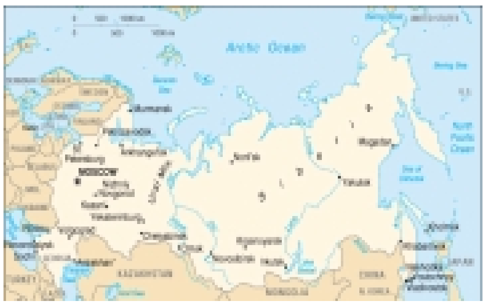
Russian Federation Country Overview



BASIC FACTS:
Capital: Moscow
Area: 17.1 square kilometers
Population: 146.1 million (July 2000 est.)
Currency: 1 ruble (R) = 100 kopeks
Exchange Rate: $1 = 29.1 Rubles
GNP: US$329.0 billion (1999)
GDP Growth: -4.9% (1998); 3.2 (1999); 4.3 (1999-03);
GNP per capita: US$2,250 (1999)
Inflation: 18% (2000)

EXECUTIVE SUMMARY

Russia spans 11 time zones and is home to approximately 150 million people. It possesses tremendous natural and human resources, and has a strong demand for imported consumer goods, capital equipment, and services, with imports representing an unusually large percentage of the national market. Despite this outstanding long-term market potential, however, Russia continues to be a difficult country in which to conduct business. The effects of the 1998 financial crisis are continuing to dissipate and economic and political factors have turned increasingly favorable for business in Russia for the near term and possibly longer, if the new Russian administration can make good on its design for reform.

Favorable economic signs include economic growth likely to top 4% this year, annual inflation reduced to about 18%, a large balance of payments surplus, and real investment up 4.5%, the first increase since 1990. Moreover, on the policy front, President Putin's administration has declared its intention to improve the business climate and seek more foreign investment, and it has produced an economic strategy document spelling out its plans. It has delivered the first installments on these commitments by recently pushing through a major tax reform and maintaining tight fiscal discipline for the past year. There are, nevertheless, a number of factors that limit the prospects for growth in some sectors and could even cut short the current expansion. Perhaps the greatest overall difficulty is Russia's slow progress in restructuring the banking sector to the point where it has the capability to attract substantial savings and channel them to productive investments. The government's continued poor credit ratings, Russian government limits on sovereign guarantees, and the weakness of domestic banking institutions have restricted lending by the U.S. In addition, consumer purchasing power is recovering very slowly from a 30% drop in personal income after the 1998 crisis. On balance, however, the 2000-2001 period could renew the intensity of U.S. business interest in Russia. In the wake of the economic crisis, U.S. exports fell by about half to $1.85 billion in 1999, but there have been signs of moderate recovery this year. The pace of U.S. investments recovered by the fall of last year and reached a level of $2.92 billion, 30% above 1998 and nearly equaling 1997.

ECONOMIC OUTLOOK

Healthier Economy

Halfway through this year, the Russian economy looks much healthier than anyone would have imagined a year ago. Economic growth is continuing, inflation is moderate, the ruble is stable, net international reserves are again positive, and investment is increasing. President Putin's election has brought a sense of political stability, which is a plus for investors.

Russian GDP grew 3.2% in 1999, and industrial production advanced 8.1%. The major stimulus came from higher net exports, particularly due to higher oil and commodity prices and substantially lower imports. Most notably, real investment was up by 4.5%, the first increase since 1990. Analysts are raising their 2000 growth forecasts.

The Economics Ministry raised its forecast from 1.5% to 4.5%, with some private estimates as high as 6.2%. Growth will likely be led by a recovery in domestic demand, with net exports contributing less than last year. Russia's macroeconomic framework is particularly favorable, enjoying both current account and federal budget primary account surpluses. The Central Bank of Russia (CBR) has accumulated international reserves and has not financed the budget; the Russian government has used its primary surplus to service more of its debts; inflation has moderated and the ruble has firmed in nominal terms. In large part, this favorable dynamic is due to an improved fiscal situation. The government's 1999 budget was the first Russian budget ever passed and fully executed. Substantially improved revenue collection has continued in 2000, ahead of budget every month in the first quarter, with a primary surplus of 3.5%. Higher oil and gas prices, increased turnover, the expansion of the Treasury system, improved tax administration, and insistence on cash tax payments have all contributed to better budget results.

Nonetheless, the current rosy economic scenario poses some risk for foreign trade and investment. First, domestic competition has increased as Russian producers have benefited from a combination of steep ruble devaluation, high world commodity prices, and low domestic energy and unit labor costs. So, previous cost advantages are fading. Furthermore, international oil prices are moderating, while domestic energy prices are rising. In real terms, labor costs are rising and the ruble is slowly appreciating. The continuing weakness of the banking sector limits lending to the real economy, contributing to working capital restraints on growth. Higher domestic liquidity resulting from the CBR's accumulation of international reserves poses risks for inflation, especially as domestic demand recovers. The CBR has only a few instruments to affect monetary policy but has coped well to date, aided by what appears to be social consensus in Russia against inflation.

The Banking Sector

The banking sector is slowly recovering from the 1998 financial crisis. The CBR reports that as of January 2000, 80 of the 1349 licensed banks in operation showed symptoms of insolvency, down from 320 in April 1999. Part of that reduction is due to CBR revocation of 250 bank licenses. Aggregate capital in the banking sector (excluding Sberbank) has risen, from 41.2 billion rubles in March 1999 to 111.3 billion rubles in December 1999. In U.S. dollar terms this is still only about one-half of the capital in the banking system in June 1998. Surviving banks have difficulty raising capital because it is difficult to generate significant returns on ruble assets relative to funding costs. If industrial sector performance continues to improve, banks may begin lending to industry. That positive dynamic, however, will take time, effort and more capital.

The rebuilding of financial and banking markets in Russia will take time. The finance ministry's placement of new T-Bills in February will help revive the short-term money market. A few large Russian companies continue to issue corporate bonds. Discussions have intensified to create a negotiable commercial paper market, a development that would allow many managers to access the market directly for short-term needs.

BUSINESS AND INVESTMENT CLIMATE

Leading Sectors for U.S. Exports and Investment

The strength of leading sectors are likely to be decidedly mixed in the coming year as some sectors recover smartly, and others appear to face limited prospects or stagnation until conditions change. The oil and gas industry is expected to remain the leading sector both in size of market and potential growth not only because of high oil prices but also due to new sources of financing, slowly advancing Western investment projects and evolving pipeline projects. Telecommunications is the next strongest sales and investment prospect, as Russia shows a strong demand for modernized communications infrastructure, and the industry is opening up through privatization, intensified competition and entry of foreign investors. Although computer hardware sales are off, related high tech areas of the Internet, e-commerce and off-shore programming are showing signs of beginning rapid growth from a low base.

Doing Business in Russia and Keys to Success

Although Russia presents many opportunities, special challenges abound. Weak financial institutions that cannot provide routine financing for purchases exacerbate the problem. A related problem is finding credit-worthy customers in an environment where due diligence information is limited and many firms are tangled in a web of payment arrears and barter transactions. For these reasons, finding good Russian partners and agents is particularly important. Despite all of these challenges, however, hundreds of U.S.-owned businesses do manage to conduct regular business in Russia. There is hope that new reform laws are slowly, but steadily taking some of the confusion out of the legal situation. In the past two years, the adoption of comprehensive new codes has begun the rationalization of civil law, customs and taxation. Of particular importance to business is the new tax law, which will not be completed until a third and final set of chapters is passed this fall. The new law establishes a simplified tax framework, modern legal language, and reduced levels of taxes. Hopefully, the new atmosphere will also create a new civility in enforcement by the Tax Police, an investigatory body that often conducts unannounced on-site investigations, some times employing harsh measures. Another key area is the settlement of disputes that are adjudicated through the Arbitration Court system. Foreign companies can win cases, but must struggle to get judgments enforced. Major U.S. accounting firms and many experienced Western law firms are available in Moscow and St. Petersburg to provide authoritative interpretations and defense. While crime and corruption are prevalent, most firms report they are able to comply with the U.S. Foreign Corrupt Practices Act. High operating costs are also a problem, but the situation is easing. The cost of commercial rent, for example, declined due to a sharp fall in demand following the 1998 crisis and the subsequent arrival of new "class A" space on the real estate market. U.S. companies' quality and innovation give them an advantage even in this price-sensitive market, but those that approach Russia with an eye toward quick sales and low up-front investment are typically disappointed. Conversely, firms which research tax, customs and other requirements with professional sources in advance, which visit Russia often to cultivate customers, which produce product literature in Russian, and which invest sufficiently in marketing and distribution channels often do find success. Permanent representation in Russia is generally considered essential.

POLITICAL CLIMATE

Bilateral Relationship with the United States

The U.S. relationship with Russia has evolved since the break-up of the Soviet Union through numerous summits and Bilateral Commission meetings that have built a substantial agenda for U.S.-Russian cooperation. The last bilateral summit was held in Moscow in June 2000 and another is planned for later this summer. In addition to resolution of regional crises, such talks have focused on arms control, non-proliferation of weapons of mass destruction and the means for their delivery, counter-terrorism, organized crime, and the environment. The United States continues to support Russian efforts to build a democratic society and market economy, with the goal of integrating the country more broadly and firmly into the international community. The United States also continues its support to engage international financial institutions with Russia.

Major Political Issues Affecting Business Climate

Democratic institutions are fragile in Russia. The March 2000 presidential election was the first democratic transfer of power in Russia's 1,000-year history; the election reassured investors about Russia's political stability. Nevertheless, other legal and juridical factors affect the business environment in Russia. Although Russian law now includes a civil code (which contains a commercial code) and a criminal code, key amendments are needed to improve the business environment. Protectionist elements in the Russian executive and legislative branches have risen in response to the broad belief that free trade and foreign business activity have caused the nation's industrial decline. Some politicians advocate limits on foreign share holdings or property ownership, or an increased tax burden on foreign businesses. Putin and the Russian government have pledged to improve the business climate and increase legal protection for investment.

Political System, Elections, and Orientation of Major Parties

As outlined in the Russian Constitution adopted in December 1993, the Russian Federation is governed by a political system modeled after many in the West. The federal system is composed of three branches: executive, legislative and judicial. The Federation is composed of 89 subjects which include regions, autonomous republics, territories and the cities of Moscow and St. Petersburg. These subjects are granted some authority over internal economic and political issues. Nonetheless, there is considerable ambiguity in the power sharing agreements which the central government has signed and continues to negotiate with many Federation subjects. In May 2000, President Putin issued a decree dividing the country into seven federal districts. This and other initiatives are designed to strengthen the power of the center and to rein in regional leaders, some of whom have become czars in their own realms.

SOURCES OF FINANCING

Overview of the Banking System

The Russian banking system does not meet the nation's capital and credit needs, but a company doing business in Russia can find minimal banking services. The process is complicated by Russia's slow recovery from its 1998 financial crisis, which crippled many of the largest banks. Since 1995, the total number of banks has declined from approximately 2,600 to 1,320; of these, 300 barely survive. During the ruble's devaluation, the assets of Russia's banks shrank from $88.7 billion to $34.4 billion, a rate of more than 60%. By spring 2000, banks in the country experienced moderate improvement as their capital increased 2.8 times over the previous year. Nonetheless, capitalization of the banking system remains at 75% of the pre-crisis level. The problem partly results from limited government action to restructure Russia's banks after the crisis. The Agency for Restructuring Credit Organizations (ARCO) is charged with providing supervision of and temporary financial assistance to insolvent banks, but its resources are inadequate. To date, ARCO has attempted to restructure two large banks and about 15 small ones. After the 1998 crisis the Central Bank of Russia (CBR) proposed changes to the banking system, but no new legislation or institutions have appeared to improve the shortcomings of the banking system. Limited choices and difficult tradeoffs confront companies choosing a bank in Russia. Companies can choose from three types of banks: a foreign-owned subsidiary, a state-owned Russian bank (newcomers to the commercial field), or a variety of Russian private commercial banks.

Foreign-Owned Banks

Most foreign businesses prefer to deal with foreign-owned banks because they are more stable and generally offer better quality service. Until recently, these banks concentrated their activity in highly profitable financial markets and were not interested in commercial banking. However, strong demand has drawn them into diversifying their services to include foreign trade transactions and commercial banking. Many foreign banks now provide regular commercial services including accounts, transfers, currency exchange, credit, documentary operations, letters of credit, and trade financing. Some of these banks will establish individual accounts for non-residents and employees of their institutional clientele. Unfortunately, the lack of nationwide branches makes these services largely unavailable to customers operating outside the major metropolitan centers of Moscow and St. Petersburg.

State-Owned Banks

Some state financial institutions are taking on the role of commercial banks and project an image of stability and prestige. Sberbank is the largest such institution in Russia because it was the savings bank for Soviet citizens. Following the August 1998 crisis, it received individual accounts transferred from banks liquidated by the government. Therefore, Sberbank has an unmatched nationwide network of 50 branches and over 2000 outlets handling millions of private and commercial accounts. Sberbank is rapidly increasing its commercial loan portfolio but must prove that it can develop the organizational and management skills to successfully operate as a commercial bank. Vneshtorgbank is another state bank. Originally founded to facilitate international trade, it is almost wholly owned by the Russian Central Bank. Since the crisis, it has focused on retail and corporate clients. Vneshtorgbank survived the 1998 crisis in by minimizing speculative trading in GKOs (short-term federal obligations) on which the government defaulted. As one of the few institutions which met its obligations after August 1998, its has since garnered 7,300 new corporate and 7,100 new retail clients.

Russian Private Commercial Banks

Other viable Russian banks include emerging service-oriented banks and large banks owned by financial-industrial groups. The 1998 crisis severely impacted the major Russian banks, closing about 15 of the largest and leaving others in a weakened state and needing reorganization. The most aggressive component of the Russian banking system is a group of new banks which grew larger following the 1998 crisis. These banks survived because they avoided speculation in GKOs and because they offer professional services. These banks are likely to remain customer oriented and to find creative solutions to Russia's business complexities. A potential weakness is their limited capacity to provide services comparable to those of large international banks. Furthermore, they lack nationwide coverage. Ten of the leading banks are:

- Gazprom Bank
- National Reserve Bank
- Sobinbank
- MDM Bank
- Bank of Moscow
- Mosbusinessbank

- Mezhprombank
- Avtobank
- Rosbank
- Alfa-Bank.

General Financing Availability

The Russian economy has shown some strength as it has recovered from the 1998 crisis. Real growth in the economy has spurred some lending by financial institutions; it has also led to domestic and foreign investment. Russian banks have recently become more active in equipment financing, providing such services as factoring and leasing. A number of western investment banks and venture funds which scaled back their Russia operations after the 1998 crisis have reactivated their lending. Additionally, the European Bank for Reconstruction and Development (EBRD) and a number of bilateral and multilateral financing programs provide more opportunities for traders and investors. The use of limited recourse project financing remains hampered by several factors: the immaturity of commercial legislation, contract enforcement, asset title, rights of debt and equity holders, and contractor performance requirements.

U.S. Export Credit Financing

The U.S. Export-Import Bank (Exim). Exim began lending to support U.S. exports to Russia in 1992, offering loans based on sovereign guarantees from the Russian Government. Exim also developed financing structures based on hard currency revenues. With Russia's budget constraints undermining the Russian government's willingness and ability to offer sovereign guarantees, Exim has sought creative ways to finance transactions, including project finance. Exim's Oil and Gas Framework Agreement relies on pledges of exported oil to guarantee loans. Since 1993, Exim has supported nine transactions worth more than $1 billion in the oil sector. In 1996, Exim opened for short- and medium-term private sector transactions in Russia with commercial banks acting as either obligators or guarantors. The maximum repayment term is five years for transactions involving Russian commercial banks, and there is an informal limit of US$10 million per transaction. Exim has established threshold criteria that a Russian commercial bank must meet before Exim will consider taking its obligation or guarantee. Companies interested in Exim financing should contact the bank directly.

The Overseas Private Investment Corporation (OPIC). In an agreement ratified at the June 1992 summit, the U.S. Overseas Private Investment Corporation (OPIC) was authorized to provide loans, loan guarantees and investment insurance against political risks to U.S. companies investing in Russia. OPIC generally insures against three political risks: expropriation, political violence and currency inconvertibility. In 1994, to meet the demands of larger projects in Russia (and worldwide), OPIC doubled the amount of insurance and quadrupled the amount of finance support - to $200 million in each case - it can commit to an individual project (a total of $400 million). OPIC also makes equity capital available for investments in Russia by guaranteeing long-term loans to private equity investment funds. There are currently six OPIC backed investment funds which concentrate on Russia, the other NIS and the Baltic States, and another four funds which are global in scope. Through the end of fiscal year 1997, OPIC had committed $3.26 billion in insurance, finance and OPIC-backed investment funds to over 125 projects in Russia. In December 1994, OPIC also committed to provide up to $500 million to support defense conversion projects. Following the ruble devaluation of August/September 1998, OPIC ceased offering currency inconvertibility insurance for investments in Russia, although it still extends its other services. In December 2000, OPIC reintroduced inconvertibility insurance for OPIC-eligible investment projects in Russia on a case by case basis. Russia is a member of the Multilateral Investment Guarantee Agency (MIGA).

TELECOMMUNICATIONS SECTOR

The Russian telecommunications services market has great potential. The industry attracts domestic and foreign investment and is one of the most dynamic sectors of the national economy. The 1998 ruble devaluation severely hit the industry because telecommunications companies, especially traditional operators, used ruble-based fee schedules but invested hard currency to build and upgrade their networks. Recent economic developments suggest a recovery in all industry sectors, including telecommunications.

Russia's telecommunications market is still not up to the standards of most industrialized countries. It is not a homogeneous market; available infrastructure and services vary greatly from region to region. While digitalization networks in urban areas reached 29% in 1999, this percentage would be much smaller if Moscow was excluded. Telephony service in rural areas remains almost 100% analog. Russia averages 22 telephone lines per 100 people. Six million people are still on the waiting list for basic telephone service. Difficulties of getting a regular line to one's home contributed to the rapid growth of wireless telecommunications, but low consumer purchasing power limits its penetration.

The total of US$4 billion in 1999 telecommunications services revenue came mainly from international and domestic long-distance calls, local telephony, and wireless communications. Value-added services are still a new concept in Russia that will require a lot of customer education. For example, 95% of cellular phone owners use their handsets only for voice communications. The companies in saturated markets offer some value-added services in order to demonstrate technological superiority and expand their business proposition.

The Russian telecommunications industry has an increasingly privatized and competitive structure. Basic services are provided by over 80 regional phone companies, which have been partially privatized under the umbrella of the state-owned holding company, Svyazinvest. These companies complain about regulated low rates and mandated social duties, but enjoy monopoly positions in their respective regions. Rostelecom, another company controlled by Svyazinvest, owns a nation-wide backbone network and provides services to local carriers. Other strong players - the Ministry of Railways (Transtelecom), Gazprom (Gaz-Svyaz) and the UES (electric power network) - have entered the market, wiring telecommunications networks along their respective infrastructure networks.

Strong competitors in Russia's telecommunications market are the alternative operators, which are mostly joint ventures led by international phone companies. They focus on high-return services, including data transmission, wireless and

Internet, and on international and domestic long-distance calls. Last year, their revenue grew more than six times to US$2.4 billion, more than half of the industry's revenue. These companies mostly target corporate customers and people with average-and-higher disposable incomes.

The best sales prospects for 2000-2002 are high-speed, broadband Internet access, voice over IP, wireless services, including wireless Internet access, and video-conferencing. This report provides an overview of selected telecommunications value-added services, including high-speed Internet access, WAP, web hosting, and call center services.

The Russian telecommunications services market presents good opportunities for U.S. companies that offer financial management, marketing and customer service expertise in addition to advanced telecommunications technologies. Due to existing business practices and the important role of the Russian government in regulating the industry, U.S. companies are advised to pursue telecommunications ventures in this country with a reliable Russian partner. Acquisition is another feasible market entry strategy in saturated industry segments.

INFORMATION TECHNOLOGY SECTOR

Software is one of Russia's most rapidly growing information technology sectors. It is showing a 10% annual growth as computers become ever more prevalent in Russian business. Following global patterns, software sales have been growing faster than hardware sales for the last 10 years. The size of the software market in 1999 was estimated to be US$560-580 million, and the volume of imported packaged software was around US$70 million. The main trends of software market development in 1999 were: the growth of Enterprise Resource Planning (ERP) systems, regrouping among PC assemblers, and a doubling of Internet users. In 1999 (after the financial crisis of August 1998), the volume of PCs sales dropped by 8% but the sales of software products remained stable. Sales of Enterprise Resource Planning (ERP) programs increased by 25% (up to US$44 million).

Russia is very receptive to U.S. software products, and companies such as Microsoft, IBM, Hewlett Packard, Sun Microsystems, Novell, and Oracle are name brands universally recognized for their quality and sophistication. The leading U.S. companies are present in the Russian market and their products are available either directly or through representatives or distributors. Imports from third countries are also growing, though they presently account for a minor share of the market. Some local experts on computer and office equipment expect at least 20% growth in U.S. imports by the end of 2001, although this prediction rests on an acceleration of Russia's overall economic growth and continuation of aggressive marketing efforts by U.S. suppliers.

The domestic Russian software industry is relatively young and is composed of thousands of firms specializing in a broad range of activities including development and customization, localization and translation, production, distribution and technical support. According to the McKinsey Global Institute, the Russian software market can, with obvious exceptions, be generally characterized by small-scale operations and lower value products and services. Local software houses, system integrators and application service providers also work as distributors for foreign companies. The sector is reaching a stage of maturity, and new-to-market companies will face serious competition from long-established companies.

The actual total demand for software is difficult to determine due to the high level of "pirated" copyrighted software, estimated by some trade sources to be as high as 90%. In recent years, the Russian government has tried to increase enforcement actions against software piracy, but further efforts are needed to reduce the extremely high level of piracy, which the main barrier to importing packaged software.

One of the emerging trends of the Russian software industry is a growing potential to become an export–oriented industry in the future with over 50% of domestic production sold abroad. There are good opportunities for outsourcing in Russia due to its well-educated labor force, and aggressive industry.

The most popular software expected to be sold in Russia are branded system and networking software; application software tools such as document flow automation, operating and, data base management systems; and Internet applications. Internet use in Russia is not widespread at present, but there is much potential for the future and it represents an interesting market for U.S. exporters. At the moment, the number of Internet users is 2.5 million (3% of the population) and the industry projects that the number will be 6 million by the end of 2001.