Enhancing Opportunities: 2011 Russia Attractiveness Survey

By Ernst & Young

The world economic recovery continues. There are concerns about a double-dip recession and the recovery remains unbalanced. The world is no longer dominated by developed countries and the potential of emerging markets is recognised by business leaders globally.

Russia, like other BRIC countries (Brazil, India and China) has not had the lasting impact from the global economic crisis. It has a growth model based on high oil prices that has sustained its continued economic expansion. However, future drivers of growth need to be different, since there are new challenges: a demographic decline and increasing external competition.

Russia presents many advantages to foreign investors. It has abundant natural resources and a strong domestic market with a well educated and highly productive workforce. However, administrative barriers, lack of transparency in business practices and a recovering financial system often compromise the benefits of investing in Russia.

Russia's government and business community are committing to modernise institutions and technologies in order to increase Russia's attractiveness. Russia has great development potential and is finding new ways to compete and to lead.

THE GLOBAL CONTEXT: RUSSIA COMPETES AMONG GLOBAL REGIONS

The world becomes increasingly interconnected, regional gaps are being reduced

In January 2010, Ernst & Young launched a report which examined the impacts of globalisation on the world economy[1]. The report showed that the globalisation of the world's 60 largest economies will continue to deepen between 2010 and 2014. This interconnected world - with many but divergent spheres of influence - is the global context within which we evaluate Russian attractiveness.

In the wake of the economic crisis, many developed economies are still growing only slowly. Rapid growth in key developing markets has driven global recovery. Emerging markets are seen as an increasingly important source of growth, offering surging numbers of accessible consumers, and often attractive investment opportunities.

In 2005, the most attractive region scored 63% in Ernst & Young's European attractiveness survey, and the least attractive 6%. In 2011 the spread was between 38% and 11%, reflecting a more polycentric world in which emerging markets have become more attractive FDI destinations.

Global FDI flows rose by just 0.7% in 2010, but this figure hides significant differences in performance. Rapid growth economies received more than 50% of world FDI for the first time. The developed economies suffered a decline in FDI of - 7% (despite US FDI inflows surging 43%).

Russia consolidates and grows

According to the European attractiveness survey, Russia's attractiveness has almost doubled since 2005. In the meantime, Western Europe, formerly the leading region, has lost 28 percentage points in its attractiveness.

In Russia, although investors remain cautious against a variable global economic background, investment projects have begun to flow again. Russia's economic fundamentals stabilised in 2010, and the economy grew by 4%.[2] The value of FDI into Russia in 2010 was steady at US$37b, a positive sign when compared to the decline of 2009.[3]

Russia remains a fairly complex option for inward investors, especially small and medium enterprises. However, it is beginning to correct a past over-reliance on oil and gas exports and improve its attractiveness. At the same time, government policies have improved Russia's risk profile.

RUSSIA AS IT IS PERCEIVED: RUSSIA'S ATTRACTIVENESS PROFILE

Attractive for its promising market

Russia's domestic market is the country's most attractive feature for investors surveyed. Growth opportunities, especially in serving consumers, are "very attractive" for 30% of investors and appeal to 75% overall, an unusually high proportion. Today, though wealth is unevenly distributed, the Russian middle class has more disposable income and greater access to consumer products than ever before. Foreign investors see a unique opportunity to establish brand loyalty and capture market share across a diverse population.

Cost competitive labour

Investors say Russian workers are affordable. Overall, 69% find that Russia has attractive labour costs. Although not a low-cost destination in global terms, Russia offers an attractive alternative to wage rates in many European countries. The average Russian wage was US$593 per month or US$7,116[4] per year, in line with gross national income (GNI) per capita of US$7,530. When compared to labour costs[5] in Central and Eastern European countries, Russia is very competitive.

Improving productivity to increase market share

The potential for productivity gains is also a big appeal of locating in Russia. The possibility of improving corporate productivity in Russia is highlighted by 67% of investors surveyed, with 27% seeing a "very" good opportunity. Investors also understand that opportunities are greatest in sectors with the least government intervention,[6] where private companies can use efficiency to gain a competitive edge over rivals.

Investors clearly see opportunities to bring more advanced manufacturing techniques to Russia and use these advances to win market share. Although Russia has experienced solid productivity

[1] *Winning in a polycentric world: globalization and the changing world of business, Ernst & Young, 2011.*
[2] *IMF World Economic Outlook (WEO), April 2011.*
[3] *Doing Business in Russia, Ernst & Young, February 2011.*
[4] *World Bank 2011*
[5] *Approximated by GNI per capita*
[6] *The Russian Competitiveness Report 2011: Laying the foundation for sustainable prosperity, World Economic Forum, 2011.*

growth over the last decade,[7] the productivity gap between Russia and OECD countries remains large. Rapid growth and investment are essential to raise productivity in the Russian economy.[8]

The Russian government is beginning to create incentives that attract high-end manufacturing. Such manufacturing would allow Russia to develop leading-edge industrial production, while enhancing its internal market and service sector.

A complex operating environment

Investors see Russia's investment climate as enticing, but risky. They fret about three key areas: transparency, political stability and interaction with public authorities.

29% of investors say the "transparency of the political, legislative and administrative environment" is not attractive. This ranking highlights a fear among investors about protecting their investment in Russia.

Russia's legal system is uncertain for investors. Various Russian government bodies are implementing new regulations and decrees on diverse topics, including the tax code and regulatory requirements. Contract negotiations and due diligence on investments remain complex and lengthy, and do not always provide clear answers. Investors increasingly realise they must take extra care that their contracts comply with Russian law and protect investors from possible complications.[9]

21% of investors perceive the "stability of the political, legislative and administrative environment" as unattractive.

They worry that changes in legislation, the administration, or government policy may harm their investment projects or that they may lose control of their investment.

Perceptions of the investment climate in Russia have been impacted by the slow pace of structural reforms to enhance the role of the private sector, and by government efforts to reassert influence on some sectors of the economy.

Competition: Russia, the only rapid-growth challenger in Europe

Investors see an interesting combination of Asian and European investment perspectives.

Russia competes with Central and Eastern European countries for export-oriented, high value-added manufacturing projects. Yet Russia also resembles Asian countries, with a fast-growing economy, a need to upgrade infrastructure and a large and blossoming consumer market.

Investors see Russia increasingly in competition with Asian countries: 64% of investors identified an Asian country as its main competitor, while only 15% said Russia's main competitor was in Europe. Forty–six percent of investors chose China as Russia's main competitor, and 14% suggested India as its main investment rival. At the same time, Russia shares many important characteristics with European economies. Investors recognise this and say Germany (5%) and the US (4%) are its next closest competitors.

Russia is not a cheap labour destination such as China or India, though average Russian salaries are lower than those in Western Europe. Russian labour productivity is also higher than that of China or India. But per dollar of wage, a Russian worker produces half the output of a Chinese or an Indian worker. To attract more FDI, Russia needs to adopt a strategy similar to that of many Central and Eastern European countries. It must focus on improving its business environment, increasing efficiency and aligning productivity with international wage-productivity ratios.[10]

Commodities complicate growth

Russia had demonstrated rapid growth before the recent crisis, "but economic instability over the past decade, the result of a dependence on commodities, poor governance and weak procyclical economic policies, does not parallel with the Chinese or the Indian economies."[11]

Russia's apparent similarities to China and India are overestimated. Like China and India, Russia is a rapid-growth emerging market economy with a large internal market. But Russia also has the legacy of a developed economy, enormous natural resources and a comparatively well-educated workforce. Growth in Russia is tied today to commodity prices and output volumes rather than the price of labour, making consistent fast growth more difficult to attain.

RUSSIA AS IT REALLY IS: RUSSIA IS THE NUMBER FOUR FDI DESTINATION IN EUROPE

Russia has achieved clear success as a FDI destination, with a rate of growth in project numbers during 2010 outpacing the European average of 14%. Yet, its share of total European projects was little changed at 5% in a recovering European FDI market. The UK and France remained Europe's FDI leaders, but they lost market share to more cost-competitive countries, notably Germany, Poland and Russia.

The US, Germany and the UK were the leading source countries for FDI projects in Europe; China and India provided 6% of all FDI projects in the region. European inward FDI was focused on three sectors: automotive, business services and software, and innovation activities (R&D).

FDI projects into Russia have more than doubled over five years, growing through the crisis.

Although the value of FDI into Russia fluctuated significantly, especially during the global economic crisis of 2008-09, Russia has attracted more projects every year since 2006. The number of projects in Russia multiplied by 2.3 from 2006 to 2010. During this period, Europe experienced highly volatile FDI levels, ranging from -11% to +14%. FDI growth into Russia slowed, but was always positive.

Since 2004, Russia has pursued macroeconomic stability and sound fiscal policy. It has managed external debt well and accumulated foreign reserves. Government investments in infrastructure have also encouraged inward investment. Finally, higher prices for oil and other natural resources have attracted new investors. The combination of high natural resource prices and policies that promote stability has underpinned an increase in the number of investments projects.[12]

Russia's industrial sectors attract the most investment

Two thirds of Russia's export receipts come from oil and gas[13], and extractive industries remain key contributors to the Russian economy. But natural resources are becoming less dominant. In 2010, manufacturing provided 60% of aggregate GDP growth in Russia. Russian manufacturing grew by 13.4% in 2010, almost 2.8 times faster than extractive

[7] *The Russian Competitiveness Report 2011: Laying the foundation for sustainable prosperity, World Economic Forum, 2011.*
[8] *The Russian Competitiveness Report 2011: Laying the foundation for sustainable prosperity, World Economic Forum, 2011.*
[9] *2010 Investment Climate Statement – Russia, Bureau of Economic, Energy and Business Affairs, US Department of State, March 2010.*
[10] *The Russian Competitiveness Report 2011: Laying the foundation for sustainable prosperity, World Economic Forum, 2011.*
[11] *Russian Federation – Concluding Statement for the 2011 Article IV Consultation Mission, International Monetary Fund, 14 June 2011.*
[12] *Russian Trade and Foreign Direct Investment Policy at the Crossroads, The World Bank Development Research Group Trade and Integration Team, David Tarr and Natalya Volchkova, March 2010.*
[13] *Doing Business in Russia, Ernst & Young, February 2011.*

industries (natural resources), which grew by 4.8%.[14] Although energy has dominated the Russian economy since the fall of the Soviet Union, industrial production has begun to increase, providing a more stable and skills-intensive basis for economic growth.

Foreign investors are attracted by Russia's industrial potential and have supported its growth. In 2009-10 manufacturing projects accounted for 54% of Russian FDI.[15] Strong growth of foreign investment in the automotive sector was encouraged by government policies to promote vehicle production. Significant investment also flowed into manufacturing of mineral products, food, chemicals, logistics and equipment.

Over the past five years, FDI projects in Russia were focused on the automotive sector, where 84 FDI projects created 17,690 jobs. Food production came in second, with 80 projects generating 9,766 jobs. Non-metallic mineral products ranked third, with 61 projects hiring 3,785 people.

Although by value, the largest share of FDI in Russia targets natural resource extraction, Russia's manufacturing potential clearly appeals to investors. The state policy to promote vehicle production has paid off. But Russia lags behind European averages in the race to develop a knowledge-based economy. Investment in business services and software averaged 25% of the total for 44 countries in Europe, but only 8% of investment in Russia.

Supplying Russia's consumers

Over the past five years, 52% of FDI in Russia has gone into manufacturing, reaching 54% in 2010. Sales and marketing accounted for 32% of projects. The emphasis on manufacturing and sales and marketing clearly suggests investors are targeting Russia's emerging consumers. In both production and sale of consumer goods, Russia is attracting the type of investment that will allow it to achieve well-rounded and steady growth.

But Russia's success in attracting investment aimed at consumer markets does not carry over into services or R&D.

Only 3% of Russian inward FDI projects are in R&D, and 1% in business support services, whereas for the 44 countries in Europe, the average for R&D is 8% and for business support services, 3%.

REFORMS AND EXPECTATIONS: ROADMAP FOR RUSSIA'S FUTURE ATTRACTIVENESS

Feedback from the investor community is broadly positive

Globally, investors still need to be convinced that Russia wants FDI: only 12% of investors believe that current Russian government policy to attract foreign investment is efficient. Another 44% think that it is probably effective, but 38% of investors think it does not encourage foreign investors, and 6% of investors cannot make up their minds on whether these policies are working.

Inconsistencies in Russian foreign investment attractiveness policy make it harder to improve the investment climate and investor confidence. In a positive development, the government recently allowed foreign investors to access strategic sectors, and to control private banks. But it has become more difficult for foreign car companies to operate in Russia and the government is planning to increase taxes on petroleum companies.[16]

Overall though, investors see Russian government initiatives to improve the investment climate as positive. They believe there is "a lot going on under the surface that we don't see in the news."[17]

A high level of confidence in the future attractiveness of Russia

Investors believe in Russia's opportunities: 70% are confident of the future attractiveness of Russia. This is a very positive score. It is more than double that of France, where 31% of investors are confident in France's future, or Germany and the UK where 47% of investors express confidence. The only region to challenge Russia on future attractiveness as an investment destination is Africa, where 72% of investors see bright prospects.

Recognising that further reform is necessary, the Russian government has outlined its objectives in the "3+5" formula, which builds on three strengths and addresses five priority challenges facing Russia.

The three strengths that the Russian government wants to leverage are natural resources, the size and growth of the domestic market and Russia's highly educated population. Reminding investors why investing in Russia is profitable, and highlighting the skills of Russian workers, will improve perceptions among investors who don't know the Russian market and eventually attract investment projects.

The five challenges that the government wants to tackle are reforming the inefficient and corrupt institutional framework; improving the quality of education; boosting competition to increase efficiency; stabilising financial markets and facilitating businesses' access to finance and increasing the sophistication of business practices. The Russian economy has many factors that attract investors. Lack of competition, instability and corruption can make investors nervous. By energetically and publicly tackling these problems, the government will boost Russia's long-term attractiveness to foreign investors.

Russian initiatives to promote foreign investment and combat threats to attractiveness

The Russian government has launched initiatives to enhance Russia's appeal for investors. In March 2011, President Dmitry Medvedev announced a 10-step plan to improve Russia's investment climate.

One element is a government-backed investment fund, designed in a way likely to change investor perceptions of Russia.[18] This Russian Direct Investment Fund will invest in IT, health care, infrastructure and other sectors - excluding energy - that could serve Russia's rapidly growing middle class.[19] The Fund will be capitalised with US$2b a year for the next five years. It will invest US$50m to US$500m in deals, with private investors matching the Fund's investments dollar for dollar.

This 10-step plan also focuses on fighting corruption, increasing transparency and improving the rule of law. These three issues have been major concerns for the Russian government and are among its top priorities.[20] Medvedev set up the Council for the Fight against Corruption and introduced anti-corruption legislation in 2008 when he came to power. It requires state officials to report their incomes and those of their family members.

[14] *Russian Economic Report, The World Bank in Russia, March 2011.*
[15] *Ernst & Young European Investment Monitor 2011, Ernst & Young, 2011.*
[16] *"The Russian Government's inconsistent policy towards investors," Center for Eastern Studies, 30 March 2011. http://www.osw.waw.pl/en/publikacje/eastweek/2011-03-30/russian-government-sinconsistent-policy-towards-investors*
[17] *Mark Dampier: "Look East, where streets are still paved with gold", The Independent, 8 January 2011. http://www.independent.co.uk/money/spend-save/mark-dampier-look-east-where-streetsare-still-paved-with-gold-2179079.html*
[18] *"Meeting of the Commission for Modernisation and Technological Development of Russia's Economy", Russian Presidential Executive Office, March 2011. http://eng.news.kremlin.ru/news/1981*
[19] *"FACTBOX-The Russian Direct Investment Fund", Reuters, June 2011. http://www.reuters.com/article/2011/06/13/russia-rdif-idUSLDE75C08H20110613*
[20] *"2010 Investment Climate Statement - Russia", Bureau of Economic, Energy and Business Affairs, US Department of State, March 2010. http://www.state.gov/e/eeb/rls/othr/ics/2010/138134.htm*