

# **Master's thesis**

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**NORDIC INVESTMENTS IN RUSSIA:**

Current business environment and outlook following

Russia's accession to the WTO

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Signature of student

## **Abstract**

This research project describes Russia's much improved recent record as a destination for foreign investments. Overview of economical and political historical development and current situation leads to a conclusion that Russia is a country with great potential.

The project analyzes the business cooperation between Nordic countries (Norway, Sweden and Iceland) and Russia. Such Nordic-Russian cooperation has a long history due to geographic closeness. Northern Norway has a border with Russia, which enhances business relationship between two countries, especially related to oil industry due to common interest in exploring Arctic areas.

Russia has a great potential for foreign investors, foremost due to its rapid economic development over the last two decades, increasing affluent middle class and recently obtained WTO membership. The country has a vast territory with enormous natural resources, has a rich cultural heritage and possesses valuable human capital. In this research the investment and business environment in Russia is investigated providing information about current legislation and future outlooks. Russian business culture is also explored.

Russia was finally granted WTO membership in 2011, after 18 years of negotiations. WTO membership is expected to speed up reforms and to have overall positive influence on the business environment in Russia. In this research the indirect influences of Russia's WTO entry on foreign investments are discussed in details. A comparative analysis is also done on Russia's and China's WTO entry in 2001 and tried to give a picture of possible influences of the membership on Russia.

The aim of the research project is to investigate the operational challenges Nordic companies face in Russia, and give recommendations on how to overcome those challenges. A qualitative research was chosen in order to investigate the challenges and answer the research questions. The research was conducted with in-depth interviews with respondents from Nordic companies and experts within the subject field. According to the research findings, cultural differences represent the main challenge. Formal and informal rules in the Russian business environment influence the corporate behavior, which is different from the Nordic model.

It is argued that the findings from the research project are significant for Nordic companies wanting to operate on the Russian market.

## Preface

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Finally, I would like to thank my family who supported me in various ways throughout my research process. My sister Violetta Bankovskaya has set a personal example of hard work and encouraged me to stand up to the challenge.

Умом Россию не понять,  
Аршином общим не измерить:  
У ней особенная стать –  
В Россию можно только верить.

Þú getur ekki skilið Rússland  
eða lýst því með almennum orðum:  
Því landið á engan sinn líka.  
Trúðu á það, ef þér er unnt.

Med visdom fattes Russland ei  
Å tenke i vanlig mål – ånei!  
Det er et eget land – må vite,  
På Russland må vi bare lite!

You will not grasp her with your mind  
Or cover with a common label,  
For Russia is one of a kind –  
Believe in her, if you are able...

Fjodor Tjuttsjev  
(1804 -1873)

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# 1. Introduction

The BRIC nations (Brazil, Russia, India and China) have in recent years represented many possibilities for foreign investors. For the Nordic countries Russia is the closest geographically and culturally of these four countries. But is Russia attractive for Nordic investments? In order to attract foreign investors a country should represent opportunities where return on the investment is likely to be higher than the cost of capital, taking into account the risk of operating within the country (Kearney, 2008).

In recent years many Nordic companies have turned their focus on Russia and other countries from the former Soviet-bloc. *“Russia is now a big industrial player,”* says Anders Bäckman, Head of Corporate at the Swedish law firm *Magnusson*, which opened an office in Moscow in 2006. According to Mr. Bäckman, a lot of manufacturing and real estate is being generated domestically and by international investment.

*“The clients have identified the Russian market as the place to expand their business. I think that’s a general trend that is particularly strong in the energy sector,”* explains Øyvind Eriksen, chairman of another Oslo based law firm BA-HR, which has been cooperating with many Russian law companies over the past several years.

The opportunities and Russia’s growth potential makes it attractive for investments.<sup>1</sup> However, there are number of challenges Nordic companies face as they explore those business opportunities in the undeveloped Russian market. Jan Waselius, founding partner of the Finnish law firm Waselius & Wist, has had a long experience of doing business in Russia. He advised on the first Western joint ventures in the former Soviet Union back in 1987. He has said that some of the firms entering the Russian market have been naively optimistic, as it takes long time to establish contacts and build business relationships (Robinson, 2008).

What are the outlooks for the future? In December 2011 Russia finally became a member of the World Trade Organization (WTO). The membership will bring Russia more firmly into the global economy and make it a more attractive place to do business. Chris Weafer, a chief analyst at Russia’s oldest investment bank Troika Dialog, argues that WTO membership will not have an immediate impact on economic growth; the day to day operations of corporations or the risk premium investors apply in Russia, but the

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<sup>1</sup> See the Chapter on Economical Development of Russia: 1991-2012, p. 19.

membership will establish a powerful catalyst for a more serious approach to economic reform and industrial efficiency (Weafer, 2011).

## **2. Research Methodology**

### ***2.1 Objectives***

Research can be described as a search for knowledge with the help of objective and systematic method of finding solution to a problem. This research project focuses on the experience of the business relations between the Nordic countries and Russia, and its WTO membership. A chapter of the research is also devoted to analysis of possible influences of the Russian WTO entry.

In international business there are challenges when companies from different business cultures collaborate. A country's historical background, culture, and institutions have a strong influence on the corporate governance in that country, and countries that share many similar characteristics may have a common corporate governance system (Thomsen, 2008).

The Nordic countries have similar system of corporate governance, those countries are relatively small and have a history of social democratic governments and share the Nordic legal traditions (Thomsen, 2008). Due to these similarities, it is possible to generalize research findings and argue that the challenges one Nordic company experiences in Russia may also be the same challenges any other Nordic company could face when doing business in Russia.

Any company considering entering the Russian market should assess the opportunities and threats present in the market. This research is aimed at helping companies who are planning to invest in Russia. When entering the Russian market it is a matter of vital importance for companies to be prepared for the reality which can be encountered there. The purpose of the research is to identify challenges Nordic companies have experienced and to give some recommendations on what should be done to succeed.

### ***2.2 Definitions***

***Nordic companies:*** companies from Norway, Sweden, and Iceland. Managers from those countries were interviewed in the research but not from the two other Nordic countries, Denmark and Finland. The final recommendations are composed to serve the interest of

Nordic companies, can probably also be relevant to companies from all the five Nordic countries and other countries as well.

***Nordic countries:*** Norway, Sweden and Iceland. See definition above.

***Russian business environment:*** the set of political, economic, social and technological forces in Russia that are largely outside the control and influence of a company, and which can potentially have both a positive and a negative impact on the company.

***Corporate culture:*** collective behavior of people that are part of an organization while corporate governance refers to the set of systems, principles and processes by which a company is governed.

## **2.3 Questions & Structure**

A research question is critical in determining the type of information to be explored in the research. The research topic is “*Nordic investments in Russia: Current business environment and outlook following Russia’s accession to the WTO.*” Based on this topic, research questions identified are following:

- *What is the experience of Nordic companies who have invested in Russia?*
- *What challenges did they encounter and how were they managed?*
- *What recommendations can be given to Nordic companies in order to maximize profits in the Russian market?*
- *What are the future outlooks for the investments environment in Russia after its membership in the WTO?*

Correctly identified research questions make it easier to collect the relevant data so these questions can be answered.

### **Structure**

The work on the project began in October 2011. This was when the research topic and the supervisor were chosen. Time frame for completion of the research project is set 25 May 2012. The research proposal was submitted 1 March 2012, which allowed the necessary time for conducting qualitative research and analyzing the results.

The research topic is studied in two perspectives: the historical one and the current situation. From the historical perspective it is interesting to trace back the development of the cooperation between the Nordic countries and post-Soviet Russia. Focusing on the

problems Nordic companies used to face throughout history helps to understand better present business settings. The current situation is described focusing on business environment in modern Russia, its infrastructure and legislation.

The research can be divided into three stages from January till May 2012, which are the following:

- In the first stage (mid-January till mid-March), all the necessary data was obtained from the secondary sources, which provided a solid theoretical framework for the research. Cooperation between Nordic countries and Russia was explored from a historical angle. At the same time political and economical development of Russia was investigated. Business environment and business culture in modern Russia was described in order to give an accurate picture of the country. Future outlooks of Russia's membership in the WTO is an important part of the research, therefore a lot of information concerning this topic was acquired.
- In the second stage of the research (mid-March till mid-April) in-depth semi-structured interviews with the 14 managers of 14 Nordic companies were conducted. The interviews were mostly carried out in person in the headquarters of the companies, but also via Skype (4 interviews). In order to acquire more background information about Russia, unstructured interviews were conducted with experts in the field of study. Discussions with those experts further deepened the knowledge of the Russian business environment and opened up for more specific questions.
- The third stage of the research (mid-April till mid-May) full analysis was conducted of the empirical results obtained from the secondary and primary data collection. Analysis is followed by conclusions drawn from the research.

Below is a detailed research structure designed for the purpose of the research:

## **I. Gathering of relevant information on Nordic investments in Russia**

1. Exploration of Internet sources, library research regarding historical cooperation of Norway, Sweden and Iceland with Russia.

2. Contacting and visiting the Icelandic Trade Council, the Norwegian- and the Swedish-Russian Chambers of Commerce.
3. Getting a list of companies for interviews and their contact information.
4. Russia and the WTO: valuable information and contact names in Russia received from Stefán Haukur Jóhannesson, who was the Chairman of WTO's Russian Accession Working Group. Information points were:
  - Situation before the accession
  - What will change?
  - The most important implications of the membership
  - Possible consequences for the Russian business environment (comparison with China and its joining WTO).

## **II. Qualitative research with Nordic companies**

1. Prepared questions for companies (divided into several parts exploring individual, company and country-level experience).
2. Conduct in-depth interviews with 14 companies.

## **III. Analysis of the results**

1. Nordic investments in Russia.
2. Cultural issues identified.
3. Future outlook.

### ***2.4 Qualitative research***

Since qualitative research seeks out the answers “*why*” rather than “*how*”, it presented the perfect method to collect information from respondents. Qualitative method is usually used when researchers need to gain insight into people’s attitudes, reasons behind the decisions, behaviors, value systems, concerns, motivations, aspirations, culture, etc. Qualitative research also involves the analysis of any unstructured material, such as reports or media clips (Aaker, Kumar & Day, 2007).

#### **2.4.1 Data Collection**

Data was collected both from primary and secondary sources. Secondary data was gathered from Internet sources, books and journal articles written within the field of

study. Primary data was collected through qualitative research, as such research design was considered to be the best suitable for the purpose of proposed research.

Data was collected in two stages. During the stage one the plan was to evaluate secondary data and document analysis. This has helped to set questions for semi-structured in-depth interviews with Nordic companies working in Russia. Interviews were conducted during the second stage. The data collection methods have included:

1. Desk research for collecting secondary data (theoretical framework: literature and Internet resources were used in order to get closer insights into the research topic).
2. Primary data collection: Personal semi-structured in-depth interviews with Nordic companies' managers and document analysis (investment memorandums, contracts, etc).

In-depth interview (IDI, one-on-one) is an interview with a single individual rather than a group of people. IDI typically lasts from 30 to 90 minutes, depending on the subject matter and context of the interview. IDIs may be carried on in person at a research facility, the respondent's home or workplace or a public location, or by telephone (McDaniel, 2008). The main strength of qualitative interview is its openness and flexibility, which is very important for obtaining desired knowledge about respondents' experience of Russian business environment.

Semi-structured interview design has been chosen as it is believed to be necessary to prepare an interview guide beforehand. Though interviews were thought of more as an open discussion rather than just getting strict answers, questions for the respondents were designed with the purpose of pointing the interview in the desired direction. It is essential to receive answers to critical questions from all respondents in order to conduct accurate analysis. Since respondents had often limited time for the interview, it was very important to have guidelines at hand. Guidelines can be found in the Appendix 1 of this report.

The research uses a systematic approach for ensuring that the data collected from the primary and secondary sources is accurate. The process will involve data immersion, data reduction, categorization, processing and finally data evaluation in order to gain an insightful analysis of the relevant facts and figures in explaining market trends (Aaker, Kumar & Day, 2007). In the final chapter of the research report findings are summarized and conclusions drawn in accordance with the research questions.

## **2.5 Literature & the Research**

During the research work it is very important to choose carefully the literature that helps to get a deeper insight into research problem and covers the topic from different angles. There is enormous amount of books and articles which have been written about Russia and its business environment. Since the country's economy has been rapidly emerging during the past decade, Russia's situation presents an attractive topic for discussion and research among many scholars.

All the respondents chosen for the research on Nordic companies in Russia possessed a deep knowledge and extended experience from working in the country. Besides sharing their experience, the contribution to the research has been even greater as they gave valuable advices on the choice of the literature for the research.

The most valuable source of information for the research on Nordic companies in Russia is the book *In from the Cold: the Rise of Russian Capitalism* edited by Peter Westin and published by London publishing partnership in association with Aton in 2012. The book offers a balanced picture of Russia's progress during the past two decades and concludes a collection of essays of contributors that have been professionally involved in Russia's capital markets in one way or another since early 90's. The majority of authors speak Russian and have lived in the country, thus they were able to share insights that can only time from the experience obtained on the ground.

In tackling the issue of corruption and bureaucracy in Russia Alena Ledeneva presents a novel approach in her recent book *How Russia Really Works*. Rather than looking at what does not work in Russia and why, she has chosen to focus on what does work well and how. Ledeneva analyzes post-Soviet politics and describes business environment from the perspective of informal practices. During her research she discovers rarely visible forms of activity and dispels a number of commonly held stereotypes about corruption and illegality.

A report in Norwegian language, "*Den besværlige virkelighete - Norske bedrifters erfaringer fra næringsvirksomhet i Nordvest-Russland 1990-2010*" ("*The troublesome reality - Norwegian business experience in Northwest Russia 1990-2010*") written by Kristin Høiby and Ulrich Kreuzenbeck describes the evolution from chaos of mid-1990s to present day Russia. The perspective is the "*set of Norwegian business eyes*" with input from representatives from the business community who have tried various business



ventures during this period. Some have succeeded, but it's no secret that many of the experiences have not been positive. Many lessons have been learned for sure since a lot of time, capital and other resources have been used in Russia projects that have ended with the withdrawal and large losses. What makes report extremely valuable for the purposes of research on Nordic companies is the fact that it offers guidelines for companies on how to act in present day Russian market in order to be successful.

### **3. Economical Development of Russia: 1991-2012**

It is almost 20 years since the Soviet Union was dissolved in 1991, communism gave way to democratic reforms and the Iron Curtain fell. With these historic events came the opportunity to start integrating this large country into the World economy and society. One of the fundamental issues with communism was that it didn't give the individual sufficient initiative to undertake anything beyond the bare minimum. The system didn't offer rewards for private initiative. Those values are gradually changing under the Western influence (Håkansson, 2010).

The Austrian economist and political scientist Joseph Schumpeter (1883-1950) introduced more than half a century ago a term which offers an important lesson for Russia. The term is "*creative destruction*" which denotes the mechanism that cleanses the economy. Schumpeter showed that through destruction of old companies, methods, and ideas and the arrival of new companies that are more productive and profitable the economy lives and grows. During Soviet times the mechanisms of competition and creative destruction was essentially turned off. These mechanisms are responsible for nearly half of the long-term growth in advanced economies. The main element of technological progress, entrepreneurship, was punished by imprisonment under communism. Soviet economic policy was characterized by inefficiency of industry and agriculture and underdevelopment of the services sector, which eventually bankrupted the Soviet Union itself. The problem of limited creative destruction is exacerbated in Russia by deficiencies in the corporate bankruptcy code, which limits self-cleansing mechanisms of the economy (Gurieva & Tsyvinski, 2010).

It would be correct to divide recent economical and political history on Russia in two main periods: the period from the 1990 to 2000 and the period 2000 to 2012 (a period that extends to present day). Boris Yeltsin took possession of Gorbachev's Kremlin office in 1991. The latter period starts with the time Vladimir Putin became president of Russia in 2000. Opinions differ about the quality of Russia's economic management since the 1990s and the wisdom of the reform strategy chosen.

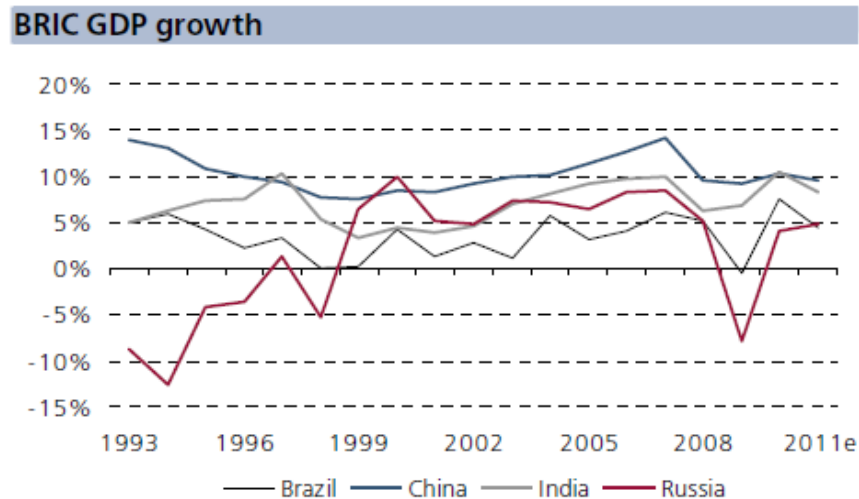
Much has changed since the Soviet Union collapsed taking away the old way of life. Most changes on the economy and the society are regarded to be positive. Russia opened up to capitalism and foreign investments were welcomed with the collapse of the Soviet Union. Transformation from communism to democracy and from a command

economy to a market economy opened the door to significant economic and political opportunities (Halloran, 2010).

The start in early 1990s was turbulent: chaotic privatization and lawlessness led to that enormous resources and value accrued to a few hands – the era of oligarchs in Russia. During that time there was almost anarchy and no predictability in the regulatory framework for foreign investors who dared to invest in the country (Høiby, 2012). The period from the beginning till the end of 1990s is often described by turmoil. Russia has inherited a highly centralized Soviet system of intergovernmental fiscal relations, in which the center used financial transfers to the regions as a means to maintain the integrity of Russian empire. Only political reasons were behind those transfers and did not take into account economic considerations (Zhuravskaya, 2010).

Since the 1990s Russia has made a remarkable progress on the economic front. From 1992 to 2011 GDP in Russia has grown from 66 billion USD to almost 1.8 trillion USD, or by 270%. The standard of living of the average Russian has improved significantly, but GDP per capita has risen over the same period from 443 USD to 12.900 USD. Poverty has been reduced dramatically and a thriving middle class began to grow (Westin, 2010). An overall increase in the population's well being and a formation of a middle class has helped Russian society to make a successful transition toward a more consumer oriented economy (Das & Gurushina, 2010).

Russia was not the only country to experience a major transformation over the last twenty years. India, China, and Brazil – which together with Russia form the BRIC collective – shared many similar experiences. The graph below shows the key figures in GDP growth for the BRIC countries during the period 1993 – 2011. The scale of China's economy and pace of its development has out-distanced those of its BRIC peers largely because of a strong, centralized and efficient state, where the main players are foreign companies. Russia was the only BRIC economy whose real GDP growth in 2010 remained below the pre-crisis highs – despite the far-reaching and sizeable fiscal and monetary stimulus package and the normalization of the international capital markets.



**Figure 1. Real GDP growth in BRIC countries (%). Source IMF, Bloomberg**

Russia has experienced two major financial and economic crises in the past two decades. The first one in 1998 was Russia-specific but the second crisis of 2008-9 was a consequence of global crisis. Economic recession has followed on each occasion and the stock market suffered huge losses. The Russian Trading System (RTS) stock index<sup>2</sup> fell by 93% in 1997-8 and by 80% in 2008-9. Remarkably, each time Russia has succeeded in fast economic recovery and became the top-performing market among emerging markets in the year following each crisis. Such a quick rebound can be explained mostly by a strong increase in the oil price (P. Westin). Daniel Treisman, one of the authors of the book *Russia after The Global Economic Crisis*, underlines that “*during the recovery phase, the link between oil prices and economic growth was far clearer in 2005-09 than in 1999-2001 (when growth owed more to the devaluation) and 2001-04 (when higher output of oil and minerals mattered at least as much as prices)*”.

Fareed Zakaria on CNN made an interesting statement when he said that “*oil is life blood of Russian economy; it provides two-thirds of its exports, half of the federal government’s revenues*”. The journalist says that oil was the real hero of Russia’s rescue after the economic crises. “*The dramatic rise in the average Russian income has been a consequence not of Putin’s policies but of oil prices. The price of oil when Putin came to*

<sup>2</sup> The **RTS Index** (abbreviated: **RTSI**, Russian: Индекс РТС) is a free-float capitalization-weighted index of 50 Russian stocks traded on the MICEX-RTS Stock Exchange in Moscow, Russia. The list of stocks is reviewed every three months by the RTS Information Committee. The RTS Index value is calculated in a real-time mode. The index was introduced on September 1, 1995 with a base value of 100.

*office was \$27 a barrel. From that point, it began an almost unbroken rise and is now at \$116 a barrel*". Putin's government has ramped up its revenues to the point that it now needs oil to approach \$125 a barrel simply to balance the budget. The conclusion is that the Russian regime will survive challenges still presented in the country until and unless oil prices decline (Zakaria, 2012).

### **Kudrin's contribution to Russia's economic recovery**

Another important factor in quick rebound after the economic crisis of 2008-09 was the Minister of Finance Alexei Kudrin's prudent fiscal management policies. Kudrin was Minister of Finance from May 2000 till 26 September 2011, making him the longest-serving Finance Minister in Post-Soviet Russia. Kudrin received several awards, including "*Best Finance Minister of a Developing European Country*" in 2006 by the IMF and the World Bank published Emerging Markets newspaper, and "*Finance Minister of the Year 2010*" by the Euromoney magazine. After the 1998 default in Russia, Kudrin was adamant that Russia must rebuild its credibility on international markets. Kudrin's ideas were not popular but Putin backed him, as he introduced highly punitive tax rates that applies, and still apply, to Russia's vast oil industry. The so-called "*Kudrin's scissors*" system compelled Russia's oil companies to pay taxes equivalent to around 90% of export revenues above USD 25 per barrel. As oil prices rose, the money started flowing to the Stabilization Fund of the Russian Federation, which was used to build reserves and pay off national debt. These measures provided stable macroeconomic platform which helped control inflation in the country and contributed to Russia's consecutive budget surpluses from the early 2000s. Mattias Westman, founding partner of the largest Russia-focused investment fund Prosperity Capital Management with about USD 5 billion assets, and one of the authors of the book "*In From the Cold*" published in May 2012, is convinced that "*Kudrin's insistence on saving for a rainy day was to stand Russia in good stead, not only in the first years of the new millennium, but also in the aftermath of the Lehman Brothers collapse in 2008*" (Westman, 2010).

## **4. Current Economic Situation in Russia**

### **An emergence of a thriving middle class**

Peter Elam Håkansson, a founder and chairman of East Capital, one of the largest investors in Eastern Europe, is convinced that doing business in Russia is about three words: consumer, consumer, and consumer. The big thing in Russia is the development of the middle class. Today many companies realize that Russia's biggest opportunities come from that fact. It is a time to stop looking at the country as an oil and gas economy only.

The emergence of a significant middle class has made a very material difference to the economic, social and political arena in Russia. People have now become very frustrated with the lack of progress in dealing with corruption among state officials. There is a declining level of confidence in Russia's economic future as recent protests during presidential elections in March 2012 have shown. Today, expectations seem to be a lot higher and tolerance much lower than before.

### **Insufficient economic model**

A common opinion among business analytics is that existing economic model is insufficient. One of the biggest problems is the fact that there is relatively little existing governmental budget support to help new industries grow, especially those in SME sector. It is acknowledged that it is very difficult to start up a new business, and existing businesses regularly complain about administrative barriers and a generally unfavorable business climate. Russia needs a new business model - a model that makes it easier for businesses to start and expand (Weafer, 2010)

It may prove impossible for Russia to become an economic superpower without major investment in infrastructure. The consensus is that progress in the economy will not be achieved while the power supply is vulnerable to breakdowns, roads are inadequate, and the country remains so reliant on imported food and basic medicines (Weafer, 2010)

Attempts by the Russian government to reform the economy have not always been implemented as intended or the results were not as expected. Russians themselves often quote former Prime Minister Viktor Chernomyrdin: *"Khoteli kak luchshe, a poluchilos"*

*kak vseгда*" – *"We wanted the best, but the result is as usual"*. It is acknowledged that rule of law is working only selectively in Russia and many unwritten rules have to be followed when the law is full of holes or not possible to enforce (Høiby, 2012).

### **New economic model: Greater need for foreign investment**

According to Robinson (2008), Russia's leaders finally seem to understand that an *"open door"* foreign economic policy will swing both ways. Many of the country's major corporations also need to create strategic alliances with established companies abroad, especially the ones in Europe. Strong ties with successful international corporations will have positive effect on the Russian economy. The Russian government is therefore determined to improve foreign investors and major corporations view of the country. This explains why Russia is so keen to attract major sporting events like the Formula One Grand Prix and the Winter Olympics in Sochi 2014, World Cup in 2018. The same reason was behind the greater urgency for Russia to be admitted into the WTO by end of 2011, after years of delay (Weafer, 2011).

Russia needs not only investment capital from abroad, but also the expertise and business experience of international companies if it is to break economy's dependency on oil. *"Putin's government has a tough battle ahead to change the Russia's lingering negative perception and clear the legal and administrative obstacles that still make it difficult for foreign direct investors to work in the country"* says Chris Weafer, a chief analyst at Russia's oldest investment bank Troika Dialog. He also adds that *"a softer foreign policy, WTO membership, hosting high profile sports events and a better PR campaign will surely help, but to achieve a significant, long-term change in how investors view Russia and its high-risk factor, there will also have to be very visible success in lowering corruption, cutting business red tape and improving the reliability of the legal system to give greater investor protection"* (Weafer, 2011).

Ian Pryde, founder and CEO of Eurasia Strategy & Communications in Moscow, argues that Russia has failed to convince both Russian and international investors that it is ruled by the law and not by men. He says that *"even Russian investors believe that rules and regulations can be changed at the drop of a hat, so they don't invest to anywhere near the extent the country needs and prefer to park their money offshore, despite the flat-rate income tax of just 13 percent."*

In spite of the enormous progress Russia has made, both the economy and the capital markets still have a long way to go before reaching the economic development and the sophistication of capital markets in the developed countries. As mentioned earlier, dependence on oil prices in the global market is a great weakness of the Russian economy. Guriev and Tsyvinski argue that another great weakness is corruption, which still remains a huge and persistent problem, and the lack of institutions to fight it and improving the rule of law (Guriev & Tsyvinski, 2010).

Russia's internal problems relate to the "*resource curse*" and it is especially problematic as the ruling elite seems not to be interested in building such institutions. It has been argued that resource sectors are less sensitive to bad institutions and good institutions also constrain the rent seeking by the ruling elite and increase political competition, raising the chances of the elite being replaced. Another hindrance for a healthy economic development, a consequence to the above, is low level of domestic and foreign investments. In order to improve the investment climate in the country the government needs to apply drastic measures (Guriev & Tsyvinski, 2010).

Over the next 10-15 years Russia might face the toughest demographic challenge among the BRIC countries. The country's population is aging and shrinking, which means raise of pension and healthcare costs as people retire. The first warning signals appeared already in 1990s when Russia's population began to fall. This process continued through the past decade, when Russia's population shrank by almost 4%, compared to 5%, 10% and 13% respective increases in China, Brazil and India. In the next decade Russia is expected to lose another 5% of its population. This process will have a negative political and economic impact (Das & Gurushina, 2010).

### **What lies ahead?**

Although above mentioned challenges remain, Russian economy has undoubtedly settled on a steady upward trajectory. Russia's recent accession to the World Trade Organization (WTO) in December 2011, which will be finalized in summer 2012, is the biggest milestone achieved on this way. WTO membership should provide Russia with the necessary long-term foothold for further economic development. Changes in Russia are though expected to come slowly rather than dramatically, but it is crucial that they will come.



In discussions about Russia's economy "*oil and gas*" are usually used as the main source for both Russia's positive and negative characteristics. That is not surprising given the fact that nearly 45% of the federal budget revenues come from the energy sector and "*oil and gas*" accounts for more than 60% of the overall exports. The oil price plays an important role in the Russian economy and has done so over the last decade. There is a direct correlation between the oil price and the RUB/USD exchange rate, budget revenues, exports and international reserves. Increasing global oil prices contribute to rising income and hence growing domestic consumption and a higher demand for imports (Westin & Risk, 2010).

### **Outlook on Putin's government**

There are numerous other challenges present in modern Russia as well. One of the problems is low labor productivity. The Caucasus region is almost turning into a separate country. Russia's ethnic diversity is straining its sense of nationalism (Zakaria, 2012).

Mark Robinson, head of equities at the investment bank Wood&Company, sees two avenues open for current Russian government: populist or reform-minded. Going down the populist's path is only possible if crude oil prices sustain at higher levels than now, as it would be fiscally-driven (increase social spending, not cut pensions). However, the other populist possibility, "*oligarch-bashing*" through taxation, would be politically tricky and would squeeze the natural resources sector, an engine for the economy, further. According to estimations made by former finance minister Mikhail Kudrin, 40% of budget revenues already come from the oil and gas sector. Mark Robinson underlines that the reform path looks more logical, reasonable, and politically expedient, meaning easier to promise and perhaps eventually fall short on delivery (Robinson, 2008).

It is speculated whether the protests that followed Duma elections in December 2011 and presidential elections in March 2012 will force Vladimir Putin and his prime minister and former president Dmitry Medvedev to speed up modernization reforms and to fight corruption that thrives in the form of persistent "*shadow economy*". Measures may be required in diversifying industry, improving the services sector, building a sovereign wealth fund/pension plans for the population, building appropriate institutions and developing capital markets. Most observers rightly argue that while much-needed reforms such as reduced red tape present the obvious solution, it runs the risk of greater

freedom and independence for businessmen and citizens - and a subsequent loss of Kremlin control (Pryde, 2010).

As mentioned earlier Russia's problems relate to the "*resource curse*". If oil prices remain high, Russia will probably delay much needed economic reforms. "*So long as oil prices were growing, many, almost all of us, to be honest, fell for the illusion that structural reforms could wait,*" former Russian president Dmitry Medvedev confessed during his annual address to the Federal Assembly in November 2009. The "low hanging fruit" of basic economic reform and prudent macroeconomic policies has already been picked. Future economic growth of the country requires building stronger political and economical institutions such as constraints on the executive branch, improving the rule of law, lowering corruption, improving protection of property rights, contract enforcement, and competition. Such institutions are difficult to build in every society, but they are vital for a country's development (Sergei Guriev, Aleh Tsyvinski).

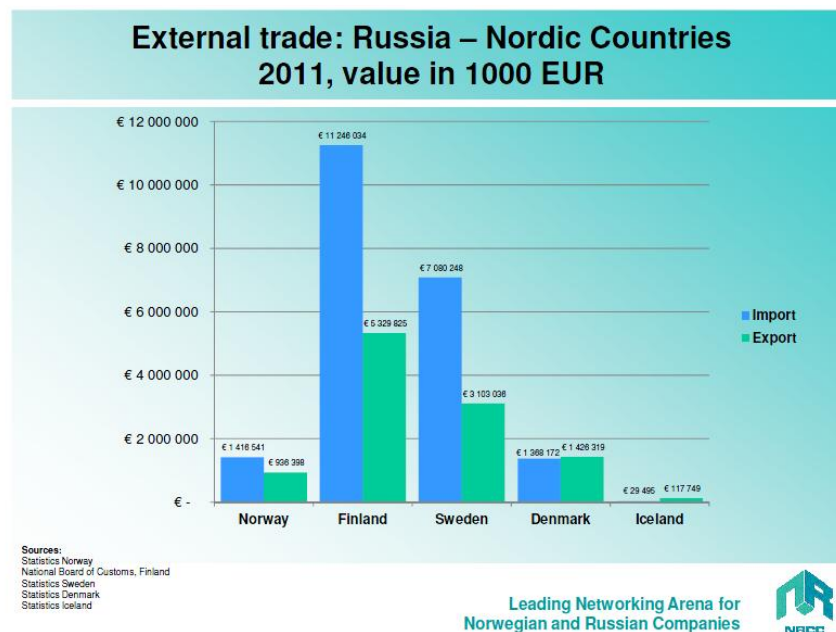
Putin was inaugurated as president on 7 May 2012, and it will be interesting to see what his first steps would be. Prior to the presidential election 4 March 2012 Putin confirmed his intent to hold the course of further democratic reforms. Otherwise it is very unlikely for Russia to catch up with advanced economics in the next 10 to 15 years. Sergei Guriev and Aleh Tsyvinski, contributing authors to the book "*Russia after The Global Economic Crisis*", argue that if reforms are not implemented, Russia is in danger of entering a new decade of Brezhnev era-like "70-80" stagnation.

## 5. Nordic Business in Russia

Trading in many forms has flourished between Nordic countries and Russia for a long time. After the collapse of the Soviet Union Nordic business people, entrepreneurs from the cross-border areas in Norway, Sweden and Finland started to do business in North Western Russia. These were the new pioneers; adventurous and fascinated by the vast possibilities in the neighboring country.

Even though many of ventures of the Nordic companies in North Western Russia didn't succeed during 1990s, several companies did and continue their operation. Those companies have gathered experience and knowledge from that time, not to mention building of network and understanding how things work in Russia. In the 90s there were many challenges in the Russian market and many companies are still facing those challenging to a large extent (Høiby, 2012).

Of the Nordic Countries Finland is the biggest trading partner with Russia, followed by Sweden, Denmark, Norway and Iceland, according to recent numbers from the Norwegian-Russian Chamber of Commerce.



**Figure 2. External Trade Between Russia and Nordic Countries. Source: NRCC**

### ***5.1 Norwegian-Russian Economic Relations***

Norwegian industry and companies have been present in North West Russia since the beginning of the 1990s, when the Barents Regional Council was established. Norwegian interests are concentrated in Murmansk, Arkhangelsk, St. Petersburg and Moscow areas. Kimek company working in oil and gas industry and situated in Kirkenes, a Norwegian town close to the Russian border was among the first companies which managed to create a sustainable business in Russia. Kimek developed strategy with a long-term perspective on their business relations with Russia. The company was established in 1987, including Finnish owners (45%) and was led by a Finnish CEO Olli Mäkelä. In 1989 Kåre Storvik from Norway took over as CEO of Kimek when the first contacts with Russian companies were established. Kimek has worked closely with companies in the Kola Peninsula and Arkhangelsk (Høiby, 2012).

Norwegian companies have in recent years started to explore business and investment opportunities in other regions in Russia than the North West region. Currently there are about 100 registered companies (including representative offices) in Murmansk and Arkhangelsk with Norwegian interests, according to a study by the company Ramboll Storvik (NRCC, 2012). In 2011 around 40 Norwegian companies were established in Murmansk according to the Norwegian General Consulate in Murmansk. The actual number of active participants is significantly lower, as the number takes into account not only trading and manufacturing companies, but also representative offices. The companies, which come from all over Norway, are well-established and have a larger resource base and are more adapted to pioneering activities in Russia than the companies back in early 1990s (Høiby, 2012).

Norwegian companies have accumulated valuable knowledge and established network in Russia over the years. Communicating acquired knowledge is a primary task of the professional advisory groups such as NBA (Norwegian Business Association) and FIBA (Foreign Investors Business Association). Norwegian-Russian Chamber of Commerce also has a significant influence possessing a lot of knowledge about Russia (Høiby, 2012).

Major Norwegian investors in Russia include names such as Telenor, Statoil, A-pressen, Orkla, Norsk Hydro, Yara International, Ølen Betong, Wenaas Gruppen, Jotun Gruppen, Sparebank 1 Nord Norge, Innovation Norway and DNB. Russian companies

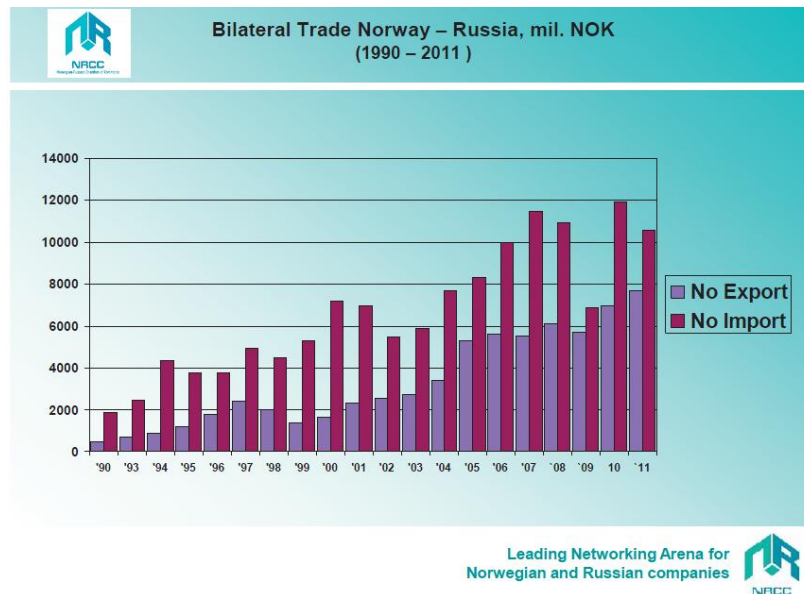
have not made any considerable investments in Norway, mainly limiting their presence there to representative offices or branches, such as Intourist, Aeroflot, Dalmorneftegeofysica etc. (NRCC, 2012).

### **A journey to Murmansk**

The border between Norway and Russia has opened in the early 1990s offering new opportunities for both nations. The journey across the border from Kirkenes to Murmansk could be made by bus from the Norwegian-Russian border at Storskog followed by a direct train trip to Murmansk. When arriving to Murmansk, there were striking differences from Norway: the shops were mostly empty, the few restaurants there had little offered other than herring, dry schnitzel and salad made of tomatoes and onions. There were great opportunities both for selling consumer goods and for other types of business. There was a huge market for drinking water, beverages, and various kinds of food, clothing, hotels, equipment for the mining industry, and equipment for fishing vessels, equipment for the harbor. From that time Norwegians who intended to start business in Russia recall that they “*just had to roll up the sleeves and get on!*” (Høiby, 2012).

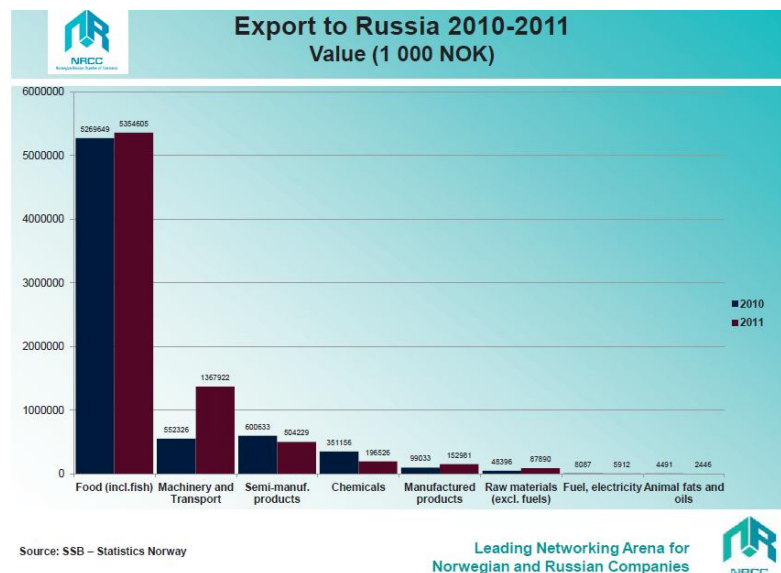
### **Norwegian-Russian Bilateral Trade**

Norwegian-Russian bilateral trade over the period from 1990 till 2011 has shown enormous growth, both in terms of import and export, according to figures from Norwegian-Russian Chamber of Commerce. The variety of imported and exported goods between Norway and Russia has remained stable over the years. Traditionally, more than 50% of Norwegian export to Russia is fish and seafood, while more than 50% of Russian export to Norway is metals (mostly aluminum) (NRCC, 2012).



**Figure 3. Bilateral Trade Norway-Russia. Source NRCC**

The value of Norwegian exports of seafood for the year 2011 totaled NOK 53 billion according to the latest numbers obtained from the Norwegian Seafood Council. Russia and France are by far the two most important markets for Norway with almost NOK 11 billion of the total sales in 2011. The export to Russia amounts to NOK 5.2 billion, while France holds the second place with an export value of NOK 5.1 billion. This makes Russia the most important export market.



**Figure 4. Export from Norway to Russia 2010-2011. Source NRCC**

The 1<sup>st</sup> quarter of 2012 was primarily characterized by a significant growth in the volume of Norwegian salmon exports. “It is Russia that stands out with a particularly

strong growth, and Russia is now our largest salmon market in terms of both volume and value” says Egil Ove Sundheim, Market Information Director for the Norwegian Seafood Council. According to Council’s website, in a period of two weeks at the end of 2011 Norway exported the same amount of salmon to Russia during those two weeks as the country did in the whole year of 2000.

### **Arctic exploration deal**

The most recent and important development in Norwegian-Russian cooperation is the deal between the Russian oil giant Rosneft and Norway’s Statoil of a joint oil exploration in the Arctic Sea and the three blocks in the Far Eastern Sea of Okhotsk. The deal was signed on 5 May 2012 by the chief executive officers of the two companies in the presence of Russian former Prime Minister and president-elect Vladimir Putin.

According to the agreement, Statoil will get ownership of a third of a new joint venture and will finance the initial exploration necessary to determine the commercial value of the four licenses. *“Pending results further exploration wells could be drilled, and if we are successful in making discoveries there will be substantial investments for developments”*, Statoil spokesman Bard Glad Pedersen announced. The deal offers Rosneft an opportunity to acquire stakes in Statoil’s projects in the North Sea and in the Norwegian sector of the Barents Sea.

*“By building on both companies’ competence and experience, this agreement is a significant step further in the industrial development of the northern areas,”* Statoil’s Chief Executive Office Helge Lund said in the statement. *“We value our relations with our neighbors and are confident that the project will develop well. There is no question that it will have the government’s full support.”* – Mr. Putin said to the press. Some media reports estimate the value of the agreement at about \$2.5 billion, but Statoil told the BBC that it has *“not given any valuation of the deal”* (BBC, 2012).

Norway’s leading business newspapers think that the deal is very risky for Statoil and Norway. The Finansavisen’s headline from the 5<sup>th</sup> of May 2012 issue says *“Superdeal med SUPERRISKO”*. DagensNæringsliv says that Norwegians *“take chances with Russians”*; its headline from the 7th of May 2012 calls the deal *“høy risiko”*.

## **5.2 Swedish-Russian Economic Relations**

### **Early 1990s Swedes’ invasion to Russia**

Sweden's proximity to Russia and the countries' entwined histories means that there has always been enormous interest in Sweden in its massive Eastern neighbor.

In the mid-1990s lots of Swedes became involved in Russia's nascent financial services industry. Mattias Westman, a founder of Prosperity Capital Management (PCM), the largest advisor on Russia-focused funds since 1996, recalls that Russian-speaking Swedes, like himself, practically invaded Moscow during early-1990s. Brunswick Brokerage, one of Russia's first investment banks, was run largely by Swedes. Paul Leander Engström, who became a co-founder of PCM, was Brunswick's first Head of Research. Vostok Nafta investment fund was launched during those days, as well as Alfred Berg, a Nordic asset management company. Swedish entrepreneurs working in Russia trusted each other, and the trust was essential to make Russia's fledging stock market work. *"As more Swedes got involved, and made money in Russia, our press started to report what was happening and the thing snowballed"* says Mattias Westman in the book *"In From the Cold"*, which came out in May 2012. Over the last 15 years, PCM's development has been consistent with that of numerous Russian companies. In the beginning of 2012, PCM's asset was around USD 5 billion, which above its pre-crisis high and investors include private banks, pension funds, insurance companies and sovereign funds (Westman, 2011).

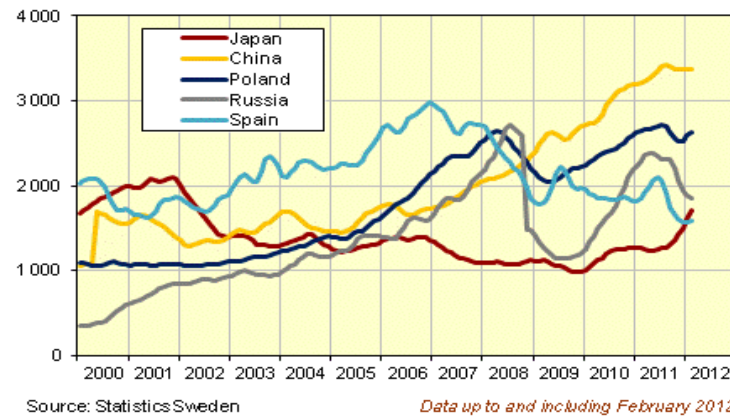
### **Trade with Russia**

The volume of Swedish-Russian trade has been increasing significantly over the past decade. The Embassy of Sweden in Moscow confirms that the interest in Russia within the Swedish business community is steadily on the rise, with approximately 400 Swedish companies presented in the Russian market in 2011. The Embassy of Sweden in Moscow estimates that the trade (export/imports) between the two countries, which rose by 600% from 1998 to 2008, has now fully recovered after the economic crisis in 2009. According to Embassy's information, exports to Russia increased by 49% in 2010. Important export products are automobiles, equipment for the telecommunications industry, and pharmaceutical products. Figures from Statistics Sweden website show that during the first quarter of 2011 exports to Russia increased by 78 percent while imports from Russia increased by 34 percent. This sharp increase in exports was mainly due to a larger export in electronics/telecommunication and road vehicles.



### Exports to large trade partners

The Swedish export of goods to five large countries of destination (SEK million). Trend.

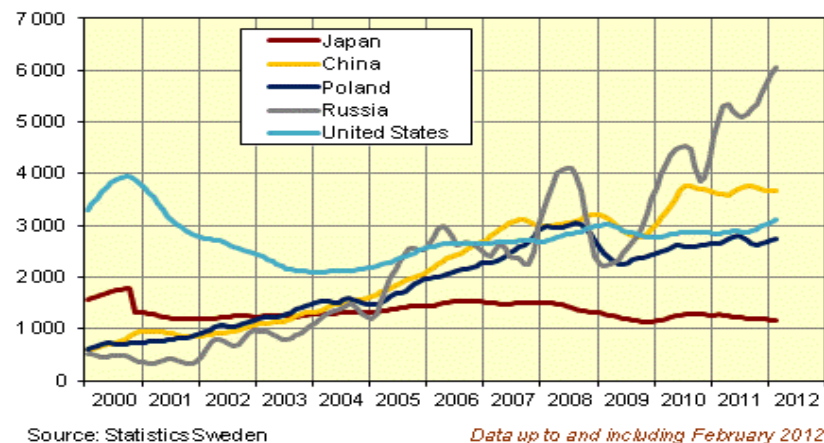


**Figure 5. Exports from Sweden to large trading partners in 2000-2012. Source: Statistics Sweden**

Imports from Russia consist mainly of raw materials, in particular crude oil. The value of Swedish imports amounted to USD 8.4 billion in 2010. Increases in Swedish imports from Russia are partly the result of oil price increases. Crude oil represents 72% of Sweden's total import from Russia.

### Imports from large trade partners

The Swedish import of goods from five large countries of consignment (SEK million). Trend.



**Figure 6. Imports to Sweden from large trade partners in 2000-2012. Source: Statistics Sweden.**

There are two main organizations that enhance economic relations between the two nations. The Swedish Trade Council is a governmental organization with offices in Moscow and St. Petersburg. Its mission is to promote and facilitate trade between Sweden and Russia. The Council has built an extensive network and experience in

Swedish industry and commerce, and it can quickly identify the right suppliers and provide quick answers to questions about Swedish exports. The Swedish Trade Council also assists Swedish companies seeking to establish a presence in Russia. The Swedish-Russian Chamber of Commerce is another organization that offers information about trade and business opportunities through seminars and informal meetings.

### **Investments**

Embassy of Sweden in Russia states that Swedish investments in Russia are gradually increasing. As of 2012, Sweden is among top ten foreign investors in Russia and was one of few countries increasing its investments during the global recession in 2009. The Swedish-Russian Chamber of Commerce reported in its newsletter from January 2012 that Volvo has decided to invest EUR 35 million in the construction of a plant for production of excavators in Kaluga. The plant will be located at the industrial park “Kaluga South” next to the plant for the production of trucks, which Volvo established in 2009. The launch of the plant is planned for early 2013 (Swedish-Russian Chamber of Commerce, 2012).

### ***5.3 Icelandic-Russian Economic Relations***

Russia and Iceland have enjoyed good bilateral relations over a long period of time. Next year, 2013, the countries will celebrate a 70<sup>th</sup> Anniversary of diplomatic relations. The relations between the countries can obviously be traced much farther back or to the time when Iceland took the initiative in developing bilateral naval contacts as early as in the 18th Century. The first formal business connection between Russia and Iceland was agreement relating to Commerce and Navigation, which came into force in May 1927 (Nr. 274 from May 25, 1927).

Even though the Soviet Union and Iceland were at the opposite sides of the geopolitical divide during the Cold War, the two countries enjoyed remarkably good bilateral relations. Not least due to the fact that when a fishing dispute arose between Iceland and Great Britain in 1952 and Icelandic fish imports were banned into Great Britain the Soviet Union became one of the largest export markets for Icelandic fish. (MFA, Iceland)

Foreign trade between Iceland and the Soviet Union has remained on a solid basis since 1953 when a trade and a payments agreement was concluded (Nr. 275 from August

1, 1953). This agreement has opened new large market for Icelandic products, which had invaluable meaning for developing economy of Iceland. The other important treaties were agreement on cooperation in the fields of culture, science and technology (Nr. 278 from April 25, 1961) and agreement on scientific and technical collaboration, consultation about fisheries and cooperation in the field of research of sea biological resources (Nr. 9/1977 from April 25, 1977).

During most of the fifties, sixties, and seventies, the Soviet Union became one of Iceland's most important trading partners. High figures of 17.8% for exports and 15.7% for imports were attained during the peak period 1954-1960 of Russian-Icelandic economic relations. The main Icelandic export products have been frozen fish, especially ocean perch fillets, and salted herring, as well as sheep skin. Oil was by far the most important product imported from the Soviet Union, representing 90.5% of purchases from that country in 1984. Iceland also was buying timber, automobiles, machinery and various other products. Because of foreign trade policy of the Soviet Union government, there were special quotas on imported and exported products. Purchasing of oil remained the term for all the business relations between Iceland and the Soviet Union. That was the main reason for significant decrease in import of oil after the Soviet Union collapsed in 1991 (MFA Iceland, 2006).

### **Development since 1991 and current status**

The bilateral relations between the Russian Federation and Iceland are based on solid mutually beneficial grounds. In December 1991, Iceland formally confirmed its willingness to develop stable good-neighbor relations with the democratic Russia. Thus, new trade agreement was signed (Nr. 31/1991 from the December 4, 1991). This agreement was supposed to ensure the development of economic collaboration between Russia and Iceland.

After 1991, there was a big change in the economic relations of the two countries. The business relations were no longer determined by the Russian government export and import quotas but by a free competitive market. This is the reason why purchase of oil from Russia has decreased significantly since 1991, when Iceland was no longer obliged to buy it. According to the information from Icelandic Bureau of Statistics, Iceland has increased purchases of timber, frozen fish, shrimps, machinery and other products. At the same time, export of mechanical equipment and textiles has increased significantly.

In December 1994, a Declaration on fundamentals of relations between Russia and Iceland was signed. There Iceland officially confirmed its readiness to develop stable bilateral relations with the democratic Russia after the Soviet Union collapsed. Since April 1999, regular political consultations have been held in the field of political affairs. Since 2001 extensive consultations and cooperation in economical and trade affairs, particularly on fishing issues, have been ongoing.

Foreign economic relations between Iceland and Russia are also developing on the regional level. The Icelanders attention is concentrated on the expansion of economic connections with Moscow, Saint Petersburg, and Northwestern region of Russia. Fishing areas, such as Murmansk, Vladivostok, Kamchatka Peninsula, and Chukotka are very important as well.

According to the Embassy of the Russian Federation in Iceland, one of the main directions of Russian-Icelandic relations is collaboration in the fishing industry. Signing of the agreement between Russia, Iceland and Norway in May 1999, concerning certain aspects of cooperation in the area of fisheries, has solved the problem of the uncontrolled fishing of cod by Icelandic vessels in the open part of the Barents Sea. In April 2000, Russia and Iceland signed the new agreement on cooperation in fisheries. Annual meetings of the Joint Russian-Icelandic Fisheries Commission have become regular (Embassy of the Russian Federation in Iceland, 2012).

From 1997 till 1999 the volume of trade between Russia and Iceland reduced by 80%. The share of the fish- and sea products among export products from Russia to Iceland exceeds 45%, while oil and metal conclude 40%. In 2003, total trade volume between Russia and Iceland reached 89.7 million dollars. Iceland's export to Russia was 13.8 million dollars and Russian's export to Iceland was 75.9 million dollars. By the volumes of its export, Russia occupied the 9th place among the commercial partners of Iceland (Embassy of the Russian Federation in Iceland, 2012).

The President of Iceland Olafur Ragnar Grimsson's first visit to Russia in April 2002 was a very important milestone in the development of economic relations between the two countries. The purpose of the visit was mainly to intensify foreign trade, which decreased after the financial crisis of 1998 in Russian Federation. President of Iceland visited Saint Petersburg, Moscow, Novgorod and Salekhard. Olafur Ragnar Grimsson discussed the complete spectrum of Russian-Icelandic relations with the President of the Russia Vladimir Putin. President of Iceland also had meetings with the head of the

government Mikhail Kasyanov and Patriarch of the Russian Orthodox Church Aleksey II. During September 2002, the President of Iceland took part in the second session of the Northern Research Forum in Novgorod City. In April 2003, Olafur Ragnar Grimsson participated in the celebrations dedicated to the 300<sup>th</sup> anniversary of Saint Petersburg. In August of the same year, the President of Iceland visited Chukotskiy autonomous district, where he met its governor.

Along with the other improvements of Russian-Icelandic economic relations, bilateral legal base is being gradually renewed. In 1998 an agreement about air transport between the two countries was signed (Nr. 7/1999 from December 11, 1999). In 2003 a convention about avoiding of double taxation entered into force (Nr. 3/2003).

In November 2005 an agreement was signed on a significant tax reduction on most important export products to Russian Federation. It will come into force after Russia's membership in the WTO is ratified in summer 2012. This agreement opens new possibilities for the foreign trade relations between Russia and Iceland, whereas tax on various types of fish and plastic pallet containers will be considerably reduced. For example, tax on export of herring and capelin will be reduced from 10% to only 3%. (MFA) According to figures from the Icelandic Bureau of Statistics, during the 1<sup>st</sup> quarter of 2012 the share of both herring and capelin concludes 58% of the total export from Iceland to Russia (Lecture by Foreign Minister, Halldór Ásgrímsson, at the Diplomatic Academy of the Ministry of Foreign Affairs, 2001).

### **Cooperation in the Arctic and on geothermal energy**

In an official visit to the Russian Federation in November 2011 the Icelandic Minister of Foreign Affairs Össur Skarphéðinsson met with his Russian counterpart, Sergei Lavrov, in Moscow. The Foreign Ministers had earlier signed an agreement that facilitates trade in dairy products from Iceland to Russia. The development of tourism between the two nations was also discussed during the meeting.

During the same visit, Mr. Skarphéðinsson confirmed an agreement on cooperation of both countries on Arctic affairs. Iceland and Russia will continue to monitor the development of the sea and air traffic in the region, with specific focus on Trans-Arctic sailing routes and the development of port infrastructure. The agreement outlines the development of academic links between institutions and universities in Iceland and Russia. Both nations declared their intention to enhance cooperation through the Arctic

Council and the Barents Euro-Arctic Council as well as through bilateral meetings and agreements (Embassy of Iceland in Russia, 2012)

Another important outcome of the Icelandic Foreign Minister visit to Russia was a signing of a Declaration of Modernization in the area of labor affairs, which aims at cooperation between authorities and experts in Russia and Iceland on mutual modernization projects. The goal of the agreement is to increase trade, innovation, and science in the relations between Iceland and Russia. The Foreign Ministers of both countries discussed the modernization of the renewable energy sector in terms of the use of geothermal energy in the Kamchatka Peninsula, Krasnodar and elsewhere in Russia. Further discussions have been between the countries with emphases on Iceland's interest in exporting expertise and know-how in the field of geothermal energy to Russia (Embassy of Iceland in Russia, 2012).

#### ***5.4 Restrictions on foreigners' right to own a land near federal borders***

On January 2011, the former Russian president Dmitry Medvedev issued Decree No. 26 *"On approval of the list of border areas in which foreign citizens, stateless persons and foreign legal entities may not hold titles to land"*. The decree caused a serious tide of anxiety among foreign citizens and representatives of foreign companies, who own land in border areas or who plan to acquire such land. The regulation states that foreign individuals or companies may not claim ownership of land near federal borders, which is listed in Decree No. 26, no matter on what basis this right appears (for example, by purchasing from a private owner). In Russia a company is considered foreign if the non-Russian stake is bigger than the 66,6 percent for a "OOO" (Russian abbreviation for Limited Liability Company or "LLC" in English abbreviation) and greater than 75 percent of an "OAO" (Russian abbreviation for Open Joint Stock Company, the common English abbreviation is "OJSC") (Høiby, 2012).

A ban on the ownership of real estate by foreigners has been in force in Russia's border areas for some time, but the scope of the border zone was not clearly defined in the legislation from 2001. The ambiguity in the interpretation of the term "border area" was eliminated with the new decree, which incorporates 380 border areas in 48 regions around the country where it applies. The list includes mostly rural areas and small cities excluding the cities of Kaliningrad, Magadan, Murmansk, Pskov and Salekhard, the

southern sea resort of Azov, and Kronstadt, a port town that is a part of St. Petersburg (Government of the Russian Federation, 2012).

Norway has a border with Russia in the Murmansk region where the biggest part of Norwegian-Russia cooperation takes place. Many of the Norwegian businesses have been established in that area, which became in the scope of the new restrictions. Finland and Russia share a 1,250 kilometer common border that also serves as the border between Russia and the European Union. Finland is questioning the significance of the decree, according to the Finnish broadcasting company YLE, but the list of places where sales of land to foreigners or foreign companies is forbidden includes most of the areas along Finland's eastern border, a total of 34 cities and districts (Russia Briefing, 2012).

At a network meeting in the Norwegian-Russian Chamber of Commerce in Murmansk on the 12<sup>th</sup> of December 2011, a lawyer from the Swedish law firm Mannheimer Swartling estimated that the new law restricting foreigners' right to own a land in Russia-defined border areas, will become a subject to future lawsuits. The lawyer outlined possible solutions to the problem that foreigners can experience with this new regulation and proposed the following 3-step model: (1) A foreign company that wants to buy a land near federal border should establish a Russian subsidiary first, (2) then Russian subsidiary establishes another subsidiary, which will be 100% Russian owned, (3) which in turn can buy a land in a border area. The same model could also apply to existing ownership because the ordinance can have retroactive effect. A number of foreign-owned companies must then reorganize their corporate structure. The lawyer underlined that those arrangements can cause some problems for foreign companies (including tax law). Besides, no one can guarantee that this will work after authorities discover that the regulation is circumvented in this way.

It is difficult to see that this ownership chain is not a circumvention of the Decree. Take an example: (1) A foreign company A is owned by foreigners (2) establishes a Russian subsidiary B it owns 100%, which then (3) establishes a Russian subsidiary C it owns 100%. The real- and beneficial owners of the Russian subsidiary C, which would own the Russian land in the border area are foreigners, owners of foreign company A.

Innovation Norway, the Norwegian government official trade representative abroad, advises against having a corporate company structure where the central power is allocated to a Russian subsidiary's subsidiary, since it can create an opportunity for asset disposal (Høiby, 2012).





## 6. Russian Investment and Business Environment

### 6.1 Investments in Russia

*“I am not in the least afraid of foreign capital, since I consider it is in the interests of our country. No country has been developed without foreign capital. What I am afraid of is just the opposite that our way of doing things has such specific characteristics, so different from the way things are done in civilized countries that not many foreigners will want to do business with us.”*

Sergei Witte, Russian Prime Minister  
at the end of the 19th century

Western asset managers who consider Russia as “*un-investable*” generally think in clichés. They still think in old stereotypes, viewing Russia in terms of oligarchs, vodka and Soviet-era attributes. In reality, the country can present opportunities of a lifetime. Spinning 9 time zones, Russia is a greatly diverse country possessing world-class reserves not only of natural resources, but human capital as well (Westman, 2010).

Bernard Sucher, a member of the Board of Directors at the investment fund ATON Capital, said that foreign entrepreneurs have been investing in Russia despite the lack of favorable business conditions: “*Russia’s shortcomings may be serious, but they have not stopped thousands of companies, domestic and international, from building strong and profitable businesses over the past two decades*”. Russia has a vast territory with a large population and a great amount of natural resources, such combination is difficult for any multinational corporation to ignore (Russia Beyond the Headlines, 2012).

The largest deals in the history of foreign investments in Russia were made in 2011 and 2012, which are believed to have substantially boosted global investor’s confidence in Russia and its improving business climate. PepsiCo’s acquisition of Russia’s largest dairy and fruit drink maker Wimm-Bill-Dann. “*Wimm-Bill-Dann is a terrific business with significant opportunities*” said CEO of PepsiCo Europe Zein Abdalla. Russia is best known for its natural resources, but PepsiCo deal shows that the emerging middle class is now capturing the attention of multinational companies. Another strategic global alliance made in 2011 is a joint venture of Britain’s leading oil company BP with the largest Russian energy firm Rosneft to exploit potentially huge deposits of oil and gas in

Russia's Arctic region. The BP has come into huge problems with its dealings in Russia, with special forces raiding its offices in Moscow August 2011. The raid was a day after the US ExxonMobil signed a deal giving it access to fields BP had hoped to develop. The raid highlighted BP's problems in Russia since it fell out with the authorities (Reuters, 2011). In May 2012 Rosneft signed a joint venture with Norway's Statoil on developing Russia's Arctic oil and gas resources.<sup>3</sup> These deals have been welcomed by the Kremlin that committed to modernization of the country by luring large investors which can bring not only cash, but necessary technology and management skills (BBC, 2012).

During the first ten years of transition to market economy, after the Soviet Union collapse in 1991, FDI in Russia were very low compared to other Eastern European and BRIC countries due to unfavorable tax system, high level of corruption, the lack of production sharing agreements in the fuel sector, and the overall economic and political uncertainty. The situation changed in 2002-03 when oil prices rose causing tenfold increase of FDI inflow to Russia, by 2006 surpassing even those to China in per capita terms. Outward FDI from Russia started early in the post communist transition period and is more significant than in other emerging-market economies (Tarr & Volchkova, 2010).

<b>Year</b>	<b>Net FDI inflows (USD billions)</b>	<b>Percent of GDP</b>
2000	2.7	1.0
2001	2.7	0.9
2002	3.4	1.0
2003	7.9	1.8
2004	15.4	2.6
2005	12.8	1.6
2006	29.7	2.9
2007	55.1	4.2
2008	72.8	4.5

**Table 1. Foreign direct investment (FDI) inflows to Russia, 2000-2008.**

<sup>3</sup> See more on this deal in Chapter 3, pp XX

**Sources: World Bank, World Development Indicators, 2009: Central Bank of Russia.**

In 2009-10 the flow of investments was cut in half compared with that in 2008, mostly due to the global financial crisis. FDI inflow in 2009 and 2010 was only USD 36.5 billion and USD 43.3 billion respectively, according to information obtained from an OECD statistic database. It has been argued that the FDI decline was caused by the lack of reforms to improve the business and investment climate. For the past several years Russia's government has set a course toward economic modernization putting emphasis on attracting foreign capital to the country. Implemented measures resulted in increase in FDI in 2011 to USD 52.8 billion, as stated in OECD statistic database on FDI inflows (OECD.Statextract, 2012).

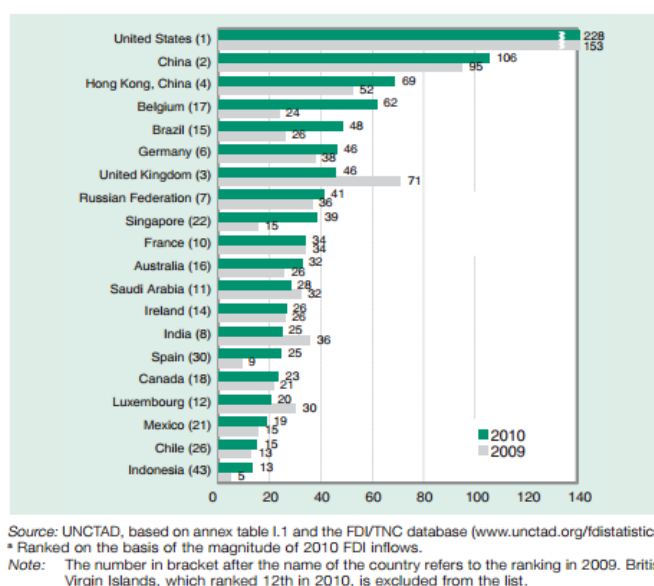
## ***6.2 Russia's Investment Environment – World rankings***

In 2009 World Bank's and Enterprise Surveys concluded that 50 percent of the surveyed firms in Russia mentioned corruption as a main constraint. Despite the efforts to fight corruption, it still remains persistent problem for doing business in the country. Table below illustrates Russia's corruption ranking from 1995 to 2010 in Transparency International Corruption Perception Index list. Russia ranked 143th out of 182 countries in 2011. Yet the country does not perform particularly badly in all areas. Russia performs worst in "*licensing requirements*", "*dealing with workers*" and "*trading across borders*" (export and import costs are high in Russia) (World Bank, 2012).



**Figure 7. Russia's ranking in Corruption Perception Index. Sources: Transparency International; Independent report "Putin. Corruption"**

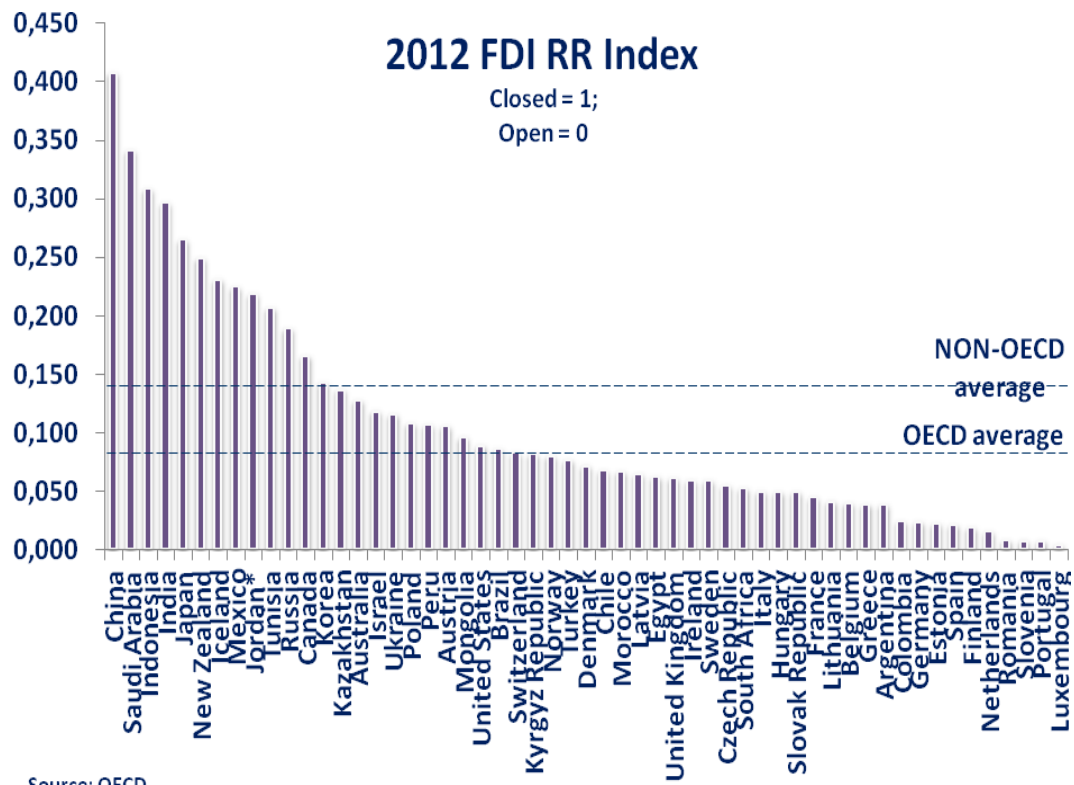
Report issued by United Nations Conference on Trade And Development (UNCTAD) in 2011, puts Russia in the 8th place among the world's top nations in terms of attracting foreign direct investment, with a total of \$207.7 billion received by the country (Government of the Russian Federation, 2012).



**Figure 8. Global FDI inflows, top 20 host economies, 2009 and 2010 (Billion USD)**  
**Source: UNCTAD**

In the World Bank's well-known ranking on "Ease of Doing Business" Russia rose by four points from the previous year, in 2012 ranking 120th among 183 countries. Russia is among the top 25 in terms of progress in reforming the investment climate, according to the same World Bank's report. The recently published Bloomberg's ranking "*Best Countries for Business*" places Russia among the top 50 countries with favorable investment climates out of 160 countries analyzed. Russia is in 48th place, ahead of its BRIC's colleagues India and Brazil, which took 49<sup>th</sup> and 50<sup>th</sup> place respectively. Bloomberg's survey measured conditions for attracting more foreign investment. It took into account numerous economic indicators, from the degree of economic integration and the cost of setting up a new business, to the cost of labor and materials and the readiness of local consumers. Yet the Bloomberg ranking is also controversial, since the 2012 World Bank report has Russia in 120th place in its report. The credibility of the Bloomberg ratings has been questioned considering such discrepancies. On the other hand, it has been argued that Bloomberg and the World Bank rankings are not easily comparable because they utilized different criteria and use different methodologies for the surveys. The Bloomberg ranking could well encourage new investors to take advantage of stable incomes and the low level of inflation in Russia in 2011 (Russia Beyond the Headlines, 2012). (See also Government of the Russian Federation, 2012, for partly the same statistics)

OECD FDI Regulatory Restrictiveness Index (FDI RR Index) is a tool for benchmarking countries, measuring reform and assessing its impact. It covers statutory restrictions, which involve all discriminatory measures affecting foreign investors, including market access restrictions and departures from national treatment. Institutional quality and degree of implementation is not covered. See graph below (OECD, 2012).



**Figure 9. 2012 FDI Regulatory Restrictiveness Index (FDI RR Index). Source OECD.**

The FDI index can be used to measure the relative FDI restrictiveness of each country, changes in restrictiveness over time, a country's performance in attracting FDI for a given level of restrictiveness, the effect of FDI liberalization on FDI inflows. For 2012 Russia was in the eleventh seat of the countries with the most regulatory restrictions having FDI RR Index of 0,189. China had the highest FDI RR Index of 0,408. OECD average was 0,083 and the Non-OECD average was 0,140 (OECD, 2012).

### 6.3 Corruption

*"Everybody in Russia who did not spend the last Decade staying in bed willingly or unwillingly has violated the law." Boris Berezovsky*

*(to Frankfurter Allgemeine Zeitung, July 18, 2000).*

Throughout Russian history, the society has always relied on unethical practices such as bribery (the use of individual's position for personal gain) and "blat" (Russian word for the informal exchange of favors). "Blat" requires membership of a certain social network, where favors are provided to people belonging to the circle. Favors are not paid for, but other favors are provided in return. It may be suggested that bribery and corruption is simply a consequence of political and economical situation in the country;

those practices are a result of the monetarization of shadow, informal and personalized practices which used to permeate the “*command*” economy.

It can be challenging for foreigner to do business in Russia due to political instability, crime, corruption and bureaucratic red tape still being present in trade. This explains why Russian businessmen take so much time to build up network of relations (Gesteland , 2005).

In Russia corruption has been a bit like that elephant stuck in the corner of the living room: everyone knows that it is there but does not want to acknowledge it or do anything about it. In his article on analysis of corruption in Russia Gregory Feifer, senior correspondent at Radio Free Europe, puts it this way: “*It’s like oil in a car’s engine. The system can’t work without it. It prefers that kind of relationship and it makes up for the ineffectiveness of institutions*” (Feifer, 2012).

Corruption and inequality in Russia remain at alarming high level presenting crucial obstacles to sustainable economic growth. Forty percent of firms in Russia reported making frequent unofficial payments and roughly the same percentage named corruption as a serious problem in doing business, according to figures from the Business Environment and Enterprise Performance Survey made by World Bank and the European Bank of Reconstruction Bank’s (EBRD). Unlike in other emerging markets, the level of corruption in Russia has not declined with economic growth. It remains as high as in countries with one-quarter the per capita income of Russia. One barrier for sustained corruption is Russia’s powerful bureaucracy, which is often called the “*fuel for corruption*”. It is difficult to fight corruption without political reform, media freedom, and a vibrant civil society (Guriev & Tsyvinski, 2010).

Russians perceive inequality of opportunity to be very high; this undermines their trust in the capitalist economy and their support for private property rights. According to EBRD’s Life in Transition Survey, the majority of Russians believe that to acquire wealth one needs to be involved in criminal activity and have political connections; only 20 percent believe that talent matters. Most Russians neither take risks to become entrepreneurs nor favor economic and political liberalization. The persistent attitude toward entrepreneurship is that it being “*criminal*” rather than “*lawful*” activity (Guriev & Tsyvinski, 2010).

Despite shocking statistics about rising level of corruption, Russia has launched some significant initiatives to mend its reputation. For example, soon after his election

2008, Russian President Dmitry Medvedev made it clear that tackling corruption was number one issue on his agenda. Few years ago he surprised Russians by delivering on his promise and signed a new anti-corruption legislation package. The legislation was a first step in a fight with corruption. Since the start of the first year of the legislation, 106 investigations were initiated, and 12 corruption cases were tried involving bribes and damages for total amount of approximately 29 billion dollars. Among accused were high-level figures such as Interior Ministry officials, customs agents, Audit Chamber members, prosecutors, and local officials. Recently, a former Russian government investigator was sentenced to nine years in prison for bribery (Government of the Russian Federation, 2012).

An article in the magazine *The Economist* “*Back in Kremlin*” about the presidential inauguration of Vladimir Putin 7 May 2012, says that his return offers Russia a peculiar form of stability, but it may eventually bring about the opposite. Sixty six percent of Russians think official corruption will stay the same or grow in Mr. Putin’s new term, and sixty four percent think they could be victims of abuse by police and prosecutors, a recent Levada Centre poll shows<sup>4</sup>. Moving against this system, which yields profit and power to so many colleagues, would undermine the ruling architecture that Mr. Putin has built over the past decade (The Economist, 2012).

## **6.4 Government policy**

Ian Pryde, a founder and CEO of Eurasia Strategy & Communications analysts’ network in Moscow, says that “*distrust between the state and the people in Russia remains as great as ever*”. Russian businessmen still see the state as arbitrary and unpredictable, so they prefer to keep their money offshore. The government seems to realize the need to prevent capital flow out of the country and create favorable conditions for domestic businesses (Pryde, 2012).

In foreword to the guide “*How to invest in Russia*” the Association of European Businesses (AEB) guide to theory and practical advice for making investment in Russia in 2011, Elvira Nabiullina, Minister for Economic Development of the Russian Federation, writes that “*Attracting direct foreign investments is one of our top priorities. That is why the Government of the Russian Federation pays special attention to the*

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<sup>4</sup> Levada Centre is a Russian independent, non-governmental polling and sociological research organization.



*improvement of the business environment for all Russian market players” (AEB guide, 2011).*

In a meeting 23 April 2012 Prime Minister Vladimir Putin had with the board of the Ministry of Economic Development, Elvira Nabiullina, Minister for Economic Development of the Russian Federation, said that the growth rates and quality depend on the situation of Russia’s economic institutions and business climate. Not only are the GDP growth rates important indicators of the development, but also the character of the change in the economic structure. In the meeting Nabiullina said the following: *“We have to implement new measures. In particular, this means drastically improving business safety – which is mentioned by businessmen at every meeting – primarily through strengthening the judicial and legislative and law-enforcement systems. This also includes the transparent implementation of the programme for the government’s withdrawal from business capital in competitive sectors. The measures also include combating corruption and, lastly, consistent progress in competitiveness in all sectors”* (Government of the Russian Federation, 2012).

There have been improvements, which are illustrated in the world’s rankings that Russia has achieved in 2011-2012. But it is obvious that the measures Russia has implemented to improve the business climate are not enough. Russian authorities seems to be committed to improve the business climate further with new measures.

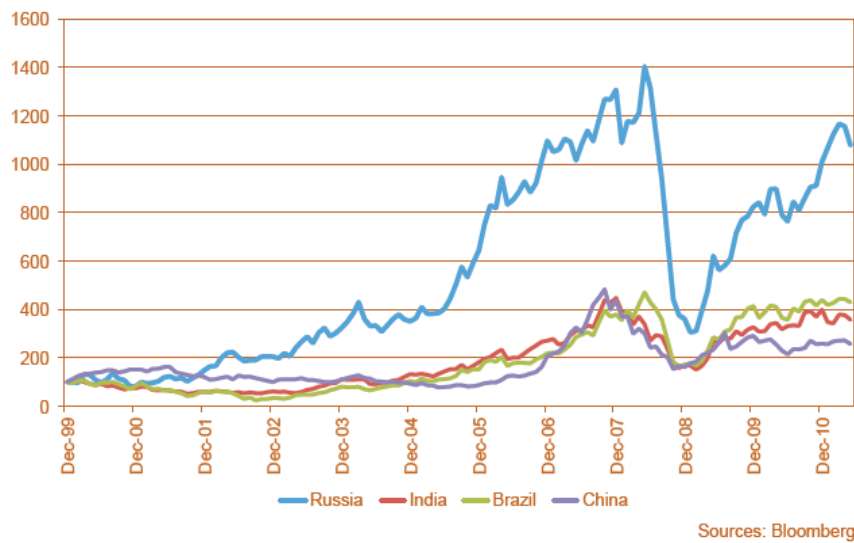
## **6.5 Stock market**

Russia has put a lot of efforts into developing its stock market, which presents one of the largest stock markets of the emerging countries<sup>5</sup>. Over the last ten years, Russia has easily outperformed every other major stock market in the world. Since 1999, China’s share index has risen 2.5 times in dollar terms; the Indian index rose 3.5 times, while Brazil’s index has risen 4.3 times. According to comparison of BRIC markets offered by Bloomberg, the RTS index of leading Russian shares, meanwhile, is up around 11 times as of mid-2011 (Westman, 2010).

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<sup>5</sup> This is maybe an indicator the Russia is a natural economic capital of the post-communist world and can succeed as an international financial center. See discussion page 80.

### BRIC MARKETS COMPARED (\$ TERMS, DEC 99 = 100)



**Figure 10. BRIC stock markets compared. Source IMF, Bloomberg.**

In December 2011, the Russian Trading System (RTS) listed 260 companies with a combined market capitalization of almost USD 800 billion. Another evidence of success is the seventh highest place weighting of the 21 countries included in the MSCI Emerging Markets Index. According to the data from MICEX, which is the more liquid of Russia's two exchanges, the average daily trading volume of equities has in 6 years grown nearly 11 fold, from USD 500 million in 2005 to USD 5.3 billion in 2011. Since its inception in 1995, the RTS index rose by 1.400%, in 2007, making Russia the world's top-performing emerging market over the period. In 2008 the RTS index has declined massively following global economic crisis. Since the beginning of 2009 the RTS index has been steadily increasing. Shares have been volatile, but such volatility has been around a very strong upward trend (Westman, 2010).

According to an article at Bloomberg's website from May 2012, Russian stock prices increased substantially only hours after Vladimir Putin was inaugurated as Russia's president on 7 May 2012. Investors have been waiting for signals from Putin and his government to get a sense of what course of action they will be taking. Putin's fast reaction to sign and define timelines for pro-market reforms was taken positively and increased the country's credibility on the world's market. Power and utility stocks are expected to benefit most from Putin's return, according to Mattias Westman, founder of London-based Prosperity Capital Management. Putin and his officials *"want to make a good impression, they do want to be serious, but they have to lift the horizon a bit as*

*unpredictability is one of the things that is holding the market back*” Westman said in a May 4 phone interview. The whole stock market was slightly paralyzed for the six months before Putin’s elections (Bloomberg, 2012).

## **6.6 Risks**

While the large and developing Russian market can be attractive for foreign investors, several very clear risks can be associated with the Russian economy. The high share of output and exports in the energy sectors is often named as the main risk factor and possible reason of reduction in FDI inflows. Economy’s dependence on a small number of commodities with volatile prices on the global market makes the whole economy relatively volatile. The Stabilization Fund of the Russian Federation was launched in 2001 to fight the potential risks of instability associated with fluctuations of oil and gas prices in global market (Tarr & Volchkova, 2010).

The other potential risk comes from increased government control over the economy and slow pace of regulatory and administrative reforms, as the past decade has showed. Government control increased when Putin became Russian President in 2000. The Russian state gradually became dominant in key business sectors, such as aircraft, energy, shipbuilding, car manufacturing, forestry, and banking. As a result, many private firms may find it difficult to compete with state enterprises that are subsidized. Less competition in many domestic markets leads to decline in efficiency, higher prices, and lower quality of domestic production (Tarr & Volchkova, 2010).

It is often said that all the major investment deals have to be first approved by the Kremlin and Putin personally. A key piece of legislation in this regard was the Law on Foreign Investment in Strategic Sectors which came into force in May 2008. The law defines conditions under which foreign investment can operate in 42 strategic sectors that can be aggregated to broad categories such as military and defense industries, nuclear, space and aviation-related sectors. The list also includes industries covered by the Law on Natural Monopolies: large communication companies, TV and Radio broadcasting, and printing services; industries that are not deemed as strategic in many economies. Under this legislation a foreign investor requires prior authorization to be able to control any business entity in these industries. It has been argued that the law was designed to increase state control over the Russian economy and can discourage potential FDI inflows. On the other hand, the positive effect is that conditions of investing in specified

industries are clearly defined and can be accounted for beforehand (Tarr & Volchkova, 2010).

## **6.7 Legislative basis**

The main **regulatory framework** for foreign investments in Russia is the Federal Law No.160-FZ dated July 9, 1999 “*On Foreign Investments in the Russian Federation*”, which determines and guarantees the fundamental rights of foreign investors. Other regulations are also both directly and indirectly regulating investment-connected relations. Foreign investors may be granted certain extra guarantees under bilateral international agreements between Russia and other countries. Such agreements on the encouragement and mutual protection of capital investments have been signed with the governments of Switzerland, Norway, Italy, USA, Japan, and China. In addition, Russia is the legal successor to the former Soviet Union that concluded similar agreements with the governments of Germany, France, Great Britain, Austria, and Finland (Government of the Russian Federation, 2012).

Regulation of **property rights** is very important issue for investors planning to have local presence in Russia. The country was ranked 51st out of 183 economies for ease in registering property, as the World Bank’s “*Ease of Doing Business*” 2011 report shows. The report contends that efficient property registration reduces transaction costs and helps formalize property titles, which results in less corruption (World Bank, 2011).

The Constitution of the Russian Federation and the Civil Code of the Russian Federation uphold the right to own private property. Under Russian law, investors have choices in terms of using, leasing, and owning property. It is important to note that under the Russian law land is still treated separately from buildings. The Land Code N 136-FZ of the Russian Federation was signed by Vladimir Putin in October 2001. The new law and its follow-up legislation permitted the sale of urban and commercial land across the country to both Russian citizens and foreign investors. Prior to that time, holding land property in Russia was not clearly guaranteed despite provisions in the Constitution and the Civil Code (Government of the Russian Federation, 2012).

Restrictions on foreigners’ right to own a land near federal borders were imposed in January 2011, when former Russian president Dmitry Medvedev issued Decree No. 26

*“On approval of the list of border areas in which foreign citizens, stateless persons and foreign legal entities may not hold titles to land”<sup>6</sup> (Høiby, 2012)*

*“Despite the existence of a legal framework to protect intellectual property, enforcement is weak”* is stated in “Investing in Emerging Markets: Russia” report prepared by PwC analytics in 2011. According to their findings, copyright infringement is common, with computer software and electronic media being the most popular targets. Intellectual property theft is also said to be sophisticated and professionally executed and to represent a thriving business in Russia. PwC professionals working in the country noted that the situation was *“improving within the private sector as companies look to protect their own ideas and technologies”* (PwC, 2011).

## **6.8 Improvements**

Though being far from perfect, the investment environment in Russia has improved significantly since the early days of market existence. Company information and financial statements were difficult to obtain and transparency level was very poor. In such market conditions investors barely knew what they were buying. Now the situation is different: Most companies publish financial results in accordance with international accounting standards, thus modern financial analytical methods can be applied in examining company accounts and financial performance (Westin, 2010).

Following steps toward more business and investment friendly environment have been taken in 2010-2012: Simplified migratory regulations for foreign highly- skilled specialists was enacted; laws aimed at perfecting the customs administration; tax remissions were introduced; the price for connection to infrastructure was cut; a wide-scale 2011-2015 program for privatization of state property was adopted in order to reduce the public sector in the economy; simplified procedures in the construction sector; substantially reduced the costs of providing Greenfield investment projects with power, engineering and communication infrastructure; liberalization of the procedure for foreign investment; introduced investment ombudsman on federal and regional levels (AEB guide, 2011-12).

There are several aspects of Russia’s investment climate that could be improved. The government has changed its public stance in the last two years, arguing for modernization of the economy via FDI. To increase Russia’s attractiveness as a

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<sup>6</sup> See also Chapter 5.4 about restrictions, p. 39.

destination for FDI, the government should work in several important directions. First, the country needs to improve efficiency of domestic institutions in order to make Russia a better for doing business.

Second, in order to increase Russia's investment attractiveness important steps should be taken toward making Russia a better location for production process as trade flows in the 21<sup>st</sup> century are highly linked with FDI inflows. In order to do so, Russia needs to build appropriate infrastructure, improve business climate in the country, including transparency, and improve customs regulations at its national borders (Tarr & Volchkova, 2010).

The last point, improvement in customs regulations, is related to Russia's WTO membership. According to World Bank's Logistic Performance Index (LPI) for 2012, Russia ranks only 95<sup>th</sup> out of 155 countries. LPI overall score reflects perceptions of a country's logistics evaluating efficiency of customs clearance process, quality of trade- and transport-related infrastructure, ease of arranging competitively priced shipments, quality of logistics services, ability to track and trace consignments, and frequency with which shipments reach the consignee within the scheduled time (World Bank, 2012).

Experts recommend uniform tariffs and pre-shipment inspection services to solve Russia's problem in customs performance. Enormous merits are considered to be in uniform tariffs, which reduce the incentive to smuggle or to misclassify goods. By far the biggest advantage is the political economy incentive, because it eliminates gains to individual sectors and removes incentive for industrialists lobby for higher tariffs. Uniform tariffs would give Russia a more liberal tariff regime, which something a WTO membership will bring (Tarr & Volchkova, 2010).

## **7. Russian Business Culture**

### ***7.1 Russian business culture in a globalized world***

This chapter will focus on the Russian business culture, which is quite different from the Western European one. The average Russian will smile when someone asks for a description of the Russian character. They will answer: “Indefinable”. Russians are very proud of their inner inscrutability to the rest of the world. Winston Churchill’s famous description of Russia as a “*riddle wrapped in a mystery inside an enigma*” has become conventional wisdom in the West (Wilson, Donaldson, 1996).

Culture is becoming more important in business and management as the world is becoming one integrated marketplace. People tend to over generalize cultural differences and look at the foreign people through their own cultural lenses (parochialism). This behavior can be costly for companies and can even ruin business relationships. Knowledge about how cultural values impact people’s behavior and business practices is important. Business communications can run smoothly only if attention is paid to the cultural values of the other party (Gesteland, 2005).

Although Russia is geographically close to the heart of Europe, there are still a lot of cultural differences between Russia and Western Europe,<sup>7</sup> which foreigners intending to do business in Russia should be aware of. In general, the Russian way of doing business and negotiating hasn’t changed much since the collapse of the Soviet Union. There are still many hindrances for doing business in Russia, such as corruption and bribery. However, a new generation of people is willing to learn from the West and adapt their business practices to the Western world.

### ***7.2 Russian Cultural Dimensions***

Communication process can be viewed along dimension called low-context and high-context. Representatives of low-context cultures choose to communicate directly, without any hidden meaning. Information is clear and context-free. Individuals from high-context cultures prefer to communicate indirectly. Meaning is embedded in the context of the communicated message and must be decoded to be understood (Hall, 1976).

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<sup>7</sup> The term Western Europe and Westerners are perhaps a bit unclear. These terms are here used for the peoples and the geographical area which were west of the Iron Curtain during the Cold War. Neutral countries like Sweden, Finland, Austria etc. are here also considered a part of Western Europe.

According to findings of anthropologist Edward T. Hall, Russia has been characterized as a high-context culture. It means that communication is not direct and holistic and should be done with caution. Russians transmit information subjectively and associatively, which is typical for high-context communication norms. It also implies that Russian negotiators will use indirect communication tactics. In general, individuals from high-context cultures use general information networks among family, friends, colleagues and clients that often are built on close personal relationships (Hall, 1976).

Individualism versus collectivism is a cultural dimension described by Geert Hofstede, an anthropologist from the Netherlands. Individualism and collectivism form two opposite dimensions of national cultures. Individualism stands for a society in which ties between individuals are loose; everyone is expected to look after himself and herself or her immediate family only. Collectivism stands for a society in which people from birth onwards are integrated into strong cohesive in-groups, which throughout people's lifetime continue to protect them in exchange for unquestioning loyalty (Hofstede, 1994). Russians tend to be collectivists, which comes from the days of Communists' ruling. From the post-medieval times, Russians have relied on a strong communal feeling that is still reflected in Russian business environment today. Individuals from collectivistic cultures tend to be more collaborative and cooperative rather than competitive inside the group. This sense of togetherness is one of the characteristics that differentiate Russians from Westerners. Applied to business culture, it means that Russians prefer teamwork, thus they tend to work in groups during negotiations and business meetings. In addition, they will engage in a discussion to reach an agreement (Gesteland, 2005).

Power distance is another important cultural dimension described by Hofstede. Its characteristics are acceptance of unequal distribution of wealth and power in the society. Individuals from that culture tend to be comfortable with hierarchical structures, clear authority figures and the right to use power with discretion. Russia can be described as high power distance culture according to Hofstede (Hofstede, 1994). In Russia social status is very important and hierarchy is a leading cultural value. In business terms, rank and status are important: Russians are extremely status conscious and believe in co-equals. Power and hierarchy frame Russian social norms and play a ruling role in internal relations and decision-making process. That is why it is important to remember that the person at the highest level within Russian organization is the most powerful and should be treated with a great respect (Gesteland, 2005). During meetings, there is often status-



conscious atmosphere. When several people are in a meeting it is important to identify which person is in charge and address him with key issues; otherwise discussing important matters with his subordinates will offend the leader of the meeting.

Russians don't value time as money as Westerners do. Business in Russia is usually done step by step, in a slowly pace. They take time to gather valuable information and evaluate partners, looking for weak spots. Russian business people need to build a confidence with the parties they are going to deal with. They put strong emphasis on choosing partners who they know well and can trust. Business in Russia is based on bonding, thus Russians would like to get to know their partners better (Wilson, Donaldson, 1996). Russian acquaintance should get to know the personal side of his business partner, which would be a way of developing trust and a healthy foundation for the business relationship itself. Thus foreigner should be ready that it will take a long time for decisions to be made. Also, stalling on decisions may be used a part of Russian negotiating strategy (Sabath, 2004).

Russian business people view negotiations as a win-lose situation, or a battlefield. Compromise is viewed as a sign of weakness and like something morally wrong. To compromise means weakness, and it has negative implication. They usually seek to win a point rather than enlarge the total gain for both parties. These practices are slowly changing though, as more and more Russians go abroad to receive education and learn from the Western World (Gesteland, 2005).

Russians generally trust more feelings than facts. A Russian may judge a person by a gut feeling more than by person's background or potential. Sentiment takes over statistics and numbers. In addition, Russians believe that strong feelings should be expressed in any case. If a Russian dislikes someone, he will say so directly. Russians believe that restricting their emotions is unnatural and dishonest (Wilson & Donaldson, 1996). The author of this paper is not so sure of this last statement. There are differences between Russians coming from Northern and Southern Russia, the former being more reserved than the latter.

## 8. Interviews

### 8.1 Primary Data Collection

A research project should contribute with new knowledge within the field of study. Kvale (1997) defines qualitative research interviews as *“attempts to understand the world from the subjects’ point of view, to unfold the meaning of peoples’ experiences, to uncover their lived world prior to scientific explanations”*. The aim of conducting a qualitative research among Nordic companies is to obtain desired knowledge about respondents’ experience of Russian business environment. In order to get a deeper knowledge about Nordic Investments in Russia, 14 in-depth interviews (of approximately of 2 hours duration) were carried on with Swedish, Norwegian and Icelandic companies. It was a criterion that the respondents should be from a Nordic country and have operations in Russia. Furthermore, the companies should be present in Russia, and have a Nordic origin.

In the research project the respondents were introduced to the topic beforehand, in order for them to prepare for the interview and to assess whether they had the required experiences. By introducing the topic it becomes easier to pose more direct questions early on in the interview (Kvale, 1997).

Kvale (1997) believes that a common mistake is to confuse the criteria of a qualitative study with the criteria of a quantitative study and thereby include too many respondents. It is advised to keep interviewing respondents until the amount of new information received is marginal. The research was continued until all the research questions had been discussed.

The responding companies were:

- 1) **East Capital** - Swedish Investment Company with headquarters in Stockholm. The company was founded in 1997 by a group of knowledgeable professionals with extensive experience from the financial markets and corporate world in Russia.
- 2) **Fund Management Group (FMG)** - a specialist in emerging market investments, using the multi managed route to diversify investment risk. FMG has offices in Oslo and Stockholm among been investing in Russia since 1995.

- 3) **Prosperity Capital Management (PCM)** - founded in 1996, the company is the largest Russia-focused asset manager in the world. Lead by a Swedish founding partner, PCM is investing in Russia on behalf of many Nordic companies.
- 4) **Mannheimer Swartling** – leading corporate law firm in the Nordic region. The company is based in Sweden, and is operating an office in St. Petersburg. In 1990, Mannheimer Swartling was the first European law firm in what was then the Soviet Union.
- 5) **DNB** – Norway’s largest financial services group, headquartered in Oslo. The bank started operations in Russia through DNB Monchebank in Murmansk, acquired in 2005.
- 6) **Norwegian Hydro** – Norwegian aluminium and renewable energy company, headquartered in Oslo. The company has been cooperating in Russia since the early 1990s.
- 7) **Jotun Group AS** – is one of the world’s leading manufacturers of decorative paints, marine, protective coatings and powder coatings, headquartered in Sandefjord, Norway. In Russia, Jotun is represented through its fully owned company “Jotun Russia”, with head-office in St. Petersburg. In 2011 the company has launched a project of building manufacturing facility in Russia.
- 8) **Sherpa Konsult** - consulting company, headquartered in Oslo. Has offered Business Development and Social Development services in Northern Norway and Northwest Russia for 25 years.
- 9) **Innovation Norway** - Norwegian Government’s most important instrument for innovation and development of Norwegian enterprises and industry. The organization provides and arranges financing, links customer enterprises to know-how and helps them to build networks for their innovation projects in Russia among other countries.
- 10) **Tschudi Group** - is a shipping and logistics group with particular focus on the east west trades of cargoes and projects involving the Baltics, Russia, the CIS countries, with head-quarters in Oslo.
- 11) **Ølen Betong AS** – is the biggest concrete producer in Norway. The company has opened a concrete plant in Murmansk in 2008.

- 12) **The Confederation of Norwegian Enterprise** (in Norwegian Næringslivets Hovedorganisasjon; **NHO**) - is Norway's major organization for employers and the leading business lobby.
- 13) **Straumborg ehf.** – is a privately held Icelandic investment company, was operating in Russia since 2006 through its subsidiary Norvick Bank based in Latvia.
- 14) **Íslenskar sjávarafurðir hf. (Icelandic Seafood Company)** - has started cooperation with Russia in fish processing in Kamchatka region, which lasted from 1993 to 1997.

In order to acquire more background information about Russia, unstructured interviews were conducted with Ksenia Borzenina, consultant at the Norwegian-Russian Chamber of Commerce; Stefán Haukur Jóhannesson, Ambassador from Iceland, who led the accession negotiations with Russia on behalf of the WTO as chairman of the WTO Working Party on the Accession of the Russian Federation to WTO; and Ruta Zarnauskaite, a policy coordinator on Russia's WTO accession, European Commission Directorate-General for Trade of the European Commission. Discussions with those experts further deepened the knowledge of the Russian business environment and opened up for more specific questions.

## ***8.2 Analysis of the interviews***

The semi-structured interview has the character of a normal conversation, but with a specific purpose and a specific structure (Kvale, 1997). The interviewer therefore followed up on relevant dimensions found in the answers. To be able to follow up on the right issues, it is essential that the interviewer is able to understand the meaning of what is being said (Kvale, 1997). This was made possible due to the preparatory work done before the unstructured interviews with experts and the collection of secondary data.

Kvale (1997) points to the advantages of tape recording for future analysis of the data collected. In that way the interviewer can focus all attention on the topic of discussion and the dynamic interaction with the respondent. However, Bryman and Bell (2003) underline an important drawback of recording interviews: the risk that the respondents can become self-conscious about the fact that their words will be recorded. This drawback was considered to be relevant for the research project, as the respondents might feel that questions regarding corruptive acts in Russia were sensitive and would not

talk openly if the interviews were recorded. That is why it was decided not to use a tape recorder, but rather trust the memory and write the findings down immediately afterwards, minimizing the loss of details. Having the interview guide at hand facilitated this work and as Kvale (1997) mentions, an advantage of using this method is that the memory acts as a filter, where only the most important statements are being reminded.

Kvale (1997) identifies five different methods of analyzing primary data: concentration, categorization, creation of a narrative, interpretation and ad hoc analysis. In concentration analysis, narrative analysis and interpretation analysis the end result includes a written text. The categorization analysis, on the other hand, presents in numbers while the ad hoc analysis might use numbers, figures or words. The interpretative analysis was chosen in this case, as it aligns best with the purpose of the research. The categorization analysis can help discover deeper meanings when describing respondents' experience of Russian business environment.

According to Kvale (1997), analysis of the research should be formulated in a way, which makes it easy for the reader to understand the results. Structuring the interview guide around the different types of questions simplified the analysis, since it made sure that the required depth was reached. The primary data received was organized according to the individual, the company and the country level, in accordance with the structure of the interview guide. This made sure that all necessary questions were posed in order to answer the research question.

Throughout the analysis of the interviews all quotations and statements made by the respondents will be anonymous and the respondents will be referred to as Company or Expert.

### ***8.3 Individual Level***

Individual level of analysis reflects respondents' experiences of Russian culture, both in general and in business terms. All of the interviewed companies have at some point in time had managers present in Russia, or still operating in the country, thus they possess a great knowledge in the research field. Many of respondents speak the Russian language as well.

#### **Cultural differences**

When asked to point out the main characteristics of Russian culture, most respondents mentioned hospitality and openness. *“Though they might appear reserved at first, they Russian open up once you get close”* as Company A observed. Company E says that Russians have *“stone face”*, *but once you get to know them, they are very hospitable*. Russian people are described as straight-forward as well. *“They are proud of their culture and history and like when past achievements of the country are recognized”* says Company D and concludes *“Russia is a developing country, but a sophisticated society”*.

Skepticism, especially toward foreigners, was mentioned by Companies A and D as one of the characteristics of Russian culture: *“Russians trust more when you come back again and again”*. Company M says that *“Nordic people are often described as naïve and trustful people, while Russians don’t trust so easily”*. Personal relationships are very strong, so they create a circle of family and friends, which they can trust. *“Outside of that circle the attitude is often: Cheat before you are cheated”* states Company J.

### **Features of Russian business culture**

In business terms, overall experience of the Russian culture was not positive. Business mindsets are very different from Nordic models, which is why doing business in Russia can be challenging. *“Company doesn’t matter for Russian workers as there is no feeling of belonging to the work place”* as Company H puts it. Company B continues *“Russians focus on getting personal benefits instead of benefits for the company that they work for”*. There is a lack of involvement in company’s operations, as in the Nordic countries. Companies C and K explained such behavior as a legacy from communist times, when people got used taking care only of the things they owned themselves.

A completely different attitude to the concept of time is a big issue for companies working with Russia. The Western concept that *“time is money”* doesn’t work in Russia. Company I says that one of the main characteristics of the country is *“TTT model: Things Take Time”*. Many aspects of business operations can be expected to take considerable time.

### **Trust issues**

According to Company A and F, lack of trust in Russian business partners is another problem for Nordic companies. All of the respondents underlined the importance of having trustworthy Russian partners. The problems of trust are predominantly seen to be evident when Nordic companies acquire or enter into Joint Ventures in Russia. Company J noticed that information provided by Russian partners is often unreliable. Considerable

background check has to be made before starting business with Russian partner. Company G continues by stating that *“Russians don’t like to share profits, they look at business as win-lose situation”*. This is opposite from Nordic business mindset, where both parties work on maximizing their mutual benefits and create “win-win” operations. According to Company H, *“in Russia there are winners or losers.”* Respondents also observed that Russian business people have rather short-term perspective. According to Company B *“Russians would rather do one business deal and rip most of the profit instead of building long-term business relationship”*. Company L continues that *“Russians have a very different work moral than Nordic people”*.

Respondents who worked in Russia for over a decade have noticed big changes in business culture. They believe that *“when old generation is recycled, the future for young generation will be bright”*, as Company N points.

## **8.4 Company Level**

The purpose with the interview questions concerning a company was to learn about respondents’ perception of corporate governance, corporate culture and experience of financial reports in Russian companies. Corporate culture reflects the collective behavior of people that are part of an organization while corporate governance refers to the set of systems, principles and processes by which a company is governed.

### **Corporate culture**

Due to the fact that Russian society is extremely hierarchical with large power distance, decision-making processes are very different from Western (especially Nordic) models<sup>8</sup>. Almost all of the respondents pointed that Russians employees are not used to make independent decisions and take initiatives because of fear of being punished if something goes wrong. That is why they would rather wait for orders. The result is low efficiency in Russian companies. Company F believes that it has improved during the past decade, but is still deeply rooted and that employees seek approval from superiors. In line with this, Expert A states that the Russians are used to be controlled and told what to do, historically. Company J believes Russian Orthodox Church has greatly contributed to *“accept and obey”* mindset as majority of Russians are religious people.

It is seen as important to make the Russian staff members understand that they have the possibility to unfold and to take initiatives, since it has shown to have a motivating

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<sup>8</sup> See also Chapter 7 about Business culture in Russia, p. 56.

effect on them. Company H and Company N have made an observation that it is easier to deal with Russian female employees, especially with the ones younger than 35 years old, who have no experience of working under communist regime. *“Russian female employees are more loyal than men as they are more driven by non-monetary incentives created by Nordic management (such as maternity leave benefits etc) while male managers can be easily tempted by higher salary in another company”* states Company K.

### **Corporate governance and need for Nordic expatriates**

According to Company D, *“legal system in Russia doesn’t support corporate governance”*. Huge difference from Nordic model is observed. Company H says that *“Russians need a clear set of written instructions”*, hence it is very important to follow-up and to have clear routines for operations. According to several of the respondents, this concerns following-up on daily operational tasks, strategic objectives as well as budgets. *“If you are to cooperate with a Russian, you have to be very specific about what you want from them. This is probably the most common mistake Nordic companies do when they come to Russia”* concludes Company A.

Company A furthermore states that Russians are not very entrepreneurial, which offers great opportunities for Nordic entrepreneurs. Company E states that it would be the best decision to place a Nordic expatriate in the management team of start-up in Russia (either as a CEO or a CFO). Company E points to some difficulties of keeping the management control with the Russians. The local CEO is looked upon as a *“God”*, whereas it can be problematic to implement decisions from the headquarters abroad.

Company A states that their reason for keeping Nordic managers in Russia is that: *“[...] it is impossible to have only Russians in all the positions in the company, even if that would be an ideal solution, since the company is present in Russia. The Russians do not have the experience of doing business, and that is why expatriates are needed.”* The need for sending expatriates was pointed by Company D as well: *“Russian managers tend to have huge plans but lacking skills for implementation”*. Combination of Nordic business skills and the local knowledge brings very positive results.

### **Creating Networks**

All of the respondents mentioned the importance of networks and relationships that are present in Russia. Company A furthermore states that it is important to know that it has to be a Russian manager who handles these networks and connections as *“between Russians*



*the relationship mean everything. We definitely think of this when we hire people, we are very careful who we employ.”*

*“I think it is important to create networks in the Russian market, in fact, it is important everywhere, but it is even more essential in Russia.”* (Company E)

Creating professional and non-professional networks is mentioned as highly important in Russia. Since the local authorities have both high interest and power to influence Scandinavian companies’ operations, the Scandinavian companies should create networks where the local authorities are included. However, this does not refer to creating contacts that directly can affect decisions. It is more about knowing where to go and whom to ask, especially in regards to the bureaucratic system. By creating a valuable network, the access to the Russian business environment will be greater and it will speed up the time-consuming processes in relation to the bureaucracy.

When asked about reliability of the financial reports, company H states that information received from Russian partners is often misleading. Company K says that *“In Nordic countries accounting gives good and realistic overview on company’s situation, whereas in Russia the system is based on mistrust”*. The fact that many stamps are required to prove some information fuels bureaucracy and boosts corruption.

According to Company A, Joint Ventures with Russian companies are not very common, which probably has to do with uncertainty and lack of trust in local business partners: *“Nordic companies do not feel that they have the right connections with a Russian partner, if they have not established a required long-term relationship.”* Company J, who underlines the importance of selecting the right partner if entering into a Joint Venture in Russia, supports this statement.

In terms of competition, Expert C expresses the opinion that Nordic and Russian companies do not compete on mutual terms. This is largely due to high tariffs on import of foreign goods, as the government is trying to encourage domestic production. However, Expert C states that the situation will change once Russia’s WTO membership commitments come into force in summer 2012.

Company E and H also recognize the benefit Russian companies have in knowing the administrative system. Company J points to the dirty tricks that are being used sometimes: *“We know that some Russian companies take advantage of this. They might arrange for a foreign company to get a tax inspection all of a sudden.”* That is the reason why Company H underlines the importance of having all of the documentation in order

and in compliance with Russian law. However, Company A does not view competition as a problem, stating that it is doing a lot better than their Russian competitors. The reason for this is believed to be that the Russians lack the competences needed.

## **8.5 Country Level**

### **Opportunities**

The most evident answer to why the Nordic companies decided to enter Russian market was the great opportunities Russia constitutes. Company E points that Russia is seen as *“the land of opportunities, fascinating and lucrative”*. Russia is a vast country and rich in natural resources. Companies A, C and K believe that oil, fishing and technology sectors look most promising. Company D says that there are special ties between Russia and Norway, as there has never been a war between them. The only dispute about the border in Barents Sea has been resolved in 2011. Norway’s expertise in oil and fishing industries creates a huge opportunity of business with Russia. According to Company D, *“Russians want Norway’s oil technologies”*.

The country represents one of the fastest growing markets in the world and according to Company B, it has a large potential for growth. Company C states, that it sees Russia as a strategic market in terms of the growing middle class and with the potential of becoming one of the largest consumer markets in the world. However, according to Expert A, managing businesses in Russia is not an easy task and Nordic companies should not think that Russia is the same as their home market.

### **Legislation**

Law system is viewed as *“modern and appropriate, but not applied”*, according to Company B. As Company’s G experience shows, *“Russian law system is contradictory because sometimes new laws say opposing older legislation”*. Company E states, that the lack of transparency in the jurisdiction definitely is a problem. Ownership rights are often disputed which represents a huge risk premium. Company D says that legal due diligence is very important.

Company B furthermore points to the lack of independence of the courts, where economically powerful people often influence the functions. However, Company H argues that the Russian legislation is evolving and improvements in court system have been observed over the last years: *“Now we win most of the cases if we are right. Before*

*it did not matter and we lost a lot*". According to Company A and Company H, it is very important to use expertise of consulting agencies and law firms, which can provide all the necessary information regarding Russian legislation.

### **Corruption**

All the respondents acknowledge that corruption is a large problem Russia and represents the biggest challenge for Nordic companies doing business in the country. The other main issues are "*red tape*" and bureaucracy, which are believed to be a "*fuel for corruption*", as Company A describes it. According to Expert B, the government officials and local authorities try to pressure foreign companies, based on their unfamiliarity with the bureaucratic system in Russia, to engage in corruptive acts. However, none of the companies admit taking part in receiving or offering key money. Company D believes that it is rather difficult for companies to stay completely ethical, and "*It will take very long if everything is to be done the correct way. It is definitely possible, but it will be a lot harder.*" Company D continues saying that "*corruption is like a snowball – once you get involved it will never stop*", that is why it a matter of vital importance not to take part in "*shadow economy and schemes*". Company E agrees and advises: "*Just say "No"; otherwise it will haunt you forever*". When asked about corruption issues, Company A demonstrates examples of British Petroleum (BP) and Norway's Telenor, who were forced to sell their shares at low price because of troubles with Russian partners.

However, Company A argues that corruption is not only a Russian phenomenon, especially in the oil and gas industry sectors. Company D, K and B believe that the problem of corruption is real in Russia but overblown by negative Western media coverage. From Nordic point of view, corruption in Russia is sky high. But if compared to the level of corruption in China for instance, it would not be considered so high. "*It is important to set the point of reference for valid comparison*" added Company N.

### **Contracts**

Contracts are often not easy to negotiate with Russian counterparties. Sometimes Russian business partner want one of the Force Majeure circumstances in a contract to be defined as unforeseen measures taken by the Government of the Russian Federation. In the case of a Force Majeure incident the parties of a contract are free of responsibility. Circumstances in the Force Majeure clause are defined as: natural disasters, acts of war,

civil disorders – and then added is in the clause - unforeseen measures taken by the Government of the Russian Federation (Høiby, 2012).

### **Managing the bureaucracy**

Expert C states that Nordic companies entering Russia believe that everything will happen a lot faster than it does in reality. All of the respondents point to challenges connected to the high level of bureaucracy in the country. In accordance with this, Company E states that the largest challenges in the Russian market are connected to the market entry phase and they concern all the approvals and stamps needed from country officials. Expert A believes that functioning institutions are lacking.

Expert C recommends Scandinavian companies to have the necessary papers and documents in order before the start-up of a business, even though it is very time-consuming. Company K continues: *“[...] there are a lot of permits, approvals from city officials and so on. You need a lot of stamps in order to get going. Unfortunately, this is an area where corruption comes into play, because every time you need a stamp there is someone who could either speed the process up or slow it down.”*

One way of managing bureaucracy in Russia is *“to know the laws and rules better than the Russian themselves, and keep track of every little loophole there is”* as Company C states. Even though the bureaucratic system is demanding, foreign companies can learn it, since there is a structure in the system. By obtaining the required stamps and permits, the informal institutions legitimizing corruptive acts will not be enforced. Moreover, Company J discusses a way to minimize the transaction costs in relation to the bureaucracy in the short-term is to employ Russian staff members on a full-time basis handling issues concerning the bureaucracy. Company A notices that *“bureaucracy kills efficiency”*.

### **Cultural challenges**

Company H continues by arguing that *“after you have set up the business, the cultural challenges become evident”*. Company D agrees that culture differences represent a big a challenge for Nordic companies doing business in Russia as *“there is a structure in the bureaucracy; it is just a question of figuring out what kind of requirements you have to live up to, in order to reach the desired goals”*. But culture is not so easy to figure out, it

requires investing a lot of time and efforts. Company B and Company K note that knowledge of Russian language is essential allowing Nordic companies to communicate with their Russian partners without intermediaries, which helps to build stronger business relationship.

### **Russia in the WTO**

When asked for opinion on Russia's WTO membership, all but one of the respondents agree that it will have positive implications for the country, but it would take some time to become evident. Joining WTO is viewed as a step toward economic and political improvements. Company F states, that *"stable economy creates a strong platform for investments and increases return on the investments ratio"*. Most of the companies believe that Russia's WTO membership will have indirect positive impact on their businesses when more transparent system will be implemented in the country. Increased transparency is believed to attract more foreign investors to the country. Company K believes that nothing will change because of differences in mentality and that Russians would always find a way to cheat on the rules.

## **8.6 Recommendations**

Looking back, Nordic companies working in Russia advise companies contemplating expanding into the Russian market to do the following:

- All respondents recommend to **be prepared** to use quite a lot of resources (time, personnel and money) on building an organization that works according to Russian legislation and culture. It will help defending your company from corruption and bureaucracy. It is highly advised to be accurate with bookkeeping, approvals, certificates, customs etc. Saying *"Our way of doing things should be good enough"* or *"this is absurd, I won't do it"* should be avoided at all times (Company L). Company J said that *"If you leave the window open – it's your fault if you get robbed"*.
- Since the Russian business environment is very different from the Nordic one, it is preferable to conduct a **thorough research of the formal and informal rules** regulating economic exchange, prior to the entry to the market. The research should be conducted as open-mindedly as possible and with a humble approach that conducting business in Russia is a learning-by-doing process (Company G).

Homework should be done properly to escape corruption spinning wheel (Company B).

- All respondents point that since it is very important to know the laws and rules of the Russian society, it is recommended to employ **reliable local team**. *“Smart local people can bridge the gap between cultures”* (Company F).
- Finding **trustworthy Russian partner** is essential to all the companies as well. It is though recommended not to give them absolute power over company’s operations in the country as it can lead to troubles. There should be clear set of rules and directions (Company L and Company J).
- *“To know the road ahead, ask those coming back.”* – the Chinese proverb is here used as an advice. It is important to **use the knowledge of companies already working in Russia**. There are organizations in the Nordic countries that focus on utilizing such an expertise and sharing it among the members: Norwegian-Russian Chamber of Commerce (NRCC), The Swedish Trade council, Swedish-Russian Chamber of Commerce, Icelandic Trade Council. Embassies of the Nordic Countries in Russia are believed to play an important role in communicating knowledge as well.
- **Physical presence in the market** after the entry is required (sending Nordic expatriates is highly advised) (Company G, Company L). Local presence helps to speed up the process boost confidence and trust (same around the world).
- Import and Exports are advised to be the country **entry mode** – no assets in the beginning (Company G)
- *“Cooperate with local administration and show them respect!”* (Company I). Seek support in the **informal network/people** with influence in the region where you will establish your activity, build bonds with Russians (Company H and Company J).
- *“Have **no tolerance to corruption**, but realize that small things can make difference, like flowers, chocolates, or bottle of Akvavit can take you further than cash”* (Company J).

- **Learning Russian language** is advised in order to integrate better into Russian society and build stronger relations with Russians (Company B, Company K)
- “*Be aware of what kind of **power of attorney** your local management has*” as it may be offensive for Russians to deal with representatives of a foreign company who have no sufficient power to make decisions. It may also be viewed as a sign of disrespect by Russian partners and officials (due to hierarchical structure of Russian society) (Company N and Expert A).

## **9. Russia in the World Trade Organization**

### **9.1 *The WTO***

The World Trade Organization (WTO), which began to operate in January 1995, is the international organization which creates global rules of open trade between nations. The WTO was founded to stimulate fair competition and to ensure that world trade flows as smoothly as possible to the benefit of all member nations. The WTO included in May 2012 some 155 members, of which 117 are developing countries or separate customs territories. WTO members account for 97% of world trade, after the accession of Russia.

The General Agreement on Tariffs and Trade (GATT), which was established after in 1947 the Second World War, was the predecessor to WTO. GATT and WTO have over the past 60 years greatly contributed to global economic growth by contributing towards a more stable and prosperous international trading system. The WTO is largely based on the operation mechanism of GATT, but provides a broader legal and institutional framework for the trade-political relations of the member nations on the basis of multilateral agreements (including services trade and intellectual property rights). All WTO members have agreed on a regulatory framework that includes 16 multilateral agreements. These principal agreements and other legal documents are jointly called the International Trade Agreements (ITA). There are also two agreements, which only some WTO members are parties to: The Agreement on Government Procurement (GPA) and the Agreements on Trade in Civil Aircraft. In order for Russia to accede to the WTO, it must agree to comply with the terms of all WTO agreements, including GATT 1994, the General Agreement on Trade in Services (GATS), and Trade-Related Intellectual Property Rights (TRIPS). Then Russia had to make commitments through bilateral negotiations with current WTO members on tariff reductions and negotiations with the WTO Working Party on Russia's accession.

The most important benefit from a WTO membership is a more favorable access to international goods and services markets on the basis of predictable and stable development of trade relations with WTO member states, including transparency of their foreign economic policies. Another advantage is access to the WTO dispute settlement mechanism providing protection of national interests, if infringed on by counterparts, thus eliminating discrimination (WTO, 2012).



The WTO has developed a unique mechanism of settling disputes, which may arise from interpretation and application of the agreements. The WTO regards this mechanism as the central pillar of the multilateral trading system making “*unique contribution to the stability of the global economy*” (“Understanding the WTO”, 2012). WTO members have agreed on using this dispute settlement mechanism instead of taking action unilaterally in case they suspect fellow members of violating trade rules (WTO, 2012).

The most important WTO’s functions include: Control over the compliance of agreements; regulation of trade discussions between member nations; monitoring member countries’ national trade policies; settlement of various trade disputes by consultation and negotiations; cooperation with specialized international organizations; and technical support to developing nations in WTO-related matters.

Five fundamental principles make the heart of the WTO, which are the following:

- 1) Non-discriminatory trade, which has two major components:
  - a. Most favored nation (MFN) rule obligates all WTO members to apply the same conditions on all trade with other members.
  - b. National treatment policy requires equal treatment of imported goods and domestically produced goods (at least after the foreign goods have been introduced to the market). This policy targets the issue of nontariff barriers to trade, such as technical standards and security standards, discriminating against imported goods.
- 2) Mutual granting of the national treatment to goods and services of foreign origin is introduced to limit free riding problem that may arise because of the MFN rule.
- 3) Refusal to use quotas and any other restrictions, which set limits on quantities of imports. This principle allows the WTO system to improve predictability and stability of international trade.
- 4) Binding and enforceable trade regulations mostly by tariff methods.
- 5) Trade policy transparency: WTO members are required to publish their trade regulations and to respond to requests for information from any other member. Members are also obliged to notify changes in trade policies to the WTO. These internal transparency requirements are facilitated by periodic country-specific reports which are integrated parts of the Trade Policy Review Mechanism (TPRM).

Director-General of the WTO Pascal Lamy discussed in a speech at the University of Addis Ababa on 11 May 2012 the benefits of WTO membership in economic policy making, where he outlined the reasons why governments pursue WTO membership. Firstly, he named “macro” level implications: *“WTO membership lends added credibility to government policies and sends clear signals to investors about a country’s commitment to an open economy.”* Lamy said that acceptance of WTO rules is synonymous with acceptance of internationally recognized best practices. *“This encourages the inflow of foreign investment and technological know-how”* he said. Secondly, the improvements would appear at the “micro” level. The main purpose of the WTO framework is improving the business environment for foreign and domestic private sector operators. Domestic businesses benefit from the establishment of a transparent and predictable trade environment that follows WTO accession, because *“the domestic reforms necessary in WTO accession can provide a foundation and a tool to enhance a country’s competitiveness”*. As in the case of Ethiopia, export-oriented operators are likely to benefit directly from guaranteed and enhanced access to the markets of all WTO Members on a Most Favored Nation basis. *“The process of WTO accession can be seen as a gradual process of investing in a country’s future legal security and competitiveness”* as Pascal Lamy concluded (“Lamy: WTO accession”, 2012).

### **9.3 Russia and the WTO membership**

*“The WTO membership gives the opportunity to defend our interests in a civilized and legal way”*

Vladimir Putin, as Prime Minister, reporting to the State Duma on government performance in 2011 (ITAR-TASS, April 11, 2012)

Putin made WTO accession a priority in his first term of presidency (2000-2004). Russia WTO membership was seen as a vital part of future economic development. Putin stated in a conference in July 2005 that *“The contemporary WTO facilitates global trade development. It is a kind of quality certificate that provides favorable conditions for investment, increases the country’s credibility, and is obviously an advantage”*. Dmitry Medvedev continued the same course of policies (WTO, 2012).

Russia joined the WTO on 16 December 2011, after 18 years of negotiation, when a WTO ministerial meeting in Geneva approved Russia's membership. Russia was the last of the large economies to join the WTO.

The story of Russia's WTO accession began in June 1993 when the Working Party (WP) on the accession of the Russian Federation was established. The WP comprised of 60 WTO member countries (the largest in the WTO history) and was responsible for negotiation process (Tarr & Volchkova, 2010). In October 2011 final stage of the accession negotiations was achieved when the last barrier to WTO membership was removed, which was a dispute between Russia and Georgia over international monitoring of trade along the border of Abkhazia and South Ossetia. The Working Party completed its mandate on 10 November 2011, under the chairmanship of Ambassador Stefán Haukur Jóhannesson from Iceland. In the WTO Ministerial Council on 16 December 2011 Russia's negotiated accession documents were approved and Russia gained admittance as a member. Under the WTO rules, the admission comes into force and a country becomes a full member 30 days after national ratification of its accession package by State Duma, which is scheduled for July 2012 (S. H. Jóhannesson, personal communication, April 6, 2012)

#### ***9.4 Impact of WTO entry***

In this research, the indirect influences of Russia's WTO entry on foreign investments in the country will be discussed in more detail. To understand these indirect influences it is important to discuss the main changes.

With WTO membership, Russia is committed to bring its trade laws and practices into compliance with WTO rules and other market-opening measures. In doing so, Russia will integrate its trading system with the rest of the world. During the accession process measures were taken to align Russian laws with WTO standards. Therefore, implementation of the commitments in the Working Party's Report will not require any significant changes in Russian laws. There may be some exceptions for subsidies prohibited by WTO in industry and agriculture, which will be amended to be in compliance with WTO standards, or exceptions for regulations in the area of veterinary, sanitary and phytosanitary control ("On the Outcome of Negotiations on Russia's Accession to the WTO", 2011).

The commitments in the Working Party Report include the following:

- Nondiscriminatory treatment of imports of goods and services;
- reducing tariffs and binding tariff levels;
- ensuring transparency when implementing trade measures;
- limiting agriculture subsidies; enforcing intellectual property rights (IPR) of foreign holders of such rights;
- forgoing the use of local content requirements and other investment measures that limit imports;
- opening government procurement contract opportunities to foreign firms;
- accepting WTO dispute settlement procedures.

Russia will have a relatively long transitional period for compliance with WTO rules compared to other countries. Depending on business sector the transitional periods will vary; some changes will come into force immediately, while others will take from two to seven years to implement, according to information from the Working Party Chairman Ambassador Jóhannesson. A timeframe of preparation for compliance with WTO rules is not unusual and establishes a timeline to effect positive industry change. The experience of WTO membership in other countries is that it has positively impacted domestic industries and led to accelerated development, as local companies have had no choice but to compete with established international operators (Weafer, 2011).

The impact of Russia's WTO membership can be analyzed in the following way:

**Consumer.** Domestic producers will face greater competition from cheaper imports.

**Monopolies.** Greater liberalization and end to state subsidies in the gas sector in the domestic energy market are required. This would mean a more competitive domestic gas market with prices moving closer to net export price and a greater access for independent producers, which would mean an end to Gazprom's export monopoly.

**Manufacturing.** Will face competition from imports after a lengthy period of transition.

**Exporters.** Fewer export obstacles in terms of import tariffs and quotas, which will be phased out gradually with membership (Weafer, 2011).

Ownership restrictions for operating in Russia will be removed in some sectors:

**Banking.** The ceiling on total foreign ownership in the Russian banking sector will be raised from 15% to 50%, but will allow 100% foreign ownership of banks and other non-insurance financial entities. Russia refused to allow foreign banks to open branches but will allow foreign banks to open subsidiaries which come under the regulatory control of

the Russian central bank. (Russia agreed to discuss the issue of bank branching again when it negotiates its membership in the OECD.)

**Insurance.** 100% owned subsidiaries allowed, instead of 49% equity stake restriction.

**Telecom.** Limits on foreign ownership will be lifted to 100% from 49%. Russia agreed to eliminate the government monopoly on land-line long distance services.

**Business service and distribution companies.** Market access for foreign providers will increase. Foreign-owned companies can establish 100%-owned business service companies. Distribution companies will be allowed to establish wholly owned subsidiaries (Weafer, 2011).

### ***9.5 Jackson-Vanik Amendment***

European companies are initially better placed than other companies to benefit from Russia's WTO entry, as the European Union is the largest part of Russia's external trade. There is a fear among U.S. companies that they "*may be left out of the parade*" as the Wall Street Journal's reporter Sudeep Reddy discusses in his article "*U.S. Firms Fear Missing Russia Boom*". Reddy says that the issue is the Jackson-Vanik Amendment passed by the U.S. Congress in 1974, which is "*a Cold War measure that restricts U.S. trade relations with nations that limit emigration*". The law meant to ensure that Jews could leave the Soviet Union freely, primarily to Israel (Reddy, 2012). As the Soviet Union no longer exists, Jackson –Vanik Amendment is viewed as a relic from a past conflict.

Before the Jackson-Vanik amendment was a significant irritation only to Russia while the U.S. had no commercial pressure to remove it. With Russia's WTO membership coming into force, the pressure is rising from the U.S. exporters and investors. Farm groups have been especially vocal in urging Congress to take the necessary steps to grant Russia Permanent Normal Trade Relations (PNTR). At this point the U.S. will almost certainly terminate the amendment's application to Russia. (Tarr & Volchkova, 2010)

Sudeep Reddy argues on the other hand that the election-year sparring in the U.S. could delay lifting long-standing restrictions on trade with Russia by the time the country joins the WTO in summer 2012. As a result, opportunities for the U.S. companies will be constrained because of the Jackson-Vanik amendment (Reddy, 2012). The U.S. companies wouldn't receive the same legal protections against Russian tariffs and other

hurdles to business that companies from other countries would gain. This will result in putting the U.S. businesses at a competitive disadvantage (Tarr & Volchkova, 2010)

## **9.6 WTO Accession – a catalyst for reform**

The political economic dimension has been extremely important for Russia in the WTO accession. It is argued that reforms which were accomplished in the context of WTO accession would not be achieved as quickly and would not be as deep without the external pressure. That is, WTO bindings make it easier for a government to adopt a trade policy designed to promote growth and reduce poverty. Moreover, once a country commits to a reform at the WTO, it will be difficult to reverse in the future by a less reform-minded government. The process of negotiating bilateral market access to the WTO has dramatically increased reform in Russia's trade and foreign investment regimes, thereby helping the country move toward an open economic model of economic development (Tarr & Volchkova, 2010).

According to Sergei Guriev and Aleh Tsyvinski reforms face two general problems in a country suffering from a resource curse. The first is limited capacity of reformers: Reformers in government are scarce and rent seekers abundant. The second problem is limited commitment to reform. There are two devices to create commitment to reforms: a critical mass of stakeholders and outside anchors.

(1) A critical mass of stakeholders, namely private owners, who will support reforms, can be generated in two major ways. The first is privatization of large companies. The owners of privatized firms will know that their success is contingent upon building market institutions. Second is further deregulation of small businesses, which will unlock the entry and growth of such businesses. Owners of small businesses are the most faithful proponents of competition, property rights, and contract enforcement. Once a critical mass of small business owners emerges, it will become a powerful lobby against predatory regulation and corruption. Both these measures should be complemented with flat income tax and a tax system that provides incentive for entrepreneurs to pay rather than evade taxes, given the persistent attitude toward entrepreneurship as being “*criminal*” rather than “*lawful*” activity.

(2) Outside anchors must be identified for reforms. EU accession was a strong anchor for Central and Eastern European countries to implement institutional reforms. Russia has two anchors WTO and Organization of Economic Cooperation and

Development (OECD) accession, which both can help promote rule of law for both domestic and foreign investors. Two other “*self proclaimed*” outside anchor are: (1) raise the ruble to the status of an international reserve currency and (2) build an international competitive financial center in Moscow. Both these ideas can be successful if pursued with persistence. Russia is a natural economic capital of the post-communist world and can succeed as an international financial center, provided financial regulation and infrastructure are improved (Guriev & Tsyvinski, 2010).

### ***9.7 Economic gains for Russia***

According to Chris Weafer, chief strategist at Troika Dialog, the net economic effect of Russia’s membership in the WTO would be positive and will establish a powerful catalyst to “*a more serious approach to economic reform and industrial efficiency*”. Membership is not expected to have an immediate impact on economic growth, the day to day operations of Russia’s corporations or the risk premium investors apply to investment in the country, but over time positive effects will become evident (Weafer, 2011). With WTO membership Russia will pursue the following goals:

- Improvement of existing conditions for access of Russian products to foreign markets and provision of non-discriminatory treatment for Russian exporters;
- Access to the international dispute settlement mechanism;
- Favorable climate for foreign investments as a result of legal system change in accordance with the WTO standards;
- Opportunities for Russian investors in the WTO member-countries, particularly in banking;
- Conditions for growth of domestic production quality and competitiveness as a result of increased flows of foreign goods, services and investments to the Russian market;
- Participation in negotiations of the international trade agreements taking into account national interests;
- Improvement of the image of Russia as a competent international trade participant (WTO, 2012).

The World Bank commissioned several studies on the consequences of WTO membership for the Russian Ministry of Economic Development and Trade. Russia

should annually gain about 3.3 percent of GDP (or about \$53 billion per year based on 2008 GDP at market exchange rates) from WTO membership according to the World Bank's study made by Jesper Jensen, Thomas Rutherford, and David Tarr. When long term impact on investment climate is incorporated the gains should increase to about 11 percent of GDP (or about \$177 billion per year at market exchange rates) same study concluded. Rutherford and Tarr examined household and poverty impacts and found that virtually all households should gain from WTO membership. All regions should gain substantially, but those most successful at attracting FDI and creating a good investment climate would gain the most (Tarr & Volchkova, 2010).

The conclusion can be drawn that the major consequence of Russia's WTO membership will come from increased foreign investment in the Russian market for services, as the World Bank analysis stresses. WTO membership alone will not convince cautious investors, but opening the Russian economy to international practices can only have positive benefits for the business climate.

### ***9.8 Changes in the Business and Investment Environment<sup>9</sup>***

With Russia's membership in the WTO, foreign investors will find the rules-based, WTO-enforced business environment far more predictable and legally viable, which will have positive effects on the country's investment attractiveness. In general, the investment as such has a limited direct coverage in WTO accessions due to the limited avail the WTO rules give in this area. However, mainly indirectly, improving business and investment climate was one of the key objectives in the accession talks (personal communication with a member of the WTO Working Party, May 15, 2012).

*“By becoming a WTO member, Russia will have to import certain rules and regulations that will address the very issues that foreign investors usually complain about, like corruption, the protection of minority shareholders, and the independence of the judiciary”* said Ivan Tchakarov, chief economist at the Russian brokerage Renaissance Capital in a BBC interview. He also said that *“Since the 2008-09 [global financial] crisis there has been certain recognition at the very high level in Russia that... Russia will have to open up a little bit to foreign investment, because this is the only way for Russia to become a more competitive economy.”* A major benefit of Russia's WTO

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<sup>9</sup> See more on current status in Chapter 6, Russian investment and business environment, p. 42.



membership would be a better and improved resource allocation within Russia, from less competitive to more competitive industries (“Russia becomes WTO member”, 2012).

One of the most important impacts on the investment climate will be Russia’s commitment to provide the required transparency level of laws and practices governing the foreign trade. All general regulations governing the trade operations will be published in official sources with no entry into force until officially published. Besides, while developing the regulations, Russia will provide opportunity for all interested persons to make, within reasonable time frames, their comments and proposals on drafts of such regulations prior to their approval. This measure should ensure the required level of legal environment predictability in Russia (“The Certificate of Russia’s obligations”, 2011).

The **political elite**<sup>10</sup> in Russia is little inclined toward the WTO membership, which will bring the economic liberalism. This has been demonstrated in favoring national economic champions instead of foreign investors, protectionism policy during the 2009 economic crisis and Russia’s willingness to engage in trade wars with its neighbors. It seems like the Russian political elite sees the WTO accession as an entitlement, and views it more as a political process than a technical one. For them tariff reductions are concessions to trade partners, rather than a mean to stimulate trade and competition (Feen, 2011). Same perspective can be derived from the discussions in Chapter 5, Russian investment and business environment.

Chris Weafer underlines that the WTO membership “*while not offering any quick fix to the generally poor business environment or the high level of investor skepticism toward investment risk in Russia, will nevertheless be a very important step in the government’s efforts to force industries to become more efficient and to attract larger volumes of foreign and domestic sourced investment capital*”. In the expert’s opinion membership will generate an improved regulatory platform for foreign investors and “*create a long term incentive for Russian industry to become more efficient in the face of increased foreign competition*”. This gives hopes that the next government will start to address the perception of high country risk and increase the involvement of foreign manufacturing and service companies in the economy. There will have to be a visible success in lowering corruption, cutting business red tape and improving the reliability of the legal system to give greater investor protection. The government support for the WTO

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<sup>10</sup> See also on the ruling elite and the resource curse, p. 25 .

membership in 2011 confirms the understanding that it is now time for openness and investment (Weafer, 2011).

It is important to note that aligning Russia's business environment to WTO practices will require significant regulatory and cultural changes.<sup>11</sup> It is not enough for the government to implement new rules, there has to be a broad understanding in the society of the need for change which embraces the opportunities and the benefits that can come with open market economy where entrepreneurship is appreciated and looked upon favorably, not as a criminal activity as mentioned above. Education about WTO rules is absolutely necessary, as many Russian ministries and agencies are not familiar with the new regulations which will come into force with WTO membership. It will definitely take time and probably dispute settlements in the WTO before rules are followed. Russian producers must realize that in order to be competitive in the international market, their products must be of a high quality comparable to foreign production. If there is a stable and a harmonized business environment, foreign companies will have additional incentives to move across the border to establish their operations in Russia. Infrastructure in the country should be changed as well, if Russia wants to attract foreign investments. It is argued that transition process will be painful for some Russian business sectors, but the same can also be observed in the other countries that have joined WTO. Modernization is a bitter pill but is vitally important for economic development (personal communication with a member of the WTO Working Party, May 15, 2012). As has been mentioned earlier in this thesis the other course is a Brezhnev-era like stagnation.

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<sup>11</sup> See chapter 7 on Business Culture in Russia, page 56.

## **10. China's WTO membership**

China's economy has been at the centre of attention by foreign economists and entrepreneurs in recent years. Dynamic economic growth and increasing volumes of exports, imports and investments draws the world's attention. China's entry into the WTO in December 2001 has caused profound changes in its economic and social life, though it is still early days to access the full impact. It has been argued that if the impact on the last large economy to join the organization in December 2001 – China - offers any clue, the outlook for Russian trade and its economy has much improved (WTO, 2012).

Director-General of the WTO Pascal Lamy said, in a speech in Beijing on 11 December 2011 commemorating the 10th anniversary of China's accession to the WTO, that WTO membership has anchored reforms in the country and has served as a stabilizer and accelerator in China's economic development. The goal to become a WTO member acted as a lever for the process of domestic modernization. It generated trust by foreign investors who have been key actors in China's take-off through Foreign Direct Investment and transfer of technology. WTO membership also underpinned Chinese export-led growth with a strong insurance policy against protectionism (WTO, 2012).

After WTO accession countries normally become a viable partner for free trade agreements. China has done such agreements and Russia will probably create such agreements after their accession.

Kenneth Rogoff, Professor of Economics at Harvard University wrote in an article from 2 May 2012 that China has inevitably become a more attractive investment destination after the country joined the WTO over a decade ago. China's over-reliance on investment as a driver of growth has actually become a concern. Investment constitutes almost half of GDP, more than twice the global average. The country is engaged in massive investment stimulus as a response to the global financial crisis in 2008-09 (Project Syndicate, 2012).

China's record in the WTO has not been without controversy – not surprising given such a huge and complicated accession. Implementation of WTO commitments has been mixed. A raft of sensitive cases against China, mostly prosecuted by the USA, has been working its way through the WTO dispute settlement mechanism (Rutland, 2009).

A view of all the 13 disputes, from March 2004 till March 2012, with China as respondent and with United States as complainant (13 cases) are listed below:

<a href="#"><u>DS309</u></a>	China – Value-Added Tax on Integrated Circuits (Complainant: United States)	18 March 2004
<a href="#"><u>DS340</u></a>	China – Measures Affecting Imports of Automobile Parts (Complainant: United States)	30 March 2006
<a href="#"><u>DS358</u></a>	China – Certain Measures Granting Refunds, Reductions or Exemptions from Taxes and Other Payments (Complainant: United States)	2 February 2007
<a href="#"><u>DS362</u></a>	China – Measures Affecting the Protection and Enforcement of Intellectual Property Rights(Complainant: United States)	10 April 2007
<a href="#"><u>DS363</u></a>	China – Measures Affecting Trading Rights and Distribution Services for Certain Publications and Audiovisual Entertainment Products (Complainant: United States)	10 April 2007
<a href="#"><u>DS373</u></a>	China – Measures Affecting Financial Information Services and Foreign Financial Information Suppliers (Complainant: United States)	3 March 2008
<a href="#"><u>DS387</u></a>	China – Grants, Loans and Other Incentives (Complainant: United States)	19 December 2008
<a href="#"><u>DS394</u></a>	China – Measures Related to the Exportation of Various Raw Materials (Complainant: United States)	23 June 2009
<a href="#"><u>DS413</u></a>	China – Certain Measures Affecting Electronic Payment Services (Complainant: United States)	15 September 2010
<a href="#"><u>DS414</u></a>	China – Countervailing and Anti-Dumping Duties on Grain Oriented Flat-rolled Electrical Steel from the United States (Complainant: United States)	15 September 2010
<a href="#"><u>DS419</u></a>	China – Measures concerning wind power equipment (Complainant: United States)	22 December 2010
<a href="#"><u>DS427</u></a>	China – Anti-Dumping and Countervailing Duty Measures on Broiler Products from the United States(Complainant: United States)	20 September 2011
<a href="#"><u>DS431</u></a>	China – Measures Related to the Exportation of Rare Earths, Tungsten and Molybdenum(Complainant: United States)	13 March 2012

**Table 2. List of disputes between United States (complainant) and China (respondent). March 2004 - March 2012. Source: WTO**

### ***10.1 China and Russia in a comparative perspective***

Many sharp differences and a few points of similarity can be found when analyzing Russia and China in comparative perspective. Russia and China are large autonomous countries with strong state traditions. Similarities start with the size of the countries; both are large physically with sizeable populations, which make them very attractive in terms of export and foreign investments. With nearly 1.352 billion people China is the world's most populous country, while Russia occupies 8<sup>th</sup> place with 142.7 million people (Financial Times, 2008).

Another similarity between two nations is rooted in the fact that both Russia and China have distinct cultures, tracing their roots and maintaining their identities outside of European culture. However, Russia's interactions with Europe were much more intense, so Russia is a hybrid with strong European elements, unlike China (Rutland, 2009)

Both countries emerged historically as land empires in the center of Eurasia. This left them with a legacy of a strong central state with a distinct identity and legitimacy. They both turned their backs on the global capitalistic system in the 20th century, and adopted communist systems. As a result, China and Russia have had weak traditions of civil society. The state acted as a gatekeeper for the country's interactions with the outside world, which was seen as hostile and threatening. Both Russia and China abandoned an orthodox Marxism-Leninism regime during 1990s, but have not yet established stable alternative political and economic arrangements. Russia has not developed sufficiently to either create or fully sustain a democratic society. Similarly, China's political culture, social order and history have each affected its level of development and modernization, both of which are considered factors in democratization. China's uneven economic development has benefited urban centers while leaving rural areas largely disadvantaged (Rutland, 2009).

China's transition away from state socialism is generally considered a success, while Russia is still struggling. China has doubled its GDP every decade since 1990s, and has lifted 400 million people out of absolute poverty, which is the largest single increase in human welfare in world history. In contrast, following the collapse of the Soviet Union it can be argued that Russia lost half of its territory and population while experiencing a deep economic recession that occurred after 1991. Chinese leaders have scrutinized developments in Russia before and after the collapse of the Soviet Union to learn from Moscow's mistakes (Rutland, 2009). On the other hand there is little evidence that Russia has learned from China's success, which supports an observation made by a member of WTO working Party on Russia's accession, who said that *"China's tactic is to go out and learn from WTO members, while Russians want WTO to come and teach them"*. This observation illustrates differences in mentality between Russians and Chinese (personal communication with a member of the WTO Working Party, May 15, 2012).

A key difference between Russia and China is the sequencing and pace of reforms. China followed a gradual path while Russia embraced shock therapy in 1992 with implementation of radical reforms.

Beijing's reforms were middle-up rather than top down as in Russia – the center encouraged and tolerated initiative from below, and local entrepreneurs and politicians responded to the challenge. The Chinese leadership consciously embraced globalization and welcomed transition to market economy, and saw it as an opportunity rather than a threat. The reaction in Russia has been quite different, since during the 1990s the country seemed to suffer from the impact of globalization (Rutland, 2009).

The Shock therapy in Russia involved sudden release of price and currency controls, withdrawal of state subsidies, trade liberalization and a large scale privatization of previously state owned assets. These rapid and radical systemic changes led to serious deterioration in living standards. Millions of Russians were thrown into poverty due to their savings being devalued by massive hyperinflation, which was more than 2.000 percent in 1992 (Bloomberg). The privatization, which started in the fall of 1993, and break-up of state assets from the Soviet Union, led to much of the country's wealth was handed to a small group of powerful business executives, later known as the Russian oligarchs, for much less than their value<sup>12</sup>.

The goal of the shock therapy<sup>13</sup> in Russia was to create an economic system comparable to those of Western Europe. The premises of it did not examine existing institutional structures and how to change them to reach the goal, but rather on ways and strategies to replace these structures entirely. History, society, and the economics of present institutions were all minor issues in choosing a reform program. Given the existing structures were the problem, society had to be side-stepped in the reform process. This top-down policy was considered viable because the knowledge of how to create market institutions was viewed as readily available and easily implemented<sup>14</sup> (Murell, 2008).

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<sup>12</sup> Shifting to a Western European ownership structure required that enterprise governance be removed from the workers councils and managers and placed squarely in a supervisory board (or board of directors) controlled by the owners of the enterprise. In essence, privatization of the enterprises requires first that ownership rights, now vested in the enterprises, and particularly in the workers councils, must be eliminated (Lipton and Sachs, 1990).

<sup>13</sup> In regard to the shock therapy it is interesting to compare Russia and Poland, as Peter Murell does in his article, What is Shock Therapy? In Poland, he says, policy was rescued from the radical technocrats (the shock therapists) and began to show a hue of an evolutionary model. Solidarity and the Church were important in this policy change. The society began to shoring up policy, rather than policy creating a new society. The Polish success has been due to the resources of Polish society in muddling through with its own model of reforms, rather than due to some magical dose of top-down policy (Murell, 2008)

<sup>14</sup> It has been argued that the debate about the speed of the liberalization (shock therapy versus gradualism) has been to a large extent misfocused, whereas the crucial importance of strong institutions for good performance was overlooked. Institutional capacities depend to a large extent on the combination of the rule of law and democracy. Data seem to suggest that both authoritarian and democratic regimes with the strong rule of law can deliver efficient institutions,

The table below is summarizing the main characteristics of reforms in Russia and China (P. Rutland, 2009).

	<b>Sequence</b>	<b>Pace</b>	<b>Initiative</b>	<b>Spirit</b>	<b>Western advice</b>
<b>Russia</b>	Politics first	Rapid	Top-down	Shock therapy	Strong influence
<b>China</b>	Economy first	Gradual	Middle-up	Controlled transition	No influence

**Table 3. Contrasting Reform Paths in Russia and China.**

The picture has changed over the past decade, as Russia has regained political stability and experienced rapid and sustained economic growth while continuing a policy of greater integration with the global economy. The initial political conditions in the beginning of transition in Russia and China were very different. Despite starting in different places and heading in different directions, the two countries are heading upward toward economic and political development with both countries' WTO membership being a vivid example (Rutland, 2009).

In both countries access to political power remains tightly controlled. In Russia and China the ruling party and the political elites have been strengthening their power by expanding into business. In Russia, the all-important energy sector is regarded as a foundation of national power – as well as the personal wealth of the ruling elite. In China, the Communist party's stakes in large cash-generative state monopolies has led some to a joke that it is now *“the world's biggest holding company”* (Financial Times, 2008).

There are several problems with comparing Russia with China. An article in the Financial Times issue from May 2008 argues that Russia and China are facing different internal challenges. China is a country with the world's largest population and undergoing rapid industrialization over the last several decades. China is the third largest world exporter, after Germany and the U.S., exporting high technology, high value-added goods. Russia is a developed country with substantial natural resources in the world's largest country geographically. Russia relies on inherited natural wealth and on inherited Soviet capital stock, human capital, and level of technology. Russia's rapid expansion is

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whereas under the weak rule of law authoritarian regimes do a better job in maintaining efficient institutions than democracies (Popov, 2009).

more recent and more fragile – driven as it is by the rising price of oil and gas. On the contrary, China doesn't have as much of natural resources, the country creates new industries and new technologies instead, moving to more and more advanced frontiers, as reported recently by the WTO. Thus, China's economic boom has been going on for a generation and is heavily dependent on manufacturing, while Russia is a resource dependent economy (Financial Times, 2008).

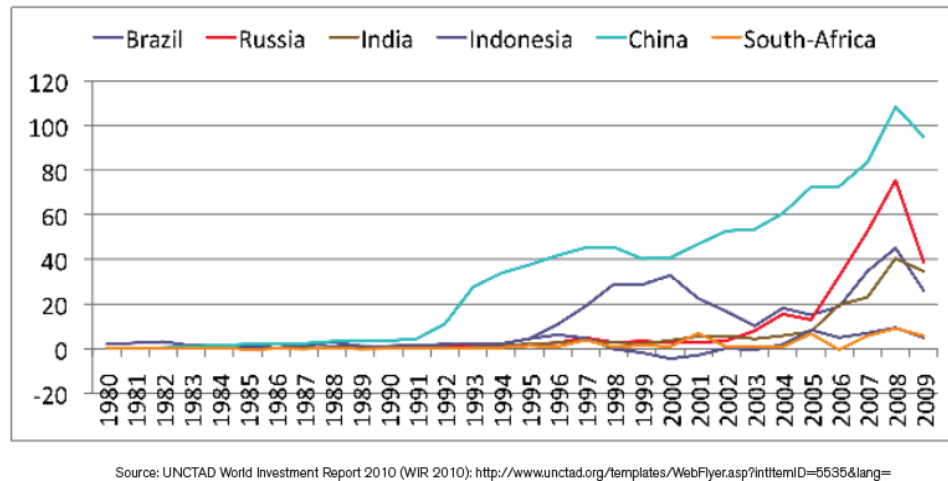
In foreign policy, Russia still thinks like a global power – while China is only just beginning to flex its muscles outside of Asia. After a hazardous period of economic and political liberalization in the 1990s, the period of control by Vladimir Putin has seen a re-assertion of the power of the Russian state. The process of Chinese economic liberalization has been more orderly and linear. Despite the assumption that economic liberalization leads to democratization, neither Russia nor China have made the transition to successful liberal democracy (Financial Times, 2008).

Peter Westin, chief equity strategist and economist at ATON Capital, one of the oldest investment companies in Russia, argues that another main difference between Chinese and Russian economies is attitude toward foreign investments. If a foreign company sets up a headquarters in Shanghai, the local government will give land for construction, senior management will be given housing, and the company is provided with sufficient tax breaks for several years. The concept of special economic zones has truly been a success in China. *"In Russia, the notion of welcoming foreign workers is still alien"* says Westin. In terms of the attitude toward foreign investments, apart from Kaluga region and a few others in Russia, there is little to be desired. Foreign companies, as well as domestic, continue to have to deal with red tape, corrupted officials, and frequent inspections from different authorities (police, fire department, health and safety, etc). The change must come from a desire for economic development from all levels of government (Westin, 2010).

China has long understood that in order to bring its economy to a new level the country needs to attract foreign capital. There is a common understanding that Western companies are also vital business partners. China has climbed up the world rankings for trade and FDI with lightning speed. It has been the second-largest recipient of FDI in the world since 2000. Inward FDI (investments flowing into the country) was USD 110 billion in 2008, a massive increase from 2007, though it came down to about USD 95 billion in 2009, following the crisis. Foreign investments are still mainly in



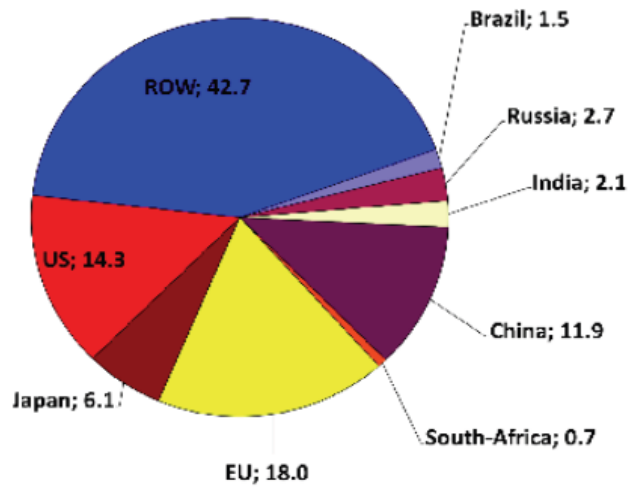
manufacturing, but they have increased rapidly in services, which now account for over 40 percent of total FDI. The government estimates that over 90,000 foreign-invested enterprises (FIEs) have been established in services sectors in China, with investments of over USD 160 billion. According to the information from the graph below, Russia is still quite below China with only USD 40 billion of inward FDI in 2009 (ESIPE report, 2011).



**Figure 11. Inward FDI flows for BRICS in bln USD in 1980-2009. Source: UNCTAD World Investment Report 2010 (WIR 2010)**

China first displaced Japan as the world's second-largest trading nation (third-largest if the EU is counted as one), and then Germany as the world's leading exporter of merchandise goods, with almost 12 percent of world's merchandise exports by 2009 (figure 2); while Russia world's exports volume is only 2.7 percent (ESIPE report, 2011).

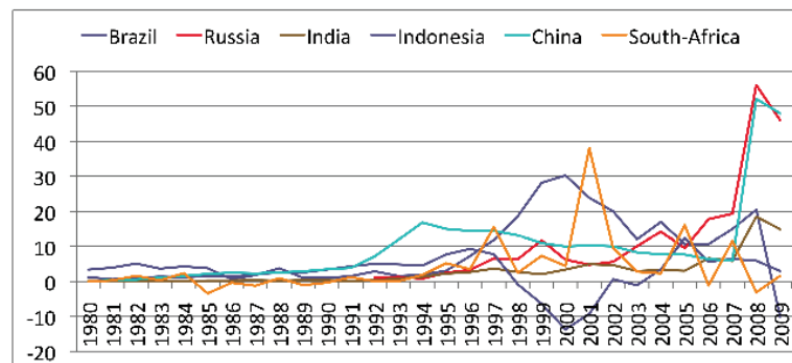
**BRICS Share of World Goods Exports (2009)**



Source: WTO, International Trade Statistics 2010, [http://www.wto.org/english/news\\_e/pr598\\_e.htm](http://www.wto.org/english/news_e/pr598_e.htm); Eurostat and own calculations.

**Figure 12. BRICS, EU, US and Japan share in global exports in goods (2009: Excl. EU intra trade)**

China's outward FDI (investments of Chinese companies abroad) has also been growing rapidly. It reached almost USD 50 billion in 2009 (Figure 3). After 2007 governmental policy toward the foreign expansion of Chinese firms has been “*Go Out*” and “*Go Global*”, which was pursued by mainly state-owned enterprises (SOEs). This outward reach is quite recent, so China's stock of outward FDI remains minuscule, especially compared with that of the EU and the USA. Russia's outward FDI have increased substantially since 2007 as well and by 2009 has reached the same level as the Chinese or about USD 50 billion. It seems that Russian and Chinese outward FDI policies are moving in the same direction (ESIPE report, 2011).



Source: UNCTAD, FDI/TNC database ([www.unctad.org/fdistatistics](http://www.unctad.org/fdistatistics)).

**Figure 13. Outward FDI flows from BRICS in bln USD in 1980-2009. Source: UNSTAD, FDI/TNC database.**

## ***10.2 Outlook for Russia in comparison with China***

Over the last decade, the two most important WTO accessions have been China in 2001 and now Russia in 2012. Russia's WTO membership has often been compared with that of China's in 2001. Both accession processes were lengthy due to the size of the economies. The differences in the Chinese system from other WTO members resulted in a complex protocol of accession and many transitional rules being needed. Under the WTO rules, the average final bound tariffs for industrial and agricultural goods for China are higher than bound tariffs for Russia, a reflection of the less developed nature of parts of the Chinese economy. Still, Russia's bound tariff rates on industrial goods in particular are far above rates found in the U.S., the EU or Japan (ESIPE report, 2011).

	<b>Russia</b>	<b>China</b>
Industrial goods	7.3%	8.9%
Agricultural goods	10.8%	15%

**Table 4. Average Bound Tariff Rate after Implementing All WTO Commitments**

Analysis made by the European Centre for International Political Economy (ECIPE) show that entry to the WTO has opened up opportunity for China to achieve its growth through participation in the open global trade system. Compared with Russia, China has an advantage in terms of its large scale, cheap labor force as well as efficient infrastructure, such as roads and public transport systems, built by public investment. Russia still has a long way before its infrastructure becomes efficient (ESIPE report, 2011).

For the last decade, China has been implementing the program of liberalization measures under the WTO agreements. Assuming that Russia and China share certain characteristics (economy size, both are large countries, historical similarities), allows to predict the possible impact of WTO membership on Russia based on the effect it had on Chinese economy. It is interesting to look closely in at the changes in three main sectors of the Chinese economy.

### **1) Agriculture**

China's membership in the WTO has raised the issue of competitiveness of Chinese goods - especially agricultural products. Low quality and high cost of production in agricultural sphere presents a serious obstacle to the expansion of exports. At the same time, China's entry to the WTO opened domestic market for cheap imported agricultural products that more than doubled from 5% in 1995 to 12% by 2010. Special programs have been introduced to increase competitiveness of domestic production in the global markets. Russia will face the same problems upon joining WTO; domestic production has to be in line with world's standards in order to be competitive.

### **2) Industry**

China has committed to reduce quotas for industrial products, as well as to cancel or substantially reduce tariffs on a wide range of products. In 1999 tariffs averaged 24.6%, and in 2005, in accordance with the commitments to the WTO, declined to 9.4%. In 2005 most of the quotas were abolished for industrial products, which meant gradual expansion of the market for imported goods. Improvements in the structure of manufactured industrial goods became visible year after year. Russia is expected to follow the same road.

### **3) Capital Market**

Foreign investments are the reason for accelerated development of the Chinese economy since the mid 90's. China has a leading position among the world's largest recipients of foreign capital. Sectoral structure of foreign investment is characterized by the overwhelming predominance of investments in the manufacturing industry, with the most rapidly growing share of high-tech enterprises. China's success in attracting foreign investment is based on the country's high level of socio-economic and political stability, large domestic market and cheap labor, active foreign investment policy, continuous improvement and liberalization of law base towards the creation of favorable treatment of foreign companies. All these factors resulted in a high and stable return on investment in China. Large global corporations are planning further expansion of their activities in the country following progressive reduction of economic and political risks of investing in the Chinese economy. China has more than 70 agreements on mutual protection of

foreign investments, in particular, with the UK, Germany, France, Japan, Australia, and Republic of Korea. It seems that if Russia wants to succeed in the international market and achieve the same results and gain positive benefits as China did after joining WTO, it has to put emphasis on creating a favorable investment environment in the country (Tarr, 2007).

Positive impacts on the Chinese economy became visible after the first four years in the WTO, as was noted by Yin Wang, a junior associate at the Center for East Asian policies at Moscow State Institute of International Relations in his research on the impact of WTO membership for China. It is safe to say that China's accession to the WTO as a full member has substantially strengthened its position in the global market. China is actively using the WTO tools in its economic interests. But one should not assume that similar processes can be automatically started in all the countries acceding to the WTO (Tarr, 2007).

China's success is largely based on its unique specificity; cheap labor force and large manufacturing capacity. When predicting the impact of WTO membership on Russia based on China's experience, experts caution that the Russian and Chinese economies are inherently different. Russia is often thought to be a classic case of the "*resource curse*" – the idea that natural resource wealth tends to impair democratic development, while China's economy mainly depends on manufacturing.

The problem of corruption<sup>15</sup>, which in turn arises from the lack of a rule of law and of political rights, is now endemic to Chinese business, though much has been improved in that area over the past years. It seems that the rule of law and political uncertainty will likely remain a problem in Russia as well. But over time, those may come into line with world trade too. Patience is a key, as it has been with China (Tarr, 2007).

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<sup>15</sup> See also Chapter 6.3 about Corruption, p. 47

## 11. Conclusion

The findings from the research conclude that Nordic companies have to spend resources (time, personnel and money) when building an organization that works according to Russian legislation and culture and to build up defense against corruption and bureaucracy. Accuracy in bookkeeping, approvals, certificates, customs etc. is important. When preparing the entry to the market an open-minded thorough research of the formal and informal rules regulating economic exchange has to be done with a humble approach. There should be no tolerance to corruption. A reliable local team should be used to bridge the gap between cultures, since the Russian business environment is very different from the Nordic one. Finding a trustworthy Russian partner is essential, but it is recommended not to give them absolute power over company's operations in the country as it can lead to troubles. Knowledge of companies already working in Russia should be used. Sending expatriates is highly advised to have physical presence in the market. Build bonds with Russians and to seek support in the informal network/people with influence in the region where you will establish your activity and it is important to cooperate with local administration. Learning Russian language is advised in order to integrate better into Russian society and build stronger relations with Russians. There should be clear set of rules and directions and be aware of what kind of power of attorney your local management has, as it may be offensive for Russians to deal with representatives of a foreign company who have no sufficient power to make decisions. It may also be viewed as a sign of disrespect by Russian partners and officials (due to hierarchical structure of Russian society).

Russia's WTO entry will be a catalyst for reform and have indirect influences on foreign investments in the country. With WTO membership, Russia is committed to bring its trade laws and practices into compliance with WTO rules and other market-opening measures, which will have positive benefits for the business climate. Russia will have a relatively long transitional period for compliance with WTO rules compared to other countries. The political economic dimension has been extremely important for Russia in the WTO accession. It is argued that reforms which were accomplished in the context of WTO accession would not be achieved as quickly and would not be as deep without the external pressure. The impact of Russia's WTO membership will increase competition, which will benefit consumers. Greater liberalization and an end to state subsidies are

required, e.g. in the gas sector. Manufacturing will face competition from imports after a lengthy period of transition. There will be fewer export obstacles in terms of import tariffs and quotas, which will be phased out gradually with membership. Membership is not expected to have an immediate impact on economic growth, the day to day operations of Russia's corporations or the risk premium investors apply to investment in the country, but over time positive effects will become evident.

The conclusion can be drawn that the major consequence of Russia's WTO membership will come from increased foreign investment in the Russian market for services. Foreign investors will find the rules-based, WTO-enforced business environment far more predictable and legally viable, which will have positive effects on the country's investment attractiveness. Access to the international dispute settlement mechanism is important. Russia will import rules and regulations that address issues foreign investors usually complain about, like corruption, the protection of minority shareholders, the independence of the judiciary. One of the most important impacts on the investment climate will be Russia's commitment to provide the required transparency level of laws and practices governing the foreign trade.

Russia's WTO membership has often been compared with that of China's in 2001. Both accession processes were lengthy due to the size of the economies. China's success is largely based on its unique specificity; cheap labor force and large manufacturing capacity. When predicting the impact of WTO membership on Russia based China's experience, experts caution that the Russian and Chinese economies are inherently different. Russia is often thought to be a classic case of the "*resource curse*" – the idea that natural resource wealth tends to impair democratic development, while China's economy mainly depends on manufacturing. The problem of corruption is big, which arises from the lack of a rule of law and of political rights. But over time, those may come into line with world trade too. As it has been with China, patience is a key. Only the future can tell the real influences of Russia's WTO membership, but only the Russians themselves will decide their own future.

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## 13. Appendix

### *13.1 Research Introduction Letter to Companies*

Dear Madam/Sir [name].

I am working on a research „**Scandinavian Investments in Russia**”, which will be my final thesis in my Master Program in International Business at Reykjavik University (RU). (...) gave me your contact information. I have already met him and his colleagues at East Capital to discuss my research.

I will conduct a qualitative research interviewing managers of Scandinavian companies who have invested in Russia. The purpose of the research is to give a picture of the challenges Scandinavian companies have encountered in Russia, evaluate the current situation and outline the lessons to be learned for successful future investments. The interviews (ca.30 min) would start with a few general questions followed with an open discussion on the research topic. The research should give a valuable insight into the Scandinavian investment experience in Russia. Companies who participate in the research will get a copy of the final report.

I graduated in 2006 from University of Iceland with a B.S. degree in Business Administration (major in Marketing). For 5 years I worked in marketing for the fashion design company ELM ([www.elm.is](http://www.elm.is)). I am Russian but have lived in Iceland for the last 11 years. I am an Icelandic citizen and write and speak fluent Icelandic. Last fall I studied at ESADE Business School in Barcelona as part of my RU studies. Currently I live in Oslo with my Icelandic boyfriend who is a lawyer at DNB, and study Norwegian and work on my thesis. I can send you my CV for further information.

I really hope you can afford your time to meet me to discuss and participate in my research.

Thank you very much in advance.

Yours sincerely,

Olessia Bankovskaya

## ***12.2 Interview Guidelines***

### **People**

- 1) What is your experience of Russian culture? Are Russians open or reserved people?
- 2) What do you consider to be the main characteristics of Russian culture?
- 3) Please describe your experience of communication with Russian partners, cultural issues you might have had.
- 4) What should Westerners be aware of when doing business with Russians?

### **Company**

- 5) The overview of the history of your company's business in Russia.
- 6) Current situation.
- 7) What is your experience of corporate culture in Russia?

### **Finances**

- 8) What is the reliability of financial reports in Russian companies? Is there any specific areas that should be focused on in the accounting reports?
- 9) How do you choose companies for investments? Have you conducted any independent financial background research?

### **Law**

- 10) Company law in Russia, corporate governance, structure.
- 11) Have you bought any real-estate in Russia? How was the legal environment and documentation of the ownership – was it reliable?
- 12) How do you verify the ownership of the companies and real estate you were buying?
- 13) How do you secure collaterals? What is the legal framework?

### **Country**

- 14) What are the major attractions for investment in Russia?
- 15) What are the major hindrances for doing business in Russia?

- 16) Scandinavian investments in Russia in comparison to investments in other countries.
- 17) Russia's WTO membership: What will change and what are the future outlooks?
- 18) Which implications will Russia's WTO membership have for your business?
- 19) Has corruption been an issue for your company?
- 20) Do you think there is a high level of bureaucracy in Russia? Have you experienced problems because of it?
- 21) How can you defend a company from both of them? What is your advice?
- 22) Which advice could you give to companies who would like to invest in Russia?