Business Climate Development Monitor

"Going Beyond Growth: Avoiding the Risk of Complacency"

Semi-annual Report

 Business Climate Development Monitor's Semi-annual Report is a joint effort with the NES and FIAC and provides a glance at conditions and activities affecting Russia's ability to attract and retain Foreign Direct Investments (FDI)

Preface

The Business Climate Development Monitor's first *Semi-annual Report* focuses on the need to go beyond setting growth targets to avoid the risk of complacency in order to sustain interest in improving the country's business climate. Earlier this year, Prime Minister Medvedev announced a target of 5% growth per year. Since then, however, forecasts for 2013's growth rate have dropped from close around 4% to 2.4% and the IMF's forecasts for 2014-2018 are 3.6% p.a. This could provide a much needed stimulus for examining what the country can do to boost growth by an extra 2% to 3% per year to achieve this target, or even exceed it. Improving the business climate could play an important role in this strategy to boost efficiency, attract and retain investments and unlock Russia's greater potential, especially in other sectors outside energy.

However, relying too heavily on this growth target risks complacency since conditions could change and the country could achieve higher rates of growth, as in the past, despite a lack of reforms. This report argues in favor of establishing a broader, explicit, set of objectives, such as investment levels, diversification, labor market outcomes, and small and medium sized enterprise expansion that business climate reforms should also influence in specific ways. Going beyond growth targets in this way will not only help mitigate the risk of complacency, but also when complemented with information in other business climate indexes help to identify and prioritize reforms, monitor and evaluate progress, as well as recognize achievements when they happen.

This *Semi-annual Report* on Russia's Business Climate comes six months after our first *Annual Report* in January and is the result of a joint project between the New Economic School's (NES) Center for Economic and Financial Research (CEFIR), Ernst & Young, and the Foreign Investors' Advisory Council (FIAC) over the past 18 months. 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* (see Appendix 1 for details) to help gauge potential changes in investors' intentions and we regularly provide an update and summery of the findings.

The content of this report has benefitted from contributions from each of the partner organizations 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, Professor of NES, and Natalya Volchkova, E.ON. 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,

Table of Contents

List of Figures

Semi-Annual Highlights

BCDM's *Semi-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 six months.**

At the Gaidar Forum in January, which brought together government officials and independent experts in Moscow, 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 the then 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.

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* (UNCTAD, 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.

Citing a slowdown related to external market conditions, primarily weaker demand in Europe in late March, the Ministry of Economic Development lowered its growth forecast for 2013 from 3.6% to 2.4%. This makes the 5% growth target appear even more difficult to achieve.

In March the World Economic Forum released its 5th *Travel and Tourism Competitiveness Report*. The TTC Index uses indicators across 14 pillars in three broad areas covering (1) Regulatory Framework, (2) Business Environment and (3) Infrastructure, and Human, Cultural and Natural Resources to rank 140 countries in terms of competitiveness in this sector. Russia fell 4 positions from 59th in 2011 to 63rd this year (See Figure 5 and Figure 6 in this report) despite the launch of a Federal program announced in 2011 "*Domestic and Inbound Tourism Development 2011-2018*" and recognition that the tourism sector had been underperforming.

In May Russia's Prime Minister, Dmitry 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 foreign investors: systematic corruption.

Forbes released its ranking of the *30 Best Cities for Business in Russia* in May. 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 (Forbes, 2013).

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 (Lossman, 2013).

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 the UK and France have the most retail shopping space with 16.48 and 16.95 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.

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.

In Bloomberg's latest *Best Countries for Business Index*, released in January, Russia has fallen to 56th place out of 161 countries from its position last year at 48th out of 160 while in the latest rankings from IMD's *World Competitiveness Center* in May Russia's position improved to 42nd out of 60 from last year's at 47th out of 59. See Figure 4 in this report for a summary of where Russia stands across the rankings (Bloomberg, 2013; IMD, 2013).

1 Going Beyond Growth Targets

__In Brief__: *At the beginning of 2013, Russia's government announced a growth target of 5% per year. Forecasts, however, fall short of this and for 2013 alone have already dropped from about 4% to 2.4% since this announcement was made. Although this gap between forecasts and the 5% target could provide an important stimulus for improving the quality of the business climate to boost growth, it also runs the risk of complacency should conditions change for other reasons and growth prospects improve.*

There is a need to go beyond growth targets to avoid this risk of complacency by outlining a broader range of objectives and outcomes to be achieved through business climate reforms. Combined with other relevant data and information, such as business climate indexes, this would help to identify and prioritize reforms, monitor and evaluate progress as well as recognize achievement.

1.1 Introduction

At the beginning of this year, Prime Minister Medvedev announced a growth target of 5% per year. This target appears to be both ambitious and a potentially important stimulus for improving the country's business climate. Since 2000, Russia has grown on average by about 4.6% per year during a period of exceptionally high oil and natural resource prices (See Figure 1 below). A target of 5 % aims to outdo even this recent average level of past performance. Forecasts for 2013, however, have already begun to fall during the past six months from roughly 3.3% to 4% down to 1.8 to 3.4% (see Figure 8). Over the next five years they are expected to fall well short of 5% (IMF, 2013). This widening gap between the target and forecasts could spark a much needed discussion about what the country can do to boost growth by an extra 2% to 3%, and perhaps by even more should conditions and forecasts worsen further.

This could provide an ideal context for turning attention to the quality of Russia's business climate as a way to improve efficiency, unlock the potential of underperforming sectors, especially beyond energy, attract and retain investments ultimately boosting growth in the process. The potential efficiency gains from reforms are also likely to be high given Russia's potential (large domestic market with rising incomes, natural resource wealth and agricultural land) and the fact that the country lags well behind most other transition economies in Eastern Europe and Eurasia and achieved past growth despite this lagging position[1].

1.1.1 The risk of complacency

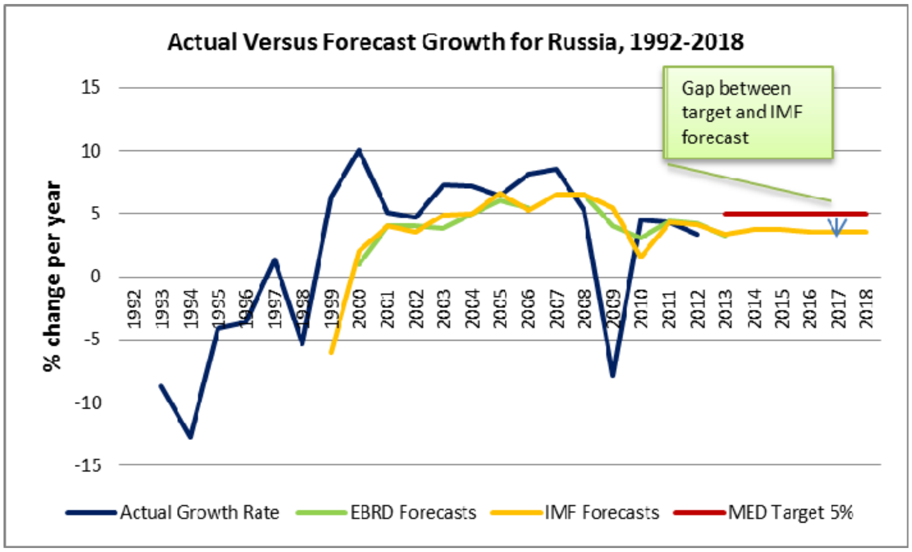
While setting an ambitious growth target could provide a welcome stimulus for improving the business climate, it also comes with a serious risk in terms of *complacency*. The wider the gap between the growth target and forecasts, the greater the need to identify potential sources of growth and develop strategies and implement reforms to close the gap. The first relevant issue[2] with setting this target is that there is a chance that Russia's forecasts could improve for reasons beyond changes in the business climate. If energy prices increase, or the situation in Europe improves, these factors could have a positive effect on Russia's performance, growth could increase, and the pressure to reform fall into the background, as it has in the recent past.

[1] During a period of high energy and resource prices (2000 to 2013), Russia grew on average by about 4.6% per year, however, the relative quality of the business climate is low when compared to other transition economies in Eastern Europe and Eurasia according to various indexes such as the World Economic Forum's *Global Competitiveness Index* and the World Bank's *Doing Business Index*. Had Russia improved the quality of its business climate earlier, the assertion here is that its performance in terms of growth, investment attraction, and development may have been even higher, although this hypothesis has not been strictly tested.

[2] Questions could also be raised about why this target was set and how 5% was choosen. However, this is beyond the focus of this report.

Figure 1 helps illustrate the risk of complacency by drawing attention to unexpected factors in the past that contributed to swings in Russia's growth performance. Figure 1 shows the actual rates of growth for Russia from 1993 through to 2012 as well as forecasts to 2018. It also shows the EBRD and IMF forecasts for each year since 1999 one year in advance[3]. This allows a comparison to be made between the growth rates achieved in each year with what these two institutions expected the country to achieve that year when they made their forecasts the year before.

Figure 1 – Actual Versus Forecast Growth Rates for Russia, 1992-2018



Note that since the late 1990s, there has consistently been a gap between the forecasts for Russia's growth and what the country actually achieved. Typically, forecasts have either fallen short with the exception of the financial crisis in 2008-2009 when they overestimated the growth rate by a wide margin. Second, Russia's growth during the past 13 years or so has generally hovered around 5% and the target (in red) appears to be within an acceptable range of this past performance (in blue). Third, the forecast for the period beyond 2013 from the IMF (in yellow) is below the target and this gap of 1.4% is essentially the stimulus to seek ways to boost growth to achieve or exceed the target.

There are, however, several specific observations in this figure that help to identify realistic conditions that have taken place during this period that help demonstrate the fact that future growth could be influenced by external factors, or for reasons other than a business climate reform agenda. These are, briefly, the:

- **Unexpected Severe Downturn** - The 1990s was dominated by a severe prolonged contraction, or negative growth. Although forecasts are not presented for these years, generally, many economists did not foresee the depth of economic decline in the Former USSR in the early 1990s or the length of time this decline would last. The immediate impact of collapse and the pains associated with transition were grossly underestimated.

- **Unexpected Sharp Upturn** - The reverse observation takes place at the end of the 1990s when both the IMF and EBRD expected Russia to grow by far less than what actually took

[3] These forecasts were obtained from the EBRD's and IMF's digitally archived Annual *Transition Reports* and *World Economic Outlooks* respectively. (EBRD, 1994-2012; IMF, 1998-2013)

place. Russia's economy bounced back sharply in 1999 while in 1998, the IMF expected the economy to continue to contract in that year (i.e. 1999) by -6% while growth was +6%.

- **The Unforeseen Impact of the Financial Crisis** - Throughout most of the 2000s, both the IMF and the EBRD continued to underestimate Russia's growth rates. This situation, however, reversed during the financial crisis and Russia experienced a severe rate of negative growth, about -7.8%, in one year (2009) despite both institutions expecting growth to remain above 5%.

These observations highlight that Russia's growth can be influenced, and unexpectedly, by diverse events, whether it is the severe cost and decline associated with transition, high oil prices, or the impact of the financial crisis. It follows that looking forward, although setting a 5% growth target may help stimulate a policy discussion about what needs to be done to boost growth prospects, 5% could be achieved "by accident" if, for example, the situation in the Eurozone improved unexpectedly, oil prices rose further, or for some other plausible reason. This possibility indicates that there is a real risk that higher growth rates could happen and if they do, this stimulus to boost growth likely diminish, much as it has during the period of high oil prices and unparalleled growth worldwide in FDI flows, etc. There is, therefore, reason to suspect that complacency could return when it comes to implementing business climate reforms and further delaying them to some future period when, once again, growth prospects dwindle and the issue of the need to boost growth returns.

1.1.2 Drawbacks and Risks of Business Climate Indexes

This risk of complacency, however, might appear to be partially mitigated by other targets and policy goals the government has already set and announced which may also help sustain interest in business climate reforms. Before, during and after the Parliamentary and Presidential elections, President Putin recognized the need to attract investments and announced a goal of climbing 100 positions from 120th to 20th in the World Bank's *Doing Business Index* (World Bank, 2012). Other policy initiatives ranging from acceding to the WTO, and the stimulus to improve the business climate this should provide, to goals outlined by Prime Minister Medvedev to enhance the growth of small and medium sized enterprises and enlarging the share of the private sector in the economy, as examples, can all be monitored and assessed and therefore, could help sustain interest and efforts in reforms.

While these are important steps in the right direction, they are not enough to mitigate this risk of complacency. First and foremost, if high growth rates are achieved due to external market conditions, such as high energy prices, large scale energy investment projects will likely continue and they will dominate and overshadow the needs of other sectors, as they have done in the past. Second, despite some progress in business climate reforms, such as the introduction of an investors' ombudsman for foreign and domestic investors, the pace of reforms has remained slow. After acceding to the WTO, announcing for example the need to boost competitiveness and improve the business climate, the rankings have changed little during the past year or two. While improving slightly in the *Doing Business Index* by 8 positions due to few changes, the country slipped in other indexes, such as Bloomberg's (48th to 56th place). Further, after identifying the need to improve the competitiveness of a specific sector currently underperforming in 2011, namely *Tourism*, Russia has also dropped in rank by four positions from 59th to 63rd in the World Economic Forum's *Travel and Tourism Competitiveness Index* by 2013 (WEF, 2013). If these commitments and announcements have not generated dramatic improvement in the past, there is reason to doubt whether they will be enough, on their own or in conjunction with the 5% growth target, to stimulate business climate reforms.

There is another important issue related to improving the quality of Russia's business climate that needs to be mentioned and borne in mind when it comes to these indexes. Even if they were enough to stimulate the kind of broad reform agenda the country needs, they still are not enough to ensure that the right types of reforms are identified, prioritized, and actually carried through. In fact, they run a serious risk of focusing on climbing rankings whether they generate genuine progress in terms of the quality of the business climate or not, and further, whether they improve outcomes beyond growth, if even that.

At first glance, these drawbacks might appear to be obvious since no two indexes appear to place countries in the same positions or ranks consistently and that progress in rankings does not always seem to go along with high rates of growth[4]. There are several major problems with these indexes that need to be noted to demonstrate that while they can provide an incentive to reform as well and monitor progress, they are unlikely to provide the kind of specific guidance a country needs to efficiently allocate scarce resources where they are most beneficial to achieve desirable outcomes. This means that after extensive efforts to climb an index such as the World Bank's might fail to be correlated with improvements, and thus, those involved in the reform process, which is no easy task, could lose interest in bothering with the entire process[5].

Briefly, the types of specific drawbacks for these indexes are as follows[6]:

- **Different Goals** – Indexes can differ in terms of what they wish to measure overall, such as the ease of opening, operating and closing a small business to broader concepts such as competitiveness. A different focus will mean prioritizing policy reforms that aim towards one goal at the expense of another. If the reforming country does not share the goal(s) of the index, it might risk focusing on reforms that detract from other objectives that matter more.

- **Different Methods** – Different indexes rely on different methods for gathering data and indicators, weighting them and combining them, as well as whether they rely on opinion surveys, harder data, or some combination of the two. A change in the method used is likely to generate different views about where policy reforms are needed most, for example, by over-relying on a small number of foreign businesspeople in a community for their priorities versus a larger pool of smaller local entrepreneurs who have different needs and views.

- **Different Indicators** – Indexes can use many similar indicators, but they often use many different ones and this can mean that a policy area that might require more reform efforts might be neglected in one index, but covered in another. There is a risk that the basket of indicators might not fit with those a specific region needs for its purposes, conditions and goals.

- **Data Quality** – All too often, the quality of the data varies between countries and time periods in reporting and this can make it difficult to compare, rank, but also assess the true state of affairs in a specific case. Quality changes might appear to be measured as slight, but

[4] Georgia, for example, is now in the top ten in the Doing Business Index, but it is not in terms of investment destinations.

[5] See (Fisher, 2005) (Skoro, 1988) (Eifert, 2009) (Erikson, 1987) for more details on the background of these types of indexes, their strengths and weaknesses, as well as problems with applying them in country specific conditions

[6] This is a general list that applies across indexes and does not exclude that there are drawbacks to relying too heavily on a specific index. For example, the Doing Business Index (World Bank, 2012) only represents conditions in the capital city of a country and thus, does not really rank countries per se. Conditions could vary widely as well as reform programs and progress underway outside of cities and, it follows, a ranking may very well change if simply a different city were selected to represent a country. Although sub-national reports are a step in the right direction to counter this drawback, the list of problems with indexes generally would still apply.

they could be dramatic. The need for a reform could be overstated, understated and progress may not be genuinely captured simply due to this issue.

- **Indicator Quality** – There are always questions as to how well a specific indicator actually measures, consistently, the quality it attempts to represent. The tax rate, for example, businesses face is difficult to state. There may be additional fees involved in administering a business labeled a “fee” and not a “tax” in one jurisdiction and the reverse in another. Businesses could end up paying more fees despite tax rates falling, or paying less if they are rising as fees switch to taxes. Improvement on any specific indicator may or may not be associated with progress.

- **Time lags** – Even in the situation where a decision is made to improve a country’s position on a specific set of indicators by implementing reforms, there are often time lags between when the reform is identified and carried through to when results are actually seen let alone when the index may reflect the change.

- **Reliance on observations** – Indexes generally rely on observed data, such as surveys of business people who already operate a business in a specific location. This runs the risk that a sector or activity which has great potential, but has been held back due to severe policy barriers, may benefit the most from specific policy reforms that need to be made, but were not identified or represented since there are no observations from surveys of people in that area yet. Indexes generally do not cover hidden potentials very well and this can be a particularly important drawback for those regions or countries that are considerably underdeveloped where it would be difficult to imagine the nature of which activities could blossom and which priorities need to be addressed to do so.

These drawbacks draw attention to the risk of relying on climbing or improving in specific business climate related indexes, even if momentum and stimulus for reforms were in place. However, one of the most severe drawbacks is that although they provide important information on business climate issues, they do not necessarily reflect conditions in a specific country setting. The costs and benefits of the policy areas covered in these indexes are likely to differ across countries and over time. This is due to the simple fact that the same policy reform will generate different outcomes and have different costs and benefits across countries. Improving border access in one country and providing secure transitions, or ensuring that people receive specific sets of skills in public schools will cost different amounts to implement and they will likely differ in their relevance in terms of immediate priorities. A country with a relatively older generation of working age people with a lack of skills will benefit more from adult retraining programs than one with a considerably youthful population. This will mean that they should differ in the degree of importance placed on different education and training programs aiming to improve access to low cost skilled labor to attract investment activity.

While Indexes can provide a stimulus for reforms as well as information on where a country or region does relatively well or poorly, they carry a risk that they do not necessarily reflect where a specific country needs to direct its attention and scarce resources the most to generate the best possible outcomes for sacrificed made.

1.1.3 Broader sets of indicators

A broader set of targets beyond growth can help mitigate the risk of complacency, identify and prioritize business climate reforms, as well as monitor and evaluate progress. Implementing reforms is no easy task and requires consistent and prolonged commitment by stakeholders to decide which reforms should be placed on the agenda and how much effort and resources need to be dedicated to achieve change. Further, business climate reforms may target improving broad concepts like growth and development, but even these can be broken down into more specific outcomes that people would like to see improve, such as small and medium sized enterprise growth, broader employment opportunities for young people, labor productivity growth so the country can compete more effectively for higher skilled, higher valued, jobs, and so on.

Being more specific about the types of desirable outcomes is an important step in the business climate reform process. First, it helps add clarity to the reasons or objectives of the reforms and sustain interest in carrying them out until improvements in specific areas felt to be important are achieved, or at least observable progress made. Second, reforms are costly and if over time the types of outcomes desired are not being achieved, changes can be made. This not only helps to avoid waste associated with continuing to implement the incorrect reform, it also reduces the possibility of people giving up on reforms altogether since the ultimate objectives are likely to remain an issue. If, for example, poverty reduction is sought through regional development and business climate reforms are seen as a way to go about this, specific policies and reforms may be put in place that could fail. However, if the poverty remains, and people continue to be focused on this issue, they are more likely make further changes.

There are several other additional reasons for being explicit and specific. Conditions across regions and sectors are likely to differ, such as skilled labor scarcity, infrastructure needs for different geographical positions or industries, or the need to adopt standards to export such as across foods versus technical goods. This diversity in conditions means that there are likely to be significant differences in specific objectives across regions and industries that would result not only in different policy priorities, but also differences in how much people are willing to commit to different business climate reforms. It should be the case, particularly in a country as large and diverse as Russia, that priorities should differ. In other words, applying the same list of policy reforms to climb a specific business climate index across these different industries and regions would likely be inefficient since the needs differ. Being specific about outcomes, rather than broad categories like overall growth, facilitates this type of discussion and is much more likely to result in tailored approaches that unlocks region specific, or industry specific, potential.

Figure 2 below provides a simplified picture of this type of outcomes-based approach. On the right hand side of the diagram is a list, not exhaustive, of the types of outcomes that reforming a country's business climate are often associated with. Although they are listed as "separate", this is more of a matter of convenience since many of these objectives are interconnected. Nevertheless, improving the business climate is often associated with objectives such as growth, development, diversification (moving away from reliance on the energy sector in Russia's case), improving trade and/or exports, regional growth, and the creation of small and medium sized enterprises.

On the left hand side of the diagram are those factors that generally influence the quality of a business climate. These types of factors typically range from the quality of institutions, such as law and order, or the independence of court systems in resolving disputes in a fair way, through to the macroeconomic environment, the quality of the workforce and infrastructure, to a range of others. Many of these types of conditions are contained in the basic types of business climate or competitive indexes used to rank countries and assess where improvements are needed. The aim of improving these areas generally focuses on improving the business climate, which is placed in the center of the diagram. More specifically, this means lowering the real cost of operating in a specific location to improve the benefits of locating economic activity there; making it not only more attractive for investments, but also broadly as a place to produce, work and live.

Figure 2 – An Outcomes-Based Framework

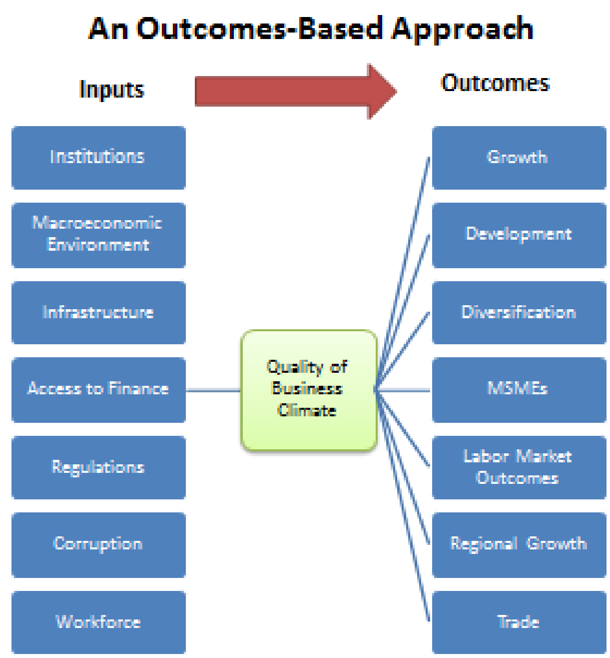


Figure 3 provides an example of making one area of the outcomes as specific as possible. Improving various qualities of the business climate to attract investments may have as one of its core objectives improving labor market outcomes. Perhaps youth unemployment is a serious issue facing a region or a country, or unemployment has risen since businesses have left or closed. Figure 3 contains a more specific list of these types of labor market outcomes. This makes it more possible to identify indicators that people want to see improve by dedicating resources to reforms and being involved and co-operate in carrying them out. If significant efforts and sacrifices are made to attract specific types of investments that may be relevant for the types of skills and knowledge the population already has, stakeholders would expect to see improvement in these areas over time, and potentially adjust reforms and policies to further enhance their ability to achieve their goals.

Figure 3 – Sample Outcomes-based Indicators for Labor Market

Labor Market Outcomes

- Employment Rate
- Wage Growth Rates By Sector and Region
- Labor Productivity
- Unemployment Rate
- Underemployment Rate
- Latent Labor Supply
- Skills Mismatches
- Youth Unemployment
- Youth Underemployment

Thus, this approach does not advocate replacing indexes or the 5% growth target with a new set of objectives, rather, it advocates a broader approach. Part of the reason for improving specific areas of the business climate and investing in these reforms is for achieving specific goals. By combining specific information about the outcomes to be achieved with information on the quality of the business climate, it is more likely that specific policies can be identified and prioritized for attention.

Going beyond growth targets with additional specific outcomes from business climate reforms is likely to mitigate the risk of complacency since many of these targets are not likely to see improvement through growth alone or happen all at once accidentally. Further, an outcomes-based approach aims to improve efficiency by helping to identify which policies matter more under specific conditions in a region or industry and are more likely to sustain interest in the challenging process of reforms. This approach should also help to monitor and evaluate progress and recognize achievement.

Our next section continues in line with our monthly, quarterly and annual reports by providing a look at some of the types of outcome indicators related to improving the quality of the business climate. The focus is not on an exhaustive list, rather on a brief list of some of those indicators that can be tracked and change monthly or quarterly to help provide useful information on issues and challenges related to reforming the country's business climate.

2 Semi-Annual Indicators

BCDM's *Semi-annual Indicators* **aim to provide a brief look at statistics 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. It also provides an update since the Annual Report released in January and the last Quarterly Report in April.**

2.1 Russia's Business Climate Across Indexes

During the first half of 2013 the World Competitiveness Center (IMD) and Bloomberg released their latest country rankings. Russia's position improved on the IMD's Competitiveness Scoreboard from 48^{th} to 42^{nd} position while it fell on Bloomberg's Best Countries for Business Index from 48^{th} to 56^{th} over the past year. The World Economic Forum also released their Travel and Tourism

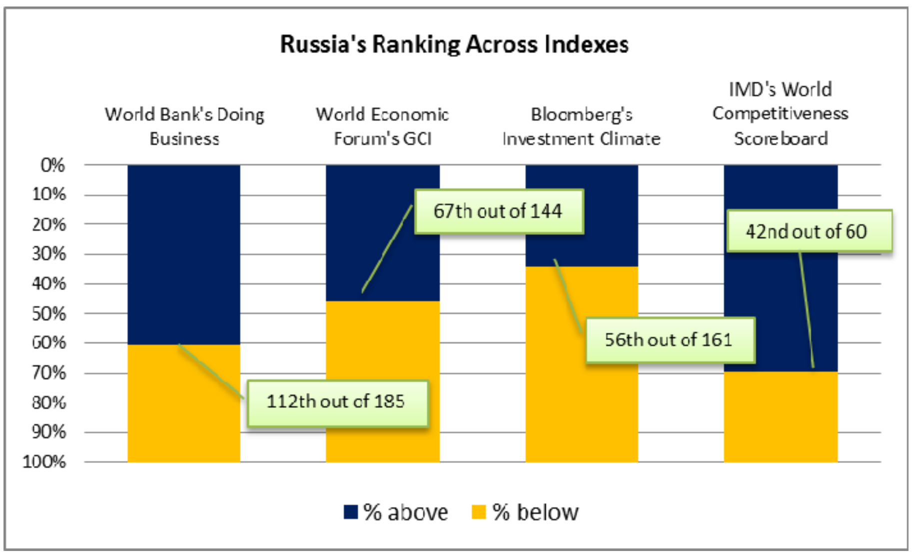
Competitiveness Report 2013. In their 5th Travel and Tourism Competitiveness Index, Russia's position fell 4 spots from 59th in 2011 to 63rd this year.

2.1.1 Overall Rankings

Figure 4 provides an update of Russia's position in Indexes which consist of indicators which can be used to assess various qualities of the country's business climate relative to other countries. For each index, the percentage of countries ranking above Russia are represented in blue while those falling below in yellow. The rank out of the total number of countries included in each index are listed in bubble capitions for each one.

To date, Russia remains at 112th position out of 185 countries in the World Bank's *Doing Business Index*, which was released in October, 2012, which is 8 positions higher than the year before. One of the stated aims of President Putin is to climb 100 positions in this index within 6 years to 20th position, however, the pace of reforms so far remains slow and it remains to be seen how much progress will have been made by the next release later this year.

Figure 4 – Russia's Position in the Rankings (Updated)



In the World Economic Forum's *Global Competitiveness Index*, Russia remains in 67th place out of 144 countries included while in the Bloomberg *Best Countries for Business Index*, Russia has fallen from 48th to 56th position. At the end of May, IMD's World Competitiveness Center (WCC) released its latest scoreboard showing an improvement in Russia's rank from 48th position last year to 42nd this year.

Generally, across these indexes Russia continues to rank low relative to other countries worldwide and other transition economies in Eastern Europe and Eurasia in particular. The pace and breadth of reforms also remains low and is reflected by the fact that Russia's relative position tends to change little from year to year.

2.1.2 Competitiveness in Russia's Tourism Sector

Depending on where the line is drawn between measures of directly and indirectly linked activity and employment, estimates of Russia's tourism industry place it close to 6% of GDP in 2011 (WTTC, 2012). This makes it a significant sector and further, due to concern that it has been underperforming relative to its greater potential, has been targeted for attention by the government. Notably, in 2011, then-Prime Minister Putin released “Domestic and Inbound Tourism development 2011 – 2018” aiming to boost this sector.

Figure 5 shows the latest ranking of this sector in the World Economic Forum’s Travel and Tourism Competitiveness Index relative to other transition and BRICS economies (where a ranking is available). Russia ranked in 63rd place, down from 59th in the Forum’s last the TTCI in 2011, and relatively behind all of the economies in Eastern Europe except for Serbia (89th), Moldova (102nd), Macedonia (75th) and Bosnia and Herzogovina (90th). Russia further ranks behind China (45th), but ahead of the other transition economies in Eurasia.

Figure 5 – Russia Relative to Other Transition and BRICS in WEF’s TTC Index, 2013

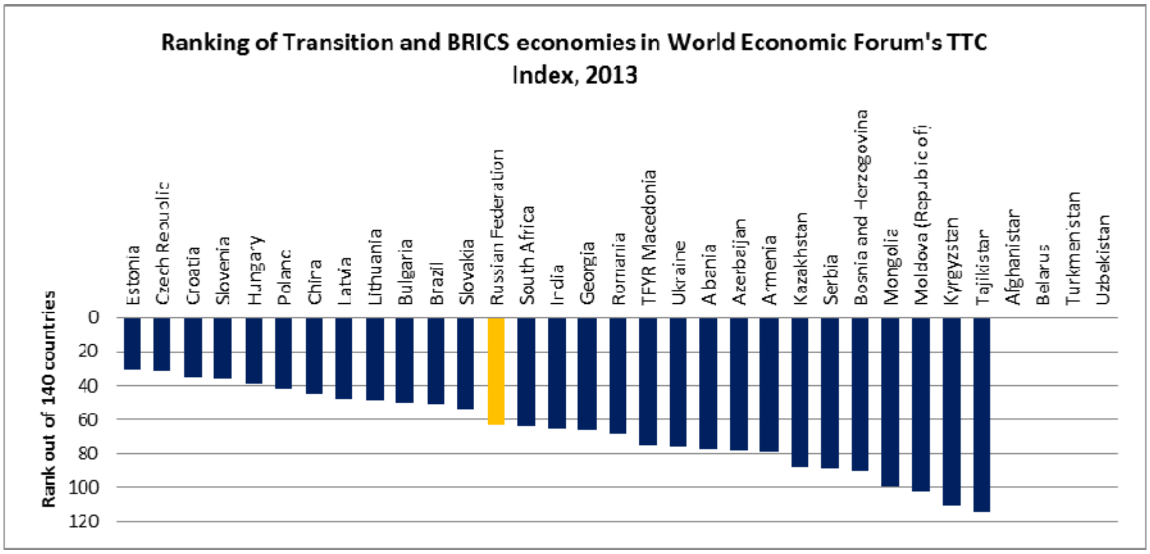
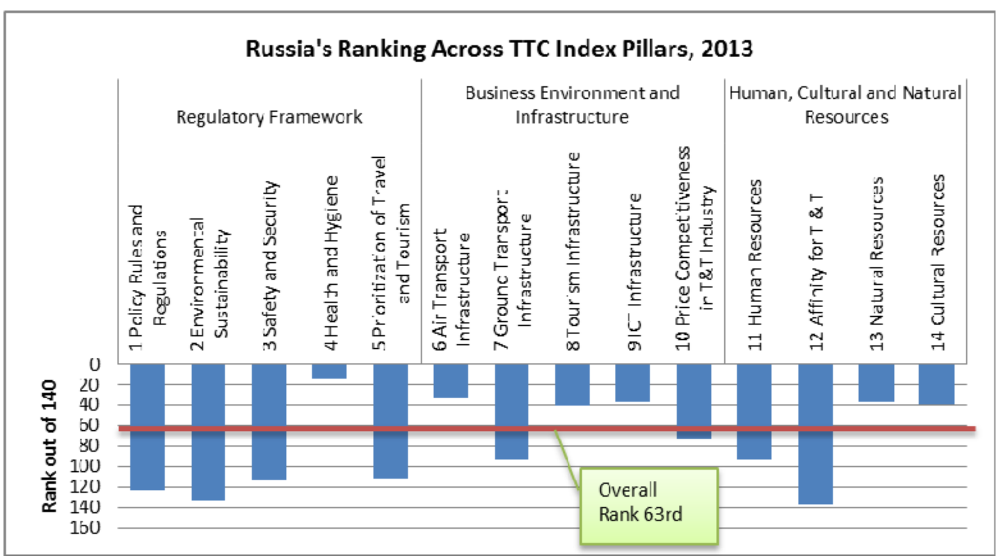


Figure 6 provides a closer look at Russia’s ranks across the three categories and 14 pillars in the TTC Index. The red line shows Russia’s overall rank of 63rd to highlight in which pillars Russia ranks above its score and in which below. This helps draw attention to which of those areas are pulling Russia’s rank downwards.

Figure 6 - Russia’s Ranking in World Economic Forum’s TTC Index by Pillar



While Russia ranks very high relative to other countries in terms of its cultural and natural resources, health and hygeine and many aspects of its infrastructure, such as air transport, it performs poorly on many others such as policy rules and regulations, safety, environmental sustainability and ground transport. Also low is the area of affinity towards travel and tourism which aims to measure people's attitudes and openess to foreign travelers.

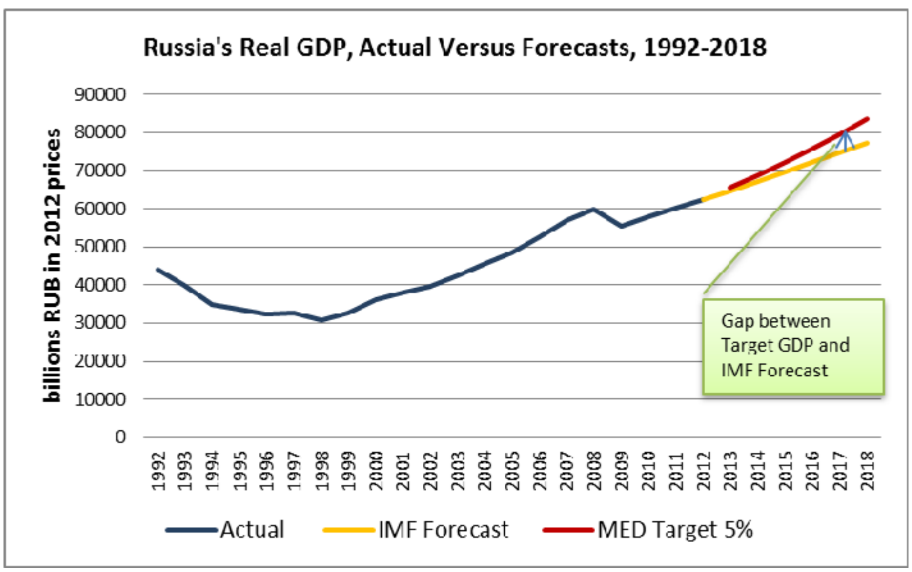
It is worth noting that despite the attention this sector has received, the desire to make it more competitive during the past two years, the ranking has fallen. Further, as will be noted in the New Investment Announcement section below, very few investment intentions have been made related to this sector both in value and in number. Given the large share of the economy this sector represents, there are indicators, both in terms of this index and new investment activity announcements below, to suggest that performance could be enhanced.

2.2 Near Term Growth Forecasts

Between 2000 and 2012, Russia's economy grew on average by 4.6% per year. Forecasts for 2013 have fallen during the first half of this year from close to 4% to 2.4% and, according to the IMF's World Economic Outlook should hover around 3.6% between 2014 and 2018. These forecasts fall below the 5% target announced by the Russian government at the beginning of the year.

Figure 7 below shows Russia's actual level of GDP, in billions of Rubles at constant 2012 prices, from 1992 to 2012 (in blue) along with the IMF forecasts (in yellow) for 2013-2018 and the target 5% growth (in red) announced by Prime Minister Medvedev at the beginning of the year.

Figure 7 - Actual Versus Forecast GDP for Russia, 1992-2018



After declining for most of the 1990s, Russia's economy started to grow positively again in 1998 and grew steadily until 2009 when the country experienced a severe decline related to the global financial crisis. In 2010, however, growth resumed and is forecast to continue into the foreseeable future (to 2018).

Worth noting here, however, is that although growth is forecast to remain positive for the next five or six years, and at rates higher than in advanced economies, the forecasts are lower than the 5% target. Further, the gap between the implied level of GDP if the target were achieved, and the implied forecast level if the economy grows in line with forecasts, appears to widen over time. This means that it is predicted to become tougher in the foreseeable future to boost growth by enough to achieve this target level of GDP.

This widening gap could provide the stimulus needed to focus more attention on the quality of the country's business climate to boost growth.

2.2.1 Current Year - 2013

Forecasts for growth in 2013 have declines across institutions during the first half of this year from a range of 3.3 to 4% to a range of 1.8 to 3.4%. It is not known yet, however, if what impact this decline may have on longer term forecasts moving forward, and whether this will make achieving the 5% growth target even more difficult beyond 2013.

Figure 8 - Annual Growth Forecasts by Institution and Quarter

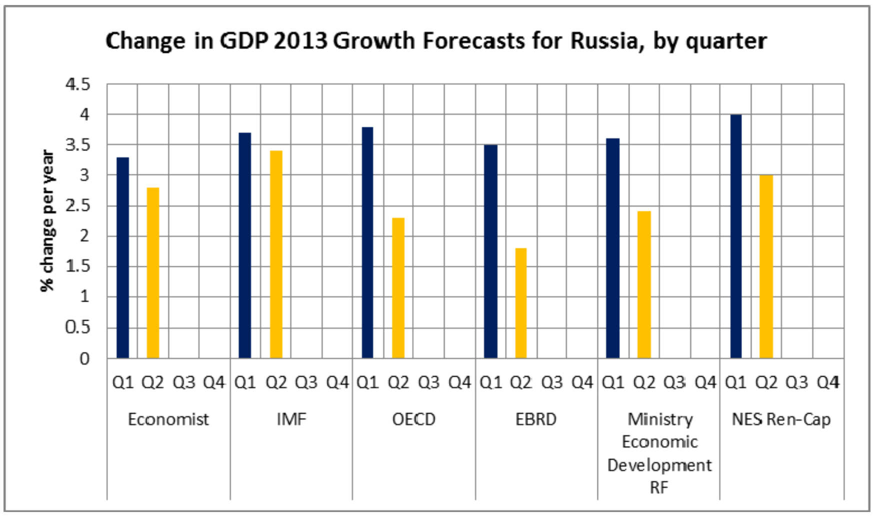


Figure 8 above provides forecasts for Russia's growth rate in 2013 across a sample of institutions and shows how these forecasts change from one quarter to the next. The forecasts during the first quarter, shown in blue, were generally higher than those made during the second quarter, shown in yellow, and each of the institutions sampled have reduced their forecast for this year.

The reasons for these reductions varied. Russia's Ministry of Economic Development has cited lower than expected investment levels so far this year as part of the reason for their reduction from 3.6 to 2.4%. 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 to 1.8% 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%.

The decline in this year's 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.

2.2.2 Quarterly

Forecasts for quarterly growth can provide further information on what is expected to happen in the more immediate future as well as which conditions seem to be driving the changes. Further, this can highlight some conditions that might be relevant for examining qualities of the business climate that do not emerge from less frequent numbers, such as annual or longer term growth, which tend to average out potentially important short run changes.

Quarterly growth estimates for 2013 continue to show weakness in Russia's economy, although improving slightly since last quarter due to a slight rebound in March.

Figure 9 below shows the RenCap-NES estimates for quarter on quarter growth, seasonally adjusted, for 2013. Except for Q2 with 0.3% growth, the other two quarters are in negative positions with Q1 at -0.1% and Q3 at -0.2%. This is partially due to weaker performance across a number of key industrial sectors in Russia continuing to hinder performance coupled with stagnant commodity prices.

Figure 9 - Seasonally Adjusted Q-o-Q growth

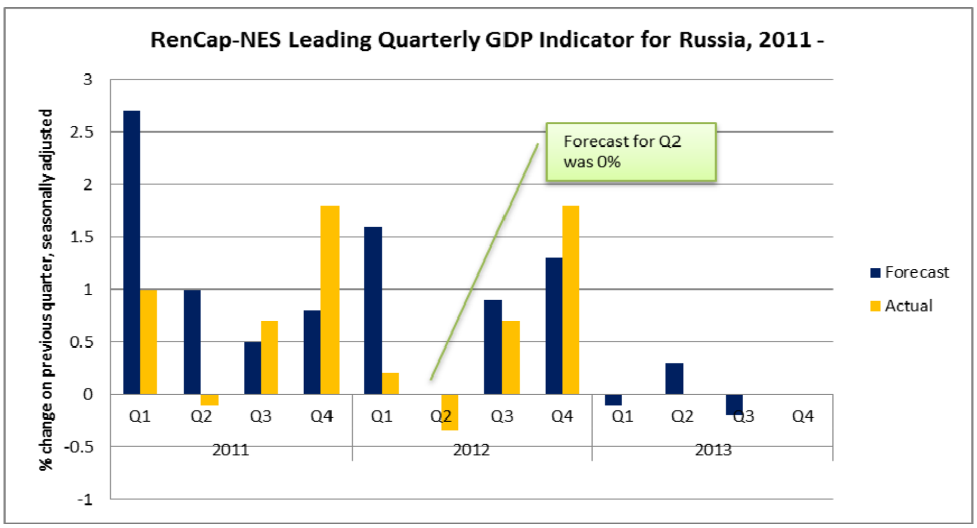
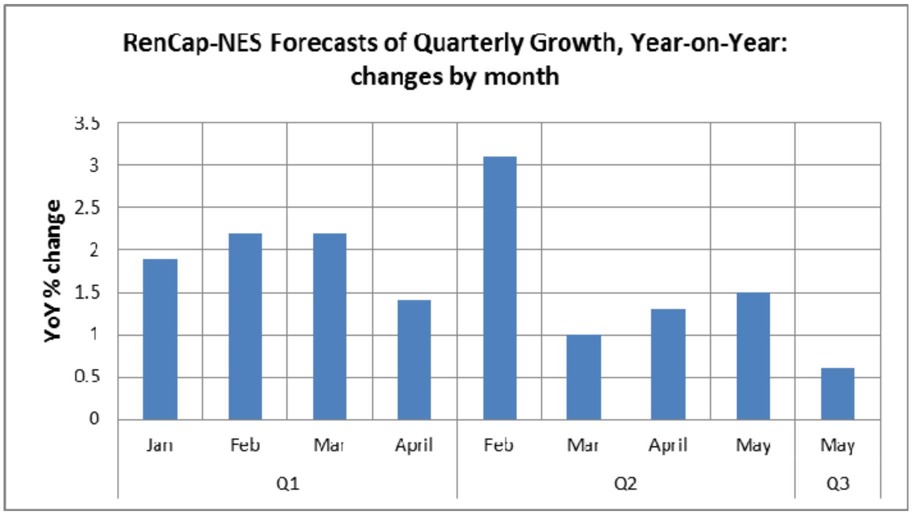


Figure 10 below shows growth forecasts for the first three quarter of 2013 relative to the same quarter the previous year. These year-on-year forecasts provide insight into how well the macroeconomy is performing relative to the same period last year without having to adjust for seasonal effects between quarters. Further, this graph shows how the forecasts for each quarter has changed monthly to use the latest statistics available to assess whether there are indications of a slowdown or pick up in performance

Figure 10 - RenCap-NES Y-o-Y Growth Estimate Changes by Month, 2013



For Q1, the estimates made each month for year-on-year growth dropped by April in part due to weaker performance across key industrial sectors, which appears to remain unchanged so far. Q2, however, has seen a dramatic decline between February and March followed by a slight rise in May. This is in part due to slightly better consumer spending. Current estimates for Q3 remain weak. Overall there are indications of a slowdown that are likely to mean that 2013 will not achieve the higher rates of growth forecast at the beginning of the year.

These figures also stress the reliance of growth on commodity prices, related trade flows, and the spillover they may have on the rest of the economy adding further weight to the need to boost the performance of other sectors through broader based business climate reforms.

2.3 Private Investment Flows

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.

Figure 11 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 as far as possible due to revisions since the Annual Report in January, 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).

Figure 11 - Quarterly Net Private Capital Flows, 2006 - 2013

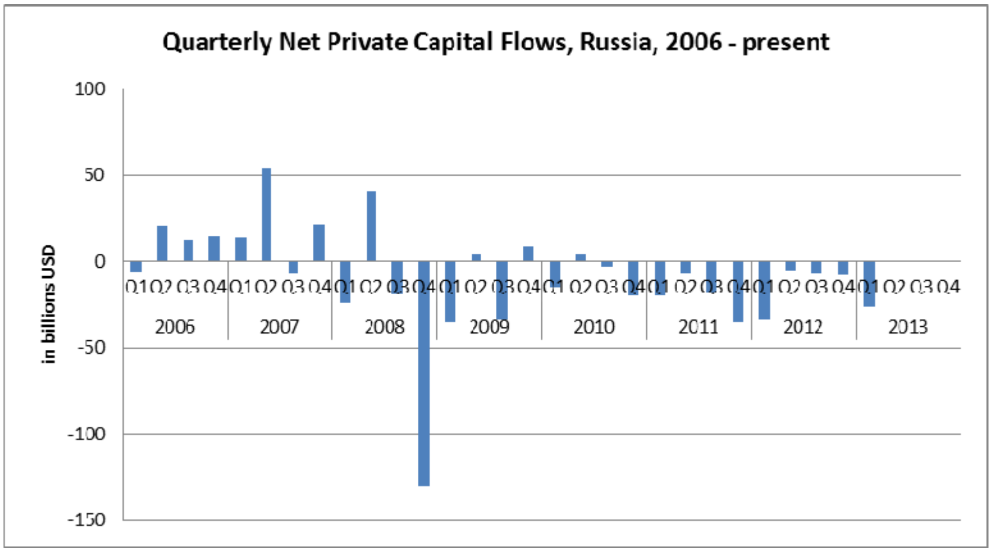


Figure 12 below shows greater detail on net private capital flows for Russia by month to the latest month for which data has been published by the Bank of Russia; December 2012. This figure provides a more clear picture of the rise in net capital outflows from Russia in the months leading up to and during the elections in late 2011 and early 2012, likely associated to some degree with the risk of political uncertainty. After the Presidential election and the eventual announcement of new appointments in May of 2012, this outflow slowed down dramatically. This trend is consistent with the view that political risk may be a genuine challenge for the country and, if true, could return having similar effects should uncertainty arise again.

Figure 12 - Net Private Capital Flows by Month, 2011-2012

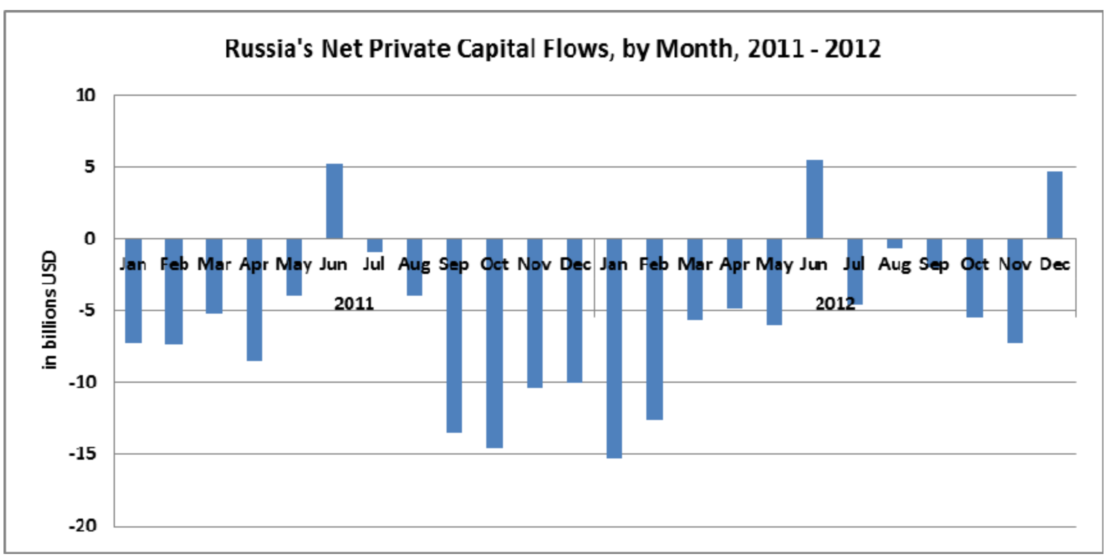
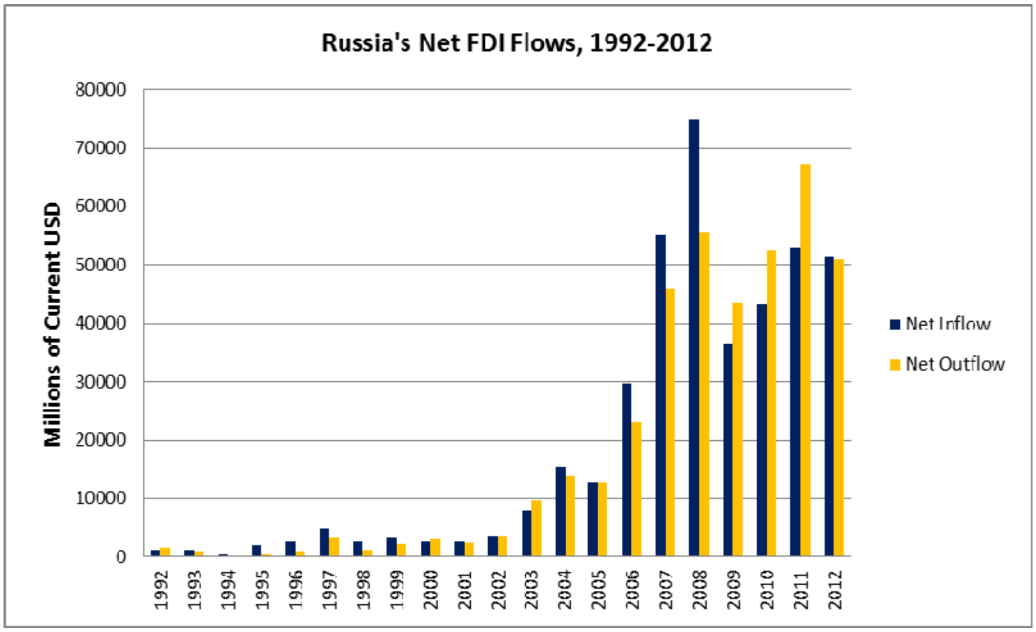


Figure 13 below shows the net inflows and net outflows of FDI for Russia from 1992 to 2012. From 2003 onwards, there was a dramatic rise in both spiking just before the global financial crisis before dropping in 2009 and again growing until 2011. Since FDI flows grew globally during this period, it is 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.

Figure 13 - Inflows and Outflows of Russia's FDI, 1992-2012



Source: UNCTAD for 1992 to 2011 followed by the Bank of Russia for figures for 2012.

Russia, however, shares this trend in particular with BRICS countries. UNCTAD's Global Investment Trends Monitor (UNCTAD, 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.

So far for the first quarter of 2013, net inward flows of FDI are estimated at $6.3 bln while net outflows are an incredibly high $66.4 bln. To date, there is not enough information available to explain this substantial increase given that the net outflow for all of 2012 was just over $51 bln. This may be due to large scale energy related investments and asset transfers representing a one time fluctuation rather than a more permanent fundamental change in trends.

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.

2.4 New Investment Announcements

New Investment Announcement data can be useful to gauge investors' intentions to make future investments in expanding production, both in aggregate and in specific types of economic activities. This section presents data tracked and collected between December 1 2011 and May 30, 2013, to highlight key trends, issues and challenges related to the quality of Russia's Business Climate.

Between December 1, 2011 and May 30, 2013, a total of 713 new investment announcements were tracked for a total value for those which disclosed financial details of $1524.5 bln, up from the $1256 bln reported in the first BCDM *Annual Report* released in January, 2012. 74% of the value of these announcements were in the Energy sector, and in particular, $720 bln alone (almost half) was comprised of only 3 large scale, multi-year, energy projects related to Rosneft and its partners. By number, however, Energy investments only represented 24% of activity while the "Other" category, dominated mainly by retail expansion, represented 30%.

New Investment Announcement activity continues to indicate that investors' future intentions to expand production in Russia will be dominated in value terms by a small number of large scale multi-year projects in the Energy sector despite Russia having potential in other areas such as Agriculture, Tourism, and Retail. However, trends also indicate activity beyond Energy that could potentially benefit from broader based Business Climate reforms.

New Investment Announcements

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.

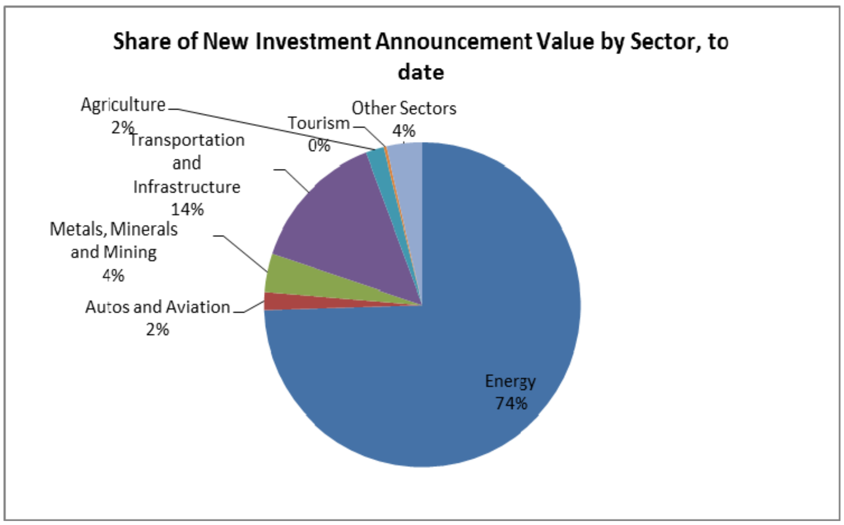
This data, however, have to be used with caution. They do not represent actual investment levels since they have not necessarily taken place yet and it is possible for an investor to backtrack on commitments made in response to unforeseen changes in conditions. Second, not all intentions to invest are 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.

2.4.1 Aggregate New Investment Announcement Activity

*This section presents the data collected over the past year in aggregate followed by type of economic activity and month in the next section 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.*

During the past 18 months, a total of $1524 bln worth of new investment announcements have been tracked. Figure 14 shows the share of this total value by sector. The vast bulk of new investment announcement activity, 74%, is related to energy sector activities. All other sectors combined, ranging from agriculture to automobiles, mining and minerals (outside petroleum and energy) represent only 26%. This indicates that as far as public commitments and financial disclosures are concerned, investors intend to continue to invest predominantly in energy activities in Russia in the foreseeable future.

Figure 14 – Share in Value of New Investment Announcements to date by Sector



There are two problems, however, with judging this situation purely by value terms. First, energy sector investments tend to be larger in scale and over longer time horizons than other activities, such as opening a small enterprise, as an extreme opposite example, or many of the other typical investment activities taking place, such as textile design and production, or pharaceutical development. Second, many of the other announcements tracked do not full disclose financial figures. These two issues tend to result in energy overshadowing the rest of the economy.

Figure 15 below instead provides a picture of the share of each sector out of the total number, 713, new investment announcements tracked during the past 18 months. "Other Sectors" is typically dominated by retail investment announcements and this accounts for 30% of the total whereas energy now represents 24%. Further, this disagram shows much more activity and diversity actually taking place that would be otherwise hidden by the financial size and scope of energy investments.

Figure 15 – Share in Number of New Investment Announcements to date by Sector

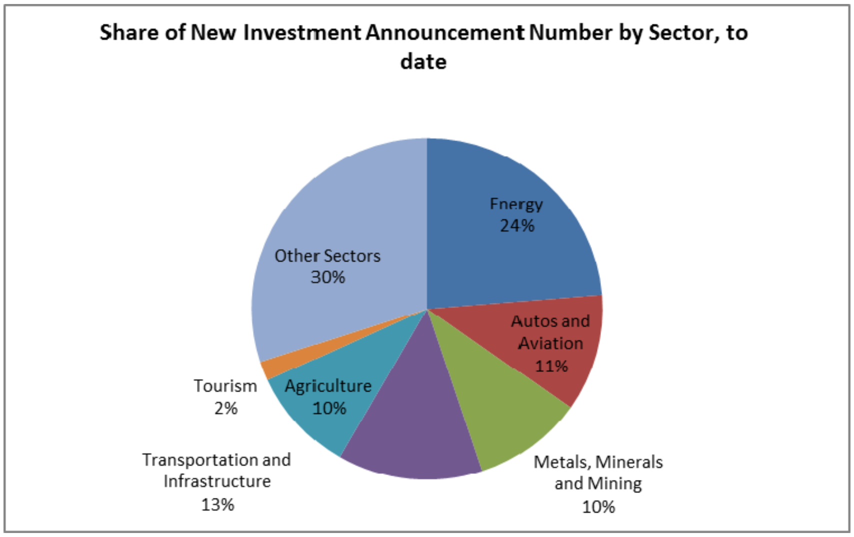
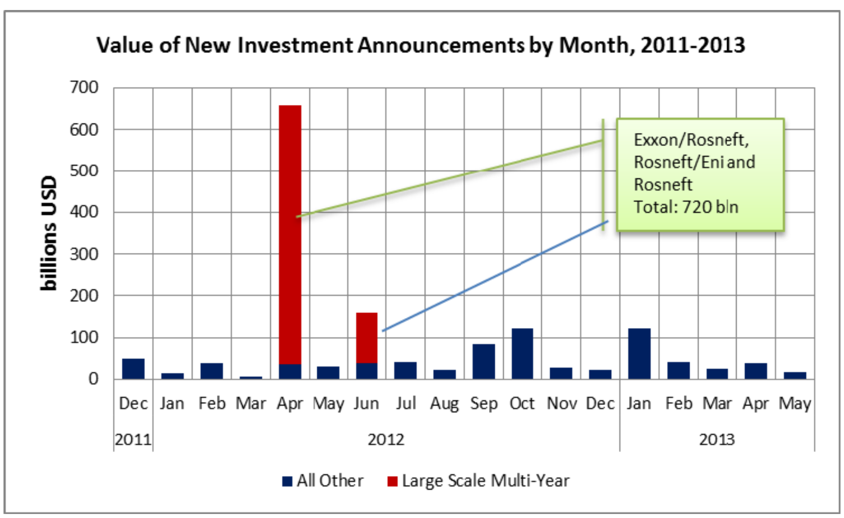


Figure 16 below provides a breakdown of the total value of investment announcements tracked each month for this period (18 months) beginning in December, 2011 and ending on May 30, 2013. It also makes an adjustment for three large scale, multi-year, investment announcements in Energy in April and June of 2012 that were related to Rosneft and totaled $720 bln (47% of the total tracked value). These large investments tend to distort the scale of the figure, however, generally, the value of the new investment activity was higher in the second half of 2012 and beginning of 2013 than during the beginning of the year, which is consistent with the idea that political uncertainty may have caused investors to hold off making public commitments to invest in Russia until election outcomes were known.

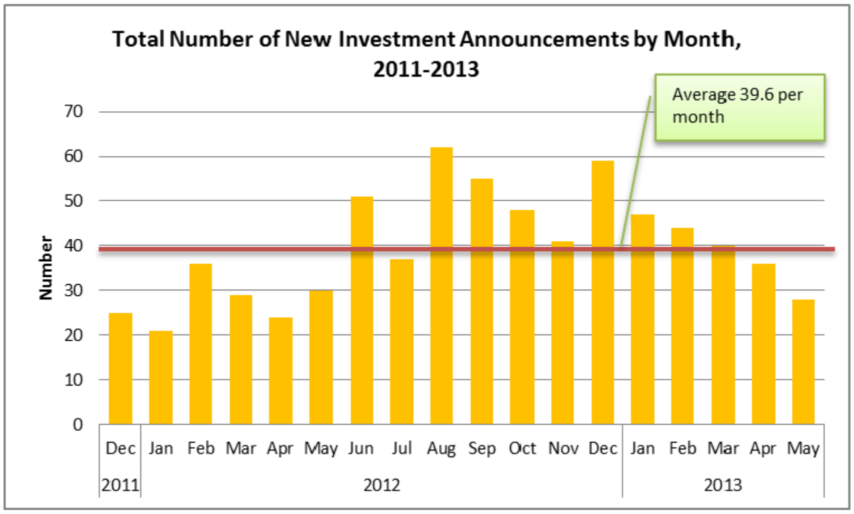
Figure 16 – Total Value of New Investment Announcements by Month, 2011-2013



This trend is more obvious by turning to the number of new investment announcements by month in Figure 17. The red line represents the average per month of 39.6 announcements and the first half of 2012 upto June falls under this average while the remainder of the year is generally above. Even the decrease noted during the past two months still remains relatively higher than the beginning of

2012 and end of 2011. More data will need to be added to this, however, to see to what extent, if at all, political risk appears to have affected investors' intentions.

Figure 17 – Total Number of New Investment Announcements by Month, 2011-2013



2.4.2 New Investment Announcements by Sector

Some sectors may be more affected by specific qualities in the business climate than others, and some may be in need of specific reforms to improve their performance and achieve their greater hidden potential. This section provides a breakdown of the value and number of new investment announcements by sector and month to help identify relevant trends and challenges, especially those which may be overlooked in less frequent, more aggregate, reports.

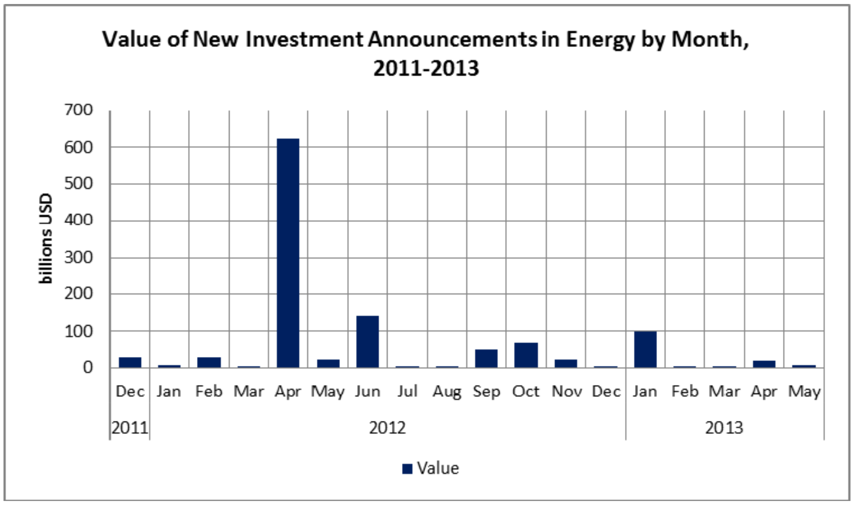
2.4.2.1 Energy

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 and natural gas.

During the past 18 months, 169 new investment announcements were tracked in this sector representing 24% of the total and worth an estimated $1135.97 bln (74% 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.

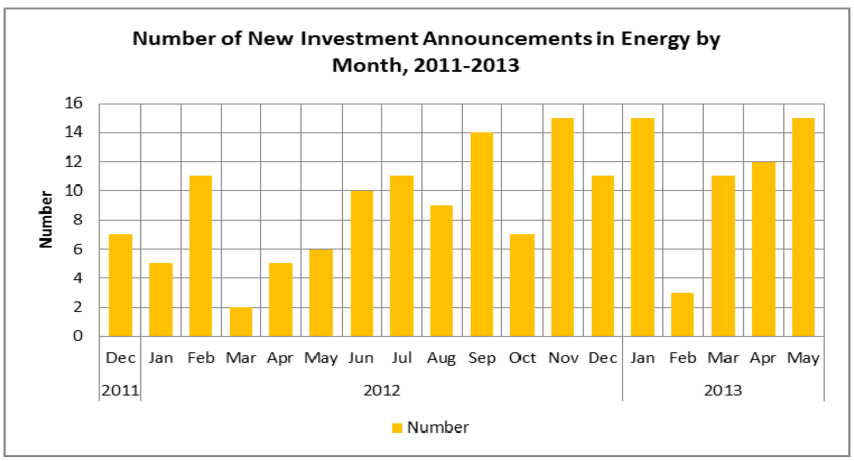
In fact, three large scale, multi-year, new investment announcements tracked during 2012 in April and June, related to Rosneft and its partners, totaled $720 bln. These two months show up easily in Figure 18 which shows the value of new investment activity in this category during the past year by month. These three investment announcements alone account for 47% of the total announcement activity tracked over the year.

Figure 18 – Value in Energy by Month, 2011-2013



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 19 below. Despite the large share of the value of new investments announcements in April and June of 2012 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 and remains high into 2013 with the exception of February.

Figure 19 – Number in Energy by Month, 2011-2013



2.4.2.2 Autos and Aviation

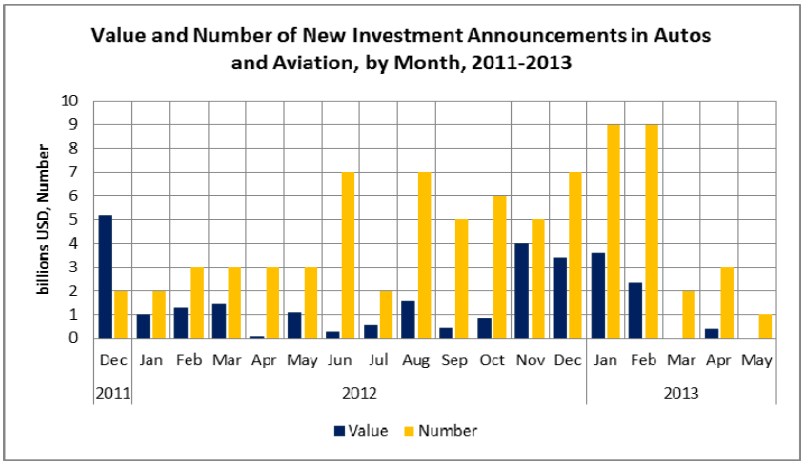
The Autos and Aviation category generally covers investment activity in creating new automobile or aviation factories, or factories for auto or aviation parts, expanding them, as well as other related investment activity.

In this category, 79 new investment announcements were tracked during the past 18 months (Dec, 2011 to May, 2013) for a total value of $27.5 bln. This represents only 2% of the total tracked value of new investment activity, but 11% in terms of the total number of announcements.

Figure 20 below shows the total value and number of new investment announcements related to Autos and Aviation by month since December, 2011. Generally, in this sector many new investment announcements do not disclose the full value of investments to be made. However, it appears that the number of investments has increased during the past 18 months up to March of this year and this sector has remained relatively active during the entire period. Although there seems to be more activity in the second half of 2012 and the first two months of 2013 than during the first half, which would be consistent with political uncertainty related to elections, the trend does not appear as obvious as in other activities. 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[7].

Figure 20 – Autos and Aviation by Month, 2011-2013



2.4.2.3 Metals, Minerals and Mining

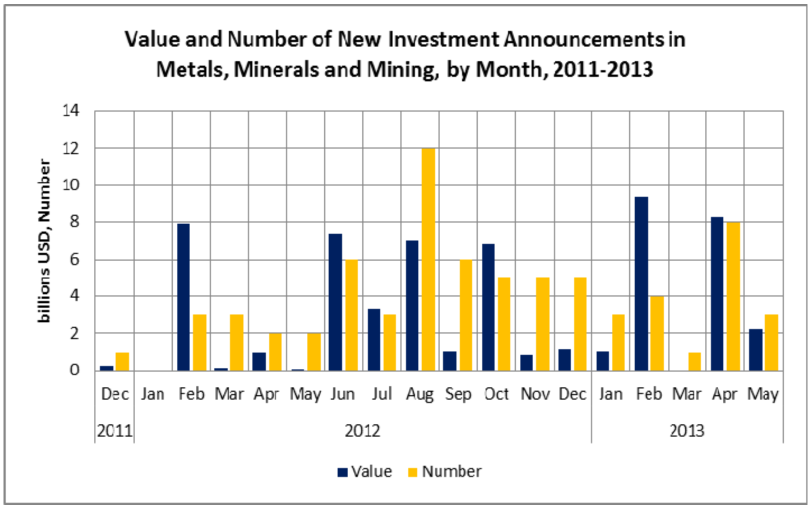
This category generally covers investment activity related to expanding mining operations, constructing or expanding metal production or processing facilities, as well as other minerals and related activities.

During the last 18 months from December, 2011 to May, 2013, 72 new investment announcements in this category were tracked representing 10% of the total number worth $ 57.9 bln, or 4% of the total value.

Figure 21 below shows the number and value of new investment announcements during this period broken down 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 general trend shows a high level of activity across months consistent with this potential.

[7] See (Babushkin, 2012) for brief highlights on this market.

Figure 21 – Metals, Minerals and Mining by Month, 2011-2013



However, the change during the 18 month period also shows that activity was slower during the first half of 2012 than after, both in value and number. This trend suggests that like many 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.

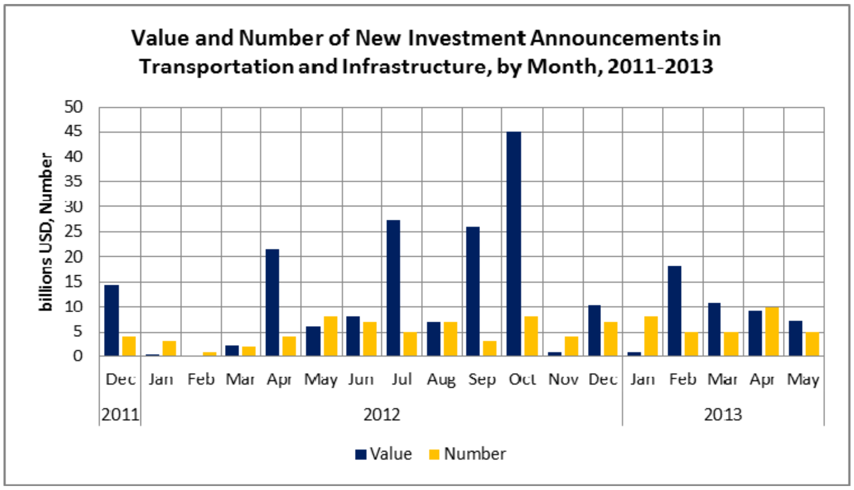
2.4.2.4 Transportation and Infrastructure

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 past 18 months, 96 new investment announcements were tracked in this sector representing 13% of the total. In value terms, there were $215 bln of worth of announcements representing 14% of the total value.

Figure 22 below shows the value and number of new investment announcements by month during the past year and a half. Generally, during the first months of 2012, activity in value and number were low and picked up in March and April with almost all the value and number taking place in the latter part of the year. So far, this trend appears consistent with other sectors in terms of indicating that investors may have held off public investment commitments during the period of political uncertainty.

Figure 22 – Transportation and Infrastructure by Month, 2011-2013



2.4.2.5 Agriculture

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 as well as expanding cultivable land.

During the last 18 months, 70 new investment announcements were tracked in Agriculture representing 10% of the total number and were valued at $28 bln, or 2% of the total value. In this sector, it is common for announcements to not disclose financial figures, but also many smaller scale farmers do not announce investments they may intend to make to improve or expand their operations.

Figure 23 – Agriculture by Month, 2011-2013

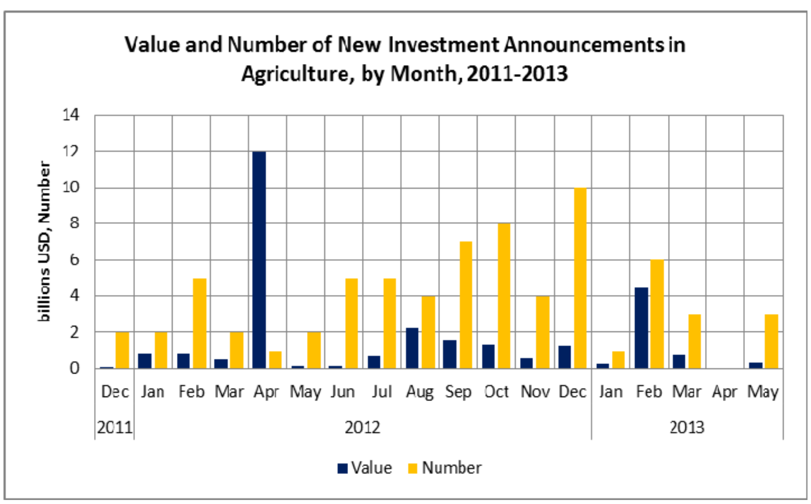


Figure 23 above shows the value and number of new investment announcements in this sector during the past 18 months. With the exception of April, 2012, it generally appears that activity picked up in the second half of 2012 in both number and value. This is consistent with the possibility that investors in this activity waited for the political dust to settle after the elections and a new government was formed. However, activity also appears generally lower in the first few months of both years and more data will be needed from the second half of 2013 to shed more light on whether this dip in 2012 was likely due to political uncertainty, and if so, to what extent.

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, 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. As noted in the highlights at the beginning of this report, a lobby[8] has been recently formed, for example, to support new regulations for bio friendly farming practices to enhance growth and development, as well as export potential, for organic products. In addition, recent reports have cited that part of the growth in Russia's agricultural output might be met through expanding land under cultivation.

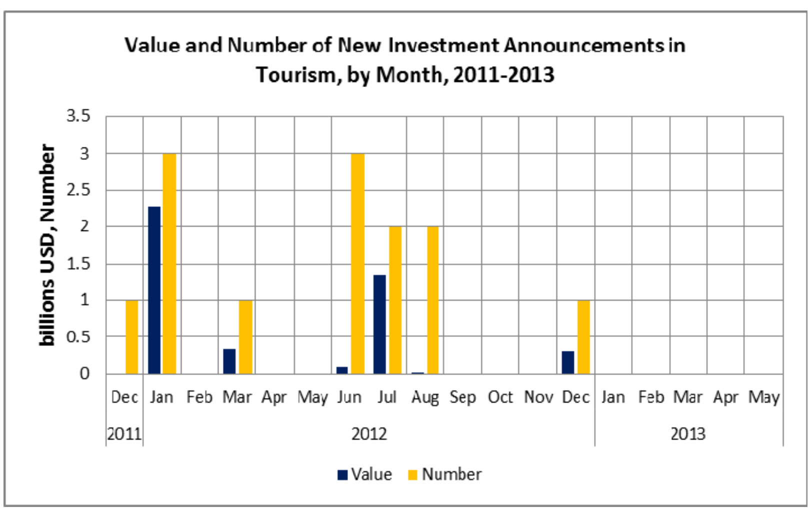
2.4.2.6 Tourism

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 and "export" activity in terms of national income accounting while use by domestic residents would not be.

During the past 18 months, only 13 new investment announcements were tracked in this sector representing 2% of the total. The value of these investment announcements, to the extent that financial figures were disclosed, totaled $4.36 bln, or about 0.2% of the value of all tracked new investment activity.

Figure 24 below shows the value and number of new investment announcements in tourism by month during this period. At the beginning of the BCDM project, there were sufficient numbers of announcements to warrant a separate category for tourism in addition to the fact that estimates of GDP directly and indirectly tied to tourism place it close to 6% in 2011 and about 5.3% of employment, which is significant. This would be slightly larger than the auto sector.

Figure 24 – Tourism by Month, 2011-2013



[8] See (Mentyukova, 2013)

The lack of new investment announcement activity in this sector suggests that there is likely to be little in the way of future investments in Russia's tourism sector in the near future. Yet, this sector has drawn attention as having a greater potential given the country's natural and cultural resources as well as infrastructure. Despite some government attention as recently as 2011, Russia's tourism sector has fallen slightly in its competitiveness ranking in the World Economic Forum's *Travel and Tourism Competitiveness Index* (see Figure 5 and Figure 6) from 59th to 63rd place. Further, estimates range from 2/3 of foreign visitors coming from other CIS countries and some 70% of the tourism activity being primarily purchased by domestic residents.

2.4.2.7 Other

The "Other" category of New Investment Announcement activity captures those investments announcements made in new income generating activity outside the energy sector and the other sectors covered above; all remaining new investment activity. Although this category sometimes includes investments made in diverse areas such as pharmaceuticals or technology, the vast majority of activity captured monthly is related to retail sector expansion[9]. One of the additional features of this category is that many its new investment announcements do not disclose financial figures, and thus, the value can be taken as a lower bound in terms of investors' intentions.

In this category during the last 18 months, 214 new investment announcements were tracked representing 30% of the total, yet the value was $55 bln, or only 4% of the total value across sectors. This is in part due to the lack of financial disclosure, but also that many of these investments are relatively much smaller than the relatively larger scale, often multi-year projects, in *Infrastructure, Autos and Aviation, Agriculture,* and of course, *Energy*.

Figure 25 – Other Non-Energy by Month, 2011-2013

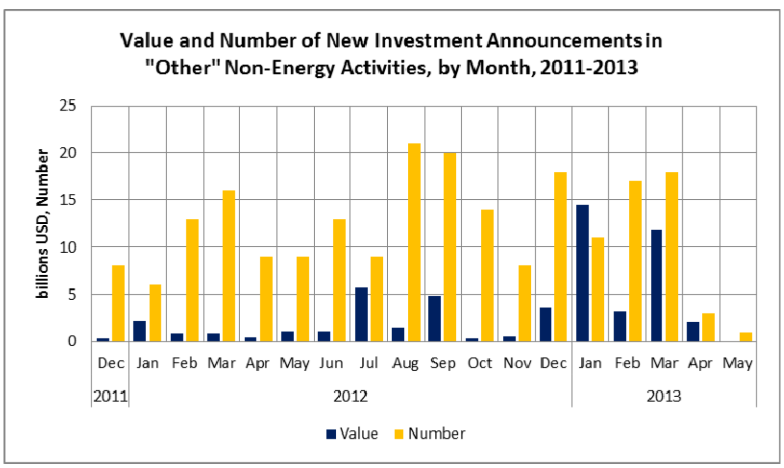


Figure 25 above shows the value and number of new investment announcements in this "Other" category since December, 2011. The trend so far shows the number of new investment announcements picking up in early 2012 before dipping in April and May, but generally remaining strong. Most of the public commitments in value terms took place after June 2012 but both appear to have dropped significantly in April and May 2013.

The evidence for this type of activity here is consistent with the strong potential Russia has in terms of retail expansion. With Europe's largest population, rapidly growing average incomes, and room for

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[9] 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.

expansion, there is an expectation of investment potential for investors, both domestic and foreign, including small and medium sized enterprises.

3 Key Findings

This section briefly summarizes the key findings from monitoring changes, issues and trends related to the quality of Russia's Business Climate during the past 18 months. Further, it updates this information from those findings reported in BCDM's first Annual Report released this past January, 2013.

3.1 The risk of complacency

The major theme focused on in this report is the *risk of complacency*. At the beginning of 2013, Prime Minister Medvedev announced a target rate of 5% growth for Russia per year. Later statements by him and President Putin confirm the importance the government has placed on raising Russia's growth rate. Further, although questions could be raised about how this target was set, 5% per year does appear in line with the average growth the country has achieved since 2000 (about 4.6% per annum) and setting an ambitious target can provide an important stimulus for identifying growth friendly policies and programs that ultimately aim to improve the country's prosperity.

This target could also provide the kind of stimulus needed to support business climate reforms. Citing a slowdown in investment activity and market conditions, the forecast for Russia's growth in 2013 has fallen to the low 2% range. The gap between what the country is likely to achieve and the target appears to be widening and as long as it does or the gap remains, there will be a need to identify sources for growth. Reforming the business climate could lead to improvements in efficiency, productivity and help to attract and retain investments.

However, there remains a significant risk in terms of *complacency*. During the past 12 years, Russia has continued to rank low in terms of the quality of its investment and business climate and remains behind relative to most other transition economies in Eastern Europe and Eurasia in the breadth and depth of reforms. High growth rates were largely supported by high energy prices and the growth in this sector has buoyed the economy and allowed the authorities to ignore reforms. If growth rate prospects improve for reasons other than business climate reforms, such as higher energy prices or a change in global market conditions, there is concern that once again, the quality of Russia's business climate could be pushed aside and put off to some future period.

Adopting a broader set of objectives and outcomes, such as investment attraction and retention, labor market outcomes, productivity measures, and others, could help to reduce the risk of complacency involved with this 5% growth target. Further, these additional targets could be used to identify underperformance in regions and sectors as well as helping to identify and prioritize which reforms are most needed to improve performance. They would also support evaluating, recognizing and monitoring progress and would serve to complement other Indexes.

3.2 Diversification

Diversification continues to be a serious challenge facing Russia and the quality of its business climate. Despite years of high growth, some progress with reforms, and success with attracting investment inflows, the energy sector continues to dominate the economy in terms of revenues for state budgets, export activity, and the vast bulk of investments. The country remains exposed to the risk of over relying on a small number of extremely high value, large scale, multi-year projects in energy exploration and development. Further, new investment announcement data indicates that as far as investors have made their future intentions publicly known, energy will continue to be the focus of investment activity in the foreseeable future.

Although it is natural for a country to benefit for vast natural resources, such as energy deposits, it is also true that Russia has great potential in other activities such as agriculture, tourism, consumer retail and offers a low cost high skills labor force with growing incomes.

With growth on the agenda, attention needs to be turned to broader based business and investment climate reforms that can support Russia seizing opportunities in other activities outside energy.

3.3 Political risk

At the beginning of this project to monitor qualitative changes and issues related to Russia's business climate, *political risk* appeared to be a significant issue. It appears to remain such. Net private capital outflows grew as uncertainty over Parliamentary and Presidential elections increased and new investment announcement activity generally appears to have been higher in number and value during the second half of 2012 than during the first half. In other words, once the new government and policy directions were announced and appointments made, it appears that new investment announcement activity increased.

For the time being, the dust may appear to have settled, but the issue remains that if political risk is real and significant, the moment uncertainty returns, such as a future election period, similar outcomes can be expected and economic performance could be weakened if this issue remains on the backburner.

3.4 The pace of reforms

Although there are many ambitious commitments made, such as climbing to 20th place in the World Bank's Doing Business Index, and achieving a 5% growth target, the pace of reforms remains an issue. During the past year Russia has only climbed from 120th to 112th position on this index and growth forecasts have fallen from close to 4% to closer to 2%. Further, despite government commitments made in the tourism sector two years ago, the latest World Economic Forum Travel and Tourism Competitiveness Index shows Russia falling 4 positions from 59th to 63rd between 2011 and 2013.

Given that many of the other transition economies in Eastern Europe and Eurasia have made significant progress in business climate reforms during the past 12 to 13 years, 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.

3.5 Regional approaches

There is a need to tailor business climate reforms and approaches to meet regional needs, challenges, and conditions as well as recognize progress where and when it has taken place. During the last 18 months, a noticeable portion in the value and number of new investment announcements involved activities and expansion plans outside of Moscow and St Petersburg. Most recently, it was noted that some 70% of the expected growth in retail space of over 1 million square meters, for example, would be outside Moscow and this is expected to make Russia Europe's largest shopping area. Many of these trends highlight growth potential in a broad range of activities across Russia's vast land mass. Various indexes examining business climate qualities at the sub-national level have also drawn attention to regional variation in the attractiveness of various locations in terms of opening and operating an enterprise.

This wider potential coupled with diversity indicates a one-sized fits all approach is unlikely to be efficient or effective and that conditions in Moscow or St Petersburg do not necessarily reflect those found elsewhere. This indicates a significant need to identify, prioritize, 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 greater potential.

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Appendix 1 New Investment Announcement Data

This appendix outlines what a *New Investment Announcement* is and how the data was derived for the purposes of this report in addition to 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 that already exists and is already producing something. 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, is 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.

New investment announcements should provide us with some useful information about investors' intentions to make investments in the future to expand production. Further, changes in the quality of the business climate, positive or negative, should influence investors' intentions to invest and actually follow through with those commitments they made, all other conditions remaining the same.

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 as conditions change in the market place, or for example, in the quality of the business climate.
- **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 investment, 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 26 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.

Step 1 – Excluding non-new investment announcements

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.

Step 2 – Separating domestic from foreign investment announcements

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. [10]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 foreign expansion activities. 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.

Step 3 – Dividing the New Investment Announcements into sub-categories

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.

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[10] 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.

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.

Step 4 – Converting the total values to a common currency (USD)

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.

Figure 26 - Filtering Process to Generate New Investment Announcement Dataset