



MEMORANDUM

Investment Climate in Russia

Submitted by

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Investment Report

Bringing foreign investment into Russia remains an increasingly important issue for many investors that wish to have a successful financial future in Russia. A number of factors contribute to the overall environment, and in turn this article is meant to describe the overall investment climate in Russia. With the many positive aspects to doing business in Russia, one can look forward to achieving success in a land filled with changing laws and regulations, a changing government, and most importantly, a country with millions of people adopting new cultures and customs from throughout the world.

Here are some major statistics that have been reported:

- Russia ended 2007 with its ninth straight year of growth, averaging 7% annually since the financial crisis of 1998¹.
- Fixed capital investments have also increased by more than 10%¹
- Personal incomes have achieved gains by more than 12%¹.
- A 7.8% growth rate was posted in just the first nine months of 2007².
- Last year in 2006, the growth rate was 6.7%².
- Foreign Direct Investment (FDI) inflows exceeded \$40 billion in the first 9 months of 2007 compared to \$26 billion in 2006².

These are just some of the facts that emerged from last year and the projections are expected to do better than the past year.

New Legislation

The new policy on foreign investment of Russia remains to be a popular topic and a very important piece of recently introduced legislation. Recently, a new law was drafted that significantly reduced foreign investment in various strategic sectors.

- The law was drafted on April 29th, 2008 and established new restrictions on companies that belong to Joint Stock Companies or Limited Liability Companies.
- There are 42 different sectors that are affected by this that include areas such as mineral resources, aviation and space activity, encryption and secret translation services, and nuclear energy services.
- The law requires that an investor needs to gain permission from various government agencies if the investor wishes to acquire more than 50% of all shares.

What this means for investment is that it is still possible to take part in these sectors of the economy, but the new law will end up reducing additional investment. It will be harder for investors to take part in this because the law is very vague at this point. The government agencies that assign the approval for the acquisitions are not yet determined in the law. So the approval process for many investors is at a standstill. Investment can still be done in these sectors, but not to a point where it would jeopardize the security of the Russian Federation. Investors need to be kept up to date on recent developments on this legislation.

To create an added incentive to businesses, Russia has added legislation that will create another Special Economic Zone in which companies can develop in specialized areas. The various zones include

¹ CIA World Fact Book

² U.S. Department of State – Economic Outlook (www.state.gov/e/eeb/ifa/2008/101005.htm)



Industrial-Production, Technological-Innovative, Tourist and Recreational, and a Port zone; with the Port Zone being the addition. There are also Special economic zones in the Kaliningrad Region and Magadan Region.

The main purposes of SEZ creation are:

- Development of processing and hi-tech economy branches;
- New type of products manufacture, import-substituting manufactures development
- Transport infrastructure development
- Development of tourism and sanatoria- and health-resort sphere³

A development in the Special Economic Zones can be seen with the Lipetsk Region and their dealings with Croatia. Administrators from the economic zone visited Croatia and help talks to generate possible interest for Croatia establishing business in the zone. Croatia is expected to visit the zone later this year to plan development⁴. This is only one example of where the economic zones deal with companies. The zones provide tax breaks and other incentives for companies and are a great way to help a company thrive in the Russian economic environment.

Other legislative highlights⁵:

1. Legal framework was established for official statistical recording
2. Fund created to promote housing and utility reform
3. Law of mutual insurance was passed
4. New law on court enforcement
5. Improvements were made to registering rights to real estate

Possible Concerns to Investors

While financial issues seem to dominate the economic and investment climate, another issue that investors need to be aware of is the population decline. Investors should be cautious when making their investments with these recent statistics appearing. Given existing trends, demographers say the population will shrink from the current level of 142 million to something between 125 million and 135 million by 2025, and could fall to as low as 100 million by 2050⁶. This statistic is crucial for investors and it will benefit investors to know about this information ahead of time. Less people living in Russia will mean a diminished consumer market. According to a group of Russian demographers sponsored by the United Nations, there will be as many as 8 million fewer people in the work force by 2015 and possibly 19 million less by 2025⁶. This change in population in the workforce can have two effects on the future.

- One is obviously that there will be less people in the consumer market which will affect consumer spending.
- But then one may need to consider the businesses that are present now and how the companies will handle the loss of people in the future.

Will these businesses that are present now still be in existence? Can they survive? If this demographic trend continues, experts say the Russian economy is set to lose \$400 billion U.S. in the next two decades and the number of economically active Russians will shrink by 3.6 million people in

³ RusSEZ

⁴ Press Service Information – Federal Agency for Management of Special Economic Zones

⁵ American Chamber of Commerce Economic Situation and The Investment Climate in Russia 2008

⁶ Moscow Times - Boosting Population a Vague Science - Nabi Abdullaev

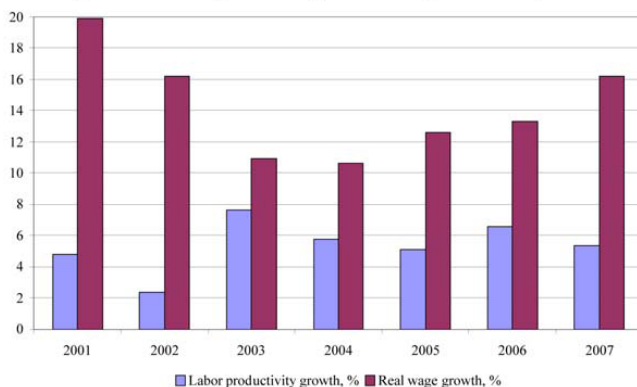


the next five years. Zhanna Zaenchkovskaya, who heads the Center for Migration Studies in Moscow, says the consequences of the demographic crisis could be devastating for the Russian economy. "From the middle of this year a natural decrease in the Russian workforce will begin. And in Russia now, even before this natural decrease, we had a deficit of around one million job vacancies. This will grow like a snowball. Immigration will be the only solution in such a situation."⁷ Even though this is a strong concern, with proper handling of a company with professional help in keeping updated on laws and regulations, a company should be able to maneuver around this obstacle.

Another concern infiltrating 2008 is the possibility of an overheating economy. The overheating of an economy occurs when its productive capacity is unable to keep pace with growing aggregate demand⁸. The difference between the actual output and the potential output is what determines if a country could be headed for the overheating of the economy. The Russian economy has the following factors that contribute to the overheating of the economy:

- (i) High (double digit) or accelerating inflation, seemingly not responding to monetary policy interventions;
- (ii) high utilization of factors of production (capital and labor),
- (iii) nominal wage growth significantly outpacing inflation,
- (iv) real wage growth higher than productivity growth,
- (v) infrastructure constraints, reflected, for example, in tighter electricity balance or shortages, transport congestion, and firms incurring additional infrastructure costs in order to maintain steady service supply,
- (vi) rapid growth in real estate prices, and
- (vii) rapid growth of imports and deterioration in the external current account⁸

Annual growth of Labor productivity and real wages in Russia, 2001 – 2007



*Russian Economic Report; World Bank

Additional Progress

The policies on intellectual property rights are significantly improving as well. The intellectual property issue has been plaguing Russia for some time now as it proves to be one of the reasons why the country has not yet entered the world trade organization. Russia has been criticized widely for their non-interest in preventing the illegal use of pirating, counterfeiting, and illegal use of companies' trademarks and slogans. According to the Coalition for International Property Rights, it is estimated that the illegal use of intellectual property is costing businesses in Russia an estimated \$1 billion a year⁹. Half of the companies surveyed stated their yearly losses attributed to IPR violations amount to at least \$1 million,

⁷ VOA News. <http://www.voanews.com/english/archive/2006-03/2006-03-08-voa62.cfm>

⁸ The World Bank in Russia – Economic Report June 2008

⁹ Coalition for Intellectual Property Rights – Intellectual Property Rights – Key to Russia's Economic Revival



and a third said losses were between \$5 million and \$50 million. It is interesting to note that this is a major problem for companies that wish to do business in Russia. The result of an unprotected copyright or trademark leads to thousands of dollars not generated for the company. The companies most affected by counterfeiting and infringement of their products are fast-moving consumer goods, tobacco, alcohol, personal health care, and the automotive industry⁹. Though this news might seem troubling, Russia has been improving the situation for this problem. The Coalition for Intellectual Property Rights has continued to improve the environment in Russia. As an investor, the continued improvement of this situation will lead to future success for the company.

Conclusion

As indicated in this article, the investment climate in Russia at this time remains to be a very exciting and very challenging. With the oil industry booming and the fact that Russia is using its natural resources to boost GDP growth, the continued growth for Russia will be very successful. There were many positive aspects in 2007 that will undoubtedly carry over into 2008. The Russian economy grew at a higher rate than the rest of the world: in particular, it exceeded the growth rates of most Central and East European and CIS countries¹⁰. With the condition on the Intellectual Property Right situation improving, the Russian Federation steps closer into becoming a member of the World Trade Organization. The possible admittance to the World Trade Organization will lead to future benefits to investors. Many issues need to be improved upon as well such as the ones cited in this article, but the Russian government continues to take steps to improve the current issues. With many new recent additions to the law and amendments being made, investors should be kept up to date with the latest information and legal advice.

¹⁰ American Chamber of Commerce Economic Situation and The Investment Climate in Russia 2008