GCI than many of the other transition economies, in particular those with lower income per capita, such as Tajikistan or the Kyrgyz Republic. However, Russia ranks considerably lower than other transition economies, such as Azerbaijan and Kazakhstan, which also have considerable natural resource endowments. This suggests that Russia could be ranking higher despite the hardships associated with transition.
- The following graph shows Russia's rank across various indexes. For each index, the percentage of countries ranking higher than Russia is shown in blue while the percentage ranking lower is shown in red.
- Although there is considerable disagreement on how best to measure the quality of a Business or Investment Climate, or Competitiveness, comparing the results across the indexes which use different measures, weights, and subjective opinions to different degrees, Russia generally ranks low.
- In the World Bank's *Doing Business Index*, which focuses on the quality of the operating environment for businesses, Russia ranks in 120th place out of 183 countries included in the survey. In the Forum's *GCI*, Russia ranks in 67th place out of 144 countries, in the Bloomberg *Investment Climate Index*, 48th out of 50 countries surveyed, and in the IMD's *Competitiveness Scoreboard*, 48th out of 59.



- UNCTAD 's *Inward FDI Potential Index*, however, ranks countries according to qualities that make a country attractive for foreign direct investments, namely, the domestic market, availability of low cost skilled labor, enabling infrastructure and the presence of natural resources. In terms of these qualities, Russia is ranked in 6th place out of 176 countries covered and ranks in 2nd place due to the presence of natural resources alone.
- Given that Russia has these attractive features, it should be able to attract a lot of FDI and it has especially during the last 12 years. UNCTAD's *Inward FDI attraction Index* ranks countries by how much FDI they manage to attract relative to the size fo their economy. In this case, Russia ranks in 19th place out of 176 countries. This is considerable improvement since ranking in 95th position in 2002.

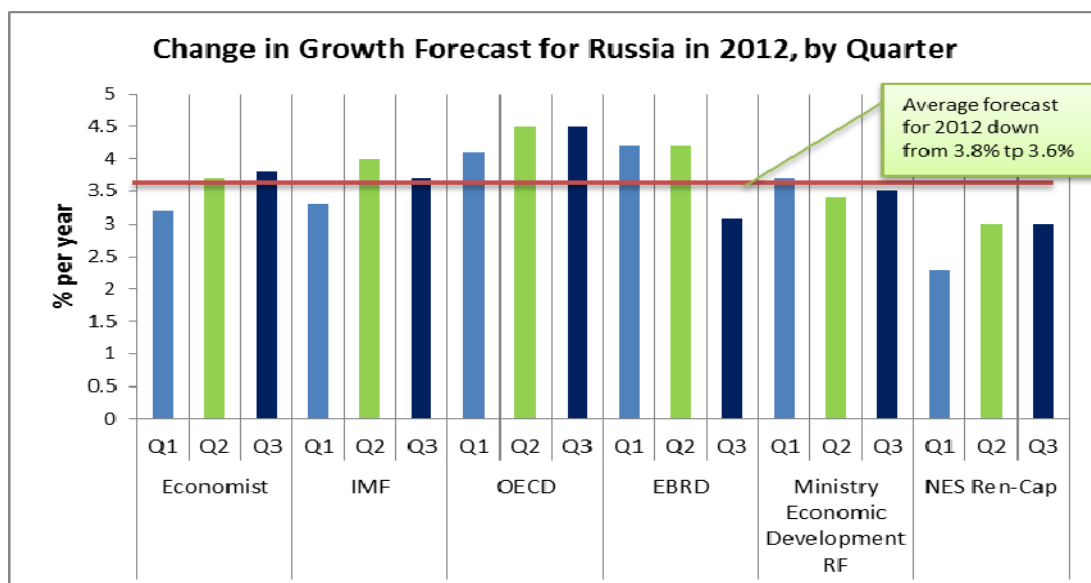
What these ranking suggest is potentially good news for Russia despite this year's low ranking in the Forum's GCI amongst other Indexes released earlier this year. Russia has, according to UNCTAD's Index, a great potential due to its market size (14th place), accessible low skilled labour costs (24th place), enabling infrastructure (31st place), and natural resources (2nd place). The relatively low quality of the Business Climate coupled with a dramatic improvement in inward FDI inflows suggests that, first, Russia has attracted investments simply due to its potential, but more importantly, and second, that improving the quality of its Business Climate should facilitate even greater, more diverse, inflows in the future.

Russia's Growth Outlook in the Near Term – Q3

Following a worsening outlook for global growth in 2012 and, in particular, the impact of a slowdown in the developed economies on Russia and other transition economies, the average GDP growth forecast for the year has fallen slightly from 3.8% in Q2 to 3.6% in Q3. The range of forecasts sampled, however, remains unchanged from 3% to 4.5% in part due to differences across organizations in updating their annual forecasts to reflect trend changes.

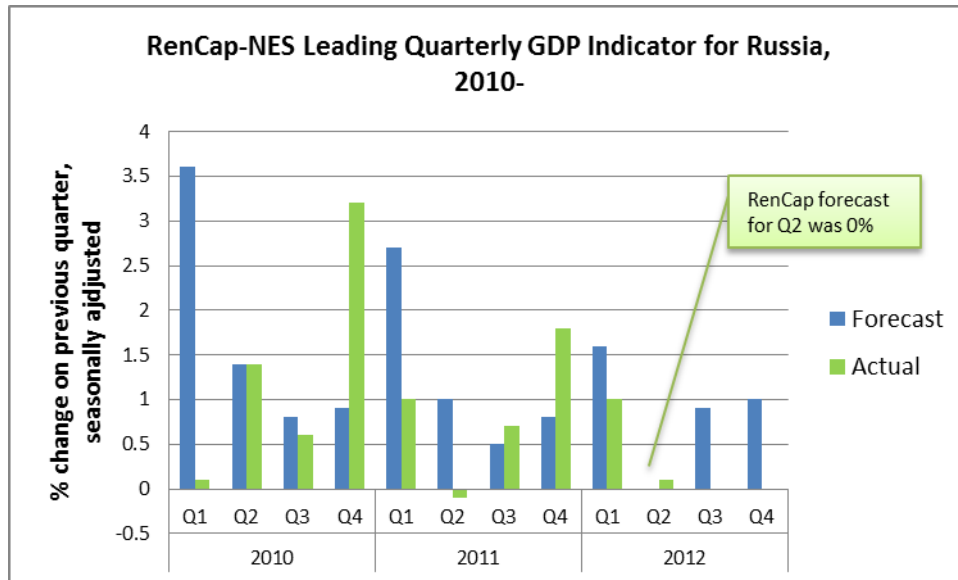
- The figure below shows forecasts for Russia's GDP growth in 2012 across a sample of organizations by quarter. Changes in the forecast for the year made between quarters can help highlight which conditions are thought to have impact on Russia's overall economic performance as well as to what degree, including qualitative changes in the country's Business Climate.

- Russia's GDP has grown at an average annual compound rate of 5.1% during the last 12 years. During the first three quarters of 2012, the forecast for this year's growth is significantly lower than this average and has varied. During Q1, the average forecast for the sample cited below was 3.5% with a range of 2.3% to a high of 4.2%. By the end of the second quarter, most forecasts were revised upwards for a new average forecast of 3.8% and the range reflected this trend by moving upward to 3% to 4.5%.
- Whereas the growth forecast for 2012 was originally downgraded early during Q2 by Russia's Ministry for Economic Development citing lower than expected investment activity in Russia (*likely due in part to political uncertainty surrounding the 2011 Parliamentary elections and 2012 Presidential elections*), the Ministry along with other organizations raised their 2012 forecasts during Q2 citing higher commodity prices and the easing of Euro tensions.
- Q3 saw a reversal. The International Monetary Fund (IMF) has downgraded growth forecasts citing a gloomier than originally expected outlook for 2012 and the European Bank for Reconstruction and Development (EBRD) cited the spillover effect from the Eurozone crisis as a primary reason for lowering its growth forecast for transition economies in 2012 from 3.1% in Q2 to 2.7% in Q3.



- 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)
- Actual growth for Q1 in 2012 was lower at 1% than the 1.6% originally estimated.
- Forecasts for Q2 were lowered since the first quarter from 1.1% to 0% while forecasts for Q3 fell from 1% to -0.1%.

- The forecasts for Q3 have been subsequently raised, however, from -0.1% reported in the previous *BCDM Quarterly Report* to 0.9% and the forecast for Q4 is 1%.
- Part of the revision upwards of growth by quarter has been driven by stronger than expected industrial production in July, particularly in manufacturing, although the second half of the year is expected to worsen due to inflation eroding consumers’ purchasing power and a poorer than expected harvest for 2012.



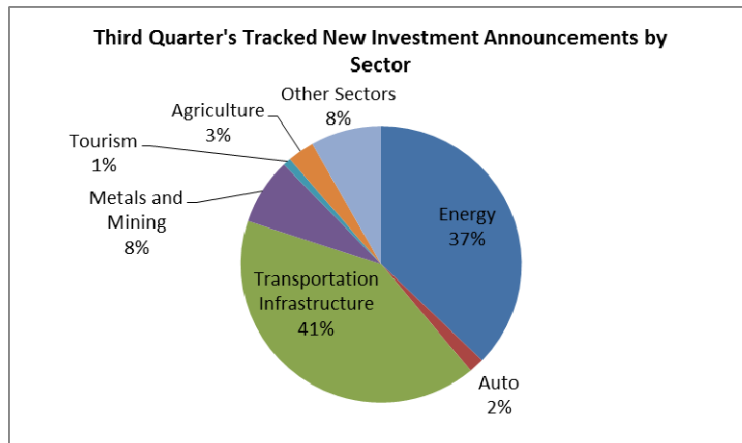
Although the change in forecasts for the year as a whole sampled across organizations indicates a decline in expectations for Russia’s growth in 2012 due to changing global market conditions, the change in movement upwards on a quarterly basis draws attention to domestic factors, such as manufacturing output being higher than expected, and the importance of domestic consumers’ purchasing power.

New Investment Announcements

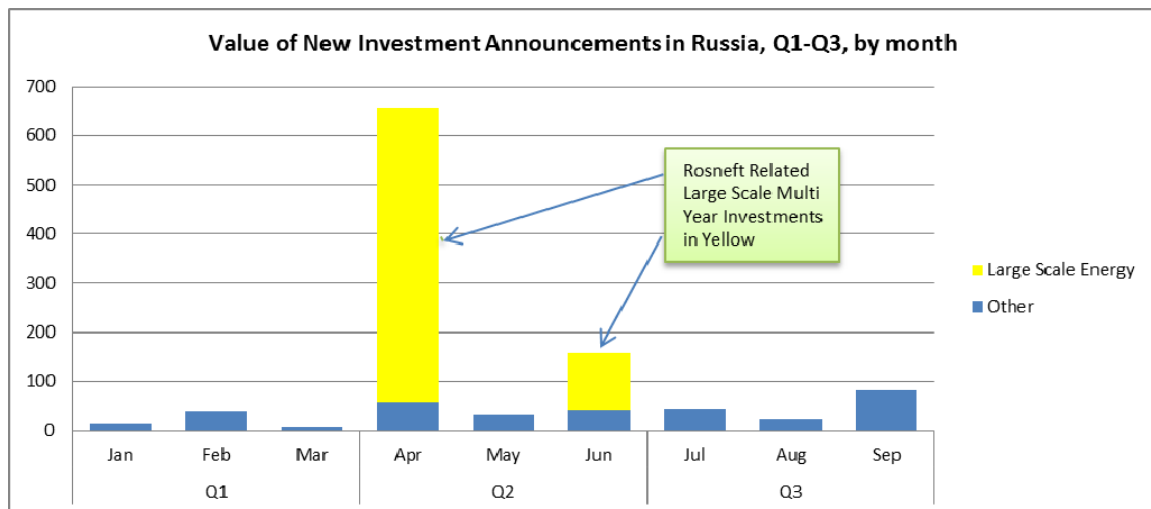
BCDM tracks new investment announcements monthly. A new investment announcement can reflect an intention to follow through with an investment in a particular activity over a future period and does not reflect an actual investment expenditure made. Tracking announcements monthly can help identify important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

The total value of new investment announcements picked up in Q3 with a noted rise in September, in part due to energy related investments, but also due to several large scale projects in transportation and infrastructure announcements in September.

- Tracked new investment announcements (excluding outward), for which there were investment figures disclosed, totaled **\$146 bln** during **Q3**. The figure below shows the breakdown of new investment announcements by sector. Unlike the previous two quarters in 2012, energy contributed a smaller share to the total during the third quarter, at 37% while several considerably large investments in infrastructure and transportation increased this sectors relative share to 41%.



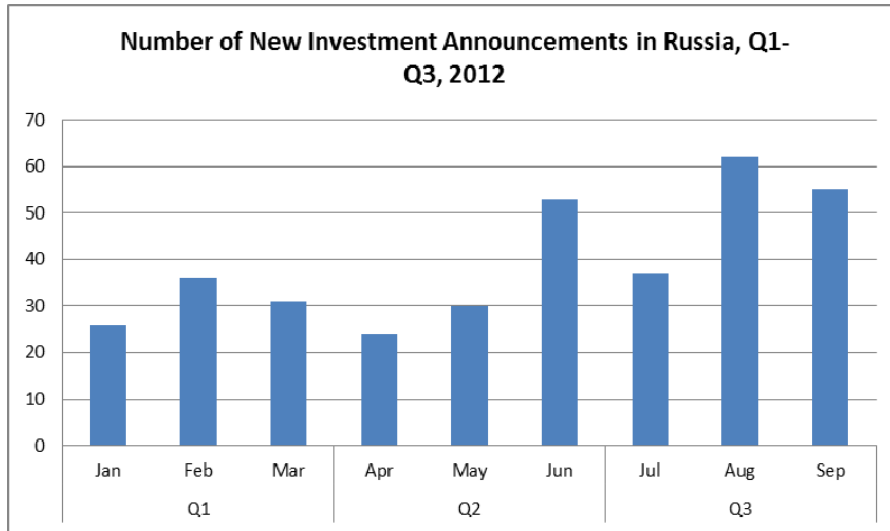
- It remains generally true, however, that several relatively large investment announcements in these two sectors tend to overshadow investment activity in other sectors of Russia's economy.
- The following figure shows the value of new investment announcements in Russia by quarter and by month. It also makes an adjustment to the total to separate out three large scale multi-year investment announcements in the energy sector related to **Rosneft** in April and June that accounted for \$720 bln, denoted in yellow. These three investment announcements would otherwise overshadow regular underlying trends in the data.



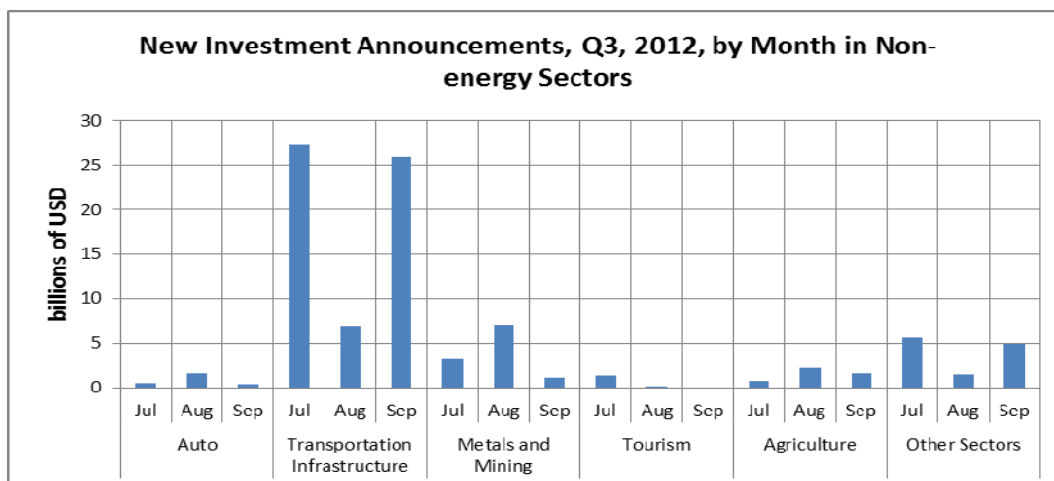
- The total for Q3, \$ 146 bln, was significantly higher than the \$60.7 bln in Q1, likely reflecting in part the political uncertainty surrounding Russia's Parliamentary elections in December, 2011, followed by the presidential election in early 2012, in addition to the impact of the Euro crisis on investment volumes in Russia.
- If the \$720 bln in large scale multi-year investment announcements is excluded from Q2, the total for Q3 also appears higher than the \$128 bln in Q2, with the value of new investment announcements picking up in particular towards the end of Q3 during September.
- In Russia's case, it is important to break down new investment announcements also by number and by value in non-energy sectors. This is due in part to the dominance of a small number of large scale multi-year investments announcements related to energy sector

investments and the fact that many smaller scale announcements do not disclose investment figures. This tends to result in energy activity dominating graphical representations as well as overshadow underlying trends in other sectors.

- The following figure shows the number of new investment announcements by month and quarter for 2012.



- Generally, over the past three quarters, a noticeable rise in the number of announcements has taken place, particularly in May and June. This trend is consistent with the view that many investors may have held off making public commitments until after the political uncertainty associated with the elections had fallen considerably in May with the appointment of a new government with a more clear agenda moving forward.
- The following figure shows new investment announcement activity by month during Q3 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.
- During the third quarter, there was a noticeable absence of activity in **Tourism**, relatively higher levels of activity related to **Metals and Mining**, and a strong dominance of activity in **Transportation and Infrastructure**.

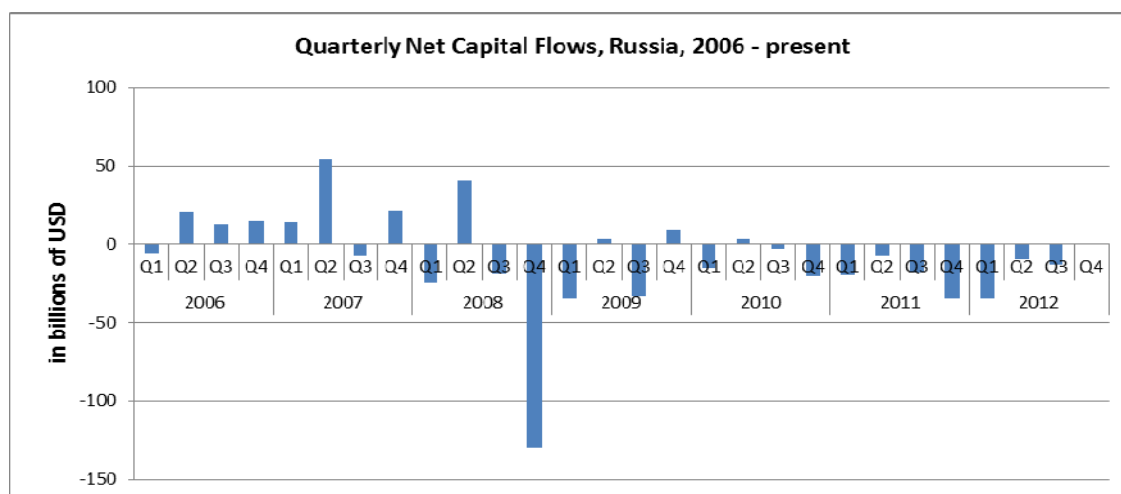


Note on Data : New investment announcements are tracked monthly and totaled in USD only for those announcements for which figures were disclosed. The monthly edition of the BCDM discloses both announcements for which figures were and were not disclosed, but nevertheless tracked. Disclosed sums in other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

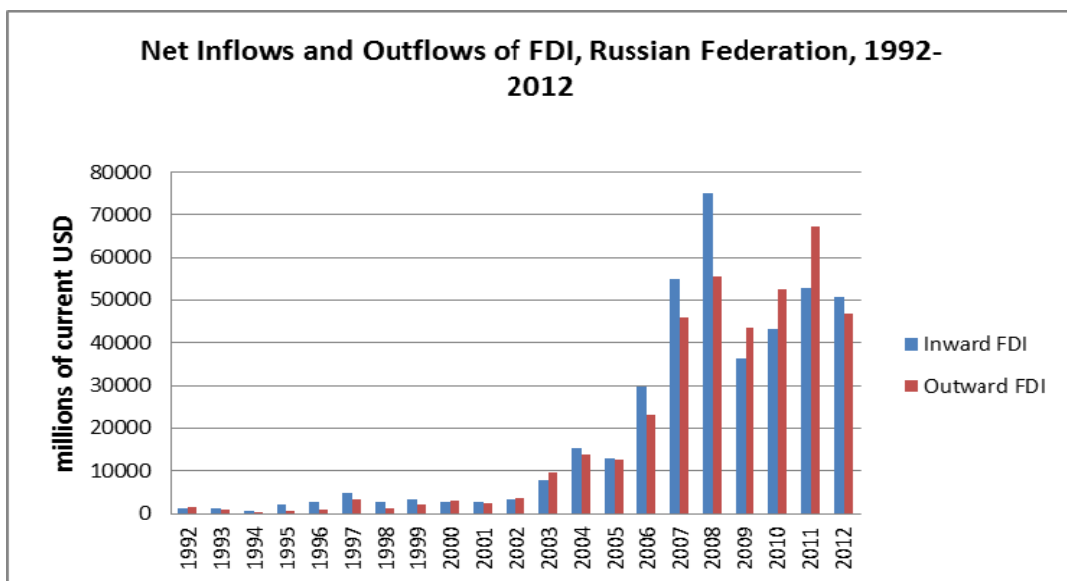
Estimates of net private capital flows for the fourth quarter of 2011 and the first three quarters of 2012 indicate that significantly more capital continues to leave Russia than enter. Net inflows of Foreign Direct Investment for 2011 indicate that net inflows were up over 2010 and early estimates for 2012, based on Q1 data from Russia's Central Bank, indicate this may remain true, although net outflows may be down.

- The following figure shows net capital flows for Russia by quarter since Q1, 2006, to the latest quarter for which data was available, Q3, 2012. The figures have been updated since the Q2 report.
- The estimate of net capital outflows was reduced for Q1, 2012, from -\$ 35.1 bln to -\$ 33.9 bln in the Q2 report, but has since been increased to -\$ 34.6 bln.
- The latest estimate for Q2, 2012, is that net capital outflows slowed down to -\$ 9.7 bln. The earlier estimate for Q2 was -\$ 9.5 bln.
- **For Q3, the Bank's figures indicate that net capital outflows have increased since Q2 from - \$ 9.7 bln to an estimated - \$13.6 bln.**



Source: Bank of Russia

- The following figure shows both net inflows and outflows of FDI since 1992. During Q3, the Bank of Russia released estimates for FDI net inflows (\$12.7 bln) and outflows (\$11.7 bln) for Q1, 2012. The figure shown for 2012 in the graph is based on Q1 net inflows and outflows annualized to show what the year would look like compared to other years if the rate of net inflows and outflows remained constant for the remaining three quarters.
- 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.
- Although this graph remains largely unchanged since the first quarter, the first estimates for net inflows and outflows of FDI indicate a possible slowdown for 2012 if Q1 flow rates are maintained.



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 while estimates for 2012 are based on the Bank of Russia’s figures for Q1, 2012, annualized.

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.

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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