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Russia’s New Horizons

ROADMAP TO A BETTER INVESTMENT ENVIRONMENT

Briefing

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Moderator:

Alexander Ivlev, Country Managing Partner, Russia, Ernst & Young

Panellists:

Andrey Belousov, Minister of Economic Development of the Russian Federation

Sir Suma Chakrabarti, President, European Bank for Reconstruction and Development

A. Ivlev:

Good morning, colleagues.

I suggest we get right down to the topic of our briefing: ‘Roadmap to a Better Investment Environment’. I would like to welcome the Minister of Economic Development of the Russian Federation, Andrey Belousov, and President of the European Bank for Reconstruction and Development, Sir Suma Chakrabarti.

At the end of the briefing, the Government of the Russian Federation and the European Bank for Reconstruction and Development will sign an agreement to create a Russian Technical Cooperation Special Fund.

Keeping in mind that we are running a bit behind, I suggest we start with the issues directly related to the subject of our briefing. I would like to address the first question to Mr. Belousov.

In recent years, we have seen the Government implement a large number of initiatives to improve the investment and business climate. Newly formed structures include the Russian Direct Investment Fund, which has been quite successful, and the Agency for Strategic Initiatives. The National Entrepreneurship Initiative was also implemented. I headed one of the working groups, and I believe we did a good job of designing the roadmaps. A number of funds have been established within the Bank for Development and Foreign Economic Affairs (Vnesheconombank). The Ombudsman Office was opened a year ago. This is all part of a wide range of positive initiatives based on the best global practices.

Take a look at the recently released ratings. The World Bank has given us a positive Doing Business rating: Russia has improved by eight points, moving from 120^{th} to 112^{th} place. That is not bad. At the same time, the European Business Association released a report that shows that our investment climate has got worse. My company, Ernst & Young, also conducted a study of Russia’s investment climate. Our results show that while the situation has not deteriorated, it has not improved either.

Can you tell us how we can measure the effectiveness of all these initiatives? We have implemented them, but the situation is not improving. Thank you.

A. Belousov:

For me, the best and most objective indicator of our success is investor behaviour. I cannot say it has improved, but I think that the fact that it has not got any worse is itself a positive sign. I will mention two figures. First, over the last three quarters, between the third quarter of last year and the first quarter of this year, we saw a steady inflow of foreign direct investment that was quite high for Russia. This is despite a general slowdown of investments in the country's capital assets, which I will discuss a bit later. We can debate the nature of these foreign direct investments: how much comes from Russian capital, and how much is purely foreign in origin. This is a familiar discussion, but the fact remains: while developing markets are experiencing a general investment drought, foreign direct investment is flowing into Russia's non-financial sector at the rate of USD 16–18 billion per quarter. This is a very good sign for Russia. I will remind you that the volume of foreign direct investments fell to USD 5 billion and even to USD 4 billion in the second quarter of last year. Many of the largest investors, including those working with the Russian Direct Investment Fund, feel quite positively about investing in Russia.

Now, on to the second figure I wanted to mention. We are actively discussing the slowdown of investment in the country's capital assets: early last year these investments accounted for 16%; then they fell to 10%; and today they stand at 0%. If we look more closely, we will see that this slowdown, this decreasing rate, is related either to state investments, which have fallen by 15%, or to investments made by major state-subsidized companies: Gazprom, Transneft, energy producers, and a number of others. Investment in the private sector remains quite high, increasing by 9–10% year-on-year. We believe this is also a very good indicator and a positive sign.

Ratings aside, investor behaviour indicates that while we are not seeing significant breakthroughs in Russia, investors vote with their dollars. This is the first point. The second point is effectiveness. In spring, an expert delegation from the World Bank came to Russia to conduct the new Doing Business rating study. I value what those experts told me during our meeting at that time. They said that in the past, they had had a feeling that only around a dozen people worked on improving Russia's business climate. Today, however, hundreds of people from practically every agency are involved in this process. I think that this is the most important outcome of the work we have been conducting over the last year and a half.

Another very important aspect is that the country's major regions, primarily Moscow, are now involved in this work. Two years ago, we conducted a subnational study together with the World Bank, which examined 30 of Russia's regions, including Moscow. Using a methodology similar to that used in the Doing Business rating, though slightly cut down, Moscow had the honour of taking thirtieth place out of 30. During last year's Forum, I remember asking Andrei Sharonov what place he thought Moscow would occupy in a rating of 50 regions, rather than 30. Since then, the Moscow administration has made colossal efforts to improve the regulatory environment, especially in those areas that have the biggest impact on the business community. Take, for example, the construction industry in Moscow. The number of procedures measured by the World Bank which a typical site, logistics centre, or warehouse has to undergo, has decreased from 42 to 10. The time it takes to obtain a permit has fallen from 344 to 103 days, while the cost has decreased approximately threefold. As for access to energy infrastructure, the number of procedures has been cut from ten to four; the time it takes to be connected to the grid has fallen from 281 to 146 days; and the cost has decreased more than tenfold. At the same time, the Moscow administration has taken very strict measures to prevent prefectures and municipalities from implementing or using additional approval procedures. In the past, local administrations severely abused this power. These are only the initial results, but the important thing is that the process has been launched. As Mikhail Gorbachev used to say, "the process has begun."

A. Ivlev:

Thank you. He also used to say, "the important thing is to get started."

It is true that the process has been launched. Now, we have to look at the results. And we do have them. If we look at the overview presented last October during Russia’s Foreign Investment Advisory Council meeting, we will notice this interesting fact: 90% of foreign companies which have invested in Russia are happy with their decision to enter our market. At the same time, fewer than 25% of companies that do not operate in Russia are cautious about investing in our economy.

Sir Suma and I were discussing this just before this session: sometimes, Russia does not quite do the right thing in terms of informing the community about what is happening in the country. In reality, we have done a great deal.

Sir Suma, I would like to ask you to comment on why our country is perceived as worse than it really is, and what we can do to correct the situation.

S. Chakrabarti:

Thanks very much, Alexander. I think Andrey is right about the facts. The facts are that there is foreign direct investment coming into the Russian Federation. The good news is it is around 3% of GDP; that is not very different from the other BRICs. That is pretty good. The other piece of good news, and I think Ernst & Young’s own work shows this, is that it is not just oil and gas, that is a myth. It is going into the automotive sector, the business services sector and EBRD has played a part in that, particularly in the automotive sector recently. So that is the good news. The difficult news, I think, goes to the heart of surveys that I have seen in our own work – it is very difficult to convince new foreign direct investors to come here despite the progress made. I spend a lot of time on the road with my colleagues at EBRD, going to India, Israel, the United States, trying to convince firms who do not know about Russia that this is a great place to come and do business and that you can do very well here, there is a lot of potential. That is a very hard sell at the moment. It is something that I worry about because I agree with Andrey that a lot of work is being done here in Russia on improving the business environment. The roadmaps that the Government has put together, both on issues but also by regions, are extremely good things. They have involved business associations here in putting these together, and those business associations are also involved in tracking them. I say all of this when I go to other countries and no one believes me. Why? I think this is something we should be debating, as to whether Russia's Government or authorities can do a more impressive job abroad of trying to convince new investors that this is a really good place to come and work. I think too much of this is infected by politics, obviously. But I think the economic and commercial facts are not getting out there enough and we need to do a joint job on that, but also others who are supporters of what is happening in Russia should do that. So there is quite a big task, in my view, going ahead on that front.

A. Ivlev:

Thank you very much.

Mr. Belousov, I have a question for you.

Today, when we talk about investment policy, we pay close attention to the regions. This is a good strategy, because foreign investments flow primarily into places such as Moscow, St. Petersburg, Nizhny Novgorod, Kaluga, and Tatarstan. Unfortunately, investors have yet to reach other regions. Some people complain about the lack of infrastructure; others talk about a shortage of human resources. Some areas have hostile administrations. Still, we have to address this issue. My question is whether all of the country's regions take the same approach to attracting investment, and what the federal government can do to help the regions bring in foreign money.

A. Belousov:

Thank you, Alexander.

As you know, one of the first projects the Agency for Strategic Initiatives undertook was to create a regional investment climate standard. We applied very simple logic to choosing the approach and deciding where to begin. The thing is, two years ago we already knew that nothing prevented local organizations, local administrations, and regions of the Russian Federation from undertaking a comprehensive campaign to attract investment. By then, we already had the shining example of Kaluga Region, as well as Tatarstan and Ulyanovsk Region. A number of other regions also began working on this. At the same time, the overwhelming majority of the regions simply waited.

To spur them on, we developed a very straightforward set of requirements, which consisted of around fifteen simple conditions. We were drawing on the best practices from Tatarstan, Kaluga, Ulyanovsk Region, and other regions, things that had to be implemented in a given region before it could hope to see any changes: regulatory requirements, a system dedicated to protecting investor rights at the regional level, and creating comfortable investment and investment management conditions in the region. We needed to create a single-window system for investors. Investors had to be involved, at least in a consulting role, in developing certain aspects of regional policy that affect them most. These included requirements for information support relating to the opportunities in the region, the regulatory framework, and so forth. We put all this down on paper, launched the project, and had business associations conduct an independent review of its progress, just like we had done with the National Entrepreneurship Initiative.

I must say we are already seeing results. But the overall conclusion is that if a given region is interested in attracting foreign investment, if it is ready, it has every opportunity to do so. Our colleagues from the European Bank for Reconstruction and Development play a very positive role in this. They were in the vanguard: the EBRD had cleared the ground for us to sow the seeds of these initiatives; and now we are watering them in hopes that the resulting tree will bear the results we are looking for.

We are currently facing two considerable obstacles. The first obstacle is the lack of professional education. This is a lesson we learned from vanguard regions like Kaluga. All regions complain that companies which move into the regions, and those that have already established a presence there, run up against a shortage of professional staff. It is not surprising that the Governor of Kaluga and the Governor of Ulyanovsk currently lead the country in dual education policies, implemented with the help of German, French, and other foreign companies operating in Russia. We need to focus our attention on this aspect.

The second obstacle is transportation. Every region working on investment projects naturally has certain strengths compared with other regions. I am talking primarily about Greater Moscow and surrounding areas, and the regions that are focused on the Moscow market. Anatoly Artamonov told me that it is possible to develop manufacturing, attract investment, and build new factories in the Kaluga Region using its existing platforms and infrastructure – but they cannot get the products to Moscow because of traffic, even across a little over 100 kilometres along the relatively free-flowing Kaluga Road. Moscow is the largest logistics hub in the entire country, with 20% of all goods moving through it.

This concerns other regions as well. Tula is currently undergoing rapid development, and beginning to attract foreign investors. The new governor and his new, young administration have begun active work in this sphere. Currently, they have only one transport route unburdened by traffic, only one free-flowing channel. As soon as it reaches its full capacity, it will become another obstacle to development.

Unfortunately, this is largely outside the jurisdiction of the regions: it is the purview of the federal government, and requires budget funds. We are always talking about the need to develop our transport infrastructure. If we fail to do so, our efforts to improve the country’s investment climate, including at the regional level, will be largely worthless.

A. Ivlev:

Thank you.

I would like to ask Sir Suma what the European Bank for Reconstruction and Development has encountered in Russia’s regions. Lately, you have been focusing particular attention on this issue. You have also started to consider which types of companies you would like to work with. Tell us more about this.

S. Chakrabarti:

I sure can. I think I will make three or four points. First of all, it is very important to have an analysis of what is happening in different regions and not to lump all of the regions together as if everything outside of Moscow and St. Petersburg was some sort of monoculture. It is not. Our own business environment and enterprise performance study looked at many regions and showed the great interregional variation in quality of the business environment. So the first thing we did was to try to show the evidence base, and it showed that the successful regions are those that made improvements in transparency and land allocation, and which created industrial parks to provide infrastructure solutions to investors. They moved ahead on e-government, one-stop shops for potential investors, and they began tackling things that Andrey was saying about professional and managerial skills, which are a real problem in many parts of the country. So that gave us a base with which to work with government and the private investors and I think, to give the authorities some credit here, the Agency for Strategic Initiatives, the Ministry and Delovaya Rossiya have also been working together to try and introduce a standard for investment attractiveness for the regions, and that has now been piloted in several regions. We have been helping with that. The standard consists of some 15 steps that must be implemented to make the region attractive for business. Thirdly we have, as Alexander said, really pushed our new country strategy. This is a push towards the more difficult regions to get private investment into, and it is a huge challenge to persuade new and existing investors to go to many of the regions. If I were to highlight one thing that is particularly coming through as a challenge in any sector, to get private investments to these regions, it is about infrastructure. Again, Andrey mentioned this. The day before yesterday I landed at Pulkovo Airport, another EBRD project, and headed straight to see Lenta Hypermarkets, one of our clients, and they are expanding. It is a great success story, a turnaround story, and they are expanding eastwards and southwards, which is wonderful. But their big complaint was the quality of infrastructure. That is what is holding up the development, for them, of regional distribution centres and their outlets. We had a very good session about infrastructure with the President last night. It was a good discussion about how we can all help in that. But there are a number of steps that need to be taken to tackle the infrastructure deficit in Russia, which is a surprisingly large deficit given the standard of development in the country and that is where we need a lot more foreign direct investment. The sums of infrastructure deficit are huge in the regions – possibly up to USD 100 billion need to be spent every year – and that is a large amount of money that cannot be spent by the state and should not be. It is very much something that the private sector should be helping with and that is where I think our efforts should be targeted.

A. Ivlev:

Thank you.

During various speeches yesterday, we heard four or five different statements on the issue of capital outflow. When we talk about investment, we must not forget about the considerable amount of funds leaving our country. During yesterday's discussion, we heard a number of approaches to solving this issue.

Mr. Belousov, the next question is for you. What practical tools do we currently have to prevent capital outflow? And how do we channel this capital back into our economy?

A. Belousov:

The very expression 'prevent capital outflow' seems to me to be a bit absurd. Preventing capital outflow is the last thing we should be thinking about. I think we should be making a different point. I simply did not have the time to talk about this during the meeting with the President. We touched upon this when we started talking about free flow of capital. We have signed bilateral agreements to incentivize and protect investments with the overwhelming majority of our partners: with 70 countries. These agreements address the issues of free flow of investments, free flow of profits, transparent procedures for out-of-court and in-court settlement of investment-related disputes, and fair compensation of investment losses caused by the actions of the state. We have settled these issues at the international level. I want to repeat: we have agreements with all major countries that serve as sources of investment into Russia, as well as the targets of Russia's own investments.

Naturally, we fight for inflow of capital. This competition is related first and foremost to improvement of the investment climate, but that is not the only factor. Today, Russia does continue to attract foreign direct investment, despite the fact that the overall trend is moving towards capital outflow from developing markets.

Russia's financial market is classified as developing. Why? The first reason – and we must mention this in the name of fairness – is our high interest rates. Interest rates in Russia are currently at around 10%; and lending rates for investments with a maturity term over one year reach 12%. On the one hand, this is one of the key factors inhibiting investment activity. On the other hand, this factor helps the inflow of capital. The same thing can be said about the strengthening of the rouble. On the one hand, it drives up costs for Russian companies; on the other hand, a stronger rouble makes rouble assets more attractive to investors. All of these elements undoubtedly have their effect. But we believe the key factor for the long term is an improved business climate, which includes: improved regulation; a transition to international financial reporting standards; an improved judicial system and out-of-court settlement procedures, such as arbitration courts; improved professional education; and the elimination of infrastructure limitations.

I could go on, but I will stop.

Thank you.

A. Ivlev:

Thank you very much.

In just a few minutes, this room will host the signing of an agreement between the Government of the Russian Federation and the European Bank for Reconstruction and Development to create a Russian Technical Cooperation Special Fund. I would

like to hear your perspective. Mr. Belousov, what does this mean for Russia? Sir Suma, what does this agreement mean for the EBRD?
Thank you.

A. Belousov:
For Russia, this is another step towards strengthening our cooperation with the EBRD. It would be a truism to call the EBRD our biggest and oldest partner. All we need to do is look at the numbers: if I am not mistaken, nearly 700 projects, maybe even more, have been implemented since 1991. I know it was 682 projects, but this number grows each year, so I might be behind. I know that I am right in saying that a total of more than EUR 20 billion has been invested. In the last two years alone, we have seen the implementation of projects totalling a little under EUR 3 billion per year. This is the largest project. But I am not even talking about amounts: I am talking about the quality of these projects. As I said before, the EBRD is a unique organization which provides regional solutions to improve the investment climate in the widest sense of the term. Today, our priority is to create the conditions which will encourage private investors with large investment portfolios to come to our country's regions.
As far as the Technical Cooperation Special Fund is concerned, the amount might not look like much. It makes me think of acupuncture: a small prick in a spot where it will have a huge impact. All we need to know is that approximately half of the EUR 40 million earmarked for this fund will be used for infrastructure assistance; and something like EUR 3 million, if I am not mistaken, will be used to develop medium-sized companies, primarily to develop corporate mechanisms for medium-sized companies. EUR 6 million – and this is very important – will go towards supporting small business. Small business is currently the focal point of our efforts and our policies. We have not touched upon this today, but it is true.
We welcome this agreement with open arms, and believe that it will serve as a new impetus, and will create new opportunities for cooperation.

A. Ivlev:

Thank you.

S. Chakrabarti:

Well I can only echo those words. I think this is important, this agreement, for both symbolic and substantive reasons. It is important symbolically because EBRD, as Andrey said, has been a very long-term partner for Russia, EUR 23 billion worth of investment and more than 750 projects – a huge long-term investment. Russia is our largest and most significant country of operation and we want it to stay that way. It is really important and it is also symbolically important as it shows Russia really arriving at the international stage as a major donor in its own right. This is a donor effort here by Russia, so it is important on those two levels. On substance, what this fund will do is support EBRD strategy, which is now much more stretching, as I said earlier. The new country strategy approved by the board last December aims to do more difficult things in more difficult places. It will be about quality and not just quantity, and that is very important, as Andrey said. And this new technical cooperation fund will support that new strategy. He has already outlined a number of things it will do, let me outline a couple more. I think it is very important that the TC fund helps medium-sized companies in implementing international standards – governance standards, international accounting standards, energy-efficiency standards, all those kinds of things. It will help with that. A big part of the push to help Russian entrepreneurs grow is trying to help the Russian SME sector grow in the regions, so I really hope this fund can help SMEs prepare better business plans. That has been one of the problems, when you talk to Sberbank and others. One of the problems is getting SMEs to prepare good plans that provide good investment opportunities, so this fund will help with that. And thirdly, Russia has been a very energy-intensive economy, something the Government wants to tackle and we have been trying to help it, so it is very important that this TC fund also helps to prepare energy audits. That really will help many companies, ahead of investments in energy efficiency, to get those audits done. So those are three examples, to add to

Andrey’s many examples of what this TC fund can do. It is very powerful symbolically, but it can also make a great difference to the partnership and what we do on the ground, so I am very grateful indeed for the work done by the authorities with us over several months now, and it is a great moment to be signing this with you.

A. Ivlev:

Thank you.

Now, I propose we move on to signing the agreement. Please come over to the table with the documents.

I want to thank all the participants in today’s briefing. I think this is the end of our session. We will see you at other Forum events.