

# Doing Business with Russia? Yes, Please

by Olga Annushkina

*When talk turns to the need to internationalize Italian businesses, it is most often about “the Chinese fever” with opportunities in Eastern Europe and Russia considered less strategic. But the Russian market has the size, prospects for strong growth, unexplored market opportunities and geographical and cultural proximity to Italy and could provide interesting development opportunities for Italian companies.*

Russia is one of the 20 largest economies in the world (Table 1) with a per capita GDP in 2003 of approximately \$3,000. The size of the market (about 145 million people with an average income of approximately 200 euros per month) and the prospects for growth (5 - 6% per year in the short to medium term according to conservative estimates) make Russia one of the most interesting countries to invest in both production facilities and for commercial purposes.

In May 2003 President Vladimir Putin set the goal of doubling GDP within ten years, with an annual increase of 7 - 8 %, while analysts at the World Bank and the International Monetary Fund are more conservative, estimating the increase at 5 - 6%.

In the past, the Russian economy had been stimulated by the export of raw materials and by the recovery of productive capacity that was underutilized during the crisis years. To maintain growth in the coming years, structural factors – like productivity and efficiency – will have to be more leveraged and this will give added emphasis to economic reforms. One of the major obstacles that needs to be faced in the short term is the obsolescence of industrial machinery: the estimated average age in 2002 was about 20 years, even though the situation is less serious in those sectors that attract national and foreign investment, like energy production, the extractive industries, metallurgy and the food sector.

Direct foreign investments (DFI), one of the factors that stimulates growth in production and one of the economic indicators that instills confidence in the international community, are picking up again following the crisis of August 1998 (Table 2). The cost of labour, although relatively low compared to that of the other countries in Eastern Europe, is not a major determinant in selecting Russia as a country in which to outsource production. Foreign investors choose to invest in acquiring and building plants in Russia mainly to sell on the local or neighbouring markets. And if on one hand consumer purchasing power can be compared to that of the other countries of Eastern Europe (Table 3), on the other hand the size of the market is decidedly greater. According to official data, in 2004 average monthly income in Russia was \$200 (averaging between \$240 and \$260 dollars for urban dwellers and \$70-\$80 dollars for people living in the country).

But average income data can not fully reflect the potential of the

1. GROSS DOMESTIC PRODUCT, 2003, BILLIONS OF US DOLLARS

	GDP, 2003 (bill US dollars)
1 United States	10.985
2 Japan	4.301
3 Germany	2.408
4 Great Britain	1.798
5 France	1.754
6 Italy	1.470
7 China	1.409
8 Canada	866
9 Spain	840
10 Mexico	626
11 South Korea	605
12 India	575
13 The Netherlands	512
14 Australia	508
15 Brazil	497
16 Russian Federation	434
17 Switzerland	309
18 Belgium	303
19 Sweden	301
20 Taiwan	285

Source: World Economic Forum

Russian market. The main questions that have to be asked are: "Is there a mass market and is it reachable?" And, is there a market outside of Moscow and Saint Petersburg, both famous for the wealth of their elites? Statistics on income distribution are encouraging: the Russian "middle class" is growing and the income levels in the regions are catching up with those reached in Moscow a few years ago. From the point of view of proximity and thus whether the final consumer can be reached or not, 76% of the Russian population lives in the European part of the country (west of the Ural Mountains), even though Siberia and the Far East are becoming more and more interesting because of their growing wealth.

But what is meant exactly by "middle class" in Russia? In 2004, at least a quarter of the population had an average per capita income of more than \$225 per month. Most families own their apartments, and given the low rate of savings (due to inflation and the financial crisis that destroyed the savings of most families) the biggest part of income is spent on the purchase of goods and services. According to data provided by the Goskomstat (equivalent to the Italian Istat), in 2002 100% of Russian families had a TV and a refrigerator, 95% had a washing machine, 50% had a VCR. According to the same source, in 2002 it was estimated that a third of Russian families had no difficulty purchasing major consumer goods and clothing, while 8% had enough income to purchase durable goods for the home, and about 5% had sufficient income to purchase any type of product or service except for a house. Note that in Russia consumer credit and mortgages are still in an embryonic stage of development, although growing rapidly: most people use their own resources to acquire durable goods and furniture. With the increase in wealth, the demand for durable goods and services (transportation, communications, tourism) will become a more important part of family expenditures, while the amount spent on food (currently around 45% of family spending) should gradually drop, yielding the position to "secondary" needs. The size of the food market still remains large: it was about \$55 billion in 2002; the retail market for non-food consumer goods in 2002 was estimated at approximately 63 billion dollars.

Direct foreign investments are distributed around the country based on the attractiveness of Russian regions as determined by the wealth of the final consumer: until 2001 more than half of direct foreign investments in the Russian economy was concentrated in Moscow and Saint Petersburg, because the major offices of Russian companies are here and these are the two largest and richest cities in Russia, with ten million and four and a half million inhabitants respectively having an average income well above the national average.

And the attention of foreign investors, many of whom are already established in the two major cities, is

## 2. DIRECT FOREIGN INVESTMENT (CUMULATIVE) IN RUSSIA

Direct Foreign Investment (cumulative)	
Millions USD	
1995	48,9
1996	73,0
1997	77,8
1998	52,2
1999	51,1
2000	55,0
2002	55,7

Source: UNCTAD

## 3. COMPARISON OF EASTERN EUROPEAN COUNTRIES: SOME ECONOMIC DATA

	Per capita GDP 000 USD 2003	Number PC per 1,000 people 2002	Population (millions) 2003
Slovenia	13,4	301	2,0
Czech Republic	8,4	177	10,2
Hungary	8,2	108	10,1
Croatia	6,4	174	4,4
Estonia	6,2	210	1,4
Slovakia	5,9	180	5,4
Poland	5,5	106	38,2
Lithuania	5,3	110	3,5
Latvia	4,2	172	2,3
Russia	3,0	89	143,4
Romania	2,7	69	22,2
Bulgaria	2,5	52	7,8
Ukraine	1,0	19	48,4

Source: UNCTAD

## 4. AVERAGE MONTHLY INCOME

Region	2001 (USD)	2004 (USD)	Increas 2004 from 2001 %	Population (2002)
Centre	152	313	+106%	37.991
...Moscow	353	700	+98%	...10.358
North-West	52	125	+140%	13.986
South	51	124	+143%	22.914
Volga	88	155	+76%	31.158
Urals	108	230	+112%	12.382
Siberia	67	171	+155%	20.064
Far East	83	217	+161%	6.687
<b>Russia</b>	<b>94</b>	<b>200</b>	<b>+113%</b>	<b>145.182</b>

Source: Goskomstat data processing, Central Bank of Russian Federation

## 5. NUMBER OF SUBSCRIBERS TO MOBILE PHONE SERVICE IN RUSSIA, 10 LARGEST PROVINCES, 2003

Region	Number of subscribers to mobile phone service for 100,000 people
Russia	253,6
Moscow	873,6
Saint Petersburg	672,7
Kaliningrad	379,5
Province of Moscow	379,0
Krasnodar	330,0
Murmansk	322,8
Samara	302,3
Tomsk	290,5
Novosibirsk	280,9
Jaroslavl	243,8

Source: IKS Consulting, "Expert"

now being directed towards other regions. Siberia and the Urals, for example, are of interest to investors not only for their natural resources but for the strong growth in the people's wealth: people employed in those industries that extract and refine natural resources or produce energy are beginning to represent a large market for mass consumption goods. The rise in incomes in some of the other regions during the past years will surpass the income levels in Moscow and in the European part of Russia (Table 4). The same trend can be seen from analyses of the mobile phone market: the number of subscribers in some Siberian cities is growing and reaching the levels attained a few years ago by Moscow and Saint Petersburg (Table 5).

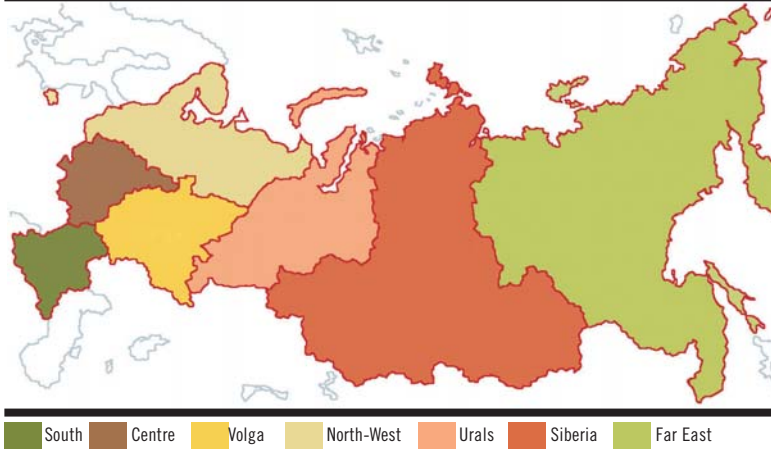
But there are also factors that slow economic activity and investments in Russia. According to the World Economic Forum, Russian businessmen and managers list the following problems: corruption, bureaucratic inefficiency, tax laws and taxation levels, difficulty in obtaining credit, inflation. The government is using its own efforts to resolve these problems, for example with the recent reduction of taxes on individuals and companies.

The successes of some Italian companies confirm the appeal of the Russian market. Indesit Company, former "Merloni Elettrodomestici" has been doing business in Russia since 1993 and is now the market leader in home appliances with a share of approximately 25% (about three times more than its major competitor). The acquisition of Stinol, one of the major producers of refrigerators in Russia and the construction of a washing machine factory which opened in April 2004, confirm the long-term interest that companies have in the Russian market.

ZAO Banca Intesa also opened for business in April 2004. It is the first Italian Bank with a licence to operate in Russia; its goal is to assist Italian firms that are already active in the area and all those interested in working in the Russian market.

But the Russian market will not only attract large corporations. In 1996 the Italian businessman Gianfranco Confalonieri invested in the acquisition of a factory producing faced chipboard panels and furniture in Smolensk (400 km from Moscow). Now Confalonieri's

## RUSSIA'S REGIONS



company Eurostandard controls 5% of the Russian market for chipboard panels and his second plant, Eurodesign, is growing in the furniture market. In addition, he is evaluating whether to develop further in the more distant regions of Russia, such as Siberia, it being understood that some major difficulties related to local workforce development need to be overcome (not only from the technical standpoint). Also supply quality and inefficiencies in the financial system need to be dealt with.

Another sector that is growing rapidly is shopping malls. For over three years the Italian company Promo Centro has been doing business in the Russian market, designing and building large malls: one for the Metro in Saint Petersburg, two others in Moscow, and another in Kaliningrad. In these situations they hire local personnel with experience in the sector; but who are ready to absorb "European" know-how. An evaluation is now underway regarding the building of shopping centres in Russian cities having populations over one million people, such as Nizhny Novgorod and Rostov-na-Donu.

The shopping centre sector is growing rapidly, thanks to a wider Russian middle class and to a growing demand for goods. In this page, the shopping centre of Petrouka Passage in Moscow.

