

■ Growing Market and Partnership Opportunities in Russia

Caution Advised

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Closer political and security relations are encouraging better economic relations between the United States and Russia. The U.S. Department of Commerce is working to open the Russian market for small and large U.S. companies. The department has been especially active in the energy, health care, pharmaceuticals, and railroad sectors, as well as in the promotion of good governance. This issue highlights these sectors and related Commerce Department programs.

Positive Indicators

Positive business trends have been reaffirmed by recent transactions such as Tenneco Automotive's announcement that it will produce auto mufflers in Tolyatti, Oracle and Russian telephone line monopoly Svyazinvest's announcement of a contract worth \$150 million for an automated management system, and Marathon's purchase of a Russian oil company.

Moody's Investors Service raised Russia's sovereign credit rating to investment-grade status in October, recognizing the Russian government's impressive fiscal progress, especially an

improved ability to service debt, and well as economic reform.

EXPANDING THE POTENTIAL

A World Bank study concludes that Russia's GDP growth of recent years is still largely dependent on high international oil prices, with neither domestic consumption nor domestic investment yet able to sustain high levels of growth. The bank estimates that the direct and indirect effects of oil price increases accounted for 3 percent of the 7.2 percent economic growth in the first half of 2003. However, consumer spending has contributed more to economic growth than energy in the last two years, indicating that Russia may be on the way to becoming a consumer-driven economy.

Investment

In the first half of 2003, foreign direct investment was up 35 percent over the same period of 2002 to \$2.35 billion, and overall capital inflows (including loans and foreign subscriptions of Russian government and corporate bonds) rose 51 percent. Russia's stock market—dominated by natural resource companies—hit record highs in September before falling back under pressure from the Yukos affair, which

involves the arrest of one of Russia's wealthiest "oligarchs." U.S. firms continue as leaders among direct investors in Russia. Estimates of cumulative U.S. foreign direct investment in Russia range from \$5 to \$6 billion. U.S. companies made direct investments in excess of \$600 million into Russia in 2002, and this level is expected to increase markedly in 2003, based on anecdotal reports of expansion plans by several U.S. firms operating in Russia.

Trade

U.S. exports to Russia in 2003 through August were on pace to total \$2.2 billion for the year—a 4 percent drop from 2002, partially due to a 30-percent plunge in U.S. meat and poultry exports following the imposition of Russian quotas. Leading U.S. exports to Russia include machinery and heavy equipment, meat and poultry, medical devices, chemicals, and pharmaceuticals.

Energy

Prospects for expansion of U.S.-Russian economic ties depend significantly on the ongoing revitalization of Russia's oil and gas industries, where U.S. technology can facilitate development. The oil and gas industry is expected to

remain the leading sector both in size of market and potential growth—not simply because of continuing high oil prices but also because of ongoing Western investment projects and evolving pipeline projects. This September, Secretary of Commerce Donald Evans led a trade mission of 13 companies to St. Petersburg and Moscow and hosted, together with Secretary of Energy Spencer Abraham and Russian counterparts, a second U.S.-Russia Commercial Energy Summit aimed at encouraging more partnerships between U.S. and Russian companies. See the article on the summit on page 21.

REGIONAL OPPORTUNITIES

Because Moscow and St. Petersburg are very competitive markets, some foreign companies find that moving to the regions may be the best way to expand into Russia.

Moscow Oblast

Moscow oblast, the region surrounding Moscow, offers a unique mix of opportunities to local companies and foreign investors. Foreign companies enjoy proximity to Moscow's consumer market while retaining relatively low production and overhead costs. The region offers a well-developed infrastructure including a transportation network, telecommunications, and a services market. Much the same can be said for Leningrad oblast, the territory surrounding St. Petersburg.

Sverdlovsk Oblast

Sverdlovsk oblast is one of the Russia's most urbanized areas. Yekaterinburg, Russia's fourth-largest city, is a major road and rail hub. Its banking infrastructure is the best in the Urals, with about 30 banks and many branches of commercial banks from other regions. Sverdlovsk oblast leads the Urals in investment potential, although local government interference with investments is a hindrance to further development. Sverdlovsk's top industries are steel, copper, chemicals, and titanium. The region's forests and wood processing industries offer other opportunities.

Sakhalin Oblast

Sakhalin Island is positioned to become one of the most important centers in the Russian Far East for commercial and investment activity. Considered to be Russia's North Slope, oil and gas projects on Sakhalin are now attracting one in every four dollars of foreign direct investment in the Russian economy. As much as \$45 million may be invested in coming years in foreign-led oil and gas projects. Supporting projects will include improving existing airports and seaports on Sakhalin, road and bridge construction, telecommunications, and transportation services. Already, Sakhalin has the third-highest concentration of expatriates in Russia. This translates into construction projects for new housing and offices. There will be demand for everything from medical services and household goods to Western foods and dry cleaning equipment.

BEST PROSPECTS FOR EXPORTS

Consumer Goods

Russia's already expanding consumer market appears poised for accelerated growth based on rising personal incomes, decades of pent-up demand, and rapidly expanding availability of consumer credit. Consumer credit is likely to have particularly pronounced impact in a market where consumers previously had no alternative to saving up to pay full purchase prices in cash. Shopping malls and retail outlets accounted in 2002 for the biggest share of foreign direct investment in Moscow, estimated at \$750 million. Retail sales growth in Russia exceeded 9 percent in 2002, and sales of consumer durables grew even faster when financing was available. Banks have begun mass marketing of credit cards, and the number of people holding debit

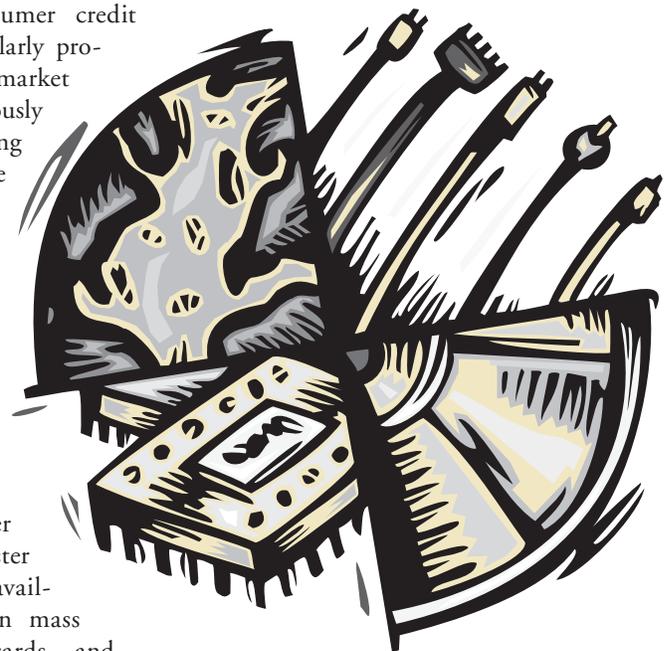
cards, currently exceeding 14 million, is expanding more than 30 percent annually. Responding to expansion of consumer demand, Russian banks are beginning to enter the consumer finance sector, where they perceive the possibility of larger profit margins and lower risk than in the business loan sector.

Housing and Construction

Housing construction should receive a significant boost in coming years from greatly expanded availability of mortgages from the current very small base of 40,000 mortgages as of mid-2002. The government-sponsored housing mortgage lending agency has begun selling bonds to finance mortgage programs, and the European Bank for Reconstruction and Development and the World Bank plan to lend \$100 million to Delta Credit, which accounts for over half the value of mortgages in Russia.

High Tech and Telecommunications

After energy, telecommunications is the next strongest sales and investment prospect, as Russia shows a strong demand for state-of-the-art communications infrastructure. There is large demand from consumers for computers



and related technology. However, low levels of disposable income mean that relatively expensive American computer hardware will be limited primarily to corporate customers for some time.

Health Care and Pharmaceuticals

In 2002, the United States exported \$350 million of pharmaceuticals and medical devices to Russia. The Department of Commerce participates in the Russian-American Interagency Coordination Council on Harmonization in the Health Care Sector to reduce the burden of unnecessary regulations and to foster U.S. exports and position the United States as a stronger partner in Russia's health care sector.

Beauty and Health Products

The beauty and health products market is one of the fastest-growing sectors in Russia. According to Staraya Krepost Association, which unites leading Russian cosmetic manufacturers, in 2001 the Russian cosmetic market ranked sixth among the world's fastest-growing cosmetic markets.

Rail Sector

The reorganization of the former Russian ministry of railroads has led to the creation of the joint-stock company Russian Railways, with a capitalization of \$50 billion. Given the territorial vastness of Russia, rail is one of the primary modes of transportation for a number of goods, yet investment in railways and rail services has dwindled in the last decade. Thus, commercial opportunities may be developed by U.S. companies in areas such as production of locomotives and cars, supply of equipment, project finance, and consulting. In Spring 2003, the Department of Commerce led a railway business mission of 18 U.S. rail supply companies to Russia. The mission included meetings with the Ministry of Railroads, the Union of Car Builders, and the Association of Rolling Stock Owners.

Selected Markets

There are likely to be substantial sales opportunities in such areas as mining

and construction equipment, automotive equipment, general aviation, and agricultural and food processing equipment. In the near term, industries such as aluminum, food processing, and forestry products seem to have sufficient cash flow and organization to be potential prospects for trade and investment. In the longer term, there should be high demand in such sectors as electrical power and agricultural equipment.

CAVEATS

Rule of Law

Weak rule of law in the business environment continues to create potential hazards for U.S. firms. Small firms, both foreign and domestic, report that corruption and red tape in the Russian bureaucracy is an outright barrier. Larger companies report that the same issues are costly but more of a nuisance. These businesses may reconsider expanding operations in Russia or investing. Although in 2002 some steps were made in court and legal reform, law enforcement and judicial systems remain unpredictable and susceptible to corruption. Noting that investors will not put large volumes of capital at risk unless they can be confident in the integrity of the Russian marketplace, U.S. government officials are concerned about rule of law issues raised by recent legal proceedings against executives of Yukos.

Corporate Governance

Poor corporate governance has been one of the primary impediments to investment. During the last two years, both the Russian government and the private sector have made efforts to improve the quality of corporate governance in Russia. In 2002, the federal Commission for the Securities Market issued a corporate governance code, and the Russian Union of Industrialists and Entrepreneurs has established a commission for corporate ethics and a national council for corporate governance in order to improve Russia's business culture. However, these efforts may not be sufficient for attracting

investment if the Russian government and major companies do not demonstrate in practice their full commitment to the rule of law. More about rule of law and the Commerce Department's Good Governance Program can be found on page 8 in this issue.

Intellectual Property Rights

U.S. industry characterizes Russia's IPR situation as one of the most serious of any country in the world, because of the international growing impact on other markets. Of particular concern is a recent surge of exports of optical media from Russian pirate plants into markets in Western Europe, with U.S. industry estimating its worldwide losses of up to \$1 billion annually. Piracy is a major burden for other industries, including software, multimedia, pharmaceuticals, and consumer goods.

DEPARTMENT OF COMMERCE ASSISTANCE

Companies considering business expansion to Russia should conduct their own due diligence before entering into business ventures. The Department of Commerce can help companies by providing business information and counseling through the U.S. Commercial Service (www.buyusa.gov/russia/en), which has offices in Moscow, St. Petersburg, Vladivostok, and Yekaterinburg. The Commerce Department's BISNIS program (www.bisnis.doc.gov), with offices in Washington, D.C., and across Russia, provides free country and industry reports, market information and counseling, and sales and partner leads to U.S. companies. Additionally, the Special American Business Internship Training (SABIT) program (www.mac.doc.gov/sabit) offers grants to U.S. companies interested in doing business in Russia. A grant allows a U.S. company to form associations with current or prospective partners by hosting an intern from the Russian firm. ■