

## Business Climate Development Monitor

# “Little Growth, Little Business Climate Change”

*Year on Year Report*



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**1** Business Climate Development Monitor's Year-on-Year 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 **Year-on-Year Report** addresses two related challenges facing Russia today. The first is the slowdown in growth in 2013 after quite strong performance for over a decade. The current government has set itself a target of achieving 5% growth per year and this looks increasingly difficult to reach given current global market conditions. The second is the state of Russia's business climate. Despite some progress and policy statements by the government to improve the situation, Russia remains behind most other transition and BRICS economies in terms of its relative attractiveness as a country to produce, live and work. While past growth may have been largely fueled by high resource prices, namely oil and gas, coupled with Russia's abundant supplies, the country's future depends on tapping into the potential of other diverse sectors of the economy. Although improving the quality of the business climate will not come in time to change the forecasts for 2013, it is not too late for securing future growth and prosperity.

This *Year-on-Year Report* on Russia's business climate comes three months after the first *Semi-Annual Report* in June 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 22 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 summary 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, Rector of NES, and Natalya Volchkova, EO.N. Professor of Energy Economics at NES and Policy Director of CEFIR. 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,

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## Year-on-Year Highlights

**BCDM's Year-on-Year 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 twelve months.**

In October, 2013, the World Bank released its latest *Doing Business Report*, focusing on smarter regulations for small and medium sized enterprises. Out of 185 countries, Russia's rank improved 8 positions to 112<sup>th</sup> from 120<sup>th</sup>. The latest rankings are due at the end of October, 2013.

In his speech at the Russia Calling Forum in Moscow in October, 2012, President Putin drew attention to the need for restructuring the economy away from its dependence on energy. A new tax code to attract investment activity and a direct investment fund were announced, although other specific policies on how diversification will be achieved remain less clear.

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 6<sup>th</sup> *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%. Later, in August, the forecast was further reduced to 1.8% in light of stagnant growth and low investment activity in the first half of the year. This makes the 5% growth target appear even more difficult to achieve.

In March the World Economic Forum released its 5<sup>th</sup> *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 59<sup>th</sup> in 2011 to 63<sup>rd</sup> this year 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, 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 56<sup>th</sup> place out of 161 countries from its position last year at 48<sup>th</sup> out of 160 while in the latest rankings from IMD’s *World Competitiveness Center* in May Russia’s position improved to 42<sup>nd</sup> out of 60 from last year’s at 47<sup>th</sup> out of 59. (Bloomberg, 2013; IMD, 2013).



Over 100 businessmen have been released as part of an amnesty announced late in Q2 by the government for primarily financial crimes committed in the past that would no longer be seen as criminal under current legislation. After rejecting the first proposal, President Putin announced a surprise reversal at the St Petersburg Economic Forum in June if certain crimes were excluded from the amnesty and ordered a speedy passing of the legislation before summer.

In September, the Ministry for Economic Development announced that investments in infrastructure projects would help boost future growth rates combined with easing of monetary policy and other investments stimulated, in part, by improved business climate conditions.

In September, 2013, the Central Bank of the Russian Federation became the nation's financial regulator. Transferring aspects of the Federal Financial Market Service to the Bank is thought to enhance the country's ability to respond to shocks as well as harmonizing regulations. This could help in making the country more attractive for investments although the impact will remain to be seen for some time.

# 1 The Current State of Russia's Business Climate

**In Brief:** Despite over a decade of growth, two decades of transition and recent signals from the government that business climate reforms are on the agenda, Russia continues to rank low across indexes, and in particular behind most other transition economies in Eastern Europe and Eurasia. Given Russia's greater potential, however, in terms of a large and growing consumer market, well-educated labor force, agricultural and energy resources at a time when other high income countries are experiencing decline, improving the country's business climate could not only stimulate stagnant growth, but help the country diversify away from energy dependence and achieve higher levels of prosperity.

Russia's government has stated repeatedly that one of its goals is to improve its position in the World Bank's *Doing Business Index*, which features many business climate qualities focused on the life-cycle of operating a business (opening, registering, operating and closing failing operations). During the elections in 2011 and 2012, Putin stated that the country is aiming to climb from 120<sup>th</sup> position in this index to 20<sup>th</sup> within six years. Further statements by Prime Minister Medvedev citing the quality of the country's business climate as a serious cause for concern and related to attracting and retaining investments have also been publicly made. More recently, in late August, 2013, Russia's Ministry for Economic Development has linked improving the business climate to improving growth in light of the recent slowdown or slump as part of its strategy to improve growth rates<sup>1</sup>.

This section summarizes, to date, the most recent rankings of Russia across indexes which focus on various aspects of the business climate. They often differ in approach, methodology, data used, and their comprehensiveness; however, by applying a similar method across countries, they can provide some insight into those areas where Russia has to improve in order to move up ranks relative to other countries. They can also be used a starting point to stimulate a policy discussion of where reforms might genuinely be needed to improve efficiency and attract economic activity, both as a whole, and in particular activities, such as tourism. Additional benefits of monitoring indexes include evaluating progress and identifying best practices.

As mentioned in previous reports, namely BCDM's *Annual* (January, 2013) and *Semi Annual* (June, 2013) *Reports*, these indexes also come with drawbacks and must be used with caution. One of the most serious drawbacks in terms of relying on business climate indexes is that the "rank" of an indicator does not necessarily reflect "economic relevance". It might be, for example, that corruption might rank as a higher priority (harming the country's ranking) more than tax rules and regulations. First, these issues are not necessarily separate and they might move in opposite, unexpected, directions. Reducing corruption is likely to be costly as wages are raised to deter the acceptance of bribes, for example, and enforcement officers and costly auditing processes employed. This would require a budget and, unless there are decreases in expenses for other programs, a potential tax rate rise coupled with tax system changes. This might improve the corruption rank, but harm the tax rate rank. Many of the indicators used are connected in far more complex and nuanced ways than their combination would suggest at first sight.

The second aspect of this important difference is that the costs and benefits of different indicators are not reflected in the rank. Retaining the same example as above, dealing with corruption is likely to be very costly to fix and require a lot of time, commitment and resources. It might rank as a higher issue, but it remains possible that focusing instead on a lower ranking issue like taxes and the tax system might be relatively less costly to fix, yet generate more benefits, especially if investors view

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<sup>1</sup> Prime Minister Medvedev announced at the beginning of 2013 a target of 5% growth per year, which is considerably higher than the current Ministry of Economic Development's forecast for 2013 of 1.8%!

the lower costs as more beneficial than the relative costs involved with corruption. Improvements in tax rates and regulations are typically more transparent and easier to measure and convey to potential investors than corruption, as well, and be easier to use to attract activity to the country.

**Using Business Climate Indexes and indicators is a useful starting point for raising awareness and providing a stimulus for change, but an actual reform process should assess the costs involved with the indicators and potential consequences of changing them before prioritizing which reforms are needed most to achieve specific objectives.**

## 1.1 Russia's Business Climate Across Indexes

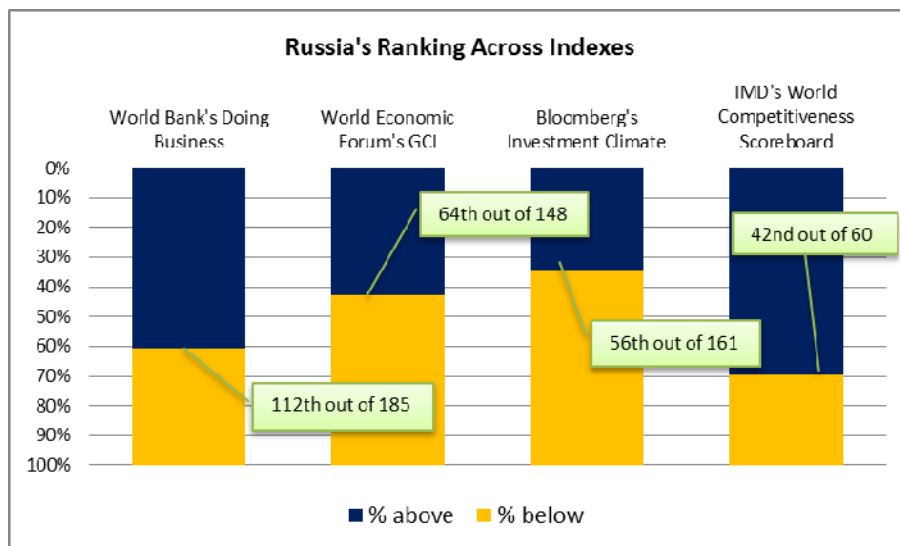
During the first half of 2013 the World Competitiveness Center (IMD) and Bloomberg released their latest country rankings. Russia's position improved on the IMD's Competitiveness Scoreboard from 48<sup>th</sup> to 42<sup>nd</sup> position while it fell on Bloomberg's Best Countries for Business Index from 48<sup>th</sup> to 56<sup>th</sup> over the past year. The World Economic Forum also released their Travel and Tourism Competitiveness Report 2013. In their 5<sup>th</sup> Travel and Tourism Competitiveness Index, Russia's position fell 4 spots from 59<sup>th</sup> in 2011 to 63<sup>rd</sup> this year. More recently, in the Forum's Global Competitiveness Index, Russia climbed slightly from 67<sup>th</sup> to 64<sup>th</sup> place.

### 1.1.1 Overall Rankings

Figure 1 provides an update of Russia's position across Indexes which consist of indicators that 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 captions for each one. (These rankings have been updated since BCDM's *Semi-Annual Report* in June, however, it should be noted that the World Bank is expected to update the *Doing Business* rankings at the end of October, 2013)

To date, Russia remains at 112<sup>th</sup> position out of 185 countries in the World Bank's *Doing Business Index*, which was released in October, 2012. This 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 20<sup>th</sup> 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 1 – Russia Across Business Climate Related Indexes



In the World Economic Forum’s *Global Competitiveness Index*, Russia is in 64<sup>th</sup> place out of 148 countries (*recently updated*) included while in the Bloomberg *Best Countries for Business Index*, Russia has fallen from 48<sup>th</sup> to 56<sup>th</sup> position. At the end of May, IMD’s *World Competitiveness Center* (WCC) released its latest scoreboard showing an improvement in Russia’s rank from 48<sup>th</sup> position last year to 42<sup>nd</sup> this year.

**Generally, Russia’s Business Climate tends to rank low across diverse indexes with little dramatic change during the past two years noted.**

### 1.1.2 Russia’s Relative Rankings

Figure 2 below shows Russia’s position in the World Bank’s *Doing Business Index* relative to other transition and BRICS economies. Russia is considerably further behind than the majority of transition economies and only ranks ahead of Brazil and India in terms of BRICS. Because this index is comprised mostly of indicators reflecting the ease with which a business can be opened, operated, and closed, this relatively low ranking suggests that Russia is a relatively difficult country to operate in relative to the others, despite its potential in terms of market size, consumer growth, etc. On the other hand, it suggests that since Russia has a relatively high potential due to these features, improving the ease of operating a business may come with serious benefits and support growth, employment and entrepreneurship.

**Figure 2 – Russia’s Relative Rank in the Doing Business Index**

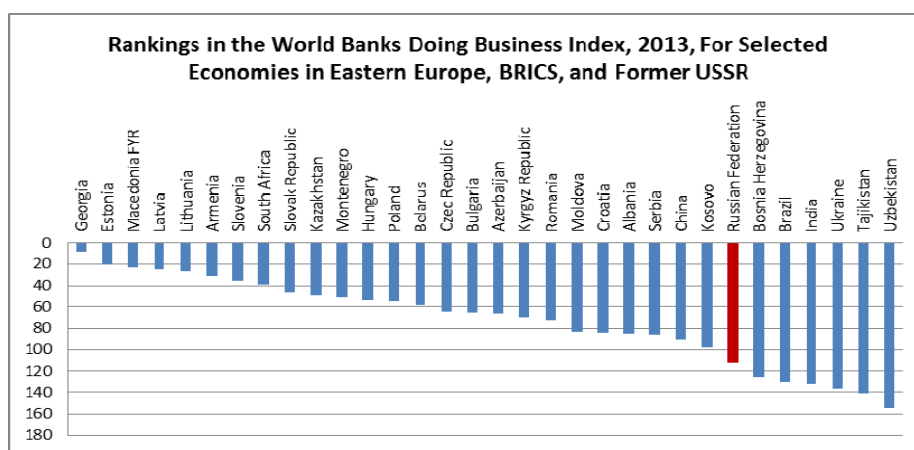
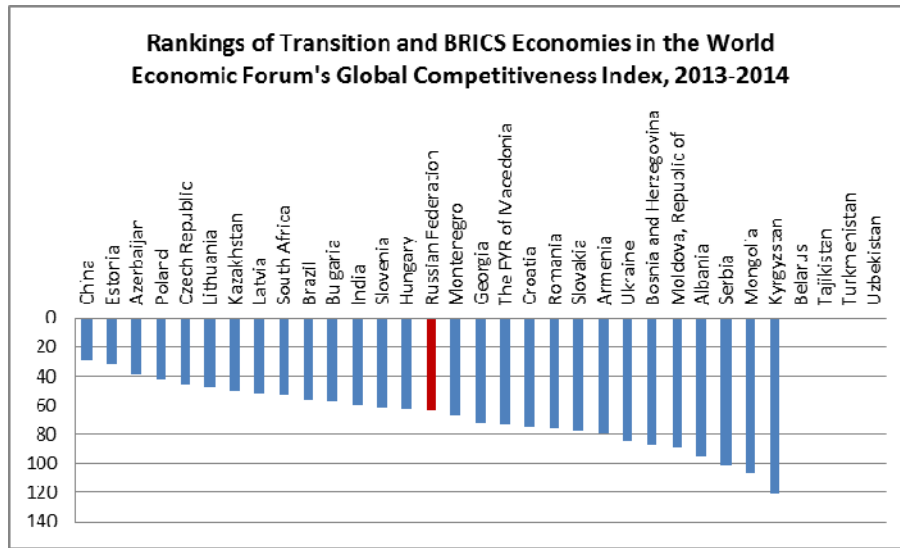


Figure 3 below show’s Russia’s ranking in the World Economic Forum’s most recent *Global Competitiveness Index* relative to other transition and BRICS economies. While the World Bank’s Index focuses primarily on those conditions that affect the ease of operating a business, the Global Competitiveness Index is generally broader and looks at conditions that affect a country’s level of productivity. Countries that are more competitive are able to use their scarce resources to produce goods and services at lower costs relative to less competitive economies. In the GCI, Russia (64<sup>th</sup> place) is behind the other BRICS and in the middle of other transition economies. More noticeably, Russia is behind Kazakhstan (50<sup>th</sup>), which has also gone through transition facing fundamentally similar challenges coupled with a strong reliance on natural resource products (i.e. energy).

**Figure 3 – Russia’s Relative Rank in the Global Competitiveness Index**

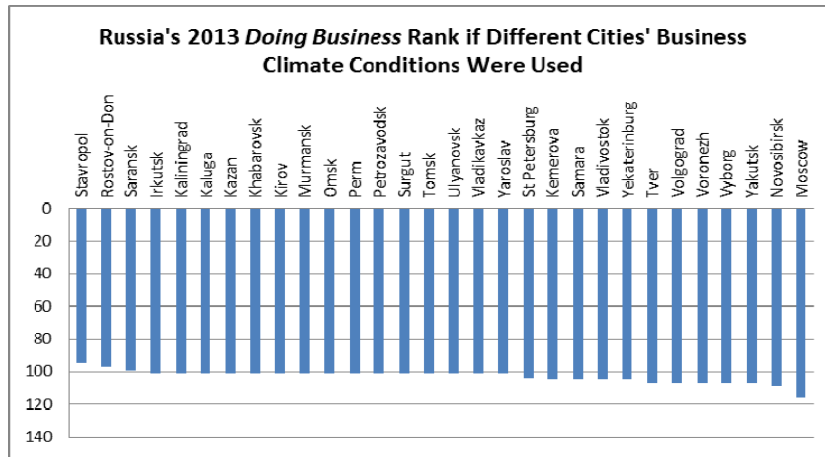
Generally, across these indexes Russia continues to rank low relative to other countries worldwide and other transition economies in Eastern Europe and Eurasia in particular. The pace and breadth of reforms also remains low and is reflected by the fact that Russia’s relative position tends to change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

### 1.1.3 Russia In Pillars and Indicators

One of the drawbacks of the World Bank’s *Doing Business Index* is that conditions in a country’s capital city are used to rank countries rather than average conditions across the country as a whole. Thus, Russia’s rank of 112<sup>th</sup> is based on conditions in Moscow, which may or may not accurately reflect the types of conditions people will face elsewhere in the country. This means that countries’ ranks could be quite different in the index had other cities been chosen. This is likely to be less of a concern for very small countries where conditions in the capital may be closer to national averages, but for a country as vast as Russia, it poses a serious drawback.

Figure 4 shows the result of a simulation that examined how Russia’s rank would change in the *Doing Business Index* has one of 30 other cities been used. In 2012, the World Bank produced a subnational report ranking 30 of Russia’s cities across four of the ten usual pillars: getting electricity, starting a business, registering property and dealing with construction permits. Further, their reform simulator was used to see how the country’s rank would change if the conditions for these four pillars were used instead of Moscow’s.

**Figure 4 – Russia’s Doing Business Rank if Other Cities Were Used**



If Stavropol were used instead of Moscow, Russia would rank in 95<sup>th</sup> place, in the top 100 worldwide, instead of the current 112<sup>th</sup>. Further, it should be noted that Moscow ranks in last place out of the 30 cities used in the subnational report (sort of a worst case scenario) and thus, there is reason to suspect that the national ranking under-represents the conditions businesses likely face in the country. Second, there is considerable diversity in conditions among these four pillars between various cities and third, this suggests that business climate reforms and projects are likely underway to different degrees across the country. Fourth, it shows that there is a possibility of demonstration effects. If regions are permitted to experiment with reforms, their success may help provide important lessons and models for improvements elsewhere in Russia while failures could show which practices to avoid.

Figure 5 below shows how Russia performs across the ten pillars used in the World Bank’s *Doing Business Index* in 2012 and 2013. The further downward the bar, the lower Russia’s rank within the pillar. First, within a year, very little change has been seen generally across all pillars with the exception of paying taxes. This suggests that the country would need to take much more aggressive action to achieve a climb of 100 places within 6 years. Second, basic bureaucratic areas related to dealing with construction permits, getting electricity and trading across borders are those areas that harm Russia’s rank the most while the country seems to do relatively well in contract enforcement.

**Figure 5 – Russia Across Doing Business Pillars**



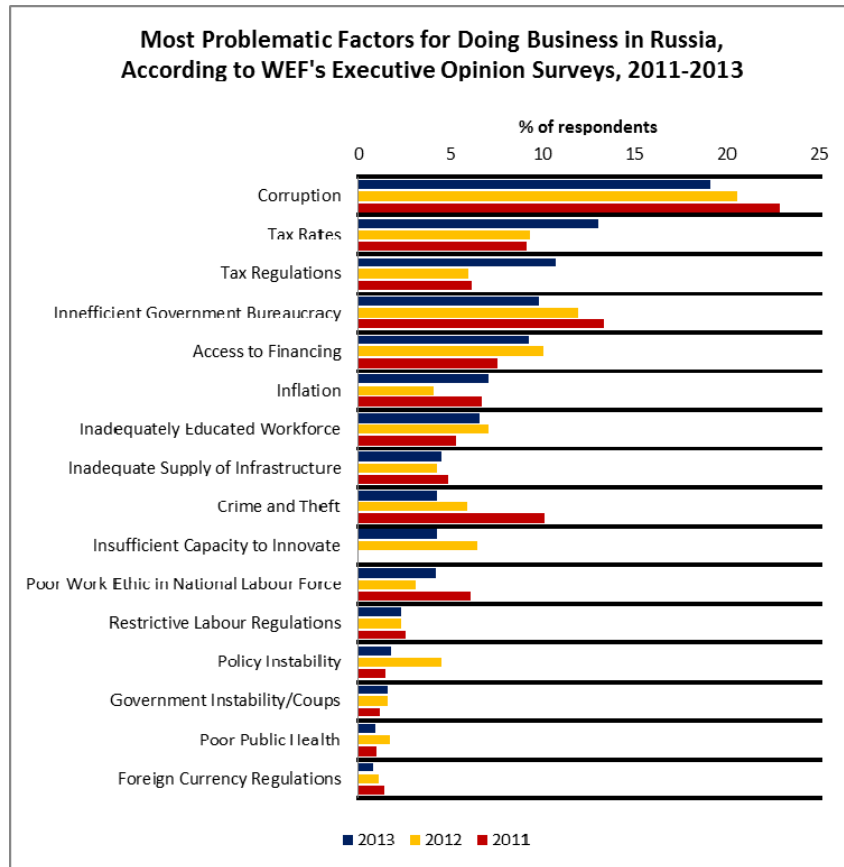
Figure 6 below shows the top twenty indicators for Russia in the World Economic Forum’s *Global Competitiveness Index* (GCI) in terms of worst rank relative to other countries. The country currently ranks 64<sup>th</sup> overall, and these indicators can be used to show which ones are related to holding the country back from ranking even higher. At the top of the list (out of 114 indicators) are imports as a percentage of GDP, but also other critical aspects of the country’s business climate, such as road quality, property rights, minority shareholder rights, availability of the latest technologies, and the impact of business rules on FDI.

Figure 6 – Russia’s Top 20 Worst Indicators in the Global Competitiveness Index



Figure 7 shows the results from the World Economic Forum’s Executive Opinion Surveys across three years (2011-2013). Business leaders were asked to choose from a list of 16 areas which ones they thought presented the most significant barriers for doing business in the country (except in 2011, when there were 15 areas on the list). First, the overall ranking of issues seems to consistently indicate corruption, tax rates and regulations and inefficient government bureaucracy as the most problematic factors for doing business in Russia. Second, the views of executives have changed over the years, notably some improved perception of the level of corruption or its impact, as well as the inefficiency in government bureaucracy. Tax rates and regulations, however, appear to have worsened even though they show up more favorably in the *Doing Business Index*.

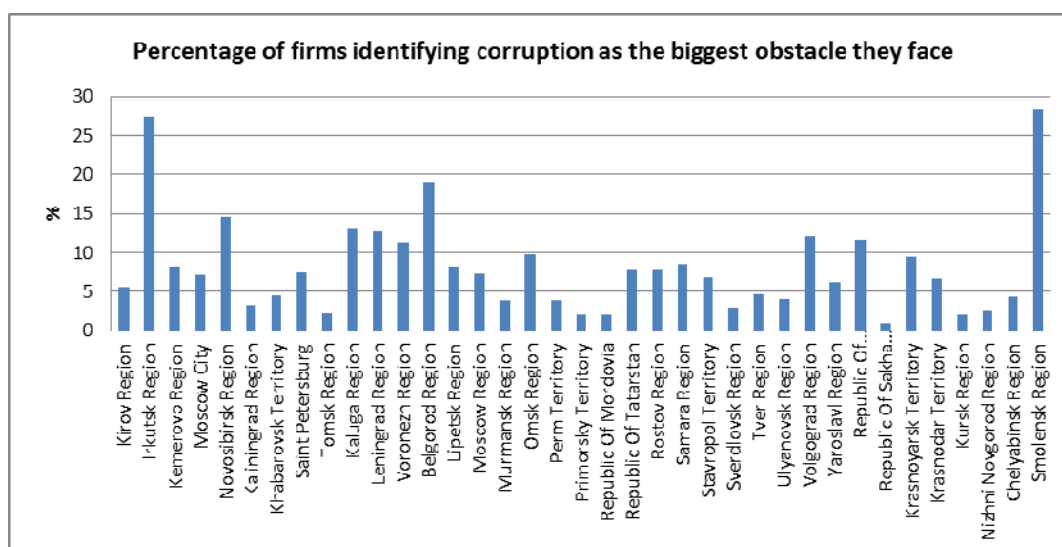
Figure 7 – WEF’s Executive Opinion Survey Results for Russia, 2011-2013



A closer look at corruption is presented in [Figure 8](#), which shows results from the World Bank’s Enterprise surveys broken down by regions within Russia. The data show the percentage of firms surveyed identifying corruption as the biggest problem they face. Surprisingly, there is considerable variation across regions suggesting that there might be other problems considered even more severe than corruption; if corruption is as high as it appears above in other figures, this would be even worse. However, it might also have a silver lining in suggesting that many areas in Russia have found ways to deal with this issue.



Figure 8 – The Corruption Barrier Viewed Across Russia’s Regions



This range of diversity within a single issue demonstrated the complexity of relying too heavily on a simple, single, indicator in any of the indexes as a basis for reforms.

**In a country as large and diverse as Russia, a much closer examination is needed across indexes, indicators, sectors and regions to identify which reforms are needed most in addition to which types of reforms might be most suitable for which areas. It appears that significant variation of business climate conditions within the country might be a strength in the sense that successful reforms in one region may be tailored to fit and implement elsewhere.**

## 1.2 Competitiveness in Russia’s Tourism Sector

**In the most recent World Economic Forum World Travel and Tourism Competitiveness Index, Russia’s rank fell slightly from 59<sup>th</sup> in 2011 to 63<sup>rd</sup> position.**

*In addition to the likelihood of considerable diversity of business climate conditions across regions in Russia, relative conditions are likely to vary across activities and sectors. This section looks at tourism for several reasons. First, data and rankings are available due to the publication of the World Economic Forum’s World Travel and Tourism Competitiveness Index. Second, there are data across two years allowing for some degree of progress or regress to be assessed. Third, despite a great potential for tourism, and the possibility that the Winter Olympics in Sochi (2014) might provide a stimulus for investment activity, BCDM’s regular monitoring activity has come across scant evidence of investors publicly announcing much in terms of future investments in this 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. However, as will be shown in *New Investment Announcement Activity* in Section 2 of this Report, there is little evidence that much investment is expected to take place in tourism in the near future when it comes to investors publicly announcing their intentions.

Figure 9 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 63<sup>rd</sup> place, down from 59<sup>th</sup> in the Forum's last the *TTCI* in 2011, and relatively behind all of the economies in Eastern Europe except for Serbia (89<sup>th</sup>), Moldova (102<sup>nd</sup>), Macedonia (75<sup>th</sup>) and Bosnia and Herzegovina (90<sup>th</sup>). Russia further ranks behind China (45<sup>th</sup>), but ahead of the other transition economies in Eurasia.

**Figure 9 – Russia Relative to Other Transition and BRICS in WEF's TTC Index, 2013**

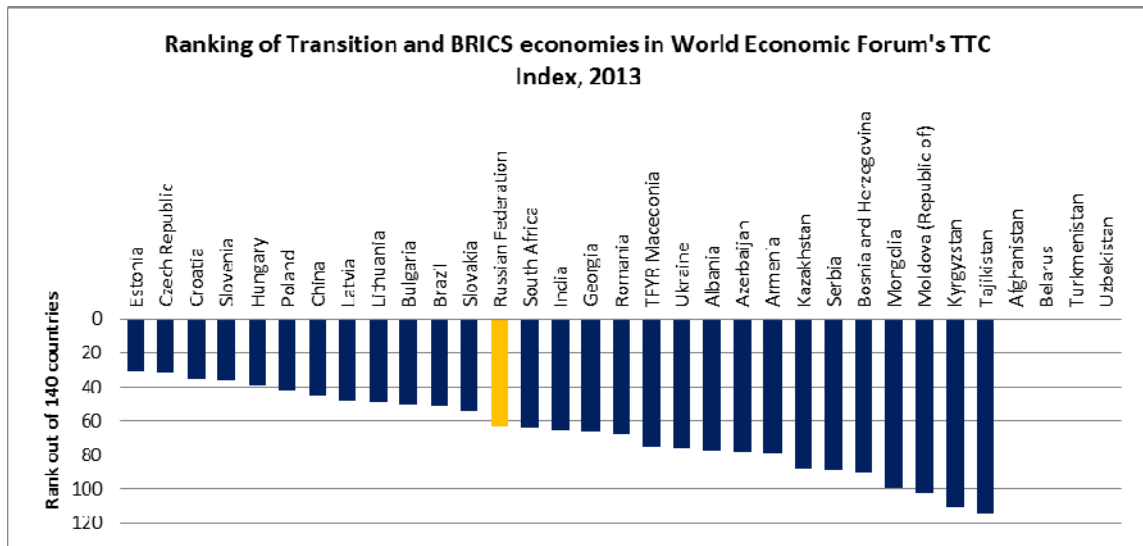
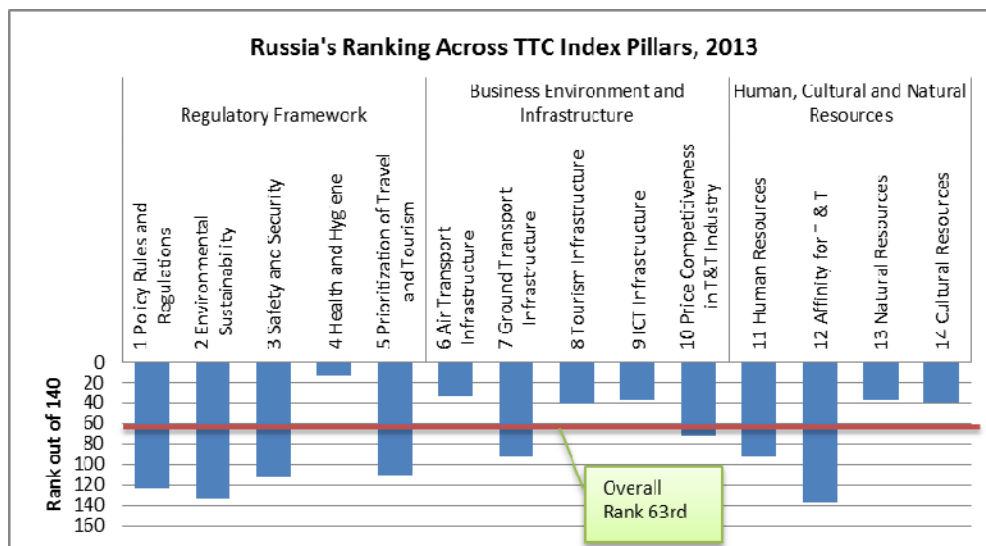


Figure 10 provides a closer look at Russia's ranks across the three categories and 14 pillars in the TTC Index. The red line shows Russia's overall rank of 63<sup>rd</sup> to highlight in which pillars Russia ranks above its score and in which below. This helps draw attention to which areas are pulling Russia's ranking downwards.

**Figure 10 - 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 hygiene 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 openness 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 and should be enhanced.**

## 2 Indicators

**BCDM's 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 Semi-Annual Report released in June and the last Quarterly Report in July.**

Improving a country's Business Climate is not an easy task. It takes considerably time, effort and energy, as well as commitment from stakeholders, to identify and prioritize where reforms are needed the most in addition to carrying them out, monitoring and evaluating change as well as accepting some degree of responsibility, or accountability, for successes and failures.

Not carrying out much-needed reforms, however, also comes with costs, risks and responsibilities. Investors may seek other, more attractive, locations for production and, given the opportunity to leave, the country may experience some difficulty retaining those businesses that are already located there. With fewer opportunities for production and work, skilled workers may also find it more attractive to leave and overall, these problems would likely hinder growth, investment levels and a host of other socio-economic indicators.

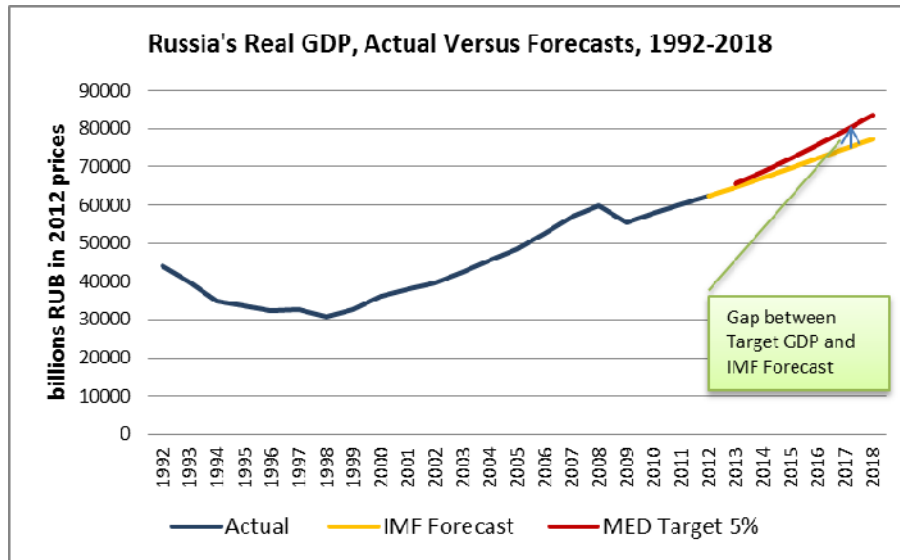
This section overall focuses on a small selection of outcome indicators related to the quality of Russia's business climate. In other words, levels of growth, investment and future investment activity, that business climate reforms often aim to improve. These indicators serve as a reminder or incentive for why business climate reforms are necessary in addition to helping prioritize, potentially, which reforms matter most.

### 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 three quarters of this year from close to 4% to as low as 1.8% 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 11 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 11 - Actual Versus Forecast GDP for Russia, 1992-2018**



After declining for most of the 1990s, Russia's economy started to grow positively again around 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 at least 2018; the extent of the current forecasts).

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. During 2013, so far, growth has declined to levels hovering around 0% between quarters suggesting this target may be even more difficult to achieve any time soon. 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, both to achieve or exceed the target, but also to deal with looming stagnation in the shorter term.**

### **2.2.1 Current Year - 2013**

*Forecasts for growth in 2013 have declined across institutions during the first three quarters of this year from a range of 3.3 to 4% to a range of 1.8 to 2.5%. It is not known yet, however, 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 12 - GDP Forecasts for 2013

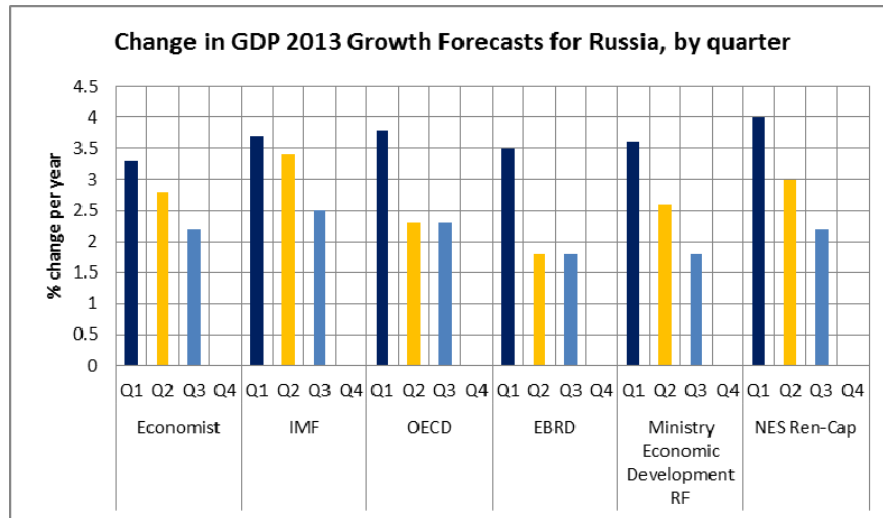


Figure 12 above provides forecasts for Russia's growth rate in 2013 across a sample of institutions and shows how these forecasts change from one quarter to the next. The forecasts during the first quarter, shown in dark blue, were generally higher than those made during the second and third quarters, shown in yellow and light blue respectively. 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%. More recently, in August in Q3, they further reduced this to 1.8% in response to more information about how slowly the economy appears to have grown so far this year. 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% in Q2 and now to 2.2% in light of information on how slowly the economy has grown in the first half of the year.

**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 13 below shows the RenCap-NES estimates for quarter-on-quarter growth, seasonally adjusted, for 2013. Forecasts for Q1 indicated that the economy was expected to grow by -0.1% since Q4 of 2012, but in fact the economy appears to have shrunk by even more than expected, by about -0.24% according to the latest ROSSTAT estimates. Later quarters, Q2, Q3, and Q4 are now expected to show signs of positive Q-o-Q growth at rates of 0.6%, 0.8% and 1.2 % respectively. The original slowdown in the first half of the year was seen as partially due to weaker performance across a number of key industrial sectors in Russia continuing to hinder performance coupled with stagnant commodity prices, while now there are indications that the economy may have bottomed out in the first half and be experiencing a mild turnaround now.

**Figure 13 - Seasonally Adjusted Q-o-Q Growth**

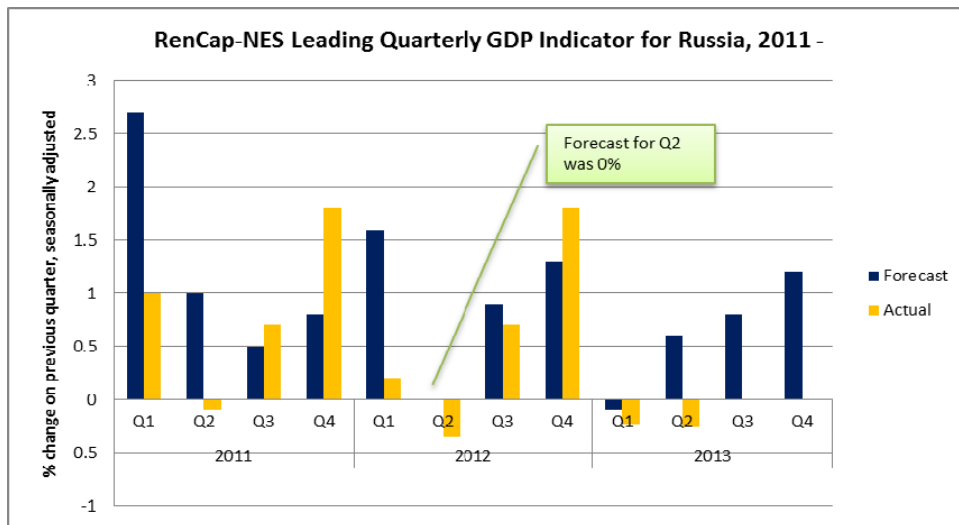
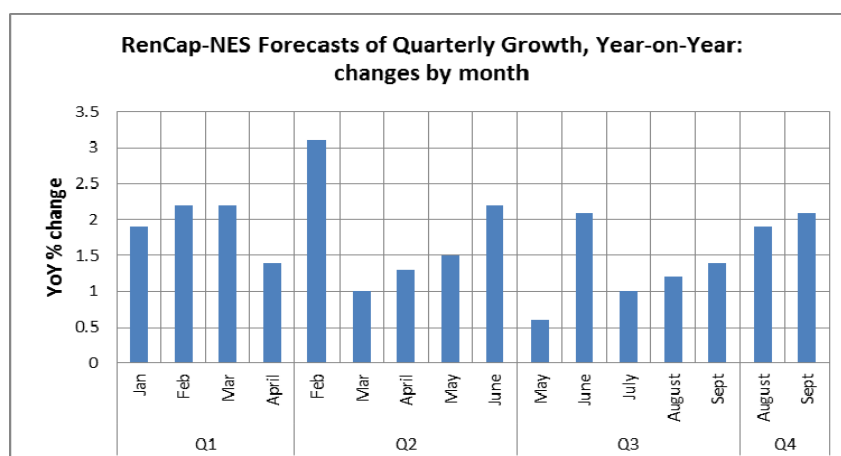


Figure 14 below shows growth forecasts for all four quarters of 2013 relative to the same quarter the previous year. These year-on-year forecasts provide insight into how well the macroeconomy is performing relative to the same period last year without having to adjust for seasonal effects between quarters, as was done above. Further, this graph shows how the forecasts for each quarter have changed monthly to use the latest statistics available to assess whether there are indications of a slowdown or pick up in performance.

**Figure 14 – RenCap-NES Y-o-Y Quarterly 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 and June with signs of mild recovery. This is in part due to slightly better consumer spending. Current estimates for Q3 remain weak although there has been a rise since the summer, also in part due to a possible turnaround. The most recent, and initial two months, of forecasts for Q4 show that positive Y-o-Y growth is expected.

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, with the first half of the year experiencing some of the worst growth since 2009.

**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 -\$28.2 bln, up from the earlier estimate of -\$25.8 bln. Both figures are 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 more than half of the total estimated outflows for 2012 of -\$54.1 bln.*

Figure 15 shows net private capital flows per quarter since Q1, 2006, to the latest quarter for which an estimate is available, Q3, 2013. Data has also been updated as far as possible due to revisions since BCDM's Semi-Annual Report in June, although overall trends remain unchanged as a result.

The estimate of net private capital outflows for Q1, 2013, is at -\$28.2 bln, a 244% increase over the outflows of-\$8.2 bln in Q4 of 2012. Estimates for Q2 and Q3 are -\$7 bln and -\$12.9 bln respectively. Part of the explanation for this sudden increase in Q1, however, is likely linked to the recent TNK-BP takeover by Rosneft announced in March, making Rosneft the largest listed oil producer in the world. The \$55 bln deal involved a transfer of an estimated \$16.7 bln to BP.

After the 2008 crisis, the figure below shows that there was a dramatic increase in net outflows at the end of 2008 followed by several other larger quarterly outflows in 2009 (compared to the more recent quarterly outflows). Further, at the end of 2010 and beginning of 2011, there was another

wave of outflows and this continued on a larger scale at the end of 2011 and beginning of 2012 (partially associated with political uncertainty in Russia coupled with the Eurozone crisis).

**Figure 15 – Net Private Capital Flows by Quarter**

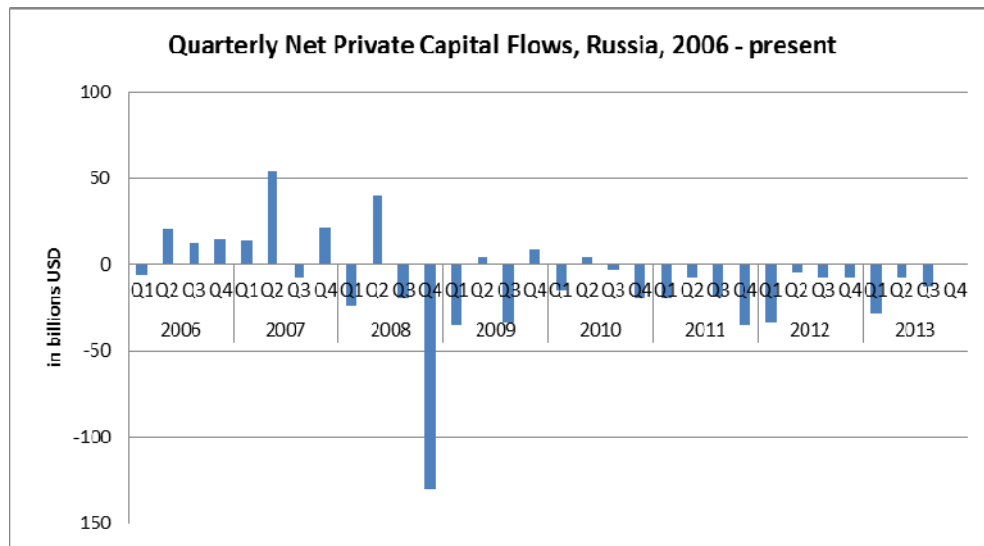
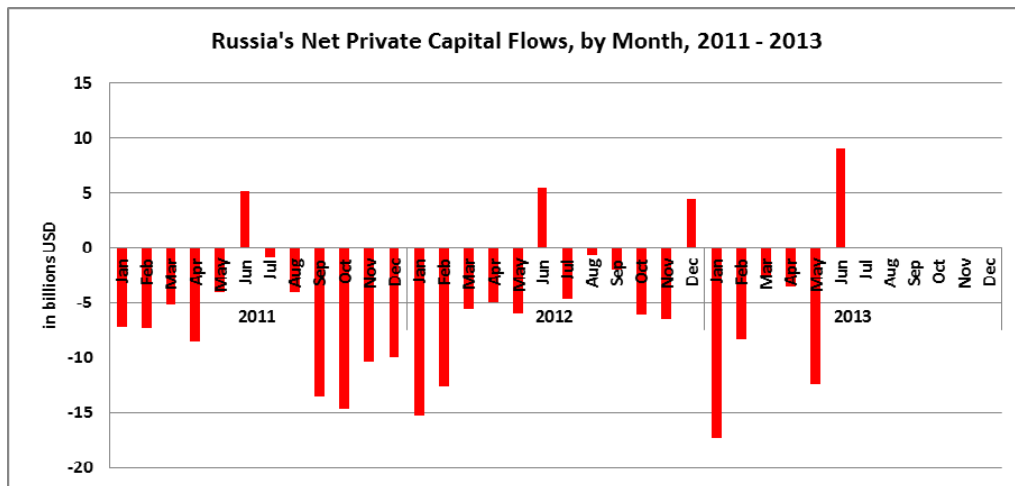


Figure 16 below shows greater detail on net private capital flows for Russia by month to the latest month for which data has been published by the Bank of Russia; June, 2013. This figure provides a clearer picture of the rise in net capital outflows from Russia in the months leading up to and during 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 16 – Net Private Capital Flows by Month**

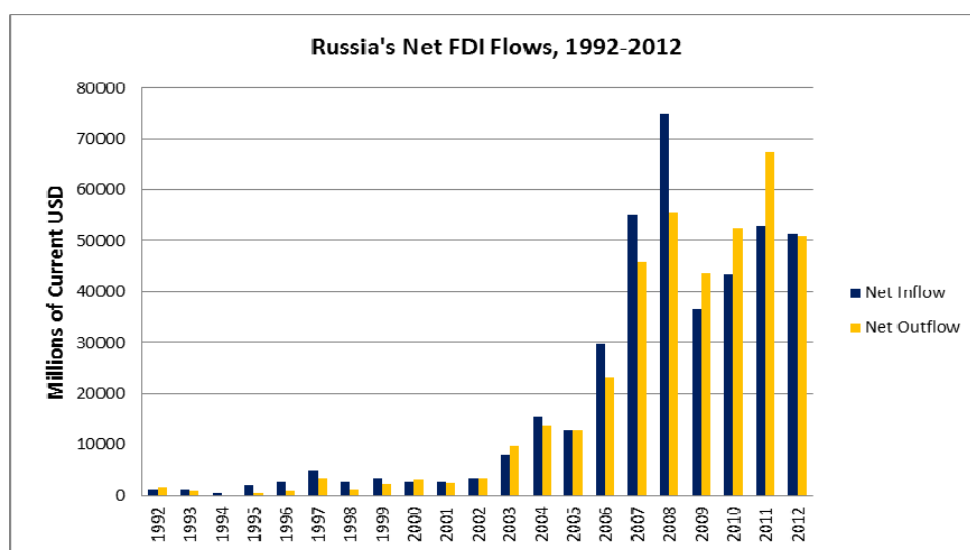


Although more evidence is needed to draw a stronger set of links, the wave of net capital outflows in 2013 might be due to debt restructuring in Europe and stagnation in Russia's economy.



Figure 17 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 17 - 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 \$40.7 bln while net outflows are an incredibly high \$67.183 bln. This may be due largely to the Rosneft- BP-TNK deal mentioned above. To date, there is not enough information available to explain this substantial increase given that the net flows for just one quarter of 2013 exceeding those for all of 2012. 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.*

During the past twelve months, covering October 2012 through to, and including, September 2013, a total of 536 new investment announcements were tracked for a total value for those which disclosed financial details of \$ 546.7 bln. 47 % of the total value was in the energy sector, which continues to dominate other activities in value terms, but represents only 26% of the total number of announcements.

A total of 906 new investment announcements have been tracked to date, since December 2011, for a total value of \$ 1652 bln for those which disclosed investment figures. \$720 bln alone ( 43.5%) 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, represents 27.4%.

*The following sections provide an update on the value and number of new investment activity tracked by month and sector.*

***New Investment Announcement activity continues to indicate that future investment activity in Russia will likely continue to be dominated by energy-related activities as far as publicly disclosed investors' intentions are concerned. Further, a small number of large scale, multi-year, energy projects will likely continue to play a vital role, overshadowing other investment activity and indicating further that the country is exposed to a high degree of success of these projects and dependence on energy prices, namely oil and gas.***

#### [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.

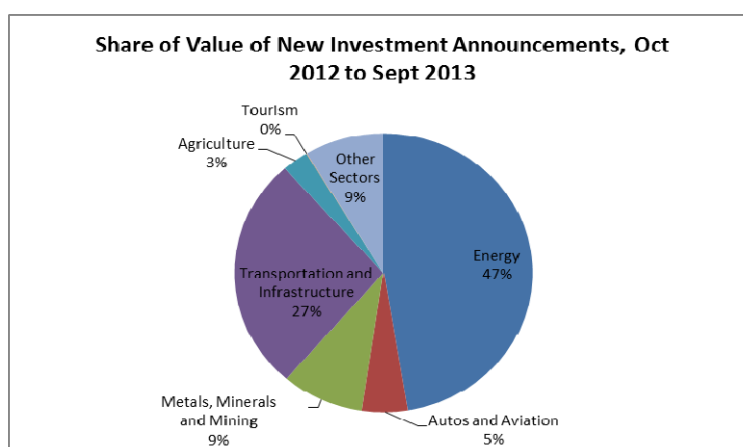
This data, however, have to be used with caution. They do not represent actual investment levels since they have not necessarily taken place yet and it is possible for an investor to backtrack on commitments made in response to unforeseen changes in conditions. Second, not all intentions to invest are 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 12 months 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 12 months, a total of \$ 546.7 bln worth of new investment announcements have been tracked. [Figure 18](#) shows the share of this total value by sector. The vast bulk of new investment announcement activity, 47%, is related to energy sector activities. All other sectors combined, ranging from agriculture to automobiles, mining and minerals (outside petroleum and energy) represent 53%. 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 18 – Share in Value of New Investment Announcements, 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 pharmaceutical development. Second, many of the other announcements tracked do not fully disclose financial figures. These two issues tend to result in energy overshadowing the rest of the economy.

Figure 19 below instead provides a picture of the share of each sector out of the total number, 536, new investment announcements tracked during the past 12 months. “Other Sectors” is typically dominated by retail investment announcements and this accounts for 23% of the total whereas energy now represents 26%. Further, this diagram shows much more activity and diversity actually taking place that would be otherwise hidden by the financial size and scope of energy investments. This is potentially promising, in the sense that Russia is attracting these other kinds of investments outside energy, however, it is unclear to what extent the boost in energy activity supports or it tied to these other activities.

Figure 19 – Share in Number of New Investment Announcements, by Sector

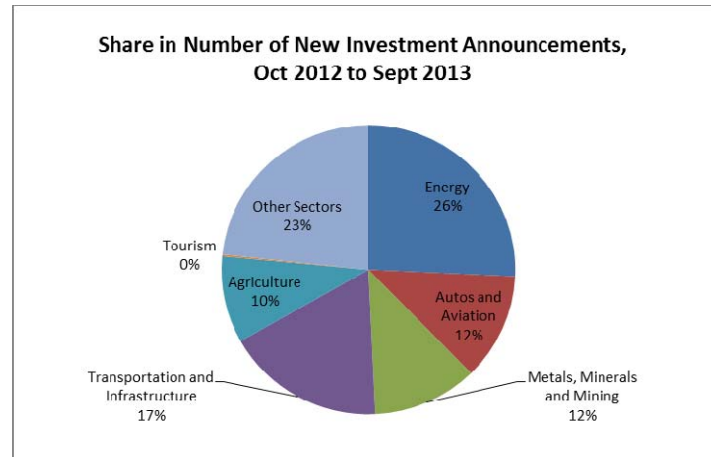
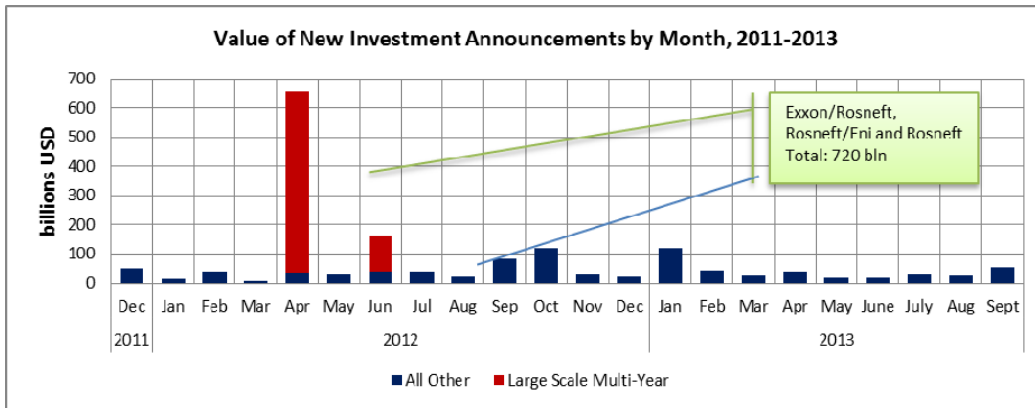


Figure 20 below provides a breakdown of the total value of investment announcements tracked each month for the whole period (22 months) beginning in December, 2011 and ending on September 30, 2013. It also makes an adjustment for three large scale, multi-year, investment announcements in Energy in April and June of 2012 that were related to Rosneft and totaled \$720 bln (43% 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.

Further, an apparent slowdown in value in 2013 is consistent with low levels of investment activity and growth slowdown in Russia. Many investors may have turned off publicly stating further future commitments, or be holding off for better times ahead.

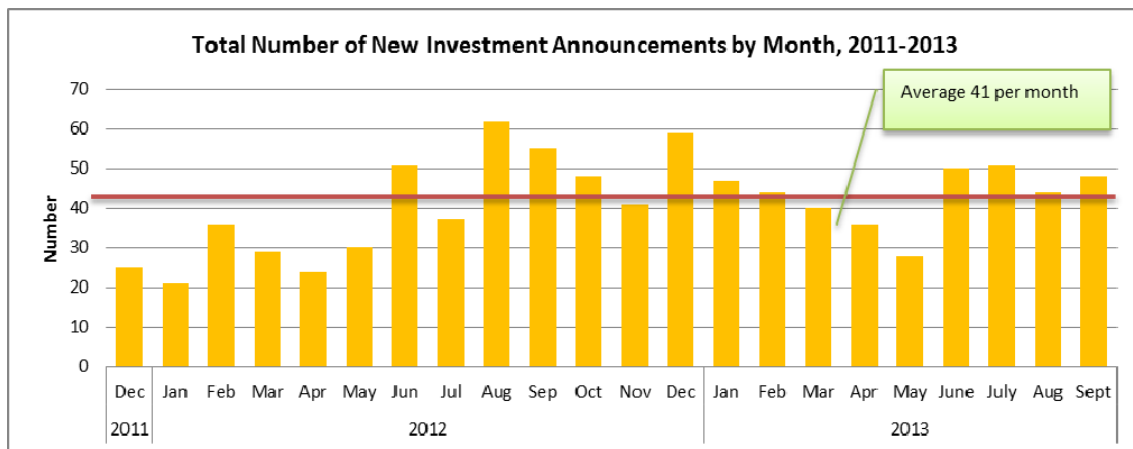
Figure 20 – Total Value of New Investment Announcements, by Month



These trends are more obvious by turning to the number of new investment announcements by month in Figure 21. The red line represents the average per month of 41 announcements (up from 39 reported in BCDM's Semi Annual Report in June) and the first half of 2012 upto June falls under this average while the remainder of the year is generally above.

Further, the dropoff in number in 2013 is primarily in the first half of the year, when little or no growth seemed to take place, while there appears to be a pickup in the second half, consistent with signals that the economy might be showing signs of a mild turnaround.

Figure 21 – Total Number of New Investment Announcements, by Month



Although these overall trends lend some support to the idea that political instability and growth may be important factors in changes in investors' intentions to publicly commit, 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.

## 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.

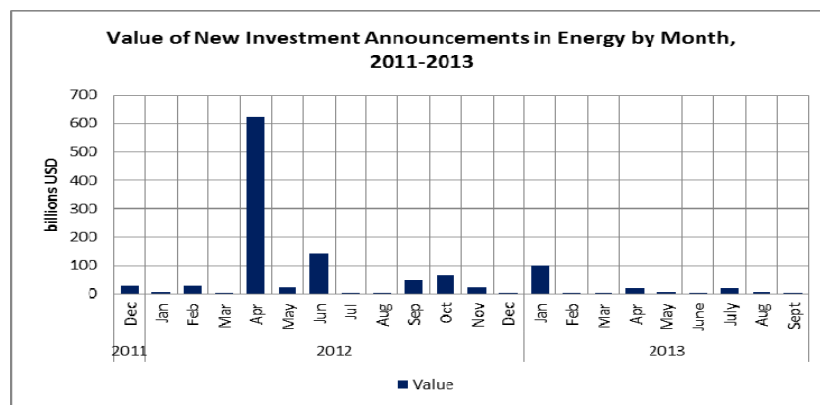
## 2.4.2.1 Energy

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, nuclear power, or more traditional oil and natural gas.

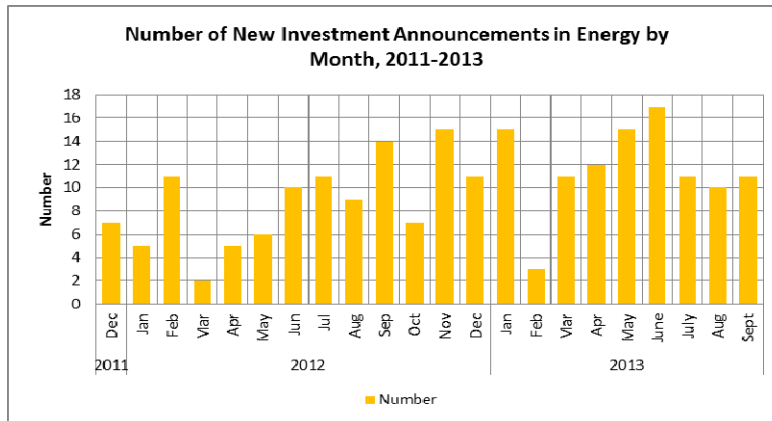
During the past 12 months, 138 new investment announcements were tracked in this sector representing 26% of the total and worth an estimated \$258.8654 bln (47% of the total value). Russia, however, is well known for its abundant energy resources and ranks high in the world in terms of proven oil (8<sup>th</sup>), natural gas (1<sup>st</sup>), and coal reserves (2<sup>nd</sup>), 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, 2012, related to Rosneft and its partners, totaled \$720 bln. These two months show up easily in Figure 22 which shows the value of new investment activity in this category during the past 22 months. These three investment announcements alone account for 44% of the total announcement activity tracked during the period.

Figure 22 – Value in Energy, by Month



Due to the problem of scale in this category, it was important to separate out the number of investment announcements by month. This is shown in Figure 23 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 for 2012 and remains high into 2013 with the exception of February.

**Figure 23 – Number in Energy, by Month**

The data overall suggest that future investment activity in Russia is likely to continue to be highly related to the energy sector, and in particular, dominated by several large scale, multi year projects which together represent nearly half of all tracked investment announcements by value. This shows the risk the country faces in terms of continued future reliance on energy, energy prices, and the success of these projects (a cut back in any one of them could have serious consequences).

#### 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, 64 new investment announcements were tracked during the past 12 months for a total value of \$27.5 bln. This represents only 5% of the total tracked value of new investment activity, but 12% in terms of the total number of announcements.

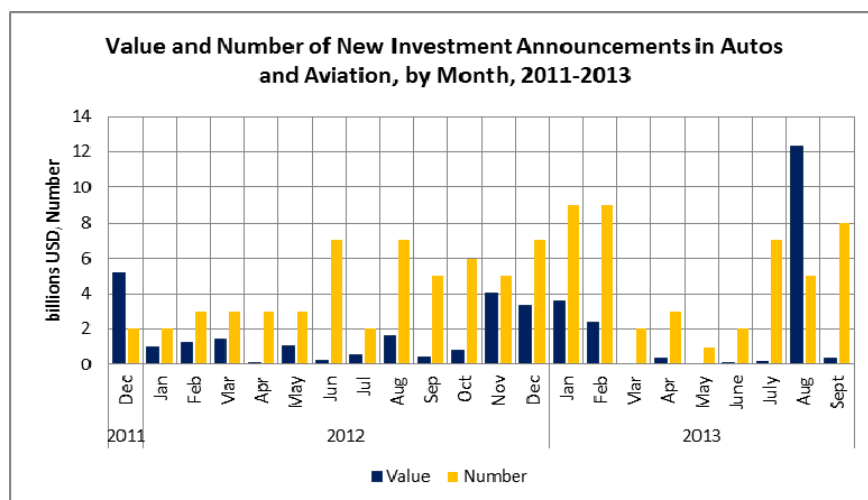
Figure 24 below shows the total value and number of new investment announcements related to Autos and Aviation by month since December, 2011. Generally, in this sector many new investment announcements do not disclose the full value of investments to be made. However, it appears that the number of investments has increased during the past 18 months up to March of this year when a noticeable slowdown in both value and number set in.

The increase in activity in the second half of 2012 would appear to be consistent with political risk that year while the slump in 2013 coincides with the industrial slowdown and stagnant economy, picking up later when the economy has indications of recovery. As noted above, new investment activity is about future expansion, not current levels of investment expenditure, and thus, this might be taken as a sign that investors' in this sector were sensitive to making public commitments for further expansion until there were signs of growth.

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<sup>2</sup>.

**Figure 24 – Autos and Aviation by Month**



The latest data suggests that future investments in Autos and Aviation may be quite sensitive to economic growth, although more significant testing and evidence would be needed before drawing a stronger conclusion about the links.

### 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.*

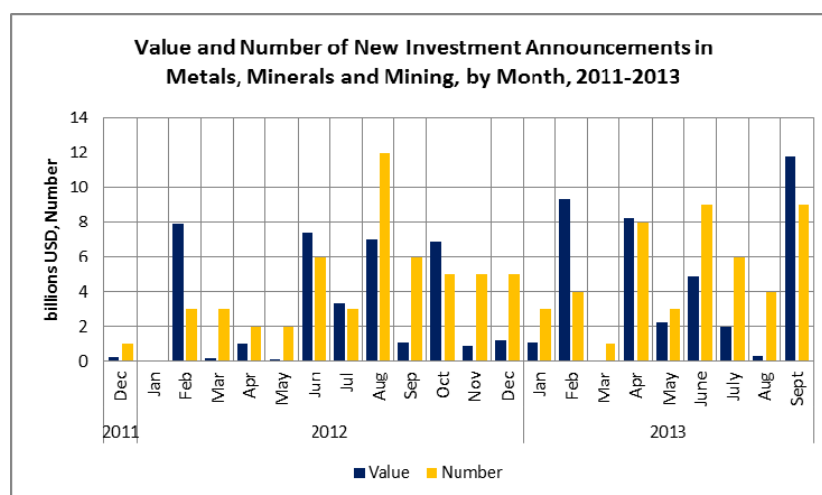
During the last 12 months, 62 new investment announcements in this category were tracked representing 12% of the total number worth \$ 48.6 bln, or 9% of the total value.

Figure 25 below shows the number and value of new investment announcements during the past 22 months. 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.

<sup>2</sup> See (Babushkin, 2012) for brief highlights on this market.



Figure 25 – Metals, Mining and Minerals by Month



However, the change during the 22 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 significantly in June.

**Although the new investment announcement activity in Metals, Minerals and Mining appears to be consistent with political risk in the first half of 2012, this sector does not appear to be as sensitive to the slump in growth in 2013 as others. This might indicate that the future of this activity has remained unchanged.**

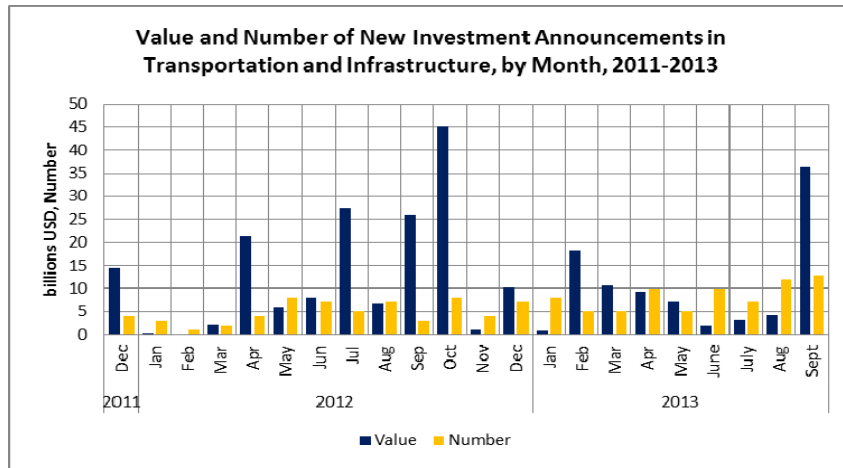
#### 2.4.2.4 Transportation and Infrastructure

*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 12 months, 94 new investment announcements were tracked in this sector representing 17% of the total. In value terms, there were \$148.7 bln of worth of announcements representing 27% of the total value.

Figure 26 below shows the value and number of new investment announcements by month during the past 22 months. 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 26 – Transportation and Infrastructure by Month**



New investment announcement activity in this sector appears to be consistent with political uncertainty in 2012, but less clear in terms of its relationship to the recent slump in growth likely indicating that these longer term projects are less sensitive to short term fluctuations.

### 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 12 months, 52 new investment announcements were tracked in Agriculture representing 10% of the total number and were valued at \$15.5 bln, or 3% 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 27 – Agriculture by Month**

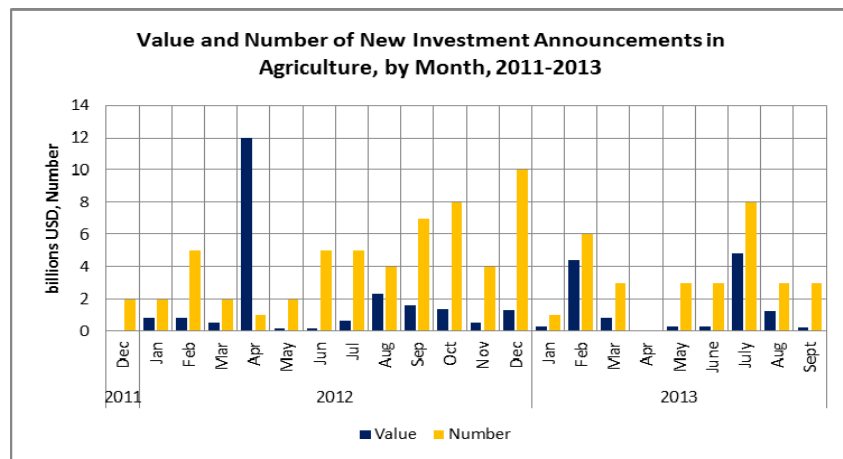


Figure 27 above shows the value and number of new investment announcements in this sector during the past 22 months. With the exception of April, 2012, it generally appears that activity picked up in the second half of 2012 in both number and value, before slumping during the first half of

2013. 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, the relationship to the economic slump in 2013 is less clear. 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 and early 2014 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<sup>3</sup> 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.

**Given Russia's potential for growth in agricultural products, the low amount of new investment announcement activity should raise some concern since it suggests that there may be little future investments in this sector relative to others.**

#### 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.*

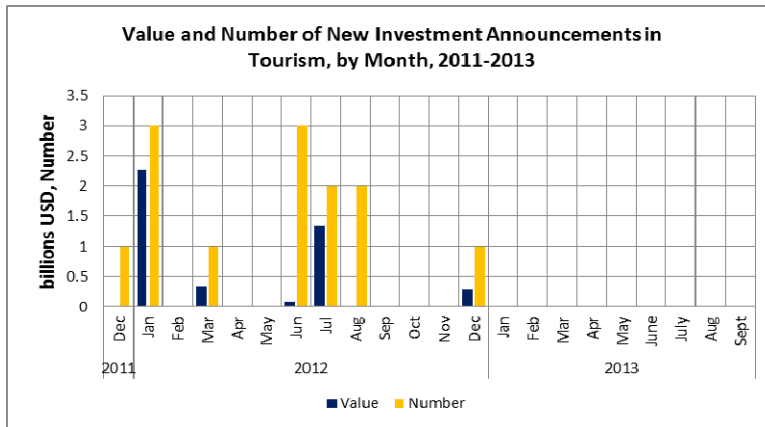
During the past 12 months, only 1 new investment announcements was tracked in this sector representing an insignificant share of the total. The value of these investment announcements, to the extent that financial figures were disclosed, totaled \$0.3 bln.

Figure 28 below shows the value and number of new investment announcements in tourism by month during the last 22 months. 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.

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<sup>3</sup> See (Mentyukova, 2013)

Figure 28 – Tourism by Month



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* from 59<sup>th</sup> to 63<sup>rd</sup> 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.

**After some activity was tracked in 2012, this sector appears to show little signs of interest in terms of future investment activity, and given the potential of Russia for tourism, this should also be a cause for concern.**

### 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<sup>4</sup>.*

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 indicating investors’ intentions.

In this category during the last 12 months, 125 new investment announcements were tracked representing 23% of the total, yet the value was \$47.15 bln, or only 9% 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.*

<sup>4</sup> 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.

Figure 29 – Other by Month

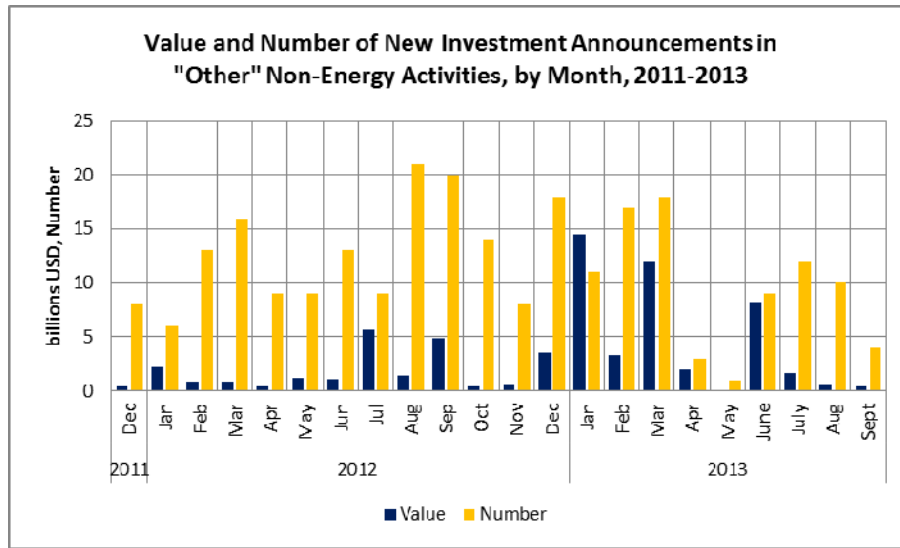


Figure 29 above shows the value and number of new investment announcements in this “Other” category since December, 2011. The trend so far shows the number of new investment announcements picking up in early 2012 before dipping in April and May, but generally remaining strong. Most of the public commitments in value terms took place after June 2012 but both appear to have dropped significantly in April and May 2013, suggesting to some degree that there might be a link between this activity and recent slump in growth.

**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 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 22 months. Many of the conclusions have not changed significantly from month to month, quarter to quarter or since our Semi-Annual Report in June. The Key Findings below are updated, where necessary, to reflect the changes that were monitored.*

**In addition to the lack of overall progress made in terms of the quality of the Business Climate compared to most other transition economies in Eastern Europe and Eurasia, BCDM has drawn attention to the risk of complacency (easy growth could permit putting reforms off even longer), the dominance the energy sector is likely to continue to play in future investment activity, the economy overall, and the risks this dependency imposes on the country's prosperity (should energy prices fall or one of the large projects fail, like Shtokman), the need to address political risk, regional needs and the pace of reforms.**

### ***3.1 The risk of complacency remains***

One of the two challenges addressed in this report is the growth slowdown. 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 below 2%. 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*, as argued in our Semi-Annual report specifically addressing this issue. 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. Failure in any of these projects would have a significant negative impact on the economy. 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, and a sharp decline in growth prospects for 2013, 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 20<sup>th</sup> 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 120<sup>th</sup> to 112<sup>th</sup> 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 59<sup>th</sup> to 63<sup>rd</sup> 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. Very little progress has been noted since June with the release of the latest World Economic Forum's Global Competitiveness Index.**

### 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 22 months, a noticeable portion in the value and number of new investment announcements involved activities and expansion plans outside of Moscow and St Petersburg. 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. It's also needed to help identify better practices as different regions experiment with policy reforms.**



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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 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 30 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.<sup>5</sup> This step is usually straightforward, but also involves some grey area where an investment may be announced in total sum, but involve both 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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<sup>5</sup> 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 30 - Filtering Process to Generate New Investment Announcement Dataset**

