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Description of the key trends affecting investment in Russia

After the deepest financial recession observed in Russia in 2009 and in the beginning of 2010, the situation has started to stabilize, which is evidenced by the data on direct investments (see fig. 1). If in 2009 the investments abroad fell by 21.5%, and into Russian economy - by 51.3%, then in 2010, restorative increase was 20.3% and 18.6% respectively.

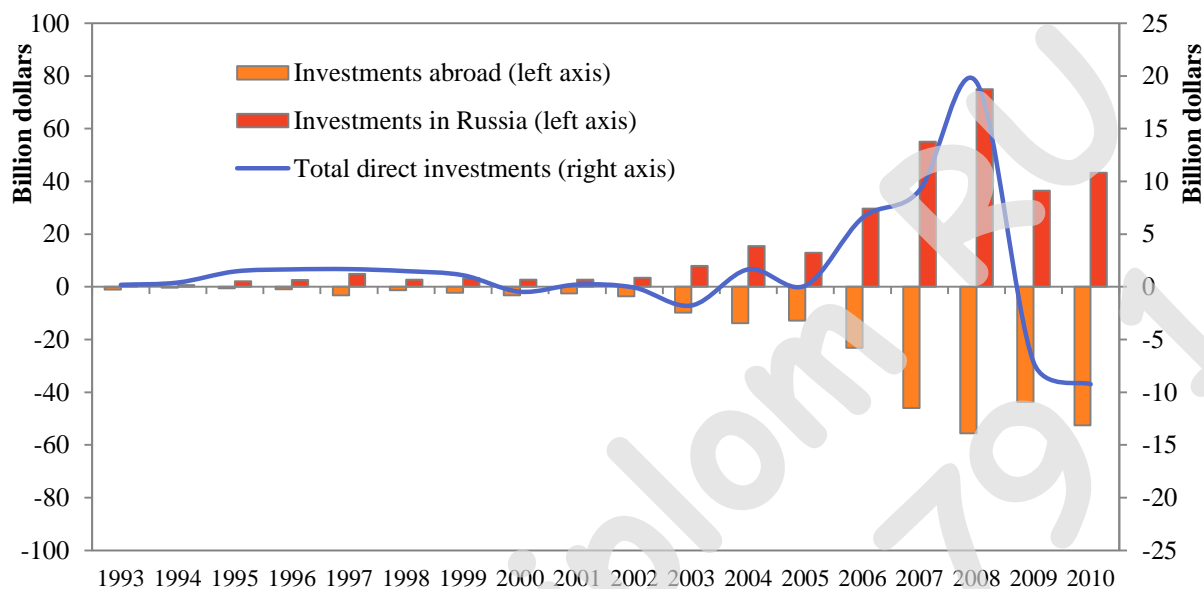


Fig. 1. Direct investments in Russia (RF CB, 2012)

However, the crisis has taken its toll - it has resulted in two consequences:

- first, the current pace of economic development, and this means, the investment activity as well, does not show the dynamics, observed in the pre-crisis period of 2003-08 (see fig. 2);
- second, investing abroad have become more popular than investing capital funds in domestic economy, which, according to the methodology of the Central Bank of the RF (CB RF), denotes capital outflow (see fig. 1).

Thus, on the whole, direct investments have decreased in Russia, and a large volume of them is flowing overseas. Although it cannot be said that this characterizes the situation in the country in utterly negative way. The dynamics of economic development remain stable (4.1% - GDP growth in 2012/13 (OECD, 2012), and the investments sent abroad in many ways determine whether the Russia's business meets global competition. Besides, it should be mentioned that capital funds are often transferred overseas in order to be invested into Russia by offshore companies, which have the chance to get benefits from the state pursuing active policy on attracting FDI.¹ Nevertheless, on the whole, the changes that have emerged denote a decrease of investment attractiveness of the Russian economy due to the impact of a range of trends.

First of all, there should be noted the influence of the established business climate - the Russian market, least of all, maintains sound competition compared to the developed market and BRIC countries². According to OECD data (2011), Russia is ranked second after China

¹ FDI – Foreign Direct Investment

² BRIC – a group of countries comprising Brazil, Russia, India and China

by Product Market Regulation Indicator (PMR)³, which indicates a high degree of market control and business having no initiatives required for efficient market development.

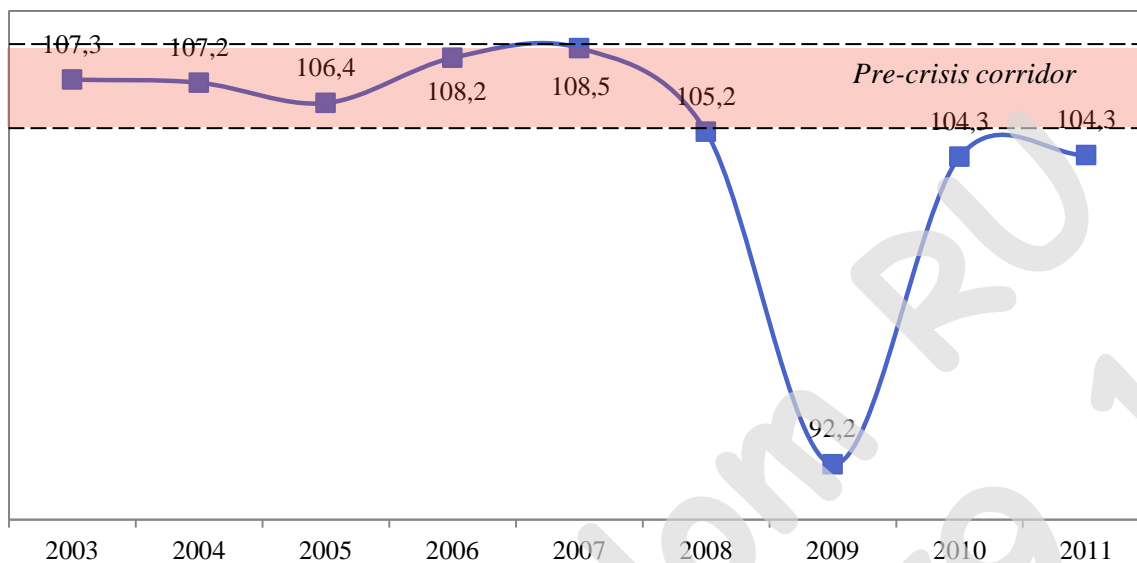


Fig. 2. GDP quantum index (FSSS, 2012)

In particular, the country is different for:

- a high level of economy regulation on the part of the state (second after China - 4.3 out of 5), which results in a large number of laws, standards and licenses;
- high barriers to enterprise (administrative burden on corporations - 11th place, on sole proprietors - 7th place, legislative barriers - 7th place) due to high level of bureaucracy, additional requirements on business, etc.;
- low efficiency of anti-monopoly policy (the last but one place) due to firm market positions occupied by the state enterprises and their subsidiaries, price collusions (gasoline at filling stations) etc.;
- extremely high level of corruption (the last place by purity of policy and business), which is manifested in bribery, nepotism, restriction of freedoms in order to satisfy the interests of third parties, etc. (OECD, 2011).

Of course, all the listed above characteristics had existed before the crisis as well, when a flow of direct investments to the country had been observed, however today their negative impact have become more noticeable for the investors due to a decreased attractiveness of the local economy. According to International Monetary Fund data (IMF, 2012), during the crisis, Russia experienced the deepest recession among BRICS⁴ and, according to the current forecasts, will no longer be able to compete against India in terms of GDP growth rate, occupying the same level as Brazil and South Africa (see fig. 3).

Apart from everything else, the investors are put off by the lack of clear perspective for Russia's development. Despite modernization policy pursued by the state government (CB RF, 2011), the country still depends on the sales of energy resources (gas, oil), as is evidenced by the reaction of the local stock market players to oil price changes (see fig. 4). Along with that, a range of weaknesses is revealed, identifying the problems in implementation of the

³ Hereinafter the positions of Russia are represented respectively of the countries members of the Organization for Economic Cooperation and Development (OECD)

⁴ BRICS – a group of countries comprising Brazil, Russia, India, China and South Africa

designed modernization plan: low activity at the level of research and development (R&D) in the Russian companies, underdeveloped conditions for invention and implementation of innovations (low level of competition, lack of a range of regulations, corruption), infrastructure that does not correspond to the requirements (OECD, 2011). In addition, the Russian state government is intended to persistently implement innovations through establishment of the institutions controlled by it, although, on the whole, the process should suggest providing support to the organizations at different levels (small and medium-sized business, corporations, etc.) (OECD, 2011).

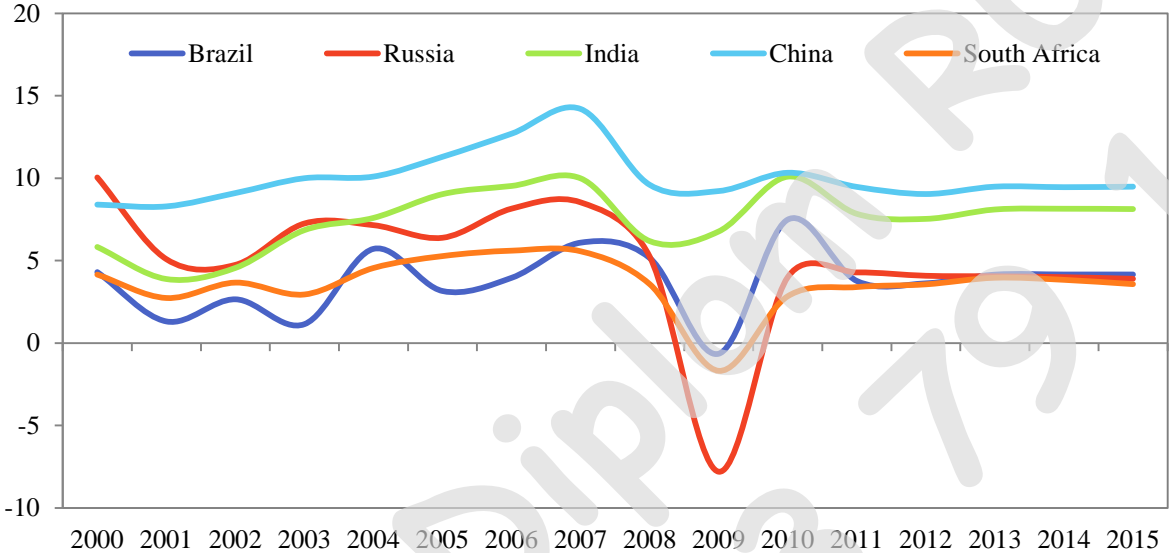


Fig. 3. GDP growth rates in constant prices (IMF, 2012)

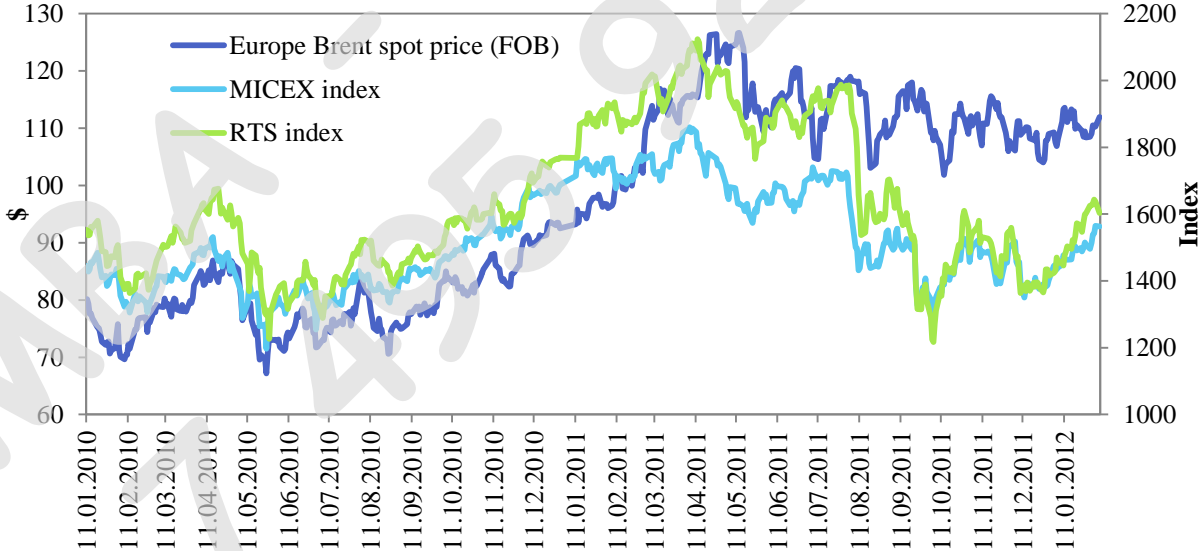


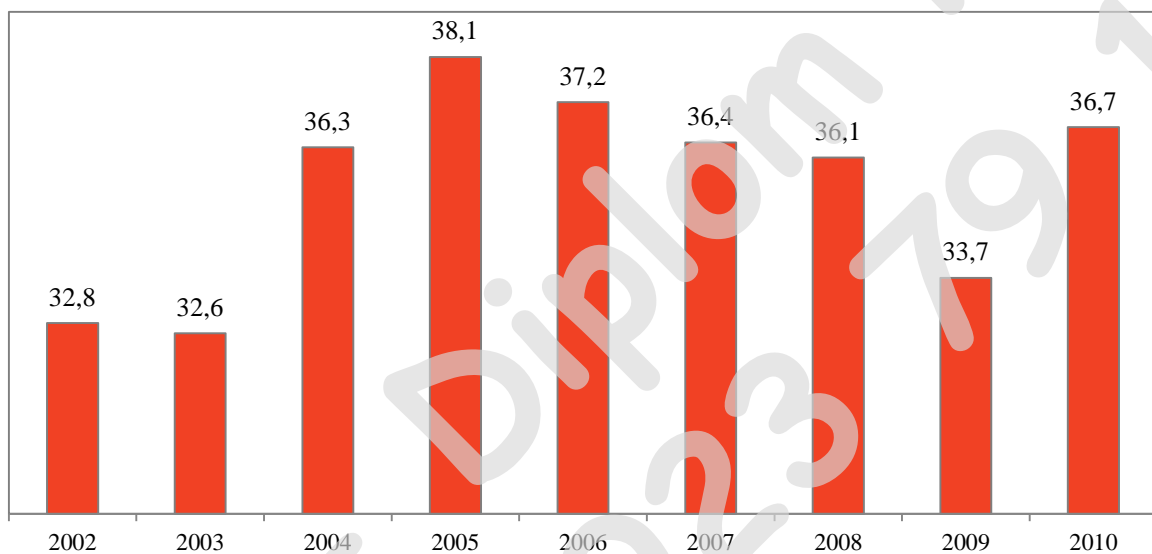
Fig. 4. Dynamics of oil prices and indexes of Russian stocks in comparison (RBC Quotes, 2012)

Thus, the current situation in Russia indicates economic stagnation and a lack of perspective to escape from the existing situation in the nearest years. Many factors causing such effect have systematic character and get formed at the level of politics and legislation, condoning the performance of state enterprises. For these reasons the investment attractiveness of the country have decreased, as is evidenced by the capital outflow.

Impact of the trends on manufacturing industry

The identified tendencies, namely a high level of economy regulation and resulting corruption, the barriers to entrepreneurship and inefficient modernization policy under decreasing GDP growth rate have a significant influence not only on the level of investment but on the state of the Russian manufacturing industry. Along with that, here one should rather speak about long-term negative dynamics.

On the whole, manufacturing industry still continues to play a significant role in Russia's development: since 2002 till 2010 its GDP had increased by 3.9% (from 32.8% up to 36.7%) (see fig. 5). Nevertheless, these tendencies are not characteristic for the manufacturing industry, where a stagnation has been observed over the last several years, showing no prospects for the industry's future development.



**Fig. 5. Dynamics of manufacturing industry in Russia's GDP, %
(World Bank, 2012)**

In particular, within the frames of the last decade there has been observed a gradual decrease of the share of industrial products in the total volume of the Russian export: from 22.8% in 2002 it dropped down to 14.7% in 2010. The reason for that ties with the worsening international competitive positions of the Russian products, the demand for which is falling, and in the developing countries as well. Along with that, a share of industrial products in the country's GDP remains practically unchanged: over the 2002-2010 period it had reduced from 17.1% down to 16.4% (World Bank, 2012) (see fig. 6). Thus, the current Russia's manufacturing industry has problems in development in both qualitative and quantitative aspects, which, together with increasing extraction industry capacities and gradually evolving service sphere makes the industry even less significant for the country.

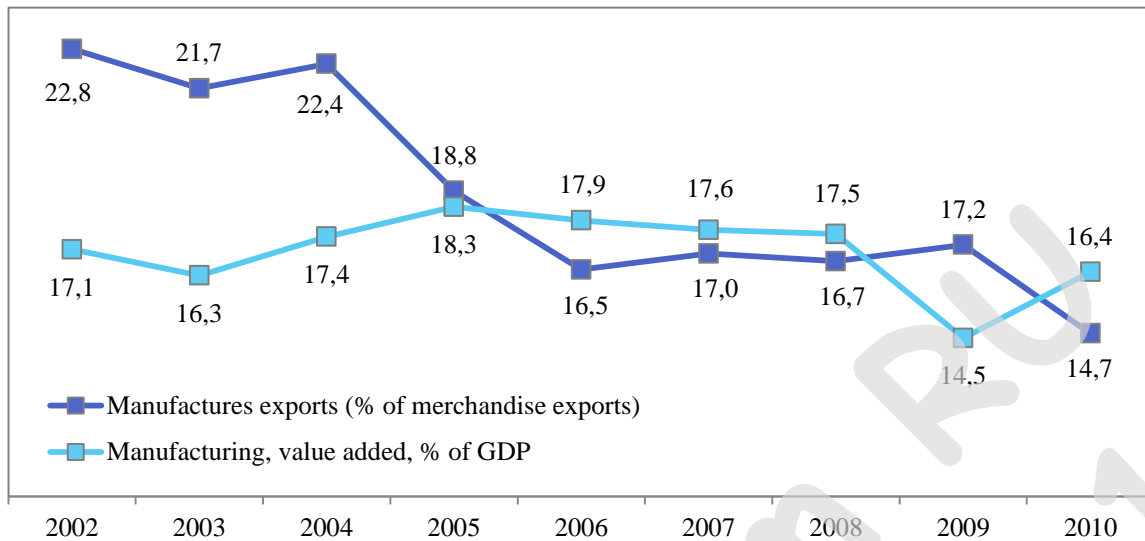


Fig. 6. Dynamics of indicators characterizing Russia's manufacturing industry (World Bank, 2012)

Such factors as high level of regulation and corruption create additional barriers to the development of small- and medium-sized business in manufacturing sector. Such enterprises though lacking financial resources, nevertheless, have high flexibility for adapting new technologies and establishing innovative manufacturing directions. However in reality, the existing market conditions in Russia contribute to the choice of the service sphere for developing medium- and small-sized business. Therefore the efficiency of the modernization, forced in the country, is gradually coming to nought. This is confirmed on the basis of World Bank data, according to which, a share of the carried out researches and developments in Russia's GDP continues its gradual, however steady decline: if in 2000 the indicator was 1.05%, then in 2008 - 1.03% (World Bank, 2012). Along with that, one can observe that a share of high technology export in the total volume of exported industrial products is declining fast enough (16.1% - in 2000 , 8.8% - in 2010) (see fig. 7), which, on the whole, indicates a loss in scientific potential of Russia. Under unstable global economy and modernization carried out in many countries, Russia is doomed to remain a "raw-material appendage" for the developed countries until the energy resources at its disposal are exhausted.

Certain problems are also observed in actualization of policy on developing green manufacturing and increasing its efficiency. In particular, Russia remains the country with average air pollution level (8th place by pollution per capita), high level of greenhouse gases emission (1st place by volume), as well as inefficient energy consumption (2nd place in consumption per \$1000 GDP) (OECD, 2011). This points to the problems in implementation of innovative production technologies, aimed at environment protection, due to which not only the country's population suffers (Russia is on the second place by death-rate due to air pollution), but also the attractiveness of its products in the global market (OECD, 2011).

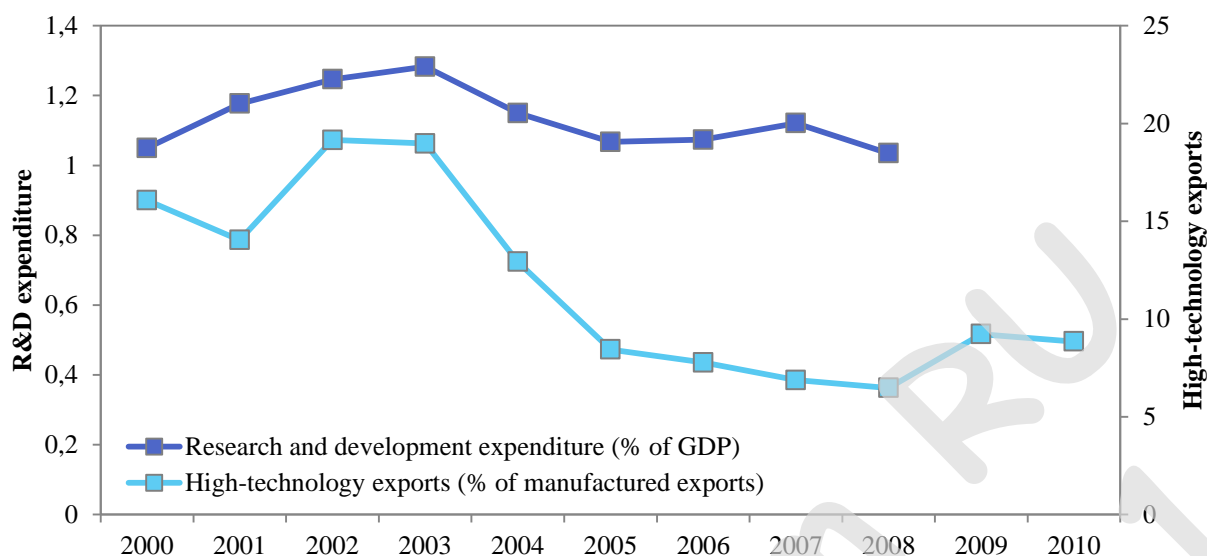


Fig. 7. Dynamics of Russia's technological development

It is important to note that, within the frames of manufacturing sector, negative tendencies had been observed even before the crisis. In particular, in 2000-07, there was observed a rise in unemployment among people with secondary (technical) education, which later most often started to work as specialists at production and in adjacent directions (technical support, transportation, warehousing, etc.). At the same time, a share of people with primary education, starting to work in service sphere, where no specific skills are required, and also a share of people with tertiary education striving to get more remunerative positions in management, marketing and other nonproductive spheres, continued to increase. As a result, if in 2000, a share of people with secondary education was 43.7% from the total number of unemployed, then in 2007 - 51.2% (World Bank, 2012) (see fig. 8). Thus, the problems of production development in Russia have deep roots, which leads to negative effects in long-term perspective.

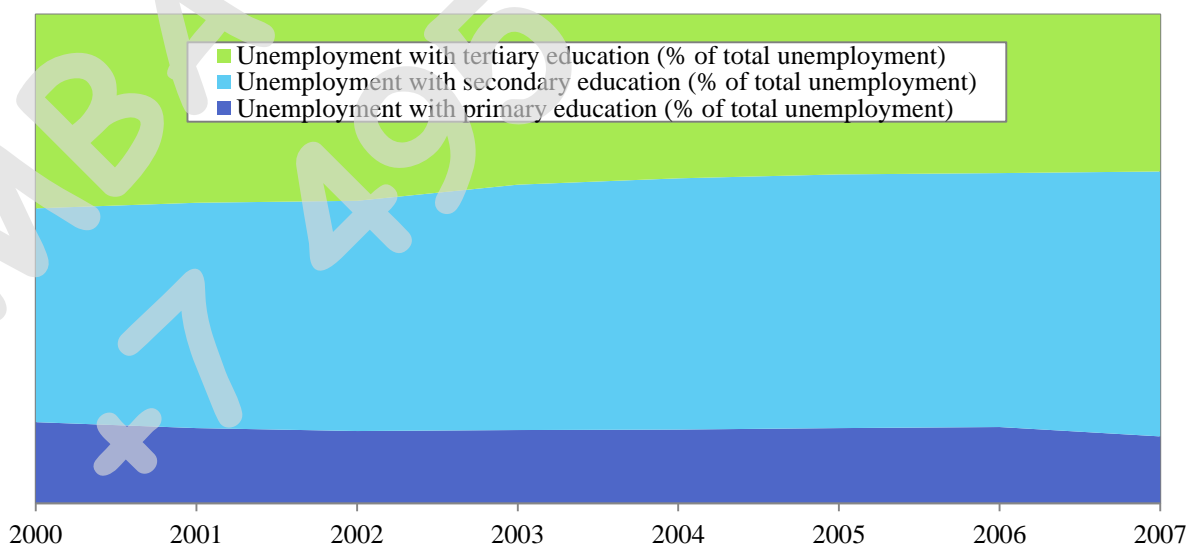


Fig. 8. Unemployment in Russia by education level (World Bank, 2012)

Thus, during the years the ruling party (Edinaya Rossia) has been in power, the country has not been able to restore its production potential, which have had a significant impact on

working class and have changed the shape of the Russian economy in many respects. Such factors as corruption, underdeveloped infrastructure, high barriers to small business, high regulation of market operation principles lead to that the country's manufacturing industry becomes a slowing down sector, which undergoes a deep systemic crisis, connected with a drop in the competitiveness of domestic products, reduction of worn out capacities and a decreased demand for qualified workers.

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⁵EIA – U.S. Energy Information Administration