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SINCE MY ARRIVAL IN Moscow from New York in 2000, I have been fortunate to witness firsthand the quality of the investment environment in Russia improving, year in, year out. During this time, the attitude of the Russian Government to foreign investment, particularly American investment, has also changed significantly for the better.

Over the course of the last several years, AmCham-member companies have benefitted from two major trends. Russia’s recent drive for modernization has attracted an impressive number of companies, including large corporations and global leaders in their sectors, aiming, for example, to improve the extraction of oil or the processing of steel. A second positive trend is the changed tone in business relations between the U.S. and Russia. Elections in Russia this spring and elections in the U.S. in November have perhaps temporarily revived old Cold War rhetoric, but it is now clearer than ever that when companies – whether Russian or American – feel that geopolitical issues are being solved in a quiet way, there is a better environment for long-term strategic transactions, like the one signed by Rosneft and ExxonMobil. Hopefully, recent differences on some issues will be resolved or discussed privately between the two Governments. I remain confident that the greater the economic relationship between Russia and the U.S., the shorter the lifespan of old Cold War attitudes and rhetoric.

Russia has already become a free market in many ways. Certainly, the state continues to influence some strategic sectors significantly, which is not unusual practice globally. But some of the fastest-growing sectors of the last ten years, such as consumer goods, retail and automobile production, have basically been left alone by the state. We do run into bureaucratic hurdles in many sectors, but we are almost always able to resolve problems by effective advocacy.

Russia’s recent WTO entry will now nudge those American companies who refused even to look at the Russian market to start at least to study it. There are very few opportunities for growth in the world, and certainly few in the U.S. and Europe at the moment. Russia is one of the places that offers significant growth. If the Russian Government continues to try to modernize the economy, as I believe it will, there are many sectors in which U.S. companies can play an important role. Therefore I am positive about growth going forward in Russia in the short- and medium-term. The main challenge to the sustained economic development of Russia, as most business leaders and Russian policymakers understand, is dependence on oil. Russia needs to diversify its economy, as the analysts featured in this special AmCham News supplement make clear.

The disadvantages are also well-known: image, corruption, and bureaucracy; but Russia continues to hold several advantages as it develops its economy. First, in comparison with other emerging markets, the education level of the country’s population is high, particularly relative to other BRIC countries. And this is true of the population throughout the country, which gives companies a platform on which to train people. The second big advantage is, of course, its mineral wealth. The third advantage is the amount of available arable land for agricultural development: Russia is going to play a key role in feeding the world population by 2050, or even earlier.

There is much work to be done to shape Russia’s business climate more effectively and positively, but the tools to do so are available, and the opportunities are enormous.
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The American Chamber of Commerce (AmCham) is the largest foreign business organization operating in Russia. Founded in 1994, AmCham advocates the trade and investment interests of more than 700 members, which include major U.S. Corporations, as well as large European and Russian companies. The Chamber advances commercial relations between the Russian Federation and the international community by promoting an investment-friendly environment. In so doing, the Chamber maintains a constant dialogue with the Russian government to protect and promote the economic interests of member companies.
Expectations from Investors

From Ernst & Young’s 2012 Russian Attractiveness Survey: Positioned for Growth

Confidence has declined this year...
The majority of investors continue to believe that Russia’s attractiveness will improve in the medium term. However, only 57 percent are optimistic about Russia’s future attractiveness, compared with 70 percent last year. It appears that confidence has fallen as a result of instability in global markets and the Eurozone crisis. Thirty percent say that Russia’s attractiveness will remain the same in the medium term, while only 7 percent are pessimistic about Russia’s future.

...but remains at a comparatively high level
Russia’s numbers, however, are very positive compared with Europe as a whole. In our 2012 European attractiveness survey, only 38 percent of respondents said they believe the continent’s attractiveness will improve, while a similar percentage believe that it will remain the same. This suggests that while the Russian economy will be affected by the crisis in Europe, the effect will be modest compared with the European economies.

Over the next three years, do you think the attractiveness of Russia as a place for your company to establish or develop activities will...?

![Survey results](image)

Source: Ernst & Young’s 2012 Russia attractiveness survey. Total respondents: 208

WTO deal has boosted confidence
After almost 18 years of negotiations, Russia is set to become a fully fledged member of the WTO. The overall consequences of Russia’s accession to the WTO are expected to be positive and to boost foreign investors’ confidence in the country. More than 60 percent of respondents believe Russia’s accession will have a medium-to-high impact on the country’s investment appeal.

According to the World Bank, in the medium term, the gains should be about 3 percent of GDP per year, with wages rising 4-5 percent and more than 99 percent of households gaining income. In the long run, the gains should be about 11 percent of Russian GDP per year, with wages rising 13–17 percent.

To ensure that Russia maximizes the benefits of its accession to the WTO, the Government should take urgent steps to restructure uncompetitive Russian industries. Measures should first and foremost be taken to achieve a shift in manpower from uncompetitive industries and enterprises to regions and industries that have the capacity to develop.

The past experience of nations that have acceded to the WTO, and the assessment of the likely consequences of Russia’s accession, show that FDI in Russia’s liberalized services sector may eventually deliver growth in production of up to 11 percent of GDP. To enhance that effect, Russian authorities, at all levels, should regard an improvement in the investment climate as a key policy priority.

Accession to the WTO, renewed privatization and Government initiatives to reduce reliance on energy exports are all reasons why we expect investor confidence in Russia to rise.

Will Russia’s investment appeal have any impact on its accession to the WTO?

![Survey results](image)

Source: Ernst & Young’s 2012 Russia attractiveness survey. Total respondents: 208

Russia needs to create an investor-friendly environment
Investors are looking for a better and more efficient operating environment
Russia offers investors a high-growth economy, a large domestic market and highly skilled labor at moderate cost. But its enduring reputation for difficult business conditions deters investors.

Doing business in Russia is fraught with challenges associated with corruption, government bureaucracy, complex regulatory requirements and a lack of transparency. Investors continue to suggest that improving the effectiveness of the rule of law (53 percent), reducing bureaucracy (47 percent) and improving transparency of business regulations (37 percent) are the top three priority measures to enhance Russia’s investment climate. However, investors’ emphasis on these measures has reduced in comparison with last year (when improving the effectiveness...
of the rule of law scored 63 percent, reducing bureaucracy 53 percent and improving transparency 39 percent), suggesting some improvement in Russia’s operating environment in the last 12 months. In their push to accelerate WTO and OECD membership, Russian leaders have adopted new regulations to combat the challenging business environment, and successful accessions will further improve the environment. Finally, although the goals are ambitious, the Russian Government aims to climb up the Doing Business index from the current rank of 120 to 50 by 2015, and 20 by 2018.

1. Russia is tackling corruption and increasing transparency

Currently, investment in Russia is hindered by corruption that undermines the rule of law. According to Transparency International’s Corruption Perception Index (CPI), Russia is perceived to be far more corrupt than any OECD country and is also the most corrupt BRICS country. The average size of bribes and commercial payoffs in reported crimes increased by approximately 250 percent in 2011 to RUB236,000 ($7,866). In 2011, Russian law enforcement agencies detected 37,831 incidents of corruption against the Government, services in the public sector and local authorities. Although Russia is a member of the Council of Europe Group of States Against Corruption (GRECO), the country has fulfilled only about one-third of the anti-corruption obligations set by the GRECO. In 2011, however, the Government was active in curbing corruption cases and bribery, also pledging to sign international anti-corruption treaties. Russia was ranked 143 out of 182 economies in Transparency International’s 2011 CPI ranking, a huge improvement from its ranking of 154 in the previous year.

In 2011, the Russian Interior Ministry’s economic security department reported a 50 percent increase in funds recovered from corruption cases involving government contracts awarded in the health care, utilities, construction and education sectors. The Russian Government signed a bill in February 2012 to accede to the OECD Anti-Bribery Convention. This legislation subjects Russia to peer reviews of its compliance with the convention. Under former president Dmitry Medvedev, Russia undertook a series of initiatives to deal with corruption. These included the establishment of the Anti-Corruption Council and the institution of an anticorruption law that raises fines for officials caught taking bribes to up to 100 times the amount of the bribe. Also, in March 2012, the former President signed a bill approving Russia’s National Anti-Corruption Plan for 2012-13. The bill also made amendments to certain acts of the President of the Russian Federation on countering corruption in the country. He also announced a draft law which compels public officials and members of their families to explain the origin of funds spent on major purchases.2 Russia’s current

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1 Over 37,000 cases of corruption registered in 2011 — prosecutors,” Interfax: Russia & CIS Military Newswire, 28 April 2012, via Factiva © 2012 Interfax Information Services, B.V.

President Vladimir Putin has also affirmed his plans to tackle corruption by highlighting a need to introduce legislation to establish anti-corruption standards in the law enforcement practices. These measures and examples illustrate that Russia’s fight against corruption is on.

2. Russia is reducing bureaucracy
Investors complain about the pervasive influence of government bureaucracy in business operations and unofficial barriers imposed by regional authorities. However, it would be unfair to say that the Russian Government is doing nothing about this. In early 2012, the “open government” project was introduced to attract outside experts to discuss government decisions, including measures to fight corruption. Russia’s 2020 Strategy also details measures to reduce bureaucracy. The Russian President has proposed the creation of an anti-bureaucracy filter for business legislation as part of the country’s long-term economic policy objectives.

In April 2012, Russia officially expressed its intention to join the Open Government Partnership (OGP), a global initiative that promotes transparent, effective and accountable government around the world.

3. Building an environment conducive to SME development
Russia has an underdeveloped SME market. According to the OECD, SMEs account for about one-fifth of employment in Russia and an even smaller share of output. This is very low in comparison with most OECD economies, in which both figures are over a half. Russia ranked 111th out of 183 countries in the “World Bank 2012 Doing Business” rankings for ease of starting a business, a drop of five places from the previous year. This low ranking explains the reason for the low numbers of new firms setting up in Russia. To make the country attractive for new SMEs, a lot has to be done to improve the business environment for entrepreneurs. The Russian Government has been developing initiatives to promote entrepreneurship in the country. In 2011, the Agency for Strategic Initiatives was created to help talented people, especially young people, promote new and innovative ideas, and to help businesses overcome bureaucratic barriers. Russian banks have also shown more interest in lending money to SMEs because it is more profitable than lending to large businesses.

Reducing Russia’s dependence on oil and gas
Overdependence on the oil and gas sector and an unfavorable environment for innovation and SMEs are among the biggest challenges that the Russian economy faces today. These challenges make apparent the need for structural reforms. On the positive side, a reduced percentage of investors think that Russia will be surpassed by strong competition (18 percent in 2011 vs. 29 percent in 2010) and will be challenged because of its social and economic model (16 vs. 31 percent).

How do you see Russia in 2020?

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>A leader in the energy sector</td>
<td>56%</td>
</tr>
<tr>
<td>Surpassed by strong competition from more dynamic countries</td>
<td>18%</td>
</tr>
<tr>
<td>Challenged on its social and economic model</td>
<td>16%</td>
</tr>
<tr>
<td>One of the world leaders in strategic industries</td>
<td>14%</td>
</tr>
<tr>
<td>A leader in R&amp;D and innovation</td>
<td>13%</td>
</tr>
<tr>
<td>A country with one of the best education and higher learning systems</td>
<td>7%</td>
</tr>
<tr>
<td>Can’t say</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: Ernst & Young’s 2012 Russia attractiveness survey. Total respondents: 208
there should be a more balanced approach, and other key industries should be given due attention. Investors highlight ICT (20 percent), agriculture (13 percent), consumer goods (13 percent), and transport and automotive (11 percent) sectors as the keys for growth in the next couple of years.

2. The R&D and innovation challenge

While there is little or no doubt as to the abilities of Russian scientists and technicians, investors are more concerned about the unfavorable environment for R&D. Inadequate infrastructure and a lack of government incentives are two of the hindrances that are holding back innovation and R&D in Russia. The country is behind Western economies when it comes to R&D and innovation expenditure (1.3 percent of GDP), and business openness toward innovation. Russian authorities have recently pursued a series of innovation-related initiatives, including the development of science cities, technoparks, and venture capital funds. The Skolkovo Innovation Center (also known as Russia’s Silicon Valley) will benefit from innovative companies and will provide them with the necessary business and innovation support. In March 2012, Cisco signed a strategy document with the Skolkovo Foundation that outlined its R&D plans, marking an important milestone in Cisco’s multi-year, $1 billion investment in sustainable innovation in Russia. In February 2012, Russia’s Ministry of Economic Development published its revised strategy “Innovative Russia—2020,” which will drive economic development. The success of these government initiatives is apparent in the GE Global Innovation Barometer 2012 survey. More than 87 percent of the top Russian managers surveyed said they had seen an improvement in Russia’s innovative environment over the past five years. However, they continued to highlight weak government and private sector support for innovative companies, as well as the poor quality of the regulatory environment.

3. The education challenge

A larger proportion of Russian high school students go on to tertiary education than in any OECD economy. The country has a literacy rate of nearly 100 percent. Russia also produces a substantial number of scientists, technicians, and other skilled workers. Yet only 7 percent of respondents see Russia as a country with one of the best education and higher learning systems. What explains this perception, and what can be done to improve it?

- Increase government spending. Overall education spending in Russia remains low compared with OECD standards. There is a need to increase government spending on all levels to improve the quality of teachers, infrastructure, and the overall standard of education.

- Bring industry and academia closer together by encouraging collaboration. To ensure preparedness for the market environment, the current curricula of universities and colleges require upgrading. The new curricula should be designed in collaboration with the business sector so that the skills learned are those that business requires. The Government should also seek ways of strengthening vocational training.

- Develop universities of a global standard. According to the “2011—12 Times Higher Education” rankings, no Russian university is in the world’s top 200. Moscow State University is listed in the top 300 and St. Petersburg State University in the top 400. The Russian Government needs to modernize its higher education system to meet current global education standards. In 2011, Vladimir Putin announced that the Government will allocate RUB70 billion ($2.4 billion) to build an innovative educational infrastructure in Russian universities in the next five years. However, we believe this might not be enough. More needs to be done to improve the current quality and infrastructure of Russian universities.

Extraction has the strongest potential

Unsurprisingly perhaps, a large majority of respondents view extractive industries as having the greatest potential to attract foreign investments into Russia in the next two years. According to 39 percent of the investors, the mining, oil and gas sector is expected to attract the most FDI in the next two years. The distant second choice of investors was the information and communication technologies (ICT) sector followed by energy and utilities, agriculture, consumer goods and automotive.
cell phone usage. In 2011, the number of Russians online went up by 14 percent to 53 million, making the country’s online population the largest in Europe. However, internet penetration is still comparatively low at 37.1 percent, indicating huge potential. There is a significant demand in Russia for subsectors within ICT, such as data transfer, telephone systems and data network optimization, information security, business process management (BPM) systems and software development. The growth of some technologies has stemmed from the fact that technology-oriented applications, including process management systems, are now being implemented in various functional areas of large organizations.

2. Renewed interest in food and agriculture

Rapidly rising disposable income is driving the food and agriculture sector in Russia. Russia’s membership of the WTO will have a positive impact on this sector. The WTO will give added impetus to the growth of agricultural exports, encouraging new strategic investors to enter the sector. This membership will lower tariffs and open new business opportunities for foreign companies that had been held back from entering the Russian market by high tariffs. The Government is also trying to encourage investment in the grain sector, ruling out restrictions on exports and preparing for privatization of the state grain trader.

3. Automotive flourishes

The automotive sector is already the largest recipient of FDI projects in Russia. The country’s automotive industry experienced a milestone year in 2011: sales rose by approximately 40 percent year on year, almost reaching the pre-crisis level. Sales were driven by pent-up demand, recovery of consumer confidence, credit availability and government incentives. Sales of Russian-made foreign brands have recorded a significant increase. Recently, more and more alliances have been forged between Russian and foreign auto manufacturers. In May 2012, Renault-Nissan confirmed a $750 million deal to acquire a controlling stake in Avtovaz, Russia’s leading auto manufacturer. Renault-Nissan and Avtovaz are targeting market share of 40 percent in Russia by 2016. In October 2011, Ford and Russia’s Sollers OJSC entered into a 50:50 joint venture for vehicle and engine production in Russia. In June 2011, Volkswagen also signed an agreement with Russian carmaker GAZ to produce 110,000 light vehicles annually for Volkswagen. These alliances help foreign companies to share risks, provide immediate access to the Russian market, develop inter-market ties and gain necessary local experience. The Russian companies, on the other hand, benefit from modernization, and new and innovative technology. Russia’s accession to the WTO will see a considerable reduction of customs duties on vehicles from 2012 to 18, which will accelerate the shift in demand in favor of foreign vehicles and increase their share in overall sales.


Which business sectors will attract the most foreign investments in Russia over the next 2 years?

- Mining, oil & gas: 39%
- Information and communication technologies (ICT): 20%
- Energy and utilities: 18%
- Agriculture: 13%
- Consumer goods: 13%
- Transports industry and automotive: 11%
- Real estate and construction: 8%
- The pharmaceutical industry and biotechnologies: 6%
- Banking/finance/insurance: 5%
- Clean techs: 4%
- B to B services excluding finance: 3%
- Aircraft manufacturing: 3%
- Logistics and distribution channels: 3%
- Cultural activities: 2%
- Research and development: 1%
- Defense sector: 1%
- None/none in particular: 2%
- Can’t say: 16%

Source: Ernst & Young’s 2012 Russia attractiveness survey. Total respondents: 208
The Russian Federation: A New Innovation Policy for Sustainable Growth

By Leonid Gokhberg and Vitaly Roud, Higher School of Economics, Russian Federation

Over the last two decades, the Russian Federation has completed its transition to a market economy, and for a range of macroeconomic and social indicators it is now comparable to countries of the Organisation for Economic Co-operation and Development (OECD); its integration into global chains of production and knowledge flows has become more established and has deepened along with the country’s economic and social changes. However, the model of such integration proves to be highly unsustainable: the emphasis on exports of raw materials makes social welfare strongly dependent on external economic conjuncture instead of depending on, and establishing, internal sources of growth. The country’s overall share of machinery and equipment accounts for just 13 percent of exports; the rest is represented mainly by raw materials. Under these conditions, even the large financial reserves spent to compensate for the 2008–09 global crisis effects appear to be insufficient to revitalize the country’s economic growth at pre-crisis rates.

Global technology trends also challenge further socioeconomic development if that development continues within the traditional carbon-hydrogen paradigm that is based predominantly on oil and gas extraction. Widely endorsed contre-carbon efforts have already resulted in convincing advances in alternative energy technologies backed by large-scale national public procurement programs, direct and indirect incentives for energy-efficient producers and users, corporate initiatives for technological and organizational innovation, and international actions. Disruptive technologies in these and other areas may damage the positions of companies in established markets—including specific high-tech niches such as nuclear energy, aircraft, space, armaments, and so on—all globally and domestically.

Lower productivity and inefficient resource utilization have also been among the endogenous factors hampering the country’s economic development. In certain sectors of the economy, technological gaps with leading industrial nations have accumulated during the last decades. Furthermore, the monopolistic structures of most local markets that serve to suppress incentives to increase competitiveness, the persistent barriers to entrepreneurship and innovation, the achieved quality of corporate governance, and inadequate protection of ownership rights all limit the potential of extensive sources for improving the Russian Federation’s socio-economic performance. The consequent deficit of trust results in lower incentives for encouraging a pragmatic coalition among business, state authorities, and society, and eventually decreases the effectiveness of public governance.

The above-mentioned challenges demonstrate an obvious need for a new model of innovation policy aimed at strengthening the nation’s positioning in the global economy and at knowledge flows that would allow the Russian Federation to benefit from the available high-quality human capital and scientific potential, while meeting the tight constraints related to the demand for social stability and a GDP-per-capita ratio exceeding that of most rapidly developing economies.

The Russian national innovation system: Trends and problems

Recent years have been notable for the substantial changes in innovation policy in the Russian Federation. Innovation has become a central part of the top-level policy agenda: coordination committees chaired by the President and Prime-Minister were established, key strategy documents were published, and a network of development institutions (the Technology Fund, the Russian Venture Company, the Development Bank, etc.) providing an “innovation lift” was put in place. Earmarked programs to promote university research and development (R&D) and the enforcement of innovative activities at state-owned companies were launched, and the scope of tax incentives for R&D and innovation was widened.

However, all these actions have not yet resulted in increasing the impact of innovation on economic growth and social welfare. At present, innovation activity in Russian industry is still marked by its limited scale and limited performance over a broad range of indicators (Figure 1). The percentage of innovative enterprises here has not exceeded 10-11 percent since 2000. This is considerably less than that for both developed European countries and a number of developing economies. Innovation intensity related to total sales is 1.9 percent in the Russian Federation, compared with 5.5 percent in Sweden and 4.6 percent in Germany as well as the output of innovation investment (innovation products comprise roughly 5–6 percent of total sales for 1995–2009) is similarly low.

1 Åslund, 2007; OECD, 2011c.  
2 Rosstat, 2011  
3 Gokhberg and Kuznetsova, 2011b.  
4 See also Gokhberg and Kuznetsova, 2010.
The poor aggregate performance of the national innovation system (NIS) is explained by a number of structural and institutional imbalances—the innovation cleavages that diminish synergetic effects and discourage innovation-based growth.

- **Science-industry split-offs.** Business exhibits little demand for innovation, which has not become a priority for domestic companies. International markets are targeted by only 2 percent of manufacturing enterprises. A typical business model focuses on local markets with lower competitive pressures, non-economic entry barriers, and subsequently limited incentives for longer-term investment in science and technology (S&T) and innovation. As a consequence, a usual innovation strategy of Russian companies is based on technology adoption via acquisition of machinery and equipment, while spending on R&D and technology lags behind that of the leading European Union (EU) economies (Figure 2). At the same time, R&D organizations tend to fail to provide technologies at the required level of readiness, novelty, and competitiveness. Against the background of rapidly growing public appropriations for R&D, these factors have led to a decline of business enterprise contribution to gross (domestic) expenditure on R&D (GERD) from 33 to 27 percent during 2000–10, versus the averages for the OECD area at 65 percent and for the EU-27 at 55 percent. The outcome has been underdeveloped linkages in the NIS (Figure 3) and, finally, a minimal proportion of new-to-market innovative products (0.8 percent of the total industry sales, compared with 3.3 percent in Germany and 6.3 percent in Finland) attributed to a follow-up model of technological development.

- **Institutional model and the performance of the R&D sector.** The Russian R&D sector still retains the Soviet institutional model in terms of its organizational structure and state participation. It is heavily biased towards research institutes and allied R&D-performing organizations legally independent of both universities and enterprises. These organizations concentrate over 80 percent of GERD; the remaining share is equally divided between the two latter. Because of the deterioration of R&D activities at some public higher education establishments and the rapid growth of a respective private network during the last two decades, only 45 percent of universities are involved in R&D. The gap between science and education has been affecting the quality of teaching staff and educational programs, and hampers the competitiveness of university graduates in the labor market.

- **Sectoral discrepancies.** Different sectors of the economy tend to differ significantly in all major S&T and innovation indicators. The percentage of innovative enterprises varies from 23 to 36 percent in pharmaceuticals, computers, telecommunications equipment, and aerospace (which matches the EU industry average) to 2 percent in specific extracting industries. Service sectors also demonstrate lower levels of innovativeness than they do in the EU. Inter-sectoral and sometimes intra-sectoral differences in the novelty of technological bases, quality of the labor force, and efficiency of corporate governance lead to the fragmentation of Russian industry into technologically and economically incompatible segments.

5 Gokhberg et al., 2009.
6 A billion is 1,000 million.
7 OECD, 2011a.
Figure 2: Expenditure on technological innovation in industry by innovative activity, %

![Expenditure on technological innovation in industry by innovative activity, %](image)


Figure 3: Innovation cooperation in industry (% of innovative companies cooperating with particular types of establishments, 2010)

![Innovation cooperation in industry](image)

Source: HSE, 2011.
Regional polarization. The regional dimension represents one more vector of NIS fragmentation. Regions are characterized by diverse business climate conditions, competition regimes, and availability and accessibility of both innovation and non-innovation (standard) infrastructures (e.g., energy, transportation and logistics, healthcare, education, etc.). Particular combinations of such factors could result in a self-retaining deadlock hampering regional development and prosperity.

Our analyses suggest that this situation requires a shift towards a new regulatory model expressed by a comprehensive and well-balanced policy. Such a policy should have a long-term focus, and should identify and promote prospective priorities with particular attention to emerging post-industrial markets. It should not necessarily be linked to a traditional earlier-obtained understanding of economic growth.

Russian S&T and innovation policy: A new model

Learning from over 20 years of the post-Soviet evolution of the Russian S&T and innovation policy framework (see Box 1), several key principles for efficient regulation at a new stage of socioeconomic development can be derived:

- Since the state remains the key actor of innovative development, prompt and consistent efforts should be made to increase the efficiency of allied policies on both demand and supply sides. One of the areas that must be addressed is the innovation-oriented public procurement system, possibly differentiated along the phases of the innovation cycle. To be successful, it is necessary to ensure the coordination of innovation strategies of state-owned companies, public R&D organizations, universities, and governmental agencies. Regular monitoring and evaluation of the initiatives launched is crucial to identify and disseminate successful practices.

- Indirect instruments (tax incentives, innovation-friendly customs and export regimes) should be carefully evaluated to determine their efficiency and actual administering practices. A revised taxation system is needed for start-up companies and transactions involving intellectual property rights (IPR) that takes innovation costs into account (e.g., costs of allied technology acquisitions, design, engineering, and training activities), exporters of innovative products and services, and so on.

Table 1: Competitive positions of Russian S&T

<table>
<thead>
<tr>
<th>Basic Research</th>
<th>Citations, ranking, 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia Federation: 27</td>
<td>China: 4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Applied Research</th>
<th>Export of technology, 2010 (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Triadic patent families, 2009</td>
<td>Russian Federation: $0.6 (2010)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Share of new-to-market innovative products in total sales, 2009 (%)</th>
<th>Share in global high-tech exports, 2009 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russian Federation: 0.4</td>
<td>Russian Federation: 0.20</td>
</tr>
<tr>
<td>Germany: 3.3</td>
<td>Hong Kong (China): 8.94</td>
</tr>
<tr>
<td>United Kingdom: 2.0</td>
<td>Singapore: 6.61</td>
</tr>
<tr>
<td>Republic of Korea: 5.27</td>
<td></td>
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</tbody>
</table>

Source: Gokhberg and Kuznetsova, 2011a, 2011b.
• One of the most important functions of the state is the facilitation of networking and collaborative initiatives among NIS actors. An unfavorable business environment in a combination with high commercial risks of innovation can halt or postpone self-governed interactions. Under these conditions, specific public-private partnership regimes prove to be an efficient instrument for easing interaction barriers.

• To increase performance of the national R&D sector, reforming its institutional structure is essential. Identifying and promoting the centers of excellence and best-performing research groups in different fields of S&T and in various forms, and fostering of their communication and cooperation should become a principal focus of this policy domain.

• Proper sectoral specialization of the innovation policy seems to be crucial for the Russian industry, at least in the mid term. Limiting policy measures primarily to high-tech sectors, as it used to be, results in excessive concentration on the technology aspects of innovation, restricting its scope and applications. Addressing mass-scale innovation processes across all sectors can ignite more significant effects for the economy and quality of life.

• Incorporating social interests and concerns into the innovation policy design process can significantly increase its impact. Leveraging the uneven access to innovation for different social groups and understanding the specific needs of those groups can produce extra drivers for both demand and supply of innovation. Ignoring such heterogeneity creates severe obstacles for the public perception of innovation and enabling of innovation-driven growth.

Recent official initiatives indicate a new step towards efficient and systemic policy making for S&T and innovation. Strategy-2020, which intended to complete the transition to sustainable evolution of the Russian Federation’s economy and society, contains a chapter entitled “From Stimulating Innovation Towards Innovation-Based Growth.” It presents scenarios and recommendations for a systemic policy mix focusing on the following key areas:

- fostering mass innovation activities in all sectors of the economy rather than an excessive and myopic focus on high-tech;
- ensuring modernization and activation of innovation in the existing industry sectors and facilitating the growth of emerging technology-based markets;

---

**Box 1: Periods of S&T and innovation policies in the Russian Federation: 1990–2012**

**Post-Soviet “market romanticism” (early 1990s):** Drastic changes in governance and economy resulted in a striking decrease in R&D funding; the disintegration of human resources; and the disturbance of established linkages and networks, production, and technology chains caused by dissipation of the centralized planning system and execution flaws. Hopes for efficient self-reorganization of S&T and innovation by market drivers were never realized. The first attempts to establish new mechanisms of R&D funding and governance (public science foundations, state research centers, etc.) were made.

**Stagnation (“market formalism,” mid 1990s):** The key focus of government initiatives concerned principal economic reforms overshadowing S&T and innovation policy. Actual measures were fragmentary and targeted mainly at slowing down further NIS disorganization.

**Recovery (“market pragmatism,” late 1990 to early 2000s):** First efforts to specify strategic policy objectives took place, accompanied by a gradual increase in budgetary R&D financing, experimentation with competition-based public funding, and further development of innovation infrastructure. The overall focus of actual S&T and innovation policy was narrowly targeted at short- and medium-term issues. Delayed-effect initiatives were limited. Debates on reforming the institutional structure of public R&D institutions and funding schemes continued without much progress, while innovation remained a marginal activity for enterprises that faced economic and ownership-protection challenges.

**Agenda for transition to the knowledge economy (2004–09):** The ideas of innovation development had been rooted deeply within the official policy discourse. Much effort was devoted to creating a structured policy framework and efficient regulation. National S&T foresight became a basis for the identification of priority S&T areas, and included a list of critical technologies. Major national development institutions for technology commercialization and innovation were established—for example, the Russian Venture Company Vneshekonombank to support investment projects, and so on. This period also is associated with the launch of the Russian Nanotechnology Program and the creation of Nanotech Corporation (RUSNANO) to foster development of nanotech goods and services and their market penetration.

**Post-crisis “innovation-based growth” (end-2000s to present):** Responding to the effects of the world economic crisis and reacting to the limited performance of existing measures, the government has introduced a number of initiatives to increase the regulative potential of the S&T and innovation policy framework. Specific actions started to improve efficiency of the R&D sector (national research centers, national research universities), strengthen university research and its cooperation with industry, intensify innovation activities of state-owned companies, provide indirect incentives to innovative enterprises, and revitalise innovation initiatives at the regional level. The Strategy for Innovation Development adopted by the government in December 2011 and the innovation policy chapter of a new Socio-Economic Strategy until 2020 (Strategy-2020) were designed for the forthcoming decade on a more systemic basis.

Sources: Gokhberg et al., 2009, 2012; Gokhberg and Kuznetsova, 2011b; OECD, 2011b.
• increasing the impact of innovation policy via particular efforts to stimulate resource efficiency; to promote networking and out sourcing services for innovative companies; and to decentralize decision-making in favor of regions, businesses, and development institutions;

• combining stimuli to both demand for innovation and quality of innovation supply; and

• facilitating social aspects of innovation (by developing human resources and promoting the creative class, by including vulnerable social groups, and improving the public perception of innovation).

The recommendations of Strategy-2020 have already been widely communicated and have contributed to the adjacent activities at different levels of the government. These recommendations are also strongly linked to the above-mentioned Strategy for Innovation Development. Importantly, the newly promoted mechanisms of S&T and innovation policies are considered within an integral framework of broader economic reforms aimed at improving the business climate, fighting corruption and removing administrative barriers, privatizing state-owned companies, stimulating investment and exports, and so on, thus distinguishing it from previous stages by a horizontal synchronization towards a whole-of-the-government policy.

One of the principal outcomes of such synergy is the broadly accepted importance of linkage-stimulating instruments. The next section provides an overview of some of the most recent initiatives in this regard.

Priority focus: Promoting linkages and managing interfaces

Networking within the NIS appears to be not only a factor of efficiency, but also the prerequisite for its proper functioning.11 Encouraging dynamics of knowledge, ideas, technologies, and competences is a subject of appropriate state intervention and facilitation.12 A particular set of the latest policy initiatives in the Russian Federation is targeted at covering persistent innovation cleavages discussed earlier by fostering collaboration between various NIS actors.

Integrating science and education

• A network of national research universities was established by nominating leading higher education establishments with a competitively granted status. The selection was held in two rounds (in 2009 and 2010) distinguishing 27 national research universities on the basis of the multi-criteria performance evaluation, including the quality of education they provide, the level of research they undertake, their available human capital, international acknowledgement, their financial sustainability, and the validity of proposed development plans. The status of “national research university” allows recognized universities to access additional public funding in order to support new academic programs, international mobility, and research infrastructure. It has a limited span of 10 years and can be cancelled ahead depending on annual performance monitoring.

• Support provided to Science-Education Centers introduces another flexible option for promoting the integration of R&D and educational activities within universities and research institutes.

The support envisages involvement of students into R&D activities, boosting internal and international academic mobility, and facilitating the diffusion of competences. Research groups consisting of senior scientists and junior scholars (postgraduate and graduate students) are encouraged to apply for earmarked grants that provide support for three years.

• Attracting the world’s leading scientific competences to Russian universities is another direction of state intervention. A large-scale program launched in 2009–10 provides 79 grants in the range of up to $5 million each to integrate internationally acknowledged scientists into university research labs. These grants cover a wide spectrum of S&T areas such as astronomy and astrophysics, mathematics, physics, nuclear energy, chemistry, biology and biotechnology, information and communication technologies, space, energy efficiency, medicine, nanotechnology, Earth sciences, advanced materials, electronics, ecology, psychology, cognitive sciences, economics, sociology, and so on. The main requirements that need to be met to obtain one of these grants are the presence of a research leader at the university for least four months a year, independent external evaluation, and publication of results in international, peer-reviewed journals.

Encouraging university-industry linkages

• The facilitation of university spin-offs by promoting innovation infrastructure (business incubators, techno parks, engineering centers, and the collective use of research equipment and S&T information) was initiated in 2010 via a competitive subsidies program. Subsidies provide support to IPR protection, advanced training of personnel, and consultancy by Russian and foreign experts in the area of technology transfer and innovation management. Two contests allowed the selection of 78 universities for three-year-long projects.

• A co-funding scheme for research cooperation between industrial companies and universities began in 2010. The scheme is intended for technology projects resulting from university R&D. Companies should provide the same amount of financing as the government, and no less than 20 percent of the public subsidy must be spent on R&D, while the rest should be invested in tooling-up and implementation.

Fostering industry demand for R&D

• An agenda for altering the regimes of the innovation behaviour of major business actors in Russian industry is reflected in the “innovation enforcement” initiative, implying obligations for the mandatory elaboration and execution of innovation-development strategies for 46 large state-owned companies (including, for example, Gazprom, Rosneft, Transneft, Rosatom, Federal Electricity Company, Aeroflot, and Russian Railways) since 2011. Coupled with annual evaluation, these strategies pursue a significant increase of R&D expenditure, the adoption of technologies meeting state-of-the-art efficiency and ecology standards, and an increase of labor productivity and exports. Particular attention is attributed to enhancing companies’ cooperation with universities and R&D institutes, innovative small and medium enterprises, and development institutions. Companies are encouraged to facilitate spin-offs and corporate venture funds in collaboration with external investors. A twofold increase of the total R&D spending of the companies involved in 2010–13 is envis-

11 Powell and Grodal, 2005.
12 Hekkert et al., 2007.
aged, and their funding of university R&D is expected to grow by 64 percent. Ten other large companies were encouraged to participate in the initiative in 2012.

### Promoting S&T networking

Technology platforms—networks based on partnerships—launched in 2011 are targeted at fostering communication and pre-competitive collaboration among leading producers, suppliers, research organizations, universities, and engineering companies.13 These platforms are organized as public-private partnerships. Currently, the list approved by the government includes 30 technology platforms selected out of over 200 initial proposals according to the criteria of legibility of collaboration objectives, market prospects, involvement of key players in S&T and business. Among the listed technology platforms are Medicine of the Future, Bioindustry, Supercomputer Technologies, Laser and Optical Technologies, National Software Platform, Aircraft, Space, National Information Satellite System, Radiation Technologies, Intellectual Energy System, Green Thermal Power Engineering, Renewable Energy, Distributed Energy Generation, Intellectual Railroads, New Polymer and Composite Materials and Technologies, Mineral Resources Extraction, Deep Processing of Hydrocarbons, Mechatronics and Embedded Systems, Exploration of the Ocean, and Technologies for Eco-Development.

Two types of technology platforms can be distinguished. The first is represented by those platforms notable for higher business concentration ratio and centered around large companies. Their primary focus is pre-competitive research to meet the demand for technological modernization. These activities are closely connected to companies’ innovation strategies. The second type comprises other platforms marked by a lower involvement of large companies but an approach that unites research organizations, universities, and small and medium enterprises and that focuses on establishing and communicating a joint long-term vision of thematic priority areas. The role of the government in both these platform types lies in maintaining favorable conditions and removing administrative barriers.

### Technology and commercialization interfaces

One of the most resounding projects is the presidential initiative that resulted in founding the Skolkovo Innovation Center14—an ex-territorial innovation center with the objective of concentrating intellectual resources and business competences, and promoting Russian innovation activities internationally. It is based in a suburb near Moscow and includes a technology university (SkolTech) that is being developed in collaboration with the Massachusetts Institute of Technology (MIT).

It also includes several thematic clusters (information technology, space, biomedical, energy efficiency, and nuclear) and a technopark. The participants of this agglomeration enjoy special taxation and customs regimes while benefiting from communications with investors and fellow innovators. Companies from all regions are encouraged to propose innovation projects, and the contest winners receive funding and allied services (project consultancy, IPR protection, and promotion of international visibility). There are 19 joint R&D centers established by Skolkovo in partnership with leading global companies (such as SAP, IBM, Intel, Microsoft, Siemens, Nokia, etc.). Other forms of alliances with transnational and domestic businesses include corporate venture funds, co-investment in start-ups, and co-financing of research and education infrastructure. The accumulated best practice experiences are supposed to be implemented in some other regions of the Russian Federation notable for high-class R&D and innovation capacities. Time will show whether this approach will be a success or failure.15

A regional innovation clusters initiative was announced in March 2012. This initiative implies the bringing of appropriate infrastructure towards specific locations with already-established innovative production or with promising technology chains. Clusters involving closely located and interlinked companies, R&D organizations, and universities will be supported from both federal and regional budgets on the basis of matching funds to resolve existing infrastructure bottlenecks. The clusters are expected to ensure positive externalities to the overall innovation system of the region, attracting employees to intellectually intensive jobs. At the same time, the cluster participants are encouraged to join related technology platforms in order to amplify the effects of within-cluster advancements and broaden their cooperation networks.

Altogether, the described innovation policy measures provide some specific evidence of the ongoing transformation of the NIS. In some cases, the impact of particular incentives has been immediate and visible (such as, for example, absolute growth in university and business R&D, venture capital, and regional efforts), but it is too early to judge their major socioeconomic effects. The newly designed overall Strategy-2020 policy framework will be launched by the country’s new government in the second half of 2012, and its outcomes will depend heavily on the coordinated and systemic actions of the government pursuing forward-looking objectives and meeting the needs and interests of businesses and civil society. The rule of law, a positive business climate and competition, incentives for foreign direct investment, policy transparency, and trust are among the key factors required for such goals to be achieved.

This article is from INSEAD's Global Innovation Index 2012.

### References


13 Rudnik, 2011.


15 For a discussion of design and implementation problems related to government policies for entrepreneurship and venture capital, see Lerner, 2009.
Russia started negotiating WTO membership on June 16, 1993, when the “Working Party on accession of the Russian Federation to the WTO” was established. On August 23, 2012, over 19 years later, Russia was formally admitted as a member to the trade organization.

- **No instant solutions.** It has become something of a cliché by now to state that accession to the WTO is not a magic wand — it will not instantly improve Russia’s business climate or immediately change how investment skeptics view country risk. It is nevertheless a game changer that has significant medium- to longer-term investment implications.

- **WTO membership most positive for consumer and service sectors.** For investors, the more important impact from WTO membership is that it will likely sustain and expand growth in the consumer and service sectors. Imported goods (finished and components) will be cheaper, and World Bank studies show that WTO membership usually drives wage growth, especially among the lower-wage earners. Companies such as M.Video will be able to import consumer appliances cheaper and sell to a customer base with rising disposable income.

- **Construction spend may also benefit.** Construction companies will also eventually benefit from being able to buy cheaper materials and machinery. Those likely to benefit from this are Mostotrest and some of the real estate developers.

- **Importing equipment will be cheaper.** Companies that buy expensive imported equipment will also benefit as costs come down and leasing terms turn more advantageous. The cost of buying imported aircraft, for example, will be a longer-term cost saver for Aeroflot and other Russian airlines.

- **The WTO has already forced the state to support some industries.** WTO membership has already forced the state to stop procrastinating and create some real protectionist measures in socio-economically sensitive sectors. These measures, and others to follow in similar sectors, may help those industries become more competitive and more solidly based by the end of the WTO compliance period. Investors will also gain by participating in this restructuring. Examples include Sollers in the automotive sector, fertilizer producers in the agriculture sector and Pharmstandard in pharmaceuticals.

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**A Much Clearer Agenda and Time Frame**

- **Transition economies have all seen a boost to growth since joining.** Countries that have joined the WTO, some with at least the same level of skepticism that surrounds the Russia accession, have all benefited from a step-up in economic growth and inward investment. In all of these instances, it was not the specific act of joining that made the difference, but the fact that WTO membership accelerated the pace of internal reforms and forced domestic industries to adapt to increased foreign competition. World Bank studies show that all 15 of the transition economies that have joined the WTO subsequently showed a broader and deeper set of reforms than before they joined. It certainly has been argued that Russia has actually adopted many of the measures associated with WTO membership already, and because the cost base has risen so much over the past 10 years, the benefit of membership will be very limited.

- **A more urgent time frame for change.** Membership provides an improved regulatory backdrop for foreign investors and creates a long-term incentive for Russian industry to become more efficient in the face of increased foreign competition. In that context, it is a significant step that adds to hopes that the next government will prioritize increased improvement in the economy and, more importantly, by starting to address the perception of high country risk, to increase the involvement of foreign manufacturing and service companies in the economy.

- **Russia has moved into a more pragmatic phase.** Membership will therefore create a framework or a time clock for the next government’s agenda to achieve greater efficiency and diversification in the economy, just as the 2018 FIFA World Cup will provide a time table for improvements in key parts of the nation’s infrastructure.

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**Disorder and chaos will always increase in a closed system.**

*The second law of thermodynamics*
Such timelines and external pressures can, of course, be ignored or missed. This is something that investors will only find out over the next few years. But the greater government support for WTO membership this year, i.e. after more than 19 years of indifference, does at least confirm that the long period of inward focus is at an end; now is the time for openness and investment.

- Problems will not evaporate. Endemic corruption, vested interests opposed to change, intrusive bureaucracy, and unreliable rule of law are all well-known barriers to investment and growth. How these are dealt with will be just as important as the WTO changes.

- Strategic industries are the focus of greater state support. WTO membership has also pushed the government into greater efforts to boost investment and changes into so-called strategic economic sectors. There have been initiatives in the agriculture and automotive sectors, and the clearly stated intention is to provide protection and investment to help pharmaceuticals and aviation expand efficiently.

Summary Points

- Russia has agreed to cut its average bound tariff from 11.7 to 7.8 percent. This is actually a good deal compared with most countries that have joined the WTO. Only China and Latvia managed to join with higher bound tariffs of 9.1 and 9.4 percent, respectively.
- On a weighted-average basis, the cut in the average tariff is more drastic, coming down from 12.4 to 6.5 percent. This means prices of goods imported more heavily into Russia will fall the most, e.g. processed food.
- About one third of changes will happen immediately on accession, with another one quarter after three years. The remainder will then change over several years, with the longest affecting the insurance industry. These changes will take place nine years after accession.
- Russia successfully agreed to a lengthy compliance period for the industries deemed most sensitive, e.g. automotive, agriculture and insurance.
- Russia was able to avoid making any concessions on foreign bank branches – all banks operating in Russia must be registered at, and regulated by, the Central Bank.
- There were also no concessions on the domestic gas market – it will remain regulated and the 30 percent export tariff will stay in place.
- Russia has agreed to some privatization measures, e.g. United Grain Company must be sold by year end, and Rosagroleasing must be sold by end 2013. The government has also agreed to keep the WTO informed of progress concerning the privatization of major state companies.
- Russia has agreed to negotiate to join the WTO Government Procurement Agreement within four years. The aim of this agreement is to stamp out corruption in the area of state purchases.
- The World Bank estimates that the economy will benefit by a sustainable 3.3 percent ($65 billion) of GDP in the first three years, rising to 11.0 percent of GDP ($215 billion) after 11 years. The New Economic School in Moscow estimates that membership will add 0.5 percent to annual GDP growth.
- The government estimates that if membership is not accompanied by accelerated reforms, then the loss to the economy may equal 0.5 percent of GDP annually.
- The Finance Ministry estimates that the budget will lose 445 million rubles ($13.5 billion) in tariff revenues over the next two years. Some of that will be clawed back with other permissible measures and with expansion of the economy generally.
- China recorded an 18 percent jump in FDI the year following WTO accession.

Timelines

Russia has been preparing for WTO membership for many years. It formally joined the organization on August 23, following 19 years of negotiations. But it was not a case of the country having to pass a whole series of measures on day one to comply with WTO entry conditions; Russia has passed 42 packages of separate legislation in recent years to conform to WTO requirements.

It is clear now that when we are in the WTO, we should not go sluggish, but there is nothing to be afraid of either.

Vladimir Putin (January 2012)

Changes will take place over several years. Upon formal accession, Russia has agreed to adopt about one third of the entry terms immediately. A further one quarter will kick in after three years, and the remainder will be adopted on an agreed-upon timeline for specific industries. The longest concession period is in respect of the insurance sector, where Russia will only allow branches of foreign insurance companies to operate from August 2021. There are also lengthy concession periods for tariff changes in industries deemed to be of particular national importance, such as agriculture and automotive. These longer timelines have been agreed so that Russia may aid the development of these industries with a mixture of protectionism and subsidies.

Who Wins, Who Loses

- Some sectors will see theoretical gains immediately. The following industries should see some quick benefit, i.e. as other member countries drop existing tariffs or import restrictions/barriers against Russian goods:
  - Non-ferrous metals
  - Ferrous metals
  - Chemicals
Companies Affected By WTO Membership*

<table>
<thead>
<tr>
<th>Ticker</th>
<th>MCap**</th>
<th>Free</th>
<th>2013E</th>
<th>2013E</th>
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<td>2 014</td>
<td>46,8%</td>
<td>7,3</td>
<td>4,0</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Theme: transport</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Global Ports</td>
<td>GLPR LI</td>
<td>1 982</td>
<td>25,0%</td>
<td>9,4</td>
<td>5,8</td>
<td>15%</td>
</tr>
<tr>
<td>NCSP Group</td>
<td>NCSP LI</td>
<td>1 834</td>
<td>29,9%</td>
<td>5,7</td>
<td>6,3</td>
<td>-2%</td>
</tr>
<tr>
<td>Globaltrans</td>
<td>GLTR LI</td>
<td>2 846</td>
<td>35,1%</td>
<td>7,6</td>
<td>5,5</td>
<td>14%</td>
</tr>
<tr>
<td>TransContainer</td>
<td>TRCN LI</td>
<td>1 667</td>
<td>10,6%</td>
<td>9,0</td>
<td>5,0</td>
<td>16%</td>
</tr>
<tr>
<td><strong>Theme: cheaper construction materials and equipment</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Etalon Group</td>
<td>ETLN LI</td>
<td>1 873</td>
<td>27,9%</td>
<td>8,5</td>
<td>6,6</td>
<td>32%</td>
</tr>
<tr>
<td>PIK Group</td>
<td>PIK LI</td>
<td>1 097</td>
<td>43,7%</td>
<td>14,1</td>
<td>8,2</td>
<td>160%</td>
</tr>
<tr>
<td>AFI Development</td>
<td>AFID LI</td>
<td>495</td>
<td>36,3%</td>
<td>4,0</td>
<td>6,4</td>
<td>22%</td>
</tr>
<tr>
<td>Mirland Development</td>
<td>MLD LN</td>
<td>136</td>
<td>23,7%</td>
<td>3,4</td>
<td>7,3</td>
<td>81%</td>
</tr>
<tr>
<td>Mostotrest</td>
<td>MSTT RX</td>
<td>1 600</td>
<td>34,6%</td>
<td>7,1</td>
<td>3,4</td>
<td>–</td>
</tr>
<tr>
<td><strong>Theme: tougher import competition</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GAZ Group</td>
<td>GAZA RX</td>
<td>467</td>
<td>10,9%</td>
<td>2,3</td>
<td>3,2</td>
<td>2%</td>
</tr>
<tr>
<td>LSR Group</td>
<td>LSRG LI</td>
<td>2 189</td>
<td>33,0%</td>
<td>7,1</td>
<td>5,2</td>
<td>58%</td>
</tr>
<tr>
<td>Cherkizovo Group</td>
<td>CHE LI</td>
<td>705</td>
<td>38,0%</td>
<td>2,4</td>
<td>5,5</td>
<td>2%</td>
</tr>
<tr>
<td>Siberian Cement</td>
<td>SCERM RU</td>
<td>376</td>
<td>30,0%</td>
<td>4,6</td>
<td>3,5</td>
<td>–</td>
</tr>
<tr>
<td>IBS Group</td>
<td>IBSG GR</td>
<td>490</td>
<td>37,8%</td>
<td>7,7</td>
<td>4,9</td>
<td>42%</td>
</tr>
</tbody>
</table>

* based on our active coverage stock universe   ** as at close August 8th
Source: Troika estimates, Bloomberg
• Benefits to steel and chemical exporters more theoretical. In theory, the removal of export tariffs and volume import restrictions against Russian chemicals, steel and metals should give a major boost to the metals and mining sector. In practice, the benefits will hardly be seen, as the slowdown in global demand means existing tariff quotas are not being filled. The state of the global economy is much more important to these sectors in Russia than WTO membership. Also, where export tariffs are removed, the state will likely find an alternative mechanism to collect tax revenue, such an increase in MET, which is allowed under WTO rules.

• Consumer sectors best placed. In general, the consumer sectors are expected to be the first major beneficiaries of membership as import tariffs start to be lowered and import restrictions, e.g. against some food imports, are also eased. This will result in a lower retail price or service cost for the end customer. Retailers’ margins should be unaffected, as they simply pass on lower costs to their customer base.

• Wages rise as prices fall. The World Bank’s studies also show that WTO membership has the effect of boosting wages among lower-income earners and the skilled workforce. This is because more foreign companies will, over time, set up operations in Russia and hire staff. Service and expert industries, such as IT businesses and other high-skill consultancies, also tend to follow WTO membership with direct location, and they have to compete for the existing skilled labor pool. Again, this provides a boost for the consumer sectors over time.

• Other benefits take longer. Over the medium term, WTO membership, based on studies elsewhere, should provide a boost to both the range of services, quality of service and volume of end usage in the following areas:
  • Financial services
  • Telecoms
  • Other consumer-related activities

• Accession forces the pace of change. World Bank studies also show that, over a longer period, WTO membership forces companies to focus on efficiency and competitiveness to a greater extent than would otherwise be the case. There are specific dates by which foreign competition may enter the market or enter with lower prices, which tends to instill a sense of urgency not present previously. Companies that successfully embrace that challenge perform well over time, while those that ignore or resist the changes will suffer and underperform.

• Some industries come under immediate pressure. The industries that will face an immediate challenge are those that are protected with the highest import tariffs and have low export content. These are the following:
  • Food manufacturers
  • Light industry
  • Machinery and equipment manufacturers
  • Construction materials

• These companies will likely adopt a wait-and-see approach. Companies in these categories are more likely to delay investment decisions until they have a clearer picture of the effect of WTO membership and the increased competition they face. But while that will likely mean some slowing of growth, i.e. because of delayed investments and increased competition, in the longer term it is again a case of who responds well and who tries to ignore the WTO. For the former category, the long-run efficiency gains will substantially offset these short to medium-term losses.

Structure of Russia’s Imports and Exports, 2011

<table>
<thead>
<tr>
<th></th>
<th>Imports</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Share</td>
<td>$ mln</td>
<td>Share</td>
</tr>
<tr>
<td>Food and agriculture</td>
<td>13,8%</td>
<td>44,7</td>
<td>2,4%</td>
</tr>
<tr>
<td>Mineral products</td>
<td>2,1%</td>
<td>6,8</td>
<td>72,4%</td>
</tr>
<tr>
<td>Chemicals</td>
<td>15,5%</td>
<td>50,2</td>
<td>6,1%</td>
</tr>
<tr>
<td>Wood and pulp</td>
<td>2,3%</td>
<td>7,4</td>
<td>2,2%</td>
</tr>
<tr>
<td>Textiles</td>
<td>5,5%</td>
<td>17,8</td>
<td>0,1%</td>
</tr>
<tr>
<td>Metals</td>
<td>7,0%</td>
<td>22,7</td>
<td>9,1%</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>49,6%</td>
<td>160,6</td>
<td>4,4%</td>
</tr>
<tr>
<td>Other</td>
<td>4,2%</td>
<td>13,6</td>
<td>3,3%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>323,8</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Federal Statistics Service

Macro Effect

• World Bank estimates. The conclusion of the studies presented by the World Bank is that, at a macro level, the costs and gains from WTO membership will be spread over many years, both before and after accession. The bank estimates that the benefit to Russia over the first three years will equal roughly 3.3 percent of current GDP, or an extra $65 billion. Beyond the first three years, the bank estimates the longer-term gain from WTO membership at some 11 percent of current GDP, or $215 billion.

• New Economic School estimates. The New Economic School in Moscow estimates that WTO membership will add about 0.5 pp to annual GDP growth after the initial three-year period after accession, i.e. when more than half of the tariff and import procedure and rules will have changed.

• Assumptions. The studies assume the following:
  • Retail prices for consumer goods will fall as tariffs are lowered for food and services.
  • Incomes will rise across all social strata, but lower-income earners usually benefit most as wages rise and the cost of basic foodstuffs fall.
  • Studies show that in other countries that have joined the WTO, the broad effects of membership have helped cut the numbers living at or below the poverty line and have been a boost to the middle class.
It will be easier to import new technology and services under WTO rules, which will help those industries that want to become more efficient and competitive achieve their goals.

Budget to lose revenues initially. The flip side of the coin is that the federal budget is expected to lose about 445 million rubles ($13.5 billion) in revenues over the next two years as a result of the lower tariffs that the country has agreed to enact upon accession. That is 188 billion rubles in 2013 and 257 billion rubles in 2014. The counterargument is that the budget will benefit from the expansion of economic activity elsewhere.

No real benefit to exports. Russia’s exports will see very little change because they are dominated by oil, gas and metals and mining products. These are either not at all affected or are least affected. Imports are mainly made up of machinery and equipment (49.6 percent of the 2011 total), chemicals (15.5 percent) and food (13.8 percent). The import tariffs on all of these will fall after accession.

Monogorods
Legacy cities from the Soviet era are exposed. Russia has 450 of these so-called monogorod regions/cities, according to the New Economic School in Moscow. These are most at risk of serious economic downturn if the specific industry on which they depend suffers a loss of market share or profitability. The New Economic School warns that many of these cities and regions could easily become unemployment black spots or suffer depopulation. In that event, they may also easily become centers of political protest against the Kremlin and central government in the next few years.

The report from the New Economic School forecasts that growth in the main cities will be boosted by 0.88 percent annually, while that of the regions may fall by 0.14 percent annually because of WTO membership.

WTO: Basic Principles
There are five basic principles that WTO refers to as being at the core of the organization, according to Russia AMCHAM News, Issue 94, “WTO Briefing”:

No Discrimination
No WTO member can award most-favored-nation status to one or few trade partners. Trade and investment conditions offered to one country must be made available to all others.

WTO membership also mandates that imported goods and services must be treated in exactly the same way as domestically produced goods and services.

Reciprocity
This is an extension of the first principle and aims to eliminate so-called “free-riding,” or efforts to get better access or gain an advantage over others in some foreign markets.

Binding and Enforceable Commitments
Tariff commitments made as part of a multilateral trade deal are to be set out in a schedule called “ceiling bindings.” A country may

<table>
<thead>
<tr>
<th>Structure of GDP</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP at market prices</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>17.3%</td>
<td>17.3%</td>
<td>15.6%</td>
<td>16.3%</td>
<td>16.2%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>15.1%</td>
<td>14.9%</td>
<td>12.9%</td>
<td>12.9%</td>
<td>13.6%</td>
</tr>
<tr>
<td>Real estate, incl. renting</td>
<td>9.3%</td>
<td>9.6%</td>
<td>10.9%</td>
<td>10.6%</td>
<td>9.9%</td>
</tr>
<tr>
<td>Mining and quarrying</td>
<td>8.6%</td>
<td>8.0%</td>
<td>7.4%</td>
<td>8.5%</td>
<td>9.1%</td>
</tr>
<tr>
<td>Transport and communications</td>
<td>8.3%</td>
<td>7.9%</td>
<td>8.4%</td>
<td>8.3%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Construction</td>
<td>4.9%</td>
<td>5.4%</td>
<td>5.4%</td>
<td>5.8%</td>
<td>5.5%</td>
</tr>
<tr>
<td>Public administration and defense</td>
<td>4.4%</td>
<td>4.6%</td>
<td>5.7%</td>
<td>5.2%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Financial activities</td>
<td>3.8%</td>
<td>3.7%</td>
<td>4.4%</td>
<td>3.9%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Agriculture and forestry</td>
<td>3.6%</td>
<td>3.6%</td>
<td>3.9%</td>
<td>3.3%</td>
<td>3.4%</td>
</tr>
<tr>
<td>Utilities</td>
<td>2.6%</td>
<td>2.5%</td>
<td>3.6%</td>
<td>3.3%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Health and social</td>
<td>2.9%</td>
<td>2.9%</td>
<td>3.5%</td>
<td>3.2%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Education</td>
<td>2.3%</td>
<td>2.4%</td>
<td>2.9%</td>
<td>2.6%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.9%</td>
<td>0.8%</td>
</tr>
<tr>
<td>Other</td>
<td>1.8%</td>
<td>1.7%</td>
<td>1.7%</td>
<td>1.5%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Net taxes on products</td>
<td>14.3%</td>
<td>14.8%</td>
<td>12.8%</td>
<td>14.0%</td>
<td>15.1%</td>
</tr>
</tbody>
</table>

Source: Federal Statistics Service

Growth in GDP Components

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>1.3%</td>
<td>16.1%</td>
<td>18.1%</td>
</tr>
<tr>
<td>Fishing</td>
<td>-0.9%</td>
<td>13.2%</td>
<td>-9.6%</td>
</tr>
<tr>
<td>Extractive industries</td>
<td>-2.2%</td>
<td>1.7%</td>
<td>3.5%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7.5%</td>
<td>6.1%</td>
<td>14.8%</td>
</tr>
<tr>
<td>Utilities</td>
<td>-3.4%</td>
<td>0.4%</td>
<td>1.6%</td>
</tr>
<tr>
<td>Construction</td>
<td>13.0%</td>
<td>4.8%</td>
<td>43.9%</td>
</tr>
<tr>
<td>Retail</td>
<td>11.7%</td>
<td>5.0%</td>
<td>60.5%</td>
</tr>
<tr>
<td>Hotels and restaurants</td>
<td>13.6%</td>
<td>4.8%</td>
<td>34.9%</td>
</tr>
<tr>
<td>Transport and communications</td>
<td>4.8%</td>
<td>2.9%</td>
<td>26.4%</td>
</tr>
<tr>
<td>Finance</td>
<td>29.1%</td>
<td>3.4%</td>
<td>143.9%</td>
</tr>
<tr>
<td>Real estate</td>
<td>20.8%</td>
<td>2.6%</td>
<td>70.9%</td>
</tr>
<tr>
<td>State administration and defense</td>
<td>3.9%</td>
<td>2.8%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Education</td>
<td>1.1%</td>
<td>-0.8%</td>
<td>-2.3%</td>
</tr>
<tr>
<td>Health care</td>
<td>1.1%</td>
<td>31.0%</td>
<td>8.0%</td>
</tr>
<tr>
<td>Housing and social</td>
<td>8.6%</td>
<td>1.0%</td>
<td>-7.9%</td>
</tr>
<tr>
<td>GDP at basic prices</td>
<td>8.4%</td>
<td>4.0%</td>
<td>31.4%</td>
</tr>
<tr>
<td>Net taxes on products</td>
<td>9.1%</td>
<td>6.0%</td>
<td>34.8%</td>
</tr>
<tr>
<td>GDP</td>
<td>8.5%</td>
<td>4.3%</td>
<td>31.8%</td>
</tr>
</tbody>
</table>

Source: Federal Statistics Service
Summary of Changes: Winners and Losers

**Existing import tariffs**

**Changes on accession**

**Effect after full Implementation**

Positive for Negative for Longer-term impact

---

**Summary**

Average bound tariff: 11.7%

33% of tariff's change

Another 25% of tariffs change after three years

Up to nine years for longest concessions

Average tariff will fall to 7.8%

Foreign aircraft will qualify for same leasing benefits

---

**Consumer**

**Long-term reform booster**

**Light manufacturers**

Inefficient producers

WTO provides the incentives for faster domestic reforms

Membership usually boosts domestic consumption

Companies that work with foreign JV partners usually fare best

---

**Agriculture – food**

Average: 13.2%

Gradual change

Different time scale applies

Average: 10.8%

Dairy will fall from 19.8% to 14.9%

Grain tariffs will fall from 15.1% to 10.0%

Poultry has a concession period of the full eight years

Consumers

Food producers

Huge incentive for efficiency and quality gains

More spending on infrastructure

More machinery sales

More fertilizer sales

---

**Auto manufacturers**

New cars: 30-35%

Used cars: 35%

New LCVs: 25%

Used LCVs: 30%

25%

25%

10%

15%

15%

15%

20%

5%

10%

---

Consumers

Industry

LCV manufacturers

---

**Aviation**

Wide-bodied aircraft: 20%

Narrow-bodied aircraft: 20%

Change over four years

To a tariff of 7.5%

To a tariff of 12.5%

Aircraft operators

Efforts to sell new

Russian aircraft

Cheaper purchasing costs for airlines

Will increase the need for JV between UAC and foreign company

---

**Banks**

Foreign branches excluded

Total foreign bank share: 15%

Cap on foreign bank share of market to be 50%

Banks are a generally beneficiary of improved economic performance

Better consumer market will boost financial services

---

**Building materials**

Currently import tariffs range up to 20%

Gradual change

New tariffs will be bound at 9% (range 0-15%)

Construction companies

Local construction material manufacturers

---

**Construction equipment**

Tariffs on equipment can reach 25%

Gradual change

To an average of 5.3%

Construction companies

Manufacturers

Construction companies benefit from low input costs

---

**Construction materials**

Tariffs can reach 20% on materials

Gradual change

New tariffs will be bound at 9% (range 0-15%)

Construction companies

Manufacturers

Government may also benefit from lower infrastructure costs

---

**Customs**

High customs clearance costs

Fee will be cut by two thirds

Importers

Will cut end customer costs

---

**Food retailers**

High import costs

Gradual reduction in costs

Lower import tariffs will mean lower retail prices

Consumers

Domestic producers

Will also help lower inflation and push producers toward efficiency

---

**Insurance**

Foreign branches excluded

Total foreign insurance company market share: 15%

No change

Gradual change

Nine years to allow branches

Limit of foreign share to be raised to 50%

Consumers

Better choice and service

---

**Light industry – manufacturing**

Existing tariff: 9.5%

Gradual eventually falling to 7.3%

Consumers

Light manufacturers

Will force efficiency gains and JVs with foreign partners

---

**Metals**

Russian exports face tariffs

Import tariffs average 8.9%

Foreign country tariffs removed

Gradual

Reduced to an average of 6.0%

Steel exporters

Steel users

Marginal effect

In practice, exporters do not currently fill their quotas due to low demand

---

**Oil producers**

No impact

No change

Small positive from agriculture fuel sales

Subsidies to farmers end

---

**Oil services**

Restricted access

No change

No major change

Oil service providers

Foreign access limited

---

**Pharmaceuticals**

Current tariffs average 5.7%

but up to 15%

Gradual

Will be bound at 4.4%

Government plans to aid local producers and encourage JVs

---

**Railway costs**

Different costs for domestic and foreign

Equalized on accession

Shippers of goods

Will also help reduce end user costs

---

**Retailers**

Higher product prices

Prices start to fall

Lower import and domestic prices

Consumers

Domestic manufacturers

Lower prices and better access to quality goods means higher volumes

---

**Services**

Some restrictions

Full access

For retailers, wholesalers, franchise operators

Consumers

Inefficient existing operators

Better consumer choice helps boost consumer economy

---

**Telecoms**

Foreign cap at 49%

Gradual

To be removed after four years

Telecom users

Should help the industry expand

---

**Transport**

Tariff on equipment up to 20%

Gradual

Average at 7.6%

Transport operators

Manufacturers

Ports and logistics should gain

---

**Utilities**

No impact

No change

No change

Lower equipment costs and volume

---

Note: see industry descriptions later for more detail

Source: WTO, Economy Ministry, Troika estimates
change its bindings, but only after receiving agreement from the trade partners to which it relates. The partner(s) may be entitled to compensation as part of the agreement to change and can use the WTO dispute resolution process if necessary.

Transparency
Members are required to publish their trade regulations, to maintain institutions that will allow other members to review decisions and actions affecting trade and to notify all other members of any changes.

The WTO also has the right to conduct periodic country-specific trade reviews under the trade policy review mechanism.

Safety Valves
In some specific instances, governments have the right to restrict trade. There are three broad categories:

- Measures allowing for use of measures for non-economic objectives.
- Measures aimed at ensuring fair competition.
- Measures allowing for intervention in trade deals for economic reasons.

WTO Brief: Dispute Settlement

- Procedures to be followed. In 1994, WTO members agreed on the Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU) annexed to the Final Act signed in Marrakech in 1994. Dispute settlement is regarded by the WTO as the central pillar of the multilateral trading system, and as a “unique contribution to the stability of the global economy,” WTO members have agreed that if they believe fellow members are violating trade rules, they will use the multilateral system for settling disputes instead of taking action unilaterally. The operation of the WTO dispute settlement process involves the DSU panels, the Appellate Body, the WTO Secretariat, arbitrators, independent experts and several specialized institutions.

Industry Implications: Agriculture

- Russia has become a significant food importer. Russia’s agriculture sector was one of the worst hit industries in the 1990s and the early part of the last decade. Russia used to be a net food exporter in the Soviet era, but because of neglect and a lack of investment, the industry slid into decline. In 2009, for example, only 3.3 percent of the value of Russia’s exports was made up of food and agricultural products, whereas 17.6 percent of the value of imports was in this sector. That was a net deficit of $24 billion in that year, while the deficit between imports and exports last year was $32 billion.

- Crisis highlighted poor state of the industry. The agricultural crisis of August 2009 drove home the extent of that underinvestment. Although the specific crisis was caused by drought conditions and extensive forest fires, the very obvious conclusion for all to see was that a considerable contributor to the crisis was the lack of investment in the industry over the past 20 years. President Vladimir Putin, prime minister at the time, undertook to rebuild the sector and return Russia to a position of being a net food exporter. He described this as being strategically important for the economy and national security.

- Changes and incentives already in place. Since then, the government has enacted legislation (early in 2011) that will allow for the forced sale of 40 million ha of previously arable land that has been left idle for at least three years and has opened the way for foreign expert companies to gain access to the industry. Many of the items of legislation passed before the WTO deal was agreed upon relate to agriculture and are designed to either give protection to the fledgling industry or incentivize investment. Essentially, the government has created a separate development plan for the industry to run in parallel with the WTO timetable.

WTO changes

- Tariff changes. The average import tariff on food items will fall from 13.2 to 10.8 percent over an implementation period of up to eight years.
- Dairy import tariffs will fall from 19.8 to 14.9 percent.
- Grain import tariffs will fall from 15.1 to 10.0 percent over three years.
- Imports on poultry have a concession period of eight years.
- Wine imports will see the tariff cut from 20.0 to 12.5 percent within four years.

There is a long list of changes to tariffs and time frames by product available.

- Agriculture has been a contentious issue. Changes to the tariff structure and the way the state subsidized the agricultural sector has been one of the more contentious issues in the negotiations. The government has agreed to replace the current subsidy scheme with a new support program from 2013. The main thrust of the changes is to move away from a broad-based subsidy scheme to a scheme more targeted at areas for growth.

- An end to discounted sale of fuel to farmers. Farmers have benefited from a 30 percent discount on fuel costs, which saved the industry about 24 billion rubles ($740 million) in 2011.
- An end to fertilizer discounts. These discounts totaled $117 million in 2011.
- Milk subsidies to rise. These will increase from 10 billion rubles ($300 million) to 12.5 billion rubles ($380 million) as part of the program to raise standards in the dairy industry. Currently, only 20 percent of milk output and 50 percent of butter production complies with EU standards, according to the Agriculture Ministry.
- State can subsidize up to $9 billion initially. Russia is allowed to subsidize the industry up to $9 billion in 2013, but will have this cut in half by 2018 to $4.4 billion. Of course, Russia only ever spent just less than $6.5 billion (at the peak in 2008) in subsidies,
so the government actually has scope to raise spending for several years initially. The new subsidy scheme is forecast to cost 1.5 trillion rubles ($46 billion) from the federal budget and 770 billion rubles ($24 billion) from regional budgets, according to Finance Ministry data. The Agriculture Ministry had requested 3 trillion rubles ($92 billion).

- **Some subsidies are allowed.** Subsidies also break down into two categories:
  - **Amber Box, which are trade distorting**
  - **Green Box, which are not trade distorting**

- **Green Box subsidies not affected.** The limit on subsidies applies to the Amber Box category only. This is the category to which $9 billion can be applied in year one, and which must drop to $4.4 billion annually by 2018. Green Box subsidies are unlimited and include public spending on infrastructure, R&D, training, pest control, inspection services, marketing and promotion and some targeted support for low-income earners. Basically, anything that is not directly price distorting. The trend worldwide is for governments to shift more and more to these Green Box subsidy schemes.

- **Health inspections should also be less contentious.** The other significant area of compromise is in the area of sanitation and phyto-sanitation. This has been a hugely contentious area of dispute between Russia and the U.S. over the past two decades. Russia has now agreed to accept U.S. DAFS certification for poultry and pork and to joint inspection of beef production facilities. This will greatly ease the export of U.S. meat to Russia while raising competition for domestic producers.

- **Likely to lead to some JVs in machinery sector.** It should also be cheaper and, in theory, easier to import agricultural machinery into Russia. The average tariff for imported machinery fell to 5.2 percent upon entry. Some large items currently have an import tariff of 15 percent. This fell to 5 percent on day one. In practice, the import procedures will remain subject to difficult bureaucracy, so many international manufacturers will still follow the lead of companies like the U.S. company John Deere. It manufactures tractors in the U.S. and then disassembles them to send to Russia, where the tractor is reassembled. In the future, we are more likely to see JVs between international manufacturers and local producers similar to that seen in the automotive sector.

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**Longer-term impact**

- **Government has targeted agriculture for growth.** The efficiency of Russian agriculture is only 50 percent that of the EU average, and huge tracts of arable land remain idle. The ambition of the new directed subsidy scheme is to raise agricultural output by 20 percent over the next seven years. The aim of the program is to boost domestic output across crops, grains, livestock and poultry and dairy, and to make the product match the quality of imported goods. If successful, Russia would cut its food import bill significantly and agriculture-food production would rise as a percentage of GDP. It should also mean cheaper and better-quality food products in Russian stores for the consumer.

- **Infrastructure is a key part of the long-term recovery plan.** Building out the infrastructure to support the sector will mean irrigation and access roads. Manufacturers of farm machinery will not get the same broad protection as automakers, but we should see more JVs between domestic producers and established international brand manufacturers.

**Investment strategy**

- **A long-term investment theme.** The end user of food will see the quickest impact, as prices of imported products will start to ease lower and domestic competitors will also have to reduce prices to compete with a potentially larger volume of imports in the early years. The best place to position over the first few years will again be in the consumer sectors generally.

If the government does follow through with plans to develop the agricultural industry generally, then we should see more spending on infrastructure and, eventually, on agriculture inputs and machinery.

**Investment Timeline**

**Initially**

Consumer sectors, especially the retail sector that may see a pick in volume.

The ending of the fuel and fertilizer subsidies will have a negligible impact on the suppliers. Fuel supply to the agricultural industry is widespread across the oil industry, so the ending of the discount will only have a modest impact on any of them.

In the fertilizer market, the impact will be small initially, as producers have long been using different price packages to bring the domestic price up to the export level.

**Medium Term**

Providers of infrastructure, such as water pipes and pumps, for example HMS Group, are in this category.

Machinery producers, especially those that form JVs like in the auto sector, should also see a pickup. There are no currently listed names in this category, albeit the country’s largest tractor producer announced plans to hold an IPO in 2008, but has since delayed due to market conditions.

** Longer Term**

If WTO entry and the change in the government's subsidy schemes

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**Short-term impact**

- **Negative for producers.** The short-term impact on Russian agriculture will be negative. Direct fertilizer and fuel subsidies will be cut and replaced with targeted subsidies in specific areas. It will be positive for dairy producers, which will benefit from the shift to specific industry subsidies, but hurt other producers as direct costs and competition increase. Several Russian producers, e.g. Cherkizovo Group, have already said that they will delay investment plans until they can better assess the impact of WTO membership.

- **Positive for consumers.** It will be positive for the consumer sector, and for inflation. Imported food will be more readily available, and that will drive down prices in some areas.
start to deliver the growth in volume and efficiency hoped for, there will be a wide range of beneficiaries.

- Potash and fertilizer volumes will rise, albeit the export market will still be very dominant. Uralkali has spare capacity that it can load and has an expansion program. Acron has lots of expansion plans in nitrogen, phosphate and potash.

- Greater efficiency measures and lower input costs should help improve producer margins, and better-quality products should boost overall sales volumes and the share of domestic producers.

- Machinery producers will see a better pickup in the longer term.

- Rail freight will eventually see better volume growth.

**Industry Implications: Automotive**

- The automotive industry is both economically and politically sensitive. The auto sector is another of the sensitive industries that the government is eager to protect and to grow. In mid 2009, when the recession hit Russia’s so-called monogorods – one industry cities – the workers in the car sector were the most politically active. The protests brought a very quick response from Putin and a promise to start rebuilding the industry. Part of that was to try and acquire GM’s German subsidiary Opel, with Putin specifically saying that was part of the plan to bring in foreign expert partners at a strategic minority level to help Russian manufacturers become more efficient and expand.

- State intervention has helped the sector recover rapidly. As it turned out, the GEM-Opel deal failed and the government had to revert to the previous deal involving Renault. The state then pumped a considerable amount of money into the industry and introduced a cash-for-clunkers program, which lasted several years and had a considerable impact on sales volumes.

- On track to be the biggest market in Europe. New passenger car sales reached 2.7 million units in 2011, making Russia the world’s fifth largest market, just behind Germany, which sold 3.2 million units. The forecast for 2012 is that unit sales will be very close to 3.0 million. There is still considerable scope for further growth as:
  - Disposable income grows.
  - People replace older models with new, more efficient, models.
  - A larger proportion of the population buys cars.
  - There is greater access to financing options.

- Lots of scope remains. At end 2011, there were 257 passenger vehicles per 1,000 people in Russia, compared with an average of 450 in the EU. The average age of the existing fleet of 37 million passenger vehicles was 12 years.
Some state support measures. As part of the WTO entry negotiations, Russia has been able to introduce a number of parallel measures that:

- Aim to protect the domestic industry during the transition phase.
- Hope to better establish the industry to be competitive after the protective measures are removed.
- Hoping to boost SMEs. Another part of the reason for the new parallel protective measures, specifically relating to the domestic sourcing of parts, is to try and broaden the industry’s footprint. If that works, there will also be much less incentive for manufacturers to import but rather to source domestically.

WTO changes
- Tariffs will change. The changes to import tariffs will be phased in for passenger vehicles, but will alter immediately for commercial vehicles.

Auto Industry tariffs, impact of WTO accession

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<td>Passenger vehicles, new</td>
<td>30-35%</td>
<td>25%</td>
<td>15%</td>
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<tr>
<td>HCV, used</td>
<td>30%</td>
<td>15%</td>
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Source: WTO

Minimum requirement for domestic sourcing. As compensation for the tariff changes, Russia has introduced a rule that requires car producers to source 60 percent of the vehicle content locally in Russia for up to a minimum volume of 300,000 vehicles (for new producers) or 350,000 units (for already established producers). If that minimum requirement is not met, either the 60 percent content or minimum production volume, then the producer does not benefit from the new tariff regime for imports.

Short-term Impact
- More negative for LCV manufacturers. The greatest negative impact will be for producers of light commercial vehicles (LCVs), as the import tariff drops immediately from 25 to 15 percent for new LCVs and from 30 percent to only 10 percent for used LCVs. So far, there are no proposals to protect domestic LCV producers. GAZ Group is the most exposed to the WTO tariff changes, as it has a 50 percent market share of the domestic LCV market.
- Macro effect on passenger carmakers more important. For passenger car manufacturers, the short-term trend will still be dictated by the macro economy rather than the WTO. Real wages and real disposable income are both growing and supporting continued expansion in the sale of consumer goods.

Longer-term Impact
- Looking to better establish the industry. In the longer term, the government’s initiatives to force producers to source more of their parts domestically has a very good chance of creating firmer foundations for the auto manufacturing sector and for the supply and services sectors.
- LCV segment still has question marks. The situation concerning the LCV and HCV sectors is less clear, but some measures to protect the industry and to incentivize domestic production are also expected.

Investment Strategy
- Part of the consumer story. The outlook for the automotive industry is much more closely linked to the macroeconomic environment than to WTO entry. The industry is growing fast as people have greater disposable income, better access to finance and want a more modern car. The protective measures introduced by the government will help sustain domestic manufacturing growth.
- Better demand for domestic steel. Many of the suppliers of parts to the industry are not yet listed on the stock market. The one that is listed in the steel sector, MMK, is well placed as a beneficiary of rising steel demand from the automotive sector.

Investment Timeline
- Passenger car manufacturers. The listed car manufacturers are well positioned to benefit from the growing market. GAZ Group, notwithstanding its vulnerability to a loss of market share in the LCV segment, Sollers and AvtoVAZ are all well positioned.
- Steel suppliers. MMK trades more on global sector sentiment and steel prices and will continue to do so even as sales volumes to the auto sector increase.

Industry Implications: Banks and Financial Services
- Russia successfully prevented foreign bank branches. Russia achieved one of its major concessions in the bank and financial services sectors. Branches of foreign banks will not be allowed, while branches of foreign insurance companies will only be allowed nine years after accession.
- Foreign bank market share will rise. Russia has agreed to allow the market share controlled by foreign banks operating with a license in the country to increase from 15 to 50 percent. The same goes for the share of foreign insurance companies. This means that foreign banks and insurance companies regulated by the Central Bank will be able to open branches, but no branches of foreign institutions not operating under the regulation of the Central Bank.
- Central Bank remains in control. Subsidiaries of foreign banks must be registered and regulated by the Central Bank and its capital requirement based on regulations set out by the Central
Bank rather than the regulator of its parent bank. The Central Bank argued that this is necessary to ensure banks are properly capitalized and to ensure the safety of depositors. Russia made it clear that this was one of the deal-breakers in the negotiations and eventually prevailed.

• Full access for non-core activities. Russia has agreed to full access for other types of financial services, including brokers and cross-border services, such as financial leasing.

Industry Implications: Oil and Gas, Energy

• Very little effect. WTO membership has almost zero impact on the oil and gas sector. Russia successfully avoided demands that it cut subsidized domestic gas prices and further liberalize the gas industry. The gas industry will remain regulated and the 30 percent export tariff will stay in place.

• The eventual breakup of Gazprom’s export monopoly is only loosely connected. One possible/probable concession, not specifically subject to the WTO entry terms but still a likely concession, is that Gazprom’s export monopoly to Europe will be broken. Putin conceded this as likely in comments late last year, and NOVATEK appears to be in the early stages of building a customer base in Germany. No time frame has been announced or suggested.

• No impact on oil field services. In the area of oil field services, Russia has agreed to improve market access, albeit only in the segment of consulting rather than field operations.

• No major utilities impact. There is no obvious impact on the utilities sector other than the fact that companies will be able to import equipment with lower tariffs after full implementation of WTO entry terms.

Industry Implications: Consumer

• WTO provides a strong boost to consumerism. Consumers will initially be the main beneficiaries of WTO membership. The cost of imported goods will be reduced as import tariffs are cut across a range of items, including food products. There will also be easier access, in theory, for imported goods, which should also push domestic prices lower, as domestic manufacturers will need to adjust to compete.

• Retailer margins should be unaffected. There should be very little impact on the listed food retailers, as they will be able to keep their margins by adjusting the retail price to the lower input cost. The retailers benefit in the longer term from an expansion of the market, as more and better quality goods become available, and as consumer spending power increases.

• Higher wages can also boost spending. World Bank studies also show that WTO entry can lead to a steady increase in wages as more foreign companies enter the market and compete for workers. That also provides a boost for consumer spending. In the longer term, the hoped-for benefit from WTO membership is that domestic sourcing of lower-priced but higher-quality products will increase. That will also be a major driver for the domestic and consumer economy over the longer term.

WTO Changes

• A wide range of tariff changes over several years. Russia has agreed, on full implementation, to cut its average bound tariff from 11.7 to 7.8 percent. On a weighted-average basis, the cut is more significant, falling from 12.4 to 6.5 percent, according to World Bank estimates. That greater fall applies more to goods that make up the bulk of imports today, processed foods in particular.

  • For the consumer sector generally, the current tariff averages at 13.3 percent, while the average falls to 10.3 percent after accession.
  • The tariff on imported appliances will fall from an average of 12.2 percent (some are up to 20 percent) to 9.8 percent.
  • The tariff on imported furniture will fall from an average of 13.2 percent (up to 15 percent) to 9.7 percent.
  • The tariff on leisure goods will fall from 10.7 percent (up to 20 percent).
  • The tariff on textiles will fall from 10.9 to 7.9 percent.
  • The tariff on footwear will fall from (up to) 20 to 16 percent.
  • The tariff on cosmetics will from 13.5 (up to 15 percent) to 6.3 percent.
  • The tariff in computers and other electronics will fall from an average of 6.7 (up to 20 percent) to 4.0 percent.

Short-term Impact

• Will help sustain growth. The short-term outlook for the consumer sector is still much more bound up with the trend in the country’s macroeconomic environment. But the immediate cut in some tariffs in the consumer sector may lead to a one-off boost in the sale of some items as the price falls. This is more of a benefit for the retailers than any other sector.

Longer-term Impact

• WTO a big driver of consumer activity. It has been shown that time and time again WTO entry helps sustain better growth in the consumer area as prices are lowered and wages rise. The basic macro backdrop will remain the dominant factor but the benefits from WTO entry will add to the growth in the long term.

Investment Strategy

• WTO entry supports the case for domestic economic themes. We prefer domestic themes to extractive industries in Russia because of the growth outlook in the former and the taxation/regulatory risk in the latter. WTO entry enhances the case for the domestic themes in general.

Industry Implications: Other Industries

Building and construction materials

• Materials and equipment imports will be cheaper. After full implementation, the import tariff on building products will fall from as high as 20 percent in some instances to an average of 9 percent, to a range of 0–15 percent. Tariffs on construction equipment will fall from up to 25 percent for some items to an average of 5.3 percent.

• LSR Group sees both benefit and cost. The lower tariff on building materials is a positive and negative for LSR Group, as it is both a consumer (in its house building activities) and a supplier of materials that will face downward price pressure. The other real estate
and property developers will benefit. Mostotrest is also a winner, as it will see lower material and equipment costs.

- **Overall industry spending set to rise.** As Russia gears up for big infrastructure projects, such as the Sochi Olympics and the 2018 World Cup, plus the clear need for a major construction spend increase, this is one of the more lucrative industry groups to benefit from WTO entry.

  **Chemicals**
  - **Exports will be made easier.** The sector is one of those that will show an immediate gain, as currently high (in many instances) tariffs against Russian exports will be removed.
  - **The new tariff will fall to 5 percent.** For imports, Russia has agreed to lower its existing average tariff of 6.7 percent, albeit it can go as high as 20 percent, to an average of 5.3 percent. The country has also agreed to bind the tariff on just over 70 percent of chemical products at 5 percent.

  **Metals and Mining**
  - **Exports are easier after WTO entry.** The ferrous and non-ferrous metals sectors are, like chemicals, among the immediate winners from WTO entry, as tariffs against the export of Russian metals will be removed. That is the theory. In practice, the effect will be negligible at the start, as most companies are not filling their existing quotas due to low demand. The slowdown in the EU economy, in particular, has affected demand in recent years, and the positive tariff removal effect will not be seen until there is a broad economic recovery leading to higher steel usage.
  - **Benefits will likely be clawed back.** Concerning copper and nickel, the existing export tariffs will range between $450/ton and $500/ton this year and are due to be canceled by 2017. Again, in theory, that will provide a big boost to Norilsk Nickel. In practice, we expect the government to find an alternative way to collect the money, such as an increase in the MET, which is not regulated by the WTO.
  - **Import tariffs will fall to 6 percent for steel.** Against steel imports, Russia currently applies an average 8.9 percent tariff and this will be cut to an average of 6 percent after full implementation. For non-ferrous metals, the current import tariff ranges up to 20 percent. After implementation of WTO commitments, the average will fall to 8.5 percent.

  **Pharmaceuticals**
  - **State sees pharmaceuticals as a strategic industry.** The pharmaceuticals industry is on the list of industries where the state has indicated that it intends to provide strong financial and regulatory support to help domestic producers grow and compete successfully. Putin, when he was prime minister, said that the industry would be protected and that restrictions would be placed on the import and sale of medicines from foreign companies that did not source a significant volume of product locally, and which also did not locate technology and R&D in the country.
  - **Tariffs cut to 4.4 percent on average.** Russia currently has an average tariff on pharmaceutical imports of 5.7 percent, but on some items it goes as high as 15 percent. After full implementation, the average tariff will be cut to 4.4 percent.
  - **Still waiting to hear measures.** Compared with the protectionist measures announced for the automotive and agriculture sectors, very little has since been said or done in support of the pharmaceuticals sector but it remains one of the strategically important industries. Protectionist measures or other state initiatives to help the domestic sector grow are expected.

  **Telecoms**
  - **More fixed line competition.** The existing maximum quota of 49 percent aggregate foreign ownership in the telecom sector is to be removed after four years. Russia previously agreed to terminate Rostelecom’s monopoly on long-distance fixed line telephone services.

  **Transport**
  - **Tariff cut from 8.3 to 7.6 percent average.** Russia currently levies tariffs on shipping and transportation equipment up to 20 percent and with an average tariff of 8.3 percent. After full implementation, the average tariff will be cut to 7.6 percent and will be bound at that level. This applies to a wide range of transport equipment such as containers and handling equipment. This should benefit companies operating ports and in other areas of the transport sector that imports equipment or where domestic equipment will have to be priced lower to compete with imports.
  - **Cheaper imported aircraft will help major buyers.** Aeroflot is another beneficiary because of the reduction in the import tariff on wide-bodied aircraft from 20 to 7.5 percent in the four years after accession. Aeroflot and other Russian airlines plan to acquire “hundreds” of new aircraft over the next decade, both to replace the existing fleet and to expand, so the cut in tariff represents a substantial saving.
  - **State keen to develop domestic industry via JVs.** The government has set as an industry priority the development of domestic aircraft and shipbuilding industries. United Aircraft Corporation combined several previously separate state-controlled aircraft manufacturers with the aim of building a competitive aircraft holding. Progress has been slow. It is more likely that the government will look to emulate what has been done in the auto sector and bring in foreign partners to JVs that then either assemble under license or try to develop domestic products in both aircraft and ship manufacturing.

**Talking Strategy**

Chris Weafer, Troika Dialog: Does WTO entry imply substantial reforms for Russia beyond lowering its tariffs?

David Tarr, Adjunct Professor, the New Economic School, Moscow: Implementation of WTO reforms is a long process that involves reforms in a wide range of policies beyond tariffs, including customs administration, rules for using safety standards on goods in a non-protective manner, rights of market access and national treatment for foreign providers of services, rules for the treatment of foreign investors in goods, constraints on trade distorting agricultural subsidies,
intellectual property rights, rules requiring transparency in the foreign trade regime and even government procurement. Anticipating WTO accession, many reforms, like intellectual property law, were implemented in advance; others, like meat tariffs and allowing branches of insurance companies, will be implemented only eight to nine years after accession.

**Weafer:** In your experience, has entry to the WTO accelerated economic reforms and led to an improved business climate for other countries that have joined?

**Tarr:** In general, WTO accession has led to widespread reforms that open the trade and foreign direct investment regimes. This typically has led to a positive impact on the business climate. Evidence of this is that eight of the nine former Soviet Union countries that have joined the WTO are ranked in the better half of the countries in the world in the 2012 Doing Business rankings, with Georgia ranked 16th out of 183 countries. But WTO accession is not a guarantee of an automatic improvement of the regulatory environment for doing business. Ukraine has been a WTO member since 2008, but is still ranked 152nd in the world in the Doing Business rankings.

**Weafer:** Based on the experience of other countries, how long may it be before investors and foreign businesses start to see the benefit of Russian WTO membership in terms of a better risk perception and easier business climate?

**Tarr:** The answer depends on the sector. Improved conditions for foreign businesses and investors will be progressively implemented in Russia over a period of nine years. The biggest improvement for foreign direct investors will be in the business services sectors, as Russia has made market access and national treatment commitments in 116 services sub-sectors. But the “transition period” to implement the commitment varies by sector. Foreign direct investment in goods sectors, foreign investors will receive immediate legal protection against “trade-related investment measures” like local content requirements; but in the automobile sector, Russia will have six years to comply with those provisions. Foreign businesses wishing to export to Russia from abroad will see declining tariffs against their goods on about 85 percent of the tariff lines; but these tariff cuts will be implemented in stages, with some meat tariffs falling only in the seventh or eighth year after accession.

**Weafer:** You and your colleagues have written several papers analyzing the impacts of WTO accession on Russia. What is your assessment of the macroeconomic impact on Russia?

**Tarr:** We estimate that the cumulative impact of all the reforms over the medium term should lead to a gain of about 3.3 percent per year of the value of Russian GDP (or about $49 billion per year based on 2010 GDP at market exchange rates), with wages and the return to capital rising about 4-5 percent. In the long term, when the positive impact on the investment climate is incorporated, the gains should increase to about 11 percent per year of the value of Russian GDP (or about $162 billion per year at 2010 market exchange rates) with wages and the return to capital rising between 13 and 19 percent. Since the economy will be more productive, these gains will repeat each year, i.e. they are not a one-time gain.

**Weafer:** What are the sources of these gains?

**Tarr:** Russia has made commitments to provide national treatment and market access to foreign investors in 116 services sectors. We find that about 70 percent of the gains derive from improved business services in Russia, as foreign investors, with improved rights in sectors like insurance and professional services, will likely invest in Russia to a greater extent over time. This will increase the productivity of Russian manufacturing and other sectors. Improved market access for Russian exporters will provide less than 10 percent of the benefits to Russia, as Russia already enjoys Most-Favored-Nation status or better with all of its significant trading partners on a bilateral basis. Tariff reduction will provide most of the remaining gains, as Russia will shift production to sectors valued more highly at world prices.

**Weafer:** Is entry to the WTO something that equity investors should cheer or may it lead to a several-year period of disruption that may affect equity valuations?

**Tarr:** WTO accession is good for growth, which is good for corporate earnings and equity valuations in the long run. But not all sectors will benefit, especially in the short run.

**Weafer:** Many articles have appeared in recent months in the Russian press complaining that Russian manufacturing and agriculture will be hurt since Russian tariffs will come down, exposing these sectors to international competition. Do you agree that Russian industry will be widely damaged?

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**YOU PUT THE WEIGHT**
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Tarr: Some sectors will contract, but some will expand, with more expanding than contracting. Tariff reduction will have a negative impact on output of Russian firms selling domestically, as they will receive less for sales on the domestic market. But their costs on intermediate inputs will fall due to both tariff reduction and improved access to business services from the services commitments. For some firms their costs will fall more than their domestic prices. And exporting firms will see their output prices rise in rubles, since they will receive more rubles for each dollar of exports due to the real exchange rate depreciation that trade liberalization induces. So the impacts on sector output depend on how firms are positioned and what inputs they use, with exporting firms tending to benefit relative to firms focusing on the Russian market.

Weafer: Which sectors should benefit the most or contract the most from WTO accession?

Tarr: We estimate that non-ferrous metals, ferrous metals and chemicals are the goods sectors that will expand the most from WTO accession. These are export-intensive sectors that will gain the most from ruble depreciation and improved legal rights in antidumping cases. Some services sectors, notably telecommunications, financial services and truck transportation, should also expand substantially, where we include the output of foreign direct investment as part of the output of the sector. The sectors that are likely to contract the most are the processed food sector, light industry, mechanical engineering and construction materials. These latter sectors sell primarily on the domestic market and will experience more import competition from some of the larger tariff reductions.

Weafer: Won’t the radical opening of the Russian insurance market to foreign insurance companies devastate the Russian insurance industry?

Tarr: Clearly skilled workers in the services sectors, including insurance, will benefit from foreign direct investment. So the interests of workers and capital owners in the sector may not be aligned. But, surprisingly to some, many companies will also benefit. The experience of the Chinese insurance industry after their WTO accession is instructive. Due to an influx of foreign direct investment, there was a large expansion of insurance companies operating in China. Naturally, salaries of skilled workers in the Chinese insurance sector, such as statisticians and actuaries, increased substantially. Despite great fears of a contraction in Chinese-operated companies, domestic insurance firms in China doubled, as foreign firms that entered China sought Chinese companies as JV partners.

Weafer: What will happen to Russian tariffs as a result of WTO accession?

Tarr: We calculate that on an un-weighted average basis, the average Russian tariff will fall from 11.5 to 7.9 percent, after all tariff commitments are implemented. On a weighted average basis, tariffs will fall more drastically — from 12.4 to 6.5 percent. This shows that tariffs will fall more sharply on goods that are imported more heavily — such as processed food products.

Weafer: Are Russia’s commitments more liberal than the typical acceding country?

Tarr: Russia’s commitments are a liberal offer with which the foreign business community should be happy. But they are typical of commitments of transition countries that have acceded to the WTO. The majority of other transition countries have made tariff commitments and commitments to foreign investors in services at least as liberal.

Weafer: Does Moscow’s ambition to create a customs union with Kazakhstan, Belarus and maybe others later cause any complications of which investors should be wary?

Tarr: Investors need to be cautious about investing in companies that can only survive in a protected environment. The average Russian tariff is not high and will fall due to WTO commitments; but there are sub-sectors, like the meat sector, with high tariffs. The customs union has extended Russian tariffs to Belarus and Kazakhstan. This has almost doubled average tariffs in Kazakhstan. Early calculations have shown that Kazakhstan has substituted Russian imports for imports from the EU in the past year. Experience in the Central American Common Market and the East African Customs Union has shown that companies that flourish under a tariff umbrella will severely contract when the members of the customs union decide they are no longer willing to pay higher prices for partner-country imports that can be purchased more cheaply on world markets.

Weafer: You have been quoted as saying that WTO accession is a unique historical opportunity for Russia. It seems, however, that most of the gains to Russia that you estimate come from actions that Russia could do independent of WTO accession — like reducing its barriers against foreign investors in services or lowering its tariffs. Since Russia can take these actions independently, why do you see WTO accession as such an important step?

Tarr: The open economy model of trade and foreign investment, combined with a good business environment, are the keys to rapid growth. All the development miracle countries have used the open economy model of development. This includes the East Asian tigers of Singapore, South Korea, Hong Kong and Taiwan that have grown rapidly since the mid-1960s; and Mauritius, China and Chile that have grown rapidly since the early 1980s. In a business-as-usual scenario, there are many who gain from trade liberalization; but the gains are not concentrated so they typically do not lobby for liberalization. Those who lose from liberalization, however, are concentrated in particular sectors and will typically lobby to defeat liberalization. The uneven lobbying often leads to excessive protection compared with what is beneficial for the country. WTO accession involves foreign business interests and foreign governments as a counter-force lobbying for liberalization. Then policymakers at the highest levels of government must engage in the process. Experience of commitments of the close to 15 transition countries that have acceded to the WTO shows that the result is a dramatically broader and deeper set of reforms than could be achieved without the accession process. Ratification by Russia of the protocol on its accession to the WTO is thus an important step toward the open economy model of development.
Last year, the Russian Union of Industrialists and Entrepreneurs (RSPP) and KPMG performed a study to analyze regional investment climates from the point of view of foreign investors. The main objective of the study was to provide insight on how the investment situation in the regions is perceived by foreign investors, and identify the barriers that foreign investors encounter when doing business in the Russian regions, as well as the priority areas for improvements in the regions’ investment policies from the perspective of foreign investors.

The survey targeted 12 constituent regions of the Russian Federation whose income depends primarily on non-commodities. Attracting foreign direct investment to non-commodity sectors is essential for the modernization of the Russian economy.

The key findings were that, although there are significant efforts to attract investors, there are still fundamental gaps between investor expectations and the regional realities. These expectation gaps come from both hard factors, like infrastructure, natural resources, workforce, R&D base, and soft factors, such as investment processes, and tax and financial incentives. Investors clearly expressed that a disadvantage on hard factors can often be compensated by a strong performance in soft factors. The study aimed to provide practical recommendations on how the expectation gaps can be closed.

This study is the first part of an ongoing effort to bring private investors to regional markets. KPMG and RSPP will soon complete the second stage of this project, the Regional Investment Climate Barometer. At this second stage, an online tool has been created for foreign investors to share experiences they have had during any stage of the investment process. The report is due in December 2012. The online tool is available at www.kpmg.ru/fdi.

The following is a summary of key recommendations from the first study.

**Key Recommendations**

**Increasing FDI in the Russian regions requires changes among all stakeholders in the investment process, although the most critical recommendations are addressed at the regional level. We have structured our recommendations to include overall, federal, personal and investor recommendations, but focused clearly on the regional ones.**

### Overall recommendations

- All stakeholders, including investors, need to adjust their expectations and actions.
- In making the Russian regions more attractive for foreign investors, clearly the next steps need to come from the federal and regional government, since investors have already expressed support for the country’s growth and development.
- Therefore, the key overall recommendation is to become more investor oriented, i.e. customer focused as opposed to internally focused.
- Don’t blame the lack of infrastructure: in the current environment soft factors are key to attracting FDI.
- Do not try to find a 100 percent solution, it does not exist; start implementing 80 percent solutions, leaving 20 percent to micro-management.
- Trust in your own capabilities and importance: you are as important for investors as investors are for you.

### At the federal level

- The federal level remains important in relation to solving certain key issues, such as infrastructure, reputation in the outside world etc.; therefore, in increasing FDI in the regions, the federal government can have a strong role of a “coach” and “facilitator.”
- Initiate regular exchange between the regions about lessons learned, help to understand and implement best practices at the regional level.
- Establish institutions that consult the regional governments and distribute case studies, information on solutions and failures.

### At the level of individuals

- At the current stage of development, soft factors play a key role in increasing FDI in the regions; therefore, individual behavior is the key driver of change.
- Senior officials need to demonstrate commitment to increasing FDI in the regions and be involved throughout the entire investment process:
  - This applies at the stage when the region is being considered by the investor, when negotiating an investment contract, when building a factory, when hiring or developing people, when growing the business and developing the supplier base, etc.
• Every layer of regional administration needs to understand the idea that substance prevails over form.

• It is all about execution: the personal impact of individuals at each stage of the investment process creates the credibility of the region and the government as a whole.

• Put yourselves into each other’s shoes; understand that you may be coming from completely different starting points, different backgrounds.

• Learn from individual experiences and encourage your partners and counterparts to learn.

• Ensure that your administration treats the senior/junior and Russian/international staff of potential investors equally.

International investors
• Manage the expectations of your headquarters, make them accept the downside of less efficient processes: being less developed is the reason for the high growth outlook.

• Be clear to the regions upfront, outline the areas where you can be flexible and where you cannot.

• Communicate any dissatisfaction early: do not wait for the new, ideal process to emerge and pick up the issues — it never will.

<table>
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<tr>
<th>Situation</th>
<th>Complication</th>
<th>Recommendation</th>
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<tr>
<td>Social and economic development strategy:</td>
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<td>Regions need an integrated investment strategy with clear statements of priorities, especially in relation to sector clusters and the role of FDI.</td>
<td>• Regions often do not realize the advantages of a cluster approach in developing the regional economy.</td>
<td>• Prioritize sector activities and develop key sector clusters with a mix of local firms and foreign investors, with foreign investors not discriminated against in local markets.</td>
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<td>The strategy needs to be sufficiently long-term to cover the standard forecast periods of foreign investors.</td>
<td>• It is still not evident for many regions which sectors should be developed; these regions usually do not have a clear social and economic development strategy based on careful diagnosis of existing strengths and weaknesses in the context of nationwide competition between the regions for FDI.</td>
<td>• Priority sectors and companies are expected to be reviewed annually in order to re-focus efforts and identify further opportunities.</td>
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<td>Even if priority sectors are identified, the approach to attracting investors is often unclear.</td>
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<td>• Force the development of municipal strategies within the region to ensure a high degree of coordination among municipal and regional authorities in order to attract investors.</td>
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<td>Organizational structure of cooperation with foreign investors:</td>
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<td>Regions need to establish a transparent and efficient structure of cooperation with investors that will reduce administrative barriers — the key obstacle for foreign investment in the Russian regions.</td>
<td>• There is a significant number of stakeholders (including regional branches of federal agencies) in the investment process, therefore it may be difficult to distinguish responsibilities.</td>
<td>• Target and attract large anchor investors who will form the foundation for the entire cluster, as well as develop missing segments in the value chain with the help of local businesses.</td>
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<td>• Regions are not aware of best practices in creating a clear organizational structure.</td>
<td>• To decrease administrative barriers establish a special investment agency, either private or state-owned, with a focus on the following areas:</td>
<td>• Create favorable conditions for companies which invest in priority areas (tax privileges, specialized industrial parks, etc.) which will provide an additional impetus for investing.</td>
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<td>• While the top tier of regional government (governor, senior ministers, etc.) appear to be the key supporters of initiatives related to attracting foreign investors at levels below, i.e. at the levels of execution as well as on sub-regional and municipal levels, the support noticeably fades.</td>
<td>• Formulate an investment strategy and assign roles at all levels of government, with clear KPIs which will force them to work more efficiently in attracting investors as well as reflecting better coordination between the authorities.</td>
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<tr>
<td>• Many issues under the jurisdiction of federal government require its involvement.</td>
<td>• Develop a clear allocation of responsibilities throughout the entire process of cooperation with investors for all involved stakeholders (from the governor to executor).</td>
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<tr>
<td>Formulate an investment strategy and assign roles at all levels of government, with clear KPIs which will force them to work more efficiently in attracting investors as well as reflecting better coordination between the authorities.</td>
<td>• Make an agreement between the branches of federal authorities and regional authorities to reduce the time needed for consideration and approval of the investment projects.</td>
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The government needs to be in a position to guarantee the outcome of the process and issue a full scope of requirements in relation to setting up business.

- There are legal boundaries and ambiguities that allow for different interpretations of same law, which can be used to create artificial barriers.
- There are issues of coordination between different government agencies that often complicate the whole process.
- The concept of a guarantee has a different perception among investors and the authorities; where the latter understand it as merely an “obligation” but not a “guarantee” and hide behind the legal definition.
- Develop up-to-date legislation to efficiently protect investors’ rights and minimize their risks.
- Reduce the “hidden” requirements in relation to investors in order to increase the transparency of the investment process.
- Issue and publish a document outlining the steps for an investor to set up business in the region with a detailed list of steps and milestones.

Mid-size foreign investors are more sensitive to regional policies than tier 1 companies

- Mid-size multinationals receive a significantly different reception in the regions, as they do not bring significant value in the short term; therefore regions do not provide them with extensive support – organizational or financial.
- The apathetic or even negative attitude of a region to mid-size companies makes some of them a “no-go” that may result in a negative image of the region.
- Provide mid-size companies with resources (such as administrative support, an account manager) which will help them to overcome a number of critical barriers.
- Put the work with investors “on stream” and standardize all procedures and processes to minimize barriers for midsize companies.

Marketing program:

Each region needs strong examples of success stories in attracting foreign investment.

- The first example is difficult to generate and requires significant effort at all levels, but especially crucial is the governor’s involvement.
- Not every first example can be a success story so additional investments are particularly necessary at the earliest stage.
- If successful examples are not used for marketing, promotion or development of reputation, the value of examples has a tendency to diminish over time.
- Often, bad examples damage the value generated from a track record of successful examples and therefore high standards need to be maintained.
- Invest in your first success story and find an effective way to communicate it in investment circles.
- Establish a local community of foreign investors that will be a reference point for other potential investors.

Strategic marketing, coupled with the role of the governor, can increase awareness of a region and have an immediate and protracted effect on attracting FDI.

- In many cases information on the investment opportunities provided to investors is not sufficiently comprehensive and clearly structured and does not fully meet investors’ requirements.
- Provide comprehensive and clearly structured information about the region, for example via the internet, which should also include all relevant information in English internet based services but also make walk-in centers of government agencies available for personal visits.
- Ensure the participation of regional leadership in the investment process to demonstrate involvement and strengthen downward alignment across all levels of executive power.
- Use Russia’s representative offices in other countries to promote the region “closer” to potential investors.

Financial and tax incentives:

A customized package of tax and non-tax incentives or grants is a measure to encourage companies to use the region as a base.

- A system of benefits will only be effective if it has clearly defined criteria and procedures for obtaining this support.
- The complexity of administration of tax and non-tax incentives can deter investors and have an opposite effect to that planned.
- Set clear requirements and procedures for obtaining the privileges, as only providing it the system of incentives will effectively work.
- Use financial and tax incentives to stimulate technology transfer:
  - Deduction for R&D expenses.
  - Tax incentives and grants to improve R&D capabilities.
  - Venture capital fund incentives.
Program of innovative development:

Establishing an appropriate infrastructure for innovative activities and comprehensive people development programs are key success factors in bringing modern technologies to the economy.

- Applied science is significantly less developed in the regions than is required by foreign investors.
- Applied science cannot be changed immediately to meet investors’ requirements.
- Foreign businesses prefer to hire the best scientists to work in their company, leaving educational establishments without their best resources.
- Often foreign investors do not find appropriate resources for their R&D activities, in particular there is an especially large gap in terms of people skills and innovative infrastructure.

Infrastructure modernization and development:

Infrastructure in most of the Russian regions is poor: in many cases the problem can be solved through negotiating with investors.

- Although foreign investors in general have a long forecast period for their financial planning, regional governments appear to have a short-term view, even in relation to infrastructure.
- The governments make significant efforts to modernize the existing infrastructure and build new infrastructure; however, this often leaves bottlenecks that if left unresolved, have a detrimental impact and can deter investors.

Public-Private Partnership (PPP):

PPP is an important tool of cooperation with investors in areas where the government cannot realize projects on a stand-alone base.

- The PPP instrument is not widely used in the regions.
- The current government understanding and experience of PPP may not be sufficient to build a successful PPP case.

- Negotiate infrastructure needs with investors (especially with anchor investors) and provide them with the necessary facilities on a case-by-case basis.
- The provision of land-plots with connected infrastructure may help regions put their limited resources to best use.
  — Western-type industrial parks with shared common facilities are highly in demand and are likely to be the next focus for development in Russia.
- Use PPP mechanisms to create industry parks and techno parks that create new business opportunities and add value to existing companies.
- Use PPP mechanism also for the modernization of infrastructure facilities like airports, roads, electrical grid, etc.
- The existence of appropriate effective legislation, with clearly defined forms of PPP and responsibilities for each of the participants in the process, is a prerequisite for the PPP mechanism to be successful.

For additional news and information, please access KPMG’s Web site on the Internet at http://www.kpmg.ru.
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