Russia: unlocking the potential

The Russian economy will grow by 2-4% in the coming years. Sustaining this growth rate in future will depend largely on structural improvements. Oil and gas reserves will contribute towards financing badly-needed investment in infrastructure for 20 and 70 years respectively. However, this depends on developments in the global oil price. The size of the population is shrinking with consequences for the labour force. It is time for action.
Focusing on non–oil industry, high added value production, improving the legal environment and promoting more equal distribution of power and wealth are required to get the economy back on a higher growth path. The main challenge for Russia is convincing domestic and foreign investors that is serious about making progress on these issues. Its success in doing so will trigger a substantial inflow of capital, unlock other Russian treasures than oil/gas (mineral deposits) and bring the 5% economic target growth rate within reach.

Main observations

- The reliance of the Russian economy on energy resources (25% of GDP, 65% of exports and 40% of government revenues) is risky due to the dependence on the global oil price, depletion of reserves and a possible transit disruption.
- More progress in competitiveness, reduction of corruption and improvements in the business climate will help the economy to reach its potential growth rate of 5%.
- The authorities in Moscow recognise the problems and are working to address them. Accession to the World Trade Organisation last year will force changes to be implemented more rapidly.
- Foreign investors are needed, but their participation depends on the progress made to address the issues mentioned earlier.
- Signs of diversification: share of production investment goods 5% in 2011 to 10% in 10 years.

Figure 1 Comparison of Russia and Germany

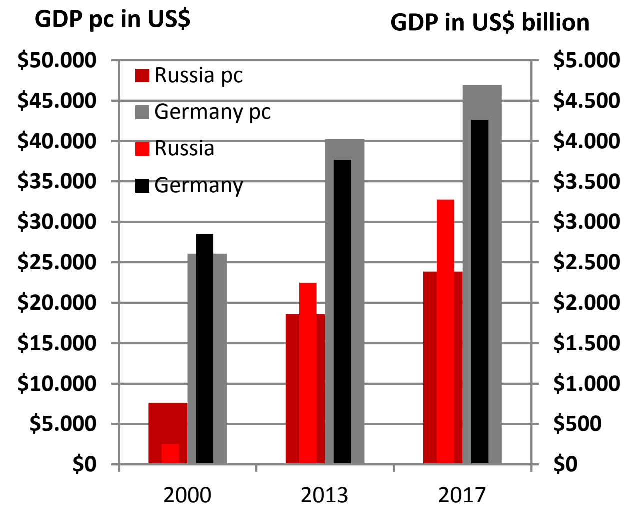
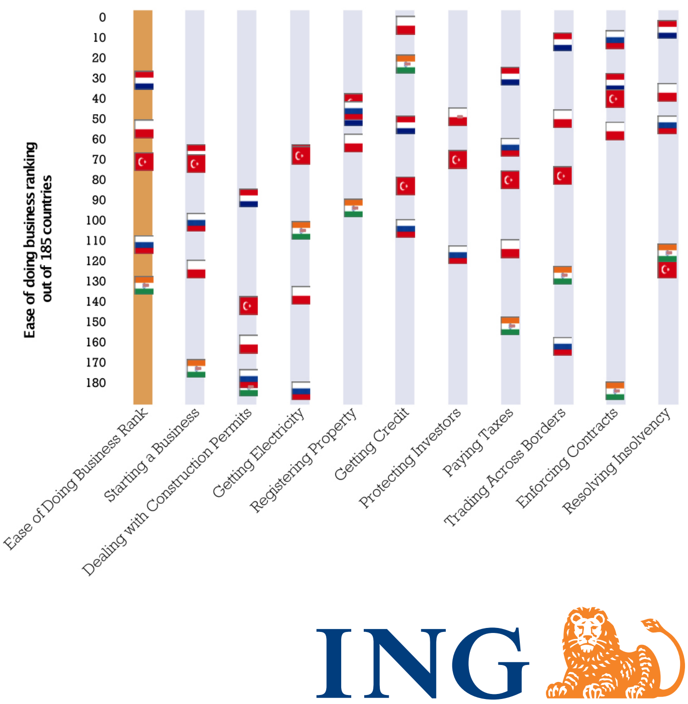


Figure 2 Ease of doing business in 2013, World Bank



Russian economic growth figure is stuck between 2% and 4% this year. In the seven years before the 2009 crisis, Russia achieved annual average GDP growth of 6.8%. Double-digit growth in private consumption and investments contributed to this high growth rate. Since export growth overtook import growth, the external sector contribution was negative for years. Current account surpluses of 10% of GDP, such as were seen before the crisis, are gone. The same goes for the government's comfortable financial position. Surpluses on the government budget seem to have disappeared. Though foreign exchange reserves cover more than one year of imports, Russia still is a net creditor nation. Russia's potential growth rate should be 5% in the long term. Structural problems are mainly what are preventing the economy from achieving this. In Davos last year, Prime Minister Medvedev made clear it is the ambition of the Russian leadership to achieve this potential growth rate as soon as possible. In the same speech Mr Medvedev identified the cause of the structural problems as domestic. Recognising these problems as top priorities in the roadmap to Russia's integration in the global system is vital. Accession to the World Trade Organisation (WTO) in August 2012 requires Russian companies to considerably increase their competitive power, both in terms of labour productivity and energy cost saving. This requires investments in percentage of GDP to increase from the current 20% of GDP to at least 25%. Figure 1 shows the advance of Russia in total GDP compared to Germany. In GDP per capita, however, no advance is registered.

The challenges

The main challenge that the government faces is to make progress in reducing the hurdles to doing business in Russia:

- Improve the business climate (measured in the World Bank's Ease of Doing Business index)
- Improve competitiveness (as measured by the index of international business school IMD)
- Reduce corruption (Transparency index)
- Invest in improving the infrastructure
- Privatisation
- Compensate for a decline in the working age population by 0.8% in 2012-2017, compared with 0.2% growth in 2003-2008. Moreover, the participation rate is already fairly high (more than 74% in Q2 2012). Employment is expected to contract by 0.5% a year on average over the next five years.

Figure 2 shows Russia's disappointing position in the Ease of Doing business index, where it ranks 112 out of 185 countries, close to Bangladesh. The ambition of leaders in the Kremlin is to be ranked 20th as quickly as possible. The main hurdles are getting electricity, construction permits and the extensive paperwork for cross-border trading. According to figure 3 the World Competitive Index (WCI) 2012, Russia's level of competiveness is disappointing, as well as its progress in the period 2002-2012. The WCI highlights the scientific and technical infrastructure as positive factors for Russia. The score for education is unchanged while weak spots are clearly management and efficiency.

Russia still has a legacy of impressive fundamental science, engineering schools and infrastructure for pilot scale production preserved in many industries. To keep its front running position in scientific and technological infrastructure and education, investment is needed. Foreign companies could play an important role to improve efficiency and productivity. Transparency International ranked Russia 133 out of 182 countries in 2012 in its Corruption Perceptions Index, on par with Iran and Honduras. There is an obvious need for swift action to improve this profile.
Apart from investments in the Winter Olympic Games in 2014 and Football World Cup in 2018, substantial invest-

Figure 3 World Competitiveness Index 2012

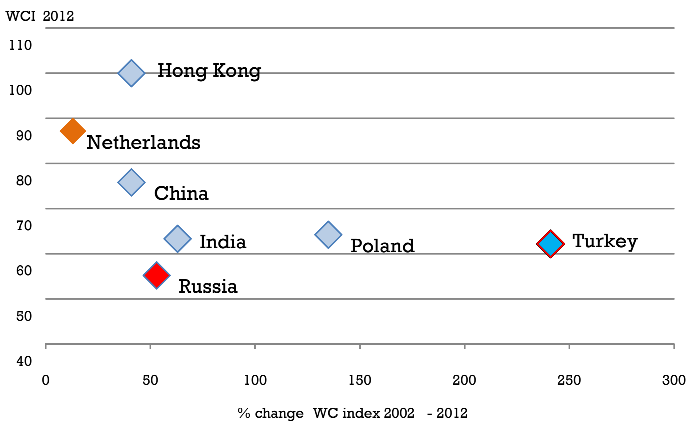


Figure 4 Russian competitiveness in detail

WCI Russia compared with 59 countries

	Ranking 2012	% chg 2002-2012
Scientific infrastructure	23	-1.3%
Technology infrastructure	34	38.9%
Education	38	-1.4%
Basic infrastructure	42	34.5%
Attitude and efficiency	51	16.4%
Productivity	53	-8.8%
Management practice	57	18.0%
Overall WCI	48	53.0%

Source: IMD

ments are needed to improve the country's basic infrastructure: roads, railways, harbours and urban structures. Over the next 50 years substantial amounts are required to replace ageing infrastructure.

Government initiatives to deal with the challenges

- Priority sectors have been identified to regain technological leadership. These include the pharmaceutical industry, high tech chemistry, composite and non-metallic materials, aircraft manufacturing, information and communication technologies and nanotechnology.
- The government has invested in institutions capable of commercialising applied research.
- Several Western firms have been attracted to participate in the Skolkovo project, Russia's version of US high-tech centre Silicon Valley.
- Large-scale privatisations have been announced, such as shipping company Sovcomflot and Russian bank VTB.

Diversification: signs of improvement

The overall picture shows the share of investment goods production increasing in future. Not only will its share in GDP rise, but also its share in total global production. The same goes for several production sectors in intermediate goods. This trend should be reflected in the export package with an increasing share of higher added value products. For the time being however, oil and gas still dominate Russia's export package. The importance of improvement in the agricultural sector and the linked food and food logistic sector is underestimated. Improvements in crops and logistical processes can help to mitigate fluctuations in food prices and reduce the inflation rate.

Increasing share production investment goods

Production of investment goods represents only 5% of GDP in 2012. This will increase by almost 11% per year in the period 2012-2016 – a growth rate two times higher than GDP growth in the same period. If the main improvements in the business climate, competitiveness and the transparency index are implemented, the share of investment goods in total GDP could be 10% in 10 years' time. The main contributors to higher growth rates are generated by the production of motor vehicles and parts, other means of transport, computers and office equipment, special purpose machinery and general purpose machinery.

Competitiveness of the production package is an important factor in forecasting the success of the switch in the production on the international market. The overall cost level is of high importance for its success. The next figure from a study published by KPMG shows the overall cost differentials by sector. Three of the BRIC countries – India, China and Russia – record a major cost advantage in labour-intensive sectors of industry compared to the US, Germany and the Netherlands. Although Russia's overall cost level is higher than that of India and China, the cost differential with the Netherlands, Germany and the US is still substantial. Labour costs are part of the cost comparison.

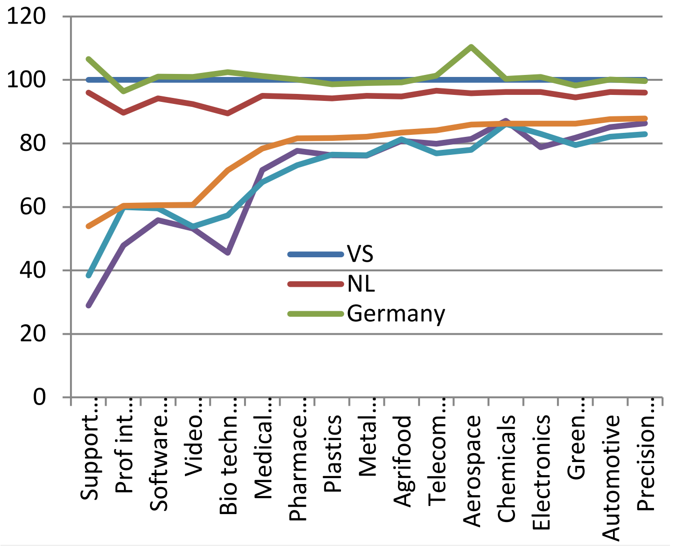
Since Russian wages are relatively low, overall labour costs are still comparatively low. However, due to real wage increases averaged 15% over 2000-2008 then falling to 5.5% in 2010-2012 while productivity increased on average with 5% since 2003 relative unit labour costs in Russia are increasing. The pace of this increase seems to flatten out this year and next. The relative unit labour cost index indicates

Figure 5 Growth by sector and contribution to GDP

	Shares in GDP 2012	Avg. Ann % change 2012-2016
Agriculture, forestry & fisheries	4%	1.8%
Industrial production	28%	4.1%
Extraction	9%	1.8%
Manufacturing	16%	5.6%
Consumer goods non durables	3%	-0.42%
Consumer goods durables	1%	-1.3%
Intermediate goods	7%	6.6%
Investment goods	5%	10.8%
Utilities	3%	2.36%
Construction	5%	5.5%
Services	63%	3.9%
	100.0%	

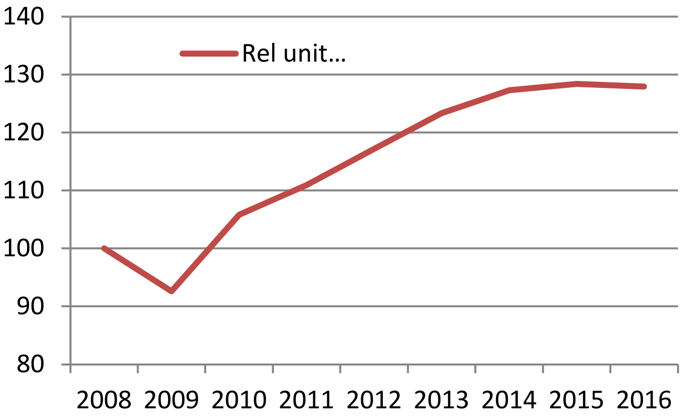
Source: Oxford Economics

Figure 6 Total cost comparison 2011, US =100



Source: KPMG guide to international business location costs, 2012

Figure 7 Relative Russian unit labour costs



Source: Oxford Economics

Figure 8 Foreign direct investment in Russia by sector

Foreign investment stock and flow by industry in % of total	2011	2009-2011
Mining and quarrying	14.5	19.9
Manufacturing	32.1	28.3
Construction	7.4	5.5
Wholesale, retail, motor	8.7	15.3
vehicles	13.5	5.2
Financial intermediation	15.5	18.5
Real estate, renting, business activities	8.3	7.3
Other		

Source: Rosstat

(figure 7) how Russian unit labour costs in US dollars are developing compared to world unit labour costs. It is the combination of unit labour costs in local currency adjusted for currency developments. If the index is above 100 it indicates Russia is less competitive against the world index.

Russia's accession to the WTO on 22 August 2012, generates a key advantage: its commitment to open, transparent and non-discriminatory trade, rising competition and more efficient resource allocation. It is, in principle, a unique chance to spur structural changes needed to improve Russia's efficiency and competitiveness. Russia already made some changes in the pre-accession period. These do not seem to have added to GDP growth so far. Key issues for Russia are the reduction in export and import tariffs, services sector and industrial/agricultural subsidies. Russia was using these instruments for protectionist reasons. The average import tariff will finally fall from 10% to 7.8%, with one third already effective, a quarter due in three years and the rest over longer periods. Academic studies flag potential gains of 3% to 11% of GDP in the short to long term, with up to 85% of the gains fully attributable to a sharp cut in barriers to foreign direct investment in the services sector. Higher foreign direct investment (FDI) would be the best outcome of WTO entry as only in a few sectors does labour productivity exceed Russia's average of 40% vs the US level.

Foreign direct investment less focused on energy

Russia's strategic priorities of economic diversification and modernising the economy reinforces the need for FDI as key instrument. Outside the extraction industries FDI inflows seem to be low. In general, the FDI stock per capita in Russia is well ahead of other BRIC countries. Per capita, Russian FDI stock was USD 2,960 in 2010. This is seven times the number for China and Brazil and 18 times more than India.

Despite the often mentioned concentration of FDI inflow in natural resources extraction, the most important destination of inward FDI in terms of stock and flows is manufacturing, with 32% and 28% of total. This suggests inward foreign direct investment in manufacturing is for the domestic market and export markets. FDI in natural resources is comparable to the FDI stock and flows in financial intermediation and real estate, renting and business activities. In 2012, 24.4% of FDI inflow came from the Netherlands, followed by 21.3% from Luxembourg, 13.8% from Cyprus, 9.3% from Ireland and 5.7% from Germany. All information according to the UNCTAD database on foreign direct investment.

Upgrading the export package will follow change in the production pattern

The upgrade of the production package is reflected in an increasing share of investment goods. These capital goods are needed to produce higher added value products for domestic consumers and export products. As a consequence, it is not surprising to see fuel still dominating exports till 2017.

Figure 9 Export of goods (2007-2017) in USD bn

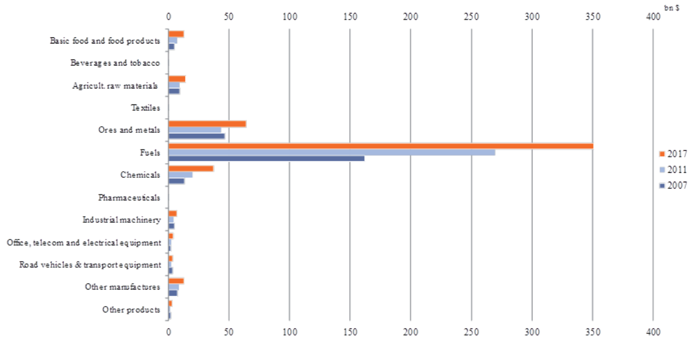
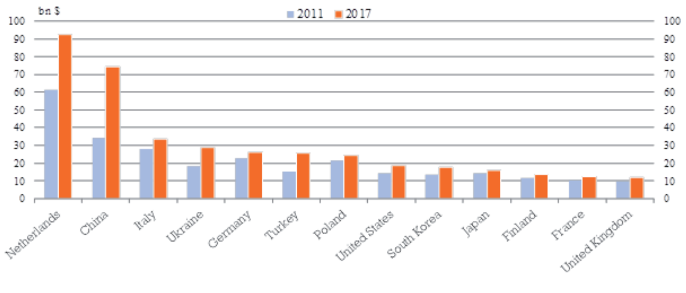


Figure 10 Exports of goods (2007-2017) in USD bn



The destination of the export flow of oil and gas is highly focused on the Netherlands as the main hub for Russian gas to other continents. China is second with its high demand for Russian coal.

Rapidly developing local market

Russia's large population of 143 million puts it high on the list of largest countries in the world. In contrast with countries such as Turkey, the population is expected to shrink. However, since per capita income continues to increase, the size of the domestic market will continue to grow. Spending power will continue to grow.

Number of persons in mln

Income bracket

	2013	2020
US$ 5,000	53.5	59.1
US$15,000	33.3	52.3

Source: Euromonitor

Growth in prosperity in the country and the shift towards middle-aged consumers increases private consumption and causes a shift in the consumption pattern. There is a huge and fast-growing demand for housing, transport, health goods, medical services, alcoholic beverages and tobacco. The category of products with a lower growth rate is clothing and footwear.

Domestic sales of food products and textiles are highly dependent on imports. Industrial machinery and transport equipment are investment goods reflecting the increasing effort to build a competitive Russian industrial base.

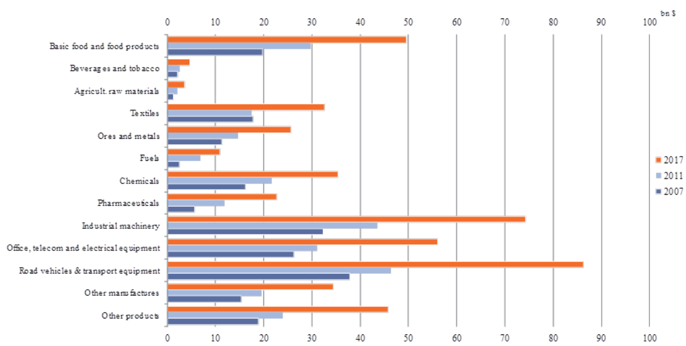
The origin of imported products depends largely on China (electrical equipment), Germany(machinery, transport equipment) and Ukraine (ores and metals).

Figure 8 Expenditure by category 2012-16 (volume

	US$ bn in 2012	CAGR 2012-16
Food and non-alcoholic beverages	293	8.8
Alcoholic beveraged and tobacco	67	7.6
Clothing and footwear	82	7.2
Housing	82	8.6
Household goods and services	45	9.1
Health goods and medical services	37	10.6
Transport	127	10.7
Communication	51	10.4
Leisure and recreation	50	9.6
Education	11	10.7
Hotels and catering	42	10.1
Misc. Goods and services	60	9.8
Total	947	9.1

Sources: National statistics, OECD, Euromonitor and ING

Figure 9 Import of goods (2007-2017) in USD bn



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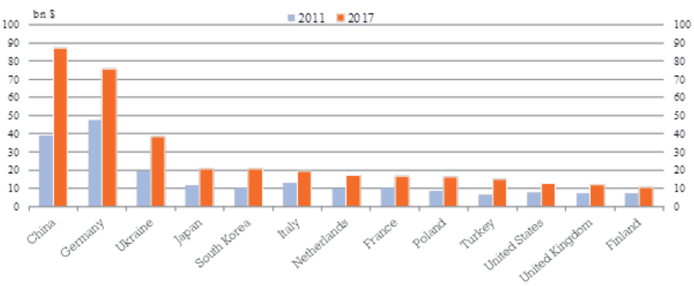

Role of foreign companies

Foreign companies are invited to participate in the transition of the Russian economy towards less dependence on energy resources. This can be done in different ways:

- Foreign direct investment (an equity participation or equity loan) in a Russia company.
- Many foreign companies test the water by establishing a joint venture first.
- Foreign companies can participate in privatisation deals, rather than establish a new presence. This is often more suitable for large corporates.
- Foreign companies are stimulated to offer their technical and managerial knowledge to Russian companies by selling technical assistance.
- Sell products, such as machinery and transport equipment, that help upgrade the production package.
- The challenge for the Russian authorities is to convince domestic and foreign investors that investing in Russia is safe. Accession to the WTO last year is a clear step in that direction, but more will still have to be done, considering the scores and ranking of Russia's competitive position and in the Ease of Doing business index as well as the transparency index score.
- The areas of interest to foreign companies are:
  - Stock of scientific and technological findings that could be used in Western production.
  - Improved logistical infrastructure, especially in the food chain.
  - Better productivity in production and logistical processes.
  - Improve crops in agriculture by offering technical assistance
  - Technical assistance to improve energy saving.
  - Participation in the 2018 Football World Cup event.

Role of Russian companies

- The scientific and technological know-how of Russian institutes and companies represents a substantial value included in pilot products and innovations. In combination with Western companies it could be investigated whether these innovations can be commercialised.
- Russian companies follow the same initiative taken by many large corporates from emerging markets to ensure access to developed markets via acquisitions.
- A new privatisation wave could spur acquisitions by Russian companies.
- Areas of interest are:
  - Energy resources
  - Transport and logistical services
  - Manufacturing of machines and transport equipment
  - Manufacturing of Computers
  - Professional services (scientific and technical)
  - Food and food logistical services

Sources

Business Monitor International, several publications
Oxford Economics, global industry database
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