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INTERNATIONAL ENTREPRENEURSHIP

The Case of Russia

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This manual is intended for students interested in international business. The theoretical concepts and practical issues of international entrepreneurship are considered with reference to Russia, one of the most promising sites for international business.

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PREFACE

This manual is developed for students of business colleges who seek to enhance their knowledge of international entrepreneurship. Experience has shown that processes of globalization and internationalization are developing so rapidly in recent years that even if students majoring in business does not intend to be involved in international business activity, they nevertheless will encounter problems relating to globalization and internationalization processes in their professional activity. For instance, they can work in one company with people from other countries (superiors, subordinates, or peers), experience in their home country how various foreign conflicts and world economic crises influence business, or compete with manufactures from other countries in their domestic market, etc. Needless to say, those who wish to be involved in international entrepreneurship must be well-versed in specific issues of international business.

In these challenging times, it is very difficult for a business to be competitive if it is not an entrepreneurial one. “Entrepreneurial” means, first of all, creative and innovative. A sense of initiative and entrepreneurship are among the most important competences of business persons. That is why an EU document, *The Key Competences for Lifelong Learning – A European Framework*, named this competence among eight major competences to be developed in European citizens. However, it is difficult for an international business person to be entrepreneurial without knowing at least the fundamentals of his or her profession. This manual is intended to give students such a basic knowledge of international business. As can be assumed from the manual’s title, the theoretical concepts and opportunities of doing business are considered in this manual with specific reference to Russia.

Being the largest country in the world by territory and possessing tremendous resources – natural, human, scientific, cultural – Russia provides breathtaking opportunities for international entrepreneurs. As a transitional country, it has a lot of underdeveloped industries and free niches. This implies more favorable conditions of doing business in terms of competition. However, international entrepreneurs encounter numerous challenges in that country. Experience has shown that strategies and tactics of doing business successfully applied in other countries often do not work in Russia. Therefore it is very important to become acquainted with the peculiarities and difficulties of doing business in that country before starting a business operation there. This knowledge can also help in doing business in other former soviet republics and currently Newly Independent States (NIS): the Ukraine, Belarus, Kazakhstan, etc. Numerous international companies and individual entrepreneurs functioning in Russia and NIS demonstrate that success is quite possible in those countries despite all the difficulties.

The major objective of this manual is to demonstrate to students the range of opportunities for international entrepreneurial activity, to familiarize them with the basic concepts and ideas of international entrepreneurship, and to consider major barriers for doing business abroad as exemplified by difficulties in the Russian transitional market. With reference to a specific country, demonstrations will be offered on how to establish new ventures, transact export and import operations, execute marketing and sales, and communicate with clients and partners. This will help students become effective entrepreneurs, investors, managers and consultants while conducting international business operations.

This manual involves the careful examination of key elements of international entrepreneurship: intention and general characteristics; legal, technological, political, ethical and social aspects; motivations to expand globally; and traits and competences of international entrepreneurs. The

manual examines the Russian marketplace in a global context and the efforts of the Russian government to stimulate foreign investments. Specific topics the manual covers include: forms of international business, business opportunity identification and assessment, establishment of a legal presence in Russia, opportunities and barriers to international trade, procurement of financial resources and labor, marketing and sales, settlement of conflicts and risk insurance. The manual also thoroughly examines the Russian business culture.

The first chapter of this manual examines the most general issues of the theory of international entrepreneurial activity. Each of the following chapters includes an introductory block elucidating general issues of international entrepreneurship on the specific topic and a major block devoted to issues of doing business in Russia. Special attention is paid to universal issues and the possibility of generalization. The manual is therefore relevant to students with an interest in any industry or country.

This manual is mainly a creatively processed compilation of extracts from reports, research and surveys of well-known international companies, Russian and foreign government agencies relating to international business, and books on international entrepreneurship by known authors. This approach has been chosen mainly to accelerate the preparation of this manual since the business environment in Russia is changing very rapidly. Practically annually legislation is changed, tax types and rates are corrected significantly, and various restrictions and benefits for business are introduced and canceled. Therefore the rapid development of a completely original manual that remains relevant and provides information is quite problematic.

Chapter 1

General Characteristics of International Entrepreneurship

1. What is entrepreneurship?

The study of entrepreneurship reaches back to the work of Richard Cantillon and Adam Smith in the late 17th and early 18th centuries, but was largely ignored theoretically until the late 19th and early 20th centuries. In the 20th century, the understanding of entrepreneurship owes much to the work of the economist Joseph Schumpeter in the 1940's and other Austrian economists such as Carl Menger, Ludwig von Mises and Friedrich von Hayek. The concept of entrepreneurship cannot be fully understood without Schumpeter's contributions.

There are many definitions of entrepreneurship but all of them can be divided into two categories. The definitions of the first type describe entrepreneurship as just a business, an activity involving trade, goods manufacturing or services delivered for money. If you undertake an enterprise you are an entrepreneur (*entrepreneur* in French is a person undertaking an enterprise). Even if your business idea is not innovative, everything may be new for you in this business and you should bear all risks and responsibilities. Therefore some scholars and practitioners argue that any person involved in a business project can be considered as entrepreneur and his activity as entrepreneurial one.

According to the second concept entrepreneurship is a specific business. What determines the specialty of this business? Joseph Schumpeter believed that entrepreneurship is a business which uses new productive inputs and results in innovation. In Schumpeter, an entrepreneur is a person who is willing and able to convert a new idea or invention into a successful innovation. He believed that entrepreneurship disappears as only business becomes a stable system. Since the main attribute of entrepreneurship according to Schumpeter is innovation he believed that not only an owner of business but a manager too may be an entrepreneur providing that the business is innovative.

The introduction of innovation leads to market disequilibrium. Entrepreneurs introducing innovations in the market upset the balance between demand and supply. This process is known as **Creative Destruction**: replacement in whole or in part an inferior innovations across markets and industries, simultaneously creating new products including new business models. In this way, creative destruction is largely responsible for the dynamism of industries and long-run economic growth. So the main goal of entrepreneurship is stimulation and satisfaction of demand. Thus, the innovation and technological change of a nation comes from its entrepreneurship.

The Schumpeter's definition of entrepreneurship is very topical because the main engine of progress for the modern knowledge-based economy is innovation. Apart from this, as G. Faltn says "If your idea is not innovative, those businesses already in the market place will have a competitive edge over you. They are the ones who already have customers, they have the experience with suppliers, and they know the specifics of the product itself, they are well-known in their environment, whereas you, as a newcomer, are not. In short, they have all the advantages, and you have a corresponding number of disadvantages. Hence, to enter the market place, it is almost a necessity to have a new idea. Most probably the innovative element of your business idea is your most crucial partner for survival" [1].

2. International entrepreneurship

Some scholars highlighted other important characteristics of entrepreneurship. Frank Knight and Peter Drucker for instance believed that the main trait of a real entrepreneur is the ability to identify business opportunities and take advantage of them with maximum profitability.

As we can see this idea underlies the modern definition of international entrepreneurship given by Benjamin M. Oviatt & Patricia P. McDougall:

International entrepreneurship is the discovery, enactment, evaluation, and exploitation of opportunities--across national borders--to create future goods and services.

According to The European Project "INTENT" supported under the Leonardo da Vinci "Transfer of Innovation" program 2007-2013 of the European Commission **entrepreneurship** is a key competence for growth, employment and personal fulfillment and is defined as "an individual's ability to turn ideas into action". In line with this definition, entrepreneurship does not mean the "ability to set up a new business" but the ability to use a set of competence such as creativity, self-confidence, innovation and risk taking in order to transform ideas into action. It's in fact more a question of "mindset", "behavioral and personal and social abilities/attitudes" [2].

Deriving from this definition **international entrepreneurship** is defined in this project as "***an individual's ability to turn ideas into action in an international context***".

These definitions imply a general set of 3 main activities in which the knowledge, skills and competence of entrepreneurs can be used. To be more concrete some examples of these 3 activities are presented in Table 1.1[2].

Table 1.1

A set of main entrepreneurial activities

Activity 1	Searching for, initiating and instigating business opportunities at international level
Examples	<ul style="list-style-type: none"> • Searching and monitoring business opportunities at international level • Exploring international market presence • Setting up local offices abroad • Creating and designing an international company strategy
Activity 2:	Preparing, organizing, participating, carrying out and following up international business activities
Examples:	<ul style="list-style-type: none"> • Designing and implementing new solutions, products, services targeted to international customers • Giving an international focus to business projects • Dealing with/being involved in international mobility and expatriation issues • Organizing and coordinating events (fairs, exhibitions, seminars, <i>etc.</i>) abroad or involving people coming from abroad • Dealing with foreigner customers or foreigner authorities
Activity 3:	Managing diverse relations and contacts in different contexts and cultures
Examples:	<ul style="list-style-type: none"> • Working and/or leading a multicultural team/working group • Recruiting and developing multi-cultural teams • Dealing/Communicating with customers, business partners, suppliers in different parts of the world (personally, by telephone, in writing through letter, fax, e-mail, <i>etc.</i>) • Managing international business relations/contacts

	<ul style="list-style-type: none"> • Gaining clients, business partners and employees trust/cooperation • Dealing with cross-cultural conflicts • Participating in international negotiations/sales • Participating in cross-cultural meetings • Dealing with/being involved in international mobility and expatriation issues • Organizing and coordinating events (fairs, exhibitions, seminars, <i>etc.</i>) abroad or involving people coming from abroad
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3. The differences between a business and an entrepreneurship

What is the difference between a business and an entrepreneurship, an international business and an international entrepreneurship? These terms are commonly used interchangeably. However, these terms have different meaning. We already know that entrepreneurship is understood by many scholars as a business which is not traditional but an *innovative* and *creative* type of a business. Innovation and creativity are the major traits of entrepreneurship. Other important characteristics of entrepreneurship and an entrepreneur are ability to set up a new business, take risk, discover and exploit opportunities, turn ideas into action, and operate in an international context. But these characteristics are important for a business too especially for an international one. It is therefore difficult sometimes to distinguish between international entrepreneurship and international business. Nevertheless we can find some differences.

International business is considered to be less risky than international entrepreneurship. Although it is difficult to measure risk, there are some obvious examples. Experience shows that initiating a franchising business in a foreign country is much less risky than starting up a new venture even at home (about 85% of franchising firms survive in 5 years after starting operations while only 5-10% of independent startups do so during the same period), doing business with the state support is also much less risky than undertaking an independent entrepreneurial project (therefore it was difficult for Ford, General Motors, Nissan in contemporary Russia or PepsiCo and Fiat in the USSR, which received government support, to fail), the managers of large corporations are not genuinely at risk, did not start the business, and are simply running things; their "undertakings" might sometimes be risky – but not in relation to total assets.

Some academics argue that international entrepreneurship is not just an international business operation like purchasing raw materials in foreign countries, drawing upon a credit in a bank of one country to finance operations in another country, exporting or importing goods, transporting goods from one country to another, etc. They believe that even building a plant in a foreign country by a large corporation is difficult to call entrepreneurship because it utilizes routine planning, financing, organizational, technological, marketing and sale procedures. That is why international entrepreneurship considers small and medium sized companies, not transnational corporations, as its major subjects of study. Currently, the share of these companies in international operations accounts for a quarter of the total.

Small and medium sized companies going global are not always entrepreneurial as well. But such a company establishing its presence abroad can be called an entrepreneurial one even if its goods or services are not innovative because it takes a great risk in a foreign market, everything is new for entrepreneurs in an alien country and there are a lot of barriers there but their resources are limited. Therefore they usually have to be much more creative than just businessmen to survive. But if they manage to survive and their business becomes a stable system, they lose the status of entrepreneurs and become just businessmen.

The same transformation occurs to a company producing innovative products or offering innovative services whether in its own country or abroad. As soon as the products or services are not innovative any more in the market, the entrepreneurial company becomes just a business.

4. The legal definition of entrepreneurship

It is important for entrepreneurs and managers to understand not only economic but also legal aspects of the entrepreneurial activity. Sometimes it is necessary to prove that activity of an organization is an entrepreneurial one or vice versa (for example, for not-for-profit organizations to avoid taxation). In the course of commercial disputes, it is usually necessary to understand what is the property accountability of each of litigants, what is the probability of bankruptcy, what is economic independence of the subject of economic activity and whether it is officially registered. Therefore definitions of entrepreneurship in legal acts are given on the ground of these considerations.

The Civil Code of the Russian Federation defines entrepreneurship as follows: “Entrepreneurship is an independent, conducted at one’s own risk activity aimed at the systematic attainment of profit through the use of property, sale of goods, execution of works or provision of services by entities registered for such activity in accordance with the procedure established by law”.

On the basis of this definition we can highlight the following legal attributes of entrepreneurship: 1) targeting at the systematic attainment of profit; 2) existence of entrepreneurial risk, possibility of losses and bankruptcy; 3) full property accountability; 4) economic independence: a) material (possession of separate property settled as one of corporeal rights) and b) organizational (right to choose a form of legal entity's incorporation and right to choose a type of business activity); 5) registration to do business (absence of this attribute does not deprive this activity of the status of entrepreneurial but makes it illegal).

5. What are the main goals of entrepreneurship and an entrepreneur?

The main goal of entrepreneurship in terms of economics is stimulation and satisfaction of demand through “creative destruction”. The main goal of an entrepreneur is maximization of his opportunities to satisfy his needs in the state of uncertainty.

6. Incentives for entrepreneurs

Much research has revealed that entrepreneurs are stimulated not only by the possibility of making profit. Incentives to undertake an entrepreneurial project can be divided into two categories: economic and non-economic.

Table 1.2

Economic incentives

#	Incentives	Clarification
1	Making profit	A powerful stimulus
2	Ability to help society and people	Charity, cheaper products, social entrepreneurship, jobs creation, regional development, quality and innovative products
3	Freedom to choose sphere of activity	Less profit but more satisfaction or less risk
4	Freedom to choose intensity of work	Master of time
5	Freedom to choose intensity of competition	Can yield in competition with other entrepreneurs or vice versa

Making profit. This is believed to be a primary goal and incentive for entrepreneurs. Although it is not always so, it is, without any doubt, a very powerful stimulus in undertaking an entrepreneurial project.

Ability to help society and people. This can be considered as a combination of economic and non-economic incentives, since ability also implies desire to help society and actual people. Some entrepreneurs speak of their “mission” to help people. They sell products much cheaper especially to poorer population groups, democratize the computer, and undertake social entrepreneurial projects. It is a pleasure for them to realize that they create new jobs, produce quality products, introduce innovations, improve the economic situation in their region, contribute to national GDP, etc.

Freedom to choose sphere of activity. An entrepreneur can do what he likes to do whereas working for a company he must perform prescribed duties. If people in a society have no freedom to choose the type of their economic activity it means that there is no market economy in that society. An entrepreneur can choose an activity making less profit but providing more satisfaction or less risk.

Freedom to choose intensity of work. Although some believe that an entrepreneur must work 24 hours a day and 7 days a week it is not always so and an entrepreneur often can choose more flexible work schedule. When business is stable and everything is going properly entrepreneurs have more leisure time and some of them become just owners of business hiring managers to run their business. But he is always in charge of his time. If a problem is not critical he can postpone its solution for a while.

Freedom to choose intensity of competition. An entrepreneur is free to choose the intensity of competition whereas an employee working for a company must try to win a competition regardless how exhausting and frustrating it is. That is an entrepreneur can yield to competition and agree to cover a narrower part of the market or choose another type of competition. Or vice versa he can decide to be more aggressive.

Table 1.3

Non-economic incentives

#	Incentives	Clarification
1	Will to win	Desire to show the ability to meet challenges
2	Aspiration for self-actualization	Desire to be a personality, to prove one’s own competence
3	Aspiration to have a personal “Empire”	Aversion to subordination, satisfaction in being a master
4	Joy of creation	Creativity in business is as exciting and fulfilling as creativity in the arts
5	Increase in social status	Desire to be respected and influential

Will to win. Surveys show that making profit is a secondary thing for many entrepreneurs. Some of them say that they could make more money working for a company. Such entrepreneurs are excited by the opportunity to struggle with and overcome difficulties. They have a strong desire to prove – to themselves and others – that they are personalities worthy of respect. Some people jump with parachutes or climb mountains to get adrenaline, others – undertake an enterprise. A hard-won victory is a significant incentive for them.

Aspiration for self-actualization. For some entrepreneurs it is important to understand what they can do in this life. They have a strong aspiration for self-actualization. They want to bring to light their latent abilities and show their competence. Discovery and actualization of their potential is very exciting for them. One thing is to think that you have talents and abilities and it is another thing to prove it.

Aspiration to have a personal “Empire”. Many creative and independent people hate to be a subordinate to anyone. It is a pleasure for them to be the absolute masters of their enterprises and use their own discretion to steer them in rough sea of business. They feel deep satisfaction observing how their intangible idea is growing into a vast and quite tangible business empire. But even if it remains a small business, they say that it is better be the head of a dog than the tail of a lion.

Joy of creation. “Entrepreneurship means the ability to set up and build something out of practically nothing; it is therefore an elementarily human, creative act. In this regard, it should be made clear that an entire area of entrepreneurship has always given and continues to give great weight to the creative aspect of developing an entrepreneurial idea” [1]. Successful entrepreneurs say that “watching something you've built become successful is one of the most fulfilling and exciting things you can do in life”. Some businesses become a common heritage and form human culture. All these give more job satisfaction.

Increase in social status. Social status connected to entrepreneurship is highly valued in almost all cultures. Studies show that entrepreneurs enjoy higher social status and wider social relationships in their respective communities than non-entrepreneurs do.

7. How to be creative?

As we have already seen some definitions describe entrepreneurship in terms of creativity. But how to be creative in business? What prevents us from finding creative solutions to entrepreneurial problems? Currently it is a common thing to argue that the main things that hinder creative thinking are so called “thinking inside the box” and our belief that we are not creative.

So to be creative in business it is necessary to “think outside the box”. This idiom originated in the USA in the late 1960s/early 1970s. It has become something of a cliché, especially in the business world. But thinking outside the box is more than just a business cliché. It is the encouragement to look for solutions from outside our usual thinking patterns. It means approaching problems in new, innovative ways; conceptualizing problems differently; and understanding our position in relation to any particular situation in a way we’d never thought of before. Ironically, it is a cliché that means to think of clichéd situations in ways that aren’t clichéd. Thinking inside the box means accepting the status quo. There is a funny historical example of such thinking: Charles H. Duell, Director of the US Patent Office, said, "Everything that can be invented has been invented." That was in 1899: clearly he was in the box!

One can find numerous recommendations on how to be creative from interesting books (for example, *M.Ray, R.Myers. Creativity in Business. Based on the famed Stanford University course. Broadway Books. New York, 2000*) to the advice to take a shower to stimulate your brain activity or ask a child when you need an original idea. The format of this course does not allow to consider this issue in more detail but it seems advisable to read good books on the topic.

Another serious barrier to creative thinking is our strong belief that we are not creative. “Popular advice for would-be entrepreneurs all too often suggests that ideas arise largely through a mysterious combination of day dreaming and inspiration. But K.Vesper (*Vesper, K. H. New Venture Mechanics. New Jersey. 1993*) draws a different conclusion from his research: *Idea creation can be approached deliberately and systematically*. This is a kind of revolution. The promise that you can deliberately and systematically create ideas is in complete contrast to the still prevailing belief that only extraordinary people have convincing new ideas. Vesper’s research suggests that it is within the reach of almost anybody to create a genuine idea. Although it is commonly believed that creativity is something rare and outstanding, modern research data on creativity in general do not substantiate

such an assertion. D.Goleman, P.Kaufman and M.Ray (1993), M.Csikszentmihalyi (1999) have demonstrated how creativity is accessible to each of us. There are a number of rules that can be learned by almost everybody. One need not be a genius to create a good idea that works. One of their suggestions is: keep a prepared mind, let the solution to a problem grow with time” [1]. Concerned readers can find interesting information on the topic in the books of abovementioned authors and in the work by G.Faltin, *Creating a Culture of Innovative Entrepreneurship*. Journal of International Business and Economy, Vol. 2, No. 1, (2001)

8. Types of entrepreneurial activities

Many studies have explicitly or implicitly acknowledged the fact that there are different types of entrepreneurial activities and that these different types should not all be lumped together. But as participants of the *OECD World Forum on Statistics Knowledge and Policy Workshop on Entrepreneurship Indicators (2007)* noticed there are two difficulties on evaluating entrepreneurship: 1) lack of fit in definitions of entrepreneurship; 2) absence of a common taxonomy of types of entrepreneurship. As a result there are numerous taxonomies of types of entrepreneurial activities, entrepreneurs and new ventures. Here, only the most important of them are considered.

The first level of differentiation of entrepreneurial activities is the nature of the entrepreneurship. It can be either an activity directed on founding and running new venture or a competence and creativity in business, specific (creative) behavior and attitude to business.

Many definitions of entrepreneurship describe it as the activity required for setting up a new business. But we have already seen that there is another approach to entrepreneurship when it is considered as the ability to use a set of competence such as creativity, self-confidence, innovation and risk taking in order to transform ideas into action. These competences can be used both in a new venture and an in existing organization.

So we can find entrepreneurial activity both within the context of an existing organization and a business formed outside the auspices of existing organizations. The former activity is called *corporate entrepreneurship* or *intrapreneurship*. The term “intrapreneurship” was coined in 1970s by Gifford & Elizabeth Pinchot. According to Guth & Ginsberg “The topic of corporate entrepreneurship encompasses two types of phenomena and the processes surrounding them: (1) the birth of new businesses within existing organizations, i.e. internal innovation or venturing; and (2) the transformation of organizations through renewal of the key ideas on which they are built, i.e. strategic renewal (p. 5)” [1]. Internal competition between organizational structures is one of the key issues of intrapreneurship. The latter activity can be called *independent entrepreneurship*.

Therefore, the next level of differentiation of entrepreneurial activities is the context of the entrepreneurial activity, *Corporate* versus *Independent*.

The last level of differentiation of entrepreneurship is the sphere (economic sector) of the entrepreneurial activity. Here we can highlight two main types of entrepreneurial activity: *Commercial* and *Social*. *Commercial entrepreneurship* includes *production entrepreneurship*, *trade entrepreneurship* and *finance entrepreneurship*. Production entrepreneurship means activity connected with manufacturing products or rendering services. Trade entrepreneurship includes *trading* as such, *trade mediation activities*, or *commodity exchange trading*. Finance entrepreneurship implies *banking*, *insurance*, *leasing*, *stock exchange* and *over-the-counter activity*.

“Definitions of *social entrepreneurship* range from broad to narrow. In the former, social entrepreneurship refers to innovative activity with a social objective in either the for-profit sector, such as in social-purpose commercial ventures or in corporate social entrepreneurship; or in the nonprofit sector, or across sectors, such as hybrid structural forms which mix for-profit and nonprofit approaches. Under the narrow definition, social entrepreneurship typically refers to the phenomenon of applying business expertise and market-based skills in the nonprofit sector such as when nonprofit organizations develop innovative approaches to earn income.

Common across all definitions of social entrepreneurship is the fact that the underlying drive for social entrepreneurship is to create social value, rather than personal and shareholder wealth, and that the activity is characterized by innovation, or the creation of something new rather than simply the replication of existing enterprises or practices. The central driver for social entrepreneurship is the social problem being addressed, and the particular organizational form a social enterprise takes should be a decision based on which format would most effectively mobilize the resources needed to address that problem. Thus, social entrepreneurship is not defined by legal form, as it can be pursued through various vehicles. Indeed, examples of social entrepreneurship can be found within or can span the nonprofit, business, or governmental sectors” [3].

9. The content of the discipline and this manual

As a discipline International Entrepreneurship appeared relatively recently – it is believed that the term "international entrepreneurship" first appeared in a short article by Morrow in 1988. The subject draws upon theories and frameworks from several disciplines – entrepreneurship, international business, economics, finance, marketing, anthropology, psychology and sociology.

An important topic within international entrepreneurship was and remains the international new venture. Interests in the discipline rapidly increased and the field of international entrepreneurship broadened from its early studies of new venture internationalization. Currently the domain also includes studies of differing national entrepreneurial cultures, alliances and cooperative strategies, small and medium sized company internationalization, top management teams, entry modes, country profiles, corporate entrepreneurship, knowledge management, venture financing and technological learning. Since international entrepreneurs can perform various international business operations the discipline also includes description and methodology of international business operations.

This manual involves the careful examination of key elements of international entrepreneurship: intention and general characteristics; legal, technological, political, ethical and social aspects; motivations to expand globally; traits and competences of international entrepreneurs. The manual examines the Russian marketplace in a global context and efforts of the Russian government to stimulate foreign investments. Specific topics the manual will cover include: forms of international business, business opportunity identification and assessment, establishing a legal presence in Russia, opportunities and barriers to international trade, procurement of financial resources and labor, marketing and sales, settlement of conflicts and risk insurance. The manual also thoroughly examines the Russian business culture.

The manual explores both the general theory of international entrepreneurial activity and issues of its practical application. Special attention is paid to universal issues and generalizability. The manual is therefore relevant to students with an interest in any industry or country.

10. Importance of entrepreneurship

Importance for the global economy. The Global Entrepreneurship Monitor (GEM), an academic research consortium, in its 2011 Survey wrote: “Most policymakers and academics agree that entrepreneurship is critical to the development and well-being of society. Entrepreneurs create jobs. They drive and shape innovation, speeding up structural changes in the economy. By

introducing new competition, they contribute indirectly to productivity. Entrepreneurship is thus a catalyst for economic growth and national competitiveness”.

GEM asserts:

“1. An economy’s prosperity is highly dependent on a dynamic entrepreneurship sector. This is true across all stages of development. Yet the nature of this activity can vary in character and impact. Necessity-driven entrepreneurship, particularly in less developed regions or those experiencing job losses, can help an economy benefit from self-employment initiatives when there are fewer work options available. More developed economies, on the other hand, can leverage their wealth and innovation capacity, yet they also offer more employment options to attract those that might otherwise become entrepreneurs. In order to maintain their entrepreneurial dynamism, they need to instill more opportunity based motives.

2. An economy’s entrepreneurial capacity requires individuals with the ability and motivation to start businesses, and requires positive societal perceptions about entrepreneurship. Entrepreneurship should include participation from all groups in society, including women, a range of age groups and education levels and disadvantaged populations. Finally, high-growth entrepreneurship is a key contributor to new employment in an economy, and national competitiveness depends on innovative and cross-border entrepreneurial ventures.

Importance for a human being. According to the European Parliament Recommendations, entrepreneurship is considered as one of the eight key competences for lifelong learning, necessary for personal fulfillment, social inclusion, active citizenship and employability:

“Entrepreneurship is the ability to turn ideas into action. It involves creativity, innovation and risk-taking, as well as the ability to plan and manage projects in order to achieve objectives. The individual is aware of the context of his/her work and is able to seize opportunities that arise. It is the foundation for acquiring more specific skills and knowledge needed by those establishing or contributing to social or commercial activity. This should include awareness of ethical values and promote good governance”.

11. Why learn international business?

Almost all large companies for which students can work in the future either conduct business operations abroad or are involved in the global economic activity in another way. Hence future specialists should be versed in questions of international commercial activity in order to climb the ladder and maintain useful contacts with other managers.

Small and medium sized companies also are increasingly involved in the sphere of international business. In the event of starting up a new venture, an entrepreneur can be forced to compete with foreign companies or buy foreign materials or sell his products abroad. Rapid development of e-trade provides new and exciting opportunities for small companies. A good website allows for any company to expand its business globally without the necessity to be present in every country. Such an opportunity facilitates significantly the entrance to the global market. Apart from this, the Internet allows one to reduce drastically international communication expanses.

The next reason to study international business is the necessity to keep abreast with competitors. Students studying business in Europe and Asia usually study several languages, travel a lot and acquire experience working in several countries. Many universities develop business study programs requiring at least one semester abroad.

Studying international business also helps to be abreast of management technology development. For example, such methods as *Just-In-Time inventory system* (also called the *Toyota Production System*) or *Kansei Engineering* (sense engineering) were invented in Japan.

The last, but not the least, aspect of studying international business which has a great importance for future managers and entrepreneurs is building cultural competence. Experience shows that ignoring cultural peculiarities can seriously damage or even ruin international business.

12. Forms of international entrepreneurial activity

The major forms of international entrepreneurial activity are *exporting and importing, foreign investment, licensing, franchising, management contract, international strategic alliances* and *joint ventures*.

Exporting and importing. Exporting, the selling of products outside the country in which they are produced, and importing, the buying of goods or services from a supplier in another country, historically are the first forms of international entrepreneurship.

“Exporting, one of the least risky forms of international business activity, permits a firm to enter a foreign market gradually, assess local conditions, and then fine tune its product to meet the needs of foreign consumers. In most cases the firm's financial exposure is limited to market research costs, advertising costs, and the costs of either establishing a direct sales and distribution system or hiring intermediaries. Such intermediaries include *export management companies*, domestic firms that specialize in performing international marketing services on a commission basis, and *export trading companies*, general trading firms that will buy your products for resale overseas as well as perform a variety of importing, exporting, and manufacturing functions. Still another alternative is to use foreign distributors.

Working through a foreign distributor with connections in the target country is often helpful to both large and small companies because such intermediaries can provide you with the connections, expertise, and market knowledge you will need to conduct business in a foreign country. In addition, many countries now have foreign trade offices to help importers and exporters interested in doing business within their borders. Other helpful resources include professional agents, local businesspeople, and the International Trade Administration of the U.S. Department of Commerce. This trade organization offers a variety of services, including political and credit risk analysis, advice on entering foreign markets, and financing tips” [4].

All export and import operations are divided into two groups. The first group is *the trade in tangible products* (examples: cloth, PCs, raw materials, etc). In US official documents such trade is called “*merchandise exports and imports*”, in Great Britain – “*visible trade*”. The second group of export and import operations is *the trade in services or intangible products* (examples: transportation, banking, accounting services, etc). In the US, this type of trade is called “*services exports and imports*”, in Great Britain – “*invisible trade*”.

Foreign investment. The second form of international entrepreneurial activity is foreign investment or transfer of capital by residents of one country to residents of another country for consumption. Foreign investment is divided into two categories: foreign direct investment and portfolio investment. **Foreign direct investment** is an employment of capital to gain and really control property, assets and whole companies in other countries (example: the acquisition of all common shares of *Volvo Corporation* by *Ford Motor Company* after which *Ford* sent its managers to Sweden to run *Volvo*). **Portfolio investment** is the acquisition of foreign financial assets (shares, bonds, certificates of deposit, etc) to make a profit instead of exercising control over companies (example: the acquisition of 1000 *Sony* shares by a Dutch pension fund).

International licensing. Licensing is another popular approach to international business. License agreements entitle one company to use some or all of another firm's intellectual property (patents, trademarks, brand names, copyrights, or trade secrets) in return for a royalty payment. Many firms choose licensing as an approach to international markets because it involves little out-of-pocket costs. A firm has already incurred the costs of developing the intellectual property to be licensed. (Examples: *The Walt Disney Company* can issue a license for a German tailoring company permitting it to sell children's pajamas with smiling Mickey Mouse; pharmaceutical firms routinely use licensing to enter foreign markets). Of course, licensing agreements are not restricted to international business. A company can also license its products or technology to other companies in its domestic market [4].

International franchising. International franchising is a special form of licensing when a company in one country issues permission to a company in another country to use its production technology, brand, trade mark, logo in return for a royalty payment (examples: *McDonald's Corporation* sell rights to open fast food restaurants all over the world; *Holiday Inn Worldwide* has used this approach to reach customers in over 65 countries). International franchising is among the fastest-growing forms of international business activity today. Smaller companies have also found that franchising is a good way for them to enter the global marketplace. By franchising its operations, a firm can minimize the costs and risks of global expansion and bypass certain trade restrictions [4].

Management contract. A management contract is an agreement in accordance with which a company in one country allows a company from another country to run its assets or provide any other management services for certain remuneration. Management contracts are common among large companies of hotel business (examples: *Mariott* and *Hilton* companies not always are owners of hotels in foreign countries).

International strategic alliances. "A strategic alliance is a long-term partnership between two or more companies to jointly develop, produce, or sell products in the global marketplace. To reach their individual but complementary goals, the companies typically share ideas, expertise, resources, technologies, investment costs, risks, management and profits. Strategic alliances are a popular way to expand one's business globally. The benefits of this form of international expansion include ease of market entry, shared risk, shared knowledge and expertise, and synergy. In other words, companies that form a strategic alliance with a foreign partner can often compete more effectively than if they entered the foreign market alone. Consider the strategic alliance established by American Airlines, British Airways, Cathay Pacific Airways, Qantas, and others. Named *oneworld*, this partnership makes global travel easier for consumers. Benefits include integrated frequent flyer programs, common airport lounges, and more efficient ticketing among member carriers so that a change of airlines is transparent when booking international flights.

International joint ventures. A joint venture is a special type of strategic alliance in which two or more firms join together to create a new business entity that is legally separate and distinct from its parents. In some countries, foreign companies are prohibited from owning facilities outright or from investing in local business. Thus, establishing a joint venture with a local partner may be the only way to do business in that country. In other cases, foreigners may be required to move some of their production facilities to the country to earn the right to sell their products there. For instance, the Chinese government would not allow Boeing to sell airplanes in China until the company agreed to move half of the tail-section production for its 737s to Xian" [4].

13. Motivation to go global

Profit is not the only goal for entrepreneurs and companies. There is a range of basic reasons which cause companies to become more global both in terms of the general development course and in terms of daily practices. In table 1.4 major incentives to go global are shown [5].

Table 1.4

Incentives to Go Global

#	Incentives
1	Profits
2	Competitive pressures
3	Unique products or services
4	Excess production capacity
5	Declining home country sales
6	Unique market opportunity
7	Economies of scale
8	Technological advantage
9	Tax benefits
10	Lower logistics costs
11	Avoidance of trade barriers
12	Purchasing resources at a lower cost
13	Diversification
14	Reinforcement of a company brand
15	Client mobility
16	Use of a company's core competency

Profits. Profit for entrepreneurs is the most serious stimulus to go global. For national companies working in any country, the world's population living outside the country offers a very large market opportunity. Sometimes companies are forced to sell to international markets. By finding new foreign markets, you can insulate seasonal local sales or it may be necessary to cover some costs incurred in domestic markets, for example R&D or start-up manufacturing costs. Otherwise these excessive costs would have to be spread over domestic sales, which can be a problem especially in price sensitive markets. You can also tap potential investors if your business is exposed worldwide. As the barriers to international trade lower, the number of companies choosing to go global is rising. They try to capitalize on new growth in emerging markets.

Competitive pressures. In some countries, companies can experience less competitive pressure than in the domestic market. Developing and transitional countries often provide tremendous business opportunities since there are numerous underdeveloped industries and unoccupied niches there. Apart from this, "when the entrepreneur's technology becomes obsolete in the domestic market or the product or service is near the end of its life cycle, there may be sales opportunities in foreign markets. Volkswagen continued to sell its original VW Beetle in Latin America for years after stopping its sales in the United States" [5].

Companies try to keep up with competitors. For example, the Coca-Cola Company actively penetrates world markets therefore PepsiCo has no choice but to follow its adversary. Otherwise Coca-Cola could use the income it earned in new markets to launch a financial attack in domestic and remaining markets. The same situation applies to many other industries, where companies holding leading positions continuously launch attacks on each other to prevent their competitors from capturing the dominant position in one or another country.

Unique products or services. Some companies produce unique products or offer unique services of which only a small amount can be consumed in the domestic market. But new international

markets can offer tremendous opportunities for them. For example, US companies producing machinery and equipment, which can work in the severe conditions of the Far North or Upper Midwest can find a vast market for their products in Russia.

Excess production capacity. Excess production capacity is a situation in which actual production is less than what is achievable or optimal for a firm. This often means that the demand in the market for the product is below what the firm could potentially supply to the market. A company with sizable excess capacity can often lose a considerable amount of money if it is not able to meet the high fixed costs that are associated with producers. To prevent financial losses the company may sell its products in foreign countries.

Declining home country sales. When domestic markets are well penetrated and share and revenue growth are static or even declining (as it occurs in some markets of the US because of aging population) but a company can produce many more products or offer more services it may be a good idea to consider international markets for penetration.

Unique market opportunity. Periodically international markets provide unique opportunities. It may be Olympic Games or comprehensive governmental programs or any other private projects. Foreign partners can also offer attractive capabilities, technologies, market access. Some governments offer subsidies to attract particular types of foreign companies and investments to help further the development of the country's economy.

Economies of scale. "Economies of scale refer to the cost advantages that a business obtains due to expansion. The economies of scale concept means that there are factors that cause a producer's average cost per unit to fall as the scale of output is increased. Economies of scale may require a larger market than is possible within a particular country – for example, it would not be efficient for Liechtenstein to have its own car maker, if they could only sell to their local market. A lone car maker may be profitable, however, if they export cars to global markets in addition to selling to the local market" [6].

Technological advantage. Technology can be defined as science applied to practical purposes. Some countries (Russia, China, India) are considered important R&D generators of the world, providing highly skilled academics at a low cost. The combination of a huge market, large number of qualified staff and the low cost of R&D in these countries respond to the three major strands of R&D motivation: market, excellence (in some areas) and costs.

Another reason to establish a presence in a foreign country may be the need to get quick access to an advanced technology. For some companies it may be more profitable to purchase a share in an existing company than to form their own R&D groups for the development or reproduction of technology. For example, in Switzerland many producers of pharmaceuticals invested in small American biogenetical companies to achieve an inexpensive access to modern biotechnology.

Tax benefits. To attract foreign investment, some countries give foreign companies *preferential treatment* in terms of corporate tax. They also provide other *incentives for special industrial zones* established by local governments to foster particular industries. In 2010, for example, the Japanese government declared that international companies will be offered hefty tax breaks and other incentives to set up regional headquarters or research operations in Japan, in a move Tokyo hopes will make the country more attractive as a business hub. The breaks reflect concern that regional rivals such as Singapore and China are proving more attractive to multinationals as centers for management and R&D [7].

An important thing for international entrepreneurs is also a *tax treaty*. Tax treaties exist between many countries on a bilateral basis to prevent *double taxation* (taxes levied twice on the same income, profit, capital gain, inheritance or other item). In some countries they are also known as double taxation agreements, double tax treaties, or tax information exchange agreements (TIEA).

Entrepreneurs also can find it attractive to move themselves to so called *tax haven*, area with reduced or nil taxation levels. It is possible for a foreigner to create a company in a tax haven to trade internationally. The U.S. National Bureau of Economic Research has suggested that roughly 15% of countries in the world are tax havens and that these countries tend to be small and affluent. The following countries are commonly cited as tax havens – Andorra, the Bahamas, Bermuda (United Kingdom), the British Virgin Islands (United Kingdom), the Cayman Islands (United Kingdom), the Channel Islands of Jersey and Guernsey (United Kingdom), Cyprus, the Isle of Man (United Kingdom), Liechtenstein, Mauritius, Monaco, Panama, San Marino, Seychelles, Switzerland, the Turks and Caicos Islands (United Kingdom) [8].

Lower logistic costs. To lower logistics cost, some countries (Russia, China, India, e.g.) rapidly build prosperous middle classes that will surely demand many products and services. When a market in another country opens the natural step is to move production closer to that market to reduce delivery cost and administration. The decision to build manufacturing facilities in a foreign country can be made if logistic costs and barriers to international trade are higher than cost of production in that country. International regulations have improved for the last decades making overseas business less of a risk.

Avoidance of trade barriers. “Sometimes an entrepreneur moves to international markets to avoid increased regulations or governmental or societal concerns about their products or services. Cigarette companies such as Philip Morris aggressively pursued sales outside the United States, particularly in developing economies, when confronted with increased governmental regulations and anti-smoking attitudes of consumers. Sometimes this took the form of purchasing existing companies in foreign markets, which is what occurred in Russia” [5].

Purchasing resources at a lower cost. Another important reason to go global is the need to buy such resources as materials, labor force, capital and technology abroad. Sometimes companies are in instant need of foreign resources because either there are no resources at all or there is a lack of them in the domestic market. For example, American wholesale foodstuffs companies buy coffee and bananas in the South America, Japanese companies buy timber in Russia and Canada, and companies of all countries buy oil in Russia and the Middle East. Sometimes it is easier and cheaper for companies to buy resources in other countries. For example, many advertising agencies shoot commercial reels abroad. In recent years, the most popular place for shooting TV commercial became the South African City of Cape Town because the cost of labor and equipment hiring there is 40% lower than in Los Angeles. Often it is cheaper to have representatives in a foreign country to buy raw materials than to purchase them at home from a mediator. There is often some cost advantages by having at least a distribution and sales office in a foreign market.

Diversification. Entrepreneurs going global can cushion the impact of adverse economic trends in one nation against relatively good economic trends in another. Diversification reduces risk.

Reinforcement of a company brand. An entrepreneur can go global to reinforce his company brand internationally and keep that image consistent. It also will foster a team culture and a feeling of unity through shared reward and recognition [5].

Client mobility. Direct foreign investment to a foreign country of a company's client may be a motivation for the company to establish its presence in that country. In case a company's client builds an enterprise in a foreign country the company management can make a decision to place the company's new manufacturing facilities in close vicinity to the enterprise to carry out the delivery quickly and on time.

Use of a company's core competency. "A core competency is a specific factor that a business sees as being central to the way it, or its employees, works. It fulfills three key criteria:

- It is not easy for competitors to imitate
- It can be leveraged widely to many products and markets
- It must contribute to the end consumer's experienced benefits.

A core competency is the result of a specific unique set of skills or production techniques that deliver value to the customer. A core competency can take various forms, including technical/subject matter know-how, a reliable process and/or close relationships with customers and suppliers. It may also include product development or culture, such as employee dedication.

Core competencies are particular strengths relative to other organizations in the industry which provide the fundamental basis for the provision of added value. Core competencies are the collective learning in organizations, and involve how to coordinate diverse production skills and integrate multiple streams of technologies. It is communication, involvement, and a deep commitment to working across organizational boundaries. Such competencies empower an organization to access a wide variety of markets. Few companies are likely to build world leadership in more than five or six fundamental competencies" [9].

Penetration in new markets. When an internal market in which a company sells its products gets saturated it becomes more difficult for the business to generate high return and earnings growth. For example, the tooth paste market in the North America and Europe is fully formed since an overwhelming majority of people there understand the necessity of proper care for teeth and can afford regularly to buy tooth paste. Therefore such companies as *Procter&Gamble*, *Unilever*, *Colgate-Palmolive* began to penetrate in developing markets of China, India, and Indonesia.

The process of penetration in new markets is accompanied by two advantages. First, a company can achieve economies of scale by lowering the average cost per unit through increased production since fixed costs are shared over an increased number of goods. Second, penetration in new markets allows the company to diversify channels of income. Working in many countries companies become less dependent on sales in one country which allows them to protect themselves from possible upsets in the economy of this country.

14. Business opportunity identification and assessment

The term "business opportunity" is difficult to define because it means different things to different people. It may mean that there is a growing market for a product or service. It may mean a favorable time or chance to do business. It can be also understood as a means or condition necessary to do business. It may be understood also in terms of comparing various international markets and identifying the best one for a particular entrepreneur. Regardless of how the term is understood entrepreneurs should gather and consider relevant information to identify and assess business opportunities. Entrepreneurs trying to internationalize their activity usually make a lot of mistakes if they are not able to gather and analyze information which is vital for their businesses.

Major types of information which are usually necessary for identification and assessment of international business opportunities are:

- Target market and its size, i.e. what and how many people, companies and organizations can buy your products or services
- The level of competition in the target market
- The level of fitness of *your* product or service to local consumers, their needs and mentality
- The relative advantages of your products or services versus competitive products or services
- Priority industries and businesses for local and regional governments and opportunity to get governmental support in the host country
- The major economic and demographic data such as population, GDP, per capita income, inflation, literacy rate, education levels and unemployment rate
- The major cultural differences and peculiarities of local mentality
- An entrepreneur's potential to do business in a particular country
- Conditions for doing business in the country or target region

Conditions for doing business can be characterized by numerous criteria, major of which are costs of doing business and the development of business infrastructure. Costs of doing business can include costs of business registration, office rental, human resources, communications, utilities, consulting, currency exchange and transfer; taxes, living and other expenses should be counted too. Business infrastructure usually includes subcontracting and contract management centers, marketing centers and agencies for export promotion, leasing companies, venture funds and other financial institutions, business incubators and technopolises (or business parks), chambers of commerce and region development offices, special mass media and other institutions.

Each year, the World Bank ranks every country with various criteria on the conditions of doing business in that particular country. It uses the following criteria to rank countries: Ease of Doing Business, Starting a Business, Dealing with Licenses, Employing Workers, Registering Property, Getting Credit, Protecting Investors, Paying Taxes, Trading Across Borders, Enforcing Contracts, and Closing a Business.

After deciding on goals of investigation and criteria to be assessed, the next stage in the research process is to conduct a desk research of secondary data. Secondary data are data that have already been collected for some purpose in the past. The following sources of secondary data may be helpful for international entrepreneurs:

- International databases: Directory of United States Exporters, Port Import Export Service (PIERS), United Nations International Trade Statistics Yearbook and United States Export by Commodity.
- National and regional Chambers of Commerce both in home and host countries.
- Trade associations. Some trade associations do market surveys of their members' international activities.
- Trade publications and periodicals. Russian-American Business Magazine http://russianamericanbusiness.org/web_CURRENT/
- World bank doing business ranking <http://www.doingbusiness.org/reports/global-reports/doing-business-2010/>
- Successful entrepreneurs. It is advisable to establish a mentoring relationship with a more experienced and non-competing global entrepreneur.
- Sites of regional governments in the target country. Here is the site of the City of St.Petersburg Administration (Russia): <http://www.spb-mb.ru/index.php?page=english>

Where information gaps remain after conducting desk research it will be necessary to commission primary research and collect primary data, i.e. original data gathered specifically for

a particular decision. Primary research can be qualitative and quantitative and involve in depth interviews, focus group discussions, surveys, questionnaires and other techniques.

15. International entrepreneurial competencies and traits

Here, the competence is understood as the quality of being competent; possession of required skill, knowledge, qualification, or capacity. Skill, knowledge and qualification can be acquired by a person through education. Here they are called *competences* as such. Capacity or an individual's mental or physical ability to do something very often can be influenced by will of an individual in a greater extent than skill, knowledge or qualification. Although capacities can be trained and improved through education too and often are determined by skills, knowledge and qualification there is an obvious distinction between them. Here therefore capacities which are important for an international entrepreneur are set aside from competences and called *traits (of an entrepreneur)*.

Major desirable competencies of an international entrepreneur

Languages. Languages are especially important for small and medium sized businesses. Even if your potential clientele speak English, there isn't a better way to understand their needs and cultural desires than to learn their language. It helps make a great first impression, and it shows that you are willing to go above and beyond to maintain the relationship. In many cultures, attempting to speak the language is viewed as a sign of respect and has the potential to open doors in the future.

Communication skills. The ability to communicate is essential to the success of any undertaking but efficient communication is especially important when an entrepreneur works with a team of foreign employees and partners. Communication does not just happen. It must be organized, developed, and built. The first step in the process is to define a communications strategy. It is necessary to define objectives, transmission channels, order of internal and external communication, feedback, language for official papers, order of translation, etc.

Knowledge of basics of international entrepreneurship. Knowledge often is viewed as the most strategically important of the firm's or entrepreneur's resources. Even if an entrepreneur has experience of doing business in his home country and intends to hire professional specialists to support him in host country it is highly recommended at least to get acquainted with basics of international entrepreneurship. Knowledge of fundamentals of export and import operations, nuances of setting up a business abroad, peculiarities of national business culture will help the entrepreneur to understand much better what is going on and control the activity of assistants.

Ability to identify and evaluate business opportunities. Good business ideas do not usually just occur to an entrepreneur. Rather, they are the result of hard work and effort on the part of the entrepreneur in generating, identifying and evaluating opportunities. The ability to come up with creative solutions to needs/problems and to market them often marks the difference between success and failure in business. It also distinguishes high-growth or dynamic businesses from ordinary, average firms. Real, successful entrepreneurs are creative in identifying new products, services or business opportunities.

Deal making and negotiation. Negotiation is a fundamental business skill and a vital tool for driving value across an organization. Whether an entrepreneur is building profitable relationships with customers, suppliers, and partners or formulating complex negotiations, the ability to think fast, analyze complex deals, and achieve optimal results is critical to success. As any other skill it can be cultivated. Therefore entrepreneurs are highly recommended to develop the deal making skills needed to achieve both personal goals and drive performance throughout any organization.

Team building. Team building is an important factor in any environment, its focus is to specialize in bringing out the best in a team to ensure self-development, positive communication, leadership skills and the ability to work closely together as a team to problem solve. In an international environment, team building often refers to the process of selecting or creating a team from scratch. Made up of professionals of many nationalities and backgrounds, international teams face unique challenges. All international team members bring their own attitudes, perceptions and beliefs to the team. These differences can cause major clashes, since issues such as leadership, management and consultation styles, decision-making and trust have potentially very different meanings in the different cultures represented within each international team. However, inviting a team-building consultant or coach may be a problem in a foreign country; therefore international entrepreneurs should learn some basics about team building. This competence should include not only knowledge of the theory and practice of organizational development but also the most important elements of human resource management like knowing how to get rid of bad employees quickly without breaking the home country's law and incurring losses.

Basic knowledge of a country's geography, economy, political system, history and customs. It may be not only difficult to do business in a foreign country without knowing all these things but also destructive for establishing personal contacts with local nationals since they can take a complete ignorance of their culture as an offense.

Major desirable personal traits of an international entrepreneur

Entrepreneur-spirit/entrepreneurial-mindset. Schumpeter came up with the German word *Unternehmergeist*, meaning *entrepreneur-spirit*, also known as *entrepreneurial-mindset*. *Entrepreneur-spirit/entrepreneurial-mindset* can be described as a group of personal dispositions, which lead to the innovative practice of identifying and/or creating opportunities, then acting to manifest those opportunities in a productive way. Scholars believe that somebody with an entrepreneurial mindset has the *means*, *ability*, and the *desire* (MAD) to materialize his vision. If any of those three pillars do not exist, then the entrepreneurial mindset does not exist. Some believe that everything begins from desire. Schumpeter called entrepreneurs *wild spirits*. A strong desire to win, and a readiness to fight to the end, are, perhaps, the most important traits of an international entrepreneur. Currently some scholars believe that not all people can have entrepreneurial-mindset while others provide persuading evidence that each of us can be creative and entrepreneurial.

Tolerance and patience. Perhaps the most important qualities to bring to a foreign country are tolerance and patience. It is not uncommon for international entrepreneurs to have moments of exhilaration and moments of frustration. The success of their experience depends in large measure upon their own efforts to acclimate themselves to living and working in a foreign country.

Creativity and flexibility. International entrepreneurs can encounter poor infrastructure, legal barriers, bureaucracy and many other unpleasant things therefore they have to be not only patient but also more creative and flexible abroad than in their own countries.

Ability to cope with stress. It is a very good idea to learn how to cope with stress before going abroad. Currently many effective technics have been developed to help managers and businessmen to cope with continuous stress.

Chapter 2

The Russian Marketplace in a Global Context

1. Globalization and internationalization

International entrepreneurship is both a cause and result of globalization. To better understand factors that can influence an international business we have to understand the essence and causes of globalization. It is also desirable to understand the difference between globalization and internationalization.

“Since its inception, the concept of globalization has inspired numerous competing definitions and interpretations, with antecedents dating back to the great movements of trade and empire across Asia and the Indian Ocean from the 15th century onwards.

The United Nations ESCWA¹ says globalization is a widely-used term that can be defined in a number of different ways. When used in an economic context, it refers to the reduction and removal of barriers² between national borders in order to facilitate the flow of goods, capital, services and labor... although considerable barriers remain to the flow of labor...” [10].

Globalization is a continuous and steady process of integration of markets, sovereign states, cultures and technology with the goal to increase material wealth, goods, and services through communication, transportation, trade and an international division of labor by efficiencies created by international relations, specialization and competition.

So, globalization, in terms of economy, can be understood as the integration of national economies into the global economy through trade, foreign direct investment, capital flows, migration and the spread of technology.

“The term can also refer to the transnational circulation of ideas, languages, or popular culture through acculturation” [10].

Internationalization can be understood as a process of cooperation among nations, especially in politics and economic matters. Internationalization is also a process of making something international in character or free for international use, bringing under the control or protection of all or many nations.

Sometimes the terms internationalization and globalization are used interchangeably but there is a slight formal difference. The term ‘internationalization’ refers to the importance of international trade, relations, treaties, *etc.* International means between or among nations. Internationalization leaves cultures and practices largely untouched. It assumes that societies defined as nation-states continue to function as bounded economic, social and cultural systems even when they become more interconnected. In contrast globalization has a potential to remake the daily practices of people in the most globalized areas such as research, science, policy and executive leadership. Globalization is more obviously transformative than internationalization. Globalization goes directly to the communication hubs and to the economic, cultural and political core of nations remaking the heartlands where national and local identities are formed and reproduced. So internationalization implies existence of differences between nations while globalization means erasure of national

¹ United Nations Economic and Social Commission for Western Asia

² The major barriers to international trade, for example, are tariffs, export fees, import quotas, *etc.*

boundaries for economic purposes; globalization erases differences between nations. (UNESCO 2003).

2. Globalization and its underlying conditions

The growth of international business in recent years has been quite obvious and highly impressive. But why such development has been possible? Why is the possibility of further activation of international business so high?

Globalization and internationalization are usually recognized as being driven by a combination of economic, technological, sociocultural, political, and biological factors. There are numerous economic theories³ which try to explain why there are international activities. For example, theories of absolute and comparative advantage say that two countries (or other kinds of parties, such as individuals or firms) can both gain from trade if, in the absence of trade, they have different relative costs for producing the same goods. Even if one country is more efficient in the production of all goods (absolute advantage), it can still gain by trading with a less-efficient country, so long as these countries have different relative efficiencies (relative advantage). Relative advantage simply means that the ratio of the labor embodied in any two commodities differs between two countries, such that each country would have at least one commodity where the relative amount of labor embodied would be less than that of the other country.

It is impossible to consider all those theories within the frameworks of this manual but the concerned reader can find their concise descriptions in [11].

Currently there are many international bodies which are behind the globalization movement. Such organizations as the International Monetary Fund, the World Bank, the World Trade Organization, to name but a few in the field, facilitate globalization.

As we have already seen in chapter I there are some strategic needs and incentives which push companies to go global. At the same time, such an increase in international business operations to irresistible proportions that the world has seen after World War II would be impossible without significant changes in the business environment particularly in the political and technological conditions for doing business.

The change of political environment. After the World War I, many countries including the USA, France, Great Britain and Germany set up custom tariffs and quotas for imported goods and ensured favorable conditions for national companies to do business providing them with state contracts for the supply of products. As the result the scope of international trade and international investment decreased significantly. However, after World War II, this practice was fully reconsidered. Many countries involved in international trade conducted negotiations on reduction of custom tariffs and quotas and elimination of restrictions for international investment. Many of these agreements were concluded in the process of preparation of the General Agreement on Tariffs and Trade, GATT, and also as the results of efforts made by its

³ Absolute cost advantage (Adam Smith, 1776), Comparative cost advantage (David Ricardo, 1817), Gravity model of trade (Walter Isard, 1954), Heckscher-Ohlin model (Eli Heckscher, 1966 & Bertil Ohlin, 1952), Leontief paradox (Wassily Leontief, 1954), Linder hypothesis (Staffan Burenstam Linder, 1961), Location theory, Market imperfection theory (Stephen Hymer, 1976 & Charles P. Kindleberger, 1969 & Richard E. Caves, 1971), New Trade Theory, Specific factors model, Diamond model (Michael Porter), Diffusion of innovations (Rogers, 1962), Eclectic paradigm (John H. Dunning), Foreign direct investment theory (FDI), Monopolistic advantage theory (Stephen Hymer), Non-availability approach (Irving B. Kravis, 1956), Technology gap theory of trade (Posner), Uppsala model, Behavioral theory of the firm (Richard M. Cyert & James G. March, 1963; Yair Aharoni, 1966), Contingency theory, Contract theory, Economy of scale, Internalization theory (Peter J. Buckley & Mark Casson, 1976; Rugman, 1981), Product life cycle theory (Raymond Vernon, 1966), Transaction cost theory, Theory of the growth of the firm (Edith Penrose, 1959), etc

legal successor – the World Trade Organization. Regional agreements such as the European Union, the South America Common Market (Mercado Común del Sur, MERCOSUR) and the North America Trade Agreement, NAFTA, also have weakened restrictions on investment activity and trade between member states.

The change of technological environment. While political changes stimulated international business operations, new technology (especially in communications, transportation and data processing) made international business easier and more profitable. Management automation tools, for example, make processes easier to execute, facilitate timely information sharing and enable consistent coordination between elements and layers of international organizations. Some experts believe that the unprecedented productivity of the US economy in 90's was caused (at least partially) by active introduction of information technology in ordinary and business life.

There are at least three aspects of the internet and other information technologies impact on international entrepreneurship. First, the internet and other information technologies support international commercial activity in the sphere of services including such different industries as banking, consulting, education, retail trade and even the gambling business. Many Canadian and American companies, for example, relocated their subdivisions providing customer services and processing data to other countries with relevant expertise and lower costs. Since all operations can be performed with the help of electronic technology, it may not be required for the enterprise and its subdivisions to be in close geographic proximity.

Second, the internet and other information technologies allow, at least to some extent, leveling conditions of doing business for large and small businesses. In the past, foreign market penetration demanded significant investment from a company; nowadays however skillful utilization of the internet can change the situation. A small company can develop an effective web site and compete with larger companies from any country in the world.

Third, the internet and other information technologies have tremendous potential for forming professional networks of commercial organizations. So called business-to-business networks (networks providing inter-corporate connections) allow unifying global companies, their suppliers, customers and strategic partners into a united information system facilitating and simplifying business operations.

3. The role and place of Russia in a global economy

The place and role of any country in the world economy depends on many factors. The main factors are:

- The geographic location, population and natural resources
- The level and dynamics of economic development
- The extent of openness of national economy
- The level of involvement in the international division of labor
- The level of development of foreign economic relations
- The ability of national economy to adapt to conditions of the world economic activity and simultaneously influence them in a desirable direction
- A friendly legal environment for foreign investment, and
- The presence of transnational corporations

Russia is an important element of the global economic system. "Following the Russian Revolution of 1917, Russia became the largest and leading constituent of the Soviet Union, the world's first constitutionally socialist state and a recognized superpower that played a decisive role in the Allied victory in World War II. The Soviet era saw some of the greatest technological achievements of the 20th century, such as the world's first human spaceflight.

The Russian Federation was founded following the dissolution of the Soviet Union in 1991, but is recognized as the continuing legal personality of the Soviet state. As of 2011, Russia has the world's 11th largest economy by nominal GDP (\$ 1,465,079 ml) or the 6th largest by purchasing power parity (\$2,222,957 ml) and 40th largest by GDP PPP⁴ per capita (\$15,807), with the 5th largest nominal military budget. It is one of five recognized nuclear weapons states and possesses the largest stockpile of weapons of mass destruction. Russia has had one of the world's fastest GDP growth rates of 7.4% from 2001-2008.

Russia is a great power and a permanent member of the United Nations Security Council, a member of the G8, G20, the Council of Europe, the Asia-Pacific Economic Cooperation, the Shanghai Cooperation Organization, the Eurasian Economic Community, the Organization for Security and Cooperation in Europe (OSCE), and is the leading member of the Commonwealth of Independent States. Russia has been characterized as a potential superpower by a number of academics, military analysts, and public policy and economics analysts” [12].

Currently Russia is still described as a transitional economy that is an economy which is changing from a centrally planned economy to a free market. Transition economies undergo economic liberalization, where market forces set prices rather than a central planning organization and trade barriers are removed, privatization of government-owned enterprises and resources, and the creation of a financial sector to facilitate macroeconomic stabilization and the movement of private capital. The process has been applied also in China, the former Soviet Union and Communist bloc countries of Europe, and many third world countries.

“In recent years, new terms have emerged to describe the largest rapidly developing countries such as BRIC that stands for Brazil, Russia, India, and China, along with BRICET (BRIC + Eastern Europe and Turkey), BRICS (BRIC + South Africa), BRICM (BRIC + Mexico) , BRICK (BRIC + South Korea), Next Eleven (Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, South Korea, Turkey, and Vietnam) and CIVETS (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa). These countries do not share any common agenda, but some experts believe that they are enjoying an increasing role in the world economy and on political platforms” [13].

The following table is a predictive list of six largest economies by incremental nominal GDP from 2010 to 2016 by International Monetary Fund [14].

Table 2.1

Predictive list of economies by incremental nominal GDP from 2010 to 2016

Rank	Country	Incremental GDP (billions of US\$)
1	China	5,341.916
2	United States	4,149.747
3	Russia	1,772.167
4	India	1,239.314
5	Brazil	1,212.544
6	Japan	1,080.684

Geography

“Russia is the largest country in the world in area; its total area is 17,075,400 square kilometers (6,592,800 sq mi). It extends across the whole of northern Asia and 40% of Europe, spanning nine time zones and incorporating a wide range of environments and landforms. The two widest separated points in Russia are about 8,000 km (4,971 mi) apart along a geodesic line. The

⁴ purchasing power parity

distance between Moscow and Vladivostok makes about 10,800 kilometers. Russia comprises roughly three-quarters of the territory of the former Soviet Union.

From northwest to southeast, Russia shares borders with Norway, Finland, Estonia, Latvia, Lithuania and Poland (both via Kaliningrad Oblast), Belarus, Ukraine, Georgia, Azerbaijan, Kazakhstan, the People's Republic of China, Mongolia, and North Korea. It also has maritime borders with Japan by the Sea of Okhotsk, and the United States by the Bering Strait.

Most of Russia consists of vast stretches of plains that are predominantly steppe to the south and heavily forested to the north, with tundra along the northern coast. The steppe has long been depicted as the typical Russian landscape. It is a broad band of treeless, grassy plains, interrupted by mountain ranges, extending from Hungary across Ukraine, southern Russia, and Kazakhstan before ending in Manchuria. Russia possesses 10% of the world's arable land.

Russia has the world's largest forest reserves (8,087,900 km²), known as "the lungs of Europe", second only to the Amazon Rainforest in the amount of carbon dioxide they absorb. The taiga, which is the world's largest forest region, consists mostly of coniferous spruce, fir, pine, and larch. This is the largest natural zone of Russia, an area about the size of the United States. In the northeastern portion of this belt (with the Northern Pole of Cold located in Yakutia), long and severe winters frequently bring the world's coldest temperatures for inhabited areas (with the record low temperature of $-68^{\circ}\text{C}/-90.4^{\circ}\text{F}$). About 33% of Russia's population lives in this zone.

Russia has an extensive coastline of over 37,000 km (22,991 mi) along the Arctic and Pacific Oceans, as well as along the Baltic Sea, Sea of Azov, Black Sea and Caspian Sea. The coastal part of Krasnodar Krai on the Black Sea, most notably in Sochi, possesses a humid subtropical climate with mild and wet winters.

Russia has thousands of rivers and inland bodies of water providing it with one of the world's largest surface water resources. Of the country's 100,000 rivers, the Volga is the most famous, not only because it is the longest river in Europe, but also because of its major role in Russian history. The largest and most prominent of Russia's bodies of fresh water is Lake Baikal, the world's deepest, purest, oldest and most capacious freshwater lake. Baikal alone contains over one fifth of the world's fresh surface water.

There are 23 UNESCO World Heritage Sites in Russia, 40 UNESCO biosphere reserves, 40 national parks and 101 nature reserve” [12].

Demographics

“The population of the Russian Federation is approximately 142 million as of 1 January 2010 (8th in the world). Of that, 79.3% live in the European portion of the country and 20.7% live in the Asian portion. Although approximately 80% of the country's population is ethnically Russian, the Russian Federation is a multinational state and is home to numerous ethnic minority groups, including sizeable Tatar (3.8%) and Ukrainian (2%) populations. In total, 160 different other ethnic groups and indigenous peoples live within its borders. Though Russia's population is comparatively large, its density is low because of the country's enormous size. Average population density is 8.3/sq km or 21.5/sq mi (217th in the world). It varies from 56.9 inhabitants per square kilometer in the Central Federal District to 1.2 inhabitants per square kilometer in the Far Eastern Federal District. Roughly 73% of the population lives in urban areas, and 13 cities have a population of over one million. The largest city in Russia is Moscow, with a population of approximately 11.5 million, followed by St. Petersburg, with a population of approximately 5 million. The total number of economically active people is 75.89 million (approximately 53.5%

of the RF population). Most of them are occupied in trade and domestic service industries (17.7%), manufacturing (16.5%) and agriculture (9.8%).

Russian is the only official state language, but the Constitution gives the individual republics the right to make their native language co-official next to Russian. Russian is one of the six official languages of the UN. It is also widely used in former Republics of the USSR. The Russian Language Center says a quarter of the world's scientific literature is published in Russian. It is also applied as a means of coding and storage of universal knowledge – 60-70% of all world information is published in the English and Russian languages.

The Russian Constitution guarantees free, universal health care for all citizens. While Russia has more physicians, hospitals, and health care workers than almost any other country in the world on a per capita basis, since the collapse of the Soviet Union the health of the Russian population has declined considerably as a result of social, economic, and lifestyle changes; the trend has been reversed only in recent years, with an average life expectancy having increased 2.4 years for males and 1.4 years for females between 2006-09. As of 2009, the average life expectancy in Russia was 62.77 years for males and 74.67 years for females. As a result of the large gender difference in life expectancy and because of the lasting effect of high casualties in World War II (27 million people), the gender imbalance remains to this day and there are 0.859 males to every female.

Russia has a free education system guaranteed to all citizens by the Constitution of the Russian Federation, however entry to higher education is highly competitive. As a result of great emphasis on science and technology in education, Russian medical, mathematical, scientific, and aerospace research is generally of a high order.

Since 1990 11-years of school training has been introduced. Education in state-owned secondary schools is free; first tertiary (university level) education is free with reservations: a substantial share of students is enrolled for full pay (many state institutions started to open commercial positions in the last years)" [12].

Natural resources and related companies

Russia is the world's largest mineral and energy supply and is known as an "energy superpower". This country takes 1st place in the world in per capita resources.

Oil and gas. "Russia is ranked first in the world by gas reserves and may contain as much as 35-40% of the world's supply of natural gas. It has proven reserves nearly twice that of Iran, the number two spot holder. It's reserves of oil are debated, but the US Geologic Survey estimates that they may be as high as 25% of the world's oil. The US Department of Energy states: "Russia is also the world's largest exporter of natural gas, the second largest oil exporter (10% share of world production), and the third largest energy consumer."

Gazprom is Russia's largest company overall and produces 18% of the world's natural gas. Via its purchase of the oil company, Sibneft, now renamed *Gazpromneft*, the country also controls substantial amounts of oil. *Gazprom* is the world's thirteenth largest company in terms of market capitalization. 2008 profits were declared at more than 23 billion USD. *Gazprom* has a monopoly on natural gas exports from Russia, but not on domestic production; both *Lukoil* and *Rosneft* also produce substantial amounts of natural gas.

Lukoil is Russia's largest oil company (and sixth largest in the world). It owns wells, refineries, and a chain of gas stations which has been franchised in the US. Net income declared for 2008 amounted to nearly 9.1 billion. It is unique among Russian hydrocarbon companies in that the majority of its shares are held by minority stock holders.

Rosneft became a major player in Russian oil after its controversial takeover of Yukos' main oil production unit. For 2008, total profits were reported at more than 11.1 billion USD. *Rosneft* is majority owned by the Russian government and made headlines for a planned 20 billion USD IPO (it actually made 10.4 billion, making it the fifth largest ever IPO). As Erik Kraus, a Moscow financial analyst, forewarned, investors, knowing a profitable proposition when they see one, will "hold their noses" and buy.

Surgutneftegas is another of Russia's largest publicly traded oil companies. With revenues of more than 15 billion USD per year, it's also among the world's largest companies. It also stands out on the Russian market as a company dedicated to reinvesting profits in new technologies and exploring new deposits.

Iron, coal, and steel. Russia may hold as much as 30% of the world's iron. It is the world's third largest exporter of hard coal and contains coal reserves second only to the US (11% of world's reserves). Russia also produces 5% of the world's steel and is the world's fifth largest steel exporter. Because of the abundance of both iron and coal, Russian steel companies are some of the world's most profitable. The companies below, like most steel companies world-wide, hold interests in all three resources. There has also been, starting in about 2006, a drive by Russian companies to acquire holdings in America – one of the world's biggest markets for steel consumption and production.

Severstal posted two billion USD in profit for 2008. The company was led to its current status by Alexey Mordashov, its Russian CEO who is also a major shareholder. The company was involved in 2006 in a highly publicized merger deal with *Arcelor*, a Luxembourg-based steel company, which would have created the world's largest steel producer. The deal fell through and *Arcelor* was then merged with *Mittal* (already the world's biggest steel company). *Severstal* continues to push for a global reach however, and says that 40% of its steel is now produced outside of Russia and half its Russian production is exported. *American Holdings: Rouge Steel* in Michigan was acquired in 2003 for 285.5 million USD. *Sparrows Point* in Maryland was acquired for 810 million USD in May 2008. *Esmark* in Illinois was acquired for 775 million USD in August 2008. *PBS Coals* in Pennsylvania was acquired in August 2008 for 1.3 billion USD. *Severstal* is additionally a joint partner in *Severcorr*, a "next generation steel plant" built by several steel industry veterans in Mississippi.

Magnitogorsk Iron and Steel Works (Magnitka; MMK) posted 1 billion USD in profit for 2008. The original factory was pronounced a "hero factory" of the Soviet Union for the steel it made for Soviet tanks, but today is completely held by private investors. It recently began a new factory in India worth 10 billion USD, and has purchased a plant in Turkey worth about 2 billion USD total. *American Holdings:* in 2007, the company was planning to build a 1 billion USD steel plant in Ohio, but the economic crisis forced the company to put these plans on hold.

Mechel claimed a 4.6 billion gross profit for 2008, but holds more diversified interests in nickel and trade ports.

Evrast produces more steel in Russia than any other company and recorded nearly 1.87 billion USD in profit for 2008. *Evrast* accounts for 23% of the world's production of rails for railroad construction. Russian railways buys nearly 60% of this production. While nearly all *Evrast's* activities are in Russia, and while nearly all the staff including management are Russian, the company is registered in Luxembourg. *American Holdings: Oregon Steel Mills* in Oregon was acquired for 2.3 billion in 2007. *Claymont Steel Holdings* in Delaware was purchased for 565

million USD in 2008. *IPSCO*, with assets in the US and Canada, was purchased jointly with *TMK Stratcor*, an American company, for 4.025 billion USD in June, 2008.

Novolipetsk Steel (NLMK) produced 15% of all Russian steel in 2008. Its gross profit for 2008 amounted to 5.39 billion USD and its market value is ranked second in Russia's heavy-hitting market. Originally opened as a state-owned enterprise in 1931, the factory has recently turned into a leader in upgrading equipment and, since 2006, in acquiring assets abroad. *American Holdings*: It owns 50% of *Duferco's* U.S. assets. It acquired John Maneely Steel in Ohio for 3.53 billion in 2008 and shortly thereafter acquired *Beta Steel* in Indiana for an additional 400 million USD.

Aluminium. Aluminium is obtained from alumina, which itself is obtained from bauxite ore. Russia controls less than 1% of the world's bauxite but produces 11% of all aluminum. This is possible in large part due to Russia's cheap supplies of electricity. Aluminum is useful in food packaging, but also essential to modern aircraft (including commercial airliners, space shuttles, and fighter jets).

Rusal controls 11% of the world's aluminum market (it also owns smelters in Africa). Its recent 8 billion expansion project involved buying *Sual*, its only major Russian competitor, to push it to number one in the world in aluminum production, taking the title from *Alcoa*, an American company that now stands in second place.

Other Metals. Russia holds as much as 33% of the world's reserves of nickel and produces 17% of the world's nickel (used in making stainless steel and the batteries used in many hybrid cars). Russia also produces 41% of the world's palladium (used in everything from catalytic converters to electronics to dental equipment), 8% of the world's cobalt (essential in the construction of space craft and turbine engines), 9% of all boron (used in the manufacture of glass and ceramic), 4% of all cadmium (household batteries), and 5% of all tungsten (light bulbs, electronics, heating equipment). About 22% of the world's titanium sponge extraction occurs in Russia. Titanium sponge is the major source of titanium, one of the world's strongest metals, which is used in military vehicles, arms manufacture, nuclear power stations, aircraft and shipbuilding, and drilling equipment. Russia also produces about 4.3% of the world's magnesium, most often used to raise the melting point of alloys (but has widely varied uses in agriculture, medicine, industry, and chemistry). Russia also holds as much as 15% of the world's reserves of zinc and 10% of lead.

Norilsk Nickel is one of Russia's largest mining and metals companies. It controls the majority of Russia's nickel, copper, and palladium production, and faces only fractured competition from within Russia. It produced 300,000 tons of nickel in 2008 alone. *Norilsk Nickel* is owned by the conglomerate *Interros Holding*, headed by Russian billionaire Vladimir Potanin. Its fate has long been undecided, however. In 2006, it was rumored that it may be merged with *Alrosa*, Russia's diamond monopoly in a move some analysts say may be the beginning of a state-controlled mining monopoly. That move never happened. Now, *Rusal*, Russia's number-one aluminum producer, is poised to buy a blocking share of the company. Investors are wondering, however, just how advantageous the move will be for either company.

Mechel, primarily a steel producer, also produces nickel (about 5% of Russian production).

UfaleiNikel is also often listed as major producer, though its production of 10,700 tons per year is dwarfed by *Norilsk's* production.

Two companies are often listed as "major competitors" for copper production: *UGMK*, and *Russian Copper Company* (no website).

VSMPO-Avisma is the world's largest titanium company, controlling 30% of the global market and all of Russia's exported titanium. *VSMPO-Avisma* also mines substantial amounts of magnesium. *Rosoboronexport*, Russia's state arms export monopoly, owns 51% of the company, with the rest held by private Russian investors.

Solikamsk is Russia's number two magnesium producer - producing 17,600 tons per year, just behind *VSMPO-Avisma's* 19,000.

Uranium. Russia controls 10% of the world's total uranium reserves and supplies about 8% of the world's needs. Both numbers are significantly higher if Russia's interests in uranium mining and export in Ukraine, Kazakhstan, Mongolia, Uzbekistan, and Kyrgyzstan are also considered.

TVEL is a private company, but wholly owned and managed by the *Federal Atomic Energy Agency (FAAE)*. *TVEL* controls 100% of uranium mining in Russia, which takes place mostly in the Chita Region by a *TVEL* subsidiary, the *Priargunskiy Mining and Chemical Combine (PMCC)*.

Texsnabexport (Tenex) is also registered as a private company and is owned and managed by the *FAAE*. It controls 100% of uranium exports from Russia as well as supplies various materials to factories owned by the *FAAE* and commercially imports speciality goods such as medical, biotech, and scientific equipment and protective clothing.

Gold. Russia is considered the world's largest unexplored gold territory, with many of its sizable deposits having been only recently discovered. Estimates vary quite widely, but Russia likely holds 25-40% of the world's unmined gold supply. Russia is currently the sixth largest gold producer in the world and is tenth on the list of the world's largest gold reserves.

Polyus Gold was formed when Russian metals giant *Norilsk Nickel* spun off its holdings in gold. Both companies are owned by *Interros*, a conglomerate that also spans banking, agriculture, and communications. *Polyus* is the largest Russian gold producer and holds a 20% stake in *Gold Fields*, one of Africa's largest gold producers. Its profit for 2008 was more than 160 million USD. The company is traded on the Russian, London, and New York stock exchanges and is worth about 9 billion USD.

Polymetal is Russia's number three gold producer. It also holds the number one slot for silver production in Russia (and the number five slot in terms of world production). Profit for 2008: more than 43.1 million USD.

The gold industry is still highly fractured in Russia, with over 600 companies in play. The development of large Russian holdings such as *Polyus* and *Polymetal*, as well as the entry of international gold giants such as *Peter Hambro Mining* (currently Russia's number two gold producer) and *Barrick Gold* should help the Russian market continue to grow by providing companies with the resources necessary to develop large, new fields.

Diamonds and gemstones. Russia is a world leader in both natural diamond and artificial diamond production. In volume, Russia controls nearly 25% of global gemstone production and 20% of the global production of industrial grade diamonds.

Alrosa is Russia's diamond monopoly. Federal, regional, and local governments own about 77% of the company, with the rest held by employees and other investors. The company is worth upwards of 6.5 billion USD and declared 112.8 million USD in profits for 2008.

Lev Leviev is also worth mentioning. He assisted the former Soviet Union in setting up its diamond enterprises in the 1980s. He later took over several of them in Central Asia in the 90s. He has since become a major competitor for *DeBeers* and now controls as much as one third of the world's diamond trade. *Leviev* distributes 30 million USD a year to restore synagogues and "support the restoration of the Jewish way of life." He now holds Israeli citizenship" [15].

Russia possesses rich reserves of other minerals: manganese, chromium, platinum, copper, silver, tin, mercury, phosphates, potassium (the world's second largest reserves) and many others. So Russia is self-sufficient in nearly all major industrial raw materials and has at least some reserves of every industrially valuable nonfuel mineral – even after the productive mines of Ukraine, Kazakstan, and Uzbekistan no longer are directly accessible. However, most such resources are located in remote and climatically unfavorable areas that are difficult to develop and far from Russian ports.

Economy

“For over 70 years, the Russian economy and that of the rest of the Soviet Union operated on the basis of central planning – state control over virtually all means of production and over investment, production, and consumption decisions throughout the economy. Since the collapse of the Soviet Union in 1991, Russia has tried to develop a globally integrated market economy and achieve consistent economic growth.

The Russian economy underwent tremendous stress as it moved from a centrally planned economy to a free market system. The nation had two fundamental and independent goals – macroeconomic stabilization and economic restructuring – the transition from central planning to a market-based economy. The former entailed implementing fiscal and monetary policies that promote economic growth in an environment of stable prices and exchange rates. The latter required establishing commercial and institutional entities – banks, private property, and commercial legal codes— that permit the economy to operate efficiently. Opening domestic markets to foreign trade and investment, thus linking the economy with the rest of the world, was an important aid in reaching these goals. The Gorbachev regime failed to address these fundamental goals. At the time of the Soviet Union's demise, the Yeltsin government of the Russian Republic had begun to attack the problems of macroeconomic stabilization and economic restructuring. By mid-1996, the results were mixed.

In October 1991, Yeltsin announced that Russia would proceed with radical, market-oriented reform along the lines of "shock therapy", as recommended by the United States and IMF. However, this policy resulted in economic collapse, with millions being plunged into poverty and corruption and crime spreading rapidly. Hyperinflation resulted from the removal of Soviet price controls and again following the 1998 Russian financial crisis. Assuming the role as the continuing legal personality of the Soviet Union, Russia took the responsibility for settling the USSR's external debts, even though its population made up just half of the population of the USSR at the time of its dissolution. Once all enterprises belonged to the state and were supposed to be equally owned amongst all citizens, but they fell into the hands of a few, who became immensely rich. Stocks of the state-owned enterprises were issued, and these new publicly traded companies were quickly handed to the members of *Nomenklatura* or known criminal bosses. For example, the director of a factory during the Soviet regime would often become the owner of the same enterprise. During the same period, violent criminal groups often took over state enterprises, clearing the way by assassinations or extortion. Corruption of government officials

became an everyday rule of life. Under the government's cover, outrageous financial manipulations were performed that enriched the narrow group of individuals at key positions of the business and mafia. Many took billions in cash and assets outside of the country in an enormous capital flight. That being said, there were corporate raiders such as Andrei Volgin engaged in hostile takeovers of corrupt corporations by the mid-1990s.

The largest state enterprises were controversially privatized by President Boris Yeltsin to insiders for far less than they were worth. Economic reforms in the 1990s privatized most industry, with notable exceptions in the energy and defense-related sectors. Nonetheless, the rapid privatization process, including a much criticized "loans-for-shares" scheme that turned over major state-owned firms to politically connected "oligarchs", has left equity ownership highly concentrated. Many Russians consider these infamous "oligarchs" to be thieves. Through their immense wealth, the oligarchs wielded significant political influence. As of 2011, Russia's capital, Moscow, now has the highest billionaire population of any city in the world.

Difficulties in implementing fiscal reforms aimed at raising government revenues and a dependence on short-term borrowing to finance budget deficits led to a serious financial crisis in 1998. Lower prices for Russia's major export earners (oil and minerals) and a loss of investor confidence due to the Asian financial crisis exacerbated financial problems. The result was a rapid decline in the value of the ruble, flight of foreign investment, delayed payments on sovereign and private debts, a breakdown of commercial transactions through the banking system, and the threat of runaway inflation.

Russia, however, appears to have weathered the crisis relatively well. Since the turn of the 21st century, higher domestic consumption and greater political stability have bolstered economic growth in Russia. The country ended 2008 with its ninth straight year of growth, averaging 7% annually between 2000 and 2008. Real GDP per capita, PPP (current international \$) was 19,840 USD in 2010. Growth was primarily driven by non-traded services and goods for the domestic market, as opposed to oil or mineral extraction and exports. The average nominal salary in Russia was \$640 per month in early 2008, up from \$80 in 2000. At the end of 2010 the average nominal monthly wages reached 21,192 RUR (or \$750 USD), while tax on the income of individuals is payable at the rate of 13% on most incomes. Approximately 13.7% of Russians lived below the national poverty line in 2010, significantly down from 40% in 1998 at the worst point of the post-Soviet collapse. Unemployment in Russia was at 6.5% in 2011, down from about 12.4% in 1999. The middle class has grown from just 8 million persons in 2000 to 55 million persons in 2006.

Oil, natural gas, metals, and timber account for more than 80% of Russian exports abroad. Ninety percent of Russian exports to the United States are minerals or other raw materials. Since 2003, however, exports of natural resources started decreasing in economic importance as the internal market strengthened considerably. Despite higher energy prices, oil and gas only contribute to 5.7% of Russia's GDP and the government predicts this will drop to 3.7% by 2011. Oil export earnings allowed Russia to increase its foreign reserves from \$12 billion in 1999 to \$597.3 billion on 1 August 2008 (\$531 billion as of July 2011), the third largest foreign exchange reserves in the world (after China and Japan). On January 1, 2004, the Stabilization fund of the Russian Federation was established by the Government of Russia as a part of the federal budget to balance it if oil price falls. The macroeconomic policy under Finance Minister Alexei Kudrin was prudent and sound, with excess income being stored in the Stabilization Fund of Russia. In 2006, Russia repaid most of its formerly massive debts, leaving it with one of the lowest foreign debts among major economies (\$39.798 billion as of February, 2011). In 2007 the World Bank declared that the Russian economy had achieved "unprecedented macroeconomic stability". The Stabilization Fund helped Russia to come out of the global financial crisis in a

much better state than many experts had expected. In late 2008 and early 2009, Russia experienced the first recession after 10 years of rising economy, until the stable growth resumed in late 2009 and 2010. Despite the deep but brief recession, the economy has not been as seriously affected by the global financial crisis when compared to much of Europe, largely because of the integration of short-term macroeconomic policies that helped the economy survive.

A simpler, more streamlined tax code adopted in 2001 reduced the tax burden on people and dramatically increased state revenue. Russia has a flat tax rate of 13 percent. This ranks it as the country with the second most attractive personal tax system for single managers in the world after the United Arab Emirates. According to Bloomberg, Russia is considered well ahead of most other resource-rich countries in its economic development, with a long tradition of education, science, and industry. The country has more higher education graduates than any other country in Europe.

The economic development of the country has been uneven geographically with the Moscow region contributing a very large share of the country's GDP. Another problem is modernization of infrastructure, ageing and inadequate after years of being neglected in the 1990's; the government has said \$1 trillion will be invested in development of infrastructure by 2020" [16].

"In 2010, Aleksei Kudrin in his traditional annual speech at the Higher School of Economics in Moscow took as examples other European countries to highlight how much needs to be done in Russia. For instance, while all of Russia's large companies collectively spent just 800 million USD in R&D in 2009, one single US firm, General Motors, invested 8 billion; in 2008, 9.6% of Russian firms implemented technological innovations, while in the same year the figure was 73% for Germany and 47% for Estonia. Furthermore, while the Finance Ministry refused to concede loans for Institutes reporting to the Academy of Science, foreign industrial companies took over, becoming the owners of Russia's technological inventions" [18].

Industries

Russia is one of the most industrialized of the former Soviet republics. In the 2000s, Russia's industry emerged from a deep crisis caused by the dissolution of the Soviet Union, due to increasing demand and improved state finances. However, years of low investment continue to leave their mark on industry capabilities and a lot of its equipment is in need of modernization. Besides its resource-based industries, Russia has developed large manufacturing capacities, notably in machinery. The defense and aircraft industries are important employers and are able to offer internationally competitive products for export.

Space. The Russian economy boomed from high prices for exports, such as oil and gas. This resulted in the Russian Duma approving a budget of 305 billion rubles (about 11 billion USD) for the Space Agency from 2006 to 2015, with overall space expenditures in Russia totaling about 425 billion rubles for the same time period. The budget for 2006 was as high as 25 billion rubles (about 900 million USD), which is a 33% increase from the 2005 budget. Under the current 10 year budget approved, the budget of the Space Agency will increase 5–10% per year, providing the space agency with a constant influx of money. In addition to the budget, Roskosmos (Russian Space Agency) plans to have over 130 billion rubles flowing into its budget by other means, such as industry investments and commercial space launches.

The federal space budget for the year 2009 was left unchanged despite the global economic crisis, standing at about 82 billion rubles (\$2.4 billion). Current priorities of the Russian space program include the new Angara rocket family and development of new communications, navigation and remote Earth sensing spacecraft. The GLONASS global navigation satellite

system has for many years been one of the top priorities and has been given its own budget line in the federal space budget. In 2007, GLONASS received 9.9 billion rubles (\$360 million), and under the terms of a directive signed by Prime Minister Vladimir Putin in 2008, an additional \$2.6 billion will be allocated for its development.

Aircraft industry. Aircraft manufacturing is an important industry sector in Russia, employing around 355,300 people. The Russian aircraft industry offers a portfolio of internationally competitive military aircraft such as MiG-29 and Su-30, while new projects such as the Sukhoi Superjet 100, Tu-204, Tu-214, An-148 are hoped to revive the fortunes of the civilian aircraft segment. In 2009, companies belonging to the United Aircraft Corporation delivered 95 new fixed-wing aircraft to its customers, including 15 civilian models. In addition, the industry produced over 141 helicopters. It is one of the most science-intensive hi-tech sectors and employs the largest number of skilled personnel. The production and value of the military aircraft branch far outstrips other defense industry sectors, and aircraft products make up more than half of the country's arms exports.

Defense industry. Russia's defense industry employs 2.5–3 million people, accounting for 20% of all manufacturing jobs. Russia is the world's second largest conventional arms exporter after the United States. The most popular types of weaponry bought from Russia are Sukhoi and MiG fighters, air defense systems, helicopters, battle tanks, armored personnel carriers and infantry fighting vehicles. The research organization Centre for Analysis of Strategies and Technologies ranked the air defense system producer Almaz-Antey as the industry's most successful company in 2007, followed by aircraft-maker Sukhoi. Almaz-Antey's revenue that year was \$3.122 billion, and it had a work force of 81,857 people.

Telecom. Russia's telecommunications industry is growing in size and maturity. As of 31 December 2007, there were an estimated 4,900,000 broadband lines in Russia. Over 72% of the broadband lines were via cable modems and the rest via DSL (Digital Subscriber Line, a family of technologies that provides digital data transmission over the wires of a local telephone network).

In 2006, there were more than 300 BWA (Broadband Wireless Access) operator networks, accounting for 5% of market share, with dial-up accounting for 30%, and Broadband Fixed Access accounting for the remaining 65%. In December 2006, Tom Phillips, chief government and regulatory affairs officer of the GSM Association (Global System for Mobile Communications) stated:

"Russia has already achieved more than 100% mobile penetration thanks to the huge popularity of wireless communications among Russians and the government's good work in fostering a market driven mobile sector based on strong competition."

The Government views the construction of main communications lines and the development of broadband and digital TV services as the top priorities of the telecoms industry.

Information Technology. The IT market is one of the most dynamic sectors of the Russian economy. Russian software exports have risen from just \$120 million in 2000 to \$1.5 billion in 2006 to 3.1 billion in 2011. Since the year 2000 the IT market has demonstrated growth rates of 30-40 percent a year, growing by 54% in 2006 alone. As for future, the country is projected to export software worth over \$15 billion by 2012.

The biggest sector in terms of revenue is system and network integration, which accounts for 28.3% of the total market revenues. Meanwhile the fastest growing segment of the IT market is offshore programming. The industry of software development outsourcing crossed the mark of \$1 billion of total revenues in 2005 and reached \$1.8 billion in 2006. Market analysts predicted

this indicator to increase tenfold by 2010. Currently Russia controls 3 percent of the offshore software development market and is the third leading country (after India and China) among software exporters. Such growth of software outsourcing in Russia is caused by a number of factors. One of them is the supporting role of the Russian Government. The Government has launched a program promoting construction of IT-oriented technology parks (Technoparks) - special zones that have an established infrastructure and enjoy a favorable tax and customs regime, in seven different places around the country: Moscow, Novosibirsk, Nizhny Novgorod, Kaluga, Tumen, Republic of Tatarstan and St. Petersburg Regions. Another factor stimulating the IT sector growth in Russia is the presence of global technology corporations such as Intel, Motorola, Sun Microsystems, Boeing, Nortel and others, which have intensified their software development activities and opened their R&D centers in Russia.

Electronics. Russia is experiencing a regrowth of Electronics and Microelectronics, with the revival of JCS *Mikron*. An example of a successful Russian consumer electronics company is *Telesystems*, whose products are sold in over 20 countries.

Nanotechnology. In its push to diversify Russia's research and development in emerging technologies, the Putin government has announced a massive \$7 billion investment program in nanotechnology. As part of the program, during 2007, \$5 billion is being invested into a new state corporation, *Rosnanotech*, that will be responsible for overseeing and coordinating research in the area. In criticism of the initiative, it has been noted that the Russian nanotech program will receive three times more state funding than the rest of Russia's scientists put together. Apart from public funding, Mikhail Prokhorov, a leading Russian metals and banking tycoon, has announced the creation of a \$17.5 billion holding company that will focus on high-tech investments, including alternative energy and nanotechnology.

Automotive industry. Automotive production is a significant industry in Russia, directly employing around 600,000 people or 1% of the country's total work force. In addition, the industry supports around 2–3 million people in related industries. Russia was the world's 15th largest car producer in 2010, and accounts for about 7% of the worldwide production. In 2009 the industry produced 595,807 light vehicles, down from 1,469,898 in 2008 due to the global financial crisis. The largest companies are light vehicle producers AvtoVAZ and GAZ, while KAMAZ is the leading heavy vehicle producer. 11 foreign carmakers have production operations or are constructing plants in Russia.

Nuclear Industry. “Russian nuclear industry is one of the world’s leaders in terms of the level of scientific and technological developments in the area of reactor design, nuclear fuel, experience of nuclear power plant operation, NPP personnel qualification. Enterprises of the industry have accumulated huge experience in solving large-scale tasks — such as creating the world’s first nuclear power plant (1954) and developing fuel for it. Russia possesses world’s most advanced enrichment technologies, and nuclear power plants with VVER water-moderated water-cooled power reactors have proved their reliability in the course of one thousand reactor years of trouble-free operation. The high quality of manufactured products and offered services is also confirmed by the successes in international tenders for nuclear fuel supplies and NPP construction abroad.

Today Russian nuclear industry constitutes a powerful complex of over 200 enterprises and organizations employing over 250 thousand people. Industry structure includes four large-scale research and production complexes: enterprises of nuclear fuel cycle, nuclear power engineering, nuclear weapons applications, and research institutes. JSC *Atomenergoprom*, which consolidates the civilian part of the nuclear industry, is a part of *Rosatom State Atomic Energy Corporation*.

ROSATOM unites a number of enterprises of nuclear power engineering, as well as of nuclear and radiation safety, nuclear weapons applications, and fundamental research.

Under present conditions nuclear power engineering is one of the most important sectors of Russian economy. The industry's dynamic development is one of the major conditions of ensuring energy independence of the state and sustainable growth of the country's economy. Russia has made plans to increase the number of reactors in operation from 31 to 59. The Russian government plans to allocate 127 billion rubles (\$5.42 billion) to a federal program dedicated to the next generation of nuclear energy technology. About 1 trillion rubles (\$42.7 billion) is to be allocated from the federal budget to nuclear power and industry development before 2015" [18].

Construction. "The "Russian Transport 2008" project presented in Sochi details a 13 trillion rubles investment package in infrastructure over the period 2010-2015. More than 17,000 km of federal, regional and local roads, and more than 100 air fields will be built or upgraded. The capacity of Russian sea ports will be increased to more than 400 million tons per year and more than 3000 km of new railway lines will be constructed. Many of the projects will be Public Private Partnerships on the British model and will seek foreign partners. This package, approved by the state Duma represents *the largest ever investment program in Russia*. Moreover, according to the British Chambers of Commerce Russia export guide, demand for high quality building products is estimated to be growing at a rate of 10-15% per year and the market for building products valued at around \$5 billion. According to FINAM forecasts the construction market should grow to reach around 150-160 billion USD in 2011. Problems on the market however include regulation, licensing and the presence of some powerful competitors such as *Inteco* the *PIC group* and *DSK-1*. Nevertheless, with the Russian government's commitment to modernization, the approaching Winter Olympics in 2014 in Sochi and the World Cup in 2018, prospects for the construction industry remain good" [19].

Chemicals. "The market for chemicals had largely recovered and reached pre-crisis levels in Russia by the end of 2010 and the prospects for the future look good in most branches. The International Fertilizer Association forecasts that by 2014 the volume of demand for mineral fertilizers should grow by almost 12% as a result both of population growth worldwide and the reduced amount of fertile farmland. Owing to the wildfires which plagued Russia during the summer and caused significant damage to the harvest, demand for fertilizing chemicals remains high. The nitric fertilizer industry appears to be stagnating somewhat but the demand for phosphorous- and potassium-based fertilizers is forecast to grow strongly" [19].

Agriculture. "Russia comprises roughly three-quarters of the territory of the former Soviet Union. Following the breakup of the Soviet Union in 1991 and after nearly ten years of decline, Russian agriculture has begun to show signs of improvement due to organizational and technological modernization. Northern areas concentrate mainly on livestock, and the southern parts and western Siberia produce grain. Restructuring of former state farms has been an extremely slow process. The new land code passed by the Duma in 2002 should speed restructuring and attract new domestic investment to Russian agriculture. Private farms and garden plots of individuals account for over one-half of all agricultural production" [16].

"Russia produced 63.0 million tons of wheat in 2008, or about 9% of the world's total production. However, Russia's capacity for agricultural production is considerably greater. If Russia were to achieve the production levels recorded in 1992 again, it would be in first place in grain production overall. Russia is also number two in potato production – accounting for about 11% of world production. However, in this category as well, Russia's potential is far greater – a

majority of those potatoes are grown on small farms – often without machinery, fertilizer, or even extensive irrigation.

While the total amount of livestock in Russia is only about 60% of 1993 levels, production efficiency has approximately doubled. In 2008, Russia ranked fourth in milk production (in calculations that took Russia and Ukraine as a single entity). While production of most products is still quite small on world standards, as much as 80% of Russia's potential agricultural land is currently unused, meaning that the production potential is great.

Most major agribusiness companies in Russia are run by foreigners. Most are also looking to aggressively expand.

Black Earth Farming is a Swedish company that recently made considerable noise when it raised more than 115 million dollars from investors for an ambitious expansion. The company now controls about 244,000 hectares (over 1100 square miles) in southern Russia.

Russian Farms is a Russian group of companies chaired by a dual Russian-American citizen and which is attempting to bring modern machinery, processing, and distribution to Russian agriculture. The firm has recently received media coverage inside Russia when President Putin visited one of its dairy production units.

Heartland Farms Penza is a British-run business controlling 27,000 hectares in the Volga Region. They are currently seeking additional funds to expand (by perhaps as much as 150,000 hectares) and are currently working on contracts from *Pepsi* and *Heinz*.

Razgulay is a Russian group of companies involved primarily in grain, sugar, and rice production.

Rusagro is a Russian agroindustrial holding focusing mostly on sugar and meat.

Several professional unions unite various agricultural sectors in Russia including: the Russian Grain Union; the Union of Russian Sugar Producers; the Russian Dairy Union; the Union of Russian Brewers; and the Russian Meat Union” [15].

Foreign Trade. “Russia reported a trade surplus equivalent to \$17.4 billion in June of 2011. Metals and energy make up more than 80 percent of Russia's exports. Russia imports mostly vehicles, machinery and equipment, plastics, medicines, iron and steel, consumer goods, meat, fruits and semi-finished metal products. Its main trading partners are: European Union (Germany, Italy, France), China and Ukraine. Trade with the EU forms 52.9%, with the CIS 15.4%, Eurasian Economic Community 7.8% and Asia-Pacific Economic Community 15.9%. Russia is the EU’s 3rd largest trading partner, and an essential energy supplier – 30.3% of EU crude oil, 7.9% of hard coal and 30.7% of natural gas imports originate in Russia” [12].

Transportation. As a huge country, Russia has one of the world's longest webs of railways, highways and subways, though its European part is more developed than its Asian part.

Rail transport

Russia has 87,157 km of railways.

Rapid-transit systems

Moscow Metro – 12 lines, 183 stations, 278.8 km

Saint Petersburg Metro – 5 lines, 63 stations, 105.6 km

Nizhny Novgorod Metro – 1 line, 13 stations, 15.3 km
Novosibirsk Metro – 2 lines, 12 stations, 14.3 km
Samara Metro – 1 line, 8 stations, 10.3 km
Yekaterinburg Metro – 1 line, 8 stations, 8.5 km
Kazan Metro – 1 line, 6 stations, 8.3 km

Also there is a Metrotram system in Volgograd and three more cities with metro systems under construction: Omsk, Chelyabinsk, Krasnoyarsk.

Roads and highways

As of 2006 Russia had 933,000 km of roads, of which 755,000 were paved. Some of these make up the Russian federal motorway system.

Road safety in Russia is poor with road accident deaths per million population higher than all countries in the G8 and the other BRIC countries, although the absolute number is actually less than in China, India and the USA. When assessing the level of risk when travelling on Russia's roads (i.e. the number of accidents per unit of travel) it is 60 times that of Great Britain. With a large land area the road density is the lowest of all the G8 and BRIC countries.

Inland waterways

Total navigable routes in general use: 101,000 km;

Pipelines

Crude oil 48,000 km; petroleum products 15,000 km; natural gas 140,000 km.

Merchant marine

Total: 695 ships (1,000 GRT or over) totaling 3,920,923 GRT/4,867,676 metric tons deadweight (DWT). Ships by type: barge carrier 1, bulk 19, cargo 379, chemical tanker 4, combination bulk 21, combination ore/oil 3, container 25, multi-functional large load carrier 1, passenger 35, passenger/cargo 3, petroleum tanker 149, refrigerated cargo 26, roll-on/roll-off 22, short-sea passenger 7.

Airports

Airports with paved runways: 630

Airports with unpaved runways: 1,887

4. Identification of business opportunities and motivation to do business in Russia

The above survey of the Russian marketplace should help us to identify business opportunities and incentives to do business in Russia.

Dynamic economic growth. As we could see Russia is a tremendous market. With abundant natural resources, one of the fastest GDP growth rates in the world in recent years, substantial growth in purchasing power (today, more cars are sold in Russia than in India with population over 1.2 billion, more Mercedes cars are sold in Moscow than in Berlin and dollar denominated wages grew on average more than 900% from 2000 to 2011), a population of 142 million people, and a relative lack of competition in some sectors, Russia shows some signs of becoming an attractive destination for foreign investment.

Free niches and a lack of competition allow investors not only to sell out quickly but reap higher returns. In Russia it is not uncommon to hear businessmen discussing possible investment opportunities and saying that anything less than a 30% return on investment is uninteresting. One

American owner of mid-range priced hotel in Moscow said that he earns for one month more than his colleague in London for six months.

The underdevelopment of small and medium size business in Russia provides enormous opportunities for foreign entrepreneurs. Despite the fact that the small and medium-size business in Russia is on rise – the production output of this sector grew by 9.1% in 2010 – however, by data of the Russian Agency for Small and Medium Business Support, its share in the national economy is just about 10%, while in Western countries contribution of small and medium enterprises to national economy amounts to 50-90% [20].

Franchising in Russia is in its infancy and developing in a couple of industries which have very high return – networks of motorway filling stations and fast food restaurants. Markets which in the West are spanned by 80% with franchising networks – social and welfare services, car service, car wash, education, hotel and hospitality industry, *etc.* – are not occupied in Russia at all.

Travelling along Russian motorways one can see only miserable cafes with food of doubtful quality and no fast food restaurants of well-known brands. There is a significant lack of motels and hotels of economy class even in large Russian cities like Moscow and St. Petersburg. Almost all Russian cities lack neighborhood retailers, kindergartens, laundries and other social welfare facilities.

Each Russian region has the list of top-priorities industries to be developed. For example, the Penza Region offers a number of tax incentives for investors that implement projects in priority sectors: agriculture, timber processing, machine building, metalworking, food-processing industry, construction material, medical, glass and light industry. In particular, the region releases organizations, implementing the priority investment projects, from transport taxation on the territory of the Penza region. The measures also determine the new rates on property taxes. Thus, organizations, implementing the priority investment projects, will be exempt from property tax for the period of return on investment costs for up to 8 years. Furthermore, the Penza Region has a highly professional group of Research and Development personnel, which offer educational and industrial potential for the development of innovative technologies [21].

The best export opportunities for foreign companies lie in the sectors such as: oil and gas equipment and services, construction equipment, agricultural machinery, building products, autos and parts, computer hardware and software, technology equipment and services, telecommunications equipment and services especially wireless, medical equipment, pharmaceuticals, cosmetics and toiletries, wines, food and beverage, consumer goods.

Foreign experts identified the following major sectors as promising high returns on investment: advanced engineering, financial services, ICT, power/energy, sports and leisure, infrastructure.

Foreign companies working in such sectors as tourism, education, professional services can find their clientele in the Russian market. Of course all companies should look inside to see if they can really bring value to the market they are trying to get in, otherwise they will fail.

Large consumer market. Another important opportunity is the size of consumer market and the nature of the Russian consumer. Russia, with a population of 142 million, is the largest consumer market in Europe. Many foreign businessmen note that Russian customers have a remarkable, perhaps unparalleled, propensity to spend. According to Nielsen research (Online Global Omnibus 2007), 71% of the Russian population is ready to spend their money on new clothing, and 44% on new technology, while only 3% are ready to invest in equity and 9% in pension

funds. This propensity to spend is a powerful force behind the retail sector growth across the country. It is not a Moscow phenomenon. If you go to Novosibirsk or Vladivostok or any other city, you will see the same trends. Monthly retail sales in Russia average about \$50 billion, while the industry recorded revenues of \$470.3 billion in 2009 and will surpass \$800 billion by 2013 according to forecasts [8]. Strong internal demand for all kinds of goods and services and insufficient supply from local sources create a gap that is largely covered by imports.

Tax avoidance is still widespread in Russia – although personal income tax has been cut to a flat 13 per cent. But the grey economy is around 40-45 per cent of the total – which is why official statistics have to be taken with a pinch of salt. Millions of Russians are richer than they appear statistically. Little surprise, therefore, that today Russia has the highest disposable income among emerging markets – around 87% of per capita income, which compares with around 40% for Western consumers.

The low cost of housing and utilities also puts more money in the hands of the consumer. The majority, about 6 in 10 Russians, own their apartments and dachas and therefore do not have the burden of monthly mortgages. In the US, buying a house and paying for the car are the biggest components in personal debt. The consumer society is fuelled by credit. Russia is only at the beginning of this process.

Another important issue on which foreign entrepreneurs can build up in Russia is the quality of their products and services and also their attitude to consumers which often leaves much to be desired in that country. Traditionally Russians trust more foreign entrepreneurs and companies because they are not prone to cheat and quality of their products and services is often better than those of Russian companies. In Russia, consumer protection is in its infancy – there is no Russian Ralph Nader, yet. But political activism and public interest lobbying is just around the corner. Politicians are under increasing pressure to champion consumer rights. Most insurers, banks, factories utilities, pension funds and oil companies have yet to grasp that consumer rights regulations and corporate accountability are inevitable. International experience has shown that industries and investors which look after customers and the public interest will prosper – those who do not, will not [22].

Strong government support. The Russian government efforts to promote foreign investment can be considered as another opportunity for international entrepreneurs. Investment in the Russian economy is strongly supported by federal and regional authorities. “For promotion of foreign capital inflows, the Russian Government has approved a program for escalation of investment attraction of Russia, which includes regular meetings of Russian authorities and foreign business representatives, various PR events and, the most important, liberalization of land and building legislation as well as of goods certification systems and import duties.

Under the program, the Russian Government strives to ease cooperation between foreign investors and Russian government institutions, the complexity of which is one of the obvious negative factors that affect running business in Russia. For solution of the latter task, in 2008, the Ministry for Economic Development created an emergency aid system for foreign business. The First Vice Prime Minister Igor Shuvalov became an authorized representative on investor rights and deals with their protection on a permanent basis. In addition, at the end of 2008 the Foreign Investment Advisory Council was reformed, and since 2009, it includes an executive committee headed by the Minister of Economic Development E. Nabiullina. The Advisory Council administers investor’s complaints to the name of Nabiullina and Shuvalov, and currently is one of the most efficient methods of solution of the most complicated issues of foreign investors in Russia” [23].

To lower administrative barriers to foreign investment, a procedure for registering business activities by submitting a declaration to the government has been introduced and part of the process for declaring entry to business activities will be transferred to self-regulating organizations. In addition, the government is planning to shorten the time period for foreign enterprises to receive permission on investment projects. The recently formed Department of State Control of Economics will be in charge of removing barriers for foreign investors [24].

The Russian government has announced plans to spend about \$1 trillion over the next 10 years on improving infrastructure. It has also made it clear that a significant part of this investment will be in the form of Public Private Partnerships⁵ (PPP), to benefit from the leverage provided by the efficiency, competition and investment of the private sector. Private-public partnerships in Russia will be developed by means of (1) preparation of PPP pilot projects in selected regions for their further financing by *Vnesheconombank*; (2) facilitation for the development of a network of regional PPP centers and strengthening the capacity of regional and municipal authorities in joint elaboration of economically feasible PPP projects; (3) exchange of advanced experience in implementation and experience of PPP projects as well as international experts for preparation and implementation of such projects; (4) drawing up recommendations for elaboration of national policies in the PPP area and, if necessary, working out proposals to improve federal and regional legislation to this extent; (5) personnel training and development of skills upgrading programs for the staff and senior officials from government and private sectors, and PPP market participants [25].

To attract foreign investment into the regions of Russia, the Government created several Special Economic Zones (SEZ's) which are areas eligible for special business regulations (see also Chapter 4 of this manual). SEZ's offer a simplified procedure of land assignment, as well as special free customs regime and a number of tax preferences for SEZ residents. Federal economic zones in Russia are regulated by Federal Law "On special economic zones in the Russian Federation". Russia currently has 16 federal economic zones and several regional projects. *Technical/Innovational Zones*: Dubna, Zelenograd, Neudorf – industrial and business park in special economic zone near Saint Petersburg, Novo-Orlovskoye) – SEZ territory in Saint Petersburg, Tomsk. *Industrial/developmental Zones*: "Alabuga" (special economic zone), Lipetsk. *Tourist Zones*: Krasnodar Krai, Stavropol Krai, Kaliningrad Oblast, Altai Krai, Altai Republic, Irkutsk Oblast, Buryatia, Vladivostok.

The Russian SEZ's currently produce more plans than results i.e. unrealistic plans characterize the contemporary Russian SEZ's. Only the Kaliningrad SEZ and the Magadan SEZ (regional project) can be classified as fully operational, and therefore, it is far too early to make any firm conclusion on the economic impact of these zones on the Russian economy. On the other hand, the results of today do not necessarily describe the potential of tomorrow.

The regulatory environment in Russia has improved significantly in recent years. Several laws to simplify the investment process and protect investors have been adopted – "On foreign investment in the Russian Federation", "On investment activity in the Russian Federation pursued in the form of capital investments", "On the legal position of foreign citizens in the

⁵ Public-private partnership (PPP) describes a government service or private business venture which is funded and operated through a partnership of government and one or more private sector companies. PPP involves a contract between a public sector authority and a private party, in which the private party provides a public service or project and assumes substantial financial, technical and operational risk in the project. In projects that are aimed at creating public goods like in the infrastructure sector, the government may provide a capital subsidy in the form of a one-time grant, so as to make it more attractive to the private investors. Government contributions to a PPP may also be in kind (notably the transfer of existing assets). Typically, a private sector consortium forms a special company called a "special purpose vehicle" (SPV) to develop, build, maintain and operate the asset for the contracted period.

Russian Federation”, and “On Concession Agreements”. However, several sectors remain closed to foreign investment. Current regulations restrict foreign involvement in the banking sector, and the government has restricted foreign access to 39 strategic sectors of the Russian economy, including nuclear energy, natural monopolies, military and special machinery, the space industry, and subsoil development. As part of the government’s plans to simplify the process by which investors can access strategic sectors, a law to moderate foreign investment restrictions in Russia’s strategic sectors and mineral resources was adopted in 2010.

Russia has seen an improvement in corporate governance in recent years. A growing number of major Russian companies meet international and US accounting standards for information disclosure and have introduced open lines of communications with shareholders and analysts. However, there is still much of room for improvement, particularly with respect to corporate transparency.

Attractive taxation system. “With a personal income tax rate of 13% for residents, corporate tax rate of 24%, and VAT rate of 18%, Russia has one of the most generous non-offshore tax regimes in the world, aimed at promoting investment and further developing the economy. Russia has recently introduced a European-style participation exemption regime that exempts dividends received from qualifying participation. In addition, the capital gains tax is currently scheduled to go to 0% in 2010, and reorganization for companies is tax-neutral according to the Russian Tax Code. The Russian Tax Code is one of the most comprehensible of such codes in the world. And thanks to ongoing improvements, as well as a policy of resolving contradictions and ambiguities in tax legislation in favor of the taxpayer, the tax system is becoming increasingly oriented toward the investor. Tax reform continues to move forward in Russia, with a noticeable reduction in the frequency of onsite tax audits from once a year to once every two or three years, according to Ernst & Young’s 2008 survey of taxation issues in Russia. Respondents this year noted a dramatic reduction in the number of reported tax disputes being taken to court (65% versus 82% last year). A large majority (89%) of reported cases which went to court judgment continue to be settled in favor of the taxpayer” [26].

Highly skilled and well-educated human capital. Russia has one of the most highly skilled workforces in the world. Thanks to the strong Russian educational system (the literacy rate in Russia is 99.4%, around 2/3 of the population are educated to degree level) there is a large highly-skilled and, in comparison with Western Europe, cost-effective labor pool. An excellent educational background, extensive R&D, and engineering practice allow Russian professionals to take up leading positions in areas such as the natural and applied sciences, programming, R&D, engineering, etc. Strong Russian scientific knowledge provides excellent opportunities for research and development partnerships with Russian research institutes and universities [26].

Stable Social and political system. Following a transition period, the Russian economy has achieved macroeconomic and financial stability. Political stability and policy predictability have gradually increased. Government approval rates are some of the highest among the world’s leading democracies. Living standards have been steadily improving. The country has a tolerant multi-ethnic, multi-cultural and multi-confessional population.

Favorable geographic position. Russia’s geography facilitates building effective international and domestic supply-production-market chains. Russia links Europe with Asia and also borders the North American continent, offering the following advantages:

- Worldwide sea routes — Russia is bounded by three out of four world oceans
- Major functioning and planned airport hubs
- Rail and road transit routes (leads the world in length of electrified railroads)
- Pipelines, developed networks of various types of warehousing facilities

- Other transport and logistics infrastructure [26].

World Bank's business criteria. As it has been mentioned in Chapter I, each year, World Bank ranks every country with various criteria on the conditions of doing business in that particular country. The Bank rankings for Russia and some selected countries are shown in Table 2.1.

Table 2.1

Rankings of countries on various business criteria

Economy	Ease of Doing Business	Starting a Business	Dealing with Licenses	Employing Workers	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business
Singapore	1	4	2	1	16	4	2	5	1	13	2
USA	4	8	25	1	12	4	5	61	18	8	15
Russia	120	106	182	109	45	87	93	103	162	19	92
Ukraine	142	134	181	83	141	30	109	181	139	43	145

SOURCE: World Doing Business Rankings 2010

There is no denying that doing business in Russia is not for the faint at heart. While the economy is producing increasingly positive results, the country remains a complex place to do business. The difficulty in understanding Russia's business environment, however, can also be an advantage as it serves as an entry barrier that assists those who do enter and learn to operate effectively.

Chapter 3

General Terms of Business and Business Environment

1. Factors to be assessed for doing international business

The framework of this manual does not allow for considering in detail all factors to be assessed for doing business. There are some factors that make a difference between domestic and international business. Principal factors are the use of foreign exchange, customs tariffs and nontariff barriers and foreign government regulation of international trade and investment. International entrepreneurs should understand how these factors can affect their business activity in other countries.

Foreign exchange is a *commodity* which constitutes a currency issued in another country. Like prices for other commodities, the price for currency is determined (providing there is a system of floating exchange rate) through the balance between the demand and supply in the market. In international commercial operations, usually more than one currency is used therefore entrepreneurs should take into account exchange rates and understand the structure of the currency market and the essence of major currency operations.

An exchange rate is usually quoted in terms of the number of units of one currency that can be exchanged for one unit of another currency – e.g., in the form: EUR/USD. In this example, the US\$ is referred to as the "*quote currency*" (price currency, payment currency) and the Euro is the "*base currency*" (unit currency, transaction currency). Quotes using a country's home currency as the quote currency (e.g., EUR 0.735342 = USD 1.00 in the *euro zone*) are known as *direct quotation* or price quotation (from that country's perspective) and are used by most countries. Quotes using a country's home currency as the base currency (e.g., EUR 1.00 = USD 1.35991 in the *euro zone*) are known as *indirect quotation* or quantity quotation and are used in British newspapers and are also common in Australia, New Zealand and the eurozone. There is a market convention that determines which is the base currency and which is the term currency. In most parts of the world, the order is: EUR – GBP – AUD – NZD – USD – others [27].

A market based exchange rate will change whenever the values of either of the two component currencies change. Increased demand for a currency can be due to either an increased transaction demand for money or an increased speculative demand for money. The transaction demand is highly correlated to a country's level of business activity, gross domestic product, and employment levels. The more people that are unemployed, the less the public as a whole will spend on goods and services. Central banks typically have little difficulty adjusting the available money supply to accommodate changes in the demand for money due to business transactions.

Speculative demand is much harder for central banks to accommodate, which they influence by adjusting interest rates. A speculator may buy a currency if the return (that is the interest rate) is high enough. In general, the higher a country's interest rates, the greater will be the demand for that currency. It has been argued that such speculation can undermine real economic growth, in particular since large currency speculators may deliberately create downward pressure on a currency by shorting in order to force that central bank to sell their currency to keep it stable. (When that happens, the speculator can buy the currency back from the bank at a lower price, close out their position, and thereby take a profit) [27].

The **foreign exchange market** (Forex, FX, or currency market) is a global, worldwide decentralized financial market for trading currencies. Financial centers around the world function

as anchors of trading between a wide range of different types of buyers and sellers around the clock, with the exception of weekends. The foreign exchange market determines the relative values of different currencies.

The primary purpose of the foreign exchange market is to assist international trade and investment, by allowing businesses to convert one currency to another currency. For example, it permits a US business to import Russian goods and pay rubles, even though the business income is in US dollars. It also supports direct speculation in the value of currencies, and the carry trade⁶, i.e. speculation on the change in interest rates in two currencies.

The foreign exchange market is unique because of

- its huge trading volume representing the largest asset class in the world leading to high liquidity;
- its geographical dispersion;
- its continuous operation: 24 hours a day except weekends, i.e. trading from 20:15 GMT on Sunday until 22:00 GMT Friday;
- the variety of factors that affect exchange rates;
- the low margins of relative profit compared with other markets of fixed income; and
- the use of leverage to enhance profit and loss margins with respect to account size.

As such, it has been referred to as the market closest to the ideal of perfect competition, notwithstanding currency intervention by central banks. According to the *Bank for International Settlements*, as of April 2010, average daily turnover in global foreign exchange markets is estimated at \$3.98 trillion. The largest foreign exchange market is in London followed by New York, Tokyo and Singapore. These four cities account for 66% of the world currency trading. About 90% of the world currency transactions are made with participation of US dollar. The position of US dollar as such in the currency market is due to its role in the Bretton Woods system. Since the US dollar participates in the majority of currency purchase and sale transactions, it has the status of the principal transaction currency.

There is no unified or centrally cleared market for the majority of Forex trades, and there is very little cross-border regulation. Due to the over-the-counter (OTC) nature of currency markets, there are rather a number of interconnected marketplaces, where different currencies instruments are traded. This implies that there is not a single exchange rate but rather a number of different rates (prices), depending on what bank or market maker is trading, and where it is. In practice the rates are often very close, otherwise they could be exploited by arbitrageurs instantaneously. Due to London's dominance in the market, a particular currency's quoted price is usually the London market price [28].

Currency departments of large international banks (such as *J.P. Morgan Chase*, *Barclays*, *Deutsche Bank*) located in the major financial centers – New York, London and Frankfurt – play an important role in the operation of currency market. International banks are major actors in the wholesale (interbank) currency market which make transactions on their own accounts or on behalf of large commercial clients. Interbank transactions (usually for a sum of not less than \$1 million) make up the overwhelming majority of all currency transactions.

⁶ The term “carry trade” without further modification refers to currency carry trade: investors borrow low-yielding currencies and lend (invest in) high-yielding currencies. It is thought to correlate with global financial and exchange rate stability and retracts in use during global liquidity shortages, but the carry trade is often blamed for rapid currency value collapse and appreciation.

International banks play an important role in the retail currency market making contracts with private clients who want to buy or sell foreign currency. As a rule, retail clients pay for foreign currency the price which is equal to current exchange rate plus premium on exchange rate. The size of premium, in turn, is determined as a function of the sum of contract and significance of the client for the bank. A Danish network of music shops which needs \$100,000 to pay for 20,000 compact disks with albums of *Avrile Lavigne* or *U-2* will pay higher premium for this sum than General Motors which needs \$20,000,000 to repay credits provided by British investors. Certainly foreign tourists who get cash in a local currency on traveller's check in a bank or exchange office will pay even higher premium on exchange rate.

All clients of currency departments of banks can be divided into the following categories:

- *Commercial clients* – clients for whom currency exchange is a part of their routine commercial activity such as export and import of goods and services, the payout or draw of dividends and interest from foreign partners, the purchase or sale of foreign assets and capital. Some commercial clients can use the currency market to hedge (reduce) risk caused by unfavorable change in the rate of currency which in future will be used to pay or receive certain sums of cash on commercial contracts.
- *Currency speculators* – natural persons or legal entities trading foreign currency to get speculative profit on the difference of currency rates. Speculative operations may be extremely profitable but the level of risk is also extremely high.
- *Arbitrageurs* – natural persons or legal entities trading foreign currency and making profit through the difference in currency rate in different markets. Arbitrageurs try to get profit with minimal risk buying currency at lower price in one market and selling it at higher price in another market.

Central banks and financial departments (ministries) of countries are important actors in the currency market too. To maintain the market rate of national currency, they influence the national currency rate through currency interventions and other mechanisms.

There are active markets only for relatively small number of currency pairs in which US dollar, Britain pound and Japan yen do not participate. If there is no market for direct exchange between pairs of currency (for example, between Sweden crone and New Zealand dollar), the US dollar, as a rule, is used as an intermediate currency.

Internal legislation of a country may restrict its ability to trade currency in the international currency market. Currency which freely circulates in the currency market is called *convertible currency* or *hard currency*. The US dollar, EU euro, Britain pound, Japan yen, Swiss franc and Canadian dollar are attributed to the currency of this category. Currency which is difficult to buy or sell in the currency market because of restrictions imposed by the internal legislation of a country or because of unwillingness of foreigners to keep their savings in this currency is called an *inconvertible currency* or *soft currency*. National currencies of many developing countries fall into this category.

Spot market and forward market. There are many commercial operations which presuppose that payments will be made in future, for example, lending activity and the purchase on credit. Because of a floating exchange rate, such international operations may be very risky. In the modern currency market therefore currency trading can be carried out not only with immediate delivery of currency but also with delivery by a stipulated date in the future at a stipulated price. Such operations of risk reduction are called *hedging*.

Spot market or *physical market* is a market where currency transactions should be closed immediately. “Immediately” in most cases means two days after the date of entering into a

contract. Two days is a traditional time period which is necessary for a payment passing through the international banking system. Spot (cash) transactions account for 40% of all transactions with foreign currency.

Forward market is a market where currency transactions should be closed by a certain date in the future. A *forward contract* is a non-standardized contract between two parties to buy or sell a currency at a specified future time at a price agreed upon today. In currency exchanges and mass media, prices are published, as a rule, for foreign currency which should be delivered in 30, 90 and 180 days. For example, from the *Wall Street Journal* fragment below we can see that in August 6, 2011 the spot rate of Britain pound was \$1,6099 whereas its forward rate provided the delivery would be made in 30 days was \$1,6068, in 180 days – \$1,5911. In many cases, the forward rate of a foreign currency differs from its spot rate. If forward rate of a foreign currency (represented by direct quotation) is lower than its spot rate, the currency is sold with *forward discount*. If forward rate is higher than spot rate, the currency is sold with *forward premium*.

The forward rate is an overall market forecast of a currency spot rate in the future. The forward rate therefore helps international entrepreneurs forecast future changes in currency rates. These changes can influence the price of imported components used to manufacture products and also the company competitiveness and profitability of its operations. If a currency is sold with forward discount, participants of the currency market believe that exchange rate of this currency will drop in the future. In this case, a company can reduce its assets or increase liabilities denominated in this currency. In formulas for calculating currency forward rate, such components as the current spot rates of currencies, refinancing interest rates, and periods of time are used. The currency of countries with a deficit of the balance of trade or high level of inflation is sold, in the most cases, with forward discount. On the contrary, if a currency is sold with a forward premium, there is a confidence in the currency market that exchange rate of this currency will rise in the future. In this case, a company can increase its assets or reduce liabilities denominated in this currency. The currency of countries with a favorable balance of payment or low level of inflation is sold, in the most cases, with forward premium. Thus, the difference between spot rate and forward rate of currency of this or that country determines in many cases the market expectations regarding economic policy and economic prospects of this country.

Some market players carry out so called *swap transactions*. A swap transaction is an operation in the course of which one and the same currency is bought and sold but the currency is delivered at different times. For example, in the course of such typical swap transaction as “spot vs forward” an American industrial company, which draws upon a 30 day credit of £10 million from one of the British banks, sells £10 million in the spot market to get an equivalent sum in US dollars and, at the same time, buys £10 million (plus the sum of interest to the bank) in the 30 day forward market to pay back the loan. In most cases, companies which plan to buy or sell foreign currency on the basis of spot or forward transactions make corresponding contracts with international banks [29].

There are two more mechanisms in the currency market allowing companies to get foreign currency in the future at a fixed price. However, none of them provides such flexibility of contracts in terms of volume of currency and dates of its delivery as banks do. The first mechanism is a *currency future*. A currency future, which constantly is quoted in many *currency exchanges*, is a contract which is very similar to forward contract. However, unlike a forward contract, a currency future is a standardized contract which means that it has a standard sum and standard term of delivery.

The party agreeing to buy the underlying currency in the future, the "buyer" of the contract, is said to be "long", and the party agreeing to sell the currency in the future, the "seller" of the

contract, is said to be "short". The terminology reflects the expectations of the parties – the buyer hopes or expects that the asset price is going to increase, while the seller hopes or expects that it will decrease. Note that the contract itself costs nothing to enter; the buy/sell terminology is a linguistic convenience reflecting the position each party is taking (long or short).

The purpose of the *futures exchange institution* is to act as intermediary and minimize the risk of default by either party. Thus the exchange requires both parties to put up an initial amount of cash, the *margin*. Additionally, since the futures price will generally change daily, the difference in the prior agreed-upon price and the daily futures price is settled daily also. The exchange will draw money out of one party's margin account and put it into the other party's margin so that each party has the appropriate daily loss or profit. If the margin account goes below a certain value, then a margin call is made and the account owner must replenish the margin account. This process is known as *marking to market*. Thus on the delivery date, the amount exchanged is not the specified price on the contract but the spot value (since any gain or loss has already been previously settled by marking to market) [30]. A company desiring to discharge itself of the obligation of a future contract can just make a counter transaction. In practice, 98% of future contracts are settled in this way. Currency futures account only for 1% of all transactions made in the currency market.

The second mechanism – a *currency option* – is the right but not the obligation to exchange money denominated in one currency into another currency at a pre-agreed exchange rate on a specified date. Depending on whether we obtain the right to buy or sell the underlying asset, the option is called a *call* or a *put*, respectively. Currency options are freely quoted in exchanges all over the world. The Forex options market is the deepest, largest and most liquid market for options of any kind in the world. Most of the Forex option volume is traded OTC (over the counter) and is lightly regulated, but a fraction is traded on exchanges like the *International Securities Exchange*, *Philadelphia Stock Exchange*, or the *Chicago Mercantile Exchange* for options on futures contracts. Currency options account for 5% of all transactions made in the currency market.

Forwards, futures and options facilitate international trade and investment allowing companies to hedge (lower) their risks in international transactions.

Arbitrage transactions represent one more important element of the currency market. *Arbitrage* is the practice of taking advantage of a price difference between two or more markets: striking a combination of matching deals that capitalize upon the imbalance, the profit being the difference between the market prices. In theory, an arbitrage is a risk-free operation but in practice, there are always risks in arbitrage, some minor (such as fluctuation of prices decreasing profit margins), some major (such as devaluation of a currency or derivative) [31].

Arbitrage in goods – Purchasing power parity. A very simple concept underlies arbitrage in goods: if there is a difference in the price for a good between two markets, people will be prone to buy the good in the market suggesting lower price ("cheap market") and resell it in the market suggesting higher price for this good ("expensive market"). According to the *Law of one price* ("In an efficient market, all identical goods must have only one price") such arbitrage operations will continue until the price becomes equal in the both markets (having in view the price less transaction and transportation expenses and taxes). The concept of international arbitrage in goods is articulated in the *Theory of purchasing power parity*. According to this theory prices for goods in different countries have a tendency to flatten out as a result of exchange rate fluctuations. Purchasing power parity takes the place because the process of buying a good in the cheap market and selling it in the expensive market influences the demand for foreign currency (and its course too) and the market price for this good in both goods markets.

For example, let's assume that exchange rate between US dollar and Canadian dollar is US\$0.80 = CAN\$1. Let's assume also that *Levi's* jeans sell for US\$24 in the US and for CAN\$30 in Canada. In this case, there is a purchasing power parity since for the assumed exchange rate $(US\$0.80/CAN\$1) \cdot CAN\$30 = US\24 . Thus *Levi's* jeans have the same price in the both markets. Therefore neither inhabitants of the US nor inhabitants of Canada need to cross the border to buy jeans in another country.

Now let's assume that Canadian companies, as a result of new opportunities provided by the North American Free Trade Agreement, decided to increase their investment in Mexico. In this case, Canadians should sell their dollars to buy Mexican pesos thereby increasing the supply of the Canadian dollar in the currency market which results in the decline of the Canadian dollar exchange rate. Let's assume that the new exchange rate between US dollar and Canadian dollar is US\$0.60 = CAN\$1. In this case, there is no purchasing power parity. At such an exchange rate, US inhabitants can cross the border with Canada, exchange US\$18 for CAN\$30 and buy *Levi's* jeans saving US\$6 $((US\$0.60/CAN\$1) \cdot CAN\$30 = US\$18)$.

US inhabitants buying jeans in Canada increase supply of the US dollars in the currency market thereby raising the Canadian dollar exchange rate against the US dollar. Such behavior of US inhabitants results in the decline of demand for jeans in the US and the drop in price there. At the same time, they increase the demand for jeans in Canada which results in the rise of price there. Arbitrage operations will continue until the *Law of one price* is fulfilled.

Experts in international economy use purchasing power parity to compare living standards in different countries. Currency analysts use this theory to forecast exchange rate fluctuations over a long period of time. They believe that a significant disproportion between purchasing power in different countries make a signal about a probable change of currency rate. As a means of quick and approximate evaluation of exchange rates discrepancy a British weekly *The Economist* publishes regularly prices for McDonald's hamburger Big Mac in different countries which helps to determine to what extent a national currency is overrated or underrated against US dollar.

It is difficult to diminish the importance of arbitrage in goods in a long-term prospect; however its influence on the currency market is inferior to the short-term currency arbitrage.

2. Barriers to international trade

The internal policy of a state is formed in many cases with a commitment to protection of national companies from foreign competitors through the introduction of trade barriers. Various forms of the government control over a country's foreign trade can be relegated to the following two categories: tariff and nontariff barriers.

Tariff barriers. Customs tariffs are government-induced restrictions on foreign trade in the form of tax on imports or exports. Most of customs duties are collected from imported goods. There are three types of *import tariffs*:

- *Ad valorem tariff* (Latin for *according to value*) is a duty based on the declared value of a good, the tariff is usually levied as a percentage of the declared value of the good
- *Specific tariff* is a customs duty assessed on a per unit basis rather than on market value. For example, a specific tariff on a particular type of grain might be established at 20¢ per pound
- *Compound tariff* is a tariff that combines both a specific and an ad valorem component. For example, the US government currently levies a 6.4% ad valorem tariff on imported canned cherries and 9.9 cent specific tariff on every kilo of these canned cherries

The declared value in most cases is equal to the disbursing price of the good in the moment of its entrance to the national market. In most countries, a system for classification of imported goods is adopted. This classification is called the *Harmonized Commodity Description and Coding System*. The structure of such system is rather complicated therefore it is pretty difficult to apply it practically. The first problem for an importer of goods consists in defining to what category the goods can be attributed by customs officers. For example, ad valorem tariff for imported leather gloves in the US is 5.5%, however if these gloves are meant to be used for cross country skiing the tariff is only 3.5%.

The tariff system has a very complicated structure therefore the expected income of an importer can be significantly cut if a custom officer levies a higher tariff than expected. To avoid this risk, American importing companies can file a request with the *US Customs and Border Protection* agency for a preliminary tariff classification of goods which are supposed to be imported to the country in future. The importers who neglect this advice in many cases are pulled into expensive court trials. Typically, governments prefer to use import tariffs to protect their own industries, as they raise the price for foreign companies to import their goods.

Export tariffs raise the price for domestic companies to export their goods. A government economist would most likely use an export tariff if the country were facing widespread inflation. In some cases, export tariffs are used to ensure that a country maintains enough of an important good. For example, in the past, China has placed export tariffs on many major grain products. High international grain prices caused many producers of these grain products to export their goods. This caused a domestic shortage of grain products, so the government placed an export tariff to stabilize domestic demand. Though export tariffs can be powerful tools, they are seldom used.

Nontariff barriers is a second form of government control over foreign trade. Here three forms of nontariff barriers are considered: quotas, quantitative export controls and other restrictions.

Quotas. An import quota is a type of protectionist trade restriction that sets a physical limit on the quantity of a good that can be imported into a country in a given period of time. Quotas traditionally are used to benefit the producers of goods in those sectors of domestic economy which are of great importance for the state (agriculture, automotive and textile industries). Critics say quotas often lead to corruption (bribes to get a quota allocation), smuggling (circumventing a quota), and higher prices for consumers; therefore quotas are often superseded by *tariff rate quotas*.

Tariff rate quota (TRQ) implies that imports entering during a specific time period under the quota portion of a TRQ are usually subject to a lower, or sometimes a zero, tariff rate. Imports above the quota's quantitative threshold face a much higher (usually prohibitive) tariff. In this case exporters can increase the volume of their sales (at least theoretically) if they agree to pay higher tariffs.

Quantitative export control can be introduced in the form of limits on the quantity of goods to be exported. A *voluntary export restraint (VER)* is a government imposed limit on the quantity of goods that can be exported out of a country during a specified period of time. Typically VER's occurs when the import-competing industries seek protection from a surge of imports from particular exporting countries. VERs are then offered by the exporter to appease the importing country and to deter the other party from imposing even more explicit (and less flexible) trade barriers. Also, VER's are typically implemented on a bilateral basis, that is, on exports from one exporter to one importing country. VERs have been used since the 1930s at least, and have been

applied to products ranging from textiles and footwear to steel, machine tools and automobiles [32].

An *embargo* is the partial or complete prohibition of commerce and trade with a particular country, in order to isolate it. Embargoes are considered strong diplomatic measures imposed in an effort, by the imposing country, to elicit a given national-interest result from the country on which it is imposed. Embargoes are similar to economic sanctions and are generally considered legal barriers to trade [33].

Other nontariff restrictions. Some nontariff restrictions are introduced legally but most of those measures are openly of a protectionist nature. Therefore nontariff restrictions are major barriers for the development of international trade now. It is much more difficult to eliminate nontariff restrictions than tariffs and quotas since they are a part of bureaucratic procedures which are difficult to change. Most widespread nontariff restrictions are:

- Manufacturing and quality standards
- Restricted access to distribution networks
- State procurement policy
- Demand to buy from local manufacturers
- Norms of legal regulation
- Currency regulations, and
- Investment regulations.

3. Business environment

Business environment is a comprehensive concept; different authors include different elements in this notion. In general, the business environment is the aggregate of all conditions, events, and influences that surround and affect a business firm. The term “business environment” generally refers to the external factors affecting, either positively or negatively, the operation of a firm. The most important external factors include political, economic, social and technological (PEST) factors.

Business environment encompasses all those factors that affect a company's operations; including customers, competitors, suppliers, distributors, industry trends, substitutes, regulations, government activities, the economy, demographics, social and cultural factors, innovations, and technological developments. It may also be referred to as an *operating environment*.

PEST analysis method. “PEST analysis can be used for marketing and business development assessment and decision-making, and the PEST template encourages proactive thinking, rather than relying on habitual or instinctive reactions.

The PEST acronym is sometimes shown as STEP, which obviously represents the same factors. PEST is also extended to seven or even more factors, by adding Ecological (or Environmental), Legislative (or Legal), and Industry Analysis, which produces the PESTELI model. Other variations on the theme include STEEP and PESTLE, which allow for a dedicated Ethical section. STEEPLED is another interpretation which includes Political, Economic, Social and Technological plus Ecological or Environmental, Ethical, Demographic and Legal Analysis.

It's a matter of personal choice, but for most situations the original PEST analysis model arguably covers all of the 'additional' factors within the original four main sections. For example Ecological or Environmental factors can be positioned under any or all of the four main PEST headings, depending on their effect. Legislative factors would normally be covered under the Political heading since they will generally be politically motivated. Demographics usually are an aspect of the larger Social issue. Industry Analysis is effectively covered under the Economic

heading. Ethical considerations would typically be included in the Social and/or Political areas, depending on the perspective and the effect.

A PEST analysis is helpful prior to completing a SWOT analysis (a SWOT analysis – Strengths, Weaknesses, Opportunities, Threats – is based broadly on half internal and half external factors). A PEST analysis most commonly measures a market; a SWOT analysis measures a business unit, a proposition or idea. Here, in table 2.1, the PEST analysis template is presented as a grid, comprising four sections, one for each of the PEST headings: Political, Economic, Social and Technological.

Table 2.1

The PEST analysis

(Insert subject for PEST analysis – market, business, proposition, etc.)	
<p>Political</p> <ul style="list-style-type: none"> - ecological/environmental issues - current legislation in the home market - future legislation - international legislation - regulatory bodies and processes - government policies - term of government and change - trading policies - funding, grants and initiatives - home market lobbying/pressure groups - international pressure groups - wars and conflicts 	<p>Economic</p> <ul style="list-style-type: none"> - home economic situation - home economic trends - overseas economies and trends - general taxation issues - taxation specific to products/services - seasonality/weather issues - market and trade cycles - specific industry factors - market routes and distribution trends - customer/end-user drivers - interest and exchange rates - international trade/monetary issues
<p>Social</p> <ul style="list-style-type: none"> - lifestyle trends - demographics - consumer attitudes and opinions - media views - law changes affecting social factors - brand, company, technology image - consumer buying patterns - fashion and role models - major events and influences - buying access and trends - ethnic/religious factors - advertising and publicity - ethical issues 	<p>Technological</p> <ul style="list-style-type: none"> - competing technology development - research funding - associated/dependent technologies - replacement technology/solutions - maturity of technology - manufacturing maturity and capacity - information and communications - consumer buying mechanisms /technology - technology legislation - innovation potential - technology access, licensing, patents - intellectual property issues - global communications

If helpful refer to a list of these other 'headings', for example: Ecological/ Environmental, Legislative/or Legal, Demographic, Ethical, Industry Analysis. The analysis can be converted into a more scientific measurement by scoring the items in each of the sections. Scoring is particularly beneficial if more than one market is being analyzed, for the purpose of comparing which market or opportunity holds the most potential and/or obstacles” [34].

Global business environment. “The global business environment can be defined as the environment in different sovereign countries, with factors exogenous to the home environment of the organization, influencing decision making on resource use and capabilities. This includes the social, political, economic, regulatory, tax, cultural, legal, and technological environments.

The political environment in a country influences the legislation and government rules and regulations under which a foreign firm operates. The economic environment relates to all the factors that contribute to a country's attractiveness for foreign businesses.

Every country in the world follows its own system of law. A foreign company operating in that particular country has to abide with its system of law as long as it is operating in that country. The technological environment comprises factors related to the materials and machines used in manufacturing goods and services. Receptivity of organizations to new technology and adoption of new technology by consumers influence decisions made in an organization.

As firms have no control over the external environment, their success depends upon how well they adapt to the external environment. A firm's ability to design and adjust its internal variables to take advantage of opportunities offered by the external environment, and its ability to control threats posed by the same environment, determine its success" [35].

Business environment in Russia. "Following the crisis of the late 1990s, Russia was one of the world's fastest growing major economies, mainly driven by windfall oil revenues and substantial inflow of foreign investments. After years of high growth, since the end of 2008 the Russian economy has experienced a sharp decline, currency depreciation and outflow of foreign investments. The downturn was a result of the global economic crisis amid contraction of global investments, trade activities and declining commodity prices. As the global economy has stabilized and is gradually improving, there is a clear recovery trend in the Russian economy. Looking ahead, growth will benefit from stable energy prices, capital flows and fiscal stimulus.

To return to high growth and remain competitive among other major emerging economies, Russia will need further improvement of its investment and business environment. Structural economic reforms aimed at diversification of the economy and diminishing the dependency on exports of natural resources are currently among top agenda priorities.

The business environment in Russia has been steadily improving since the transition from a centrally controlled planned economy to a free market, though the economic crisis has had a significant impact on the business climate. In recent years, many reforms have been implemented, the tax system has become fairer and more transparent, Russia has become increasingly integrated with global markets, and customs have improved appreciably. At the same time, the operating environment remains hazardous on a number of fronts, with many foreign investors scared off by poor legal safeguards, as well as high levels of bureaucracy and corruption. The government has made fighting corruption a key priority. Under the crisis conditions businesses began closing down their investment programs, and they encountered difficulties in receiving payments for credits. The main problem, especially for small companies, is the availability of financial resources, the commercialization of science-intensive developments and the support of exports. RUB18 billion was allocated to supporting measures for small- and medium-sized businesses in 2009 and RUB10 billion in 2010, with a special focus on the innovation sector" [24].

Political system. "Under the Constitution, Russia is a Democratic Federal State with a Republican form of government. The Head of State is a President who is elected via a nationwide vote for a six-year period (prior to 2012, the President served a four-year term). Vested with a rather wide range of powers, the President determines a foreign policy for the country and issues decrees subject to obligatory execution on the whole territory of the country (they shall not contradict federal laws). A number of key appointments to civil and military posts in the State also fall under Presidential jurisdiction.

Legislative authority is represented by two State Houses of Parliament in the Federal Assembly. The Lower House of Parliament is the State Duma, members of which are elected through a nation-wide vote for a five-year period (prior to 2008 the term was four years). Its Lower House may amend the Constitution, develop federal laws and initiate a process for impeachment of the President. The Upper House is the Federation Council. It approves or declines legislative acts prepared by the State Duma and appoints judges to the Russian Federation highest judicial bodies as well as the Prosecutor General of the Russian Federation.

The Executive Branch is represented by the RF Government which is headed by the government chairman (often called the Prime Minister although this terminology is absent in official documents). The Chairman is appointed by the RF President with the approval of the RF State Duma.

The Judicial Branch consists of the RF Constitutional Court, which deals with matters of adherence to the RF Constitution, with courts of general jurisdiction headed by the Supreme Court that handle civil, criminal and administrative cases and with state arbitration courts headed by the Supreme Arbitrazh Court where disputes related to commercial legislation are resolved.” [23].

“Russia has been exposed to the very possibility of any form of Foreign Direct Investment (FDI) only in the last 20 years. After the collapse of the Soviet Union in the 1990’s the era known as “Wild East” under the rule of Boris Yeltsin descended on the country. This was the time when formerly state-owned property was privatized by a small group of people who shortly became known as oligarchs, and who effectively privatized not only economic, but essentially all spheres of Russian society, including politics, judicial system, mass media, and mass culture.

This was also the time when western companies, lured by Russia’s vast natural resources, as well as its huge and largely untapped market for consumer goods and services, entered the Russian marketplace for the first time after almost 70 years of communist rule.

These companies, who were acting as the first movers, had to undergo all the perils of the transition period that was characterized by the absence of articulated government policy on foreign investments, lack of a standardized legal framework, inefficiency of the bureaucratic system, weakness of the judicial branch, and rampant corruption on every conceivable level.

Those major problems were also exacerbated by the political uncertainty, since the return of the communists to power and successive de-privatization, and even persecution and abolishment of any form of entrepreneurship, was a very plausible outcome of the political struggle.

Fast forward 10-15 years from that period of chaos and unpredictability, and investors are facing very much the same questions about feasibility and level of risk involved in FDI in today’s Russia. The years of political and economic anarchy of the 90’s were followed by the “new order” represented by Yeltsin’s successor – Putin, who served as the country’s president in 2000-2008, and is currently holding the Prime Minister post under President Medvedev. These years of Putin being in office have been marked by tremendous positive economic changes for the country.

The three most remarkable tendencies in the official course of the government in the last 5-6 years have been re-defining Russian national idea (return to “strong” Russia), re-centralization of power to the Kremlin by taking it away from the oligarchs and the regional federal constituents, and putting down any political opposition and dissent.

This course correction manifested itself in a number of landmark events that is sending clear and very strong signals to business community both in Russia and abroad.

One of them was the arrest and sentencing to jail of Mikhail Khodorkovsky, the owner of one of the most successful oil companies in Russia. This trial was accompanied by expropriation of the company and its auctioning, which de-facto resulted in nationalization of its assets, as they were eventually acquired by the state-controlled oil company Rosneft. This event became known in the world as the “Yukos affair” and was largely interpreted as a successful attempt by the Kremlin to settle political accounts with the still remaining oligarchs who had been meddling with the country’s politics and trying to continue the tradition of keeping the high political profile they had been enjoying under the Yeltsin’s rule. But apart from the political and human rights aspects of this affair, the disturbing fact remains about the very obvious political undercurrent of the formal charges of “tax evasion” and later “money laundering”, and the highly questionable manner in which the private property was confiscated. The other outcome was an estimated loss of \$6-7 billion by US shareholders due to the enforced bankruptcy of Yukos.

If the Khodorkovsky case could be discarded as an unfortunate fallout of the internal political struggles, there was another warning sign, this time involving a foreign investor. For example, the highly publicized contradiction surrounding the handover of half of the shares of Royal Dutch Shell and its Japanese partners in Sakhalin-2 natural gas project to the state-controlled Gazprom. The formal excuse this time was environmental violations during the development of the project. This time there was no jail sentencing for the accused party, just a loss of the controlling packet in the enterprise. And partners cumulatively received about \$7.5 billion for a 50% stake in the estimated \$20 billion worth enterprise.

The latest high profile issue with the government meddling in the business affairs involving a foreign investor, even though fiercely denied by the Kremlin (not surprisingly), was a controversy surrounding the business dispute between BP and its four Russian partners in the TNK-BP. Even though the nature of the dispute is widely considered purely of a business nature, the outcomes for foreign investors are highly suspicious: ousting the TNK-BP’s American CEO from Russia and banning him from working there for two years. Again, the lurking shadow of Gazprom is seen behind this dispute, as it had indicated its interest in acquiring the share of the enterprise and getting control over the strategic assets of the company.

Review of just these cases that have received the widest publicity in the western media shows that the Russian government is seeking to consolidate its power by gaining back control over strategic resources. This intent is quite understandable from the country’s perspective of restoring and enhancing its national security. However the question remains whether the government is using underhanded ways in dealing with these highly sensitive issues, and whether the property right of investors, including foreign investors, are adequately protected in accordance with the norms of the civilized free market.

One of the positive signs for foreign investors was the passage of the bill on Foreign Investment in Russian Strategic Industries in spring 2008. At least this law shows very clearly areas where the foreign investments are essentially not welcome due to the country’s strategic interests.

Recommendation on feasibility of FDI in Russia’s economy. Russia is still posing a moderate risk for foreign investments in regards to political climate, in spite of all attempts of the government to present the country as free and stable market economy to the outside world. The examples that were brought up here of handling situations involving foreign investments show that the Kremlin is prone to using strong armed techniques and high pressure in the spheres where they see their strategic interests being violated. In such cases, the authorities have resorted

to the tactics of using formal excuses and selective application of the existing laws in order to achieve their goals behind the scenes, while making every effort to save the appearance of due legal process.

In spite of these warnings, many experts think that FDI to Russia is a feasible option as long as the potential investors adhere to the following guidelines:

- Carefully select the industry
- Keep low a political profile
- Be prepared to deal with other negative peculiarities of the Russian business environment, such as inefficient bureaucracy, a weak judicial system, corruption, organized crime, and an undeveloped infrastructure, among the most notable
- Develop a comprehensive exit strategy
- Carefully calculate economic rewards, make a thorough risk assessment analysis, and accept the possibility of losing it all” [36]

Economic policy. “Economic policy in Russia is primarily aimed at social, political and economic stability; further development of the institutional structure of the market; and economic diversification. In response to the crisis the government, together with the Central bank, have developed an anti-crisis stimulus package aimed at minimizing and mitigating the scale of the crisis, both for the economy and the population. In this context, the government continues to initiate change and introduce new methods to develop the currency, fiscal, budgetary and tariff policy, and the financial market and banking systems. The state is increasing its role in the economy, paying special attention to the oil and gas, banking and defense sectors. In 2005 the government initiated a much-publicized National Priority Projects program to develop social welfare and services in Russia through additional state funding in four areas: health, education, housing and agriculture. The government promised to continue funding these programs, in spite of the crisis.

Major development goals. In his Address to the Federal Assembly and his “Go, Russia” article, President Medvedev identified modernization as a key priority for the development of Russia and cited five strategic goals which can be achieved by establishing the basis for a national innovation system and creating a favorable environment for research and development:

- Increasing the efficiency of production, transport and use of energy; developing new fuels for use on domestic and international markets
- Maintaining nuclear technology and raising it to a qualitatively new level
- Using Russian experts to improve information technology and strongly influence the development of global public data networks, including use of supercomputers and other necessary equipment
- Employing Russia’s own ground and space infrastructure for transferring all types of information to be developed
- Taking a leading position in the production of certain types of medical equipment, sophisticated diagnostic tools, and medicines for the treatment of viral, cardiovascular, and neurological diseases and cancer

The Russia forum 2012: one hundred steps forward. In his speech, the Prime Minister of the Russia Federation, Vladimir Putin, remarked that at the moment the Russian Federation is currently the sixth-largest economy in the world and has a very good chance of becoming number five. The level of inflation fell to 6%, its lowest point in the last 20 years. The Prime Minister did not rule out that in the next few years this figure could drop to 4%. According to 2011 results, the Russian budget finished the year with a 1% surplus, public debt equaled 10.4% and foreign debt stood at 2.5% of GDP. However, the country still faces unresolved tasks. Russia occupies 120th place in terms of investment climate favorability. “We must move one hundred

steps forward, from 120th to 20th place in terms of our business environment”, the Prime Minister emphasized.

The Prime Minister formulated six necessary changes in Russian legislation. First, an institution of commissioners to defend the rights of businessmen will be established in the near future. The commissioners will have the power to halt implementation of current legislation if it hurts the investment climate and provides grounds for corruption. They will guarantee the protection of business interests at the institutional level. Second, legal procedures for examining deals between businesses and the state will be simplified. The state will bear the responsibility in case of incorrect claims and can be forced to compensate for a business’ financial losses that are incurred as a result of such an examination. Third, the possibility of classifying a business’ activity as criminal will be substantially limited. Fourth, control of business activity will be eased. This implies a reduction in various checks and approvals that make the life of small businessmen unbearable and force them to pay bribes. Fifth, businesses will be able to initiate mutual claims against the state. And finally, legislation will be harmonized with the best practice in developed countries. Putin also suggested to use *Key Performance Indicators, KPI* to evaluate government officials’ success or the success of a particular activity in which they are engaged. The government instituted the *Agency for Strategic Initiatives* to support innovative projects of small and medium size businesses. This agency will report directly to the Prime Minister.

International agreements. Russia is a major international power. The Russian Federation is recognized as being the successor to the former Soviet Union in international law: it has assumed the USSR’s permanent seat on the UN Security Council, membership in other international organizations, rights and obligations under international treaties, and property and debts. As one of the UN Security Council’s five permanent members, Russia has special responsibility for maintaining international peace and security. Russia has participated as a member of the Group of Eight (G8) industrialized nations since 1994, although the finance ministers of the G7 continue to meet several times a year, without their Russian counterparts. The Group of Twenty Finance Ministers and Central Bank Governors (G20), of which Russia is also a member, is to replace the G8 as the main consulting body for global financial issues. This was announced at the G20 summit in Pittsburgh in September 2009. Russia is a member of a large number of other international organizations, including the Council of Europe and the Organization for Security and Cooperation in Europe. Russia plays a special role in Central Asian organizations:

- Commonwealth of Independent States (CIS),
- Eurasian Economic Community (EurAsEC),
- Collective Security Treaty Organization (CSTO),
- Shanghai Cooperation Organization (SCO).

Membership

International Structures

- United Nations: Security Council, General Assembly, United Nations specialized agencies
- Group of Eight (G8)
- Group of Twenty (G20)
- Council of Europe
- Organization for Security and Cooperation in Europe (OSCE)
- Permanent Court of Arbitration (PCA), also known as the Hague Tribunal

Regional

- Council of the Baltic Sea States
- Arctic Council
- Shanghai Cooperation Organization

- Organization of the Islamic Conference (observer)
- CIS and CIS structures

Economic Organizations

International

Trade

- United Nations Conference on Trade and Development
- World Trade Organization

Financial

- International Bank for Reconstruction and Development (World Bank Group)
- International Development Association (World Bank Group)
- Multilateral Investment Guarantee Agency
- International Monetary Fund
- International Finance Corporation
- Bank for International Settlements
- Paris Club

Other

- World Intellectual Property Organization
- World Federation of Trade Unions
- World Customs Organization
- International Organization for Standardization
- International Trade Union Confederation

Regional

Trade

- Organization of the Black Sea Economic Cooperation
- Asia-Pacific Economic Cooperation Forum

Financial

- European Bank for Reconstruction and Development

Other

- General Confederation of Trade Unions

NATO. On 27 May 1997, NATO and Russia signed the NATO-Russia Founding Act, which provides the basis for a longlasting and robust partnership between the alliance and Russia. The creation of the NATO-Russia Council (NRC), unveiled at the 2002 NATO summit in Rome, opened a new era in NATO-Russia relations, providing opportunities for consultation, joint decisions and joint action on a wide range of issues.

EU. The bilateral basis for EU relations with Russia is the Partnership and Cooperation Agreement (PCA), which came into force on 1 December 1997 for an initial duration of ten years. The PCA established an institutional framework for regular consultations between the European Union and Russia. At a St Petersburg summit in May 2003, the EU and Russia reinforced their cooperation by creating four “common spaces” under the Partnership and Cooperation Agreement:

- A common economic space
- A common space of freedom, security and justice
- A space of cooperation in the field of external security, and
- A space of research and education, including cultural aspects.

A new partnership agreement is under consideration, but its conclusion has been postponed for political reasons.

World Trade Organization. The Working Party on Russia's accession to the WTO was established on 16 June 1993. At the end of 2011, WTO ministerial conference approved all the documents relating to Russia's accession to the organization including commitments on market access for goods and services. Russia will become a full member of this international organization with all its rights and responsibilities within 30 days of Russian ratification, expected to occur in the summer of 2012.

Regulations for business⁷. *Competition policy.* The government regulator of market competition policy in Russia is the Federal Antimonopoly Service (FAS). Its primary objective is to ensure compliance with antimonopoly regulations set out in Russian competition law⁸. The FAS has the power to prevent unfair competition, state aid or agreements that reduce competition, and permit a dominant position in the market. To be legitimate, some types of state aid – meaning granting a commercial entity any privileges in the form of property, proprietary rights or proprietary benefits – must first receive written approval from the FAS.

An agreement or activity that may imply or lead to control over prices, price fixing, or a change in prices – and thereby reduce fair competition – is prohibited. However, there are certain minor exceptions to this rule related to “vertical” agreements. Companies that dominate a market are prohibited from setting low or high prices, or different prices for the same goods. Forcing counterparts to accept disadvantageous contractual terms is also illegal. The FAS has the right to audit companies' activities with regard to their compliance with competition law and request documents and information required for the audit. Violating competition law may entail severe penalties for a company and its management. For instance, for certain violations, the FAS may impose fines of up to 0.15% of the company's revenue raised from transactions on a given market. The Russian Criminal Code establishes criminal liability for company executives guilty of breaching competition law.

Competition from State-Owned Enterprises. Despite large-scale privatizations, the eight existing state corporations still play a large role in the Russian economy. (Note: State corporations are 100% owned by the Russian government and operate under special legislation. The Russian economy also features thousands of other companies owned in part or whole by the Russian government that operate under different legal arrangements, such as unitary enterprises and joint stock companies) While private enterprises are technically allowed to compete with state corporations on the same terms and conditions, in practice, the playing field is tilted. The state corporation holding structures and management arrangements (e.g., state representatives as board members) make it difficult for private enterprises to compete. Furthermore, specific legal constructions can result in preferential treatment for state corporations. For example, state corporations have no unified legal framework, being set up under different legislation than that which applies to other corporations; this case-by-case approach leaves much scope for discretion and lobbying by company insiders.

According to the European Bank for Reconstruction and Development, the private sector's share of GDP fell from 70% in 2003 to 65% in 2010. As discussed above, the Russian government approved the 2011-2013 Privatization Plan, which aims to sell an estimated \$60 billion of government stakes in more than 850 companies.

⁷ The Russian legal environment is considered in more detail in Chapter 5 of this manual.

⁸ Federal Law of the Russian Federation No. 135-FZ of 26 July 2006 “On Protection of Competition”

Corporate governance of state corporations is characterized by the “dual management” model. *The Federal Agency for State Property Management (Rosimushchestvo)* is authorized by the Russian government to exercise shareholder rights for federally owned shares in companies and is responsible for the preparation and nomination of candidates at the annual meetings of shareholders. As a general rule, *Rosimushchestvo* nominates to a company’s board of directors representatives of the most relevant government body, based on the sectoral characteristics of the business. The sectoral state body thus participates in managing the company through its representatives. In important companies that straddle the sectoral priorities of the government and its political interests, top government officials may be nominated to the boards of directors (e.g., the Minister of Energy is the Chairman of the state-owned oil pipeline company, *Transneft*). Issues that hamper the efficient operations of state corporations include a lack of transparency, unclear responsibilities of boards of directors, misalignment of managers’ incentives and company performance, inadequate control mechanisms on managers’ total remuneration or their use of assets transferred by the state to the state corporation, and reduced disclosure requirements [37].

Price controls. As a general rule, price controls, where companies must set prices in accordance with state tariffs, exist for natural monopolies such as electricity, gas and railways. In addition, special price regulations have been established for certain other goods and services, including pharmaceutical products and alcoholic beverages. If a company is seen as dominating a market, its prices may also be subject to the control of the anti-monopoly authorities (the FAS).

4. Small and medium size business infrastructure

Economic (Business) Infrastructure means the basic physical and organizational structures needed for the operation of an enterprise or a business community, or the services and facilities necessary for an economy to function. The term typically refers to the technical structures that support a business community, such as roads, transportation and logistics, affordable housing, high technology, water supply, sewers, electrical grids, and so forth, and can be defined as the physical components of interrelated systems providing commodities and services essential to enable, sustain, or enhance business operations. While physical structures refer to the large physical networks necessary for the functioning of a modern industrial nation, organizational structures refer to all the institutions which are required to maintain the economic standards of a country, such as the financial system, the education system, the system of government and law enforcement, as well as emergency services. Viewed functionally, infrastructure facilitates the production of goods and services, and also the distribution of finished products to markets, as well as basic services.

The Federal law “On the development of small and medium-sized entrepreneurship in the Russian Federation” provides a definition of the *small and medium size business infrastructure*. According to this law such infrastructure includes:

1. The system of commercial and not-for-profit organizations including centers for the support of subcontracting and providing for the placement of orders for supplies of goods, the performance of work and the rendering of services according to state and municipal requirements, creating conditions for the establishment of small and medium-sized business entities.
2. Centers and agencies for the support of entrepreneurship, consulting centers, business training centers.
3. Foundations and other financial institutions:
 - Funds from state and municipalities for the support of entrepreneurship
 - Funds for small business credit assistance (guaranty funds and subsidizing organizations)
 - Incorporated investment funds and closed-end investment funds attracting investments for small and medium-sized business entities, and
 - Microfinance organizations

4. Business incubators, technoparks, scientific parks, innovation and technological centers, and centers for crafts.
5. Marketing centers, agencies for the support of export, chambers of commerce and industry.
6. Leasing and franchising companies.
7. Mass media specialized in small and medium-sized business.

There are about 80 state services relating to small and medium-sized business in Russia including:

- Council for the Development of Small and Medium-sized Entrepreneurship under the auspices of the Chairman of the Federation Council of the Federal Assembly of the Russian Federation (Upper House of the Russian Parliament)
- Expert Council for the Development of Entrepreneurship under the auspices of the Ministry of Economic Development and Trade
- Committee for the Development of Private Entrepreneurship, Small and Medium-sized Business under the Chamber of Commerce and Industry of the Russian Federation
- Federal Fund for the Support of Small Entrepreneurship (and 74 regional branches)
- Federal Fund for Assistance to Small Enterprises in Science & Engineering (and 58 regional branches)
- The Russian Association for Development of Small and Medium-sized Entrepreneurship (and 58 regional branches)
- Joint Stock Company the *Russian Agency for the Support of Small and Medium-sized Entrepreneurship* (established on the Russian Government initiative)
- Federal web portal for small and medium-sized entrepreneurship
- Programs for the development of small and medium-sized business in all regions.

Chapter 4

Promotion of Foreign Investment

1. Investment climate and its elements

As was mentioned in chapter I of this manual, foreign investment may be divided into two categories: foreign direct investment (FDI) and portfolio investment. Both foreign direct investors and portfolio investors are interested, first of all, in safety of their capitals. The level of investors' confidence in that depends largely on the investment climate in the country of their choice.

It is rather difficult to define *investment climate* precisely (as any other broad concept). But one useful definition is the “policy, institutional, and behavioral environment, both present and expected, that influences the returns, and risks, associated with investment” [38] One can say that the investment climate is the overall environment for investments, the situation in which an investment is made.

This environment is generally seen as having three main features: *macroeconomic conditions*, *governance*, and *infrastructure*. Macroeconomic (or country-level) factors include such issues as fiscal, monetary, and exchange rate policies and political stability. Governance relates to government interactions with business, which typically mean regulation and corruption, both of which affect the costs of starting and running a business. Infrastructure refers to the quality and quantity of physical infrastructure (such as power, transport, telecommunications, *etc.*). More broadly, it can also refer to financial infrastructure (such as banking) – or access to finance. Beyond these features of the investment climate, investors also look at international integration and human resources. Social infrastructure is also recognized as no less important than its physical and financial counterparts [39].

A favorable investment climate is likely to include low inflation, falling interest rates, growing corporate earnings, political stability, and a high degree of consumer confidence. The investment climate is a significant contributing factor in the performance of an investment. A strong investment climate can help spur investments toward growth, while a weak climate can do the opposite. An enabling investment climate reduces transaction costs for private sector companies, decreases their risks and increases the incentives for market entry and expanding business activity. It should be noted that an investment climate may be beneficial for some investments and detrimental to others.

It can be easily seen that the *investment climate* has much in common with *business environment*. But to all outward appearances the notion of business environment is broader than the notion of the investment climate. Therefore it may be said that the investment climate is a part of the overall business environment in a country.

2. International investment legislation

An enabling investment climate begins with the establishment of the Rule of Law. “For the purpose of protection, promotion and liberalization of cross-border investments, a special treaty – an *International Investment Agreement (IIA)* – that addresses issues relevant to such investments is usually concluded between countries. Most IIA's cover foreign direct investment and portfolio investment, but some exclude the latter. Countries concluding IIA's commit themselves to adhere to specific standards on the treatment of foreign investments within their territory. IIA's further define procedures for the resolution of disputes should these commitments

not be met. The most common types of IIA's are *Bilateral Investment Treaties (BIT's)* and *Preferential Trade and Investment Agreements (PTIA's)*. *International Taxation Agreements* and *Double Taxation Treaties (DTT's)* are also considered as IIA's, as taxation commonly has an important impact on foreign investment.

Bilateral investment treaties deal primarily with the admission, treatment and protection of foreign investment. They usually cover investments by enterprises or individuals of one country in the territory of its treaty partner. *Preferential Trade and Investment Agreements* are treaties among countries on cooperation in economic and trade areas. Usually they cover a broader set of issues and are concluded at bilateral or regional levels. In order to classify as IIA's, PTIA's must include, among other content, specific provisions on foreign investment. *International taxation agreements* deal primarily with the issue of double taxation in international financial activities (e.g., regulating taxes on income, assets or financial transactions). They are commonly concluded bilaterally, though some agreements also involve a larger number of countries.

Historically, the emergence of the international investment framework can be divided into two separate eras. The first era – from 1945 to 1989 – was characterized by disagreements among countries about the degree of protection that international law should offer to foreign investors. While most developed countries argued that foreign investors should be entitled to a minimum standard of treatment in any host economy, developing and socialist countries tended to contend that foreign investors do not need to be treated differently from national firms.

In 1959, the first Bilateral Investment Treaties (BIT's) were concluded, and during the following decade, much of the content that forms the basis of a majority of the BITs currently in force were developed and refined. In 1965, the *Convention for the Settlement of Investment Disputes between States and Nationals of Other States* was opened to countries for signature. The rationale was to establish *International Centre for Settlement of Investment Disputes (ICSID)* as an institution that facilitates the arbitration of investor-State disputes.

The second era – from 1989 to today – is characterized by a generally more welcoming sentiment towards foreign investment, and a substantial increase in the number of BIT's concluded. Amongst other reasons, this growth in BIT's was due to the opening up of many developing economies to foreign investment, which hoped that the conclusion of BIT's would make them a more attractive destination for foreign companies. The mid-1990's also saw the creation of three multilateral agreements that touched upon investment issues as part of the Uruguay Round of trade negotiations and the creation of the World Trade Organization (WTO). These were the *General Agreement on Trade in Services (GATS)*, the *Agreement on Trade-Related Investment Measures (TRIMS)*, and the *Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)*. In addition, this era saw the growth of Preferential Trade and Investment Agreements (PTIA's), such as regional, interregional or multilateral agreements, as exemplified in the conclusion of the NAFTA in 1992 and the establishment of the ASEAN Framework Agreement in the ASEAN Investment Area in 1998. These agreements typically also began to pursue liberalization of investment more intensively.

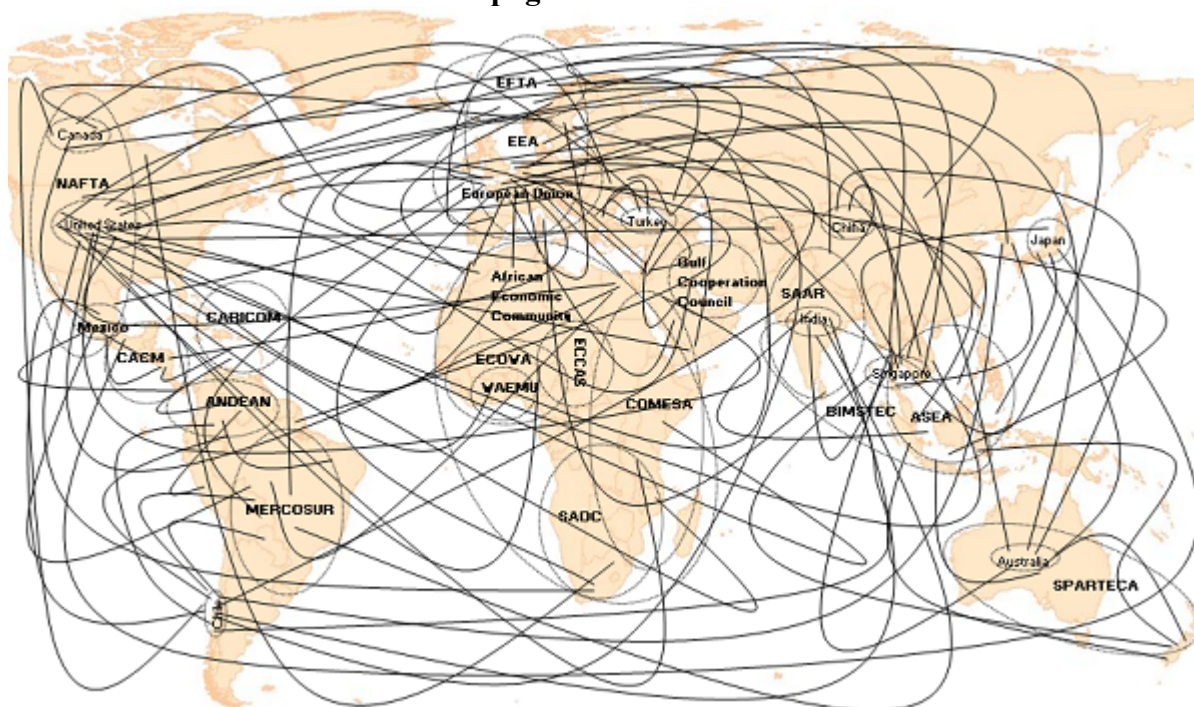
Statistics show the rapid expansion of IIA's during the last two decades. By 2007 year-end, the entire number of IIA's had already surpassed 5,500, and increasingly involved the conclusion of PTIA's with a focus beyond investment issues. As the types and contents of IIA's are becoming increasingly diverse and as almost all countries participate in the conclusion of new IIA's, the global IIA system has become extremely complex and hard to see through. Moreover, the number of IIA-based investor-State dispute settlement cases has also been on the rise in recent years. By the end of the year 2008, the total number of known cases reached 317.

Another new development in the global system of IIA's is the increased conclusion of such agreements among developing countries. In the past, industrialized countries usually concluded IIA's to protect their firms when they undertake overseas investments, while developing countries tended to sign IIA's in order to encourage and promote inflows of FDI from industrialized countries. The current trend towards increased conclusions of IIA's among developing countries reflects the economic changes underlying international investment relations. Developing countries and emerging economies are increasingly not only destinations, but also significant source countries of FDI flows. In line with their emerging role as outward investors, and their improved economic competitiveness, developing countries are increasingly pursuing the dual interests of encouraging FDI inflows but also seeking to protect the investments of their companies abroad.

Another key trend relates to the myriad of different agreements. As a result, the evolving international system of IIA's has been equated with the metaphor of a "spaghetti bowl" (see Fig 4.1). According to UNCTAD, the system is universal, as practically every country has signed at least one IIA. At the same time, it can be considered as atomized due to the large amount of individual agreements currently in existence. The system is multi-layered, with agreements being signed at all levels (bilateral, sectoral, regional etc.). It is also multi-faceted, as an increasing number of IIA's include provisions on issues traditionally considered only distantly related to investment, such as trade, intellectual property, labor rights and environmental protection. The system is also dynamic, as its key characteristics are currently rapidly evolving. For example, more recent IIA's tend to include provisions addressing issues such as public health, safety, national security or the environment more frequently, with a view to better reflect public policy concerns. Finally, beyond IIA's, there is other international law relevant for countries' domestic investment frameworks, including customary international law, United Nations instruments and the WTO agreement (e.g., TRIMS).

Fig 4.1

"Spaghetti bowl" of IIA's



Source: UNCTAD

In sum, recent developments have made the system increasingly complex and diverse. Moreover, even to the extent that the principal components of IIA's are similar across most of the agreements, substantial divergences can be found in the details of these provisions. All of this

makes managing the interaction among IIA's increasingly challenging for countries, particularly those in the developing world, and also complicates the negotiation of new agreements.

In the past, there have been several initiatives for the establishment of a more multilateral approach to international investment rulemaking. These attempts include the Havana Charter of 1948, the *United Nations Draft Code of Conduct on Transnational Corporations* in the 1980s, and the *Multilateral Agreement on Investment (MAI) of the Organization for Economic Cooperation and Development (OECD)* in the 1990's. None of these initiatives reached successful conclusion, due to disagreements among countries and, in case of the MAI, also in light of strong opposition by civil society groups. Further attempts of advancing the process towards establishment of a multilateral agreement have since been made within the WTO, but also without success. Concerns have been raised regarding the specific objectives that such a multilateral agreement is meant to accomplish, who would benefit in what way from it, and what impact such a multilateral agreement would have on countries' broader public policies, including those related to environmental, social and other issues. Particularly developing countries may require "policy space" to develop their regulatory frameworks, such as in the area of economic or financial policies, and one major concern was that a multilateral agreement on investment would diminish such policy space. As a result, current international investment rulemaking remains short of having a unified system based on a multilateral agreement. In this respect, investment differs for example from trade and finance, as the WTO fulfills the purpose of creating a more unified global system for trade and the International Monetary Fund (IMF) plays a similar role with respect to the international financial system.

By providing additional security and certainty under international law to investors operating in foreign countries, IIA's can encourage companies to invest overseas. While there is a scientific debate on the extent to which IIA's increase the amount of FDI flows to signatory host countries, policymakers do tend to anticipate that IIA's encourage cross-border investment and thereby also support economic development. Amongst other reasons, FDI can facilitate the inflows of capital and technology into host countries, help generate employment and have other positive spillover effects. Accordingly, developing country governments seek to establish an adequate framework to encourage such inflows, among others through the conclusion of IIA's.

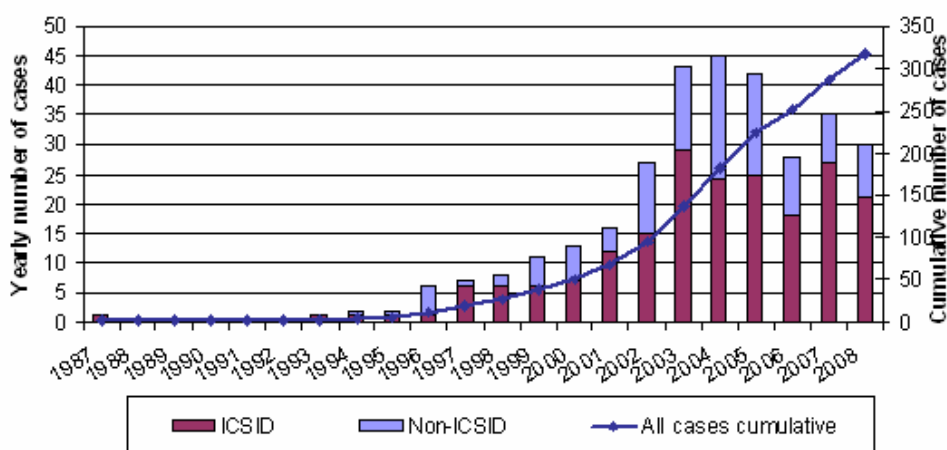
However, despite this potential to generate pro-development benefits, the evolving complexity of the IIA system may also create challenges. Amongst others, the complexity of today's IIA network makes it difficult for countries to maintain policy coherence. Provisions agreed upon in one IIA may be inconsistent with those included in a different IIA. For developing countries with lower capacity to participate in the global IIA system, this complexity of the IIA framework is particularly hard to manage. Additional challenges arise from the need to ensure consistency between a country's national and international investment laws, and from the objective to design investment policies that best support a country's specific development goals.

Furthermore, even if governments conclude IIA's with general development goals in mind, these agreements themselves usually do not directly deal with problems of economic development. While IIAs rarely contain specific obligations on investment promotion, some include provisions that advocate information exchange about investment opportunities, encourage the use of investment incentives, or suggest the establishment of investment promotion agencies (IPA's). Some also contain provisions that address public policy concerns related to development, such as exceptions related to health or environmental issues, or exceptions related to essential security. Some IIA's also grant countries specific regulatory flexibility, amongst others when it comes to making commitments for investment liberalization.

An additional burden arises from the growing amount of investor-State disputes, which are increasingly lodged against governments from developing countries. These disputes are very costly for the affected countries, which have to shoulder substantial expenses for the arbitration procedures, for the payment of lawyer's fees and, most importantly, for the financial compensation to be paid to the investor in case the tribunal decides against the host country. The problem is further exacerbated by inconsistencies in the case law that is emerging from investor-State disputes. Increasingly, tribunals addressing similar cases come to differing interpretations and decisions. This increases the uncertainty among countries and investors about the outcome of a dispute.

Figure 4.2

Known investment treaty arbitrations, cumulative and newly instituted cases by year



Source: UNCTAD

One of the key organizations concerned with the development dimension of IIA's is the United Nations Conference on Trade and Development (UNCTAD), which is the key focal point of the United Nations (UN) for dealing with matters related to IIA's and their development dimension. This organization's program on IIA's supports developing countries in their efforts to participate effectively in the complex system of investment rulemaking. UNCTAD offers capacity building services, is widely recognized for its research and policy analysis on IIA's and functions as an important forum for intergovernmental discussions and consensus building on issues related to international investment law and development" [40].

The OECD is another organization developing various recommendations which provide voluntary principles and standards for responsible business conduct consistent with applicable laws. The following OECD documents may be helpful for international entrepreneurs: *The OECD Declaration on International Investment and Multinational Enterprises*, the *OECD Framework for International Investment Policy*, the *OECD Checklist for Foreign Direct Investment Incentive Policies* and the *OECD Principles of Corporate Governance*.

3. Investment climate in Russia

Russia is increasingly becoming considered a country with a stable investment climate. Russia has witnessed a large increase in foreign direct investment inflows over the last few years, thanks to a growing domestic market, rich human capital, natural resources and political stability (though this has slowed with the financial crisis).

Constraints on foreign business are being abolished and the regulatory environment has improved. However, several sectors remain closed to foreign investment. Current regulations

restrict foreign involvement in the banking sector, and the government has restricted foreign access to 42 activities that have strategic significance for national defense and state security. Basically, they can be grouped into eight main areas:

- Nuclear materials, devices, waste, etc.
- Coding and cryptographic equipment
- Weapons and military equipment and technology
- Aviation and space
- Television and what may be called large scale radio broadcasting and printed mass media
- Natural monopolies which are designated as such on the FAS (Federal Anti-Monopoly Service) list
- Telecoms, but not internet providers and
- Geological survey and exploration and development of subsoil areas of federal significance

As part of the government's plans to simplify the process by which investors can access strategic sectors, a draft law to moderate foreign investment restrictions in Russia's strategic sectors and mineral resources was introduced in the lower house of parliament.

Russian investment policy includes tax relief, reduced administrative barriers, and developing private-public partnerships. The government is planning to invest in infrastructure projects to promote investment.

Among improvements for investors, Russia now has

- The lowest corporate tax rate of any G8 or BRIC country
- Amended laws to allow BOT (build-operate-transfer) projects
- A framework allowing foreign investment in strategic areas

The government is to lower administrative barriers to foreign investment. First, by introducing a procedure for registering business activities by submitting a declaration to the government; and second, part of the process for declaring entry to business activities will be transferred to self-regulating organizations (SRO's). In addition, the government is planning to shorten the time period for foreign enterprises to receive permission on investment projects. The recently formed Department of State Control of Economics will be in charge of removing barriers for foreign investors.

In August 2010, the Russian Government established a *Foreign Investment Ombudsman* position and appointed First Deputy Prime Minister Igor Shuvalov to this office. It is supposed that foreign investors can contact the ombudsman directly with their needs, proposals and ideas. President Medvedev posted investment ombudsmen to each of the country's 83 regions. The key role of regional investment ombudsmen is to help companies implement investment projects in a hassle-free way, by monitoring investment decisions made by regional governments. The ombudsmen are also expected to know the investment laws of each region and provide counsel to help businesses develop their presence across the country.

The Foreign Investment Advisory Council was established in 1994 as a forum for dialogue between the Russian Government and the leading foreign investors in the Russian market. The council is chaired by the Russian Prime Minister and includes CEOs from 42 international companies and banks: 3M, ABB, Alcoa, BASF, BAT, BHP Billiton, BP, Cargill, The Coca-Cola Company, Deutsche Bank, EBRD, ENEL S.p.A., ENI S.p.A., Ernst & Young, ExxonMobil, Finmeccanica, Ford Motor Company, Intel, Itochu Corp., Kinross Gold Corporation, Kraft Foods, Lafarge, Mars, METRO Group, Mitsubishi Corp., Mitsui & Co., Nestle, Novartis, PepsiCo, Procter & Gamble, Renault, Siemens, Shell, Schlumberger, SUN Group, Telenor, Tetra

Pak, Total, Unicredit Italiano, United Technologies, Unilever, and The World Bank:
<http://www.fiac.ru/about.php>

Pursuant to Government Decree No. 510 of 6 July 2008 "On the Government Commission on Monitoring Foreign Investment in Russia", the *Government Commission on Monitoring Foreign Investment in Russia* was formed: <http://invest.gov.ru>

The primary objectives of the Commission are as follows:

1. Pre-approval of transactions resulting in a foreign investor or group of entities of which such investor is a member (hereinafter, the "group of entities") gaining control over business companies which are of strategic importance.
2. Approval of the gaining of control over business companies which are of strategic importance by the foreign investor or by a group of entities, or refusal of such approval.

Activities of the Commission:

1. Soliciting petitions for pre-approval of transactions resulting in gaining control by the foreign investor, or by a group of entities, over business companies which are of strategic importance and other transactions which require pre-approval in accordance with federal law, as well as petitions for approval of the gaining of control by the foreign investor, or by a group of entities, over business companies which are of strategic importance.
2. Decision-making with regard to the following:
 - Pre-approval of transactions or approval of the gaining of control
 - Refusal of pre-approval of transactions or refusal of approval of the gaining of control
 - In exceptional circumstances, extension of the period for consideration of a petition for pre-approval of a transaction or petition for approval of the gaining of control
3. Determination of obligations of the foreign investor or legal or physical bodies constituting a single entity.

For the purpose of achieving the above objectives the Commission is granted the following rights:

- Can request from federal governmental bodies any materials and information on any issues within its scope of activities
- In accordance with the applicable procedure, enlist the services of representatives of federal governmental bodies and any experts for the examination of issues proposed for consideration by the Commission
- Hear out representatives of the federal government bodies on any issues within the scope of the Commission's activities
- Organize task groups from representatives of federal governmental bodies
- Supervise the execution of decisions of the Commission

Special regulation of rights, obligations and guarantees for foreign investors in Russia is implemented through a number of federal and local laws and other legal instruments. Several Federal Laws on foreign investments in the Russian Federation and bilateral investment treaties of the RF are among the most important acts.

International legislation. International agreements in which Russia participates are a component of its legal system and have priority over the internal legislation. The Russian Federation has concluded, signed and ratified numerous bilateral treaties regarding the encouragement and protection of capital investments, about avoidance of double taxation, and a number of conventions promoting improvement of foreign trade activities.

Currently there are about 70 international treaties (conventions, agreements) in which Russia participates. In addition to the treaties concluded by the RF Government the agreements made out by the USSR Government continue to be in force.

From the Soviet Union, Russia inherited 14 bilateral investment treaties: with Austria, Belgium, Luxembourg, Great Britain, Germany, Italy, Spain, Canada, the People's Republic of China, Korea, the Netherlands, Finland, France, and Switzerland. They were ratified in 1989-1990 and came into force in 1991. Russia has since negotiated another 34 agreements, of which 20 have so far been ratified: with Greece, Cuba, Romania, Denmark, Slovakia, the Czech Republic, Vietnam, Kuwait, India, Hungary, Albania, Norway, Yugoslavia, Italy, Lebanon, Macedonia, the Philippines, Egypt, South Africa, and Japan.

Besides general international treaties on double taxation there is a number of bilateral agreements, mainly to prevent double taxation for international (air and sea) transportation concluded by the USSR. Such agreements are in force with Algeria (dated 11.06.1988), Argentina (dated 30.03.1979), Greece (dated 27.01.1976), Iraq (dated 26.09.1974), Ireland (dated 17.12.1986), and France (dated 04.03.1970).

Russia is a signatory to the Geneva Diplomatic and Consular Conventions and Multilateral Convention for the Avoidance of Double Taxation of Copyright Royalties (Madrid, December 13, 1979).

There are also bilateral agreements with CIS countries: Azerbaijan (dated 03.07.1997), Belarus (dated 21.04.1995), Uzbekistan (dated 02.03.1994; ratified 24.04.1995), Ukraine (dated 08.02.1995).

National legislation. The national legislation on foreign investments has two levels – a federal level and a regional level that is the subject of legislation in Russia (republics, borders, areas, and so forth).

Federal Legislation. In the Constitution of the Russian Federation (the Constitution), the Civil Code of the Russian Federation (the Civil Code), and other legislation on joint stock and limited liability companies and their insolvency provide the general legal framework for trade and investment in Russia. Foreign investments are regulated by the Federal Law on Foreign Investments in the Russian Federation, dated 9 July 1999 (the Law on Foreign Investments). However, the Law on Foreign Investments does not apply to the investment of foreign capital in banks, credit organizations, insurance companies or non-commercial organizations; foreign investments in such entities are regulated under different Russian legislation.

The Law on Foreign Investments guarantees foreign investors the right to invest and to receive revenues and profits from such investments, and sets forth the terms for foreign investors' business activity on the territory of the Russian Federation.

The objective of the Law on Foreign Investments is to attract foreign materials, financial resources, and technology and management skills to improve the Russian economy, while providing stability for foreign investors. The Law on Foreign Investments is aimed at the Government of the Russian Federation conforming to standards of international law and to international standards of investment cooperation.

The Law on Foreign Investments emphasizes the role of both federal and regional legislation, and stipulates that foreign investors and investments must be treated no less favorably than domestic investments, with some exceptions. Such exceptions may be introduced to protect the

Russian constitutional system, the morality, health and rights of persons, or in order to ensure state security and defense.

The Law on Foreign Investments permits foreign investment in most sectors of the Russian economy: portfolios of government securities, stocks and bonds, direct investment in new businesses, the acquisition of existing Russian-owned enterprises, joint ventures, etc. Foreign investors are protected against nationalization or expropriation unless such action is mandated by a federal law. In such cases, foreign investors are entitled to receive compensation for any investment and other losses.

One of the most important features of the Law on Foreign Investments is the tax stabilization clause set forth in Article 9. Under Article 9.1, the Law's tax stabilization, clause, also known as "the Grandfather Clause", applies to i) foreign investors that are implementing "priority investment projects", ii) Russian companies with more than 25% foreign equity ownership, or iii) Russian companies with some foreign participation that are implementing "priority investment projects".

Article 2 defines a priority investment project as a project with foreign investment of at least one billion rubles (about \$33 million at current exchange rates), or where a foreign investor has purchased an equity interest of at least 100 million rubles (about \$3.3 million at current exchange rates); in either case, the investment project must also be included in a list of projects approved by the Russian Government.

For qualifying companies and projects, the Grandfather Clause prohibits increases in the rates of certain import duties and federal taxes until initial investments have been recouped (up to a maximum of seven years, unless this period is extended by the Russian Government under certain conditions). Key exceptions to the Grandfather Clause are established for protective customs tariffs on commodities, excise tax, VAT on domestic goods, and Pension Fund payments. Article 9.4 provides a further and potentially broad exception for laws protecting certain public or state interests. Article 9.5 contemplates the adoption of regulations to implement the Grandfather Clause. Given all of these exceptions and qualifications, it remains arguable whether the tax stabilization clause is of real benefit to foreign investors.

In May 2008 the regulatory legislation for foreign investors changed dramatically and became far more rigorous. The terms and conditions for foreign investment in Russia are now regulated by the Law "On Strategic Industries"⁹, which came into force on 7 May 2008, and the Law "On Foreign Investments"¹⁰, which was amended with the adoption of the Law "On Strategic Industries".

Under the Law "On Strategic Industries", certain Russian companies are deemed to have strategic importance for Russia's national defense and security. In addition to weapons, aviation and space industries, the law also declares natural monopolies, the mass media and companies involved in natural resource exploration and extraction (except where the Russian Government owns more than 50% of the company) as being strategic.

⁹ Federal Law No. 57-FZ of 29 April 2008 of the Russian Federation "On Foreign Investments in Companies Having Strategic Importance for State Security and Defense"

¹⁰ Federal Law No. 160-FZ of 9 July 1999 of the Russian Federation "On Foreign Investments in the Russian Federation"; Federal Law No. 58-FZ of 29 April 2008 of the Russian Federation "On Amendments to Legal Acts of the Russian Federation"

Foreign investors acquiring direct or indirect control over Russian strategic enterprises are required to obtain prior approval, or in certain cases post-transaction approval, from a special government commission. The Federal Antimonopoly Service and Federal Security Service must establish that the acquisition does not threaten Russia's national security, and the foreign investor may have to meet other requirements to gain approval.

The Law "On Strategic Industries" prohibits foreign states, international organizations and legal entities directly or indirectly controlled by foreign states or international organizations from acquiring control over strategic enterprises.

According to the latest amendments to the Law "On Foreign Investments", any transaction with the participation of foreign states, international organizations or legal entities directly or indirectly controlled by foreign states or international organizations to acquire control over any Russian entity should also be reviewed by the governmental commission to ensure that the entity is not a strategic enterprise. Transactions made in violation of the Law "On Strategic Industries" are void.

However, on 30 December 2009 the Russian Government established regulatory provisions for an Advisory Committee on Foreign Investments which will include representatives of major foreign investors and advise the government on steps to be taken to improve the investment climate in Russia.

Regional Legislation. Prior to investing in a region, and in addition to reviewing the applicable federal legislation, potential investors should also examine regional laws. One of the most instinctive features of the investment climate in Russia has been the competition among various regions of Russia to attract investment, both foreign and Russian, striving to attract as many investors as possible to their respective territories, and thus improve the social and economic conditions of their regions, the constituent entities of the Russian Federation have passed a large number of laws, regulations, and other legal measures to encourage and regulate investment. Some regions have made special efforts to introduce favorable conditions for foreign investment, while others have enjoyed no success in improving their investment climate.

One of the most progressive regional investment laws was approved in the Leningrad Oblast (region) in 1997. The goal of this law was to develop investment activity in the Leningrad Oblast. To achieve this goal, the law created a "most favorable treatment regime", and provided additional guarantees of state support to investors involved in investment projects having major economic and social importance for the region. Similarly positive, the city of St. Petersburg recently adopted a number of tax incentives aimed at attracting investment into the production sphere there.

Other pro-investment regions include the Samara, Saratov, Nizhnii Novgorod, Sverdlovsk, Novgorod Oblasts (regions), and the Krasnodar, Perm and Khabarovsk Krai (territories), all of which have attracted significant amounts of foreign capital. Laws providing for certain measures aimed at attracting foreign investors, in particular, reduction of taxation rates for investors, have been adopted in Tyumen, Kaluga, Voronezh, Lipetsk, Kemerovo, Orenburg Oblasts (regions) and in the Republic of Mordovia.

Creation of Special Economic Zones in the Russian Federation may also become a new means of attracting investors. The regulatory framework for these territories is established at both federal and regional levels. Laws providing for tax incentives for residents of Special Economic Zones have already been adopted in the Lipetsk, Moscow, Kaliningrad and Tomsk Oblasts (regions), in the Republic of Tatarstan and in St. Petersburg.

Special economic zones. In 2005, the Federal Law No. 116-FZ “On Special Economic Zones in the Russian Federation” (the Law on Special Economic Zones) was passed, which introduced new methods for the provision of investment benefits. Under the Law on Special Economic Zones, a special economic zone ("SEZ") is a territory in Russia selected by the government on a tender basis from proposals submitted by regional authorities. A special preferential regime for conducting business activities is to be provided for 20 years to encourage development of high technology industrial areas and health and recreational resorts, and for 49 years to develop transport infrastructure (international cargo sea and river ports and airports).

In December 2005 six geographic locations in various parts of Russia were selected by the government for the creation of SEZ's of two types - High Technology Incubation Zones ("TIZ's") and Industrial Production Zones ("IPZ's").

TIZs will be located in the Moscow Region (Dubna and Zelenograd), St. Petersburg, and Tomsk - four in total. Each zone has its own specialization: The TIZ in Dubna specializes in nuclear technology, energy saving, aerospace and civil engineering; the TIZ in Zelenograd specializes in microelectronics, nanotechnologies and medical studies; St. Petersburg specializes in the development and testing of computer programs, databases, and complex equipment; while Tomsk specializes in the development of new technologies and production of new types of materials, micro- and nanoelectronics.

Two selected territories have been chosen to accommodate IPZ's - in the Lipetsk Region and in Yelabuga (Tatarstan). The IPZ in Lipetsk produces consumer appliances, electronics, machinery and construction materials, while the IPZ in Yelabuga specializes in components for the automotive and petrochemicals industries.

Another type of SEZ, introduced in late 2006/early 2007 is the Zone of Tourism and Recreation ("ZTR"), which will provide for the development of tourism, and health and recreational resorts. Currently seven projects have been selected for ZTR's, to be located in Altai and Buriatia, the Krasnodarskiy, Stavropolskiy and Altaiskiy Territories, and the Kaliningrad and Irkutsk Regions. They are expected to start operating by 2012 and receive over one million visitors annually.

The Port Zone ("PZ") type of SEZ was introduced in late 2007. The exact number of PZs to be created has not been decided yet, but three projects were selected in 2008: the port in the Khabarovskiy Territory, and two airports – in the Krasnoyarskiy Territory and the Ulianovskiy Region. It is expected that several other territories also will be selected for international cargo sea/river-port and airport infrastructure development. Residents will engage in load discharging, warehouse services, transportation and forwarding, ship chandler services, ship maintenance and technical support, wholesale trade, simple assembling, packaging and marking, processing of fish and other sea products, and operation and maintenance of the PZ.

The Federal SEZ Management Agency was created by the Russian Government within the Ministry of Economic Development and Trade (more information on SEZ development is available at www.rosuez and www.rosez.ru). Russian legal entities interested in participating in an SEZ (note - benefits apply to foreign investors only upon the creation of a Russian subsidiary) should obtain the status of an SEZ resident by entering into an agreement on technology implementation activities with an SEZ Administration. The application should be supported by a business plan. A Special SEZ Expert Council (including the SEZ Management Agency, regional and local administration officials, and other SEZ residents and experts) decides on whether the applicant qualifies to be an SEZ resident based on a score evaluation system, taking into account the prior expertise of the applicant (or the founder of the applicant) in the selected industry, calculation of the investment recoupment period, the markets for the developed products,

competition and other business risk analysis, intellectual property rights issues, etc. Residents of an IPZ have to invest at least one million euros during the first year of their project and at least ten million overall during the project. PZ residents have to invest 100 million euros if developing new international cargo port infrastructure, 50 million euros if developing a new river-port or airport, and no less than three million euro if reconstructing the infrastructure of existing ports, river-ports or airports.

In September 2010, President Dmitry Medvedev signed the Law On the Skolkovo Innovation Centre (also Russian Silicon Valley in Skolkovo), which is planned to become a high technology business area. The Russian government looks to attract smaller businesses to this area. The site is intended to be an ultramodern complex created to encourage scientifically-technological based companies. It is expected that the complex will be constructed in the territory of the city settlements of New Ivanovo and Odintsovo, near the village of Skolkovo, located in the east part of Odintsovsky area of Moscow, 2 km to the west from Moscow Ring Highway on Skolkovsky highway. Unlike Silicon Valley in the US, which relies on a vast workforce of highly qualified immigrants, Russia has more in common with Bangalore in India and takes advantage of local talent. However, Russian lawmakers are also taking important steps to attract foreign specialists and hope the new regime will also bring back those Russians who have worked in the IT sector in the US. Incentives for resident companies include complete exemption from profit tax, value-added tax, property taxes, and import duties, and partial exemption from social fund payments. From January 1, 2011, the income tax for non-residents equals the standard 13% rate for Russian citizens instead of the 30% that foreigners have to pay during the first six months of their stint in Russia. Skolkovo is headed by a prominent Russian oligarch Viktor Vekselberg. Applicants for residency are evaluated and selected by an international admission board.

Residents of SEZs will be provided with the following major tax benefits:

- Exemption from Corporate Property Tax, Transport Tax and Land Tax (the latter applicable only to the owners of land plots) for the first five years after a property is acquired
- A reduced regional portion (13.5%) of the Corporate Profits Tax rate upon the introduction of this benefit in the corresponding Regional Law, resulting in a total Corporate Profits Tax rate of 20% down from the usual 24%; also, the amended provisions of the Russian Tax Code now allow residents of TIZs, IPZs and even ZTRs to immediately write-off expenditure on scientific research and development works; in addition to that IPZ and ZTR residents will be able to use accelerated amortization for fixed assets, and be able to write-off any losses without limitations, otherwise resulting in a need to carry-forward
- A Unified Social Tax (LIST) on employees' salaries on a regressive scale ranging from 14% down to 2% (usually 26% down to 2%) for TIZs
- A special "free customs zone" regime for residents of TIZs, IPZs and PZs incorporating the ability to import goods and equipment for the resident company's use with neither import customs duties nor VAT, and the possibility to acquire Russian goods under a 0% export rate of VAT. Services (works) performed by PZ residents will be exempt from VAT. Goods brought into PZs or produced within PZs and exported will be also exempt from excise tax, if it generally may be applicable

In addition to Special Economic Zones discussed above, ad-hoc legislation on specific free economic zones ("FEZ's") was adopted for several regions and is currently still in force. One example of such legislation is the Federal Law On the Special Economic Zone in the Kaliningrad Region of January 10, 2006 (which replaced previous legislation of January 22, 1996) and the Federal Law On the Special Economic Zone in the Magadan Region of May 31, 1999.

It is also of note that all gambling businesses should be transferred (beginning July,1, 2009) to four territories (zones) in the Primorskiy, Altaiskiy, and Krasnodarskiy Territories, and the Kaliningrad Region; however, these zones will not provide any special tax benefits.

Production sharing agreements. In addition to the law "On Foreign Investments," the Russian Federation has approved numerous laws which promote international trade. Russia also continues to update its existing laws in order to make them more favorable for foreign investment.

One of the most recent attempts to promote foreign investment was the passage of several amendments to the Russian Federation law "On Production Sharing Agreements" (the "PSA Law") that significantly increased the number of government authorities empowered to submit laws on production sharing projects to the Russian Federation legislative branch. These changes meant that investors now had more opportunities to conclude production sharing agreements.

The PSA Law was originally intended to attract both Russian and foreign investment into the development of Russia's natural resources (i.e., oil, gas, gold, etc.). This Law never lived up to its expectations, primarily because PSA's could only be initiated by a limited number of state bodies in the Russian Federation.

The most recent amendments provide for two alternative production sharing mechanisms and more opportunities for Russian companies and individuals to participate in production sharing agreements. They also simplify procedures for developing subsoil plots, gas deposits, oil deposits and other natural resources.

Guarantees. The incentives and guarantees provided for by the Law on foreign investment are vested in foreign investors once they acquire a certain status, i.e. from the date of the establishment of a commercial entity.

The following entities are entitled to guarantees:

- a foreign entity;
- a branch of a foreign legal entity established in the Russian Federation, provided that its purpose and activity are of commercial nature, and its ultimate parent is fully liable for the branch operations in the Russian Federation;
- a Russian commercial entity once a foreign investor becomes its shareholder.

Subsidiaries of commercial entities with foreign investments are not protected by the provisions of the Law on Foreign Investment [41].

Guarantee of legal and court protection of the foreign investor activities in the Russian Federation. The guarantee includes the right to legal protection and court representation. Foreign investors are entitled to protection of their economic interests as third parties in the Russian Federation Arbitration Court. The guarantee provides for the compensation of losses and damages caused by illegal activity (non-activity) of state authorities, local administration and its officers.

The Russian Federation is a signatory to the Convention On Settlement Of Investment Disputes Between States and Individuals/Legal Entities (Washington, March 18, 1965). Investment disputes can be heard in accordance with the procedures set by the Convention, by the Arbitration Court of the International Center for Investment Dispute Settlement (set up at the International Bank for Reconstruction and Development).

Within the CIS another convention is in force - the Convention On Investor Rights' Protection (Moscow, March 28 1997). Article 11 thereof states that disputes under the Convention are heard in courts or arbitration courts of the countries involved in the dispute, the CIS Economic Court and/or other international arbitration courts.

Guarantee to make use of various types of investments in the Russian Federation. A foreign investor is entitled to engage in any type of investment activities in the Russian Federation that is not prohibited by law. Such investments include:

- a) movables and immovables, as well as property rights;
- b) shares, participations and other kinds of investment in companies and entities;
- c) legal claims for cash invested to create economic benefits;
- d) royalties and industrial property rights (inventions, patents, trademarks and copyrights, prototypes and models), technologies and know-how;
- e) the right to engage in economic activities including commercial activities, vested on the basis of law or agreement, and relating in particular to the exploration, development, extraction and maintenance of natural resources.

Guarantee of assignment of investor rights and liabilities to a third party. On the basis of an agreement, the foreign investor may assign its rights and liabilities to a third party, and may be forced by a court decision or a provision of law, to assign its rights to a third party, in accordance with the Civil Code of the Russian Federation.

Guarantee of foreign investor's right to repatriate property and information (in hard copy or electronic format) from the Russian Federation that had been originally imported as foreign investment. The foreign investor that imported property and information (in hard copy or electronic format) is entitled to repatriate that property (without quotes, licensing, or other non-tariff trade barriers).

Guarantee to be compensated for the nationalization and seizure of property of the foreign investor or commercial entity with foreign investment. As defined by the Convention On Investor Rights Protection, investments are not subject to nationalization and seizure except for situations of force majeure (natural disasters, accidents, epidemics, epizootic and other force majeure circumstances), provided for by the national legislation when public interests are to be protected as provided by the Constitution of the recipient State. The investor is entitled to receive adequate compensation for nationalized and seized property.

Upon the discontinuation of force majeure conditions, the foreign investor or commercial entity with foreign investment is entitled to claim back its property and return the compensation received less losses and damages to the property value.

Guarantee against unfavorable amendments to the legislation of the Russian Federation. The purpose of having such a provision is to maintain the legal environment, if and when unfavorable amendments are enacted.

This provision is set by Article 9 of the law: "On Foreign Investment". In accordance with this law, the provision is applied if new federal legislation is enacted that amends (increases):

- The amount of import duties (except for customs duties imposed to protect national economic interests in accordance with the legislation of the Russian Federation)
- The amount of federal taxes (except for excises and VAT for goods produced in the Russian Federation)
- The payments to the state extra-budgetary funds (except for payments to the retirement fund)

- The amount of the aggregate tax burden for a foreign investor or commercial entity with foreign investment established to implement priority projects or that set up bans and limits to the foreign investments in the Russian Federation in comparison to the aggregate tax burden and regime in force at the date of priority project

These new federal laws and regulations as well as amendments and addendum into the legislation of the Russian Federation are not applicable in relation to a foreign investor or entity with foreign investment that implements priority projects provided that imported goods are used exclusively for such projects.

These provisions apply to a commercial entity with foreign investment if the share (participation) of foreign investor/s is above 25%, as well as to a commercial entity with foreign investment that implements priority projects regardless of the share/s and participation of foreign investor/s.

Non-enforcement of provisions aggravating foreign investor legal status provides guarantees for the entire period of the project payback, but no more than 7 years from its financing by foreign investor/s.

In extraordinary circumstances when a priority project is implemented for the manufacturing or construction of transport or other infrastructure with a minimum aggregate amount of foreign investment totaling 1 billion Rubles, and in which the payback period exceeds 7 years, the Government may extend the term of the stabilization provision.

Should international agreements signed by the Russian Federation stipulate otherwise, the provisions of the international agreements take precedence. For instance, the foreign investor is entitled to the privileges related to double taxation in accordance with the international agreement ratified by the Russian Federation.

Guarantee to use and repatriate income, profit and other legally received remuneration. The guarantee relates to the right to freely use income and profit from the investment activity for the re-investment and repatriation (after the payment of the appropriate taxes), including:

- investment income as profit, dividends, interest income and other remuneration;
- monies to perform the obligations under the agreements and transactions;
- monies received from the liquidation of the commercial entity with foreign investment or a branch of the foreign legal entity and amortization of the property and property rights, including intellectual property;
- and compensation for the requisitioned or nationalized property.

The repatriation of cash from a branch to the head office can be done without restrictions after a corporate profits tax has been paid at the permanent establishment level. In contrast, the repatriation of profits by a subsidiary is subject to Russian withholding tax (15% on dividends, 20% on interest, etc.) unless exempt or taxed at a reduced rate under a double tax treaty (please refer to Sections 10.5, 10.8).

Guarantee to acquire securities. The foreign investor may acquire shares and other securities of domestic commercial entities and government bonds in accordance with the legislation of the Russian Federation on securities.

Guarantee to take part in the privatization of assets. The foreign investor may take part in the privatization of state and municipal assets by acquiring ownership rights or share/s or participation in the privatized entity in accordance with the legislation of the Russian Federation on the privatization of state and municipal assets.

Guarantee to the right of ownership of land plots, other natural resources, buildings and constructions, and other immovable property. The right to acquire and own land plots and other natural resources, buildings and constructions, is vested by the legislation of the Russian Federation and its regions.

As stipulated by the provisions of the Land Code of the Russian Federation, it should be noted that a buyer (and a seller) of a plot of non-agricultural land can be either a foreign individual(s) or a legal entity(ies).

Recent amendments to the Land Code and the Law “On Implementing the Land Code” are important in terms of land privatization, and supporting the concept of one owner for a building and the land beneath it. The main amendments are:

- Owners of privatized buildings located on state or municipally owned land may privatize this land up until 1 January 2012. New pricing guidelines for privatizing land have been established
- Pricing guidelines for land privatization with respect to the owners of buildings that have always been private property have also been established
- Cities with over three million inhabitants have special land privatization rules, which include possible restrictions on the construction and reconstruction of a land plot. This restriction may be lifted upon payment of a fee commensurate to or even exceeding the price of the land plot
- Legal entities that hold land plots in permanent use must switch to a lease arrangement or privatize the land before 1 January 2012 (or 1 January 2015 for land plots that are located under a transport, communications and utilities line). Failure to fulfill this requirement may result in a heavy fine after 1 January 2013
- Guidelines for the privatization of land beneath linear objects (electric power lines, pipelines, etc.) are also included

Taxation of foreign direct investment. General tax rules are applicable to taxation of foreign direct investments. These rules are provided for by the RF Tax Code, other federal and local laws and by-law acts of Russian federal finance and tax authorities. The exhaustive list of the federal, regional and local taxes currently in effect is set forth in the Chapter 2 Section 1 Part 1 of the Tax Code of the Russian Federation and Articles 18-21 of the Federal Law on Fundamentals of Tax System in the RF of 27 December 1991 No. 2118-1. Value added tax, excise taxes, profits and income taxes, as well as customs duties are the most significant and sensitive taxes. Payroll taxes and payments such as social security, pension fund, employment fund and state medical insurance contributions, which are borne in Russia by the employer, represent another substantial fiscal cost of doing business.

As a general rule, income gained by foreign companies in Russia, including but not limited to income from lease or sub-lease of real property located in the territory of the RF, from leasing of movables in Russia, from distribution of property of Russian legal entities in case of their dissolution or liquidation, from loans of Russian companies, from exploiting of intellectual property rights in Russia, etc. are subject to income tax at the rate of 20 percent (with the exception to income gained from sale of real property located in Russia which is taxable in accordance with special rules). Withholding tax at the rate of 15 percent applies to dividends, interest and other income on investments. Double tax treaties may provide for other rates of withholding tax.

Real estate and other fixed assets of foreign entities are also subject to tax on assets located in the RF at the rate not higher than 2.2 percent.

Foreign investments enjoy certain tax exemptions. Capital goods (technological equipment) imported by foreign investors into the RF as a capital contribution to businesses with foreign investments are exempt from the customs duties and VAT, provided they are not subject to excise taxes (Art. 37 of the law on Customs Tariff of 21 May 1993 No. 5003-1, Art. 150 of the RF Customs Code). There are strings attached to such exemption: in case the title to such goods is subsequently transferred to the other entities, the customs duties and VAT shall be paid in full. However, these goods may be leased out without compromising the exemption (Letter of the State Customs Committee of 25 January 1999 No. 01-33/1827).

Cumulative value of imported goods should not exceed the nominal amount of the contribution stated in the constituent documents of a Russian company with foreign investments. Goods imported by the investors or operators under production sharing agreements (PSA) are exempt from Value Added Tax and excise taxes insofar as they are required for carrying out of works under the PSA. Production of businesses with foreign investments manufactured under PSA may be exempted from export customs duties under the terms of the PSA concluded with the RF Government or other authorized body.

Corporate governance in Russia. Corporate governance is one of the pillars of foreign investors' focus on sustainability following environmental and social sustainability. In the worst corporate governance environments, poor standards and weak enforcement continue to be barriers to foreign investment. Sound corporate governance principles are the foundation upon which the trust of international investors is built. Investors are set to lose a lot in case of financial mismanagement by the company in which they invested. As recent studies have shown, companies rated high in good management practices had higher returns than those rated low on the same parameters. The ideal corporate governance is based on sound economic and ethical principles.

“Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled. An important theme of corporate governance is the nature and extent of accountability of particular individuals in the organization, and mechanisms that try to reduce or eliminate the principal-agent problem.

Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. In contemporary business corporations, the main *external stakeholder* groups are shareholders, debt holders, trade creditors, suppliers, customers and communities affected by the corporation's activities. *Internal stakeholders* are the board of directors, executives, and other employees.

A related but separate thread of discussions focuses on the impact of a corporate governance system on economic efficiency, with a strong emphasis on shareholders' welfare; this aspect is particularly present in contemporary public debates and developments in regulatory policy.

There has been renewed interest in the corporate governance practices of modern corporations since 2001, particularly due to the high-profile collapses of a number of large corporations, most of which involved accounting fraud. Corporate scandals of various forms have maintained public and political interest in the regulation of corporate governance. In the US, these include *Enron Corporation* and *MCI Inc. (formerly WorldCom)*. Their demise is associated with the US federal government passing the *Sarbanes-Oxley Act* in 2002, intending to restore public confidence in corporate governance. Comparable failures in Australia (HIH, One.Tel) are associated with the eventual passage of the CLERP 9 reforms. Similar corporate failures in other countries stimulated increased regulatory interest (e.g., Parmalat in Italy)” [Corporate Governance...wiki].

The OECD Principles of Corporate Governance provide the framework for the work of national and international corporations in this area, identifying the key practical issues: the rights and equitable treatment of shareholders and other financial stakeholders, the role of non-financial stakeholders, disclosure and transparency, and the responsibilities of the Board of Directors. The OECD Principles are universally applicable to all types of corporate governance systems in countries at all levels of economic development. The OECD Principles of Corporate Governance provide best practice recommendations on corporate governance. They are used extensively worldwide as a benchmark for standard setting and identifying best practices.

In 2002, the US Department of Commerce in partnership with several international organizations, agreed to jointly and cooperatively develop, publish, and distribute a corporate governance manual for open joint stock companies in Russia. This effort was initiated by and undertaken in cooperation with the Federal Commission for the Securities Market, the Ministry of Economic Development and Trade, the American Chamber of Commerce in Russia, the Russian Institute of Directors, the Independent Directors Association, and the Investor Protection Association. Representatives from the private sector, regulators, educational institutions, international organizations, the Russian government, and others provided feedback through a series of roundtables and public commentary. The result of this inclusive consultation process is guidance – The Russia Corporate Governance Manual – that meets the needs of business, is practical in nature and easy to use, and provides detailed insight into the evolving Russian corporate governance system <http://trade.gov/goodgovernance/CorpGovManual.asp>

In 2003, the National Council on Corporate Governance was established at the initiative of the Russian Federation Government and with support of business community <http://www.nccg.ru/en/site.xp/056052053051.html>

“As a result, Russia has seen an improvement in corporate governance in recent years. A growing number of major Russian companies meet international and US accounting standards for information disclosure and have introduced open lines of communications with shareholders and analysts. However, there is still plenty of room for improvement, particularly with respect to corporate transparency.

The challenges facing Russian corporate governance practices are similar to those in other developing economies, namely: a general lack of the necessary experience and skills among boards of directors, a shortage of financial market experts among top management, a lack of maturity in risk management structures and systems, and an inadequate transparency and selectiveness in corporate information disclosure practices. Corporate governance of state-owned enterprises is a current high priority. The key challenges include strengthening the protection of minority shareholders, defining an effective state ownership policy, increasing the effectiveness of boards of directors and increasing the quality of disclosure of corporate information.

Financial information remains a relatively weak area of disclosure for Russian companies, but 2008 witnessed an improvement in the disclosure of IFRS (International Financial Reporting Standards) financial statements and notes. Not all companies report their annual financials under IFRS or US GAAP, but the situation is gradually improving. The most critical areas of weakness in disclosure practices include detailed information about related-party transactions (e.g., exact terms and indication whether such transactions are carried out on market terms), exhaustive ownership disclosure (e.g., disclosing every shareholder owning over 10%), auditor engagement (scope of services, non-audit services, and remuneration), ownership structures of affiliates and subsidiaries, and details and principles of board and executive remuneration” [24].

“The Russian corporate environment is characterized by high ownership concentration in firms, especially in the hands of insiders, weak legal institutions that lead to high private benefits of control, underdeveloped capital markets, a segmented labor market, and significant involvement of the state in business.

These features make the focus of the debate on Russian corporate governance substantially different from the one in the developed market economies, especially the Anglo-Saxon countries. The main conflicts of interest in Russian firms are between large and small shareholders, rather than between a manager and a large number of dispersed shareholders, as in the US or UK. On top of that, large owners are often in conflict amongst themselves, and with outside raiders who are attracted by possibilities to seize assets. Yet, there is another “layer” of conflict: the one between the state and private business, whose objectives may diverge substantially. Recently, government intervention into business has become very significant. A number of large companies moved under state control, others have been accused of tax avoidance and received large claims for unpaid taxes from the tax authorities; and the government has also tried to exclude foreigners from participation in large profitable businesses, such as oil extraction.

Russian privatization created tens of thousands of firms in which significant shares were distributed among insiders (both workers and managers). As a result, privatization led to insider dominated ownership structures, with a significant managerial control as managers have normally been able to convince or coerce workers to either vote with the management or sell their shares to the management. Not only has the ownership become concentrated at the company level, but also on the aggregate. Russian assets have ended up in the hands of a small group of people. According to surveys about 40% of the Russian industry belongs to the 22 largest business groups, controlled by “oligarchs”.

Despite substantial growth in recent years, the Russian financial market remains underdeveloped. Most firms have to rely on internally generated funds to make investments rather than on bank credit, bond or equity issues. Markets for stocks and bonds are still small, illiquid and are plagued by information asymmetries. These aspects raise the cost of external funds for companies, which in turn makes self-dealing a relatively more attractive strategy for controlling shareholders. In addition, the absence of reliable market signals about a firm’s performance and prospects renders conditioning managerial compensation on stock prices ineffective (if possible at all), hampers evaluation of capital budgeting decisions and impedes the emergence of an efficient market for corporate control.

The concentration of ownership and poor development of financial markets are consequences of Russia’s weak legal environment. Recent research has shown that it is strong law enforcement, rather than the mere content of the laws, that is crucial for the ability of firms to attract external finance. While Russia quickly caught up with the West in adjusting their company and bankruptcy laws to Western standards, law enforcement remains poor. This is primarily due to widespread corruption in courts, regulatory bodies and law enforcement agencies¹¹.

Importantly, the high income inequality stemming from weak legal institutions has precluded demand for good institutions (i.e. ones that ensure strong enforcement of property rights). The rich have favored low protection of property rights, keeping the country in a “bad” institutional equilibrium.

When the law does not protect minority shareholders, the value of control becomes extremely high. Strong control both insures against expropriation by others and provides the possibility of

¹¹ According to the Transparency International Corruption Perception Index, Russia is ranked 154th out of 178 countries in 2010 (a higher number corresponds to higher corruption).

expropriating minority shareholders. This explains the fierce wars for assets and the increase in ownership (and control) concentration observed in Russia in late 1990's – early 2000's.

Employees (excluding executives) are generally passive in calm times, but may become an instrument of a corporate conflict resolution. A distinctive feature of Russian firms is that workers still possess a significant amount of shares. These shares can become an important instrument of defense in the hands of the management in periods of corporate conflicts. Managers have often succeeded in obtaining workers' support by either convincing or coercing them to either vote with the management or sell their shares to the management.

Employees' shares, however, can also be a target for raiders. If the workers are unhappy with the current management (or are convinced that the raider's management will bring them more benefits) they are more likely to sell to the raider.

Nevertheless, employees are generally on the incumbent management side, because a change in control often implies layoffs (even if actual layoffs are unlikely, it may be relatively easy for management to convince the workers that they will lose their jobs with the new owner). Sometimes workers have been even used as a "live shield" against raiders. There have been a number of examples when workers would actively participate in the defense of their "home" enterprise by physically blocking the entry of the "new management" into the territory of the enterprise. When, in addition, a regional government is concerned with employment in the region, enterprises with large number of workers may receive additional support against raiders from the regional authorities.

One of the characteristics of the Russian economy has been substantial interference of the state in business. Governments of different levels can in fact be considered as companies' stakeholders, whose goals may significantly diverge from the firm value maximization. When the government has a stake in a company it is naturally interested in defending its interests as a shareholder. It also has a claim on any firm as a tax collector. However, the events of recent years have demonstrated the federal government's strong tendency to increase substantially its intervention in private business, as witnessed by a series of dubious claims to large companies for unpaid taxes and acquisitions of firms in core industries (some of them below market prices). Aggressive tax enforcement policy can actually reduce controlling shareholders' opportunism towards minority shareholders. If, however, it is just a manifestation of the state predatory behavior, it is more likely to worsen the investment climate in the country.

The most egregious case of the government's expropriation was the (in)famous *Yukos* affair. It has become apparent now that the state is pursuing a strategy of renationalization of large companies in core industries in order to reestablish control over them. After the years of accumulation of capital, Russian oligarchs are seeking to exit. The best way for them to do so would be to sell their assets to foreigners. However, the government opposes such sales as it is afraid to yield control over the key industries.¹⁶ The illegitimacy of the privatization and grave malfeasances by Russian oligarchs towards the state (tax evasion) and minority shareholders in recent years have made it possible for the state to both find legal arguments and secure public support for the renationalization. The price for the assets acquired so far seems to have been set according to political connections (e.g. close to 100% of the market price for *Sibneft* and *Power Machines*, almost 0% for *Yukos*, and below market price for *United Heavy Machinery*).

Does government predation influence a firm's corporate governance? Recent surveys have shown that firms, located in countries with a more predatory state, practice weaker corporate governance and disclose less information.

Another, more classical, manifestation of the government's intervention in business is its vulnerability to lobbying by large but depressed industries that would not survive without state support. Probably the best example in the Russian case is the automotive industry, which has long sought a number of measures to protect the national producers from foreign imports.

The evidence shows that the largest Russian companies gradually are improving their corporate governance as they move into international financial markets and want to raise their market valuation and establish good reputations. However, overall, corporate governance in a typical Russian company remains at a rather low level. Firms' ownership structures are still very concentrated and companies attract very few external funds. The unwillingness of controlling shareholders to sell part of their stakes in exchange for external finance seriously hampers economic development.

The challenges facing the Russian system of corporate governance are poor law enforcement, growing state intervention in business, and public distrust in the outcomes of privatizations. Overall, as property rights remain poorly protected, the "tradition" of expropriation – both by private parties and by the state – remains very strong in Russia. This discourages any kind of investment in developing private businesses, undermines incentives to improve corporate governance, and leads many firms to prefer obscure control and financial structures¹².

Recent and proposed legal reforms can alleviate the problem of insecure property rights. However, fighting corruption and changing public and government attitudes towards privatization are crucial steps in the development of a sound corporate governance system" [42].

¹² One of the ways in which this problem manifests itself is the phenomenon of pre-IPO greenmail that sometimes happens in Russia. Preparations for going public include making the firm transparent, but once there is transparency, greenmailers make use of the revealed information to attack the company.

Chapter 5

Entrepreneurial Law and Commercial Disputes Resolution

1. Major legal concerns of international entrepreneurship

A national company needs to follow the law and customs of its country. An international company faces a much more difficult problem – it should follow not only the law of its own country but the law of the host country as well. Both the laws of the home country and the laws of the host country influence methods of doing business. These laws determine the choice of markets, which a company can serve, prices for products, which it can charge, and the cost of necessary resources (workforce, raw materials, technology, *etc.*). Apart from this, the location of business operations depends to some extent on legal aspects of business activity. For example, some companies functioning on the basis of the internet prefer to avoid the market of the People's Republic of China because of arbitrary actions – as it seems to them – of the Chinese authorities.

Differences between legal systems. Legal systems of various states differ significantly from each other due to a range of historical, cultural, political and religious reasons. Legal norms, burden of proof, right for judicial supervision and, of course, laws themselves have specific features in each country. For example, companies in the US during an economic recession have the right to fire employees, having instructed them a very short period in advance and having paid them a minimal discharge allowance. Whereas in Belgium, companies which plan to cut labor force must notify an employee not less than three months in advance and also pay out a discharge allowance equal to the amount of his/her salary for the last three months.

Availability of access to legal systems also varies in different countries. In the US, for example, availability of a great number of lawyers and nondiscriminatory access to the legal system significantly facilitates activity of international companies in case they need to settle disputes with their suppliers and clients. South Korea, in contrast to the US, suffers from the lack of legal professionals because of very complicated exams which future lawyers have to take – only 2 percent of all candidates succeed in this. As a result many international companies working in South Korea are forced to settle disputes by a private treaty instead of court trial. The same situation pertains in India; since the court system accumulated over 3 million litigation cases hearings of which have been postponed so many attorneys recommend that their business clients resolve all disputes through private negotiations instead of waiting for trial for ten years. The situation is even worse in Portugal where it can take up to 12 years to bring a civil suit to hearing before a court [29].

Each of legal and regulatory systems is based on one of four foundations: *common law*, *statutory law*, *civil law*, *religious law*. The legal system in countries with communist and dictatorial regimes is often called *bureaucratic law*.

“*Common law* (also known as *case law* or *precedent*) is law developed by judges through decisions of courts and similar tribunals rather than through legislative statutes or executive branch action. A "common law system" is a legal system that gives great precedential weight to common law, on the principle that it is unfair to treat similar facts differently on different occasions. The body of precedent is called "common law" and it binds future decisions. In cases where the parties disagree on what the law is, an idealized common law court looks to past precedential decisions of relevant courts. If a similar dispute has been resolved in the past, the court is bound to follow the reasoning used in the prior decision (this principle is known as *stare*

decisis). If, however, the court finds that the current dispute is fundamentally distinct from all previous cases (called a "matter of first impression"), judges have the authority and duty to make law by creating precedent. Thereafter, the new decision becomes precedent, and will bind future courts. In practice, common law systems are considerably more complicated than the idealized system described above.

Common law legal systems are in widespread use, particularly in England where it originated in the Middle Ages, and in nations or regions that trace their legal heritage to England as former colonies of the British Empire, including the United States, Malaysia, Singapore, Bangladesh, Pakistan, Sri Lanka, India, Ghana, Cameroon, Canada, Ireland, New Zealand, South Africa, Zimbabwe, Hong Kong, and Australia” [43].

Common law developed differently in different countries. Therefore laws which influence business practice have peculiarities in each country which creates problems for an uninformed entrepreneur. For example, industrial enterprises permitting output of defective products are more vulnerable to charge during a trial in the US than in Great Britain which can be explained by evolutionary differences between common laws of these countries.

Statutory law. Apart from evolutionary differences in precedent law, each country of common law has its peculiarities of statutory law. Statutory law, as distinguished from common law, is that body of law laid down by a legislature. A statute is a formal written enactment of a legislative authority. Statutes may originate with national legislatures, region legislatures or local municipalities. Statutes of lower jurisdictions are subordinate to the law of higher jurisdictions. In the US, statutory law is codified under titles describing the areas of action to which they relate, and these titles are grouped together in codes.

Difference in statutory law of different countries may be quite significant. For example, many commercial bargains concluded between companies and the government of Great Britain are protected from the public scrutiny (or the glare of competitors) by the *Official Secret Act*. In the US, in contrast, more information on contracts between companies and federal government is open to public owing to the *Freedom of Information Act*. Differences in legal systems may manifest themselves in the process of administration of law. For example, in the US, legal costs are paid by both litigants – plaintiff and defendant. In many cases, defendants consent to the accelerated prosecution disregarding the complexity of the case in order to avoid an expensive trial. In Great Britain, all legal costs are paid by a litigant who loses a trial. Therefore it is not materially profitable for the British bring an unsecured claim before the court.

Civil law. Another generally accepted form of legal system is civil law. Civil law (or civilian law) is a legal system inspired by Roman law, the primary feature of which is that laws are written into a collection, codified, and not determined, as in the common law, by the opinions of judges based on historic customs. The Romans disseminated civil law over the entire Western world. The supremacy of this system was strengthened by the introduction of the Napoleon’s Code based on civil law in the territories conquered by Napoleon Bonaparte. Civil law seeks to resolve non-criminal disputes such as disagreements over the meaning of contracts, property ownership, divorce, child custody, and damages for personal and property damage.

The most significant difference between legal systems based on common and civil law is in the role assigned to judges and attorneys in these systems. In the system based on common law, a judge plays the role of a neutral arbitrator who directs actions of attorneys of opposing parties. Attorneys bear responsibility for the litigation process and selection of evidence which should be brought into the court on behalf of clients. In the system based on civil law, a judge takes upon

himself many of attorneys' responsibilities determining, for example, the scope of evidences to be presented to the court.

Religious law is based on the officially established rules of faith and religious ceremonies pursuant to one or another religion. Law, in the religious sense, also includes codes of ethics and morality which are upheld and required by the God. Examples include customary Halakha (Jewish law) and Hindu law, and to an extent, Sharia (Islamic law) and Canon law (Christian law). Sharia and Canon law differ from other religious laws in that Canon law is the codification of Catholic, Anglican and Orthodox law (like in a civil law tradition), while Sharia law derives many of its laws from juristic precedent and reasoning by analogy (like in a common law tradition).

The form of government under which civilian and criminal behavior of citizens is regulated by religious law is called *theocracy*. In Iran, for example, a group of Islamic clergymen determines legality or illegality of citizens' actions on the basis of their understanding of Quran, the sacred text of Islam. Religious law can cause specific problems for companies. For example, collection of interest on loan according to Quran is considered unfair exploitation of poor people. Companies and financial institutions operating in Islamic countries were bound to develop alternative variants of financial transactions which could permit a company or institution to accumulate and invest capital. Muslim commercial enterprises in most cases use long rent agreements to attract long term assets giving them preference over the loan scheme. In Iran, banks dealing with loans charge rental payments which, in fact, replace collection of interest on loans. Similarly owners of bank accounts in Iran receive share of their banks income instead of interest on their investment. Pakistani banks currently are in the process of transition to the similar operations which are often called Islamic banking. This transition is caused by the 1999 Pakistani Supreme Court enactment which declared all transactions with payment of interest a contradiction to Sharia. In accordance with this enactment the government, banks and investors were given two years for revision of laws, reissuance of current loans and elimination of interest. In countries where Quran is the main legal system, family companies in most cases are dominant. Additional expenses may be needed to avoid a ban; that is why members of a big family of a company owner may become an accessible source of financing.

Legal systems based on religious law have in many cases other peculiarities such as, for example, the absence of proper court procedure and appeal procedures. Foreigners should be very careful in countries with such legal systems. In Saudi Arabia, for example, foreign companies should act through a representative of local authorities or a guarantor, the role of which is played either by a government agency or a person directly connected with the royal family. In case of discrepancies between a foreign company and a representative of local authorities, police can detain an employee of this foreign company. Since in such a country, there are no independent judicial bodies, which are able to protect the rights of foreign citizens, this employee can get into a rather difficult situation.

Bureaucratic law. A legal system in communist and dictatorial countries often is called bureaucratic law. The essence of bureaucratic law is that actions and recommendations of bureaucrats have the force of law regardless what a formal law is adopted in the country. In a country with such a system, conclusion and termination of contracts are subject to the whims of people holding power. International entrepreneurs and managers quite often encounter arbitrary rule having the force of law. This happens, for example, in China. The results of one survey reveal that the Chinese bureaucratic apparatus apply some provisions of law selectively. In the Chinese legal system, there are many strict standards which are ignored in practice until a subject of law enjoys benevolence of state officials. Organs of state power can apply their authority "to punish severely" foreign investors who do not enjoy their favors [29].

International entrepreneurs should be aware of differences between legal systems to avoid misunderstandings, which can come at a high cost. Apart from this, international entrepreneurs should use knowledge and experience of local lawyers who can help them fulfill the specific requirements of the law and consult on peculiarities of proper legal procedure, legal responsibility and procedural guarantee. To handle this facet of going global, the international entrepreneur needs to have an overall sense of the legal system of a country and must have legal counsel to handle specifics. Ideally this legal council would have its headquarters in the entrepreneur's home country with an office in the host country. Several areas are critical for international entrepreneurs: property rights, contract law, product safety, and product liability [5].

“Countries vary significantly in the degree their legal system protects the property rights of the individual and business. The property rights of business are the resources owned, the use of those resources, and the income earned from their use. For global entrepreneurs, besides buildings, equipment, and land, the protection of intellectual property is a very grave concern, particularly for technology. Intellectual property such as a book, computer software code, a score of music, a video, a formula for a new chemical or drug, or other unique ideas are very important to a firm and need to be protected when going outside an entrepreneur's home country. The three major ways of protecting intellectual property in the United States are patents, copyrights, and trademarks. Few countries have laws and court procedures protecting intellectual property like the United States. You have probably heard how videos can be purchased in China at 10% of the cost in the US, sometimes even before being officially released. Before entering a country, the global entrepreneur needs to assess the country's protection of intellectual property of his or her venture and the cost if copied illegally.

Another area of concern is the contract law of the country and how it is enforced. A contract specifies the conditions for an exchange and the rights and duties of the parties involved in this exchange. Contract law varies significantly from country to country, in part reflecting two types of legal tradition – common law and civil law – previously discussed. Common law tends to be relatively nonspecific, so contracts under this law are longer and more detailed with all the contingencies spelled out. Because civil law is much more detailed, contracts under it are much shorter.

In addition to the law itself, the global entrepreneur needs to understand how contract law might be enforced and comprehend the judicial system securing this enforcement. If the legal system of the country does not have a good track record of enforcement, the contract can contain an agreement that any contract disputes will be heard in the courts of another country. Because each entrepreneur might have some advantage in his or her home country, another country is usually selected. This aspect is very important for global entrepreneurs operating in developing countries with little or even a bad history of enforcement and other anti-business countries. One company exporting Hungarian wine into Russia made sure any disputes in all its Russian contracts were heard in the Finnish court system instead of the Russian one.

The final overall area of concern is the laws of the country regarding product safety and liability. Again, the laws have significant variances between countries from very high liability and damage awards in the United States to very low levels in Russia. These laws also raise an ethical issue for the global entrepreneur, particularly one from the United States. When doing business in a country where the liability and product safety laws are much lower than in one's home country, should an entrepreneur follow the more relaxed local standards or adhere to the stricter standards of your home country and risk not be competitive and losing the business? Each global entrepreneur must answer this question when doing business in a particular country.

Intellectual property, which includes patents, trademarks, copyrights, and trade secrets, represents important assets for the global entrepreneur. Often global entrepreneurs, because of their lack of understanding of intellectual property, ignore important steps needed to protect these assets.

Because all business is regulated by the laws of the country the global business is located in, the global entrepreneur needs to be aware of any regulations that may affect his or her new venture. At different stages of the start-up, the entrepreneur will need legal advice, which will vary based on such factors as whether the new enterprise is a franchise, an independent start-up, or a buy-out; whether it produces a consumer versus an industrial product; whether it is nonprofit or for-profit; and whether it involves exporting or importing.

The infringement on the global entrepreneur and his or her venture, particularly in the case of intellectual property, reflect the disparity in laws of various countries, particularly emerging ones.

The form of organization as well as the type of franchise agreement offer many options from which an entrepreneur can choose. The global entrepreneur should understand the advantages and disadvantages of each type regarding such issues as liability, taxes, continuity, transferability of interest, cost of setting up, and attractiveness for raising capital in a particular country.

Patents. A patent is a contract between the government of a country and the global entrepreneur. In exchange for disclosure of the invention, the government grants the inventor exclusivity regarding the invention in the country for a specified amount of time. At the end of this time, the invention becomes part of the public domain.

The patent gives the global entrepreneur a negative right because it prevents anyone else from making, using, or selling the defined invention. Even if the global entrepreneur has been granted a patent, he or she may find during the process of producing or marketing the invention that it infringes on the patent right of others.

International patents. With international trade increasing each year, there is a need for international patent law to protect firms from imitations by providing some protection in global markets. In response, the Patent cooperation Treaty (PCT), with over 100 participants was established to facilitate patent filings in multiple countries in one office rather than filing in each separate country. Administered by the World Intellectual Property Organization (WIPO) in Geneva, Switzerland, it provides a preliminary search that assesses whether the filing firm will face any possible infringements in country. The company can then decide whether to proceed with the required filing of the patent in each country. It has a 20-month time frame to file for these in-country patents. Even though the PCT allows for simultaneous filing of a patent in all member countries, there may be significant differences in patent laws in each of these countries. For example, patent laws in the US allow computer software to receive both patent and copyright protection. On the other hand, in the European Union, patent protection is not extended to software” [5].

“A *trademark* is a distinctive sign or indicator used by an individual, business organization, or other legal entity to identify that the products or services to consumers with which the trademark appears originate from a unique source, and to distinguish its products or services from those of other entities.

A trademark may be designated by the following symbols:

™ (for an unregistered trade mark, that is, a mark used to promote or brand goods)

SM (for an unregistered service mark, that is, a mark used to promote or brand services)
® (for a registered trademark)

A trademark is typically a name, word, phrase, logo, symbol, design, image, or a combination of these elements. There is also a range of non-conventional trademarks comprising marks which do not fall into these standard categories, such as those based on color, smell, or sound.

The law considers a trademark to be a form of property. Proprietary rights in relation to a trademark may be established through actual use in the marketplace, or through registration of the mark with the trademarks office (or "trademarks registry") of a particular jurisdiction. In some jurisdictions, trademark rights can be established through either or both means. Certain jurisdictions generally do not recognize trademark rights arising through use. If trademark owners do not hold registrations for their marks in such jurisdictions, the extent to which they will be able to enforce their rights through trademark infringement proceedings will therefore be limited. In some countries the registration process entails several steps prior to a trademark receiving its Certificate of Registration.

The owner of a registered trademark may commence legal proceedings for trademark infringement to prevent unauthorized use of that trademark. The owner of a common law trademark may also file suit, but an unregistered mark may be protectable only within the geographical area within which it has been used or in geographical areas into which it may be reasonably expected to expand.

The term trademark is also used informally to refer to any distinguishing attribute by which an individual is readily identified, such as the well-known characteristics of celebrities. When a trademark is used in relation to services rather than products, it may sometimes be called a service mark, particularly in the United States.

The major international system for facilitating the registration of trademarks in multiple jurisdictions is commonly known as the "*Madrid system*". Madrid provides a centrally administered system for securing trademark registrations in member jurisdictions by extending the protection of an "international registration" obtained through the World Intellectual Property Organization. This international registration is in turn based upon an application or registration obtained by a trade mark applicant in its home jurisdiction.

The primary advantage of the Madrid system is that it allows a trademark owner to obtain trademark protection in many jurisdictions by filing one application in one jurisdiction with one set of fees, and make any changes (e.g. changes of name or address) and renew registration across all applicable jurisdictions through a single administrative process. Furthermore, the "coverage" of the international registration may be extended to additional member jurisdictions at any time.

The *Community Trade Mark (CTM)* system is the trademark system which applies in the European Union, whereby registration of a trademark with the Office for Harmonization in the Internal Market (Trade Marks and Designs), leads to a registration which is effective throughout the European Union as a whole. The CTM system is therefore said to be unitary in character, in that a CTM registration applies indivisibly across all European Union member states. However, the CTM system did not replace the national trademark registration systems; the CTM system and the national systems continue to operate in parallel to each other.

Another treaty of some importance affecting international practice, the Trademark Law Treaty, establishes a system pursuant to which member jurisdictions agree to standardize procedural aspects of the trademark registration process” [44].

“A *copyright* is a set of exclusive rights granted by a state to the creator of an original work or their assignee for a limited period of time upon disclosure of the work. This includes the right to copy, distribute and adapt the work. In most jurisdictions copyright arises upon fixation and does not need to be registered. Copyright owners have the exclusive statutory right to exercise control over copying and other exploitation of the works for a specific period of time, after which the work is said to enter the public domain. Uses covered under limitations and exceptions to copyright, such as fair use, do not require permission from the copyright owner. All other uses require permission. Copyright owners can license or permanently transfer or assign their exclusive rights to others.

Today copyright laws are partially standardized through international and regional agreements such as the *Berne Convention* and the *WIPO Copyright Treaty*. Although there are consistencies among nations' copyright laws, each jurisdiction has separate and distinct laws and regulations covering copyright. National copyright laws on licensing, transfer and assignment of copyright still vary greatly between countries and copyrighted works are licensed on a territorial basis. Some jurisdictions also recognize moral rights of creators, such as the right to be credited for the work” [45].

“*Trade secrets*. The global entrepreneur may prefer to maintain an idea or process as confidential and to keep it as a *trade secret*. The trade secret will have a life as long as the idea or process remains a secret.

A trade secret is not covered by any laws, but it is recognized under a governing body of common laws in some countries. Employees involved in working with an idea or process may be asked to first sign a confidential information agreement that will protect the global entrepreneur against the employee giving out the trade secret either while an employee or after leaving the global venture.

The amount of information to give employees is a difficult decision and is often determined by the global entrepreneur's judgment. Usually global entrepreneurs tend to protect sensitive or confidential company information from anyone else by simply not making the information available.

Most global entrepreneurs who have limited resources can choose not to protect their ideas, products, or services. This can become a serious problem because obtaining competitive information legally is easy to accomplish unless the global entrepreneur takes the proper precautions. It is usually easy to learn competitive information through such means as trade shows, transient employees, media interviews or announcements, and even Web sites.

Licensing is an arrangement between two parties, where one party has proprietary rights over some information, process or technology protected by a patent, trademark, or copyright. This arrangement, specified in a contract, requires the licensee to pay a royalty or some other specified sum to the holder of the proprietary rights (licensor) in return for permission to copy the patent, trademark, or copyright. Licensing has significant value as a marketing strategy to holders of patents, trademarks, or copyrights to grow their business in new markets when resources or experience in those markets are lacking. It is also an important marketing strategy for global entrepreneurs who want to start a new venture but need permission to incorporate the patent, trademark, or copyright with their ideas.

Although licensing opportunities are often plentiful, they must be carefully considered as part of global entrepreneur's business model. Licensing is an excellent option for the entrepreneur to increase revenue in a global market without the risk and costly start-up investment. To be able to license requires the global entrepreneur to have something to license, which is why it is so important to seek protection for any new product, information, or name with a patent, trademark, or copyright.

Contracts. When starting a new venture, the global entrepreneur will be involved on a number of negotiations and *contracts* with vendors, landlords, and clients. A contract is a legally enforceable agreement between two or more parties as long as a certain conditions are met. It is very important for the global entrepreneur to understand the fundamental issues regarding contracts.

Often business deals are concluded with a handshake. Ordering supplies, lining up financing, or reaching an agreement with a partner are common situations in which a handshake consummates the deal. When things are operating smoothly, this procedure is sufficient; if disagreements occur, the global entrepreneur may find that because there is no written contract he or she is liable for something never intended. The global entrepreneur should never rely on a handshake if the deal cannot be completed within 1 year" [5].

2. Russian legal system

"Russia's legal system is based on a civil law system. With civil law, influenced by Roman law, the emphasis is on codification. All decisions are based on the foundation of statutes and codes rather than judicial precedence, as is evident in common law. As in other civil law countries, the pretrial investigation in Russia is the dominant phase in the criminal process. In this part of the process, a judicial official of the state puts together a case file which is understood to contain all evidence of the case. The court holds an active role in determining case facts, utilizing a more inquisitional system. Yet, unlike other civil law countries, this legal system allows for some principles of adversarial proceedings and acknowledgement of the equal rights granted to all parties involved. This system is slowly reforming through its following of the law, as well as exercising new adaptations to codes," [46].

"The judiciary consists of three independent parts: the Constitutional Court with the right of judicial review, regionally based federal courts of general jurisdiction and courts of arbitration assigned to the resolution of economic disputes. The institution of justices of peace was introduced for the resolution of small claims at the local level.

The nineteen-member Constitutional Court decides whether federal laws, presidential and governmental decrees and directives, and regional constitutions and laws comply with the federal constitution. The Constitutional Court also resolves jurisdictional disputes between federal and lower level organs of power and may be asked to interpret the federal constitution. Rulings of the Constitutional Court are binding and final, and do not need to be confirmed by other organs or officials. Acts or their individual provisions, which have been deemed unconstitutional, become invalid

The Supreme Court is the highest judicial body for civil, administrative, criminal, and other cases within the jurisdiction of courts of general jurisdiction. Justices of the Supreme Court are appointed by the Federation Council. The Court has three divisions: civil, criminal, and military, which hear relevant cases. Thirteen specially appointed justices of the Supreme Court comprise the Presidium of the Supreme Court, the highest judicial instance in Russia with regard to cases heard by way of supervision and for newly discovered circumstances. The plenary session of the Supreme Court may issue explanations on questions pertaining to judicial practice, and it may

exercise the Court's right of legislative initiative by formulating the relevant proposals for their subsequent submission to the Parliament.

Local courts are established in all administrative units of the Russian Federation and function as courts of first instance and courts of appeals for decisions of justices of peace. These courts make initial decisions in the majority of all criminal and civil cases. Federal district courts build the second level of Russia's judicial system. Their territorial jurisdiction extends to the components of the federation where those courts have been formed. They serve as trial courts in more serious crimes and civil matters, and as appellate courts reviewing local court's judgments.

Arbitration¹³ courts are a part of the federal judicial system, but separate from regular courts and are aimed at the resolution of commercial and economic disputes. They are organized at the level of constituent components of the Russian Federation, and, despite what the name "Arbitration" suggests, their function is to adjudicate, not arbitrate, economic disputes between business entities, and to decide on complaints against organs of state and federal administration whose decisions may affect the conduct of business operations. The internal structure and principles of arbitration courts are similar to those of the courts of general jurisdiction" [47].

"There is a common confusion among those not familiar with the Russian legal system about the nature and function of the system of arbitration courts – which should be called "arbitrazh courts" – and their relationship to other bodies which have adjective "arbitrazhnyi" or even the term "arbitrazh court" in their titles. This confusion is quite understandable, since the adjective "arbitrazh" and the term "arbitrazh court" are used in Russian to refer to two different kinds of bodies, and English translation often fails to distinguish between them. The "arbitrazh courts" in the Russian Federation are a system of courts which have jurisdiction over most commercial disputes and many other cases involving business entities. These are *not* arbitration tribunals and they do *not* conduct arbitration – they are courts in the general sense of the word. They operate according to federal laws concerning their structure and procedures and they are staffed by full-time judges who are paid by the state and appointed through a formal procedure of nomination and approval by federal bodies.

As a general matter, classical arbitration is referred to by the Russian term "treteiskii sud" or "third-party court". However the confusion of terms and functions is made more difficult by the fact that there are some instances in which the adjective "arbitrazh" is used to refer to arbitration rather than to the arbitrazh courts. In particular, the two oldest arbitration facilities in the Russian federation – the Maritime Arbitration Commission and the International Commercial Arbitration Court – use the adjective "arbitrazhnyi" in their titles, with the second body using the term "arbitrazh court," although both of these bodies conduct a traditional form of arbitration. In addition, the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards is rendered in Russian using the term "arbitrazh decisions" rather than the term "treteiskii sud", and there are other instances of the use of the word "arbitrazh" alone, or the term "arbitrazh court", to refer to arbitration tribunals, especially foreign arbitration tribunals or those resolving international commercial disputes. When resolving disputes, because of this dual use of the term "arbitrazh" in all contexts, it is important to clarify the institution that is actually meant, whether in negotiations and/or the formulation of contracts, in discussions with legal counsel and/or in legal literature" [48].

¹³ Arbitration, a form of alternative dispute resolution, is a legal technique for the resolution of disputes outside the courts, where the parties to a dispute refer it to one or more persons (the "arbitrators", "arbiters" or "arbitral tribunal"), by whose decision (the "award") they agree to be bound. It is a settlement technique in which a third party reviews the case and imposes a decision that is legally binding for both sides. Arbitration is a proceeding in which a dispute is resolved by an impartial adjudicator (a professional lawyer) whose decision the parties to the dispute have agreed, or legislation has decreed, will be final and binding.

“Today arbitrazh courts are specialized courts that resolve property and commercial disputes between legal entities and registered entrepreneurs. They also examine claims seeking invalidity of governmental acts allegedly violating rights and legitimate interests of registered entrepreneurs or legal entities. Such claims include tax, land and other disputes arising out of administrative, financial and other legal relations. Arbitrazh courts also hear disputes that involve foreign legal entities or citizens. Rules of procedure in arbitrazh courts are different from procedural rules that apply to civil cases heard in courts of general jurisdiction: in arbitrazh courts the Code of Arbitrazh Procedure applies.

The system of arbitrazh courts operates at four levels. The first level consists of the federal arbitrazh courts that act as courts of first instance. The second level has 20 arbitrazh appellate courts. The arbitrazh appellate courts fully re-examine cases with respect to matters of both fact and law. The third level comprises ten federal circuit arbitrazh courts. Each of them functions as a court of cassation dealing only with questions of procedural and substantive law. The fourth level is the Supreme Arbitrazh Court of the Russian Federation, which is the superior judicial body for deciding commercial disputes and other cases handled by the arbitrazh courts.

The Supreme Arbitrazh Court enjoys a right to review, at request of the parties, cases heard by the arbitrazh courts of the Russian Federation after legal judgments have come into force. It also ensures consistency in interpretation and application of law by the arbitrazh courts. In a recently decided case, the Supreme Arbitrazh Court declared that its interpretation of law in that case would be binding on all other courts in similar cases. Although there is no explicit provision in the legislation authorizing the Supreme Arbitrazh Court to attach such powers to its interpretations, a resolution of the Supreme Arbitrazh Court, adopted in 2008 and recognized as constitutional in 2009 by the Constitutional Court, makes the decisions of the Supreme Arbitrazh Court binding on all arbitrazh courts. It also allows cases that have previously been decided differently by the Supreme Arbitrazh Court to be re-opened. In practice, lower courts have for a number of years already tended to follow the interpretation given by the Supreme Arbitrazh Court.

Historically, the rules of civil procedure in Russia have been inquisitorial as the rules of other continental law jurisdiction and not adversarial. However, the new Code of Arbitrazh Procedure, adopted in 2002, significantly limited the power of the courts to collect evidence independently of the parties' initiative, thus taking the procedure in a more adversarial direction. In contrast to courts of general jurisdiction, arbitrazh courts tend to rely primarily on documentary evidence rather than on witness and expert statements. A relatively short trial period is one of the main advantages of the arbitrazh courts. The law provides for a three-month period starting on receipt of the statement of claim and ending at the rendering of a final judgment. This period is, however, usually longer but rarely exceeds one year” [49].

“The courts of general jurisdiction are just what their name implies. They are the general courts and have jurisdiction over all cases of any kind that may be heard by a court in the Russian Federation and that are not specifically assigned to the jurisdiction of another court. The “general jurisdiction” of the court does not, however, imply a broad overlap with the jurisdiction of the other courts in the system – the arbitrazh courts and the Constitutional Court. As a rule, a particular dispute or legal matter will be considered to fall within the jurisdiction in only one of the courts in the system. For example, a law may state that cases or disputes that arise concerning it are to be resolved by a court or arbitrazh court. This might, at first glance, appear to suggest alternative jurisdiction in the two types of courts or the right of a plaintiff to choose where to file. Such a provision, however, is commonly interpreted to mean that those cases under the law which meet the required jurisdictional conditions of the arbitrazh courts will be subject to

arbitrazh court jurisdiction, while all other cases will be submitted to the courts of general jurisdiction.

As a general rule, civil law disputes that are otherwise within the jurisdiction of either the arbitrazh courts or the courts of general jurisdiction may be transferred to an arbitration tribunal. There are several exceptions to this general rule. A dispute may not be submitted to an arbitration tribunal if it is assigned by law to the exclusive competence of a particular state body or a particular court. The substantive legislation concerning the particular type of dispute may prohibit transfer to an arbitration tribunal, as is the case, for example, with the bankruptcy legislation. The transfer of labor disputes and family-law disputes in general to arbitration tribunals is prohibited by the Civil Procedure Code.

The jurisdiction of any arbitration tribunal is dependent upon the will of the parties and can be established by an agreement between them. *No type of dispute is generally assigned by law to an arbitration tribunal, and in the absence of an effective arbitration agreement, a dispute will be subject to the jurisdiction of the corresponding court, depending upon the nature of the dispute and the identity of the parties. So the submission of a dispute to an arbitration tribunal always requires an agreement between the parties, and the relevant agreement must be in writing.* The agreement between the parties to transfer the dispute can be either an arbitration clause in a contract or other agreement to which the dispute relates, or a separate, written agreement to transfer a specific dispute that has arisen.

With respect to international commercial disputes, the 1993 Law “On International Commercial Arbitration” defines the general limits of jurisdiction of arbitration bodies over such cases. That law defines the sphere of international arbitration as including two broad types of cases:

1. Cases, concerning contractual or other civil-law disputes arising out of foreign trade, where the place of business of one of the parties is located outside the Russian Federation
2. Cases in which an enterprise with foreign investment, international organization, or international association operating on the territory of the Russian Federation has a dispute with another such entity or with a domestic entity, and also cases concerning disputes among the founders of such enterprises, organizations or associations.

The Procuracy. In addition to the courts and arbitration tribunals which may be involved in the direct resolution of disputes related to business activities, there are number of other state bodies that may play an important role. One of these is the Procuracy – the general prosecutor’s office. This body has broad power and may become involved in the activities of businesses and in their disputes not only through its role as prosecutor in criminal cases and in actions to enforce civil fines and penalties, but also through its powers of “supervision” over observance of the laws and its capacity to intervene in court cases and to reopen a decision by “protesting” (appealing) it to a higher court. Under the current version of the law on the Procuracy, the procuracy’s power of supervision over the execution of the laws (previously referred to as “general supervision”) had been reduced to apply only to state bodies. General supervision over the execution of the laws by commercial entities and individuals is no longer within the prosecutor’s sphere of authority. In addition, the procurator has the authority to issue a decree concerning violations of the law by individual officials and the need to impose administrative or criminal liability on them.

In addition to the procuracy’s broad powers, there are a number of executive bodies which are empowered to directly enforce the law in a particular sphere. Examples of such bodies include the tax service, the customs authorities, and the Federal Antimonopoly Service. The structure and general powers of bodies of this type are defined by the statute on the relevant body. Additional detail on the powers and authority of the relevant body are provided by the substantive legislation which the body enforces, which defines the range of penalties, types of

orders issuable, amounts of fines, and the subject against which they may be issued for each individual type of violation that is within the jurisdiction of the relevant body.

It should be noted that some of the executive bodies concerned have the right to intervene as a third party in court cases which concern matters within their jurisdiction or sphere of expertise, even if the original case is between private parties and was not initiated by the state bodies. This may occur, for example, where the substantive laws which are enforced by the relevant body allow both state enforcement action against a violation and private court action by those injured by the violation to recover damages from the violator. While the enforcement authority may not have a direct interest in the recovery of the private plaintiff in such actions, it may have concerns about court recognition of particular behavior as a violation, about evidentiary matters and so forth. Unlike the procuracy, however, which has a general capacity to intervene in court cases to protect state and public interests, executive enforcement bodies have rights to intervene in court cases only where this is envisioned in the legislation concerning the particular court body” [48].

3. Official sources of law

“Historically, Russia belongs to the continental legal system, and a written law, which was passed under the established legislative procedure, is the main legal source. About 10,000 laws, regulations, and other legal acts are passed in Russia annually.

1. Constitution. The Constitution is the supreme Russian law and major legislative instrument. It establishes the principle of superiority of law in the system of legal sources. The law cannot contradict the Constitution. All other legal acts, such as decrees of the President, Governmental regulations, acts of Ministries and other federal executive agencies, as well as legislation passed by the constituent components of the Russian Federation cannot contradict laws. All laws are passed exclusively by the Federal Assembly (legislature). The Federal Assembly of Russia consists of the State Duma, which is the lower house, and the Federation Council, which is the upper house. Delegation of the legislative power is prohibited. The Constitution introduces several categories of legislative instruments.

2. Federal Constitutional Laws. Federal Constitutional Laws establish the group of most important legislative acts. These laws are similar to the institution of organic laws. They are passed in regards to the jurisdiction encompassed by the authority of the Russian Federation only. Because of their significance, the Russian Constitution provides for the complicated procedure of their adoption. The federal constitutional law is adopted if it has been approved by at least three-quarters of the total number of the Federation Council (upper chamber of the legislature) members and by at least two-thirds of the total number of the State Duma (lower chamber of the legislature) members. The president of Russia cannot veto federal constitutional laws. The list of federal constitutional laws is prescribed by the Constitution. It includes laws on the state of emergency, the change of the status of a constituent component of the federation, on constitutional amendments, on government, on referendum, on the judiciary, on the Constitutional Court, and some other laws. Presently, most of the required federal constitutional laws are in force.

3. Federal Laws. Federal laws constitute the second category of legal sources. They regulate issues included in the executive authority of the Russian Federation and its components. The Constitution protects the priority and the direct effects of federal laws throughout the territory of Russia. In case of a conflict between federal law and another act issued in Russia, the federal law will prevail. Meanwhile, the Constitution guarantees the priority of the act of a constituent component if such an act regulates issues outside the Russian Federation’s scope of authority. After being adopted by the Federal Assembly, a federal law is forwarded to the Russian Federation President for signing and publication. The President has the right to reject a federal

law and send it back to the Federal Assembly for a repeat consideration, but if a federal law is approved in its previous edition by the majority of both chambers members, it should be signed by the President. Often, Russian laws are adopted in the form of a Code of Law. A Code is a complete collection of rules in an entire subject area such as: civil law, criminal law, and labor law. Although Codes are usually supplemented by numerous pieces of special legislation, Codes retain their preeminence as major sources of law in a given area.

4. *International Treaties.* Universally acknowledged principles and standards of international law and international treaties of the Russian Federation are a part of Russia's legal system. Should an international treaty of the Russian Federation establish rules other than those established by a domestic law, the rules of the international treaty will prevail.

5. *Executive Regulations.* Decrees and directives of the Russian President establish a separate category of legal acts and do not belong to subordinate legislation. Due to an absence of required laws, the President can pass decrees regarding all questions without any limits if a valid federal law does not regulate this issue, except with cases when the Constitution directly says that the question requires the adoption of a federal law. A large group of executive acts comprises documents issued by the federal government, ministries, state committees, committees, and other federal agencies. All these binding documents are subordinated to laws and are graded lower than laws in the legal hierarchy. Usually, they are aimed at implementing higher level acts of law, and are largely devoted to industrial problems related to the economic development of the country.

6. *Other Legal Acts.* An additional group of delegate legislation is comprised by normative acts of federal executive authorities. These acts are related to laws through Directives of the Government. They develop, add, and concretize existing legal norms. Although ministerial documents are acts of special jurisdiction and regulate activities of the subordinated persons and legal entities, sometime they can be of interdepartmental or even general significance. There are different forms of such acts: regulations, orders and instructions, varying by their content and the procedure of adoption. Also, both chambers of the Federal Assembly adopt resolutions within their jurisdiction, which are usually passed in the non-legislative sphere and regulate such individual matters as appointments, approvals, removals from office, calls for elections, and declarations of amnesty.

7. *Judicial Decisions.* Following the traditional civil law approach, judicial practice is restricted to applying and interpreting the law, and the precedent cannot serve as a legal source. According to Russian legal doctrine, judges are supposed to use only written law contained in codes, statutes, or regulations in deciding a case; however, a decision to vacate a particular legal act prove to be a source of law, and the Constitutional Court indicated that its previous decisions shall be followed as *stare decisis*. Even though attorneys use prior judicial decisions in their arguments, judges should not refer to prior cases in their decisions. Court judgments in individual cases are not precedents for future decisions.

8. *USSR legislation.* Soviet laws and regulations are applicable when Russian domestic legislation lacks such laws and the Soviet law does not conflict with any existing Russian law. Presently, Soviet law has the transitional function and exists until the Russian legislature adopts laws in those areas.

There are three major commercial web sources of legal information in Russia today – *Garant*, *Konsul'tant Plus*, and *Kodeks*. The main feature of these legal information systems is the complexity of information, which varies among the providers. All systems include databases comprising federal legislation adopted by the highest government authorities, but they differ in

the number of included documents, which were issued by the agencies and quasi-government institutions - like the Central Bank or the Pension Foundation - that have the right to pass legislation. The number of available documents ranges from more than two million (Konsul'tant Plus) to 1.5 million with four thousand documents added to the system on a weekly basis (Garant). Because all systems use analogous translation services, the parts of the databases that provide English translation of Russian laws are similar and include primarily business-related legislation and international humanitarian law. Most of the systems are run by commercial firms that specialize in providing legal, consulting, and information services. Specialization of these firms is reflected in the information provided. It seems that Konsul'tant Plus pays more attention to the legislation on taxation, while Garant, for example, collects information on court decisions more than other databases.

The main concern of database users is the authenticity of legal texts. This problem was solved when the Consultant Plus system started to publish documents in their exact graphic format displaying the scanned copy of the original document submitted for registration at the Ministry of Justice. Major information systems and databases (Garant, Kodeks) have negotiated agreements with the Ministry of Justice and receive the copy of the control version of the original document from the Ministry and from other institutions that issue legal acts. This system ensures the comprehensive character of information on the Internet servers and in the reference systems. In addition to federal legislation, all information systems provide access to laws of the constituent components of the Russian Federation where the offices of the company are located. Garant is focused on Moscow city legislation, while Kodeks contains more information about the laws of St. Petersburg. Consultant Plus publishes weekly surveys of regional legislation, and Garant monitors legislative activities of regional authorities throughout the country. Legal education is incorporated in legal information systems. All three major legal information systems Garant, Consultant Plus, and Kodeks contain materials for law students and publish electronic law journals.

Daily and weekly monitoring and updates of current legislation are common to all information systems. Staff attorneys prepare surveys about the regulation of particular fields of business and answer questions regarding the application of Russian procedural laws. For instance, the Garant has special sites for lawyers, accountants, and students with recommendations tailored to each particular category of clients. Those who visit the Garant site can be involved in the discussion on current Russian legal development. The Garant site permits its subscribers to participate in online conferences with leading Russian legislators, government officials, and lawyers" [47].

4. The Russian legal environment

"Russia has a body of conflicting, overlapping, and rapidly changing laws, decrees and regulations, which has resulted in an ad hoc and unpredictable approach to doing business. Independent dispute resolution in Russia can be difficult to obtain since the judicial system is still developing. Courts are sometimes subject to political pressure. According to numerous reports, corruption in the judicial system is widespread and takes many forms, ranging from bribes of judges and prosecutors to fabrication of evidence. In addition, court decisions are at times not executed. The bailiffs, who are charged with enforcing court judgments, report to the Ministry of Justice rather than the courts. They sometimes fail to enforce those judgments due inter alia to legal restrictions and limited trained personnel.

Many attorneys refer Western clients who have investment or trade disputes in Russia to international arbitration in Stockholm or to courts abroad. A 1997 Russian law allows foreign arbitration awards to be enforced in Russia, even if there is no reciprocal treaty between Russia and the country where the order was issued. Russia is a member of the International Center for the Settlement of Investment Disputes and accepts binding international arbitration. Russia is

also a signatory to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. However, enforcement of international arbitral awards still requires action from Russian courts and follow-up by bailiffs, which have yet to become consistently effective enforcers of court judgments.

The arbitrage court system, where commercial disputes between business entities are heard, has special procedures for the seizure of property before trial such that it cannot be disposed of before the court has heard the claim, as well as for the enforcement of financial awards through the banks. Additionally, the International Commercial Arbitration Court at the Russian Chamber of Commerce and Industry will hear claims if both parties agree to refer disputes there. A similar arbitration court has been established in St. Petersburg. The weakness in the Russian arbitration system, as with international arbitral procedures, lies in the enforcement of decisions” [37].

“The legal system in Russia remains in a state of flux, because various parts of the government continue to implement new regulations and decrees on a broad array of topics, including the tax code and requirements of other regulatory and inspection bodies. Negotiations and contracts for commercial transactions, as well as due diligence processes, continue to be complex and protracted. Investors must do careful research to ensure that each contract fully conforms to Russian law. Contracts must likewise seek to protect the foreign partner against contingencies that often arise. Keeping up with legislative changes, presidential decrees, and government resolutions is a challenging task. Uneven implementation of laws creates further complications; various officials, branches of government, and jurisdictions interpret and apply regulations inconsistently and the decisions of one may be overruled or contested by another. As a result, reaching final agreement with local political and economic authorities can be a long and burdensome process. Companies should be prepared to allocate sufficient funds to engage local legal counsel to set up their commercial operations in Russia.

Surveys have shown that many entrepreneurs complain about the complexity of the tax code and requirements of other regulatory and inspection bodies. Well-intentioned small and medium-sized enterprises (SMEs) often go out of their way to follow the law but are then penalized for making mistakes in documentation. They complain that the tax police make no distinction between overt tax-evaders and inexperienced SMEs who do not fully understand the bookkeeping requirements. Companies often have little recourse other than the courts to resolve tax disputes. While firms have successfully appealed to the courts, tax authorities are often slow to implement judicial decisions. Penalties for noncompliance include confiscation of property and freezing a company's bank accounts. A 2010 law greatly increased the criminal threshold of tax underpayment, forbade pre-trial detention for tax offences, and allowed first-time offenders to escape criminal liability for a tax offence if they pay their arrears during the pre-trial investigation.

All draft laws that go through the Russian Duma are published on the Duma’s website. Sometimes, but not consistently, ministries and other Russian government bodies also publish proposed legislation (including draft laws, government decrees and regulations) on their websites. While there is opportunity for public comment, the general perception is that opportunity for comment is limited and that it can have minimal impact” [37].

Russian courts in practice. “While every national court system has its own characteristics, the Russian court system works differently from courts in western jurisdictions. Russian courts operate within the framework of Russian society, and the limitations of the Russian administration are mirrored in the working of the courts. Leaving aside political and economic factors, some specific features of the Russian court system deserve to be mentioned. First, it is important to bear in mind that many Russian judges certainly match the professional standards of

their western peers, but others, notably those trained in different time under a different regime, may be less familiar with many of the principles that characterize a nation under the rule of law. One obvious trait among many Russian judges is their tendency to apply statutes and contractual provision literally, even in situations where the result will appear odd. Arguments related to the purpose and systematics of statutes or contractual provisions will usually be trumped by a literal interpretation of the wording. Therefore, it is advisable to explicitly state contractual obligations and not to rely on the general duty of the parties to do everything to fulfill their contractual claims. For example, successful suing because of a violation of unwritten side duties will be difficult.

While court proceedings in all countries have a tendency to be conducted by the parties like a chess game, this is even more so the case in Russia: The parties have to send their briefs only three days before a hearing, and distribution of briefs to the parties by courts is not common. Judges may have 30-40 cases to prepare for a hearing day and may choose not to take into account lengthy arguments that are not easy to explain.

When deciding to litigate in Russia, it is important to know whether litigation will take place in St. Petersburg or in Moscow or in other regions. In the regions, a lower level of legal professionalism can be expected, and judges in such cases have a tendency to side with more formalistic arguments. Also, suing the main employer in a region may lead the court to take into account non-legal considerations in its decision.

In short, while achieving justice in Russia is not impossible, obstacles exist that are not present in western jurisdictions. But the picture is not as bleak as is commonly assumed – the majority of the claims made against tax authorities are successful.

International commercial arbitration in Russia. As an alternative to the arbitrazh courts, parties may refer their commercial disputes to ad-hoc arbitration or arbitration institutes located in or outside Russia. Russia is a party to multiple bilateral investment treaties under which investment disputes can be referred to arbitration.

Russia is a party to the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards (New York Convention). Under the convention, foreign arbitral awards can be enforced in Russia, while arbitral awards rendered in Russia can be enforced in jurisdictions of other states that are parties to the New York Convention.

Russia is also a party to the European Convention on International Commercial Arbitration of 1961. The Russian Law on International Commercial Arbitration of July 7, 1993, is based on the Model UNCITRAL Law.

Russia's leading arbitration institution is the International Commercial Arbitration Court at the Russian Federation Chamber of Commerce and Industry (ICAC). One of the advantages of arbitration at ICAC is low costs in comparison with foreign arbitration institutions.

Arbitrability of disputes is a contradictory issue in Russian legislation. In accordance with the provisions of the Code of Arbitrazh Procedure, arbitrazh courts have exclusive competence over the following disputes with a foreign party:

- Disputes over state property, privatization of state property and compulsory alienation of property for state needs
- Disputes over real property located in Russia. Disputes over granting and registration of intellectual property rights
- Disputes over invalidation of entries to state registers

- Disputes over organization, registration and winding-up of legal entities or registered entrepreneurs in Russia as well as disputes related to the challenging of resolutions made by management organs of legal entities in Russia

Many courts take the position that the disputes listed above are not only excluded from jurisdiction of foreign public courts but also are not arbitrable. In practice, this means that even if a party to a dispute has an award rendered in its favor in arbitration abroad, the Russian courts may deny enforcement stating that the dispute is non-arbitrable under Russian law.

History is full of decisions by Russian courts denying enforcement of foreign arbitral awards. Several of these decisions were based on grounds which are not in conformity with the general practice of courts in western jurisdictions. While enforcement of foreign awards in Russian is possible and occurs in practice, this process is not always smooth process and may not have a positive result in all cases” [49].

Legal acts in English. Major Russian legal acts in English can be found on the website of *Garant Service* company¹⁴. This is the most reliable database used by the Council of Europe, for example. However, information is not free except several acts in the Demo version. Documents can be requested at special fixed prices which do not depend on the document's volume. All these documents cost from US\$30 to US\$300. There are also other sites¹⁵ with some documents available but they should be used with caution.

Major business laws:

The Civil Code of the Russian Federation¹⁶

The Tax Code of the Russian Federation

The Labor Code of the Russian Federation

The Land Code of the Russian Federation

The Forest Code of the Russian Federation

The Civil Procedural Code of the Russian Federation

The Arbitrazh Procedural Code of the Russian Federation

The Civil Procedural Code of the Russian Federation

The Housing Code of the Russian Federation

The Federal Law No.129-FZ “On the State Registration of Legal Entities and Individual Entrepreneurs”, dated 8 August 2001

The Federal Law No.88-FZ “On the State Support of Small Business Entities in the Russian Federation”, dated 14 June 1995

The Law of the Russian Federation No.2300-1 “On Protection of the Consumers’ Rights”, dated 7 February 1992

The Federal Law No.129-FZ “On Accounting”, dated 21 November 1996

The Federal Law of the Russian Federation No.119-FZ “On Audit Activity”, dated 7 August 2001

The Federal Law No.46-FZ “On the Security of the Rights of Investors at the Securities Market”, dated 5 March 1999

The Law of the Russian Federation No.4015-1 “On Organization of Insurance in the Russian Federation”, dated 27 November 1992

The Federal Law No.101-FZ “On the Turnover of the Agricultural Land”, dated 24 July 2002

¹⁴ <http://english.garant.ru/>

¹⁵ for example: <http://fin-lawyer.ru/2008/normativnye-pravovye-akty-rf-na-anglijskom-yazyke/>

¹⁶ <http://www.russian-civil-code.com/>

The Federal Law No.48-FZ “On the Promissory Note and the Bill of Exchange”, dated 11 March 1997

The Federal Law No.39-FZ “On the Securities Market”, dated 22 April 1996

The Federal Law of the Russian Federation No.102-FZ “On Mortgage”, dated 16 July 1998

The Federal Law No.178-FZ “On the Privatization of the State and Municipal Property”, dated 21 December 2001

The Law of the RSFSR No.948-1 “On Competition and Restriction of Monopoly Activity on Commodity Markets”, dated 22 March 1991

The Federal Law No.82-FZ “On Minimum Amount of Wages and Salaries”, dated 19 June 2000

The Federal Law No.160-FZ “On Foreign Investments in the Russian Federation”, dated 9 July 1999

The Federal Law No.101-FZ “On International Treaties of the Russian Federation”, dated 15 July 1995

The Federal Law No.40-FZ “On Insolvency (Bankruptcy) of Credit Organizations”, dated 25 February 1999

The Federal Law No.122-FZ of 1997 “On the Registration of Rights to Real Property and Transactions with It”, dated 21 July 1997

The Federal Law of the Russian Federation No.395-1 “On Banks and Banking Activity”, dated 2 December 1990

Intellectual property protection. “Russia is a party to all major international agreements and conventions on intellectual property. From 1 January 2008, Chapter IV of the Civil Code of the Russian Federation came into force. It covers patents, trademarks and copyright issues, and replaces all previous legislation in these areas. It codifies provisions of intellectual property law, introduces clear legal terminology and new intellectual property rights, resolves conflict of laws issues, and generally strengthens protection of intellectual property rights. Russian civil law regulates the legal protection and use of inventions, utility models and industrial designs. Its provisions correspond with international treaties on patent law harmonization and the Patent Cooperation Treaty.

Consequently, many of its provisions are similar to those in other industrialized countries. In Russia, an examination of merits is conducted to confirm the patentability of an invention. The legal protection of a trademark is provided on the basis of its official registration or under international treaties or conventions to which Russia is a party, including the Madrid Agreement. The trademark owner must actually use the trademark in its business activities. If the trademark owner does not use it, an interested party can apply to deregister the trademark with the Chamber of Patent Disputes.

Copyright is generally granted to the author(s) of works of science, literature and the arts. Exclusive right to reproduce, distribute, demonstrate, modify, etc. such works are granted to authors for their lifetime plus 70 years after their death and are transferable and disposable. Software is also covered by copyright laws. To enjoy legal protection of production secrets (know-how), the owner of the know-how must undertake specific actions under Russian law. The information constituting know-how must meet Russian legal requirements and must have real or potential commercial value owing to the fact that third persons do not know it and have no free access to it.

In addition, under Russian law the owner of the know-how must introduce a confidentiality regime with respect to the information that constitutes know-how. Intellectual property license or assignment agreements for patents or trademarks must be registered with the Federal Service for Intellectual Property, Patents and Trademarks of the Russian Federation (Rospatent). Generally, copyrights do not need to be registered. Copyright owners of software or a database may register

them with Rospatent at their own discretion. After such voluntary registration, the assignment agreement for the registered software or database must also be registered with Rospatent.

Property market. Russian law upholds and protects the right to own private property, including land, buildings, premises (i.e., parts of buildings) and other types of real estate. The introduction of the Land Code of the Russian Federation in 2001 is seen as representing a major improvement in the legal regulation of the property market and a key step toward market reform in Russia. Currently, most land (unlike buildings and premises) is not privately owned, but held by federal, regional and local authorities. Owners of property built on state land may purchase the land, but many property owners prefer to lease land from the state instead. The right of ownership and other proprietary interest in real properties, their creation, encumbrance (e.g., mortgage, leasehold for a term of one year and longer, easement), transfer and termination are subject to state registration.

With effect from 1 March 2009, the government agency which performs the state registration of rights to real properties (formerly the Federal Registration Service) was renamed the *Federal Service for State Registration, Cadastre and Cartography* and became responsible for the cadastral registration of real estate (including land plots). It has become easier to obtain technical and registration documents since the recent introduction of a “one-window” system and internal standards for registration authorities. Although the Land Code provides that if a building and the underlying land are owned by the same person, it is impossible to sell them separately, the land and the facilities located on it are treated as separate legal interests and may be owned by different persons.

In general, Russian law neither imposes major restrictions on foreigners nor makes distinctions among foreigners, Russian legal entities with foreign interest and Russian legal entities/citizens in relation to the ownership of land (except for agricultural land, land located near the Russian border, and certain other territories yet to be specified). The vast majority of land (outside cities and populated areas) is still categorized as agricultural land, which means it cannot be used for development or industrial purposes. To use these lands for a purpose other than agricultural production, a landholder must first have the land reclassified to another category in accordance with its proposed use.

Russians and foreigners may acquire land held by the state or municipalities for development and construction. The Land Code allows the state or municipal authorities to refuse to grant land if the land in question cannot be alienated or privatized, if the land is reserved for state or municipal needs, and in certain other cases specifically stated in the law. Apart from land legislation requirements, a prospective developer must comply with planning regulations that are rather complex and may differ, depending on where the project is implemented. The new Town Planning Code, adopted in 2004, introduced clearer and more transparent regulations governing the issuance of construction permits and permits for commissioning facilities.

From 1 January 2007, the multiple appraisals that were previously required for reviewing project design documentation and issuing construction permits have been replaced by a single state examination (or “state appraisal”), to be carried out by a state authority. From 1 January 2010, there are no longer licensing requirements for entities in Russia undertaking certain construction activities (such as engineering surveying, preparing project documentation and construction works); instead, such entities are required to be members of a self-regulating organization. Real property and certain rights to real property can be pledged. All pledges to real property must be registered.

Unless the pledger and the pledgee enter into an agreement on levy of execution in out-of-court proceedings, it is only possible to levy on property in court. In certain cases provided by law,

out-of-court proceedings for levy of execution are prohibited. If the pledgee levies on the pledged property, the property has to be sold through an auction. Russian law allows one to secure loans backed by real estate pledges, and laws for mortgage-backed securities are developing rapidly” [24].

Free legal help offices. There are approximately 160 so called "legal clinic" in the country, including 15 in Moscow. Many of these legal help offices are located in specialized universities where clients receive consultations from students supervised by their teachers. Such clinics function in Moscow State University, Moscow University of Industry and Finance, the Higher School of Economics, St Petersburg State University and some other places.

Chapter 6

Setting up a Business Abroad

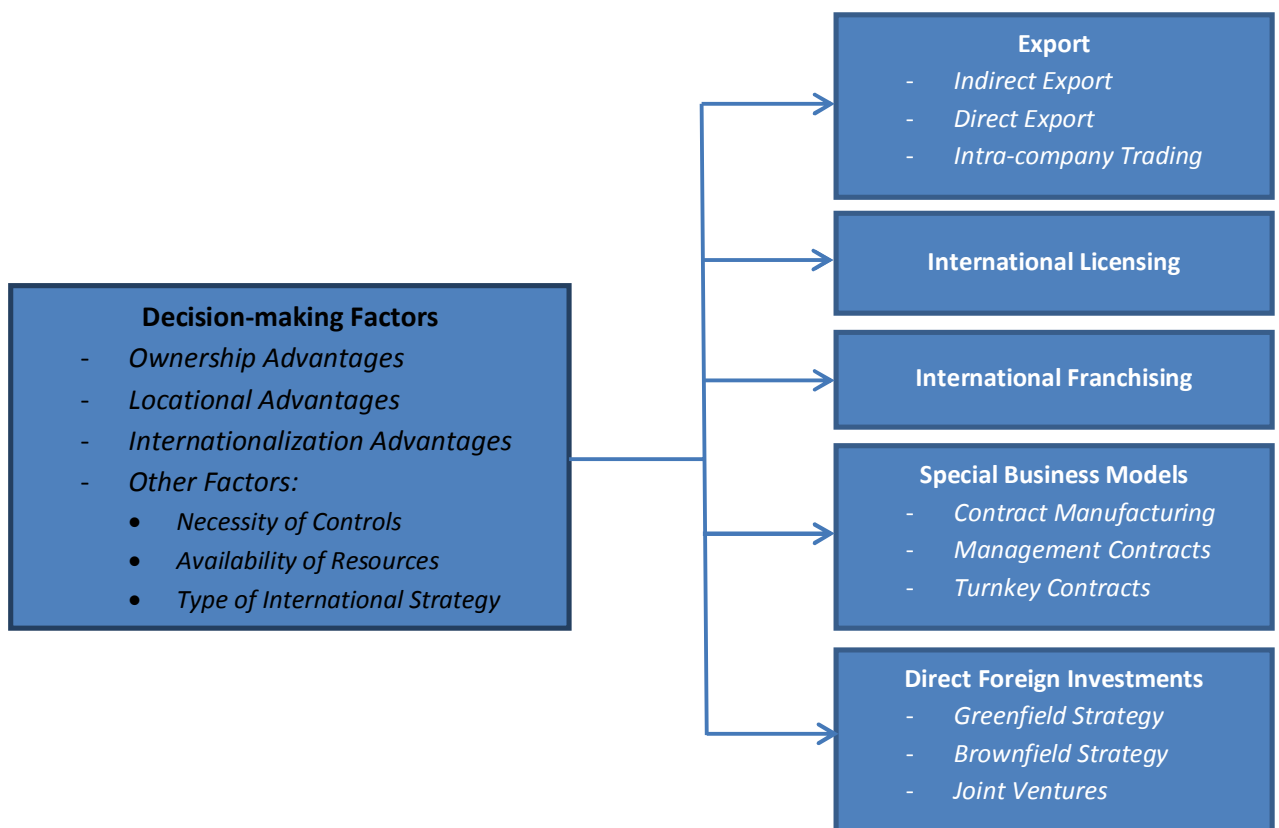
1. Alternative entry strategies

After choosing a target market, company managers should determine an effective entry strategy for this specific market. There are several theories of direct foreign investment helping entrepreneurs consider this problem from a scientific standpoint. John Dunning's Eclectic Theory, for example, allows one to make a deep analysis of the factors which help choose the way of penetration according to the following options: manufacturing goods in the home country (export); manufacturing goods in the host country in the entrepreneur's own enterprises (direct foreign investments and joint ventures); manufacturing goods in the host country at independent enterprises (licensing, franchising and contract manufacturing). Dunning's Eclectic Theory implies analysis of three factors for penetrating foreign markets: ownership advantages, locational advantages, and internalization advantages.

Other factors which also should be analyzed are: control over subsidiary enterprises, availability of resources, and company international strategy. Influence of all these factors on the decision-making process regarding penetration of foreign markets is illustrated in Fig. 6.1 [29].

Figure 6.1

Factors influencing the decision-making process



Ownership advantages. Ownership specific advantages refer to the competitive advantages of enterprises seeking to engage in foreign direct investment. These advantages are determined by availability of a company's own tangible and intangible assets (trademark, production technique,

entrepreneurial skills, returns to scale, *etc.*), which provide for the company's competitive edge over other companies. Local companies most probably have more information about conditions of doing business in the internal market than foreign companies. The latter therefore intending to penetrate a new market should possess certain assets which would allow them to surpass the informational advantages of local companies. The greater the competitive advantages of the investing firms, the more likely they are to engage in foreign production. As it is shown below the choice of entry strategy depends on character of competitive advantage determined by the availability of valuable assets. For example, the transfer of an embodied technology in most cases is better to carry out through the establishment of a subsidiary enterprise. At the same time, companies with a competitive advantage based on general notoriety of their brands are able, in some cases, to penetrate foreign markets through licensing or franchising. Apart from this, the availability of a company's specific advantages determines the possibility for conducting necessary negotiations and therefore influences decisions on entry strategy.

Locational advantages. Locational advantages refer to the alternative countries or regions, for undertaking the value adding activities. These advantages are determined by those factors on which the preferable location of manufacturing in the host country rather than in the home country depend. Undertaking the business activity must be more profitable in a foreign location than undertaking it in a domestic location. To determine the best location for manufacturing facilities, company specialists must make a detailed comparison of economic and non-economic characteristics of internal market with corresponding characteristics of foreign markets. Suppose that on the basis of such an analysis, a conclusion is made about the preferable location of manufacturing facilities in the home country rather than in the host one; in this case it is more appropriate for the company to enter the foreign market through exporting its products. On the other hand, if preference is given to manufacturing in a foreign country, a company may either invest capital in foreign facilities or sell licenses to use its technology and trade marks by local manufacturers.

The final choice between product manufacturing in the home country and the host country depends on many factors. Of great importance are such factors as existence of raw materials, low wages, special taxes or tariffs, and costs of acquiring land in the host country. Apart from this, the company can consider such factors as overcapacity and underutilized capacity of operating enterprises, availability of access to R&D facilities, consumer needs, and additional administration overheads for running a foreign enterprise. Possibilities of civil war, corruption or unstable government weaken significantly companies' willingness to allocate resources to enter the market of the country with such conditions.

Government policy also can influence the choice of penetration. High tariff barriers prevent development of export trade and stimulate foreign manufacturing. On the other hand, high income tax or government restrictions on repatriation of income hold back the flow of direct foreign investments.

Locational advantages also can be determined by cultural factors. Turkey, for example, capitalizes upon its geographical, religious, language and cultural connections with the former soviet republics of Central Asia and Caucasus. Such multinational corporations as *Siemens*, *JP Morgan Chase* and *Goodyear* located their headquarters and subdivisions exporting goods in Istanbul considering this city as a launchpad for doing business in all of Eurasia.

Internationalization advantages. Internationalizations advantages are advantages gained by self-production rather than producing through a partnership arrangement such as licensing or a joint venture. The firm must benefit more from controlling the foreign business activity than from hiring an independent local company to provide the service. The level of transaction costs (costs

of conducting negotiations, monitoring and actuation of an agreement) has crucial importance for making a decision on the extent of internationalization. If these costs are high, the company can penetrate a foreign market through direct foreign investments or joint ventures. If the level of transaction costs is not high, the company can use such ways of penetration as franchising, licensing or contract manufacturing.

Other factors. The entry strategy also can depend on other factors. If a company has no experience in operating in foreign markets it can choose penetration of a foreign market in a way which allows it to completely control its foreign operations and availability of resources in the target market.

On the other hand, if companies come short of capital or talented specialists, they may have no opportunity or willingness to invest significant funds for exercising such controls. Such companies may prefer to choose ways of entering foreign markets which could save them time and money – through licensing, for example.

A company general strategy of foreign expansion also can influence the manner of penetration. Such companies as *Ford* trying to get economy of scale and reach a synergy effect on the basis of collaboration between home and foreign units give preference to ways of entering the foreign market which are based on direct foreign investments. On the contrary, such companies as *Microsoft* and *Nike*, the competitive advantages of which are flexibility and rapid adjustment to a changing market environment, give preference to any way of penetration which allows them to better take into account local conditions. The option of market entry also may depend on the necessity to coordinate company activity in all markets if this is a part of a company’s strategy. For example, IBM, adhering to the strategy of globalization, traditionally gives preference to ways of penetration which are oriented toward investment of its own capital in construction and enterprise acquisition.

In short, a way of penetration, analogous with many other operations, is reduced in many cases to finding a compromise between the following factors: the risk level, which a company is exposed to; the potential benefits, which the company expects to get as a result of penetration of a foreign market; the opportunity to get resources, which are necessary for the company to be competitive; and the level of control desirable for the company.

Advantages and disadvantages of different ways of penetration of foreign markets are shown in table 6.1 [29]

Table 6.1

Advantages and disadvantages of different ways of penetration

Ways of penetration	Advantages	Disadvantages
Export	Relatively low level of financial risk Opportunity to gradually penetrate foreign markets Acquisition of knowledge about local markets Opportunity to avoid restrictions on foreign investment	Tariff and non-tariff barriers vulnerability Complexities with cargo delivery Potential conflicts with distributors
Licensing	Low level of financial risk Opportunity to evaluate the market potential without significant costs Opportunity to avoid tariff and non-tariff barriers and restrictions on foreign investment Opportunity to receive information about local markets from licensee	Restricted market opportunities/restricted incomes Dependence on licensee Potential conflicts with licensee Probability to creating a new competitor

Franchising	Low level of financial risk Opportunity to evaluate the market potential without significant costs Opportunity to avoid tariff and non-tariff barriers and restrictions on foreign investment More strict control in comparison with licensing Opportunity to receive information about local markets from franchisee	Restricted market opportunities/ restricted incomes Dependence on franchisee Potential conflicts with franchisee Probability to creating a new competitor
Contract Manufacturing	Low level of financial risk Allocation of minimal resources for product manufacturing Distribution of resources for other types of company activity in the value chain	Restricted controls (which can influence the quality of products, delivery time, <i>etc.</i>) Restricted opportunities to get experience Potential problems with Public Relations – necessity to check labor conditions which may arise
Management Contracts	Minimal financial risk Opportunity to allocate resources to those areas of business in which the company has maximum experience	Potential incomes are restricted by contracts Risk of accidental transfer of company know-how and experience to partners
Turnkey Contracts	Opportunity for a company to avoid all risks in a long term perspective Opportunity to allocate resources to those areas of business in which the company has maximum experience	Financial risks (overrunning permissible expenses) Construction risks (delays, problems with suppliers, <i>etc.</i>)
Direct Foreign Investments	Opportunity to gain significant income Control over operations Acquisition of knowledge about local markets Opportunity to avoid tariff and non-tariff barriers	Necessity of significant investments in manufacturing facilities and management system Higher sensitivity to political risks Vulnerability to restrictions on direct foreign investment

Export. Export perhaps is the simplest form of internationalization of a national company and a widespread form of international business. If a company makes decision to sell its products through a foreign company, it may need an insignificant amount of investment or no investment at all to do so. Financial risk in this case is restricted to initial costs such as studying the market, locating and choosing distributors or/and organizing an advertising campaign and also costs of goods or services supplied to the market. If a company makes a decision to sell its products on its own without intermediaries to tighten control over sales, it may raise its selling price. On the other hand, the amount of initial investment would increase significantly in this case since the company should establish and equip its own distribution centers, hire additional personnel, and market its products or services.

There are proactive and reactive reasons for exporting. *Proactive reasons* are caused by opportunities to do business abroad. They come from a company's strategic vision. It can be a unique opportunity emerging in a foreign market or an opportunity to exploit a unique competence of the company or increase the company's profitability or enhance the company's competitive advantage. *Reactive reasons* come from factors beyond company's management direct control. They may include an unsolicited inquiry from a potential customer or partner abroad, saturated demand for the company's products or services in the domestic market, the need to stay competitive when the company's competitors are exporting, the need to spread the

company risks across different geographic markets, the need to give a full load to manufacturing facilities, etc.

Forms of exporting. *Indirect exporting* is simply selling goods to or through an independent domestic intermediary in the company's home country. Then intermediaries export the products to customers in foreign markets. *Direct exporting* is selling goods and services to an independent party outside of the exporter's home country. Direct selling involves sales representatives, distributors, or retailers who are located outside the exporter's home country. Mainly the companies are pushed by core competencies and improving their performance of the value chain. *Intra-company trading* or *intra-corporate transfer* is a transaction that occurs between two subsidiaries of the same parent company located in different countries. For example, a supplier from one country sells to a retailer in another country and both are owned by the same conglomerate.

International licensing. Licensing is a process of giving someone the legal right to use intellectual property rights, such as trademarks, patents, or technology, under defined conditions and for certain remuneration (royalty). Licensing is widely used by many companies for penetration of foreign markets since this strategy does not demand substantial direct costs. The company-licenser has already incurred costs to develop intellectual property which is transferred through licensing therefore incomes received through licensing agreements can be recorded in the bottom line of the profit-and-loss account. Apart from this, licensing allows a company to take advantage of placing manufacturing in foreign countries assuming no rights of property in foreign enterprises and having no administrative and investment liabilities abroad.

Franchising is the practice of using another firm's successful business model. For the franchisor, the franchise is an alternative to building 'chain stores' to distribute goods and avoid investment and liability over a chain. The franchisor's success is the success of the franchisees. The franchisee is said to have a greater incentive than a direct employee because he or she has a direct stake in the business [50]. Franchising which is a form of licensing presents one more common strategy for internationalization of business. International franchising can be successful if there are certain conditions in the target foreign market. First, franchising can be an effective way of penetration of foreign markets if a franchiser is doing well in the domestic market owing to the uniqueness of his product and the advantages of business methods used. Second, franchising can provide good results if factors which caused success in the domestic market can be transferred to foreign markets. Third, the use of franchising as a strategy of penetration can be justifiable if a franchiser achieved significant success in domestic franchising.

Special business models. *Contract manufacturing* is a process that establishes a working agreement between two companies. As part of the agreement, one company custom produces parts or other materials on behalf of their client. In most cases, the manufacturer also handles the ordering and shipment processes for the client. As a result, the client does not have to maintain manufacturing facilities, purchase raw materials, or hire labor in order to produce the finished goods. There are several advantages to a contract manufacturing arrangement. For the manufacturer, there is the guarantee of steady work. Having contracts in place that commit to certain levels of production for one, two and even five year periods makes it much easier to forecast the future financial stability of the company. For the client, there is no need to purchase or rent production facilities, buy equipment, purchase raw materials, or hire and train employees to produce the goods. There are also no headaches from dealing with employees who fail to report to work, equipment that breaks down, or any of the other minor details that any manufacturing company must face daily. All the client has to do is generate sales, forward orders to the manufacturer, and keep accurate records of all income and expenses associated with the business venture.

The basic working model used by contract manufacturers translates well into many different industries. Since the process is essentially outsourcing production to a partner who privately brands the end product, there are a number of different business ventures that can make use of a contract manufacturing arrangement. Food, pharmaceutical, personal care and hygiene products, computer components, automotive parts, and medical supplies are often created under the terms of a contract manufacture agreement. The general concept of contract manufacturing is not limited to the production of goods. Services such as telecommunications, Internet access, and cellular services can also be supplied by a central vendor and private branded for other customers who wish to sell those services [51].

A management contract is an agreement in accordance with which one company provides managerial, technical and other special services to another company for a defined period of time and for certain remuneration. Management contracts allow for companies to get additional incomes without assuming investment risks and any liabilities. For example, one of *Hilton Hotels* subdivisions suggests management and booking services for those hotels which function under the trademark “Hilton” but are not this company’s property [29].

A turnkey contract is a business arrangement in which a project is delivered in a completed state. Rather than contracting with an owner to develop a project in stages, the developer is hired to finish the entire project without owner input. The builder or developer is separate from the final owner or operator, and the project is turned over only once it is fully operational. In effect, the developer is finishing the project and “turning the key” over to the new owner. This type of arrangement is commonly used for construction projects ranging from single buildings to large-scale developments.

The primary drawback of this type of agreement is the lack of control the owner maintains over design and construction decisions. For some owners, this may mean the project is not perfectly suited to their needs once it is complete. For others, this drawback may be canceled out by the potential for cost savings and shorter construction schedules. Some owners may choose a turnkey-plus contract, which leaves the developer with some financial long-term interest in the project. For example, a builder will construct a retail establishment for an owner, and the builder will receive a percentage of the gross receipts for a specific period of time. This may encourage the builder or developer to make construction decisions based on the long-term needs of the project, rather than just the short-term decisions needed to get the job done. [52]

Direct foreign investments. *The Greenfield strategy* is an example of a direct foreign investment strategy of entering a foreign market without the use of another company or middleman in order to establish a new business. Adhering to this strategy, a company buys or rents a plot of land, builds manufacturing or service facilities, hires or redeploys personnel and begins to exploit the new enterprise. This strategy has some advantages. For example, a company can choose a more convenient place for the business location and build a modern enterprise with the state-of-the-art facilities and equipment. Such enterprises create new jobs therefore local authorities suggest various stimuli to attract foreign investors. Apart from this, managers should not deal with old debts, modernize obsolete equipment or apply significant effort to change outdated methods of work which in addition are protected by trade unions which are not willing to make a compromise.

The Brownfield strategy is a strategy of purchasing incumbent companies which are doing business in the host country. Without doubts, the process of preparing a deal which involves bankers, lawyers, representative of regulatory authorities and real estate professionals may appear very complicated. Nevertheless, the main reason to pursue this strategy is quite simple. Purchasing an operating company a buyer receives control over the enterprise, personnel,

technologies, trademarks and distribution networks of the purchased company. With that, all units of this company continue to function and generate income as the company-buyer integrates this new structure into its international strategy. Apart from this, this strategy as distinguished from the Greenfield strategy, does not lead to an increase of manufacturing facilities in a certain industry. Under the conditions of excess capacity, this is an obvious advantage.

Joint ventures. A joint venture is a business agreement in which the parties agree to develop, for a finite time, a new entity and new assets by contributing equity. They exercise control over the enterprise and consequently share revenues, expenses and assets. A joint venture is commonly understood as a combination of companies. Russian law currently does not provide for a specific definition of ‘joint ventures’. In broad terms, a joint venture is a structure involving two or more independent entities that decide to work together on a specific project. Russian law generally does not provide any limitations on the types of economic activity that can be pursued in a joint venture. However, some industries are subject to special governmental regulation that may directly prohibit or restrict foreign investment.

2. Establishing operations in Russia

Establishing operations overseas is a difficult task since every country has many cultural, economic, social and other inherent specifics. In such a large country as Russia, there are also regional specifics. Although the general approach and methodology of establishing operations abroad may not vary too much from country to country, the peculiarities and hidden dangers are oftentimes quite unique. This chapter addresses some challenges and provides initial guidance to foreign companies and entrepreneurs who envision establishing themselves in Russia.

Encompassing nine time zones¹⁷, Russia is the largest country in the world by landmass. Therefore, many businesses tend to approach the Russian market on a regional basis. Most new entrants start in Moscow or St. Petersburg and then move into the regions either through an existing distributor or by seeking new distributors in those locales. As both Moscow and St. Petersburg are major population and business centers, many Western firms have representatives there. Some companies have successfully entered the Russian market by starting distribution in other key regions first because of market features and industry sector concentrations (e.g., woodworking in northwest Russia, energy projects in Sakhalin and western Siberia) and then expanding elsewhere. Well-organized distribution channels are established in western Russia, especially in Moscow and St. Petersburg, and continue to develop rapidly in southern Russia, the Volga region, Urals, Siberia and the Russian Far East. To succeed in Russia, it is important to choose sales targets and distributors carefully.

Legal framework. Companies setting up operations in Russia commonly find themselves in circumstances where a formal legal opinion is required for basic issues that in Western countries would be resolved very easily and usually free of charge, but which in Russia can dramatically change the feasibility of a deal. Foreign investors sometimes underestimate the need to follow important guidelines. This may have serious consequences when doing business in Russia. Familiarization with the basic principles of the legal framework may save considerable time and expense later if a projected business structure (commonly accepted elsewhere) is not advisable or even possible in Russia. The current legislative framework for investment and business in Russia is described below.

The following basic laws and government resolutions regulate business registration in Russia:

¹⁷ In fact, Russia has 11 time zones. In 2010, the country reduced the number of its time zones to nine from eleven after President D. Medvedev said this could make the giant nation more manageable to run and boost its economy. Time zones 3 and 11 disappeared.

- The 1999 Federal Law “On Foreign Investment in the Russian Federation”
- The 1994 Part I of the Civil Code
- The 2001 Federal Law “On State Registration of Legal Entities”
- Russian Government Resolution No. 319 “On Authorized Federal Entity of the Executive Power, Providing State Registration of Legal Entities” of May 17, 2002, and a number of legal acts.

Chapter 1 of the Civil Code governs certain types of business organisations and their foundation. It covers requirements for foundation documents, name, location, governance and state registration of legal entities. It defines branches and representative offices and governs reorganization and liquidation. Joint-stock and limited liability companies are governed by separate federal laws¹⁸.

Registration. The introduction on 1 January 2004 of a “one-window” registration procedure for Russian legal entities has not streamlined the business registration process. In Moscow, the situation deteriorated with a new requirement that only the CEO or director of a founding company may file a state registration application and retrieve in person the registration certificates – no representation by proxy is allowed. This has drawn out the registration timeframe considerably. If the CEO or director cannot come to Russia to file the application in person, it should be sent by registered mail (not by courier) to the Russian registration authorities, who process the application and return it to the address of the entity being incorporated. The registration process may take several weeks, or even months, to complete. “Shelf” companies are generally not available, and the incorporation process can take from two to three months. Preliminary approval or subsequent notification of the Federal Antimonopoly Service is required in certain cases. As of the end of January 2010, the state duty to register a Russian legal entity is 4,000 rubles. There is no processing fee for state registration.

Choice of entity. Foreign investors can choose from a number of different forms of business representation in Russia, from *representative offices* and *branches of foreign legal entities* to *Russian legal entities* to registration as an *individual private entrepreneur*. Representative offices of foreign entities are strictly limited to conducting only liaison and support functions. Branch offices are free to perform all of a foreign entity’s activities. Russian legal entities may be established in various forms, including joint-stock companies, limited liability companies and partnerships. Many investors opt for branch offices at the outset because these entities are able to engage in any kind of commercial activity, are easier to establish and are subject to less onerous reporting requirements than Russian companies. At the same time, for many investments, including joint ventures and production plants, and because of issues connected with licensing, customs and privatization of state property, a Russian legal entity may be better suited to an investor’s needs.

Representative office. The first legal form of operation in Russia is a representative office. An appropriate accrediting body must approve representative offices. There are numerous accrediting bodies authorized to grant such accreditation, including those responsible for the accreditation of representative offices in a particular industry – representative offices of foreign banks, for example, are accredited by the Central Bank of the Russian Federation. The bodies most frequently charged with the accreditation of foreign entities are the Chamber of Commerce and Industry of the Russian Federation (the “CCI”) and the State Registration Chamber at the Ministry of Justice of the Russian Federation (the “SRC”).

¹⁸ Federal Law No. 14-FZ of 8 February 1998 “On Limited Liability Companies” and Federal Law No. 208-FZ of 26 December 1995 “On Joint-Stock Companies”

After accreditation is obtained, the office should register with the local or regional registration chambers, located in many Russian cities. Advantages of an accredited office include annual/quarter (rather than monthly) reporting requirements for some activities (including some tax payments), and the ability to issue invitations for foreign partners to visit Russia on business visas. Up to five foreign employees may work with an accredited office of a foreign company. Offices are usually accredited for one to three year terms.

Accredited representative offices also must register with the State Registration Chamber in order to be included in the State Register of Accredited Representative Offices of Foreign Legal Entities in the Russian Federation. They are also advised to register with appropriate state organizations, depending on their industry. Such agencies include the Central Bank, Ministry of Economic Development Ministry of Finance, Ministry of Transportation, Ministry of Industry and Trade, Ministry of Energy and others. According to internal procedures, accreditation of a representative office or branch should take 21 business days starting from the day the full set of required documents are provided.

An accredited representative office is not a Russian legal entity, but an officially recognized subdivision of a foreign legal entity. A representative office may be opened for the sole purposes of representing and assuring a foreign company's interests in Russia. Representative offices are not allowed to conduct any production or commercial activities. A representative office is not considered a legal entity and all functions shall be carried out in full compliance with authorization from the company (within the scope of the power of attorney issued to the head of representative office according to the Russian civil code). All rights and liabilities duly undertaken by the representative office automatically give rise to legal consequences for a parent foreign company. The three sole areas of operation of a representative office are limited by law to 1) assistance in realization of trade, commercial and other agreements, 2) accumulation, analysis and exchange of relevant market information, and 3) ensuring of fulfillment of commercial and other deals concluded by a parent company. Although Russian law suggests that the scope of an accredited representative office's activity would be limited to auxiliary representational functions, in practice many foreign firms conduct commercial activities that, according to a strict interpretation of the law, should only be conducted through a registered branch or a Russian company.

Representative offices engage in commercial activities most often by rendering consultancy services, but they are effectively barred from commercial activities which entail import or export of goods. The Russian authorities have accepted this practice for more than two decades on the assumption that representative offices carrying out commercial activities pay all taxes associated with such activities. The tax rules for a representative office carrying out commercial activities are very similar to those that apply to a Russian company.

Although a representative office should be registered with the tax authorities, it is not subject to income tax as it is precluded from conducting profit-generating activities by its legal definition. A representative office is not required to adhere to accounting standards of the Russian Federation and its reporting to tax and other authorities is limited to four reports per year. Furthermore, a representative office can bring in equipment for its operation duty free, under the condition that it will be taken out of Russia later on. Foreign exchange control rules extend greater flexibility to a foreign representative office than to Russian entities. It is clear that the representative office form has its limitations (for example, is not allowed to clear goods through customs). This legal form of presence is usually used by foreign companies, which need to oversee fulfillment of their existing contracts in Russia, effectively collaborate with Russian partners and prepare and sign new contracts.

Some foreign manufacturers, in addition to using distributors, establish their own representative offices. In terms of distribution, the major advantage of opening a representative office is that foreign companies have more direct contact with their end-users and control over the promotion and distribution of their products since, under the Russian Civil Code, such offices cannot be directly involved in commercial activity. Instead, they typically oversee a network of distributors and/or agents that perform commercial functions. This approach affords greater control by the foreign supplier over the distribution process and helps to reduce risks.

All documents from a foreign legal entity must be notarized and apostilled/legalized in the country of execution, and any document supplied in a language other than Russian must be accompanied by a translation which has a notarized certification.

Accreditation is usually granted for a period of up to three years, with the right to an extension. An application letter for the accreditation of a representative office should be submitted to the appropriate accrediting body and must be accompanied by the following documents:

- The Charter or Articles of Incorporation (articles of association, or equivalent) of the foreign legal entity
- The registration certificate, Certificate of Incorporation, or extract from the trade register of the foreign legal entity certifying that the parent is a validly existing legal entity under the legislation of its home country
- The resolution of the foreign legal entity resolving to establish the representative office in the Russian Federation and to appoint the chief representative(s)
- The regulations which will govern the operation of the representative office
- A bank letter confirming the good credit standing of the foreign legal entity
- A document confirming coordination with the regional authorities of the Russian Federation on the establishment of a representative office (not required for representative offices to be located in Moscow)
- General Power of Attorney issued to the chief representative(s)
- Power of Attorney for filing the application for accreditation on behalf of the foreign legal entity
- The Accreditation Card containing information on the representative office, filled out in accordance with a sample form of a particular accrediting body and signed by an authorized representative of the foreign legal entity
- Certification from the tax authorities in the country of the foreign legal entity's incorporation confirming that the foreign legal entity is registered as a taxpayer and specifying the taxpayer identification code
- Two letters of recommendation from Russian trading partners (preferably Government bodies, social organizations, or 100% Russian-owned entities) on the official letterhead of the recommending organization, and
- A copy of a lease agreement or landlord guarantee letter, together with confirmation of the landlord's right to the property to be leased by the representative office.

Representative offices incur the following fees for accreditation: \$1,000 for one year, \$2,000 for two years and \$2,500 for three years. An additional fee of \$500 may be paid for expedited accreditation within seven days.

Branch. The second form is a branch of a foreign company. A branch is allowed to conduct all the activities of a representative office as well as to carry out all or part of the core activities and businesses of a parent company. Thus, a branch of a foreign company in Russia can actually manufacture, distribute and sell products and conduct other commercial activities. Another advantage is that bookkeeping of a branch is simplified as compared to a Russian legal entity.

The registration procedure of a branch and of a representative office is similar. A branch has to be registered and accredited by the State Registration Chamber, which is part of the Ministry of Justice of the Russian Federation, and other bodies (for example, the Central Bank of the Russian Federation), in accordance with the 1999 Federal Law On Foreign Investments. The registration process is not difficult and can usually be performed by a law firm for a standard fee. To register, branches and representative offices need to take the following steps:

- File accreditation papers with federal bodies. Accreditation is mandatory, since the local banks and administrative authorities may not recognize the branch/representative office without it
- Register with tax authorities
- Register with state statistics authorities, obtaining statistics codes
- Register with social (pension, medical and social security) funds
- Open bank accounts.

An application letter for the accreditation of a branch should be submitted to the State Registration Chamber and should be accompanied by the following documents:

- The Charter or Articles of Incorporation (articles of association, or equivalent) of the foreign legal entity
- The registration certificate, Certificate of Incorporation, or excerpt from the trade register of the foreign legal entity certifying that the parent is a validly existing legal entity under the legislation of its home country
- The resolution of the foreign legal entity to establish the branch office in the Russian Federation
- The regulation which will govern the operation of the branch office
- A bank letter confirming the good credit standing of the foreign legal entity
- A document confirming coordination with the regional authorities of the Russian on establishment of a branch office (not required for branches to be located in Moscow)
- A General Power of Attorney issued to the Director of a branch office
- A Power of Attorney for filing the application for accreditation on behalf of the foreign legal entity
- The Accreditation Card containing information on the branch office filled out in accordance with a sample form of the accrediting body and signed by a representative of the foreign legal entity
- Certification from the tax authorities in the country of the foreign legal entity's incorporation confirming that the foreign legal entity is registered as a taxpayer and specifying the taxpayer identification code
- Expert opinions from the respective ministries of the Russian Federation (the Ministry of Energy, the Ministry of Natural Resources etc.) as required by the statutes of the Russian Federation for certain types of activities, and
- Documentation of payment of the registration fee.

All documents from a foreign legal entity must be notarized and apostilled/legalized in the country of execution. Any document supplied in a language other than Russian must be accompanied by a translation which has a notarized certification.

A branch office has to be registered with the tax authorities. It is subject to a profit tax if tax authorities qualify it as "permanent establishment" (i.e., if it carries out commercial, manufacturing or other similar profit-generating activities on the Russian territory). The profit tax is paid once a year. Naturally, a foreign company operating through a branch in Russia, is subject to most other taxes and fees according to the Russian laws and regulations. Among disadvantages of a branch status is that imported goods will have to be cleared by a Russian legal entity, such as a customs broker or some other entity. Another disadvantage is that a parent

company is liable for all obligations of its branch in Russia, most importantly this rule is applied to tax, customs and related obligations.

Many investors confuse the concept of a branch and an accredited representative office, but they have important differences. An accredited representative office is not a Russian legal entity, but an officially recognized extension of a foreign legal entity. Russian law restricts the scope of an accredited representative office's activities to auxiliary representational functions.

A branch's legal status differs substantially from that of a representative office. For example, under Russian law, a registered branch of a foreign legal entity (but not a representative office or unregistered branch) is treated as "an enterprise with foreign investment". Therefore, while a registered branch can hold certain types of licenses to conduct regulated activities, a representative office or unregistered branch may not.

The state duty for branch accreditation is approximately \$4,100 as of the end of 2011. In addition, accreditation bodies charge a processing fee between \$500 and \$2,000, depending on the period of accreditation (from one year to five years, respectively).

Both Representative and Branch Offices can be attractive to foreign businesses wishing to operate in the Russian market because there are fewer tax and other administrative burdens and currency control restrictions may not apply. As Representative Offices may not take part in commercial activities, Branch Offices have become increasingly more popular.

Further information is available on the State Registration Chamber website at <http://www.palata.ru>.

Subsidiary Company. The third legal form of operation in Russia most widely used by foreign companies is a subsidiary company. This form provides greater control of ownership and management. Professional law firms can perform registration procedures and counsel on all associated issues. It is important to note that a Russian subsidiary acquires full legal capacity in Russia according to the laws and regulations pertaining to legal entities. A Russian subsidiary of a foreign company will be acting within the same legal framework as any other Russian company.

Some foreign manufacturers, particularly in the cosmetics, pharmaceuticals, consumer appliances, durables and industrial products sectors, have registered their wholly owned subsidiaries in Russia. They then sell directly to their own companies registered in Russia who import for their own account. This approach affords full control of the supplier over distribution and helps to further reduce possible risks from false invoicing and other irregularities sometimes committed by independent importers and distributors.

One of the added benefits of subsidiary company format is that it gives ability to bring in equipment as a contribution to the charter capital. This provides full relief from customs duties and VAT. However, in order for chartered equipment and machinery to be transferred to third parties, they would have to be subject to customs clearance, VAT has to be paid, etc. Naturally, a Russian subsidiary is required to conduct accounting in full compliance with the Russian laws and regulations and is subject to all customs, foreign exchange and other rules.

Forms of business entities. Currently, the following forms of commercial legal entities (for-profit) may be incorporated in Russia:

- Full partnerships;
- Limited partnerships ("kommandit" partnerships);

- Limited liability companies (OOO);
- Additional liability companies (ODO);
- Production cooperatives;
- Joint-stock companies (privately held or Closed joint stock company, ZAO; publicly held or Open joint stock company, OAO)
- Unitary enterprises (state-owned legal entities not open to foreign investors).

Of the above, only the joint-stock company resembles a corporation but with the limited partnership and limited and additional liability companies also limit the liabilities of investors, as described below.

Branch offices and accredited representative offices are both legally distinct from Russian corporations, which may be established by foreign firms either as joint stock companies with partial Russian ownership, or as wholly owned subsidiaries of a foreign firm. Foreign ownership can be as high as 100%, with some exceptions. For example, foreign investment is limited in industries defined by the “Strategic Sectors Law” (discussed in this chapter under “Joint Ventures/Licensing”).

A Limited Liability Company or Private Joint Stock Company can be founded by an individual (Russian or foreign) or by a legal entity. The founding document of a Sole ownership company is a Charter. Such a company doesn’t have some management bodies such as a General Meeting of the Founders. There is no Board of Directors. All the decisions are made by the sole founder. Accordingly legislative requirements on the calling of the general meetings, and other procedural requirements do not apply to such company. The management of the company is done by issue of written decisions of the founder. If the founder is also a General Director in the company the decisions are made by issuance of orders. At the same time such a company is a separate legal entity, and its assets are legally isolated from the assets of the founder.

Joint-stock companies. In accordance with the Civil Code, a joint-stock company’s capital is divided into a definite number of shares. The participants of a joint-stock company (the shareholders) are not liable for the company’s obligations and accept the risks of losses in connection with its activity within the limit of their respective stakes. Shareholders may conclude a shareholders agreement regulating the exercise of their rights.

Russian law provides that only joint-stock companies may issue stock, which is deemed as securities and is subject to registration. Russian legislation describes “open” and “closed” joint-stock companies, which are broadly equivalent to public and private companies. Open joint-stock companies must disclose certain financial and other information annually.

A company may be created as a new company or by reorganizing an existing legal entity (consolidation, merger, division, spin-off or a change in legal form). A company is considered created from the date of its state registration.

The share capital of a joint-stock company is composed of the nominal amount of shares acquired by the shareholders. The minimum “charter” (share) capital for open and closed joint-stock companies is 1,000 and 100 times the minimum monthly wage¹⁹, respectively.

The higher management body of a joint-stock company is the General Meeting of Shareholders, which must assemble at least once per year. A company with over 50 shareholders must have a

¹⁹ The term “minimum monthly wage” is used by the government as a ratio to calculate different payments and does not reflect the real minimum wage. As of 1 January 2001, the minimum monthly wage is 100 rubles.

board of directors. The company's executive body may be collegiate (board, directorate) and/or "one-man" (director, general director). The executive body of a joint-stock company carries out the day-by-day management of the company's activity and reports to the board of directors and to the general meeting of shareholders.

A joint-stock company may be liquidated voluntarily or by court order on the grounds established by the Civil Code. The liquidation of a company results in its termination, with no transfer of rights and obligations by succession to other persons.

Limited liability companies. Under the Civil Code, a limited liability company is established by one or several persons whose charter capital is divided into shares according to the formation documents. In this type of company, the liability of each participant is limited to the value of its contribution. The participants may conclude a participants' agreement regulating the exercise of their rights.

The charter capital of the limited liability company determines the minimum size of the company's property guaranteeing the interests of its creditors. The minimum charter capital of a limited liability company should not be less than RUB 10,000 (\$333). The management structure of a limited liability company is similar to that of a joint-stock company.

Usually, foreign investors choose a limited liability company format (Russian acronym – "OOO"). A limited liability company is easier to register and it has to comply with fewer rules and regulations than a joint-stock company. Registration of a limited liability company requires a set of documents and the whole process usually takes a few months.

However, if a foreign company/investor wants to establish a joint venture with a Russian partner, the limited liability form may not be the best option because, according to the law, the stakeholders have the right of exit. A closest alternative to a limited liability company in this case is a closed stock company.

Additional liability company. An Additional Liability Company is deemed to be a society founded by one or several persons, whose charter capital has been divided into participatory shares of amounts determined by the constitutive documents, and the participants of such company shall bear subsidiary responsibility jointly and severally for its obligations with their property in multiple identical documents for all of the value of their contributions determined by the constitutive documents. In case of bankruptcy of one of the participants of the additional liability company his/her responsibility for the company shall be distributed among the remaining participants in proportion to their contributions. Therefore, this type of a commercial company, Additional Liability Company, is not widespread in Russia nowadays.

Full and limited partnerships. A full partnership is similar to the American general partnership, in which partners bear (full) joint and several liabilities for the partnership's obligations. A participant in a full partnership may not be a full partner in any other partnership.

A limited partnership, which is closer to the European *kommandit* partnership, has both full partners and partners whose liability is limited to their contributions. A full partner in a limited partnership may not be a full partner in another partnership, and its liability is the same as for full partners described above.

Partnerships under Russian law are generally regarded as legal entities and are taxed accordingly. Contractual agreements for joint activity, although they share some of the

characteristics of a general partnership, do not create a legal entity and there are special rules governing their tax treatment.

Joint Ventures. Though not as common as in the past, foreign companies may become strategic partners with Russian firms by taking an equity position in Russian joint stock companies and thus establishing joint ventures (JV). Establishing a JV in Russia demands meticulous planning and sustained commitment. In most cases, it is advisable for the foreign partner to retain managerial and voting control. JVs in which foreign partners hold minority stakes are dependent on the good intentions of their Russian majority owners. Experience shows that foreign minority shareholders may face serious difficulty in protecting their interests in Russian courts.

One advantage of a JV is that it helps a foreign firm gain a measure of Russian identity, which can be useful in a culture where many still view foreigners with suspicion. The May 2008 Strategic Sectors Law identified 42 industry sectors requiring the Russian government's pre-approval of a foreign firm's purchase of controlling interest. Additionally political pressure is mounting in Russia for domestic content mandates in key sectors or for large-scale procurements. For example, some foreign investments in the oil industry may be required to source 70% of their goods and services from Russian providers. Firms that creatively help oil producers meet these requirements will have an advantage in this industry.

Russian and foreign partners often view JVs differently. Foreign companies, especially smaller ones, often view JVs as a means of securing a local partner with experience in the Russian market. On the other hand, many Russian managers view a foreign partner chiefly as a source of working capital and these managers may place a low priority on local market development. While there are many examples of successful JVs, a foreign investor invites trouble when the investor cedes oversight of any aspect of a JV to a Russian partner which does not share the same objectives. Before making financial or legal commitments, foreign firms should thoroughly explore whether a potential partner shares their priorities and expectations. Any firm that forms a JV in Russia should be ready to invest constant personal attention of its managerial staff to keep the business on course, both before and after the venture has achieved commercial success.

Foreign technology is sometimes licensed for Russian production outside the context of a joint venture. Major hurdles that must be overcome include quality levels attainable by Russian facilities in the absence of significant retooling, uncertain intellectual property protection and difficulty in receiving regular and prompt payments. In the opposite direction, Russian companies generally are eager to license their technologies to foreign companies in exchange for the cash infusion.

Reorganization of legal entity. The procedure of reorganization of a legal entity is regulated by the Civil Code of the Russian Federation and by the corporate legislation (the Federal Laws "On the Limited Liability Companies" and "On the Joint Stock Companies"). According to the Civil Code of the Russian Federation there are 5 forms of possible reorganization of legal entity in Russia: merger, accession, division, separation, transformation. Reorganization may be accomplished by a decision of the founders of the company (or participants) or the organ of legal entity empowered thereof by the constitutive documents. In cases specified by the Law division or separation from the company's composition of one or several legal entities shall be accomplished by the decision of empowered State agencies or by the decision of a court. In special cases, it can also be determined by the Laws of merger, accession or transformation.

Individual entrepreneurship. Each natural person may conduct business as an individual entrepreneur (on an unincorporated basis, without forming legal entities) from the moment of State registration in the Single State Register of individual entrepreneurs. In such case the

proceeds from business operation are subject to a personal income tax. An individual entrepreneur shall be liable for his obligations with all of his property except for property against which execution may not be levied in accordance with law. Pursuant to the Civil Code (Part III of November 26, 2001) and the Federal Law "On legal status of the foreigners in the Russian Federation" of July 25, 2002 and other laws, foreigners have also the right to conduct business in Russia as individual entrepreneurs.

To register as an individual entrepreneur, a foreigner should have a *permanent resident card* and get *permission to work in Russia*. Obtaining a permanent resident card is a complicated procedure. Before applying for permanent residency, the foreigner should get a *temporary residence permit* (for three years) having any type of visa except the tourist one and providing evidence of having a place of residence (for example, a contract with Russian owner of real estate). In 12 months after getting temporary residence permit, the foreigner can apply for permanent residency which is granted pursuant to annual quota (129 486 permissions in 2011). On receiving permanent resident card, the foreigner can apply for permission to work in Russia. Only having in hand all the above mentioned documents the foreigner can register as an individual entrepreneur. This way is almost never used because of the great difficulties in getting temporary residence permit.

Hiring an individual. The fastest way for a foreign entity to start business in Russia is often simply to hire an individual without establishing a registered presence through a subdivision or company. It is not a common practice in Russia for foreign companies to rely solely upon the services of the individual. Distributors and representative offices, however, often employ agents in the Russian regions in order to promote their products. Employing a person for this purpose requires careful screening and good knowledge of the individual. Generally, an individual may be hired either as a consultant under a civil law (service) contract or as an employee under an employment contract. These two options are described below.

Employment agreements are governed by the Russian Labor Code. The code lays down a number of rules that must be observed if the employee is a Russian citizen and the work is performed in Russia. These rules are at least as beneficial to the employee as are the labor law provisions in the Scandinavian countries. Service contracts, on the other hand, are governed only by general civil law. In practice, this means that the contracting parties are free to contract as they wish, and normally, consultants rendering services under civil law contracts do not enjoy the protection of the Labor Code. No mandatory rules apply to salary, overtime, vacation or termination of contract. Generally, the advice to a foreign entity that does not yet maintain a presence in Russia but wishes to hire an individual for its services is to hire an individual as a civil law consultant and not as an employee. This will allow greater flexibility in the entity's relations with the individual. It will also allow the entity to avoid the mandatory rules of Russian labor legislation. Furthermore, it is recommended that the civil law consultant be registered as an individual entrepreneur for the reason described below.

An entity that hires a Russian person to perform work in Russia either as a civil law consultant or as an employee would normally have to withhold and pay income tax and pay social fees for that person. But if an individual hired under a civil law (service) contract has registered with the Russian authorities as an individual entrepreneur, the foreign entity does not need to withhold or pay any taxes or social fees in Russia. Instead, the individual entrepreneur must make these payments, and the entity that hired the individual cannot be made liable for amounts due. Obviously, it is vital that a foreign entity which hires a person as an individual entrepreneur carefully checks that the person is duly registered.

3. Obtaining an invitation for Russian business or work visa

Every businessperson planning a trip to Russia faces the necessary and time-consuming process of getting a visa, which involves obtaining an invitation letter from an organization authorized to issue such invitations. To simplify the process and minimize possible complications in obtaining a business visa, travelers might consider hiring a visa service company accredited with the Russian Ministry of Foreign Affairs. Although the application process does not require this type of assistance, it can significantly expedite the process of preparing for a business trip to Russia.

Under Russian law, every foreign traveler must have a Russian-based sponsor, which could be a hotel, tour company, relative, employer, university, etc. Even if a visa was obtained through a travel agency in the United States, there is always a Russian legal entity whose name is indicated on the visa and who is considered to be the legal sponsor. Russian law requires that the sponsor must apply on the traveler's behalf for replacement, extension, or changes to a Russian visa. Foreign citizens are strongly advised to ensure that the sponsor listed on their visa is a known, legal entity, and that the traveler holds contact information for the visa sponsor prior to arrival in Russia, as the sponsor's assistance will be essential to resolve any visa problems or assist in cases of emergency.

Regular application process for a business or work visa. This is the most popular visa among business people. Officially business visas are intended for foreign citizens who travel to Russia to meet their business partners, take part in negotiations, sign a contract, visit an exhibition, etc. You do not need to plan hotel reservation or an itinerary to get a business visa. These visas do not imply official employment in Russia (for this purpose a work visa should be obtained). A Russian business visa can be single, double, or multiple entry for a period of 3-12 months. The Consular Section of the Russian Ministry of Foreign Affairs (MFA) is the primary body authorized to issue invitations needed to obtain a visa. Other Russian agencies that can issue invitation letters include regional representatives of the MFA and the Ministry of Interior and its local offices. An invitation letter must contain the official seat and legal address of the agency, a document registration number, date of registration, signature and name of official authorized to invite foreigners to Russia, travel itinerary, dates of stay, and names of persons invited. For citizens of EU, Norway and Switzerland (except for citizens of the UK and Ireland) invitations can be issued directly by the Russian organization. Please note that *a letter of invitation from a Russian sponsor is only sufficient if the Russian inviting company is registered with the MFA.* The standard time for obtaining an official letter of invitation from the MFA is 21 business days.

If the invitation letter is obtained directly from the MFA by the Russian sponsor, the MFA will send a telex or an original letter to a Russian consular office in the United States. Once the letter has arrived at the Russian consular office, the traveler can submit a visa application form and the required attachments. In addition to an official invitation, a Russian business visa application must include photocopies of the first two pages of a passport (passport must be valid 3 months beyond the dates of travel); three passport photos; a cover letter on company letterhead with information about the traveler, destinations, terms, and purpose of visit; and, for visits of more than 3 months, the results of an HIV test.

In order to work legally or do business as an individual entrepreneur in the territory of the Russian Federation foreign nationals must have *a work permit* for Russia. In addition to a work permit nationals of countries who need a visa to enter the Russian Federation must have *a work visa* which grants the right to work in Russia. A work visa for the Russian Federation can be obtained at a consulate of the Russian Federation abroad, on the strength of an invitation. In order to get an invitation to work in the Russian Federation an acting work permit is required. A work visa invitation is issued on the basis of work permit by the local department of the Russian Federal Migratory Service (FMS) on application of Russian organizations, accredited in this

department of FMS. Initially, a single-entry work visa is issued by a consulate outside Russia for three months only. To get an extended multiple-entry work visa, foreign nationals are required to stay in Russia during the application process and issuance of the multiple entry work visa.

Obtaining a visa through visa service companies. Travelers willing to pay for the convenience may find the visa application process less cumbersome if they use an MFA-accredited visa service company. Using one of these visa service companies allows the Russian sponsor and the traveler to avoid having to contact MFA directly. Usually, no documents from Russian business counterparts are required when a visa service company is involved. The visa support company generally will be able to process the letter of invitation for the traveler, answer questions, and render full support during the stay in Russia (visa registration, visa extensions, etc.).

Typically, visa support companies will ask the traveler to complete a visa application form and a credit card authorization form. Then, they will contact the MFA with a request for a letter of invitation. MFA later sends a telex to a Russian consular office in the foreign country, and the company notifies the traveler of the telex number. Once a foreign traveler is informed of the telex number, he or she can send the application materials as usual to the nearest consular office.

Agency fees depend on the time frame and the type of visa desired by the traveler. For example, the visa service fee for processing an invitation within 2 days for a single-entry, 1-month visa, could run approximately \$90. Visa service agencies can facilitate issuance of tourist visas as well; those with foreign offices may also process the paperwork on the other side.

Within 72 hours of arrival in Russia, a traveler is required to register a visa at his/her hotel or, if staying elsewhere, at the local Visa and Registration Affairs Office (a department of the Federal Migration Service of Russia), or through the visa support company.

Check the regulations. While obtaining a visa for some countries may simply be a formality, it is extremely important to closely follow Russian visa requirements and regulations. As requirements and fees for obtaining a Russia visa are subject to change without notice, it is recommended that the traveler contact the Russian Embassy before beginning the process to get up-to-date information, as well as to confirm the working hours of the nearest Russian consular office. Visa processing fees vary depending on the processing time, which ranges from "while you wait" and "next day" to 10 full business days.

Information on Russian business visa regulations is available on the websites of the Consular Divisions of the Russian Embassies in foreign countries (for example, in the United States at www.russianembassy.org/business-visa.html.ru). Potential investors also would be well-advised to consult the State Department and U.S. Embassy websites for the latest information on Russian visas: moscow.usembassy.gov/russian-visas.html and travel.state.gov/travel/cis_pa_tw/cis/cis_1006.html

4. Licensing and certification

Licensing. A license is a special permit for carrying out a certain activity issued by a licensing body to a legal entity or to a private entrepreneur and assuming obligatory observing requirements and conditions. A licensed activity is an activity for the execution of which at the territory of Russia a license is required. Licensed activities include activities the execution of which may result in causing damage to the rights, interests and health of people, to defense and security of the state, to the cultural heritage of the Russian Federation when control of such activities is impossible with other methods but licensing. The activity for which a license was provided can be executed only by the legal entity or private entrepreneur who received the license. Below are some of activities that require licensing in accordance with Federal Law No. 128-FZ from 08.08.2001 "On Licensing Certain Activities" as amended on 2008:

- Private safeguarding activity (licensed by the Ministry of Internal Affairs)
- Private investigation activity (licensed by the Ministry of Internal Affairs)
- Cargo shipment by inland water transport
- Transportation of passengers by inland water transport
- Cargo shipment by air
- Passengers' transportation by air
- Rail haulage of cargo-luggage
- Rail haulage of cargoes
- Cargo shipment by marine transport
- Transportation of passengers by marine transport

Licensing of activities is executed by the following state bodies:

- Ministry for Home Affairs
- Federal Migration Service
- Emergency Situations Ministry
- Federal Agency on Industry (*Rosprom*)
- Federal Space Agency
- Federal Agency for Technical Regulation and Metrology
- *Rostekhnadzor* and some others

Certification. Certification is a procedure of confirming that the results of the production activity, a product or a service conform to the regulatory requirements, and through this procedure the third party certifies with the documents that products, work (as a process) or a service conform to the preset requirements. The third part shows that an individual or an authority acknowledged to be independent from the supplier (the first party) and from the customer (the second party). The validation by the third party shall be independent, shall guarantee the conformity to the preset requirements and shall be carried out according to the rules of this procedure. Certification is a unified system of control over conformity to the requirements set by regulatory documents. It includes standardization, metrology and products' quality management activity.

Products imported to Russia must have the GOST-R certificate of conformity. This is a document certifying that the product conforms to GOST standards (Russian state standards or GOSTstandart). European certificates of quality are not valid in Russia for import. Russia continues to rely on product testing as a key element of the product approval process. Other types of product safety assurance, such as plant auditing, quality systems, and post market vigilance, are underdeveloped. Russia continues to adhere to the practices of further testing of internationally accepted certified products, which can delay entry of a variety of products into the country. Be prepared to spend quite a lot of time on the certification process.

Standards organizations. The current authority for standardization, metrology and certification matters in Russia is the Federal Agency on Technical Regulating and Metrology. Federal Agency on Technical Regulating and Metrology 9 Leninsky Prospekt Street 119991 Moscow V-49, GSP-1 Russia. Tel: +7 (495) 236 0300 Fax: +7 (495) 236 6231/237 6032, Email: info@gost.ru www.gost.ru/wps/portal/pages.en.Main (in English).

The list of authorized certification bodies is available at www.gost.ru The Federal Agency on Technical Regulating and Metrology and its authorized agents is the main authority for certification in Russia. However, other agencies are involved in certification of certain products, including the Ministry of Agriculture (food products), the Ministry of Health (medical devices and pharmaceuticals), the State Communications Committee (telecommunications equipment and services), the State Mining and Industrial Inspectorate or *Gosgortekhnadzor* (equipment for mining, oil and gas industries), the Federal Security Service (security equipment and systems),

and others. Russia's time-consuming system of certification may become a challenge to foreign companies attempting to certify products without appropriate legal advice or assistance from experienced distributors or consultants. Foreign companies should work with reliable partners and consulting companies on registration and certification issues.

Conformity assessment. Many products imported for sale into the Russian Federation are required to have a certificate of conformity issued by The Federal Agency on Technical Regulating and Metrology. GOST-R Certificate of Conformity should be obtained from an organization authorized by the Agency. The list of the authorized bodies is available at the website www.gost.ru. Some of those bodies outside Russia are German DIN COST TUV (<http://www.din-gost.de/en>), Switzerland SGS Group (www.sgs.com) and SGS United Kingdom Ltd (www.uk.sgs.com). SGS is the only *Gosstandart* accredited certification body in Great Britain that has the authority to issue GOST-R Certificates of Conformity.

The Certificate normally travels with the goods. It is presented to the Customs at the point of entry and should be available on demand by the authorities as evidence of certification. Goods without a valid Certificate of Conformity can be impounded, thus incurring demurrage and storage charges. The Certificate of Conformity can be obtained by the exporter or by the Russian partner/agent. Textiles and clothing are subjects for mandatory certification, raw materials are optional. However, companies are advised to clarify with their partner in Russia which products of their range should have a Certificate of Conformity, as it is certainly required at the point of sale. In most cases, it is recommended that this is done by the Russian partner.

Certificate types. Over 100 certification types exist in Russia, some 20 of which are mandatory, the rest are optional. Major mandatory certification types include:

- GOST-R,
- Hygienic Certificate, and
- Fire Safety Certificate.

The products subject to mandatory certification are listed in Decree N64 of 30 July 2002 issued by *Gosstandart*. If the products are not listed in this document their certification is optional, and a confirming letter from an accredited certification organization may be required for exporting the product to Russia. Since it is not easy to understand the system, it is suggested that professional advice be sought.

Market entry strategy tips:

- Developing business in Russia is resource intensive, requiring serious commitments of time, personnel and capital.
- Conduct market research, such as with the U.S. Commercial Service's Gold Key or International Partner Search services, to identify opportunities and potential Russian business partners.
- Conduct due diligence, such as with the U.S. Commercial Service's International Company Profile service, to ascertain the reliability of business partners.
- Consult with U.S. companies already in the market, as well as with the U.S. Commercial Service and business organizations, such as the American Chamber of Commerce and U.S. - Russia Business Council.
- Communicate regularly with Russian business partners to ensure common understanding of expectations.
- Travel frequently to Russia to establish and maintain relationships with business partners and to understand changing market conditions.
- Maintain a long-term timeframe to implement plans and achieve positive results. Abide by all Russian laws and regulations (taxes, customs, labor, etc.). Also retaining local tax, legal and government relations advisors is strongly recommended.

- Conduct business in accordance with all applicable U.S. laws, as well as standard U.S. and international business practices.
- Utilize letters of credit or other secure financing vehicles, and avoid sales on an open account.
- Explore use of U.S. government financing, such as the Export-Import Bank (Ex-Im Bank) and Overseas Private Investment Corporation (OPIC), as well as multilateral development banks, such as the European Bank for Reconstruction and Development (EBRD).
- Develop working relationships with national, regional and/or local governments and consider implementing corporate social responsibility programs.
- Patience, perseverance and perspective are keys to success in Russia.

Chapter 7

Importing and Exporting

1. International Economic Cooperation

According to one of the ten major principles of Economics²⁰, trade can make each nation or entrepreneur richer. The law of *comparative advantage* says that two countries (or other kinds of parties, such as individuals or firms) will both gain from trade if, in the absence of trade, they have different relative costs for producing the same goods. Even if one country is more efficient in the production of all goods (*absolute advantage*) than the other, both countries will still gain by trading with each other, as long as they have different relative efficiencies.

For example, if, using machinery, a worker in one country can produce both shoes and shirts at 6 per hour, and a worker in a country with less machinery can produce either 2 shoes or 4 shirts in an hour, each country can gain from trade because their internal trade-offs between shoes and shirts are different. The less-efficient country has a comparative advantage in shirts, so it finds it more efficient to produce shirts and trade them to the more-efficient country for shoes. Without trade, its opportunity cost per shoe was 2 shirts; by trading, its cost per shoe can reduce to as low as 1 shirt depending on how much trade occurs (since the more-efficient country has a 1:1 trade-off). The more-efficient country has a comparative advantage in shoes, so it can gain in efficiency by moving some workers from shirt-production to shoe-production and trading some shoes for shirts. Without trade, its cost to make a shirt was 1 shoe; by trading, its cost per shirt can go as low as 1/2 shoe depending on how much trade occurs. The net benefits to each country are called the gains from trade [53].

When a country imposes restrictions on international trade this may be beneficial only for a portion of product manufacturers. Other countries can take the same actions believing that they can get benefits from this too. But with the increase of such restrictions, auspicious opportunities in international trade are decreasing and all countries lose as a result. At such a succession of events it becomes obvious that all countries would be in more favorable conditions if they established cooperation and removed barriers for international trade. Agreements on international cooperation are a very important element of economic environment in which international entrepreneurs function. To achieve success, international businessmen should have a good understanding of these agreements and be able to use them to create new opportunities for doing business and increasing the competitiveness of their companies. Formation and expansion of regional trade blocks, which appeared as a result of international trade agreements, is of particular importance for international companies.

General Agreement on Tariffs and Trade [29]. The crisis of the world economy, which combusted during the Great Depression in the period between the World War I and World War II, was to a certain extent caused by introduction of prohibitive tariffs and quotas and other protectionist measures, which were directed against import of goods. As countries one after another began to pursue the beggar-my-neighbor policy, it became more difficult for international companies to carry on international trade and invest abroad. Raising custom tariffs and quotas governments of some countries hoped that this would improve the situation in domestic industries and make easier life of their citizens despite the possibility of causing damage to citizens and economies of other countries. In 1930, for example, the US government tried to protect domestic industries from foreign competition through raising customs tariffs up to 53%

²⁰ N. Gregory Mankiw. Essentials of Economics. Harvard University. Forth edition. Thomson. South-Western. 2010

on average (the Smoot-Hawley Tariff Act). However, when other countries like Great Britain, Italy and France imposed similar high tariffs, none of these countries received expected competitive advantages. As a result of deteriorating conditions for international trade, export markets contracted and all countries which imposed trade barriers suffered in the long run.

To guarantee that peace which came after the World War II would not be breached by such trade wars, in 1947, representatives of the most influential trading countries gathered in Havana, Cuba, to establish the International Trade Organization, ITO. The mission of the ITO was to support international trade. Unfortunately, this organization was never to function because of discords regarding its authority. As a result the ITO mission was delegated to the General Agreement on Tariffs and Trade, GATT, which was being developed in the process of preparation for the meeting in Havana. Since 1947 to 1994, countries which signed GATT (technically GATT is attributed to agreements not to organizations), undertook active actions to eliminate trade barriers in international trade. Within a framework of GATT, conferences were held where Ministers of Trade discussed common problems and developed general principles of economic policy in international trade. In January 1995, the General Agreement on Tariffs and Trade was replaced by the World Trade Organization which was entrusted with the GATT's functions.

During the period of GATT existence, nine rounds of talks were conducted, which were named by the names of places where each round began (see table below). As a result tariffs imposed by developed countries decreased at average from over 40% in 1948 to approximately 3% in 2003, as a result the volume of international trade increased by 25 times.

Table 7.1

Rounds of GATT talks

Round	Date	Number of Participants	Average Indicator of Tariff Decrease, %
Geneva , Switzerland	1947	23	35
Annecy , France	1949	13	-
Torquay , Great Britain	1950-1951	38	25
Geneva , Switzerland	1956	26	-
Dillon (The talks were named after U.S. Treasury Secretary Douglas Dillon) Geneva, Switzerland	1960-1962	45	-
Kennedy (The round was named after American President John F. Kennedy, who died six months before the opening negotiations) Geneva, Switzerland	1964-1967	62	35
Tokyo , Japan	1973-1979	99	33
Uruguay	1986-1994	117	36
Doha , Qatar	2001	141	The round is not yet concluded

To help international companies to compete in the world market regardless of their national affiliation, participants of GATT tried to provide equal opportunities for international trade. This was achieved through the application of *most favored nation* status, MFN, which demands that any customs privileges provided to one country should be granted to other countries as well. According to GATT regulations all parties of the agreement should adhere to MFN in relation to other participants. For example, if the US plans to reduce to 20% its tariff for trucks imported from Great Britain then it should reduce to 20% tariffs for trucks of the same class imported

from other member-states. Owing to MFN mainly multilateral (not bilateral) negotiations were conducted within the GATT framework, which enhanced the role of GATT even more. There are two main exceptions from the MFN rule:

1. To support developing countries, GATT member-states were permitted to reduce tariffs for products imported from these countries, such reduction of tariffs for imports from developed countries were not be permitted. It is obvious that such reduction of customs tariffs increases competitive pressure on domestic companies by goods imported from developing countries. International companies can respond to this with reduction of raw materials imports and operating costs through placement of their manufacturing and assembling facilities in countries which avail themselves of customs privileges.
2. Another challenge to the most favored nation principle has been posed by regional trade blocs such as the European Union and the North American Free Trade Agreement (NAFTA), which have lowered or eliminated tariffs among the members while maintaining tariff walls between member nations and the rest of the world. Trade agreements usually allow for exceptions to allow for regional economic integration.

GATT is based on the high principle of promoting international trade. Nevertheless, protagonists of this principle realized that many countries would be forced by internal political circumstances to deviate from the policy of free trade. Within the GATT framework, such countries were allowed to carry out non-discriminatory protection of domestic industries through tariff barriers only; quotas and other non-tariff restrictions were prohibited. Nevertheless, there were loopholes in the GATT's regulations, which allowed many countries to impose discriminatory quotas and other non-tariff barriers without formal breach of GATT's regulations. Exceptions may take place for some countries if they need to protect national safety or solve problems with balance of payments. Apart from this, member-states under certain circumstances can protect their domestic industries from very strong competition.

World Trade Organization. The World Trade Organization (WTO) is an organization that intends to supervise and liberalize international trade. The organization officially commenced on January 1, 1995 under the Marrakech Agreement, replacing the General Agreement on Tariffs and Trade, which became a part of the Marrakech Agreement. As of January 2011, the WTO has 153 members and 31 observers. In addition to states, the European Union is also a member. WTO members do not have to be full sovereign nation-members. Instead, they must be a customs territory with full autonomy in the conduct of their external commercial relations. Thus Hong Kong (as "Hong Kong, China" since 1997) became a GATT contracting party, and the Republic of China (Taiwan) acceded to the WTO in 2002 as "Separate Customs Territory of Taiwan, Penghu, Kinmen and Matsu" (Chinese Taipei) despite its disputed status. Russia is the biggest economy outside WTO and after the completion of Russia's accession, Iran would be the biggest economy outside the WTO. With the exception of the Holy See, observers must start accession negotiations within five years of becoming observers. Some international intergovernmental organizations are also granted observer status to WTO bodies. 14 nations and 2 territories so far have no official interaction with the WTO [54].

Among the various functions of the WTO, these are regarded by analysts as the most important:

1. Support of trade flows through stimulation of non-discriminatory and predictable policies in WTO member-states.
2. Elimination of existing trade barriers through conducting multilateral negotiations. During the first five years of WTO existence, negotiations focused on separate sectors of economy. For example, in 1994, WTO promoted signature of the Information Technology Agreement. The main objective of this agreement was to reduce import tariffs for PC, software, faxes and pagers. Similar agreements on financial services and telecommunications were signed in 1997 and 2001. Currently the most complicated

issues are reduction of tariffs for agriculture products and subsidies for their production, restriction of intellectual property rights of pharmaceutical companies in developing countries, and providing principles of free trade in service industries.

3. Development of impartial procedures to settle trade conflicts between member-states.

There are two major differences between GATT and WTO. First, GATT focused on support of commodity trade, whereas the authority of WTO is much broader: it is responsible for support of trade in commodities and services, protection of intellectual property rights, and regulation of foreign investments bearing relation to trade. Secondly, WTO exercises much more power in realization of decisions made than GATT.

WTO encounters numerous problems. One of the major problems is regulation of trade in those sectors, which are under protection of the state practically in every country.

Agriculture and textile industries belong to such sectors. The process of international trade in many agricultural products is infringed by export subsidies, import restrictions and other trade barriers. The Cairns Group – a group of countries exporting agriculture products including such countries as Argentina, Brazil, Canada, and Thailand – exert pressure on other WTO member-states to attain a significant reduction of restriction in agriculture products trade in the framework of Doha-round.

The trade in textiles has been regulated since 1974 by the Multifibre Agreement, which introduced a complicated system of quotas and tariffs comprising 65% of annual trade volume in textile goods and articles of clothing equal to \$250 billion. Developing countries are struggling to repeal this agreement, which will give these countries guarantees of free access to markets of developed countries.

On 16 December 2011, Russia cleared the final hurdle to become a WTO member. WTO Ministers adopted Russia's WTO terms of entry at the 8th Ministerial Conference in Geneva. Russia will have to ratify the deal within the next 220 days and would become a fully-fledged WTO member 30 days after it notifies WTO of the ratification. After an 18-year marathon, the finish line has been crossed. According to WTO Ministers, this is a double win for Russia and the WTO, Russia's accession to the WTO will strengthen the multilateral trading system, making the WTO a more universal organization.

General Agreement on Trade in Services, GATS. Elimination of trade barriers in trade in services is one more serious problems, which WTO faces. During the Uruguay round of negotiations, a range of principles in accordance with which the trade in services should be carried out was developed. For example, *National treatment principle* means treating foreigners and locals equally. Under *national treatment*, if a state grants a particular right, benefit or privilege to its own citizens and companies, it must also grant those advantages to the citizens and companies of other states when they do business in that country. At the same time, services significantly differ in character therefore only few agreements were signed during the Uruguay round of negotiations. In 2000, WTO member-states initiated negotiations to conclude new agreements on trade and services but these negotiations moved on very slowly.

Agreement on Trade Aspects of Intellectual Property Rights, TRIPS. This agreement, signed within framework of the Uruguay round, significantly enhanced protection of intellectual property rights. Apart from this, procedures were developed to bring into action decisions, settle disputes and prosecute transgressors of intellectual property rights. However, since many owners of intellectual property rights live in developed countries, participants of the Uruguay round made arrangements about step-by-step implementation of the agreement provisions during a ten

year period. Wide spread occurrence of HIV/AIDS and other infectious diseases in many underdeveloped countries forced governments of these countries to appeal to WTO to weaken measures for protection of intellectual property rights at least in pharmaceutical industry whose providing medicines can save lives of infected people. Producers of pharmaceutical drugs argue that without protection of intellectual property rights supply of new effective drugs to these countries will be reduced gradually, which will be a great drain on the health of future generations. The Doha round faces a complicated dilemma on accommodation of interests of public health systems to provided health for current and future generations and pharmaceutical companies to protect intellectual property rights.

Trade-Related Investment Measures Agreement, TRIMS. WTO member-states know well that there is a strong connection between trade and investments: approximately one third of the annual volume of trade in commodity and services equal to \$7.7 billion falls on foreign trade transactions between subsidiary enterprises and also between subsidiary enterprises and parent multinational companies. On the other hand, developing countries are confident that direct foreign investments may become an important mechanism to support economic growth, pass on technology and promulgate industrialization. Such countries therefore do not want to lose control over direct foreign investments. The TRIMS agreement signed during the Uruguay round is only a small step toward elimination of state control over direct foreign investments, which may break or hinder foreign trade. The TRIMS agreement touches upon the following aspects of foreign investments related to trade:

- *Rules regulating the balance of trade:* countries have no right to demand that foreign investors restrict the import of raw materials and components through limiting the volume of export of products manufactured by their entities in a country
- *Access to a currency exchange system:* countries have no right to restrict access of foreign investors to a currency exchange system
- *Requirements to sell products in the domestic market:* countries have no right to demand that foreign investors sell part of their products in the domestic market

However, developing countries have the right to refuse to observe these rules under certain circumstances.

Regional Economic Integration. The formation of regional unions to support liberalization of international trade is an important feature of the global economic situation developed after World War II. Currently there are over 100 agreements on establishing such unions though not all of them are of very practical use. These agreements not only open numerous opportunities for international companies but also pose a range of complicated problems for them.

Forms of economic integration. Regional trade blocks vary in types and functions significantly. The most important feature of a trade block from the standpoint of an international company is the level of integration between members of this block. It is caused by the fact that the degree of integration influences companies' exporting and investment capabilities when they do business with both members of a regional trade block or countries which do not participate in this block. There are five forms of regional economic integration: *free trade zone, customs union, common market, economic union and political union.*

- *Free trade zone.* Trade between economic subjects of free economic zone is stimulated through elimination of trade barriers (customs tariffs, quotas and other non-tariffs restrictions). An example of such agreement is NAFTA, *the North American Free Trade Agreement* between the USA, Canada and Mexico. Since participants of such agreement can pursue their own trade policy with countries which are not members of the free economic zone, each participant can be negatively influenced by the process called *trade deflection*. Trade deflection happens when countries which are not members of the free

economic zone change the direction of their trade currents so that they come through a country, which is a member of the free economic zone with the lowest barriers for foreign trade. Then when this trade current moves on to a country, which is a member of the free economic zone higher barriers for foreign trade occur with non-participants of the free economic zone. To avoid this violation of their interests, member-states include so called *rules of origin* in their agreements. These rules describe in detail conditions under which a commodity can be attributed to the category of products manufactured either in member-states or in countries which are not members of free economic zone. For example, according to NAFTA rules of origin, a product can get a preferential tax treatment only if it was assembled or processed in the USA, Canada and Mexico.

- *Customs union.* International trade within a customs union is based on a combination of such measures as elimination of restrictions in trade between member-states of the customs union and the pursuit of common trade policy towards countries, which are not members of this union. In the past, the most influential organization of such type was the Prussian customs union (*Zollverein*) established in 1834 by several sovereign German kingdoms and duchies. The unification of Germany, which happened in 1870, was accelerated due to the existence of this customs union, which strengthened economic connections between German kingdoms and duchies and became the groundwork of their political union. Contemporary examples of customs unions are *Mercosur* (agreement between Argentina, Brazil, Paraguay and Uruguay) and *The Customs Union between Belarus, Kazakhstan, and Russia*.
- *Common market.* Apart from eliminating restrictions in trade between member-states of the common market and pursuing common trade policy towards third countries, participants of a common market eliminate barriers for movement of factors of production (such as workforce, capital and technology) within the framework of a common market. In this case, labor productivity in all member-states is supposed to increase indispensably since agents of production can be placed just where they can provide maximum profit. The European economic zone formed by the EU member-states and some other European countries can set an example of a common market. The main objective of the European economic zone is to support free movement of workforce, capital and technology between member-states of this zone.
- *Economic union.* An economic union provides full integration of economies of two or more countries. Apart from eliminating restrictions in internal trade, pursuing common foreign trade policy and eliminating barriers for movement of factors of production between member-states of the union, the economic union demands its members coordinate economic policy (monetary and financial-budgetary policy, tax policy and social security programs) to unite economies of member-states. Currently 17 European Union member-states are creating an economic union, which is based on introduction of common currency (euro) in those countries.
- *Political union.* Political union is a full political and economic integration of two or more countries allowing these countries to act as an organic whole. Creation of a new nation, the United States of America, can serve as an example of political union, which integrated 13 separate colonies.

The Customs Union between Belarus, Kazakhstan, and Russia came into existence on January 1, 2010. Belarus, Kazakhstan, and Russia are to go on with economic integration and were set to remove all customs borders between each other after July 2011. From January 1, 2012, the three states are expected to introduce the *single economic space*.

Leaders of Tajikistan voiced their interest in potentially joining the union. In October 2011, the acting prime minister of Kyrgyzstan has announced that the country will join the union, and that the process has been agreed with the prime-ministers of the other member states. Ukrainian

President, Viktor Yanukovich has stated that the Ukraine may potentially join the Customs Union in the future, but that the Constitution of Ukraine currently does not allow that. On the other hand, he has also stated that Ukraine will not join the Customs Union. Ukraine is negotiating an association agreement with the European Union, and entering the customs union with Russia, Kazakhstan and Belarus would end the chances for this agreement according to European Commission President José Manuel Barroso. Yanukovich wants to pursue EU membership for Ukraine. In May 2011 Yanukovich stated Ukraine is "searching for mechanisms of cooperation that will allow us to work with the customs union to the extent which Ukrainian laws and our obligations to world organizations such as the World Trade Organization allow".

Russia, Kazakhstan and Belarus have launched a customs union as a first step towards forming a broader EU-type economic alliance of former Soviet states. On 19 November 2011 Belarus, Kazakhstan, and Russia put together a joint commission on fostering closer economic ties, planning to create a *Eurasian Economic Union* by 2015 [55].

2. Russia's foreign trade

Customs Regulations. The import and export of goods in Russia is carried out in accordance with the Federal Law on "Government Regulation of International Trade Activities" of 2003. As a member of the World Customs Organization, the Convention of Temporary Imports and the International Convention on Harmonized Commodity Description and Coding System, Russia is obligated to adhere to internationally accepted customs regulations and practices. In January 2004, Russia implemented a new Customs Code as part of its WTO accession efforts. The new code reduced the time for customs clearance from ten to three days. It also offered advance declaration of cargo before arrival at customs.

Other important changes introduced by the Code included:

- Restricting the Russian Federation State Customs Committee from issuing contradictory additional regulatory acts
- Making possible the settlement of disputes with customs authorities directly in a court of law;
- Establishing a definitive and comprehensive list of documents that must be submitted for customs clearance
- Prohibiting customs authorities from refusing to accept a declaration containing inaccuracies, if the inaccurate information has no impact on the defrayal of customs payments, or does not place restrictions in foreign trade;
- Allowing clearance of goods through any customs office
- Providing urgent customs clearance for perishable goods, express cargoes, or time-sensitive materials for the mass media

In 2010, Russia's existing Customs Code was replaced by the unified Customs Code of the Customs Union and the Law on Customs Regulation, which took effect as of July 1 and December 2010, respectively. The Law on Customs Regulation, in particular, contains the "ex-officio amendment," a key part of Russia's commitments under the 2006 US-Russia Bilateral Agreement on IPR. Recently, the priorities for customs modernization included improvement in regulations, implementation of IT systems and enhanced dialogue with market participants. There is also a clearer understanding of the continued need for customs to take effective action against significant levels of grey market practices and to implement effective control coordinated on a global scale. However, many examples of arbitrary practices by local customs officials still exist and are encouraged by ambiguities in customs legislation. Small and medium-sized enterprises remain the most vulnerable to these arbitrary practices.

A Customs Union between Russia, Belorussia and Kazakhstan has been in operation since 2010. The member states have adopted a common classification for goods – *the Harmonized System of*

the Customs Union (based on *the International Harmonized System*) – and common import customs duty rates – *the Unified Customs Tariff* – for goods imported from third countries. Import customs duties are levied based on the classification code and country of origin of the goods being imported. Import customs duty rates are normally expressed as a percentage of the value of goods imported, known as "ad valorem" duties. However, they may also be expressed as a set monetary amount per unit or kilogram – "specific" duties. Finally, they may be expressed as the greater or the sum of the two – "combined" duties. Several "ad valorem" rates of import customs duties are available in Russia – in the majority of cases 5%, 10%, 15%. Certain goods are exempt from import customs duty. The rate of import customs duty depends on the exact nature of the goods being imported. Goods are classified according to the Harmonized System of the Customs Union into ninety-seven groups. Basic import customs duty rates are not constant and may vary depending on the country of origin of the goods, type of goods and occasionally on other factors. Countries are classified into five groups for the purposes of applying import duty rates, as shown in Table 7.2. Import VAT and excise tax (if applicable) is also levied upon import of goods into Russia.

Table 7.2

Groups of countries and import duty rates

Group	Import duty rate
Most favored countries	Basic rate of duty applies
Developing countries	75% of basic rate applies
Less developed countries	Exempt from import duties
CIS countries	Exempt from import duties
Non-favored nations	Double the basic rate

Customs duties. Base customs duty rates vary widely, from 100% but not less than EUR 2 per liter on spirits to 0% for some printed matter and certain priority imports. Zero duty applies, for example, to a wide range of equipment and machinery. On average, duty rates fall between 5% and 20% of the customs value of goods. The base rates specified in the law apply to countries that enjoy Most Favored Nation status. Certain raw materials and handmade goods from “developing” and “least developed” countries may be imported at 75% of the base rates or zero rates, respectively. Goods originating in other countries will be subject to duty at double the base rates.

The following is a selection of tariff ranges for popular US goods entering Russia.

Commodity	Rate (%)
HS 02: Meat and edible meat products	
(within quota, but not less than .20-.25 Euro/kilo)	15
(beyond quota, but not less than 1-1.5 Euro/kilo)	50-75
HS 0207	
(within quota, but not less than .2 Euro/kilo)	25
(beyond quota, but not less than .7 Euro/kilo)	80
HS 24: Tobacco and manufactured tobacco/Unmanufactured tobacco	5-20
- Cigars and Cigarettes but not less than 3 Euro/1000 pcs	30
HS 28: Inorganic Chemicals	5-20
HS 38: Miscellaneous chemical products	5-15
HS 39: Plastics and Articles thereof	5-10
- Finished products	10-20
HS 73: Articles of iron and steel	5-20
HS 84: Nuclear reactors, boilers, machinery	0-20
HS 85: Electric Machinery	0-20
HS 87: Vehicles except railway and tramway	0-35

HS: 8708 Auto parts	0-10
HS 90: Optic, Photo, Medical and Surgical Instruments and devices	0-20
-Medical equipment	0-15

In addition to tariffs, there are two other charges applied to imports: the ubiquitous Value Added Tax (VAT) and selective excise taxes.

Import VAT. For most goods, the import VAT rate is 18% of the customs value, inclusive of customs duty and excise (if any). Food, a certain range of children's goods and a limited range of other goods (pharmaceuticals, medical supplies) may be subject to 10% or 0% VAT.

Excise tax. Certain categories of goods are subject to excise tax for import to Russia (e.g., luxury goods, alcoholic beverages, cigarettes, etc.) Generally, excise tax rates are specific (i.e., based on the volume, weight or other characteristics of goods) and varies from 20% to 570%.

Customs processing fees. Customs processing fees are established as a flat fee and vary from approximately EUR 12 to EUR 2,400 per customs declaration depending on the customs value of imported goods.

Payments. Customs payments are generally paid before or when submitting customs declarations to customs.

Customs valuation. The customs value is generally considered to be the CIF (cost-insurance-freight) price of the imported goods. A customs-processing fee is also levied. If customs officials do not agree with the customs value of goods declared they are authorized to request additional documents that support the declared customs value. It is often normal practice for customs officials to request the Shippers Export Declaration (SED), which they consider to be proof of the customs value. However, presenting SED is not mandatory and the importer can present other available documents, including an official company letter that attests to the shipment's correct value. Since 2008, Russian Customs has been particularly zealous in its efforts to determine the highest possible value for imported goods. In fact, it has recently highlighted its role in "revenue generation," whose income comprises about 50% of Russia's state budget. For further information, please refer to the Russian Federal Customs Service Website: <http://www.customs.ru/en>

Export customs duties. Export customs duties are currently levied on some goods and on raw materials, e.g. oil, metals, timber.

Tips for exporters:

- Generally, if goods are exported or imported between a foreign company and a Russian company, the Russian company is responsible for the customs clearance procedures.
- In order to import goods into Russia and clear them through customs, an importer has to make all customs payments due under the chosen customs regime and comply with other customs legislation requirements (e.g., certification requirements).
- The import of certain goods (e.g., pharmaceuticals, meat, etc.) requires licenses.
- Russia has several special economic zones that offer customs benefits.
- *Registration of importers and exporters.* There is no established procedure for registering importers and exporters with customs. However, in practice certain documents may be required by customs prior to importation (charter documents, tax registration certificates, etc.)
- *Documentation.* Russian customs regulations establish a comprehensive list of documents required for customs clearance purposes. In practice, the set of documents to be submitted to the customs authorities may vary depending on the character of imported/exported commodities, conditions of the transaction, etc.

- *Customs value declarations.* The customs value of imported goods is declared in a customs value declaration in which the customs value should be properly supported by appropriate documents. The list of such documents may vary depending on the terms of a particular transaction. While Russian customs regulations provide a general list of documents required to confirm the declared customs value, the list is not exhaustive. If the customs authorities disagree with the customs value declared by an importer, they may adjust it.
- *Warehousing and storage.* Goods which are subject to customs control (e.g., imported goods which have not yet cleared through customs) can be temporarily stored at special warehouses before being released by customs. The storage period should not exceed two months, but an importer can ask the customs authorities to extend it to up to four months. Warehouses for temporary storage are usually located near customs offices.
- *Re-exports.* Goods which have been imported into Russia may be re-exported provided they have not been released for free circulation in Russia. They are re-exported without payment of export customs duty.
- Russia's customs policy has seen several important areas of development:
 - Lowering customs duty on technological equipment imports;
 - Simplifying the customs clearance process;
 - Tighter customs control after the customs clearance of goods;
 - Further development of customs integration between Russia, Belarus and Kazakhstan.

Exemptions. There is an import VAT exemption for "technological equipment which has no equivalent produced in Russia" according to a government approved list. The equipment listed generally also qualifies for a 0% rate of customs import duty. The general rule is for each shipment to be considered on a standalone basis and so when technological equipment comprises more than one shipment, a special procedure may be applied to classify the equipment under the tariff code applicable to the assembled whole, with the import VAT and customs duty rates determined accordingly. There is also customs import duty exemption for certain equipment imported as in-kind charter capital contribution, but this is rarely used in practice. Fixed production assets must not be excisable and should be imported within the timeframe established for the formation of the charter capital. Customs authorities can check to ensure the correct use and further disposal of goods exempted from customs duty.

The following goods are exempt from customs duty: transit goods; goods imported by individuals for personal use (worth not more than approximately EUR 1,500 and weighing less than 35 kg); cultural valuables; means of transport involved in the international movement of goods and passengers; humanitarian aid and some others.

Tolling. Goods imported into Russia for processing may be placed under an inward processing (IPR) procedure (subject to certain conditions). Under IPR, goods (e.g., raw materials) imported for processing are eligible for full exemption from customs duty and import VAT, provided the processed/finished goods are subsequently moved out of Russia within a deadline agreed on with customs. No export customs duty is charged upon the export of finished goods from Russia. IPRs must be authorized by customs. Only a Russian company may apply for an IPR.

Special customs procedures (regimes). There are a number of customs procedures (regimes) that provide for either full or partial exemption from import customs duties and VAT. For example, full relief may be granted on goods which are imported into Russia to be processed and which are subsequently exported. Goods may also be imported under a *temporary import procedure*. As the name suggests, this procedure allows for either full or partial exemption from import duties and VAT for certain goods which are temporarily imported into Russia. Once the specified time period (usually two years) has expired, the goods must either be exported from Russia or transferred to a different customs procedure (e.g., release for free circulation). Temporary

importation requires permission from the customs authorities. Temporary importation requires periodic customs payments of 3% per month of the total customs payments due had the goods been imported for free circulation. Upon export of the goods, these customs payments are not refunded. Customs has the right to require a security for customs payments (e.g., a deposit, pledge, bank guarantee, etc.)

Goods that qualify as fixed assets for production purposes may be admitted and subject to a 3% monthly customs payment for a temporary import period of 34 months if the Russian user does not yet have property rights (e.g., for leasing). After this period, the goods are considered released for free circulation. In these instances, the interest on customs duty and taxes is not payable. Temporarily imported goods can only be used by the person who obtained customs' permission for their temporary importation.

The customs free zone procedure may be applied within certain Special Economic Zones (SEZ), resulting in an exemption from import customs duties and taxes on imported raw materials, components, etc. until the processed products are moved out of the zone. Moreover, goods produced in Special Economic Zones from foreign goods may be exempt from customs duties and import VAT provided that a certain level of product localization is met. The required level of localization varies according to the type of goods and operations. When foreign goods or products of their processing are subsequently released into free circulation to the rest of Russia, import customs duty and VAT are payable. If the goods manufactured in a particular SEZ are exported to foreign countries, they are subject to export duty, if applicable. Foreign goods that were imported into the SEZ but not processed may be re-exported without paying export customs duty.

Import restrictions. Certain imports to Russia require permits, certification (e.g., of conformity, sanitation), licenses and other approvals, which should be submitted to the customs authorities during the customs clearance process. Russia imposes an anti-dumping duty on certain goods (e.g., metal pipes from Ukraine). Import licenses are issued by the Russian Ministry of Industry and Trade or its regional branches, and controlled by the Federal Customs Service. Licenses for sporting weapons and self-defense articles are issued by the Interior Ministry. Licenses are required for many other items as well including:

- Alloys
- Carpets
- Color televisions (14, 21, and 25-inch)
- Combat and sporting weapons
- Ethyl alcohol
- Explosives
- Medicine, also used for veterinary purposes
- Military and ciphering equipment
- Precious metals
- Radioactive materials and waste
- Self-defense articles
- Stones
- Strong poisons and narcotics
- Tobacco products
- Vodka and many other types of alcoholic beverages
- Poultry meat
- Cattle meat, chilled and frozen
- Pork
- Technical means purposed for receiving non-disclosed information
- O-zone damaging substances

- Chemicals used for plant's protection
- Sturgeon fish species, including caviar
- Crayfish
- Wild animals, wild plants, ivory, and corals
- Valuable wood species
- Cultural valuables

To learn whether an import license is needed for a particular product, contact the Russian Ministry of Industry and Trade licensing department (www.minpromtorg.gov.ru).

Standards. Despite positive changes in the last several years, the standards regime in Russia still lacks transparency. Russia continues to rely on product testing as a key element of the product approval process. Other types of product safety assurance, such as plant auditing, quality systems, and post market vigilance, are underdeveloped. Russia continues to adhere to redundant practices of further testing of internationally accepted certified products, which can delay entry of a variety of products into the country. In addition, the former federal authority on standardization, *Gosstandart*, has been restructured twice as part of a larger government reorganization begun in May 2004, which led to some uncertainty as to exactly who in the agency did what, further adding to delays in discharging its functions. The current government authority for standardization, metrology and certification matters is the Federal Agency for Technical Regulations and Metrology (whose abbreviated name is *Rosstandart*) an agency of the Ministry of Industry and Trade. Until June 2010, the abbreviated name was *Rostekhnregulirovanie*, but it was then changed to *Rosstandart* because it is very close to the former abbreviation *Gosstandart* that was widely used in Soviet times. Affiliated with this new agency are 485 technical committees, comprised of research institutes, which develop standards.

Product certification. As the result of the establishment of the Custom's Union among Russia, Kazakhstan and Belarus, the system of certification has changed. Now there are two sets of documents dedicated to Technical Regulations and Sanitary Regulations.

Technical Regulations (Certificate of Conformity/Declaration of Conformity). As of July 1, 2010, new rules for conformity assessment, established in the CU, came into effect. As a result, manufacturers can obtain certificates of conformity and declaration of conformity according to these new rules, and unified letterhead for all three countries is used. The full set of the documents, including the unified list of accredited bodies and laboratories that governs this process, is published on the CU website (www.tsouz.ru). A "Unified list of products" was also established and according to this list, those products included need to have certificates of conformity/declarations of conformity. If a product is not included, then it should go through the conformity process according to the national standards of Russia, Kazakhstan, or Belarus. Until January 1, 2012, manufactures may choose to obtain these documents according to the national standards of Russia, Belarus or Kazakhstan or according to the Unified standards of the CU. If the manufacturer chooses the first option, its products can only be sold in the territory of the country where the documents were obtained. After January 1, 2012, certificates of conformity/declaration of conformity can only be obtained according to the Unified standards of the CU.

Sanitary Regulation (Certificate of State Registration). State registration is one of the forms of conformity assessment, so it can be concluded that the Certificate of State Registration is the same document of conformity, as the conformity certificate and declaration of conformity. On July 1, 2010, the sanitary certificate was abolished due to the fact that no such provisions exist in the CU document. Products which need a Certificate of State Registration are listed in part II of the "Unified list" that was approved by the CU Commission on May 28, 2010, No. 299 (last

edition No. 456 dated November, 11, 2010). Starting January 1, 2011, only Certificates of State Registration, according to the CU principles are being issued.

A number of other mandatory and voluntary certification systems also exist, which are partly managed by other ministries or agencies. Below are the most widely used certificates:

Fire Safety Certificate: The Federal Law No. 123-FZ “Technical Regulations of Requirement for Fire Safety,” which came into effect on May 1, 2009, now governs this process. Products requiring this certificate are listed in Government Decree No. 241 dated March 3, 2009.

Certificate of Conformity/Declaration of Conformity for Systems of Communications (system of certification in the area of communication) confirms that the equipment conforms to technical requirements. It is issued by accredited bodies and laboratories of *Rossvyaz*, with an updated list published on its website. *Rossvyaz* obtained this function due to Government Decree No. 320 dated June 30, 2004. The list of communication devices which require a certificate of conformity can be found in Government Decree No. 532 dated June 25, 2005.

License (permission) from Rostekhnadzor allows the manufacture, installation and use of industrial machinery and equipment for the petrochemical, metallurgical and other industrial facilities in Russia. The process and list of products requiring this certificate are listed in *Rostekhnadzor*’s Order No. 112 dated February 29, 2008.

Approval for Encrypted Products is issued by the Federal Security Service (FSB), while an import license is issued by the Ministry of Industry and Trade. Russia participates in the following international certification systems:

- System of the International Electrotechnical Commission (IEC) for tests of electrical, electronic and related equipment on conformity to safety standards(<http://www.iec.ch>; <http://www.iecq.org>)
- System of certification of passenger cars, trucks, buses and other transport vehicles (<http://www.unece.org>)
- System of certification of handguns and ammunition (<http://www.com-i-p.com>)
- OIML Certificate System of Measuring Instruments (<http://www.oimi.org>)

Russia’s complicated, cumbersome and often changing system of certification as well as cultural and language barriers are a challenge for foreign companies attempting to certify products without appropriate legal advice or assistance from experienced distributors or consultants. In order to minimize time and expenses, it is recommended that foreign companies work with reliable partners and consulting companies on registration and certification issues. For additional information regarding certification, please contact your country Commercial Service.

Labeling and marking requirements. Labels on food items must feature the following information in the Russian language:

- Type and name of the product
- Legal address of the producer (may be given in Latin letters)
- Weight/volume of the product (if item is preserved in liquid, weight without liquid mass)
- Food contents (name of basic ingredients/additives listed by weight in decreasing order)
- Nutritional value (calories, vitamins if their content is significant or if product is intended for children, for medical, or for dietary use)
- Conditions of storage
- Expiration date (or production date and period of storage)
- Directions for preparation of semi-finished goods or children’s foodstuffs
- Warning information with regard to any restrictions and side effects

- Terms and conditions of use

Labels on nonfood items must include:

- Name of the product
- Country of origin and name of manufacturer (may be given in Latin letters)
- Usage instructions
- Main characteristics, rules and conditions for effective and safe use of product
- Any other information determined by the state regulation body

It is advisable to place the *Rostest* mark on the label for products that have appropriate *Rostest* and sanitary-epidemiological certificates. This rule is applicable to both food and nonfood items [24], [37].

Chapter 8

Finance and Banking Environment

1. International financial management

“International entrepreneurs can carry out various financial transactions depending on their forms of international entrepreneurial activity. The most common financial issues for international entrepreneurs are these: *financing international trade, foreign exchange risk management, working capital management, investment appraisal and identification of international sources of finance.*”

Financial aspects of international trade. One can start by considering problems related to financing international trade. In any business operation, seller and buyer should come to an agreement on such basic issues as price, quantity of goods and date of their delivery. However, when seller and buyer are from different countries, several additional aspects arise:

- What should be the currency of the transaction
- When and how can one check a partner’s solvency
- what form of payment to use, and
- How can one organize the financing of the deal

Currency selection. Exporters usually prefer to get payment in their national currency to know precisely what amount of money they will receive from an importer. Importers more often prefer to pay with their national currency to know precise sum, which they have to pay to an exporter. Sometimes exporters and importers agree to settle in a third currency. For example, if both parties are from countries with relatively weak and unstable currencies they may prefer to use more stable monetary units such as the US dollar or the Japanese yen. According to some estimates over 70% of exports from developing countries and 85% of exports from Latin America are carried out in US dollars. Commercial transactions in some industries are commonly done in a certain currency. For example, the US dollar performs this function in oil production and the civil aircraft sector.

The situation for exporters is more profitable when the value of their national currency is lower than the value of the currency in which transaction is carried out since they can buy more national currency for the currency they received for their exported production. The situation for importers is the opposite. Thus, countries may gain an advantage in international trade if they manipulate the value of their currency by artificially keeping its value low, typically by the national central bank engaging in open-market operations. It is argued that the People's Republic of China has succeeded in doing this over a long period of time. In 2010, other nations, including Japan and Brazil, attempted to devalue their currency in the hopes of subsidizing cheap exports and bolstering their ailing economies. A low exchange rate lowers the price of a country's goods for consumers in other countries but raises the price of goods, especially imported goods, for consumers in the manipulating country.

Checking a partner’s solvency. If an importer is a financially capable and trustworthy company with which an exporter already had satisfactory business relations, then the latter can simplify the process of payment providing a credit to the importer. However, if the financial position of an importer leaves much to be desired or credit risk of dealing with him is very high, then an exporter can demand a form of payment, which can reduce the risk.

Carrying out commercial transactions, it is useful to check buyer's solvency. In the case of most internal transactions companies have simple and cheap mechanisms of such evaluation. In North America, for example, companies can ask buyers to provide references or contact special sources of information on solvency like *Dun&Bradstreet*. Similar sources exist in other countries too, however many emergent exporters are not aware of them. Fortunately, domestic banks of exporting companies often can collect information about foreign buyers relying on their banking operations abroad or employing services of a corresponding bank from the buyer's country. In most countries, services on checking solvency also are provided by state agencies responsible for the development of export. In some countries, also there are commercial services specializing in evaluation of creditability of different organizations.

Forms of payment and settlement. During the existence of trade, many forms of payment appeared including *payment in advance*, *open account*, *documentary collection*, *letter of credit*, *credit cards* and *counter-trade*. As in the most financial aspects each form of payment is associated with different risks and different costs.

- *Payment in advance* in terms of export is the safest method of settlement: the exporting company receives cash from the importer before shipping goods. This may be important if an exporter maintains a relatively small amount of working capital. Exporters prefer receiving electronic prepayments, which allow them to have money in hand immediately. When payment is made by a general check, the clearing in bank systems of both countries can take from four to six weeks depending on the size and development of financial services. But exporters who persist in doing payment in advance take a risk losing their clients to the advantage of competitors suggesting more attractive forms of payment.

- *Open account.* From the standpoint of the importer the safest form of settlement is an open account when an exporter ships and importer obtains possession of goods before settlement is made. After this an exporter issues an invoice/account indicating in it the sum, form and date of payment. Open accounts also are instruments of marketing since it is a kind of short term financing for purchasers. An open account allows an importer to avoid commissions charged by banks for alternative forms of settlement like a letter of credit or documentary collection. An open account is an advantage also because it requires less processing of documents in comparison to other forms of payment. From the standpoint of an exporter an open account is undesirable for of several reasons. First, an exporter must mainly rely on the reputation of an importer regarding the accuracy of payment; second, since there is no intermediary like a bank, an exporter cannot take advantage of its experience in case of disagreements with an importer; third, if an importer refuses to pay, an insufficient amount of documentary evidences can prevent an exporter from maintaining his rights in the courts of the importer's country; finally, an exporter must use his working capital to finance foreign accounts receivable. But, in the latter case, an exporter can address numerous companies specializing in international factoring operations. *Factoring* is a financial transaction whereby a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount.

- *Documentary collection* is a method of payment, which allows avoiding risks incidental to *payments in advance* and *open accounts*, when commercial banks act as agents facilitating the process of payment. Initiating such a form of settlement an exporter makes up a document called a *draft* or *bill of exchange* in accordance with which a purchaser agrees to make a payment on the due date. After shipping goods, an exporter forwards the draft and corresponding shipping documentation (packing sheet and bill of lading) to the exporter's bank. The *Bill of lading* or *consignment* plays two important roles in *documentary collection*: it is both a contract between an exporter and a transporter for the transportation of goods and a document confirming the property rights to goods (a document of title). Then, the exporter's bank connects with the

corresponding bank from the importer's country (or with the exporter's bank subsidiary in that country) and forwards all documents to the latter. If the payment terms of the contract are 'on sight', the buyer accepts the bill of exchange by signing it and pays the importer's bank. In return, the buyer receives the shipping documents, including the documents of title, allowing them to clear the goods. This is known as *sight draft/documents against payment (SD/DP)*. Alternatively, the bill of exchange might state a future date at which the buyer must pay, for example 30, 60, 90 or 180 days after sight (the time required for payment is called the *tenor of the bill*). By signing the bill of exchange, the buyer undertakes to pay on the due date. In return, the buyer receives the shipping documents, allowing them to clear the goods. This is known as *documents against acceptance (DA)*. If this method is used, the importer's bank can accept the bill of exchange for a certain remuneration thereby undertaking an obligation to pay for goods. In this case, the bill of exchange becomes a *banker's acceptance*. Some *acceptances* are sold *without recourse*, which means that the bank buying such an acceptance can incur losses if an importer will not pay. Other *acceptances* are sold with the *right of recourse*, which means that if an importer refuses to pay, the exporter must recoup the buyer of acceptance (the bank) for losses.

- *Letter of credit*. To avoid those problems, exporters often ask to pay with the use of letter of credit. Letter of credit is an instrument of payment, subject to international regulations (*The Uniform Customs and Practice for Documentary Credits, UCP*), whereby an importer's bank (issuing bank) acting at the request and in accordance with the instructions of a customer (buyer) must make a payment to a third party (exporter) through the exporter's bank against delivery of documents required, provided the exporter adheres to the terms and conditions of credit. For example, the seller may have to deliver merchandise to a shipyard in order to satisfy requirements for the letter of credit. Once the merchandise is delivered, the seller receives documentation proving that delivery has been made. The letter of credit now must be paid even if something happens to the merchandise. If an exporter fulfilled the letter of credit terms, the importer's bank must transfer money to their account even if an importer refuses the goods or does not want to pay for them. Although the issuing bank will not pay an exporter until they fulfill all the letter of credit terms, the exporter often can sell the letter of credit before the expected date of payment (to the exporter's bank, for example). So a letter of credit can be used to transfer credit risk from the buyer and seller to the bank. Since multinational banks are regularly involved on a continuing basis in many transactions in many countries, they are able to develop expertise and economies of scale in international commercial transactions. They can then spread the benefits and costs over many transactions involving many companies. After issuing a letter of credit, the importer's bank forwards it and associated documents to the exporter's bank, which notifies (*advises*) the exporter about the letter of credit terms thereby creating an *advised letter of credit*. The letter of credit can be *revocable* or *irrevocable*. A *revocable* letter of credit is a means of arranging payment, but it does not guarantee payment. It can be altered or revoked, without notice, at any time up to the time a draft is presented to the issuing bank. An *irrevocable* letter of credit, on the other hand, cannot be revoked without the special permission of all parties concerned, including the exporter. A letter of credit can also be *confirmed* or *unconfirmed*. A *confirmed* letter of credit is a letter of credit issued by one bank and confirmed by another, obligating both banks to honor any drafts drawn in compliance. An *unconfirmed* letter of credit is the obligation of only the issuing bank.

- *Credit cards*, such as American Express, VISA or MasterCard, can be used to pay for small international transactions especially between international parties and foreign retail customers. To carry out an international transaction, a company can address the well-known credit system, of course, observing restrictions imposed on the corresponding credit card. Companies issuing credit cards commonly charge parties a small fee (2-4% of the transaction sum), to defray expenses on receiving financial means from purchasers and to assume risks of nonpayment. Such

companies generally charge an additional fee (1-3%) for currency conversion. At that, they do not render to exporters or importers any assistance in preparing documents related to international trade.

- *Counter-trade* is an additional method of payment used in international transactions. It is a reciprocal trade in which goods or services are exchanged not for cash but for other goods or services. The main forms of counter-trade are: barter, counter purchase, buy-back and offset (compensation) purchase.

- *Barter* is the simplest form of counter-trade. Barter is a method of exchange by which goods or services are directly exchanged for other goods or services without using a medium of exchange, such as money. It is usually bilateral, but may be multilateral, and usually exists parallel to monetary systems in most developed countries, though to a very limited extent. Barter usually replaces money as the method of exchange in times of monetary crisis, such as when the currency may be either unstable (e.g., hyperinflation or deflationary spiral) or simply unavailable for conducting commerce.

- *Counter purchase* is a more complicated form of counter-trade. Counter purchase is an arrangement where one company agrees to sell products to a foreign purchaser for cash, but also simultaneously agrees to purchase specified products or services from the foreign partner a little bit later. Also known as *parallel bartering* (since moments of meeting obligations by parties do not coincide) and is the most commonly used form in a countertrade agreement in international business interactions.

- *Buy-back* is the next variant of counter-trade when one company sells to another one means of production and is paid by products manufactured by these means of production.

- *Offset (compensation) purchase* is another important form of counter-trade, when separate components of exported goods are manufactured in the importing country. Offset agreements are especially important when weapons and military equipment are sold to governmental bodies. Generally the seller is a foreign company and the buyer is a government that stipulates that the seller must then agree to buy products from companies within their country. Often, the aim of this process is to even-up a country's balance of trade. This is frequently an integral part of international defense contracts. Often it is difficult to control export-import correspondence. To simplify counter-trade, companies can open *clearing accounts*. In this case, exporting company is liable to make a counter purchase paying an equivalent sum, which is entered on its clearing account. When an exporter buys goods from its partner, they charge a certain sum off the account. Thus the company should not strike the balance after each counter transaction but it should fulfill its cumulative obligations by the expiration date of clearing account.

According to competent sources it is estimated that counter-trade constitutes 15-20% of world trade, and some published reports even speak about 40%. Counter-trade is especially important for countries having the lack of hard foreign currency and often is used as a means to decrease currency outflow. In 2002, for example, the Argentinian economy encountered a range of serious financial problems. *DaimlerChrysler* trying to keep its Argentinian business afloat announced of its intention to accept payments in the form of grain.

Foreign trade financing. When entering into contracts, terms of financing play a key role. In most industries, there are standard agreements on financing and an international firm should be ready to suggest such terms to its foreign customers. Depending on merchandise it may be customary in an industry to suggest buyers pay 30-180 days after receiving an invoice. When complicated engineered products (such as commercial airplanes) are sold, delivery of which can be made during several years after signing a contract, terms of financing can be much more complicated. They can include payment by installments with payment in advance, penalties for late delivery, adjustment for inflation and lower interest rates for long term financing. Capital

markets except for the QUAD countries (the United States, the European Union, Canada, and Japan) often are rather underdeveloped and local creditors establish extremely high interest rates especially for small businesses. Therefore exporters having access to cheap capital can get a competitive advantage suggesting financing to foreign buyers, which have no cheaper sources of financing. Of course, an exporter playing the role of creditor accepts additional risk of nonpayment. Therefore before making decision on granting a credit, an exporter should study all advantages in the form of increase in sales and all disadvantages in the form of failure to meet an obligation by a contractor.

As was mentioned above, banks and other commercial creditors often agree to finance exporters purchasing their letters of credits, bills of exchange or opening factoring accounts. In many developed countries such commercial creditors are supported by government programs intended to develop exports. For example, the *Export-Import Bank of the United States (Eximbank)* suggests such a program. Within the framework of this program, if an importer fails to meet their obligations, 90% of commercial credits received for financing exported goods are compensated.

Foreign exchange risk management. Experts distinguish three types of risks related to currency exchange: *transaction risk*, *translation risk* and *economic risk*.

Transaction risk. A company is exposed to transaction risk when results of international transaction can be influenced by fluctuations in foreign exchange rate after assuming by the company a liability to fulfill an operation. This risk is incidental to many typical international transactions carried out in foreign currency including the following:

- Purchasing goods, services or assets
- Selling goods, services or assets
- Providing credit, and
- Borrowing monetary funds

Let's assume that *Saks Fifth Avenue* department store preparing to New Year holidays on April 10, decided to buy in Switzerland *Rolex* watches to the tune of 5 million Swiss francs with cash on delivery, which should be done on October 10. Since this moment Saks runs the exchange rate risk that is the price of *Rolex* watches in US dollars may increase because of exchange rate fluctuations at the moment of the bargain completion on October 10. (It is also possible that the price could change another way.) If a contract is concluded in US dollars then *Rolex* will run the exchange rate risk.

Saks Fifth Avenue has several options to deal with transaction risk. In particular it can:

- Assume currency risk
- Enter a forward contract to buy Swiss francs
- Purchase a Swiss franc option
- Acquire an offsetting asset

- *Assuming currency risk.* *Saks Fifth Avenue* can ignore the transaction risk and consciously assume a currency risk understanding that it can incur losses (or vice versa save some amount of money). Choosing this "naked" variant Saks will not pay to any mediator as in all other cases.

- *Purchasing a forward contract.* In the currency market, *Saks* can buy in advance a necessary amount of Swiss francs to be delivered at a specified future time at a price agreed today. But in doing so Saks will incur some transaction expenses in the form of payment for bank services through which they purchase francs. Apart from this, Saks will lose the opportunity to profit if the US dollar strengthens.

- *Purchasing a Swiss franc option.* Purchasing such an option *Saks* gains the right (but not the obligation) to buy a necessary amount of Swiss francs to be delivered at a specified future time at a price agreed today. If exchange rate is unfavorable for *Saks*, it may refuse to fulfill the option contract. In any case, *Saks* should pay to the seller of the option a certain amount of money since in return for assuming the obligation, called writing the option, the originator of the option collects a payment, the *premium*, from the buyer.

- *Acquiring an offsetting asset.* To get rid of transaction risk, *Saks* also can acquire what is called an *offsetting* or *compensating asset*. For example, it can buy a certificate of deposit from a Switzerland bank such as *Credit Swiss*. Let's assume that annual interest rate for 6 month deposit certificates is 8% (4% for 6 months). Purchasing a deposit certificate from *Credit Swiss* in April for CHF4,807,692 *Saks* will get in October CHF5,000,000 ($4,807,692 \times 1.04$) thus neutralizing the transaction risk. A disadvantage of this approach is that *Saks* should freeze a part of its capital in a Switzerland bank until October. Although it will get some interest probably it could gain more using this capital in any other way. *Saks* could use some other offsetting assets, for example, *accounts receivable* in Swiss francs.

Translation risk. The translation risk is a risk that a company may suffer for a reduction in value because a change in exchange rates reduces the value of its accounts or assets denominated in foreign currencies. That is, if a particular currency in which a company has some assets denominated decreases in value, the value of those assets also decreases with respect to the company's main currency. Reporting financial results to its stakeholders a company should prepare a consolidated financial statement (the combined financial statements of a parent company and its subsidiaries). If foreign subsidiaries keep accounting records in foreign currency, problems can arise. For example, the *GM* company transfers \$15 million to *Barclays Bank* to open a settlement account for its new British subsidiary *General Motors Import & Distribution company, Ltd.* Let's assume that exchange rate on the date of transferring money was $\text{£}1 = \text{\$}1.50$. Thus the only asset of this subsidiary is a bank account with $\text{£}10$ million. If the exchange rate of US dollar increases to $\text{£}1 = \text{\$}1.45$ then the subsidiary still will have $\text{£}10$. However, when accountants prepare consolidated financial statement, the corporation investment into British subsidiary will be estimated at $\text{\$}14\,500\,000$ ($\text{£}10 \times \text{\$}1.45$). Thus *GM* will incur translation losses in the amount of $\text{\$}500\,000$ ($\text{\$}15\,000\,000 - \text{\$}14\,500\,000$). Since translation risk appears because of necessity to prepare consolidated financial statements, it is often called *accounting exposure*.

Financial managers might hedge translation risk by balancing assets denominated in a currency against liabilities denominated in the same currency. If this can be completely executed so that there is exactly as much liability as assets in that currency, the translation exposure will be zero. This is done for each currency not for each subsidiary. One very common method of translation is use of the current exchange rate for all assets and liabilities. Another possible approach would be to keep assets and liabilities on the books at the "historical rate" – the exchange rate that was in effect when the assets or liability was first entered onto the books. Nobody uses the historical rate exclusively, but there are several methods that mix the historical method for some items with the current exchange rate for others.

AFLAC Inc. from Georgia, USA, the largest foreign life insurance company in the Japanese market, *double hedges* its balance to protect its \$4.8 billion investment in Japan. Its Japan subsidiary insurance company possesses securities to the tune of \$2.5 billion. To finance its other subsidiaries, the parent company took credits from Japan banks in yens equivalent to \$1.3 billion.

Financial experts' opinions differ on whether it is worth protecting themselves from translation exposure or not. Some experts believe that managers should ignore translation risk and focus their attention on transaction exposure. Their basic argument is that transaction exposure may cause real losses whereas translation risk exists only on paper as a change of value in accounts books. *General Motors*, for example, adheres to such an approach. Other experts do not agree with this. They assert that translation exposure should not be ignored. For example, companies, which have to reduce the value of their foreign subsidiaries, incur a risk of initiating default articles envisaged in their credit contracts if the debt-to-equity ratio will be too high. Apart from this, in case of *ALFAC Int.* the share of Japanese business is so significant (it generates 75% of the total revenue) that the company feels obliged to manage translation risk.

Economic risk. The third type of risk is *economic* (or *operating*) *risk*. Economic risk is understood here as an impact of unexpected exchange rate fluctuations on the company value. Exchange rate can be influenced by many factors. How it can change in the long run, for example, the theory of *purchasing power parity* can help explain. Forward exchange rates are considered to be an unbiased forecaster of future spot rates in the short run. Apart from this, exchange rates can be influenced by inflation, balance of payments position, interest rate arbitrage and some other factors.

Unexpected exchange rate fluctuations can affect the company sales revenue and profitability. If, for example, a national currency exchange rate increases, a company can face a tough dilemma: either to raise prices in the foreign markets where its products are exported to and lose market share there or leave prices unchanged and lose profit. Economic risk especially affects long term investments in buildings and equipment even if they are located in the internal market.

Working capital management. Foreign exchange risk management is connected with another function of international entrepreneurs, namely with working capital management. This task is more complicated in an international company than in national one. Financial managers of a multinational company should analyze working capital of each subsidiary and in each currency used. The *Air France-KLM* airline, for example, operates 80 different currencies and its financial managers should keep an eye on state of affairs of each of them. In doing so they have to strive for achieving three corporate financial goals:

- Minimization of cash balance
- Minimization of transaction costs for currency conversion, and
- Minimization of currency risk

- *Minimization of cash balance.* All companies try to minimize available cash (not invested cash) since it does not generate revenue. One of effective methods of doing so is so called *centralized cash management*. Company appoints a cash manager in its Central Office who is in charge of collecting extra cash from subsidiaries accounts and advising them on investment objects. Apart from organizing effective cash management, this can reduce company's need for highly qualified (and highly paid) financial managers.

- *Minimization of transaction costs for currency conversion.* Foreign subsidiaries of a multinational corporation can trade components and end products with each other. For example, *Samsung*, the largest South Korean conglomerate, has manufacturing facilities, component suppliers and distributing companies all over the world. Continuous interchange of components and end products between subsidiaries results in enormous number of outstanding invoices and constant necessity to transfer money between bank accounts of these subsidiaries. Aggregate expenditures for bank services and currency translation can be rather significant. These transaction costs can be significantly reduced through *bilateral netting* between subsidiaries, when two companies set off their mutual liabilities. Instead of translating, for example, dollars to

rubles and then vice versa rubles to dollars, companies may calculate difference in mutual liabilities and make only one transfer. Transaction costs can be decreased even more if *multilateral netting* between companies is organized. But some countries trying to support their banking sector impose restrictions on netting operations. So international entrepreneurs should often think about how to avoid those barriers.

- *Minimization of currency risk.* Financial managers commonly try to optimize a set of currencies constituting working capital structure of a company to minimize currency risk. Often companies employ *the leads and lags strategy* striving to increase the supply of currency, which is expected to increase in price, and decrease the supply of currency, which is expected to go down in price. If managers expect that a currency rate will go down they can try to facilitate payments on the accounts receivable in this currency and increase accounts payable or/and maintain minimum bank balance in this currency.

Foreign investment appraisal. There are numerous methods to appraise foreign direct investments but the most commonly used are the following tools: *net present value*, *internal rate of return* and *payback period*.

- *Net present value (NPV)* is defined as the sum of the present values of the individual cash flows of the same entity. In the case when all future cash flows are incoming and the only outflow of cash is the investment, the NPV is simply the present value of future cash flows minus the investment (which is its own present value). As far as international projects are concerned it is necessary to take into account several additional factors, namely: *risk adjustment*, *selection of currency* and *position for calculating NPV – parent company or project*.

· *Risk adjustment.* Since an international project can be more risky than a national one, international companies can introduce corresponding corrections either increasing the discounting rate or decreasing cash flows. The size of correction should reflect the risk of doing business in the country where the project is to be implemented. In Germany, for example, this correction is small or not necessary at all since this is a politically stable country with respected system of law and almost perfect infrastructure.

· *Selection of currency.* Decision on the currency in which a project should be evaluated depends on the nature of investment. If a project is an integral part of the foreign subsidiary activity then the foreign (local) currency is preferable. In case of projects, which are considered as the integral part of company's global supply, it makes sense to translate cash flows into the currency of parent company. In this case the company should take into account all possible changes in exchange rate during the entire term of project fulfillment.

· *Position for calculating NPV – parent company or project.* The third factor is determination of position from which cash flows influencing NPV should be evaluated: either from the parent company position or the project position. Practically, some international companies analyze individual projects cash flows, others explore the influence of projects on the parent company position and the third is a combination of both. Because of a range of reasons, the project cash flow may differ from the cash flow of parent company. Multinational corporations often prescribe their subsidiaries some expenses related to the use of corporate trademarks or overhead coverage. Such expenses can decrease a *book income* but not the *real* cash flow received by the parent company. Let's assume, for example, that calculating profitability of a subsidiary accountants of the parent company deduct from received revenue 5%, which goes to cover corporate-wide and administrative costs. However, those 5% are not a real decrease in cash flow generated by the subsidiary. Therefore calculating the project NPV the parent company should not take into account those 5%. Similarly costs paid by subsidiaries for the use of corporate trademarks or patents should not be taken into account because the parent company does not incur any additional expenses regardless of whether a subsidiary undertakes a project or not. Financial managers also should take into account any government restrictions on

repatriation of profits. A project can be very profitable but if the parent company is not able to repatriate profit, the project may be undesirable for the company and stakeholders.

- *Internal rate of return (IRR)*. The internal rate of return on an investment or project is the rate of return that makes the net present value (NPV) of all cash flows from a particular investment equal to zero. The term *internal* refers to the fact that its calculation does not incorporate environmental factors (e.g., the interest rate or inflation). Here a financial manager also should correct his/her calculations taking into account all intragroup payments, which do not influence the value of cash flow (intragroup payments and license royalties, compensations for corporate-wide and administrative costs, etc.). After this, the manager compares the project IRR with the *hurdle rate* or the *minimum acceptable rate of return* (MARR), which is the minimum rate of return on a project a company is willing to accept before starting a project, given its risk and the opportunity cost of forgoing other projects. MARR may differ from country to country depending on the degree of risk. A company implements only those projects, which have IRR higher than MARR.

- *Payback period* is the period of time required for the return on an investment to "repay" the sum of the original investment. For example, a \$1,000 investment which returned \$500 per year would have a two year payback period. The *time value of money* is not taken into account. Payback period intuitively measures how long something takes to "pay for itself." All else being equal, shorter payback periods are preferable to longer payback periods. Payback period is widely used because of its ease of use despite the recognized limitations. Because of its simplicity the payback period often is used for preliminary selection of projects and then more complicated tools are used to choose from the remainders. Here a financial manager also should be taking into consideration all intragroup payments.

Identification of international sources of finance. Applying methods of foreign investment appraisal, through identification of international sources of finance, companies allocate their resources for national and international projects promising maximum return. On identification of such possibilities companies should find capital to finance them. They can attract either internal or external sources for this. In doing so an international enterprise tries to minimize its global cost of capital simultaneously reducing to a minimum currency risk, political risk and the global tax burden.

- *Internal sources of finance.* One source of financing is intragroup cash flows (e.g., profit from operational activity, amortization and depreciation), which can be quite significant. Although with possible legal restrictions a parent company can use the cash flow generated by one subsidiary to finance investment projects of another one. The cash flow can be transferred to the parent company as dividends. These means can be channeled to another subsidiary as a loan or investment to the subsidiary equity capital. Also one subsidiary can lend money to another subsidiary.

Two legal restrictions can influence the possibility of a parent company to transfer financial means between its subsidiaries. First, if a parent company is not the only founder of a subsidiary, it should observe rights of other stakeholders in accordance with the principles of honest market. Second, some countries impose restrictions on repatriation of profit, which hinders the intragroup transfer of financial means. Usually such restrictions are a part of programs aimed at the reduction of deficit in the balance of payments. Descriptions of active constraints and policy shifts can be found in the International Monetary Fund annual report *Exchange Arrangements & Exchange Restrictions*. However, if a parent company cannot transfer money as dividends, it can transfer it as loans to other subsidiaries. As a variant, it can receive money from its subsidiary collecting licensing royalty for the use of trademarks,

copyrights and patents or envisaging allowances for corporate-wide overheads and administrative costs. Such payments may be quite significant.

A parent company can move money between its subsidiaries through correction of *transfer prices* paid for goods and services in the framework of intragroup transactions. Let's assume that subsidiary *B* operates in a country with strict restrictions for repatriation of profit and subsidiary *A* operates in the country without such restrictions. Increasing the prices set by subsidiary *A* for goods purchased by subsidiary *B* a multinational company can transfer money from *B* to *A*. Such a policy is less disputable if pursued by a company possessing both subsidiaries otherwise the company can find itself in the position of deceiving outside stakeholders (in case of company *B*) or their enrichment at the expense of its own stakeholders (in case of company *A*).

- *External sources of finance.* Attracting capital for investment projects international enterprises can choose from numerous alternative sources of both equity and debt capital. A company can apply to investment banks such as *Goldman Sacks* and brokerage firms such as *Merrill Lynch* and *Norman*. For example, if a company wants to increase its equity capital such a mediator can place its shares with public in the home country, host country or other countries. To attract capital at the international level, many multinational companies issue their shares in the stock markets of several countries. For example, *Sony* shares are traded on the stock exchanges of New York, Chicago, Toronto, London, Paris, Frankfurt, Dusseldorf, Brussels, Antwerp, Vienna, or country stock exchanges in the Pacific, Switzerland and Japan. International companies demonstrate to foreign investors that they can easily get out of their shares if the necessity arises by including their shares into numerous foreign listings.

International companies have plenty of opportunities to borrow monies at the international level. Large multinational companies can avail themselves of medium- and short-term syndicated credits when consortiums of international banks and pension funds act as sources of capital. Often such credits are provided in *Eurocurrency*²¹ since in this case credits are cheaper due to the absence of strict regulation on the part of Central Banks. International companies can attract debt capital in the form of bonds of their own countries, foreign bonds and *Eurobonds*²².

Brokerage firms and investment banks continuously develop innovative financial instruments to put down the price of borrowings for their clients or utilize gaps in national financial legislation. For example, a multinational company can issue dual currency bonds when the borrowing of money is made in one currency and payments of interest to the principal – in another currency. As a variant, bonds can be issued in several different currencies or redeemed in gold. Some companies find rather creative solutions. For example, in 1990s, the *Walt Disney Company*

²¹ Eurocurrency is money in the form of bank deposits of a currency outside the country that issued the currency. The use of the prefix "euro" is somewhat misleading. It is used for historical reasons. Eurocurrency deposits may be of any currency in any country. The most common currency deposited as Eurocurrency is the US dollar, and the term Eurodollar is often used to refer to dollar deposits. One advantage of Eurocurrency from a bank's point of view is that it allows a bank to operate outside the regulation of the country issuing the currency in question. One particular advantage is that most countries do impose a reserve requirement on foreign currency operations: a bank can therefore lend a higher proportion of its Eurocurrency deposits, improving its interest margin. It also makes sense for a bank that has customers who wish to hold or borrow foreign currency the convenience of doing so in their own country. Sufficiently large borrowers often issue Eurobonds instead of borrowing from banks' Eurocurrency operations (also see chapter 9).

²² Usually, a Eurobond is issued by an international syndicate and categorized according to the currency in which it is denominated. A Eurodollar bond that is denominated in U.S. dollars and issued in Japan by an Australian company would be an example of a Eurobond. The Australian company in this example could issue the Eurodollar bond in any country other than the U.S. Eurobonds are attractive financing tools as they give issuers the flexibility to choose the country in which to offer their bond according to the country's regulatory constraints. They may also denominate their Eurobond in their preferred currency. Eurobonds are attractive to investors as they have small par values and high liquidity (also see chapter 9).

issued Eurobonds to the tune of \$400 million and those were not common bonds: their interest rate depended on how popular the company's 13 films would be. Investors were guaranteed 3% interest rate whereas maximum interest rate could be 13.5%. Other comparable bonds yielded only 7-8%.

The international market also has such effective instruments as *interest rate swaps* and *currency swaps*. An *interest rate swap* is an agreement between two parties (known as counterparties) where one stream of future interest payments is exchanged for another based on a specified principal amount. Interest rate swaps often exchange a *fixed payment* for a *floating payment* that is linked to an interest rate (most often the LIBOR). A company will typically use interest rate swaps to limit or manage exposure to fluctuations in interest rates, or to obtain a marginally lower interest rate than it would have been able to get without the swap. A *currency swap* is a swap that involves the exchange of principal and interest in one currency for the same in another currency. It is considered to be a foreign exchange transaction and is not required by law to be shown on a company's balance sheet. International banks play a key role in the currency swap market. These banks continuously keep a wary eye on currency markets and the banks' exposure to currency risks therefore they can satisfy any needs of multinational corporations regarding swaps" [29].

Many policymakers in governmental and international aid organizations believe that small firms have inadequate access to external finance in transitional and developing countries as a result of market imperfections. In response, significant resources are being channeled into the promotion and financing of small and medium-sized enterprises (SMEs) in transitional and developing countries. For example, the World Bank Group has approved more than \$10 billion in SME support programs in the past five years, \$1.5 billion of it in the last year alone (World Bank Group Review of Small Business Activities, 2002)²³. There is also significant renewed interest in development banks, whose mission is to provide loans that promote development by lending to constrained borrowers in developing countries, particularly small firms. [56].

2. The Russian banking system

Banking market. Despite enormous economic potential and years of very high growth, the Russian banking sector remains relatively small with total assets of about 1 trillion US dollars or 46% of GDP. The total number of banks is about 1000, many of them are very small, only about 350 banks have capital exceeding \$10 million.

The banking system of Russia developed rapidly starting from 1990. At the beginning of 1992 about 1500 banking licenses were issued. Bank registrations totaled 2500 at the peak of the sector's expansion in 1996 when for enterprises and organizations it was popular to establish their own banks. The sector has gone through a substantial transformation since then. Many banks have defaulted on their obligations and gone into bankruptcy. Because of the recent financial crisis the number of banks has decreased even further as a result of insufficient liquidity, tightened capital, anti-money laundering or other regulations.

The sector is concentrated and controlled by state banks: about half of the total banking assets and total capital belongs to the 5 largest banks, all of which are state-controlled (Sberbank, VTB, Gazprombank, Rosselhozbank and Bank of Moscow). Sberbank, with about a quarter of the total banking assets and capital, plays a dominant role, especially in retail deposits (more than 50% of the market) and about a quarter of the lending market. The state directly or indirectly keeps

²³ The World Bank provides direct and indirect support to SMEs. In terms of activities, 80 percent of World Bank programs involve direct financial assistance to SMEs, while the remaining 20 percent involve indirect support such as technical assistance for SMEs and for institutions that support SME development.

control over more than 20 other banks, including several relatively large banks which were rescued during the 2008-2009 financial crisis.

The Russian banking sector has developed rapidly in recent years, reflecting the strengthening Russian economy. The successful implementation of the *Deposit Insurance System* in 2004 has proved a critical psychological boon to the banking sector, evidenced by growth in overall deposits. Despite measured progress, the Russian banking system is not yet efficiently performing its basic role of financial intermediary (i.e., taking deposits and lending to business and individuals). Even before the financial crisis, only a quarter of Russians had any kind of a bank account. Russia's banking sector is recovering from the economic crisis, with 10-15% loan growth in 2011. The share within Russia's banking sector of non-performing and troubled loans, which during the financial crisis some analysts said could reach as high as 40%, appears to have stabilized in 2010 at around 20%. Increasing disposable incomes, greater confidence in banks and increased financial awareness within the population were among the main factors contributing to the banking sector growth. However, the global financial crisis has had a significant impact on the sector.

According to the Central Bank of Russia, net profit within the banking sector decreased to RUB 96.4 billion in January – November 2009 (compared to RUB 314 billion in 2008). In the same period, the total assets of all Russian banks increased by 2.4% to RUB 28,691.9 billion, while in 2008 there was a 39.2% increase and the capital base grew by 21.8% to RUB 4,642.7 billion.

At the same time, as a result of high interest rates bank deposits made by Russian individuals rose by 18.5% in 2009, to RUB 6,998.8 billion. Credit to individuals decreased by 10.7% to RUB 3,586.2 billion.

The total amount of credit provided to organizations, banks and individuals was RUB 20,047.3 billion, a 0.8% increase since the beginning of the year. The total amount of overdue debt reached RUB 1,043.4 billion, representing 5.2% of the loan portfolio.

As of 1 January 2010, there are 1,058 credit organizations operating in Russia (4.7% fewer than on the same date in 2009). The top five banks control 47.9% of the assets.

The government backs up the consolidation of the banking sector to increase its effectiveness. Starting 1 January 2010, Russian banks are supposed to have equity capital exceeding RUB 90 million, and from 2012 the level is set to increase to RUB 180 million. Hence the number of banks is expected to decrease in the near future because of capital insufficiency.

Over the past few years, major Russian banks have attempted to reposition themselves as retail or universal banks. Banks currently offer only a limited range of commercial and retail products (compared to what is available in the EU and the US), but new financial products are being introduced to the market.

The Central Bank of the Russian Federation (Bank of Russia). “The principal function of the Central Bank is to protect the ruble and ensure its stability; it is the sole issuer of rubles. The Central Bank sets and pursues a single state monetary policy and exchange rate policy; manages currency circulation; acts as the lender of last resort for credit institutions and manages the bank refinancing system; sets the rules for conducting banking operations; manages most categories of state budget accounts; registers credit organizations and issues licenses to them for banking transaction performance as well as supervises over activity of credit organizations and bank groups; promotes and monitors the proper functioning of payment systems; and performs a number of other functions in accordance with federal laws .

The Central Bank cooperates with international banking institutions, including the IMF and the World Bank. It also collaborates on the domestic financial market with the Federal Insurance Supervisory Service, which provides licensing and other types of supervision over insurance entities, and the Federal Service for Financial Markets to exchange information and to maintain adequate surveillance over the financial market in general. The State Duma is currently considering a proposal to unite the supervisory functions of these three institutions under one regulatory body. At the beginning of June 2010 the Central Bank cut the refinancing rate for the fourteenth time, bringing it to 7.75% (from a figure of 13% at the beginning of 2009). The easing of the interest rate is intended to help revive the lending process.

In 2010 the Central Bank started to deliver its monetary policy guidance. This suggests that the Central Bank is gradually changing and starting to be more transparent, as a typical central bank. It is expected that in the coming years the Central Bank will shift from a monetary policy based on exchange-rate management to an interest-rate managed policy – in line with most developed countries.

Commercial banks. The banking sector had been developing rapidly, faster than the economy as a whole, and was one of the most attractive sectors for investment. However, the financial crisis had a marked impact on the sector: the banks faced liquidity problems, an outflow of funds, and the level of bad debts increased.

The efforts of the Russian Government helped to prevent the collapse of the banking system. The level of government support provided to banks is considered to be one of the strongest in the world. In 2009, RUB 280 billion (\$9.5 billion) was allocated to support the banking system (in 2008 over RUB 2 trillion or \$66.5 trillion was provided). The Government's priority was to make bank resources more available to companies in the real sectors of the economy and assist in the rehabilitation of struggling banks that are important for the general sustainability of the banking system. As a result, the Russian banking system managed to survive and the majority of players were saved.

One of the main risks that Russian banks are facing is loan quality. The total amount of overdue debt reached RUB 1,043.4 billion (\$34.8), of which the Top-20 banks account for 64%. Non-performing loan rates are expected to continue rising well into 2010. The proportion of overdue loans in the total loan portfolio reached 5.2%. Though the toughest stage of the crisis passed, in 2009 credit markets in Russia remained tight and the negative impacts of the crisis are expected to make their effects felt in the next couple of years. The major challenge for the banks will be to improve the overall situation with lending.

As of July 2010, 1,039 credit institutions operated in Russia. For the past year and a half, this figure has been decreasing slowly but constantly (as of January 2009, quantity of operating credit institutions was 1,108). Reduction of operating credit institutions results from the global turmoil and displays the tendency to consolidation in this market. Currently, 49.87% of total volume of credits, deposits and other funds placed (information as of April 2010) fall on five credit organizations.

Top 10 Russian banks classified by net asset value (according to the Information Agency RBK as of the 1st quarter 2010):

1. Sberbank
2. VTB
3. Gazprombank
4. Rosselkhozbank
5. Bank of Moscow

6. VTB 24
7. Alfa-Bank
8. UniCredit Bank
9. Raiffeisenbank
10. Promsvyazbank

During Soviet times, foreign banks were only permitted to open representative offices. When the liberalization process started in the late 1980s, some of these representative offices were transferred into subsidiary banks. Historically such banks serviced multinational companies operating in Russia. Recently foreign-owned banks have become more active in the retail and corporate sectors.

As of June 2010, there were 82 credit institutions with 100% foreign capital, approximately 8% of the total number of credit institutions in Russia. The number of credit institutions with the participation of foreign capital was 221, or 21%. Nevertheless, the presence of foreign-owned banks in Russia is still relatively low. It is worth mentioning that foreign financial organizations *cannot carry out their activities in Russia via branch offices*; organizations of this type shall register as a Russian legal entity that will fully perform its activity on the territory of the Russian Federation in compliance with Russian legislation” [24].

3. Payment and collection

Paper-based payment methods are rapidly being replaced by electronic solutions in Russia. Electronically processed payments represent more than 77%, measured by volume, and 90%, measured by value, of all domestic payments. In the Central Bank payment system, this figure is higher than 99%. Nonetheless, the importance of cash payments is still considerable, although decreasing. Credit transfers are the dominant payment instrument in terms of both volume and value.

The retail credit card market in Russia is developing fast, and banks in Russia are issuing an increasing number of credit cards. The infrastructure of the payment card industry is fairly developed. Businesses are now well aware of the advantages of using corporate cards instead of cash for corporate expenses. Both debit and credit cards are used for corporate purposes and the use is expanding rapidly.

Card payments. While the use and issuance of payment cards have increased steadily in recent years, Russia remains essentially a cash-based economy. The Central Bank Regulation of December 24, 2004, No. 266 P on The Issue of Bank Cards and Payment Card Operations further facilitated expansion of the payment card market. The number of cards issued by credit institutions increased by 6% to 126 million (119 million in 2008), while the number of payment card operations reached 2,468 billion (up 17%) in 2009, and their value totaled RUB 9,883 trillion (an increase of 7%).

Since the introduction of credit cards in 2001, their popularity has continued to increase. By 2008, the number of credit cards had increased by 4% (9.3 million cards), while the number of credit card operations had risen by 53% and their value expanded also by 53%. Despite this growth, credit card operations accounted for only 8% of total payment card operations.

Credit transfers. Payment orders are the dominant cashless payment instruments in Russia in terms of both volume and value. Credit transfers can be paper-based or automated, but electronic credit transfers account for the majority of transfers. Nearly all interbank transactions are effected electronically based on written agreements between the banks.

Direct debits. Direct debits (payment requests), standing orders, collection orders and letters of credit account for a very small proportion of cashless payments in Russia.

Checks. Checks as a means of payment are used only to withdraw cash from corporate accounts because it is required by law. There is no interbank check clearing system in Russia.

Electronic banking. Electronic banking services are offered by leading Russian banks as well as international banks. There is currently no electronic banking standard. Banks either offer standard platforms provided by local or foreign vendors (such as Germany's MultiCash system) or their own proprietary software (which usually does not feature multibank functionality) for corporate banking purposes.

Internet banking for retail customers is becoming widespread in larger Russian cities. The Russian electronic banking system has been used to establish corporate-to-bank connectivity for many years. Recent trends include solutions for connectivity between corporate enterprise resource planning (ERP) systems and electronic banking systems, and global solutions that link accounts across different countries.

EDIFACT/host-to-host solutions. Businesses' growing effort to streamline payment processing is supported by a number of banks. Host-to-host (H2H) solutions are available that provide direct connectivity between the customer's ERP system and the bank's processing engine with no bank software in between.

E-payments. Micropayments are offered by domestic and global players, such as Webmoney, Yandex.Money, E-Gold, E-port, Rapida, Assist, CyberPlat, PayPal, MoneyMail, Rupay, Moneybookers and Internet. In general, such solutions rely on two important prerequisites: (1) prepayment and (2) settlement by cash, debit or credit card.

E-invoice/EBPP. No industry-wide electronic bill presentment and payment (EBPP) solutions exist on the market, although various providers operate in Russia.

Methods of Payment in Export. "Payment methods and terms vary depending upon the foreign company's business model and relationship with its Russian trading partner. For new-to-market companies, requesting advance payment for goods and services from a Russian customer may be a prudent course to follow until both parties establish a positive record of payment. Once a foreign firm has established a strong relationship with a Russian trading partner, it may consider extending short term and eventually longer term credit as a way to bolster sales volume. This should be done with caution and only after careful evaluation and establishment of successful payments.

For some large transactions, advance payment from a Russian buyer may be impractical. In such cases, financing may be provided by a bank, export credit agency or venture fund. Exporters' risk can be minimized with a bank or insurance guarantee from a Russian bank that would be acceptable to a foreign bank. In leasing deals, exporters should insist on an upfront payment of three to fourth months upon delivery as a way to mitigate some of the risk.

Leasing has become increasingly attractive to both lessees and lessors because of its economic effectiveness, flexibility and accessibility in comparison to bank finance. Most large Russian banks have leasing programs that they can offer their clients in such cases, and there is a growing list of foreign leasing companies operating in Russia that can offer Russian clients leasing terms for imported equipment. Aviation, energy, mining, construction, transportation, pharmaceutical,

forestry and fishing industries equipment which may be too expensive for Russian customers to purchase, are often leased” [37].

Resident and non-resident status. Resident organizations include legal entities, established under Russian laws and located in Russia, such as financial partnerships, companies, production co-operatives, state and municipal unitary enterprises as well as non-profit organizations. Non-resident organizations include foreign legal entities, companies and other corporate associations with a civil legal capacity set up in accordance with the legislation of foreign states, international organizations, their branches and representative offices set up on the territory of the Russian Federation.

Account ownership. Accounts in rubles as well as in foreign currency can be held by residents, domestically and abroad, and non-residents that have registered with the relevant local tax office in Russia. The tax office has to be notified of each bank account opened with a Russian bank. Effective from June 2005, Russian resident companies are allowed to open accounts in OECD and FATF countries (from January 2007 also in other countries) without the permission of the CBR but subject to subsequent notification to the tax authorities. Usually Russian banks do not charge any commission for opening of accounts but charge fees for account maintenance, servicing of banking cards, money transfer to accounts of other banks, cash withdrawals from bank accounts in ATMs of other banks.

Account types and charges. Banking transaction fees are not standardized and banks follow their own individual policies. Fees can vary substantially depending on the relationship between the bank and the customer as well as on the transaction. Russia has not adopted the IBAN system.

Deposit insurance system. Most of the banks in Russia are covered by the federal deposit insurance system. Members of the deposit insurance system have to make contributions to a special deposit insurance fund. In case of an insurance event, all individuals will have the right to a 100% reimbursement of their deposits up to a maximum amount of 700,000 rubles (approximately 17,500 EUR). Currently more than 900 banks participate in this deposit insurance system.

Cash pooling regulations. There is no specific legislation on cash pooling and no specific restrictions to the accounting and tax treatment of pooling arrangements. At the same time, each arrangement requires a good understanding of all legal, tax and operational aspects. Therefore no common cash pooling market practice exists.

Money laundering. From 2001, a number of measures were implemented to bring anti-money laundering legislation into line with international standards (Law RF 115-FZ on Counteracting Legalization (Laundering) of Illegally Obtained Income and Financing of Terrorism in 2002 and article 174 of the Criminal Code), together with organizational and administrative measures to enforce the law. This has helped to increase the number of unaddressed cases of money laundering, though this remains an important issue for the Russian economy.

Russia is a Financial Action Task Force (FATF) member and observes most of the FATF-49 recommendations. Russia is also a member of the Council of Europe’s MONEYVAL Select Committee and the Eurasian Regional Group on Combating Money Laundering and Financing of Terrorism (EAG). Russia has established a financial intelligence unit (FIU), the Federal Financial Monitoring Service (FFMS), which is a member of The Egmont Group.

Financial institutions in the broadest sense must record and report suspicious transactions to the authorities (FFMS). They must also identify their customers and report transactions exceeding

RUB 600,000 (around EUR 15,000) involving cash, bank deposits, precious materials, life insurance payments, gambling and entities in certain “high-risk” countries to the authorities.

Russian authorities are tightening control over cash flows by introducing:

- special control over transfers of funds between individuals if the amount is equal to or exceeds RUB 600,000 (around \$20,000);
- special control over transactions with immovable assets if the amount is equal to or exceeds RUB 3,000,000 (around \$100,000);
- closer control by the Central Bank over the banking system and license withdrawal.

Account operating procedures require full identification. Correspondent relationships with non-resident credit institutions that do not have a physical presence in the country of incorporation are not permitted. All foreign financial institutions must operate solely through subsidiaries incorporated in Russia subject to domestic supervision. Banks are required to keep all records for at least five years after account closing.

On 15 January 2008, amendments to a *Law on Counteracting the Legitimization of Illegally Obtained Income* came into effect. The amendments require that banks “track, at all stages, non-cash accounts and money transfers that are made without opening an account”, collecting the originator’s name, VAT number, place of residence, and date and place of birth. Without this information, credit companies should not process transactions for sums exceeding RUB 600,000.

The new law also requires oversight of the transactions of foreign public officials and their close relatives. Additionally, credit companies must now identify the sources of foreign public officials’ money and other property.

The Central Bank has extended a moratorium on revoking the licenses of banks that violated this law before 1 April 2009. The Central Bank was forced to take this action at the request of the Association of Russian Banks (ARB), since the previous moratorium expired on 1 October 2007, before the amendments had come into force.

At the G-20 Summit in Pittsburgh in September 2009, President Dmitry Medvedev and other leaders signed an agreement on firmly dealing with tax havens, money laundering, the proceeds of corruption, the financing of terrorist activity and prudential standards. The leaders entrusted the newly created Global Forum on Transparency and Exchange of Information with the task of improving tax transparency and the exchange of information, so that countries could fully enforce their tax laws to protect their tax base.

In December 2009 President Medvedev signed a draft law ratifying a treaty with other CIS countries to combat money laundering and the financing of terrorist activity. The treaty, signed in October, is aimed at improving the legal base to combat money laundering and strengthen cooperation between CIS members on this front. According to The Economic Security Department of The Ministry of the Interior of Russia, in 2009 economic crime police in Russia uncovered over 8,400 crimes related to money laundering.

4. Foreign currency market and foreign currency rules

Under Russian law, both resident and non-resident companies and individuals can freely perform currency transactions, including credit (loan) transactions, securities trading, contributions to the charter capitals of foreign entities and advance payments on certain export/import transactions.

However, there are some regulations, e.g. when making payments under foreign trade contracts and credit (loan) agreements between nonresidents and residents, Russian residents must comply with certain requirements established by Russian currency control legislation.

In certain cases, Russian residents must formalize a *transaction (deal) passport* and provide the bank with documentation supporting the legal basis for the currency transaction. There are also some requirements concerning settlements under these transactions, including repatriation requirements (i.e., Russian residents must return proceeds from foreign trade agreements to Russia in the time stipulated by Russian currency control legislation) and there are reporting requirements.

Russian law also establishes notification and reporting requirements for Russian residents who open foreign bank accounts. There is a special system in place for Russian residents using foreign bank accounts – they can receive funds in foreign bank accounts only in connection with a limited list of operations established by Russian law.

Federal Law No. 173-FZ of December 10, 2003 on *Currency Regulation and Currency Control* set out the following basic principles:

- any currency transaction which is not specifically prohibited or regulated is permitted without restriction;
- in case of doubt, Federal Law No. 173-FZ is to be interpreted in favor of market participant, whether residents or non-residents.

The Central Bank applies currency control. As a general rule, export proceeds of Russian residents must be repatriated to Russia, save for certain exceptions (e.g., if the proceeds are to be used for repayment of loans from foreign creditors from OECD or EATF countries with a maturity exceeding two years).

The establishment of foreign financial institutions or acquisitions of capital in such institutions by Russian banks require a permit from the Central Bank. All transactions between Russian residents and non-residents must be reported to the Central Bank.

Exchange rate policy. The Russian ruble is currently pegged to a basket composed of US dollars (55%) and euros (45%). The CBR sets the exchange rate between the ruble and the basket and allows a certain fluctuation corridor. After some years of currency stability and moderate appreciation, at the end of November 2008, the CBR allowed a depreciation of the ruble by almost 30%, although since March 2009 the ruble has strengthened by about 15% (39.5 RUB/EUR and 29 RUB/USD in the mid of April 2010).

Exchange rates for the most prominent foreign currencies are calculated daily, based on RUB/USD quotes in the domestic foreign exchange market and other currency quotes against the US dollar in the global exchange market.

Conversion and Transfer Policies. “While the ruble is the only legal tender in Russia, companies and individuals generally face no significant difficulty in obtaining foreign exchange. Finding a bank licensed to conduct foreign currency transactions is not difficult. Russia has no capital controls and there are no barriers to remitting investment returns abroad, including dividends, interest, and returns of capital. Nonetheless, investors would be well advised to seek expert advice at the time of an investment.

Currency controls exist on all transactions that require customs clearance, which in Russia applies to both import and export transactions and certain loans. As mentioned above a business must open a *deal passport* with the Russian authorized bank through which it will receive and service the transaction or loan. A deal passport is a set of documents that importers and exporters provide to authorized banks. Such documents enable banks, the agents of Russian currency control, to monitor payments in respect to the transaction or loan and to report the corporation’s

compliance with currency control regulations to the Central Bank. Russia's regulations regarding deal passports are described under Instructions of the Central Bank of Russia number 117-I of June 15, 2004.

Only authorized banks may carry out foreign currency transactions. According to currency control laws, the Central Bank retains the right to impose restrictions on the purchase of foreign currency, including the requirement that the transaction be completed through a special account. The Central Bank does not require security deposits on foreign exchange purchases" [37].

5. Specialized Financial Institutions

Factoring. In recent years, factoring in Russia has changed from being a service offered by banks to a separate financial business. The range of factoring services and their quality is gradually approaching global standards. In the summer of 2008, two large Russian banks entered the factoring market. Overtaking other Central and Eastern European markets, the factoring business in Russia was estimated at being worth RUB 602 billion in 2008; however, due to the financial crisis in 2009 the market declined significantly to RUB 188 billion (during the period January – September) according to the Association of Factoring Companies. The main reasons for the decrease are financing shortages and the toughening of requirements for clients and debtors. In 2009 several important events for the industry took place. A number of leading companies went bankrupt, factoring operations licensing was abolished, and market players' consolidation got underway within the Factoring Companies Association. In 2010 factoring companies intend to increase investment in business development and work on decreasing rates through attracting cheap funding.

Leasing. For the last few years, the leasing market had been growing by over 50% per year. The market's large growth potential was as a result of huge demand, which in turn was caused by a high level of capital asset amortization in the Russian economy, investment inflow and the need of mid-sized businesses for long-term financial resources. However, the economic crisis has taken its toll on leasing. According to the Russian Association of Leasing Companies, the leasing market suffered more from the crisis than many other industries, contracting more than twice. In 2009, the volume of new deals fell by 56% year on year reaching a total value of RUB 315 billion, as compared to RUB 720 billion in 2008. The value of received payments reached RUB 320 billion. Because creditors are currently apprehensive of long-term projects, leasing companies have lost almost all sources of funding. The main problems were financing difficulties and a lack of trusted clients. The leasing market began reviving at the end of 2009, and is expected to recover not earlier than 2012. At the same time, leasing is considered a safe investment and the market will quickly develop as soon as investment activity picks up again. Many large projects that were put on hold at the planning stage will result in a substantial increase in the volume of deals in the market once funding reappears.

Insurance. The Federal Insurance Supervisory Service (FISS) regulates and supervises insurance companies and insurance brokers. The prime functions of the FISS are to supervise insurance companies' financial standing; ensure that insurance companies observe prudential norms specific to the insurance activity; license and oversee insurance companies and insurance brokers; and impose penalties for non-compliance. In 2009 the insurance market, hit by the crisis, faced serious problems. Insurance premiums reached RUB 726.75 billion in Jan–Sep 2009 having increased by 2% over the last year, as compared with a 23% increase in 2008. The insurance market portfolio comprises the following segments: property 28.2%, liability 2.7%, mandatory medical insurance 45.9%, third party motor liability 8.6%, life insurance 1.4%, personal lines 11.4% and other obligatory lines 1.0%. As of 30 September 2009, there were 722 insurance companies in Russia – a significant decrease compared with the beginning of 2008 (847). Some of the top companies are *Rosgosstrakh*, *Ingosstrakh*, *Sogaz*, *RESO-Garantia* and

Rosno. The crisis pushed the market towards consolidation and as a result the market share of the top-20 companies reached 60%. The recovery of the insurance market is expected to begin simultaneously with an increase in the budgets of enterprises and corresponding increase in individuals' income.

Sovereign Funds. There are two sovereign wealth funds in Russia: the *Reserve Fund* and the *National Wealth Fund*. Management of both funds' assets is executed by the Ministry of Finance in accordance with procedure and terms established by Government of the Russian Federation. The Central Bank of Russia may act as operational manager. Reserve Fund assets can be used to: purchase foreign currencies (dollars, euros, and pounds) that are then kept in the Federal Treasury's accounts with the Central Bank of Russia, which in turn pays interest on those deposits; and/or purchase financial assets denominated in foreign currencies. The list of eligible financial asset classes is determined by Russian legislation. Ministry of Finance guidelines for Reserve Fund asset allocation are foreign (12 OECD countries) government debt instruments - 95%, international financial institutions' (a closed list of 9) debt instruments – 5%. The National Wealth Fund can be held in foreign currencies (dollars, euros, and pounds) in the Federal Treasury's accounts with the Bank of Russia, which pays interest on them according to a bank account agreement. The National Wealth Fund can also be used to purchase financial assets denominated in Russian rubles and eligible foreign currencies. The Reserve Fund and National Wealth Fund are audited by the Chamber of Accounts of the Russian Federation and the results are reported to both Houses of the Federal Assembly. In 2009 and 2010, the Russian government tapped into both funds heavily to finance bail-out programs for major banks and industries during the global economic crisis.

Chapter 9

Capital Markets and Securities

1. International capital markets

“International banks have great importance not only for currency market activity and arbitrage transactions; they also play a vital role in the financing activity of international companies fulfilling functions of both commercial and investment institutions. As commercial banks they provide financing for export-import operations, accept deposits, lend working capital loans and provide their clients with qualified services on financial management. Exercising functions of investment banking institutions international banks can guarantee accommodation of local, foreign and multinational loans or establish banking consortiums for lending considerable credits. Apart from this, international banks provide brokerage services, facilitate or even finance mergers, acquisitions and establishment of joint enterprises between national and international companies.

Major International Banks. The hardcore of international banking system is large banks specializing in short-term capital market operations. Headquarters of these banks are located in the world financial centers in the USA, Japan, Great Britain, Germany and France. These banks are involved in the world commercial activity (see table 9.1).

Table 9.1

The largest world banks

Ranking	Company	Country	Assets, \$ million
1	<i>Mizuho Holdings</i>	Japan	1 148 917
2	<i>Citigroup</i>	USA	1 051 450
3	<i>Sumitomo Mitsui Banking</i>	Japan	820 083
4	<i>Deutsche Bank</i>	Germany	813 619
5	<i>Mitsubishi Tokyo Financial Group</i>	Japan	755 481
6	<i>UBS</i>	Switzerland	752 332
7	<i>BNP Paribas</i>	France	733 423
8	<i>HSBC Holdings</i>	Great Britain	694 238
9	<i>J.P. Morgan Chase</i>	USA	693 575
10	<i>Bayerische Hypo Bank</i>	Germany	647 926
11	<i>ING Group</i>	Netherlands	627 415
12	<i>Bank of America</i>	USA	621 764
13	<i>Credit Suisse</i>	Switzerland	607 568
14	<i>UFJ Holdings</i>	Japan	605 717
15	<i>Royal Bank of Scotland</i>	Great Britain	536 527
16	<i>ABN Amro</i>	Netherlands	530 701
17	<i>Barclays</i>	Great Britain	518 867
18	<i>Société Générale de France</i>	France	456 022
19	<i>HBOS</i>	Great Britain	454 310
20	<i>Commerzbank</i>	Germany	446 067

Source: Hoover's Handbook of World Business; Corporate websites

There are several forms of international banking activity. Initially, international banking transactions were carried out mainly through *correspondent relationship* between banks located in different countries. The term “*Correspondent relationship*” means there is an agent relationship when one bank acts as a correspondent or agent for another (foreign) bank. Correspondent banks provide such services as cash disbursement to foreign companies or provide acceptance of payments from them, provision of information on solvency of foreign

companies and payments under letters of credit. To offer these operations, banks have “in another bank accounts” denominated in local currency. In the course of internationalization of large banks’ activity, the need to be competitive in the international capital market was increasing. Therefore the banks widened their network of foreign units instead of employing the services of correspondent banks.

There are several types of international bank units. A *Subsidiary bank* is a unit registered as a company independent from the parent bank. A *Branch bank* is a subdivision not registered as a separate independent company. A branch is not a legal entity. An *Affiliated bank* is a foreign bank unit, which is owned by the bank and its national or foreign partner. It often occurs in a situation where one company owns a minority interest (less than 50%) in another company.

Commercial banking services. One of the major functions of international banks is to provide commercial services. Physical exchange of paper money is an important but not the only service of international banks. They also can provide the following services:

- Short-term finance of bargains
- Transfer of payments through e-payment systems
- Forward purchase of a foreign currency
- Qualified consulting on the correct processing of documents on merchandise entry and payment, and
- Repatriation of profit, *etc.*

Investment banking services. Investment services of banks also are provided by large companies dealing with securities such as *Nomura, Solomon Smith Barney, Goldman Sachs and Merrill Lynch*. Corporate clients employ services of the banks investment department to draw up documents and allocate long-term debts and shares and also arrange bargains on mergers and acquisitions.

Eurocurrency market. The Eurocurrency market is another important element of the international financial system. The Eurocurrency market (initially called a *Eurodollar market*) appeared in the 1950’s when communist governments of Central and Eastern Europe were in need of dollars to finance their international trade but feared that the US government would confiscate or block their dollar deposits in American banks. Communist governments solved this problem employing services of European banks, which readily opened dollar accounts for them. So Eurodollars were the US dollars deposited in accounts of European banks and thus were not under the jurisdiction of the Federal Reserve. As other large banks of the world (especially Canadian and Japanese banks) began to accept deposits denominated in dollars, the term *Eurodollar* began to mean any dollar account opened outside the USA. On the other hand, as the stability and weight of other currencies (especially yen, pound and euro) were increasing, the Eurocurrency market expanded to *Euroyen, Europound, Euro currency* and other currencies. Currently the term *Eurocurrency* means time deposits denominated in a currency at banks outside the country where this currency was issued. It is important to note that the term has nothing to do with the euro, and the prefix *euro-* is used more generally to refer to deposits outside the jurisdiction of the local central bank, *e.g. Eurorable*. Currently about \$9 trillion Eurocurrency is deposited in accounts of the various world banks and about 45% of this sum is in *Eurodollars*.

In parallel with the development of Eurocurrency market, the market of Eurocredit was developing. The *Eurocredit market* comprises banks that accept deposits and provide loans in large denominations and in a variety of currencies outside the jurisdiction of the issuing central bank. The banks that constitute this market are the same banks that constitute the Eurocurrency market; the difference is that Eurocredit loans are longer-term than so-called Eurocurrency loans.

The Eurocredit market is characterized by an extremely high level of competition therefore creditors do business with very low margin (the difference between credit and deposit rates). The Eurocredit interest rates are often determined on the basis of the LIBOR (London Interbank Offer Rate). The LIBOR (/ˈlaɪbɔːr/) is the average interest rate that leading banks in London charge when lending to each other and other banks. Banks borrow money for one day, one month, two months, six months, one year, etc., and they pay interest to their lenders based on certain rates. The LIBOR figure is an average of these rates. Many financial institutions, mortgage lenders and credit card agencies track the rate, which is produced daily at 11 a.m. to fix their own interest rates which are typically higher than the LIBOR rate. As such, it is a benchmark for finance all around the world.

The Eurocredit market in most cases provides credits at the best price for large creditworthy borrowers such as government agencies and big multinational corporations. There are three reasons explaining this situation. First, Eurocredits do not depend on government regulatory enactments (such as mandatory reserve requirements), which regulate bank activity and entail significant expenses. Second, Eurocredits are allocated only for large transactions therefore the average level of expenses for borrowing is rather low. Third, only large trustworthy borrowers employ the Eurocredit services therefore creditors charge a lower risk premium.

In the 1970's, American banks began to complain that reserve requirements and other regulatory rules prescribed by the Federal Reserve Board prevented them from competition with European and Asian banks in providing international dollar credits, which constituted over half of Eurocredits at that time. Foreign banks granting credits in Eurodollars did not observe those regulatory enactments. The Federal Reserve Board therefore issued permission to establish a system of international units of the American banks with preferential treatment. An *International Banking Facility (IBF)* is a unit of an American bank legally independent from national units of this bank; it can provide only international banking services.

International bond market. For governments of different countries, international organizations and large companies, the international bond market is a major source of debt financing. This market traditionally comprises two types of fixed-yield securities: *foreign bonds* and *Eurobonds*.

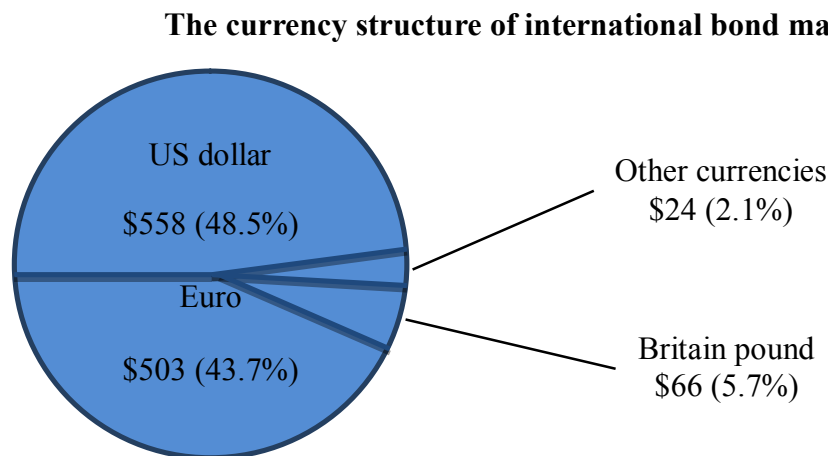
A *Foreign bond* is a bond issued by a resident of a country *A* and sold to residents of a country *B* in the currency of the country *B*, i.e. it is a bond that is issued in a domestic market by a foreign entity, in the domestic market's currency. For example, the *Nestle Corporation*, resident in Switzerland, can issue a foreign bond denominated in yens and sell it mainly to Japanese residents. Foreign bonds are regulated by the domestic market authorities and are usually given nicknames that refer to the domestic market in which they are being offered: *Yankee bonds*, *Bulldog bonds*, *Samurai bonds*, *Matilda bonds*. Since investors in foreign bonds are usually the residents of the domestic country, investors find them attractive because they can add foreign content to their portfolios without the added exchange rate exposure.

A *Eurobond* is a bond issued in a currency of a country *A* but sold to residents of other countries, i.e. it is a bond issued in a currency other than the currency of the country or market in which it is issued. Usually, a Eurobond is issued by an international syndicate and categorized according to the currency in which it is denominated. A Eurodollar bond that is denominated in U.S. dollars and issued in Japan by an Australian company would be an example of a Eurobond. The Australian company in this example could issue the Eurodollar bond in any country other than the US. Eurobonds are attractive financing tools as they give issuers the flexibility to choose the country in which to offer their bond according to the country's regulatory constraints. They may also denominate their Eurobond in their preferred currency. Eurobonds are attractive to investors as they have small par values and high liquidity. The majority of Eurobonds are now owned in

'electronic' rather than physical form. The bonds are held and traded within one of the clearing systems (*Euroclear* and *Clearstream* being the most common). Coupons are paid electronically via the clearing systems to the holder of the Eurobond (or their nominee account).

Major currencies of the international bond market are the US dollar and euro (see Fig 9.1).

Figure 9.1



As the world capital market advanced, the international bond market became more complicated. Syndicates of investment banks, companies fulfilling transactions with securities and commercial banks consolidated integrated packages of international bonds intended to satisfy needs of large creditworthy borrowers (such as multinational corporations, national governments and various international organizations) in loans. The issue of global bonds became one of such new financial instruments. A *Global bond* is a significant liquid financial asset traded in any country at any time, i.e. global bonds can be issued in several countries at the same time. Unlike Eurobonds, global bonds can be issued in the same currency as the country of issuance. Thus, global bonds may be traded either in domestic or foreign markets. For example, a global bond could be both issued in the United States and denominated in US dollars. Global bonds are usually issued by entities that have high credit ratings. By offering the bond to a large number of investors, a global issuance can reduce the borrowing cost.

For the first time, global bonds were issued by the World Bank. This bank sold global bonds denominated in US dollars to the tune of \$1.5 billion in the North America, Europe and Japan simultaneously. The World Bank managed to attract financial means lowering the interest rate by 0.225 percentage points. Although 0.225 percentage points may not seem like an impressive figure, the result received after multiplying this figure by \$1.5 billion demonstrates that the bank reduced its debt expenses by \$375,000. Inspired by the World Bank success, many other large organizations such as *Matsushita Electric*, *Citigroup* and *Household Finance* also issued global bonds.

There are some other opportunities in the international bond market. For example, a borrower can pay interest rate in one currency and loan principal – in another currency. A borrower also can secure a lower interest rate through providing protection from inflation connecting loan principal payment to the price of gold or *Special Drawing Rights*²⁴.

²⁴ Special drawing rights (SDRs) are supplementary foreign exchange reserve assets defined and maintained by the International Monetary Fund (IMF). Not a currency, SDRs instead represent a claim to currency held by IMF member countries for which they may be exchanged. As they can only be exchanged for Euros, Japanese yen, UK pounds, or US dollars, SDRs may actually represent a potential claim on IMF member countries' nongold foreign exchange reserve assets, which are usually held in those currencies [57].

The Eurobond market, as the Eurocredit market, is characterized by high level of competition therefore borrowers in many cases have the opportunity to attract funds on beneficial terms. Lump-sum transactions, creditworthy of borrowers and independence from regulatory rules, which are compulsory in the domestic capital market and fulfillment of which entails significant expenditures – all these expedite the lowering of interest rates for such credits.

Global share market. Such factors as the strengthening of the role of multinational companies and development of telecommunication technology led to globalization of the corporate share market. Opportunities for startups are not restricted any more by only internal sources. For example, Switzerland pharmaceutical companies are major sources of equity capital for new American companies developing biotechnology. Penetrating to a foreign market a company can prefer to attract funds for its subsidiary from this market. For example, *Walt Disney Company* sold 51% of shares in its project *Disneyland Paris* to French investors. Many multinational corporations also register their common stocks with several stock exchanges.

Another new method of attracting capital is the formation of a country fund. A *country fund* is a mutual fund that invests predominantly or exclusively in the securities of a single country. While a single-country fund may be diversified in other ways (for instance, it may hold both stocks and bonds), it is usually exposed to political risk. Some analysts argue that in an age of globalization, there is little difference in single-country and multi-country funds, but others dispute that.

Globalization of financial services to a considerable degree contributed to globalization of share market. Most companies specializing in providing financial services (such as *Merrill Lynch, Daiwa Securities, Deutsche Bank*) expanded their activity from internal markets to the major world financial centers. These companies vigorously strive for providing their clients in different parts of the world such services as attracting funds, investment counseling, security market analysis and complex financial transactions.

To raise money in more than one market, some corporations use *Global Depositary Receipts (GDR's)* and *American Depositary Receipt (ADR's)* to sell their stock on markets in countries other than the one where they have their headquarters.

A *Global Depositary Receipt (GDR)* is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account. GDR's represent ownership of an underlying number of shares. Global depository receipts facilitate trade of shares, and are commonly used to invest in companies from developing or emerging markets. The GDR's are issued in the currency of the country where the stock is trading. For example, a Mexican company might offer GDR's priced in pounds in London and in yen in Tokyo. Individual investors in the countries where the GDR's are issued buy them to diversify into international markets. GDR's let one do this without having to deal with currency conversion and other complications of overseas investing. However, since GDR's are frequently offered by newer or less-known companies, the prices are often volatile and the stocks may be thinly traded. That makes buying GDR's riskier than buying domestic stocks.

An *American Depositary Receipt (ADR)* is a certificate issued by an American bank representing a share of a foreign stock that the bank holds in trust but that is traded on an American stock exchange. An American depository receipt is dollar-denominated and entitles the bearer to any dividends and other benefits associated with the stock underlying it. ADR's can be traded like any other security. ADR's shield investors from foreign exchange risk and any applicable tariffs they would have had to pay if they had bought the stock outright. They also exempt the investor from any other requirements the foreign exchange authority might have levied.

Offshore financial centers. An offshore financial center (OFC), though not precisely defined, is usually a small, low-tax jurisdiction or country specializing in providing corporate and commercial services to non-resident offshore companies, and for the investment of offshore funds. Many leading offshore financial centers are located in small tropical island countries. Many offshore financial centers are current or former British colonies or Crown Dependencies, and often refer to themselves simply as offshore jurisdictions. By some measures, there are more countries that are offshore financial centers than not²⁵ but the following jurisdictions are considered the major destinations for offshore finance: Bermuda, the British Virgin Islands, the Cayman Islands, Jersey, Bahamas, Singapore, Bahrain, the Antilles (the Netherlands). Luxembourg and Switzerland, though not being island countries, also are important offshore financial centers.

Multinational corporations often employ services of offshore financial centers to get credits in Eurocurrency on beneficial terms. Many multinational corporations place their subsidiaries carrying out financial transactions in such centers to take advantage of the opportunities provided by these centers. Political stability, favorable statutory and regulatory climate, streamlined communication lines with other financial centers, also the opportunity to get qualified legal, accounting and financial consulting services to draw up lump-sum integrated credits may be added to the previous advantages. These centers' efficient activity in attracting deposits with the subsequent lending of received funds to clients from all over the world is an important factor facilitating globalization of capital market" [29].

2. The Russian capital market

The place of Russia in the world financial system. Russia has been a member of the *International Monetary Fund* and the *World Bank Group*²⁶ since 1992.

The Moscow International Financial Center (MIFC). "The necessity for development of Moscow as an International Financial Centre became evident in 2008, at the time of global economic and financial crisis. The crisis clearly indicated the critical need for the diversification of the Russian economy, particularly by means of developing a competitive financial sector and a professional financial services market. The President of the Russian Federation Dmitry Medvedev initiated a planned effort aimed at laying the groundwork for the MIFC. *The concept of long-term social and economic development of Russia until 2020* was adopted by the decree of the Government of the Russian Federation (17 November 2008, № 1662-p). This concept envisages the building of "international financial center infrastructure in Moscow". The action plan for the development of an international financial center in Russia was adopted by the decree of the Government of the Russian Federation (11 July 2009, № 911-p).

MIFC is the core of the Russian financial system and an integral part of the global interaction between investors and companies seeking to raise capital. MIFC is an ongoing process, a community effort by the business community, the government and Russian society in general. The catalyst of the project is the desire for professional financial market players to improve the business climate, to make the Russian financial market a viable part of the global market, and to

²⁵ Academics Rose & Spiegel, *Société Générale*, and the *International Monetary Fund* consider offshore centers to include all economies with financial sectors disproportionate to their resident population: An OFC is a country or jurisdiction that provides financial services to nonresidents on a scale that is incommensurate with the size and the financing of its domestic economy. – Ahmed Zoromé, IMF Working Paper.

²⁶ The World Bank Group comprises five institutions: the International Bank for Reconstruction and Development (IBRD), the International Development Association (IDA), the International Finance Corporation (IFC), the Multilateral Investment Guarantee Agency (MIGA), and the International Centre for Settlement of Investment Disputes (ICSID).

boost its attractiveness for foreign investors and issuers. The authorities offer their support by assigning Ministry officials and members of other executive bodies to Project groups.

Turning Moscow into an international financial center is a long-term project. Effective steps towards significant improvement of regulatory and legislative issues are set to be taken over this period. The success of the project will be measurable by objective key performance indicators, such as capitalization growth, improved liquidity, including cross-border trade volume growth and the launch of new financial instruments, as well as by Moscow gaining advanced positions in international financial center ratings.

Globally, the International Financial Center in Moscow will make it much easier for the established capital markets of the USA, Western Europe and China to deal with East European and ex-USSR companies, simplifying the search for new investment opportunities. Moreover, the establishment of a new well-developed international financial center will boost global financial system stability, as financial platforms of this kind contribute to global financial markets becoming more manageable and predictable.

Historically, Moscow's advantage has been its location halfway between European and Asian financial centers, while the absence of language barriers and long-lasting ties with neighbor countries have formed an important regional business center in the capital of Russia. Almost all leading national companies have a presence in Moscow.

Still, there are a number of obstacles faced by MIFC, for instance, rigid legislation and patchy regulation, low credibility from the business community towards law enforcement agencies and the judicial system, an under-developed business infrastructure in the city, a negative perception of the Moscow business climate, and a low possibility of hiring global financial specialists to work in Moscow. These problems are to be solved with the help of government authorities, as well as market players. Moscow ranks #68 in the biannual Global Financial Centers Report by Britain's Z/Yen Group. Weak areas of performance for Moscow are the range of financial services, financial market depth, transparent regulation, security and comfort.

To coordinate the MIFC effort, in 2010 the President of Russia passed a decree to form a special Taskforce headed by Alexander Voloshin. The key function of the Taskforce is to draft and submit MIFC development plans to the President of the Russian Federation as well as to manage joint MIFC efforts by state authorities and financial market professionals" [58].

The Russia's financial ratings. "Russia has moved up one step to 39th place in a global ranking of financial development according to the *2011 World Economic Forum's Financial Development Report*, which analyzes drivers of financial system development in 60 leading economies.

Hong Kong overtook the United States and England to top the list. In terms of the development of its banking services, Russia occupies 57th place, for its financial markets 41st place, and for its financial stability 43rd.

The institutional environment remains relatively weak for Russia, according to the report. The country is particularly hindered by a lack of corporate governance — giving it a ranking of 58th place — and a weak legal and regulatory system (59th). Russia is weighed down by considerable instability in its banking system, putting it in second to last place. There are some positive developments in currency stability (11th), which can be attributed to development advantages in the change in the real effective exchange rate and external vulnerability indicators.

In terms of financial intermediation, Russia continues to show strong results in nonbanking financial services, coming in at ninth place. Healthy mergers and acquisitions and securitization activity drive the solid ranking, the report said.

In terms of financial access, Russia is quite weak in commercial access to capital, ranking 53rd. Russia's rating for corporate governance also went down from last year's number.

The Ukraine received an overall rating of 54, and Kazakhstan 46. Belarus was not included in the ranking process” [59].

The sovereign rating of the Russian Federation assigned by Moody's is Baa1 (stable outlook) and BBB assigned by S&P (stable outlook). Fitch Ratings reported in 2011 that Russia's sovereign rating could be raised in the near future,. Moderating inflation (2011 CPI was 6.775 %) and a drop in the budget deficit (budget surplus was about 1% in 2011) allows Fitch to speak about a possible upgrade of Russia's sovereign rating.

Major indicators of Russian financial market development are shown in table 9.2

Table 9.2

World Economic Forum: The Global Competitiveness Report 2010–2011

#	Financial market development	Rank (out of 139)
1	Availability of financial services	109
2	Affordability of financial services	92
3	Financing through local equity market	107
4	Ease of access to loans	107
5	Venture capital availability	95
6	Restriction on capital flows	119
7	Soundness of banks	129
8	Regulation of securities exchanges	118
9	Legal rights index	103

Federal Financial Market Service of Russian Federation. The Federal Financial Market Service of Russian Federation (FFMS) is the federal executive body that regulates and supervises activity in the financial markets, including stock exchanges. It also regulates the investment of pension savings. The FFMS's key objectives are to maintain stability in the financial markets, make the markets more efficient and attractive to investors, increase market transparency and reduce investment risks. It regulates the activities of financial market players and establishes the conditions for issuing and trading securities.

“It should be noted that FFMS of Russia has some exemptions related to the lending institutions. These exemptions include the companies which FFMS of Russia cannot establish prudential measures for and regulate the issue of the their securities. The authorities of FFMS of Russia do not cover the matters of issue and circulation of the governmental and municipal securities.

Central Bank of Russian Federation. As the entity responsible for the arrangement of the currency circulation and banking stability in Russia, the Bank of Russia is vested with some powers that affect the securities market or involve securities market participants. Thus, in cooperation with the RF Government, the Bank of Russia elaborates and implements the uniform monetary policy that affects many of the parameters of the securities market. For the purposes of monetary policy implementation, being a major player on this market, the Bank is represented as the issuer of its own bonds and conducts operations on the open market with the governmental securities and its own bonds. As a bank system regulator, the Bank of Russia specifies the

features of the procedure for issue of the lending institutions' securities and registers the issues of the relevant securities. The Bank provides banking control over the activities of the lending institutions and banking groups including the relevant operations thereof as the investors on the securities market. Regarding the operations of the lending institutions, as the professional participants of the securities market the Bank of Russia actually establishes the rules of specific co-operation to be conducted (for example, depository accounting rules, etc.). Finally, the Bank of Russia provides 'indirect management' of the securities market by its involvement in providing for capital for the infrastructure entities on the securities market (e.g. MICEX). The Bank of Russia also establishes banking operation rules and rules of accounting and financial reports for the RF banking system. So, although the regulatory authorities of the Bank of Russia over participants in the security market directly cover only the lending institution operating in the market, the general influence of this institution is fairly profound in the market. Using above powers the Bank of Russia is basically the second national regulator of the securities market in terms of value.

Ministry of Finance of the Russian Federation. Based on the Regulations of the Ministry of Finance of Russian Federation (approved by the RF Government Resolution No. 329 dd. 30.06.04) this Ministry performs a number of functions related to the securities market and its participants. First of all, Ministry of Finance of Russia approves the terms of issue and circulation of the federal governmental securities, and decisions made on the offering of the specified issues of such securities, and reports related to the results of such offering. In addition to that, the Ministry of Finance of Russia operates as the issuer of the federal governmental securities as well. The Ministry of Finance is represented as the regulatory body for governmental securities of the constituents of Russian Federation and municipal securities since it maintains the state registration of the terms of issue and circulation of such securities, and it approves the standards of disclosure of the information on such securities. Moreover, the Ministry of Finance of Russia remains the regulator in the field of pension saving investments for financing of the funded part of the pension and regulator for the insurance companies for investments in securities as well (supervisory functions related to the insurance companies are performed by the Federal Insurance Supervision Service which is subordinated to Ministry of Finance of Russia.). Also, the Ministry of Finance of Russia accepts regulatory legal acts related to issues of accounting and financial reports and accredits the rating agencies upon request" [60].

Self-Regulating Organizations. On the Russian market there are a number of self-regulating organizations that unite professional market participants and work out uniform standards for their members' activities. They are *PARTAD*, the *Professional Association of Registrars, Transfer Agents and Depositories*; the *National Securities Market Association (NSMA, abbreviation in Russian – HΦA)* which unites banks and professional participants of the securities market; and the *National Association of Stock Market Participants (NAUFOR)*, whose members also include non-banking professional participants in the securities market.

Capital markets. The capital market and transactions with securities are primarily regulated by the Law "On Securities" and the Law "On Protecting Investor Rights"²⁷. Offerings of corporate securities are regulated by the Law "On Joint-Stock Companies"²⁸ and by a number of regulations issued by the Federal Service for Financial Markets – the Russian securities market watchdog.

The Russian securities market is represented by two major stock exchanges: the *Russian Trading System (RTS)* and the *Moscow Interbank Currency Exchange (MICEX)*. RTS is for trading

²⁷ Federal Law No. 39-FZ of 22 April 1996 "On the Securities Market" and Federal Law No. 46-FZ of 5 March 1999 "On Protecting Investor Rights and Interests on Financial Markets"

²⁸ Federal Law No. 208-FZ of 26 December 1995 "On Joint-Stock Companies"

shares, while MICEX is for trading bonds. The RTS stock exchange is Russia's leading stock exchange in terms of product offerings. It also calculates the RTS Index, widely used as an indicator for the Russian securities market. MICEX organizes stock transactions and foreign exchange trading and develops the derivatives market. MICEX is the largest exchange in Russia, the CIS and Eastern Europe.

Dual Stock Exchange or Stock Exchanges Merger. Currently MICEX and RTS work under one name (MICEX-RTS). MICEX and RTS stock exchanges have finally united at the end of 2011. This event had been expected since 2008. Though, only names and organizations have integrated on a new platform by this date; participants barely feel any changes: they work with the same services and under the same conditions. The joint stock exchange infrastructure that was a reason for the exchange integration is still a project. The exchange officers promised to provide a detailed plan of the integrated infrastructure introduction at the beginning of 2012. Alexander Voloshin believes that completed MICEX and RTS merger will help establish the International Financial Center in Russia.

Securities in Russia. Under Russian law, a security must be specifically recognized as such in the Russian Civil Code or other relevant laws. The Civil Code recognizes *shares, bonds, promissory notes, checks, deposit and saving certificates, bills of lading, options on shares* and *Russian depository receipts* as security instruments. Most corporate securities should be registered with the FFSM before their placement and circulation. Registration of an issue usually takes about 30 days and requires filing certain information and documents with the FFSM. In a limited number of cases, the Law "On Securities" requires the issuer to register an issue prospectus. Companies that have at any time registered a prospectus are subject to capital markets disclosure requirements.

Fundraising. A Russian company may raise funds by issuing equity or debt securities. Equity securities may be offered to the general public only by open (public) joint-stock companies. Shares of closed joint-stock companies and limited liability companies cannot be offered to the general public.

Under the current rules, the number of shares to be floated on foreign exchanges was capped at 5 to 25% (depending on the type of Russian company and on the exchange's country of incorporation) of the overall issued shares in a company.

The issue and trading of bonds is governed by the Law "On Securities", which distinguishes between secured and unsecured bonds. Secured bonds must be fully secured with a third-party guarantee or with a surety, or with a pledge (or mortgage) over the issuer's and/or third party's securities or immovable property. Only companies that have existed for a minimum of two years may issue unsecured bonds. Russian joint-stock companies may also issue convertible bonds.

The issue of regular bonds should be registered with the FFSM. The current Law "On Securities" provides for a financial instrument called the *stock-exchange bond*. These bonds are distributed to the general public through the stock exchange and issued under a simplified procedure not requiring state registration. To be entitled to issue stock-exchange bonds, the issuer must comply with certain legal requirements.

Together with bonds, Russian companies make extensive use of promissory notes for debt financing. The Russian Federation is a party to the *Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes*.

The Law “On Securities” also provides for a security called the *Russian depository receipt (RDR)*. RDR are aimed at certifying holders’ rights to a specified amount of shares or bonds of a foreign issuer.

Amendments to the Law “On Securities” adopted at the end of 2007 introduced a new type of investor: *qualified investors*, which comprise institutional investors such as brokers, dealers, credit organizations, insurance companies, non-governmental pension funds, *etc.*, as well as other legal entities and individuals that meet certain requirements. Certain financial instruments – for example, units/shares of direct investments funds, venture funds, credit funds and hedge funds – may only be distributed or allocated among qualified investors. Foreign financial instruments that do not qualify as securities in the Russian Federation can only be acquired by qualified investors.

Under amendments to Russian securities law effective as of May 2009, the circulation in Russia of securities issued by foreign companies is only permitted provided that certain requirements are met²⁹.

Generally, foreign participants in the Russian stock market establish subsidiaries in Russia with a 100% foreign capital, thereby becoming eligible for obtaining licenses to act on the Russian stock market as a professional participant.

Foreign issuers may use the Russian securities market as a source of capital by way of placing securities on the Russian stock exchanges, both directly and through the Russian depository receipts (RDR’s). As for the Russian market participants, their rights to foreign securities shall be registered with the Russian depositories that maintain accounts with foreign custodians.

The easiest way to gain exposure to the Russian stock market is by purchasing *US-traded mutual funds, exchange-traded funds (ETF’s) or American Depository Receipts (ADR’s)*. Since these are traded on US exchanges, investors can avoid the complexities and risks associated with investing directly. Some popular Russian ETF’s and ADR’s include:

- SPDR S&P Russia ETF (NYSE: RBL)
- Market Vector Russia ETF Trust (NYSE: RSX)
- Gazprom OAO (ADR) (Pink Sheets: OGZPY)

For those seeking more direct access, many US brokerages offer direct access to Russia's RTS, but often charge higher commissions for international trades. Meanwhile, those looking for full-service Russian brokerages also have many options, including the country's largest brokerage, FINAM [61].

According to the *2011 GSIA³⁰ Russia Security Market Report* the Russia security market has grown at a double-digit rate for the past few years and it is expected to continue at that rate through 2012.

Major indicators and trends of the Russian capital market. “The previous three years became for the Russian securities market the period of testing and examination of its regulatory system, market infrastructure and market intermediaries in relation to the ability to operate under crisis conditions and post-crisis recovery. Starting with the second half of 2009, the market is gradually recovering after a deep fall and is trying to mitigate the substantial effects of the crisis.

²⁹ Please note that under the previous securities legislation, the placement and public circulation in Russia of securities issued by foreign companies was actually prohibited.

³⁰ Global Security Industry Alliance

In a number of indices, in 2010 pre-crisis levels were exceeded. Along with that, in general results from these years do not show gradual dynamic growth and qualitative changes, and in certain areas there began to be seen elements of stagnation. The market has remained vulnerable to global problems. Below are two elements of the Russian capital market – instruments and institutional structure – which are considered as major indicators and trends.

- **Instruments. Share market.** By the end of 2010, the capitalization of the internal share market increased by 25 percent to 960 billion dollars that is comparable to the results of 2006.

Calculation of capitalization does not take into account the capitalization of Russian depository receipts representing shares of *United Company RUSAL* which are traded on the Russian stock exchanges. Compared to GDP, the capitalization remains at the high level of 60 percent although that is considerably less than the results of 2006–2007. Capitalization concentration is trending downwards but still remains quite high. The share of the ten most capitalized issuers in capitalization is 60 percent. Capitalization of issuers which belong to oil and gas production and processing turned out to be less than a half of the total capitalization of the internal share market (44.6 per cent).

Looking back five years there has been an increase in capitalization of metallurgical and financial companies as well as chemical works. The volume of transactions of shares on the internal exchange market in 2010 (ignoring *repos*) comprised 16.7 trillion rubles (about \$557 billion) that is about 5 percent more than the one a year ago when this index had reached its historical maximum. 2010 also saw a recommencement of growth in the volume of *repos* with shares: at the end of the year, the volume of such transactions comprised 49 percent of the total turnover of share trading in the internal exchange turnover. The focus of the internal exchange turnover on shares of certain issuers remains extremely high, despite the stable tendency downwards: the share of the ten most liquid share issuers amounts to 87 percent of the total turnover and the share of just two issuers (OAO *Gazprom* and OAO *Sberbank of Russia*) is over a half of the turnover. The ratio between trading volumes of Russian companies' shares on internal and foreign markets stays at the traditional level from 30 to 70 percent.

Table 9.3 contains summary data on the number of share issuers and the number of registered issues of shares as at the end of the period on an accrual basis from the beginning of incorporation of joint-stock companies.

Table 9.3

Share issuers in 2005–2010

Period	Number of joint-stock companies	Number of issues
2005	460 352	463 206
2006	471 010	473 881
2007	481 372	483 244
2008	487 765	490 645
2009	522 968	525 905
2010	529 132	532 125

Table 9.4 shows the list of ten most capitalized companies. Share trade is focused mainly on this quite a limited range of instruments.

Table 9.4

The list of ten most capitalized Russian issuers (at the end of 2010)

No.	Issuer	Capitalization (billion dollars)	The share in total capitalization (per cent)
1	OAo Gazprom	150.7	15.8
2	OAo Sberbank of Russia	76.5	8.0
3	OAo NK Rosneft	76.4	8.0
4	OAo LUKOIL	48.7	5.1
5	OAo MMC Norilsk Nickel	45.1	4.7
6	OAo TNK-BP Holding	41.6	4.4
7	OAo Surgutneftegas	41.4	4.3
8	OAo Bank VTB	34.7	3.6
9	OAo NOVATEK	33.1	3.5
10	OAo NLMK	28.1	2.9
TOTAL		576.3	60.4
Total capitalization MICEX		954.4	100.0

Figure 9.1

Trading volumes of depository receipts and Russian issuers' shares depository receipts of which were traded on foreign exchanges in 2005–2010, per cent

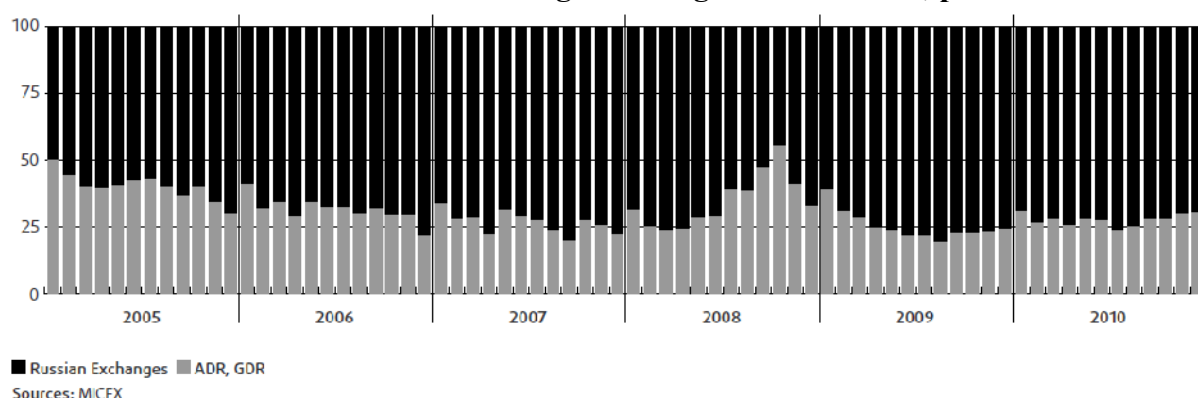
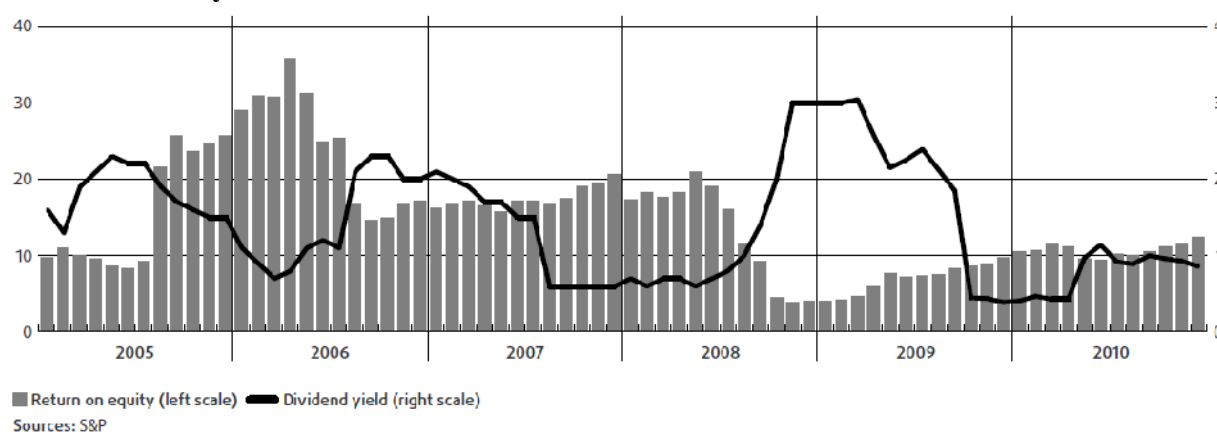


Figure 9.2

Dividend yield and the index of return on Russian issuers' shares in 2005–2010



Corporate bonds. 2010 kept the tendency of decline in the number of market issues of corporate bonds, which had appeared in 2008 (refer to table 9.5 below). At the end of 2010, the number of issuers of market bonds comprised 364 companies which was reduced by 10 percent over the past year. Compared to 2007, when the number of issuers had reached its historical maximum, it decreased by 20 per cent. Along with that, the number of issues of market bonds comprised 663

issues or an increase of 5 percent from the beginning of the year. So, the progressively smaller number of issuers make frequent borrowings on the debt market.

Table 9.5

Number of corporate bond issuers and issues in 2005–2010

Period	Number of bond issuers	Number of bond issues
2005	230	302
2006	370	488
2007	465	607
2008	463	650
2009	405	630
2010	364	663

At the end of 2010 the volume of corporate bonds in circulation comprised 3,000 billion rubles (\$100 billion) which is an increase by 18 percent over the previous year. Nevertheless, compared to GDP, the corporate bond market remained almost at the same level and comprises only 6.7 percent of the GDP. New issues of corporate bonds are distributed extremely irregularly and depend on the economic situation both in the country and in the world. The Russian corporate bond market features offering and circulation of these bonds mainly in formal trading. Exchange trade of corporate bonds is engaged in MICEX and RTS but the main trading floor for public offering of corporate bonds is MICEX.

In recent years made visible a tendency of issuers became visible as they increased their concentration in the corporate bond market. In 2010 over a half of the secondary exchange turnover accounted for the share of ten largest bond issuers. It should be stressed that the list of the most liquid corporate bonds was subject to more noticeable changes than the list of the most liquid shares. In the recent years the only bonds which are invariably in this list are bonds of OAO Russian Railways. In 2010 corporate bond duration increased by 60 per cent and reached the level of 650 days. In 2007-2008 a new instrument, that is *exchange bonds*, appeared in the corporate bond market. Issue of *exchange bonds* does not require state registration and placement report, these functions are transferred to stock exchanges which significantly shortens the period from the decision to issue to the commencement of their circulation. In accordance with MICEX, for this period 445 issues of exchange bonds were issued by 107 issuers to the amount of 1.7 trillion rubles (about \$57 billion). Table 9.6 shows data on ten bond issues and ten bond issuers the volumes of exchange transaction which were the largest in 2010.

Table 9.6

List of issuer transactions with corporate bonds which were the most active on MICEX (at the end of 2010)

No	Issuer	Volume of transactions (billion rubles)	Percent share of the total trading volume
1	OAO Russian Railways	4,044.3	16.7
2	OAO AHML	2,111.2	8.7
3	OAO Stock Company Transneft	1,615.3	6.7
4	OOO SIBMETINVEST	1,254.8	5.2
5	OAO JSFC Sistema	990.2	4.1
6	OAO Russian Agricultural Bank	717.6	3.0
7	OAO Gazprom Neft	701.0	2.9
8	OAO Mobile TeleSystems	697.3	2.9
9	OAO ANK Bashneft	685.1	2.8
10	OAO LUKOIL	683.2	2.8
Total			55.9

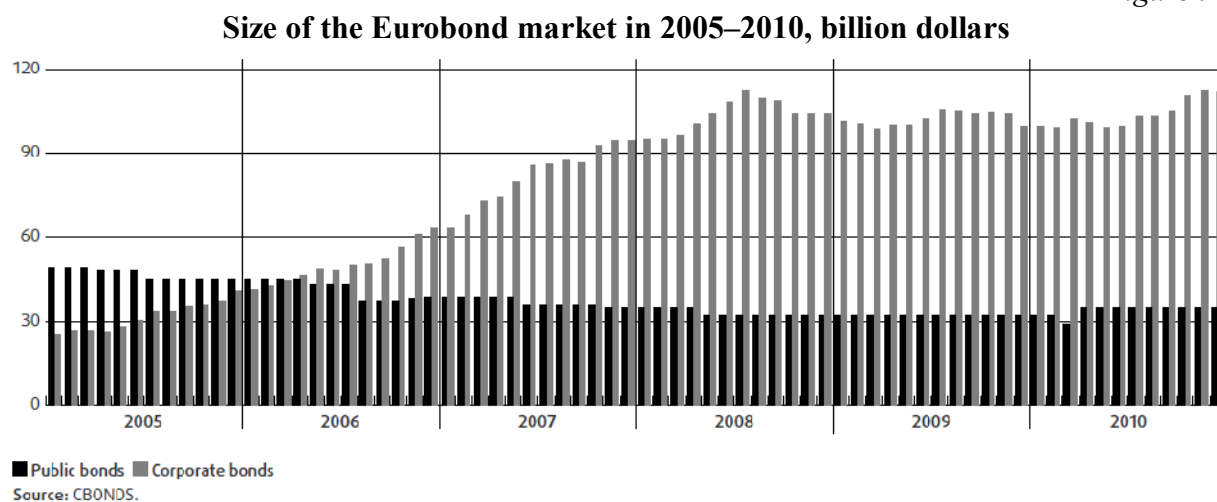
Public, subfederal and municipal bonds, bonds of the Bank of Russia. Fig. 9.3 shows monthly diagrams of the size of the internal public debt market in 2005–2010. In the first half of 2010, the size of the public bond market remained almost at the same level. In the second half year the situation sharply changed: the average monthly increase of the size comprised 5 per cent, and at the end of the year the size of the public bond market at nominal value reached 2,054 billion rubles (about \$68 billion) which is an increase of 39 percent compared to a year ago. The public bond market has not increased so significantly since 2005. Along with that, the size of the public bond market remains minor in relation to GDP and does not exceed 5 per cent. The size of the secondary market and the liquidity of public bonds are small compared to the corporate bond market. The public securities market is organized on MICEX.

Figure 9.3



Eurobonds. Constituents of the Russian Federation and Russian companies attract money for their development on the foreign market through issue of Eurobonds along with ruble bonds. Fig. 9.4 shows general data on the size of the Eurobond market. In accordance with CBONDS (a business information agency), at the end of 2010 the total volume of Eurobond issues comprised 147.8 billion dollars, including 34.4 billion dollars of sovereign Eurobonds and 112.1 billion dollars of corporate Eurobonds. Against this background, the volume of Eurobonds of constituents of the Russian Federation seems to be insignificant, because it stayed for a long time at a level slightly exceeding 1 billion dollars. From spring 2008, the corporate Eurobond market lost a positive tendency, and it was only in autumn 2010 when growth began appearing which ensured an annual increase of market size of 12.7 percent that is 12.7 billion dollars in absolute terms.

Figure 9.4



Bills. Gradually bonds force out such financing instrument as bills, but the bill market is still one of the most significant elements of the internal debt market by its size. At the end of 2010 the

share of the bill market was reduced to 9 percent of the total debt market while in the beginning of 2005 it comprised 25 per cent. Table 9.7 shows estimated data on the volume of issued bills in circulation. So, 2010 saw a revival of the bill market and a 26 per-cent increase in its size. For comparison, in 2008–2009 it was gradually reduced by 12 per cent per year on average.

Table 9.7

Size of the bill market in 2005–2010, billion rubles

Period	2005	2006	2007	2008	2009	2010
Size	350-370	500	580	510	450	570

Investment units. Exchange trade of investment units is engaged at MICEX and RTS. Table 9.8 shows summary data on investment units which are offered on Russian stock exchanges, Table 9.9 shows data on trading volumes of units.

Table 9.8

Formal investment unit exchange market in 2005–2010

Period	MICEX		RTS	
	Number of management companies	Number of unit investment funds	Number of management companies	Number of unit investment funds
2005	33	69	6	18
2006	48	114	10	22
2007	88	219	15	38
2008	99	306	23	49
2009	104	312	21	47
2010	125	365	17	43

Table 9.9

Trading volumes of investment units on MICEX and RTS in 2005–2010

Period	Investment units, billion rubles		
	Total	MICEX	RTS
2005	1.6	1.5	0.0
2006	5.8	5.0	0.8
2007	20.9	20.2	0.7
2008	23.2	23.1	0.1
2009	16.2	16.2	0.0
2010	51.0	31.3	19.7

Futures and options on securities and stock indices. At the present time, exchange derivative financial instruments with securities and stock indices as underlying assets are traded on the RTS FORTS derivatives market and the MICEX derivatives market. Table 9.10 shows the instrumental base of the derivative financial instrument market. In accordance with RTS, it should be noted that general reduction of instrumental base of the spot market leads to reduction in the number of exchange-traded contract types by 20 per cent per a year on the average.

Table 9.10

Formal market of derivative financial instruments on security assets in 2005–2010

Period	MICEX			RTS		
	Futures	Options	Total	Futures	Options	Total
2005	0	0	0	8	5	13
2006	0	0	0	11	6	17
2007	1	0	1	25	11	36
2008	1	0	1	21	14	35
2009	5	0	5	21	14	35
2010	5	0	5	18	9	27

Table 9.11

Trading results of contracts on securities and stock indices on MICEX/RTS derivatives market in 2009–2010

	FORTS		MICEX	
	2009	2010	2009	2010
Futures contracts				
Trading volume, billion rubles:	11 794	23 257	61.798	1 085.25
<i>incl. index trade</i>	<i>9 664</i>	<i>20 682</i>	<i>49.959</i>	<i>895.62</i>
<i>incl. share trade</i>	<i>2 130</i>	<i>2 575</i>	<i>11.839</i>	<i>189.63</i>
Trading volume, million contracts:	399	454	1.351	18.87
<i>incl. index trade</i>	<i>150</i>	<i>227</i>	<i>0.396</i>	<i>6.24</i>
<i>incl. share trade</i>	<i>249</i>	<i>227</i>	<i>0.955</i>	<i>12.63</i>
Number of transactions, million items:	70.6	107.5	0.308	6.61
<i>incl. index trade</i>	<i>43.6</i>	<i>70.1</i>	<i>0.136</i>	<i>1.90</i>
<i>incl. share trade</i>	<i>27.0</i>	<i>30.4</i>	<i>0.172</i>	<i>4.70</i>
Option contracts				
Trading volume, billion rubles:	436	1 316	-	-
<i>incl. index trade</i>	<i>329</i>	<i>1 197</i>	-	-
<i>incl. share trade</i>	<i>108</i>	<i>119</i>	-	-
Trading volume, million contracts:	18.0	22.3	-	-
<i>incl. index trade</i>	<i>5.1</i>	<i>13.2</i>	-	-
<i>incl. share trade</i>	<i>13.0</i>	<i>9.2</i>	-	-
Number of transactions, million items:	0.8	2.0	-	-
<i>incl. index trade</i>	<i>0.6</i>	<i>1.7</i>	-	-
<i>incl. share trade</i>	<i>0.2</i>	<i>0.3</i>	-	-

Stock Indices. At present time, numerous indices of Russian stock market are calculated by Russian and international organizations: exchanges, information and rating agencies, investment banks, broker companies and so on. The most known among them are **for share market** – RTS Index, MICEX Index, MSCI Russia, FTSE Russia; **for bond market** – Corporate bond index IFX-Cbonds, Municipal bond index Cbonds-Muni, Corporate bond index MICEX CBI, Public bond index MICEX RGBI, Municipal bond index MICEX MBI; **for polled investment market** – RUIF Indices, calculated by the National Rating Agency. In 2010 a volatility index was calculated for

the Russian derivatives market for the first time. Fig. 9.5 and 9.10 show diagrams of RTS and MICEX indices in 2005–2010.

Figure 9.5

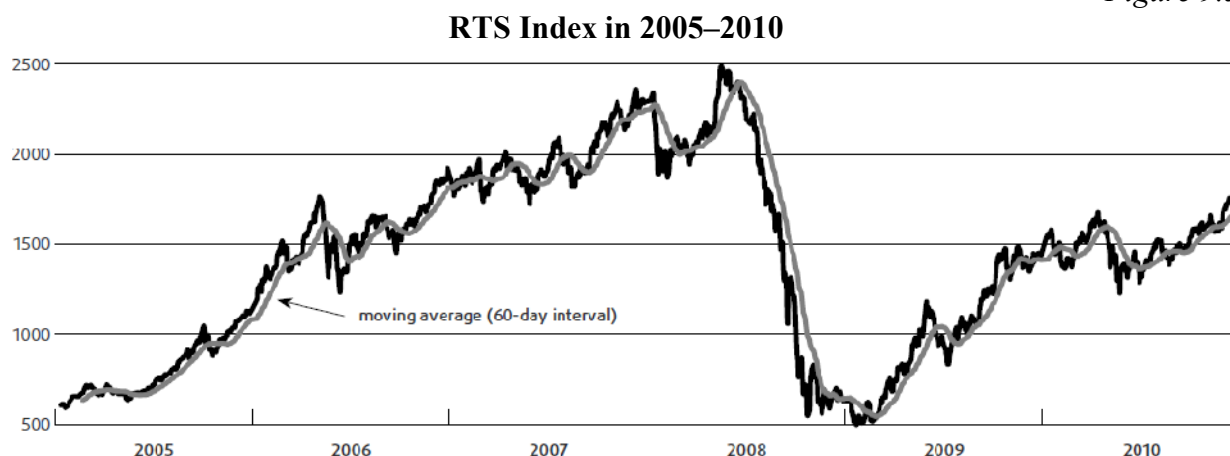
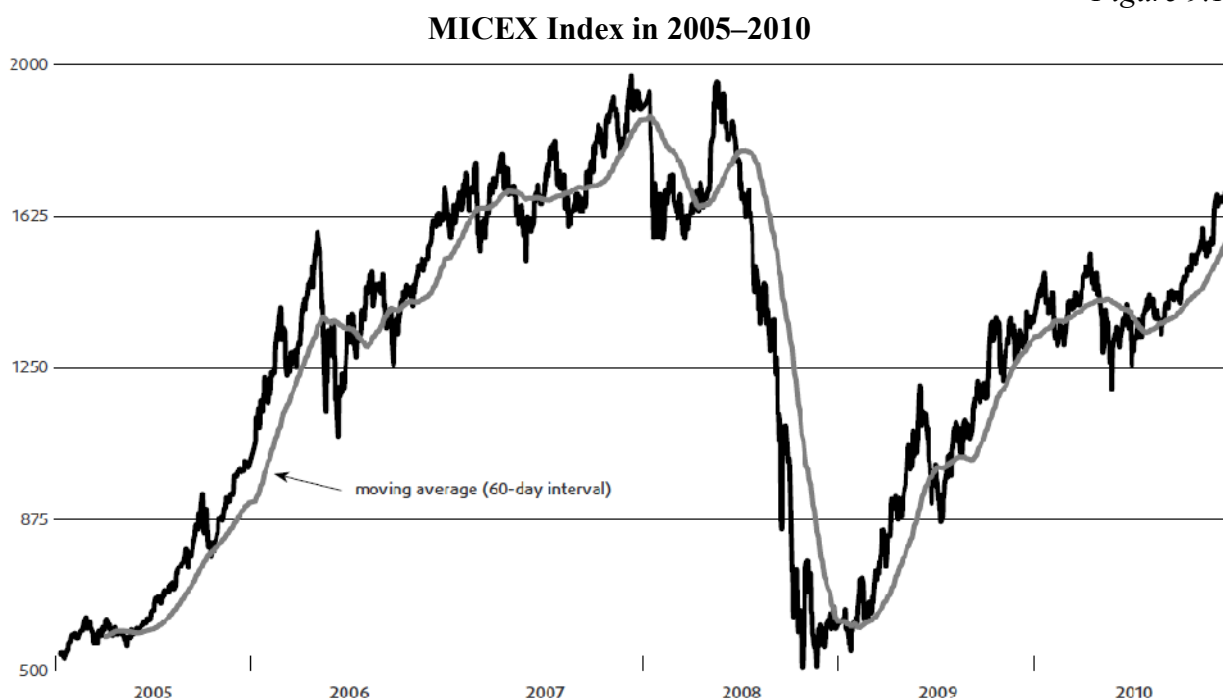


Figure 9.10



- **Institutional Structure. Issuers.** Any joint-stock company is an issuer, for even during its establishment it places shares and is able to register them. A limited liability company and, under certain conditions, a non-profit organization can also be an issuer of bonds. Data concerning issuers of securities, are presented in Table 9.3. The number of issuers (both of shares and bonds) increases at the average rate of approximately 3 per cent per year. However just few issuers of shares and bonds of their total number are presented on formal markets. The number of issuers securities which are admitted to circulation in stock exchanges has declined since 2008 at an average rate of 4-5 percent per year. At the end of 2000, compared to 2007 when the number of issuers had reached its historical maximum, the number was already reduced by 13-15 percent. The number of issuers, securities of which are included in stock exchange quotation lists, is trending upwards in relative terms. During the period from 2005 till 2010, the share of such issuers increased from 24 to 42 per cent in MICEX and from 17 to 24 per cent in RTS.

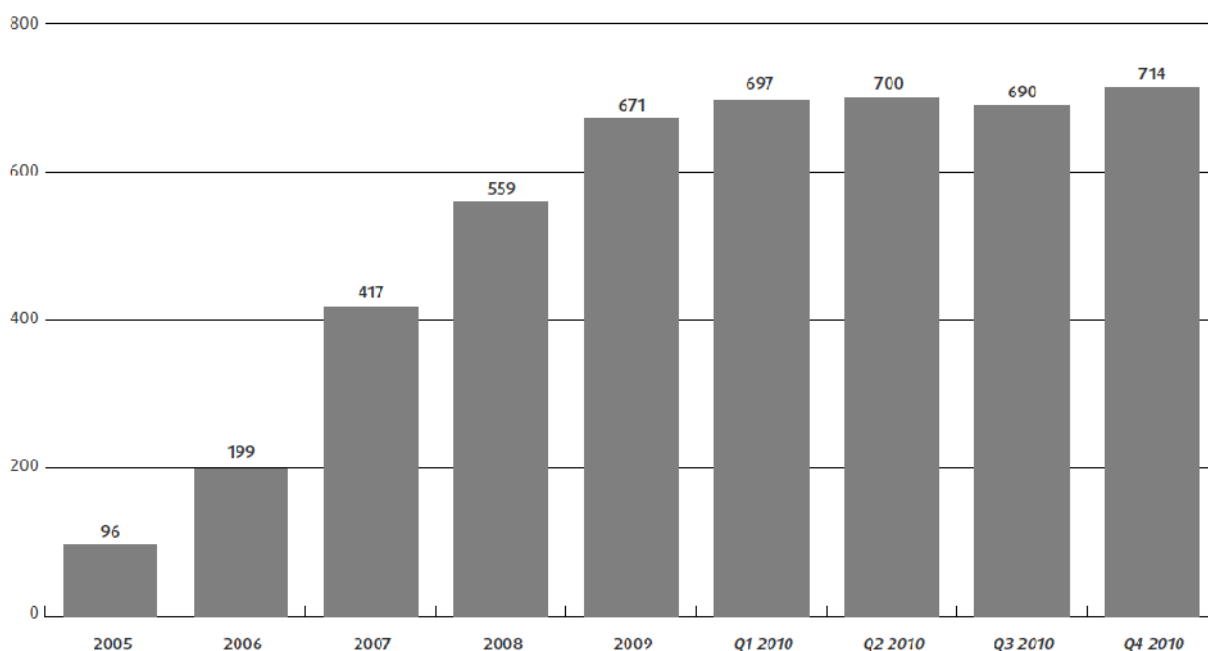
In 2007–2010 laws and regulations were prepared that gave an opportunity for offering and circulating of foreign issuers’ securities and Russian depository receipts on Russian trade floors. The end of 2010 was the first time when offering of foreign state’s bonds – those of the Republic of Belarus – took place (one issue in the amount of 7 billion rubles). Besides, at the end of the year trading began of Russian depository receipts of *OAO Sberbank of Russia* which certified the right to ordinary registered shares of *UC Rusal Plc*.

Investors. Investor means any person or institution that invests money in securities in order to gain profit. There are no official ordered data on the structure and quantitative characteristics of the investor base of the Russian securities market. Nevertheless professional participants of the securities market, self-regulatory organizations and research groups are working on data which will permit accounting and studying of the investor base.

- *Population.* Here population means market investors, who are persons that have consciously decided to invest on the securities market and occasionally employ services of brokers, trustees or have purchased investment units. The MICEX regularly discloses information about the number and structure of traders’ customers, including persons (hereafter referred to as “the MICEX customers”), who have individual identification characteristics (unique customers). Fig.9.10 shows data concerning the number of the MICEX customers – persons (unique customers).

Figure 9.10

Popular participation in investment on the securities market (MICEX customers) in 2005–2010, thousand persons



Source: MICEX.

Unit Investment Funds. From a legal point of view, unit investment funds are property complexes that are not legal entities. Depending on opportunities of a management company to present investment units for redemption, there can be established open-end, interval and closed-end funds. Table 9.11 shows summary data on the dynamics of changes in the number of unit investment funds.

Table 9.11

Number of unit investment funds in 2005–2010

Period	Type of a unit investment fund			Total
	Open-end fund	Interval fund	Closed-end fund	
2005	201	59	121	381
2006	299	86	234	619
2007	455	95	398	948
2008	446	94	457	997
2009	411	85	605	1 101
2010	404	77	770	1 251

Bank-Managed Mutual Funds. A bank-managed mutual fund is an investment product that is offered by credit organizations. A bank-managed mutual fund is a property complex consisting of the property that is delivered in trust management by different persons and the property that is acquired by a trustee in the process of trust management. From the legal point of view, bank-managed mutual funds are similar to mutual funds in essence, but participation in them is not certified by securities. According to available data, there are nearly 30 credit organizations involved in activities on management of bank-managed mutual funds, Table 9.12 shows data on the number of funds and the net asset value.

Table 9.12

Bank-managed mutual funds in 2005–2010

Period	Number of funds	Including funds in rubles	Including funds in currency	Value of net assets, billion rubles
2005	175	122	53	7.9
2006	241	172	69	17.1
2007	277	205	72	21.1
2008	287	212	75	7.4
2009	283	208	75	9.3
2010	283	209	74	8.5

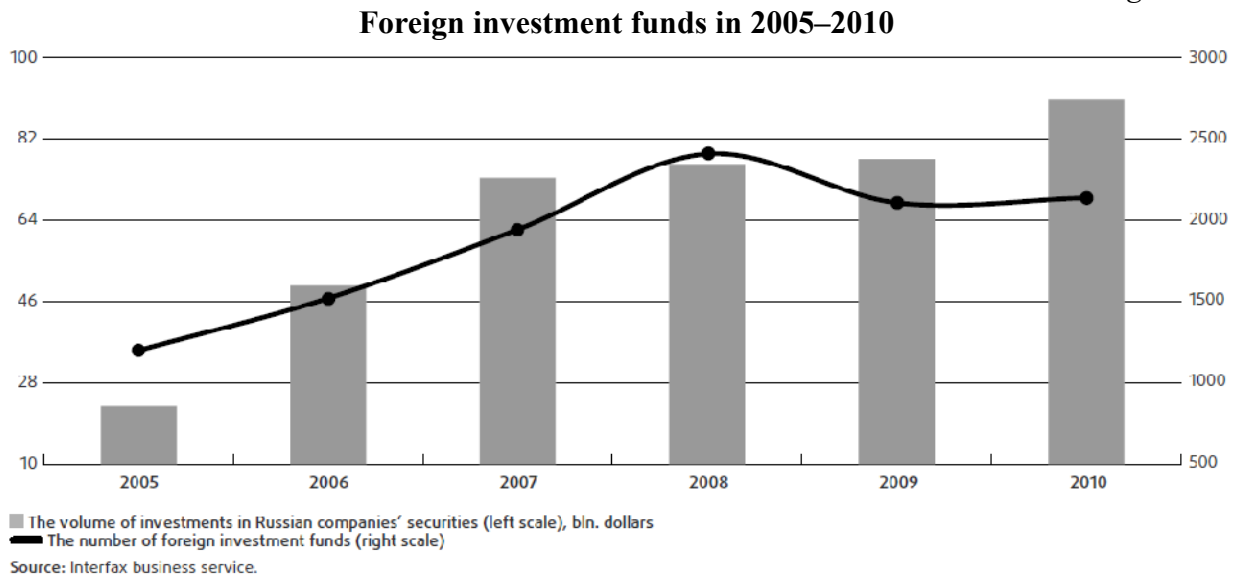
Non-State Pension Funds. In accordance with Federal Financial Markets Service, by the end of 2010, 150 organizations had valid non-state pension fund licenses and 117 funds of them were allowed to carry out compulsory pension insurance activities. During the period, the quantitative composition of pension provision subjects stabilized, while a year ago the number of non-state pension funds declined by over 30 percent. It happened due to the fact that a wide range of funds had their licenses revoked, particularly because of their failure to comply with new requirements to hold sufficient assets to secure a status of statutory activities which since July 1, 2009 had increased from 30 million rubles to 50 million rubles. Pension accumulations which were transferred to non-state pension funds are equal to about 800 billion rubles (\$27 billion).

Commercial Banks. Many Russian banks are professional participants on the securities market. In absolute terms, at the end of 2010, securities in credit organizations' assets were estimated in 5.8 trillion rubles (13 percent of GDP). The annual increase comprised 35 percent. The share of securities in credit organizations' assets varies within quite large limits depending on the capital market environment. Debt securities in the total portfolio of credit organizations' securities traditionally amount to 70 percent.

Foreign Investment Funds. The Russian securities market is a subject of unending interest for foreign investment funds. According to *Interfax Business Service*, in 2010 the number of foreign funds (that disclose the information on their activities) investing in local shares and depository

receipts slightly increased (by 1.5 percent) and amounted to 2,137 funds (refer to Fig. 9.11). During the observed period, the maximum number of funds was seen in 2008 – 2,406 funds, and as for growth rates, in 2005–2008 they were much higher – 26 percent per year on average.

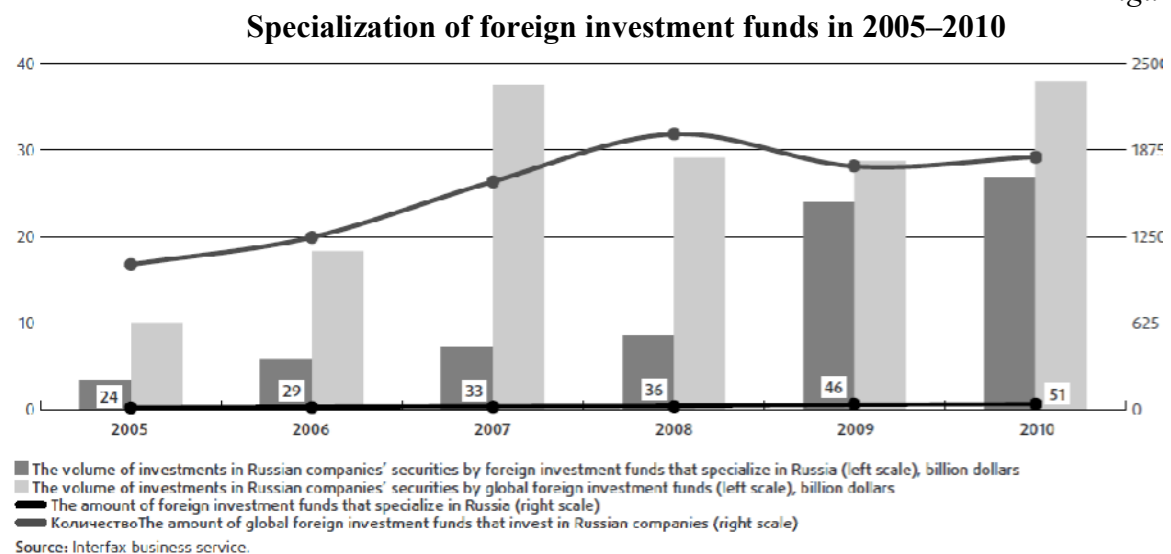
Figure 9.11



The volume of investments in Russian companies' securities (both in local shares and depository receipts) of the funds is trending upwards. In addition, the growth rates largely depend on environment in global capital markets. At the end of 2010 there was a considerable increase in investments of foreign investment funds in Russian companies' securities: it comprised 16.9 percent in relative terms and 13.1 billion dollars in absolute terms. So, the volume of investments in Russian companies' securities reached 90.7 billion dollars. The share of Russian assets in foreign funds is low, 3–4 percent of the total fund portfolio on average. About 70 percent of Russian assets are concentrated in foreign funds in Great Britain and the USA.

There are only a few funds that specialize in Russia (specializing in Russian assets means over 75 percent of the fund assets). From 2005 to 2010 the number of these funds increased from 24 to 51 (refer to Fig. 9.12). There are many more so called global funds where the share of Russian assets does not exceed 10 percent. In 2010 the number of such funds slightly increased to 1,819 funds, which is 8 percent fewer than in 2008 when the number of global funds investing in Russian assets had reached its historical maximum.

Figure 9.12



The volume of assets in the funds that specialize in Russia is constantly growing. In 2010 it continued to grow, compared to the beginning of the year the growth comprised 12 percent and the volume of assets reached 26.7 billion dollars. Though in 2009 the growth was much higher – 175 percent. In 2008–2009, global funds had a reverse tendency: the volume of Russian assets was constantly decreasing there. In 2010 this tendency changed: for the year the volume of Russian assets in global funds increased by 32 percent at once and reached 37.9 billion dollars that is at the level of the pre-crisis 2007. In general, the ratio of volume of foreign funds' investments in Russian assets offered in Russian and foreign exchanges is estimated as 25 to 75 percent.

Except foreign investment funds that disclose the information on their activities, there are foreign hedge funds that also invest in Russian assets; their activity is much less transparent, and that prevents their investments from estimation.

Professional participants in the securities market. In 2010 the total number of professional participants in the securities market performing different types of activities on the basis of certain licenses was reduced by 162 companies in absolute terms and at the end of the year comprised 1,512 organizations. So, for the year the number of professional participants declined by 9.7 percent, almost the same decline took place in 2009 as well. The decline in the number of professional participants in the securities market during two straight years is a consequence of toughening of requirements for proprietary funds and tightening supervisory policy by the Federal Financial Markets Service.

Brokers, Dealers, Trust Managers: Composition of Professional Participants. Russian laws regulate three types of activities of traders which are securities intermediaries: broker activity, dealer activity and securities management. In general, the definitions of these activities correspond with the perception that is accepted on developed markets, taking into account the following reservations:

- A brokerage activity as such does not include an accounting of customers' securities rights, so the brokers that are willing to perform the accounting should obtain a depository activity license.

- A dealer activity only includes the operations of a securities sale that are accompanied by a public announcement of a purchase and/or selling price. That is why the companies that regularly perform securities operations, including the cases when they publicly offer to purchase or sell securities without announcing the price, are free from the regulation.

- A securities trust management differs from a trust management of unit investment funds and non-state pension funds, so there are two different types of licenses for these similar activities.

Brokers, Dealers, Trust Managers: Scope of Professional Activities. Table 9.13 shows the list of traders that performed the largest volume of transactions with non-state securities on MICEX during 2010. 649 organizations participated in trading during the year in total. So, the concentration of the traders turnover is very high on MICEX: the share of the first ten most active traders is 46 per cent of the total turnover, and the share of the first twenty companies is 61 per cent. A year ago, the share of the first twenty companies was 64 per cent of the turnover of non-state securities.

Table 9.13

**List of MICEX traders that performed the largest volume of transactions
with non-state securities (at the end of 2010)**

No	Name of organization	Volume of transactions (purchase and sale), billion rubles	Share in the total volume, per cent
1	VTB Group	10 736.8	9.7
2	Troika Dialog Group	7 040.5	6.4
3	OAo Sberbank of Russia	6 466.1	5.9
4	Renaissance Group	5 310.8	4.8
5	ZAO FINAM	5 017.8	4.5
6	OOO BCS Company	4 438.4	4.0
7	OTKRITIE Group	3 929.7	3.6
8	ZAO CentroCredit Joint Stock Commercial Bank	2 704.5	2.5
9	ALOR Group	2 656.6	2.4
10	Gazprombank Group	2 422.7	2.2
11	OAo Promsvyazbank	2 355.3	2.1
12	URALSIB Group	2 143.6	1.9
13	OOO ATON	1 893.6	1.7
14	OAo NB TRUST	1 575.8	1.4
15	OAo Bank of Moscow	1 519.4	1.4
16	OAo ZERICH Capital Management Investment Company	1 477.7	1.3
17	OOO RONIN	1 447.6	1.3
18	OOO VELES Capital Investment Company	1 442.7	1.3
19	OAo UBRD	1 409.7	1.3
20	OAo MDM Bank	1 374.4	1.2
Total			61.1

Trading and Clearing Infrastructure. The trading and clearing infrastructure of the Russian securities market is formed by professional participants of the securities market that perform the following types of activities:

- Trade organization on the securities market (including stock exchanges)
- Clearing activities
- Depository activities as clearing depositories.

Except that, the infrastructure also includes non-banking credit companies that act as clearing organizations. In the recent years, the number of companies which have licenses to organize trading or stock exchange or clearing license is stable and changes slightly up or down. According to the Federal Financial Markets Service, at the end of 2010 eight companies have licenses to organize trading or stock exchange and eleven companies have clearing licenses.

Chapter 10

Principal Taxes and Tax System

1. International taxation issues

“There is a strong interconnection between accounting procedures and national taxation policy. In many countries (including the USA and Russia), a company’s financial statements constitute a base for calculating its tax liabilities. But there are different approaches to this interconnection in different countries. In some countries (Germany, France), usually there is no difference between financial statements for stakeholders and tax authorities. In other countries (the USA, Russia), companies develop two different packages of statements: one – for stakeholders, another – for tax authorities. Such actions are permitted by the tax legislation and allow firms to utilize special provisions of tax enactments to reduce income subject to tax. For example, American and Russian companies often use accelerated depreciation and amortization for tax purposes but not for developing financial statements. In Germany, companies do not have such an opportunity as a rule. If a German company wants to use accelerated depreciation for tax purposes, it must show this in its financial statements for stakeholders (which reduces the company’s income). Enforced to choose between high taxes and low income in financial statements, German firms in most cases choose the latter. Because of this inflexibility of accounting system, it is more difficult for German companies to attract capital. Though, they address their statements to large financial intermediaries such as banks and insurance companies, these investors-insiders have access to more detailed information about the results of the companies’ activity than information in publicly available financial statements.

Since any company strives to increase its net income (income after paying taxes), its business activity largely depends upon the tax code. With the help of this code, the state not only can increase its profit but also stimulate certain types of activity, such as employability of disabled people or increase in R&D expenses. The structure and amount of taxes can influence decisions on location of business, manufacturing facilities and staff hiring.

International companies, as national ones, strive to maximize their net income. But they also have to observe tax requirements (often contradictory) of all countries where they operate. As a rule, international enterprises should maneuver between taking advantage of tax incentives and getting under punitive penalties. To decrease total tax burden, international companies often use two methods: *transfer pricing* and *tax haven*.

Transfer pricing is the price that is assumed to have been charged by one part (branch or subsidiary) of a parent company for products and services it provides to another part of the same parent company, in order to calculate each division's profit and loss separately. Transfer of goods, technology and other resources between subsidiaries located in different countries is a common practice. According to some estimates, intragroup supply in the USA accounts as much as 40% of all foreign trade in commodities. Transfer prices also refer to the monitoring of the efficiency of structural units of multinational companies and awards (or punishments) of managers responsible for this efficiency (or inefficiency). Apart from this, transfer prices influence the amount of taxes paid by a multinational company both in its home country and other countries where it operates. Practically transfer prices can be calculated by one of the following two methods:

- market method;
- non-market method.

Market transfer prices. This approach implies that prices for goods and services traded between company divisions are determined on the basis of prices in the open market. Market transfer price is the best transfer price (i.e., the price that will maximize the profits of the company as a whole), under the following conditions: (1) a competitive market price exists; and (2) divisions are independent of each other. If divisions are free to buy and sell outside the company, the use of market prices preserves divisional autonomy and leads divisions to act in a manner that maximizes the profits of the company as a whole. This approach has two main advantages.

First, it mitigates the conflict between structural units regarding the price to be used. The higher the price the better will be results of the seller-unit and the worse will be results of the buyer-unit. Disputes between subsidiaries about transfer prices will be proportional to bonuses for managers or investments disbursed by the parent company in accordance with managers' efficiency: managers are interested in the results shown in the company financial statements. However, such disputes, from the standpoint of the parent company, are a waste of resources. On consolidation of financial statements, the total earnings before interest and taxes would be the same regardless whether the transfer price increased company *A*'s earnings and decreased company *B*'s earnings or vice versa. If both subsidiaries recognize that the transfer price they use is a fair market price, the intragroup conflict can be mitigated.

Second, the market approach leads to the increase in total profit of the international company because it facilitates efficiency of the seller-unit. If intragroup trade can be carried out at the market price, managers of the seller-unit realize that its profitability depends on their ability to control their expenditures. Furthermore, they also realize that if they manage to manufacture products cheaper than their international competitors do this and without deteriorating the quality then market pricing will pay off with interest.

Non-market transfer prices. Transfer prices also can be set by non-market methods. The price can be determined through negotiations between the seller-unit and the buyer-unit or in accordance with the established rules on the base of production cost plus fixed premium. Some services provided by the parent company can be priced as percentage of the subsidiary income. Payments for covering corporate overheads or employment of the parent company's technology or intellectual property can be determined this way. Multinational companies usually use non-market transfer prices. Partly this is due to the absence of an external market for some goods and services.

Non-market transfer pricing has both advantages and disadvantages. A disadvantage, for example, is that managers of seller and buyer units can waste time in disputes about transfer prices, which while not influencing consolidated taxable profit of the whole corporation affects reported profit of these subsidiaries. Apart from this, the transfer price on the base of production cost and some fixed premium provides fewer incentives for the seller because in this case any increase in expenses can be passed on to other members of the corporate family.

Nevertheless, strategic use of non-market transfer pricing can be profitable for an international enterprise. On the correct restructuring of intragroup prices, the parent company can diminish the total amount of its taxes. For example, a multinational company can decrease the tax burden of *ad valorem* tariff (tariff based on declared value) through reducing the release price for the buyer-unit thereby decreasing the base for calculating *ad valorem* tariff. Furthermore, an international corporation using such transfer pricing can push down the total amount of its income tax. Let us assume that a multinational company operates in two countries: in one country, the rate of income tax is high, in the second country – low. The company can increase transfer prices for its subsidiary from the country with high taxes and decrease transfer prices for the subsidiary from the country with low taxes. Doing so it decreases the profitability (according

to accounting documents) of the first company and increases the profitability of the second subsidiary. As a result the company profit is transferred from the country with the high rate of income tax (where it should pay more taxes) to the country with the lower rate of income tax (where it would pay fewer taxes) and the total tax burden is decreasing.

The intelligent restructuring of transfer prices also can allow a company to avoid the host country restrictions on repatriation of income. Let us assume that the host country blocks repatriation prohibiting payment of dividends. The parent company can evade this restriction through increasing transfer prices for goods and services produced by its subsidiary in this country and supplied to the company's units in countries without such restrictions. As a result financial means will be transferred from this subsidiary to other structural units in the form of payments for goods and services rather than in the form of prohibited dividends. The final result will be the same: financial means, though in another form, are repatriated from the host country.

The amount of transfer prices is often a compromise between tax consequences and legal restrictions in countries where the company operates. Much research reveals that it is a common practice for multinational companies to transfer tax burden by virtue of transfer pricing. State authorities, such as the US Internal Revenue Service, are well aware of all these opportunities to play accounting games. As a result transfer pricing policy of multinational companies is a subject of careful attention: tax authorities make sure that firms do not evade taxes and the state receives "its fair share" in the form of taxes. Usually state authorities conduct verification of the formal price when they try to determine the price which would be agreed between two independent companies. It is difficult to determine the true price in most cases therefore conflicts between international enterprises and tax authorities happen very often. It is a very rare occasion when such conflicts are settled easily and quickly.

Tax haven. The second way for international companies to minimize their tax burden is to place their operations in so called *tax haven* – a country or a territory where certain taxes are levied at a low rate or not at all while offering due process, good governance and a low corruption rate. For reasonable cost, an international company can establish a subsidiary in such a country having a 100% stake in this subsidiary. Manipulating payments such as transfer prices, dividends, interests, royalties and capital gains, a multinational company can transfer revenues of its subsidiaries in countries with high taxes to the company registered in a *tax haven* thereby driving its revenues out of the jurisdiction of tax collectors in those countries.

For example, an international company can pass title of its trade marks to its subsidiary located in the Cayman Islands. The subsidiary, in its turn, collects payments for the use of these trademarks from each manufacturing subsidiary. Income of these subsidiaries goes down, which in turn leads to a decrease in tax payments. In the Cayman Islands, licensing royalty is not taxed. The same holds true for sales revenue, income, capital gains and dividends. As a result the international company decreases its tax burden.

To attract multinational companies, the tax haven not only should refrain from levying income taxes but also provide a stable political and business climate, an effective legal system and developed banking and telecommunication spheres. The "haven" for its part exists owing to franchising and companies' registration, it also creates many more jobs than usually possible in an economy of such scale.

A tax haven can have a prosperous economy. For example, the number of employees of international companies registered in the Cayman Islands is higher than the number of residents (32,000). If necessary a company can be established and registered there for 24 hours. Companies operating there create demand for highly paid professionals: accountants, bankers,

and lawyers. As a result, the Caymans Islands is a leading banking and financial center of the world. Currently, about 500 banks with total assets of \$500 billion and over 2200 investment funds with total fiduciary assets of \$200 billion are registered there. From the standpoint of the Caymans Islands, the *tax haven* is the most “clean” sector of the local economy, which is a matter of proud for local authorities. On the other hand, existence of such a phenomenon as tax heaven causes many problems for tax authorities of other countries.

Taxation of foreign income in the USA. Taxes in different countries are levied differently, although there are some common features in many developed countries. Let us consider taxation of foreign income in the USA generated by three sources: export of goods and products, activity of foreign branches and activity of foreign subsidiaries.

Taxation of export income. In general, the US Internal Revenue Code (IRC) considers export income as income received in the internal market. However, to stimulate export activity, IRC permitted establishment of *foreign sales corporations (FSC)* for a fairly long period. According to this code such a foreign corporation should carry out a significant portion of its operations – marketing, order processing, extension of invoice, foreign sales and financing – abroad. A company fulfilling all those terms could significantly push down its federal export income tax. However, in 2000, the WTO, in accordance with a complaint of the EU, passed a decree that such tax exemptions provided to foreign corporations violate its ban on unfair subsidies. In response to this, the US Congress repealed the act on foreign sales corporations and passed the *FSC Repeal and Extraterritorial Income Exclusion Act of 2000*. However, WTO again believes that this act violates its rules. The EU has the right to take retaliatory measures until the US has harmonized its IRC with WTO norms. To tell the truth the EU authorities found themselves in an embarrassing situation. If they act too aggressively, this can ruin a fragile political coalition in the US Congress lobbying free trade. Such a result is undesirable for European companies since the American market is very important for European exporters. The situation is aggravated by the fact that the *FSC Repeal and Extraterritorial Income Exclusion Act* is of advantage to American subsidiaries of European multinational corporations. Therefore many European companies call for peaceful settlement of this dispute. As a result the EU is not in a hurry to impose sanctions against the USA.

Taxation of foreign branches income. Foreign branches are a company’s structural units, which do not have the rights of a separate legal entity. Branches operate abroad but since they constitute a whole with their parent company their income therefore is considered as income of the latter. Because of this, income of foreign branches of American companies increases the tax base of the latter regardless whether they repatriate this income to the USA or not.

Taxation of foreign subsidiaries income. Subsidiaries registered abroad as separate legal entities from a legal standpoint have independence from their parent company status. Generally, a parent company in the USA is not obliged to include income of its foreign subsidiaries into the calculation of taxable income if this income is reinvested in these subsidiaries. The Internal Revenue Code provides for the concept of “*deferral*” (or tax postponement rule) in accordance with which such income is taxed only when it is transferred to the parent company as dividends, which allows the company to postpone payments of American taxes levied on the reinvested income of foreign subsidiaries. Deferral is intended to stimulate international activity of American companies. Owing to this rule *Caterpillar*, for example, saves millions of dollars annually; as a result the company has penetrated key markets in Europe and Asia.

However, an important exception to deferral exists today (often referred to as “anti-deferral” regime): subsidiaries registered in a tax haven and designated solely to assist its parent company to postpone taxes are not subject to the rule. According to the US tax legislation a parent

company should determine whether each of its subsidiaries is a *controlled foreign corporation* or not. A *controlled foreign corporation (CFC)* is a foreign corporation in which US persons own more than 50% of the corporation's stock (measured by vote or value) provided that each of stakeholders has not less than a 10% stake in this corporation. For example, *Volvo* as a subsidiary completely belonging to *Ford*, is a controlled foreign corporation, but *Mazda* in which *Ford* has only a 33% stake and other shares which are distributed among Japanese investors is not a controlled foreign corporation.

According to the US IRC income of a controlled foreign corporation is divided into two categories: *active (real)* and *passive* (known as “*subpart F income*”). *Active income* is an income derived from traditional commercial activity such as manufacturing, marketing, and distribution. *Passive income* is earned through passive actions such as collection of dividends, interests, rents, licensing royalties – it is those particular actions commonly performed by subsidiaries in a ‘tax haven’. American companies can postpone active income derived from controlled foreign corporations but subpart F³¹ income cannot be postponed as a rule. If there were no such a restriction, American companies could get income derived from intellectual property and investment portfolio without paying taxes. They would need just to establish a subsidiary in a “tax haven” and transfer its title to trademarks, patents and investment portfolios. Differentiating between active and passive incomes, US authorities clearly demarcate stimulation of international activity of American companies and the limitation of their availability to avoid taxes through establishment of subsidiaries in “tax haven”.

International tax disputes resolution. Countries differ not only in their tax rates but also in definitions of what is the subject of taxation (taxable basis). International companies are accountable to tax authorities of each country where they operate. Requirements of these organs often are contradictory or turn out to be a very heavy burden for a company. Therefore international tax dispute resolution is a very important issue for international entrepreneurs.

Tax credits. Income of foreign subsidiaries often is taxed by authorities of host countries. If the same income also is taxed in the home country, this can be very burdensome for a company and absolutely will not stimulate it to operate in the international market. The country of a parent company can mitigate the burden of double taxation providing the parent company a tax credit (setoff) to the tune of the income tax paid by the international company in the host country. This credit decreases taxes paid by the international company in its home country.

The US IRC, except for a range of exclusions, allows American firms to cut federal income tax by the amount of income tax paid by foreign branches or subsidiaries. Foreign income tax relief cannot exceed the amount of tax levied on international activity in the USA. Nevertheless, in some circumstances companies can carry forward their tax credits into subsequent periods. In many countries where the US direct investments are forwarded to, corporate taxes are higher than in America therefore tax credits only partially compensate the high level of incomes for international companies. Apart from this a tax credit only applies to income tax but not to other taxes like VAT or sales tax. Outwardly concepts considered here are simple, however practically many provisions of the US IRC related to tax credit for taxes paid on foreign incomes are much more complicated. Usually international companies resort to services of professionals knowing all nuances of tax credits.

³¹ Subpart F of IRS deals with the U.S. taxation of amounts earned by controlled foreign corporations (CFC's). It provides that certain types of income of CFC's, though undistributed, must be included in the gross income of the U.S. shareholder in the year the income is earned by the CFC.

Tax treaties. Many countries, eager to develop international trade, enter into international tax agreements. For example, the USA concluded over 60 such agreements with other countries including Russia³² (<http://www.irs.gov/businesses/international/article/0,,id=96739,00.html>). They can differ in details but as a whole many treaties stipulate conditions for cutting taxes levied on repatriation of profits of foreign branches and subsidiaries. Sometimes such treaties are intended to cut total tax burden levied on foreign profit or completely exclude interests and royalties from taxation. As a rule such preferences are provided on a reciprocal basis: country *A* provides tax relief for companies of country *B* only if country *B* will do the same for companies of country *A*.

Foreign companies discrediting. One more source of international tax conflicts is the discrediting of international companies by local politicians, considering that they manipulate transfer prices or in any other ways structure relations between the parent company and its local subsidiary in order not to pay their fair share of taxes. For example, the Japan National Tax Agency is famous for its aggressive policy of transfer pricing control. At the end of 1990s, the agency laid claims to 50 foreign companies accusing them of tax underpayment to the tune of \$492 million due to incorrect calculations of transfer prices. Claims were lodged with such companies as *Novartis*, *Roche*, *Goodyear*, *Coca-Cola* and some others; most of these cases are not closed until now. This activity of the Japan tax authority stimulated demand for services of audit firms. One of “Big Four” firms increased by four times the number of experts on transfer pricing working in its Tokyo office.

The US Internal Revenue Service (IRS) began a similar prosecution of foreign companies when it revealed that only 28% of companies with foreign capital functioning in the US paid American income tax. However, it is still unclear how many companies use both illegal and legal methods of avoiding taxation. At the beginning of 1990's the Internal Revenue Service began to observe more strictly rules for transfer pricing, however, because of exemptions envisaged in tax legislation it managed to collect only 25% of the target sum. Two IRS claims against *Merck&Co* and *Nestle* were dismissed: the court decided that these corporations did not break tax laws. To avoid long and expensive court trials, many multinational companies such as *Matsushita Electric Industrial Co.* preferred to enter into *advance pricing agreements* with IRS in accordance with which parties agreed in advance upon transfer prices for intragroup transactions. Nevertheless, some American politicians recommended obliging foreign companies to pay a minimal sum of income tax calculated on the basis of profitability of their American competitors. Officials from the US Department of the Treasury are against this proposal so far, since they consider it a violation of existing tax agreements” [29].

2. Taxation in Russia

2.1 Tax system and administration.

2.1.1 Tax system. “The Russian tax system is relatively new and many tax concepts and issues that are standard in most market economies are just beginning to emerge in Russia. As new concepts are embraced by the Russian authorities, they are often applied differently than in the West, or in other countries with developing tax systems. Today, tax reform has largely been completed in terms of the codification and elimination of multiple tiers of regulations. The Tax Code of the Russian Federation summarizes the general tax principles, rights and obligations of taxpayers and tax authorities, a description of taxes payable and other provisions.

³² The Convention between the United States of America and the Russian Federation for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, Signed at Washington on June 17, 1992

The government is planning to introduce certain anti-avoidance provisions (including controlled company legislation). In the meantime, guidance from the higher courts lays out several anti-avoidance approaches, including the concept of unjustified tax benefits. The fiscal authorities are beginning to adopt these approaches and crack down on aggressive tax evasion. In doing so, they are beginning to use the substance over form approach. Overall, this is a rapidly developing area. They are planning to introduce certain other concepts including profits tax consolidation and a significant upgrade of transfer pricing rules, to bring them more into line with OECD guidelines.

The most significant change from 1 January 2010 is the replacement of UST (Unified Social Tax) with obligatory social insurance contributions. The assessment rates are flat (26% in 2010, which was the maximum UST rate). In 2010, an individual's taxable salary is capped at RUB 415,000 per annum. One tax base has been established for contributions to all funds. New provisions relating to key elements of the new insurance contribution system generally coincide with the relevant UST provisions. Salaries and other forms of remuneration made to foreign nationals temporarily residing in Russia under employment and civil law contracts are exempt from insurance contributions taxation" [24].

"Companies are required to register with the local Tax Inspectorate (the tax registration will also include registration with the Russian Social Security Funds). Documents for state registration should be prepared and submitted to the local Tax Inspectorate in accordance with Chapter 12 of the August 8, 2001 Federal Law "On State Registration of Legal Entities." An authorized legal entity, the Moscow Department of the Ministry of Finance of the Russian Federation (15, Tulskaia Street, Moscow) provides counseling to business people on registration procedures and registration documents. Further information on company registration, including the list of documents to be submitted, as well as contact information for local tax authorities can be obtained from the following website: <http://www.nalog.ru>

Tax Code. Major revisions of Russia's tax code took place from 1999 to 2003. The resulting tax legislation more closely matches the needs of a growing market economy, and many of the provisions of previous legislation that distorted the business environment and kept many businesses in the shadow economy have been removed. The most fundamental changes were reflected in the new chapters of the Tax Code Part II and affected the value added tax, excise taxes, individual income tax and profits tax. Also affected was the Federal Law "On the Introduction of Amendments and Additions to Part II of the Russian Federation Tax Code and to Separate Russian Federation Legislative Acts." These changes aimed at improving Part II of the Russian Tax Code were passed by the Duma and enacted into law in 2003. The ongoing tax reform has further improved procedural rules and reduced the overall tax burden in the country. Implementing numerous changes in the Russian Tax Code has resulted in some confusion. A general overview of Russian taxes follows, but companies operating in Russia should consult with a professional tax advisor to learn about the latest developments in tax codes" [37].

Administration of the tax system. "The Federal Tax Service, which is responsible for collecting taxes, is subordinate to the Ministry of Finance, which has overall responsibility for collecting state budget revenues and for setting tax policy. Other tax law enforcement bodies include the Federal Agency for Economic and Tax Crimes under the Ministry of Internal Affairs, which is responsible for investigating tax crimes.

Registration requirements. Every legal entity must register with the tax authorities in its place of location, as well as in each location in which it has a branch, a representative office, other separate subdivisions, immovable property or transport vehicles. A foreign legal entity is required to register with the Russian tax authorities in each location in which it carries out activity through a subdivision (regardless of whether the activity is taxable or not) for a period

exceeding 30 days cumulatively during a calendar year. Special registration requirements apply for foreign legal entities which (a) own immovable property in Russia, (b) own transport vehicles in Russia, (c) have movable property subject to taxation in Russia, (d) have opened bank accounts with Russian banks.

2.1.2 Direct and indirect tax burden. According to the Federal Tax Service's official website (www.nalog.ru), indirect taxes compose about 43% of total taxes collected between January and November 2011:

Direct taxes:

Mineral resources extraction tax	32%
Corporate profits tax	6%
Obligatory Social Insurance Contributions	17%
Other taxes	2%

Indirect taxes:

VAT	40%
Excise	3%

2.1.3 Principal taxes. The Russian tax system provides for revenues on three budgetary tiers: federal, regional and local. All taxes are legislated at the federal level, although regional and local authorities have the power to set (or reduce) rates and establish procedures for regional or local taxes. Lower-tier authorities cannot grant concessions with respect to taxes governed by a superior authority (i.e., regional authorities cannot grant concessions on federal taxes).

Federal taxes

- Corporate profits tax
- Value-added tax (VAT)
- Excise taxes
- Personal income tax and
- Obligatory Social Insurance Contributions (that formally remain outside the Tax Code)
- Mineral resources extraction tax
- Payments for the use of natural resources
- Water tax

Regional taxes

- Property tax
- Transport tax
- Tax on gambling

Local taxes

- Land tax
- Individual property tax

Customs duty is governed separately by the Customs Code.

2.1.4 Legislative framework. Taxes, duty and fees are enacted by law and may be changed only by new legislation. Draft laws are developed by the Federal Assembly's lower chamber (State Duma), then approved by the upper chamber (Federation Council) and signed into law by the President. The Russian legal system does not include case law, and each court ruling technically binds only the parties involved. Nevertheless, the Supreme Arbitrazh Court and Constitutional Court issue rulings and guidance for the consistent application of laws and compliance with the main constitutional principles, and this guidance plays an important role in defining the approaches taken by taxpayers and the fiscal authorities.

2.1.5 Tax treaties. Russia has signed and ratified about 80 double tax treaties. These tax treaties are usually based on the OECD Model Treaty (although the UN Model Convention is also still applied by developing countries). Local Russian tax authorities generally do not have much experience in interpreting and applying double tax treaties. Withholding taxes on interest, dividends and royalties are typically reduced by tax treaties. Treaty benefits can be claimed by any entity or person provided that the foreign company's tax residence certificate is available (no advance clearance is required to apply a treaty's provisions). Definitions of a permanent establishment in domestic law and in most tax treaties are largely similar. However, the domestic definition does not require a place of business to be "fixed", unlike most treaties. Some tax treaties provide more favorable rules with respect to certain types of tax deductions when determining the amount of business profits taxable by the Russian Federation (e.g., the German treaty allows for the unlimited deduction of advertising expenses).

2.1.6 Tax returns and payments. Companies are required to file tax returns with the tax authorities on a monthly, quarterly or annual basis depending on the particular tax and the company's line of business. Some taxes (i.e., profits tax, property tax, obligatory social insurance contributions, etc.) are paid in monthly, quarterly or annual installments, with a final adjustment made when annual tax returns are submitted. Companies may choose to calculate the profits tax either monthly (with monthly advance payments calculated based on the actual profits received) or quarterly (with equal monthly advance payments calculated based on profits received during the previous quarter). The final payment for the year is due by 28 March of the following year. The quarterly and annual returns should be filed within the same deadline as the payment due dates.

2.1.7 Assessments. The tax authorities do not issue tax assessments to enterprises. Instead, the company must pay the amount of tax indicated in the tax return.

2.1.8 Withholding taxes. Under the Tax Code, income received by a foreign legal entity and not attributed to a permanent establishment (PE) in Russia is subject to withholding income tax in Russia (to be withheld at source). Withholding income tax rates are as follows:

- 15% on dividends and income from participation in Russian enterprises through investment;
- 10% on freight income;
- 20% on some other income from Russian sources, including royalties and interest;
- 20% of revenue or 20% of margin (24% before 1 January 2009) in relation to a capital gain (from the sale of immovable property located in Russia or shares in Russian subsidiaries where the immovable property located in Russia represents more than 50% of assets). Taxation of the margin (rather than the gross amount of income received from the above sales) can be applied only if the proper documentation of expenses is available.

Tax should be withheld by the tax agent and paid within three days after the date when the income was paid. Income tax withholding rates may be reduced under a double taxation treaty if the foreign company can confirm its tax residence to the Russian tax authorities prior to the date of payment (no advance permission from the Russian tax authorities is required).

2.1.9 Tax audits. Tax returns are desk-audited by the tax authorities upon their submission. The tax authorities also have the right to perform regular field audits of companies. Field audits should not last for more than two months (in some cases they may be extended to four months – for example in audits of "major" taxpayers or taxpayers that have several separate subdivisions – or to six months in exceptional cases), and may cover only three calendar years prior to the year of the audit. Once the tax period has been audited, the tax authorities may not audit the same period again, except when a taxpayer is reorganized or liquidated, or if the respective tax audit is performed as part of a superior tax office's review, or if a taxpayer has filed an amended tax return with a reduced amount of tax due.

2.1.10 Penalties. The law covers a variety of tax violations and establishes penalties for each particular type. The underpayment of taxes may result in a fine equal to 20% of the underpaid taxes (or 40% if intent can be proven). The late filing of a tax declaration carries a penalty of 5% to 10% of unpaid tax per each month of delay in submitting the tax declaration. A number of fixed fines are imposed on a taxpayer for failure to register with the tax authorities or failure to supply them with the required information, etc. Failure to withhold tax may result in a fine of 20% for the tax agent. Interest for late payment is charged at a rate calculated as 1/300 of the Central Bank of Russia's re-financing rate (8.0 % per annum from December 2011) per day. The amount of underpaid tax and late payment interest may generally be collected by the tax authorities without the consent of the taxpayer or a court. However, the collection of penalties requires the ultimate consent of the taxpayer or a court ruling.

2.1.11 Advance tax clarifications and advance pricing agreements. Taxpayers have the right to apply to the Ministry of Finance or the tax authorities for clarification of Tax Code provisions. If a taxpayer follows such clarifications (issued individually or placed in the public domain with respect to similar facts and circumstances), it will be relieved of fines or late tax payment interest. However, obtaining clarifications is difficult and time consuming. Under draft amendments to Chapter I of the Tax Code, taxpayers will be able to conclude advance pricing agreements with tax authorities on the pricing methodology that they can use (for transfer pricing). Advance pricing agreements are not available at present.

2.1.12 Tax litigation

A) Tax dispute resolution at pre-trial (administrative) stage. Tax disputes happen quite frequently in Russia; most taxpayers have to go through the tax litigation process at least once while doing business in Russia. At present, taxpayers can challenge decisions and other documents/actions (or failure to act) of the tax authorities with a superior tax office or in court. From 2009, appealing some tax authority decisions is mandatory before the matter can be brought to court. Unfortunately, few tax disputes are resolved at the pretrial (administrative, superior tax office) stage. Taxpayers cannot negotiate tax audit results or enter into settlement agreements with the tax authorities and usually have to protect their rights in court.

B) Tax dispute resolution in court. Taxpayers can submit claims against the tax authorities with arbitrazh courts (i.e., courts that review and resolve economic disputes mainly between legal entities/entrepreneurs or legal entities/entrepreneurs and state authorities, including the tax authorities). Claims can be filed with a court within three months after a decision comes into force (provided that the taxpayer has gone through the pre-trial stage mentioned above) or after a taxpayer discovers that his rights were violated. Initially, courts of the first instance (level) review disputes and issue decisions. Decisions of a first instance court can be appealed in appellate courts (second level) and cassational courts (third level). The average litigation process (all three instances/levels) usually takes from nine to twelve months. Extremely rarely, can resolutions/decisions of the said courts be appealed in the Russian Supreme Arbitrazh Court" [24].

2.2. Taxation of corporations

2.2.1 Corporate tax system. "Profits Tax. The profits tax is levied on net profits. Effective January 2009, the profit tax rate was reduced from 24% to 20% (18% of this amount is allocated to Regional Russian authorities and 2% to Federal) to address the economic downturn. The regional authorities may, at their discretion, reduce their regional profits tax rate to as low as 13.5%. Thus, the overall tax rate can vary from 15.5% to 20%. Depreciation provisions were improved with the introduction of a 30% initial lump sum depreciation deduction and revision of non-linear depreciation rules. The tax rate was reduced in tandem with the introduction of more realistic interpretations of deductible expenses, the combined effect of which is to significantly

reduce the profit tax burden and support the Russian economy during the financial downturn. The provisions on profit taxation enable foreign companies operating in Russia to benefit from the reduced withholding tax rates and exemptions under Russia's double taxation treaties (the U.S. and Russia have had a double taxation treaty in place since 1992), which in certain cases could result in advantages to U.S. companies. For example, representative offices are permitted to deduct expenses incurred on their behalf by a parent company located abroad” [37].

Taxable entities. “Corporations and their shareholders are taxed separately. The maximum profits tax rate for all taxpayers from 1 January 2009 is 20% (it can be reduced to 15.5% by regional authorities). The corporate income tax system distinguishes between resident legal entities, which pay tax on their worldwide income (credit relief is available for foreign tax paid up to the amount of the Russian tax liability that would have been due under Russian rules), and foreign legal entities, which pay profits tax on income derived through a permanent establishment (at the rate of 20%) and are also subject to withholding tax on income from Russian sources not related to a permanent establishment (at rates varying from 10% to 20% depending on the type of income and the mechanism for its calculation – for more information, please refer to Section 1.8)” [24].

Dividends received by Russian legal entities. “Dividends received by Russian legal entities from Russian or foreign legal entities are taxed in Russia at a 9% flat rate. Dividends received from “strategic investments” are exempt from Russian income tax. An investment is considered strategic when:

- The owner (recipient of dividends) owns at least 50% of the capital of the payer of dividends, or owns depository receipts entitling it to receive at least 50% of the total amount of paid dividends
- The share or depository receipts have been owned for at least 365 days on the day dividends are declared.

An additional requirement related to the value of the investment being at least RUB 500 million (approximately USD 16.5 million) is not applicable for the distribution of dividends based on profits earned in 2010 and later. Dividends from companies residing in offshore zones with preferential tax regimes are not eligible for the tax exemption. The list of the above offshore zones is established by the Ministry of Finance.

Dividends paid by Russian legal entities. The standard 15% tax rate is applicable to dividends paid by Russian legal entities to foreign legal entities. The tax should be withheld by the Russian legal entity paying dividends. The tax may be reduced based on a relevant double tax treaty (typically to 10% or 5%).

Territoriality. A company incorporated in accordance with the laws of the Russian Federation is considered a Russian tax resident. In the future it is proposed that resident status will depend on “place of management” (the timing of this amendment is not clear).

Representative offices/branches of foreign legal entities. Technically, representative offices of foreign companies are only allowed to conduct representation activities, while branches are allowed to conduct trade or business. Whether a foreign company creates a permanent establishment in Russia depends on the scope and nature of its activities, not its legal form.

Permanent establishments. Foreign legal entities pay tax on profits attributable to a permanent establishment (PE). A PE is broadly defined as “a branch, division, office, bureau, agency, or any other place through which a foreign legal entity regularly carries out its business activities in Russia”. Russia’s double taxation treaties may define a PE differently, which could result in tax relief in some cases. Conducting business through an agent may also create a taxable PE in

Russia. A PE's profits are computed on substantially the same basis as for Russian legal entities, including the composition of tax deductible expenses. The Tax Code does not specifically provide for the deductibility of expenses incurred abroad by a head office with respect to its PE in Russia, although most double tax treaties provide for such an option. If a foreign legal entity conducts free-of-charge preparatory or auxiliary services for third parties, a PE is considered to have been formed, and the tax base is calculated as 20% of its expenses relating to such activities. Foreign legal entities operating in Russia through a PE follow the filing and payment schedules established for Russian legal entities, although they do not make monthly advance payments and pay the profits tax on a quarterly and annual basis only.

2.2.2 Incentives. At present, taxpayers may enjoy incentives granted either by regional or local authorities with respect to taxes paid to their budgets, or by special economic zones. Regional incentives are granted to classes of taxpayers (typically large investors or entities operating in specific industries). The extent of regional incentives and the willingness of regional authorities to grant them have been diminishing over time. The following types of special economic zones (SEZ) are available:

- Technical research and implementation zones for scientific projects
- Industrial production zones to develop industrial production
- Tourism-recreation zones for the development of Russian tourism, and
- Port zones.

SEZ residents are entitled to a number of tax benefits, such as reduced profits tax, exemption from property tax and land tax, and exemption from customs duty and VAT in some cases.

2.2.3 Taxable income. Tax base. There are some differences between taxable income and income reported in statutory accounts. Income from the sale of goods, services and securities may be adjusted by the tax authorities in accordance with transfer pricing rules (taxable income may be based on market rather than actual prices). Only "controlled" transactions (please refer to Section 2.5) are subject to transfer pricing analysis. The accounting period in Russia is the calendar year. The taxable base is calculated on an accrual basis (only small-scale taxpayers are still allowed to use the cash basis). Inventory valuation can be carried out by four methods: FIFO, LIFO, average cost and individual cost. The standard profits tax rate of 20% is applicable to all types of income of corporations except for dividends (please refer to section 2.1 Dividends) and interest income on state securities (15%, 9% or 0%, depending on the type of securities).

Securities. The key taxation principles for securities require that the sales price does not deviate substantially from the observable market price for publicly traded securities or the market value computed in line with Russian valuation rules for privately held securities. Only professional securities market participants have the right to deduct securities tax losses from income from other operations without any limitations. Other companies have to calculate financial results from operations with public and private securities separately and may not offset losses from a different basket.

Exempt income. Some types of income are exempt from profits tax:

- Income in the form of property received from a parent which owns more than 50% of shares in the receiving party, or from a subsidiary of which the recipient owns more than 50% of shares
- Income from the revaluation of fixed assets and securities
- Income in the form of property received as a contribution to the charter capital, and
- Income in the form of property received by a shareholder upon distribution of its subsidiary's assets (within a contribution limit).

2.2.4 Deductibility of expenses. Expenses are generally recognized on an accrual basis. The main criteria for the deductibility of expenses is that the expense is (a) incurred in the course of

an income-generating activity, (b) properly documented, and (c) not mentioned in the Tax Code as non-deductible for tax purposes.

Depreciation. Two methods of depreciation are allowed: the straight-line method and the declining balance method. The useful life of assets for tax purposes is established in the Classification of Fixed Assets, adopted by the Russian Government. Accelerated depreciation is permitted for leased property (a special ratio of up to 3 may be applied). An “amortization premium” is allowed, which means that a taxpayer, from 1 January 2009, has the right to deduct (for certain categories of fixed assets) 30% of the cost of fixed assets purchased (or constructed) in the month when depreciation started. A “premium” recorded on assets sold within five years after their acquisition must be recaptured. Intangible assets are amortized over the useful life of the asset (or ten years if the useful life of the intangible asset cannot be ascertained).

Interest. From 1 January 2010, interest expenses are deductible within the following limits:

- The average interest rate on similar loans obtained within one quarter from Russian lenders multiplied by 1.2;
- If there are no similar loans or at the taxpayer’s discretion, the following limits are applied:
 - for loans denominated in a foreign currency: 15%
 - for loans denominated in rubles:
 - if a loan was obtained before 1 November 2009: the refinancing rate of the Central Bank of Russia (8.0% per annum from December 2011) multiplied by 2 (effective as of 1 January 2010 until 30 June 2010).
 - if a loan was obtained after 1 November 2009: the refinancing rate of the Central Bank of Russia multiplied by 1.1.

Bad debts. Losses resulting from writing off bad debts are generally deductible. Companies can also use a bad debt reserve. The method of accrual for a bad debt reserve for tax purposes may differ from that in financial accounting, since it is based only on the overdue payment period – if the delay exceeds 90 days, the full amount of the account receivable is expensed to the reserve.

Employee remuneration. Employee remuneration is generally deductible. Documentation is crucial for deductibility – salary payments and bonuses are only deductible for profits tax purposes if they are set out in labor contracts.

Losses. Tax losses may be carried forward for ten years without limitations (i.e., they can be used to offset the entire taxable profit before a loss carry forward deduction). Carry back is not allowed. Losses from the sale of securities can be credited only to future income from the sale of the same type of securities (publicly traded or privately held). Losses from the sale of fixed assets are recognized evenly over the remaining useful life of the assets.

Non-deductible expenses. The Tax Code establishes a list of non-deductible expenses:

- Cost of assets transferred free-of-charge
- Penalties paid to the Russian budget
- Allowance accrued in financial reporting for revaluation of fixed assets or securities
- Some types of insurance expenses (except those specifically mentioned in the Tax Code)
- Employee remunerations not mentioned in labor contracts, and
- Other expenses.

Some types of expenses are subject to limitations on tax deductibility: entertainment expenses, certain types of advertising expenses, interest on loans and other expenses.

2.2.5 Related party transactions, transfer pricing. Currently, the following rules apply: The tax authorities may examine the prices applied in “controlled” transactions:

- Transactions between related parties
- Barter transactions
- Foreign trade transactions, and
- Transactions in which the prices fluctuated by more than 20% within a short period of time.

The prices used in these transactions may only be adjusted for tax purposes if they differ from the market price by more than 20%.

Russia uses methods of market price determination similar to those described in the OECD guidelines. The three methods available to determine market price are (in order of preference): (1) the comparable uncontrolled price (CUP) method, (2) the resale-minus method and (3) the cost-plus method. Under the Tax Code, the last method takes into account an operational rather than gross margin. On 18 July 2011 the law №227-FZ on new transfer pricing rules were signed by President. The law came into force on 1 January 2012. The main points of the law are the following:

- Significant reduction of the list of transactions where the Russian tax authorities may control prices for tax purposes
- Expansion of the list of related parties
- Burden of proof that the prices of controlled transactions that do not correspond to the market will rest with the tax authorities
- Introducing the arm's length principle as the fundamental principle of Russian transfer pricing rules
- Abolishing the present "safe harbor" provision (the allowable 20 per cent deviation of prices of controlled transactions from market prices)
- Expanding the list of information sources for determining market prices
- Formally introducing a functional analysis as one of the comparability factors
- Introducing new methods for determining market prices. Changes to the existing pricing methods to bring them more into line with internationally accepted transfer pricing principles
- Introducing correlative adjustments for controllable transactions within Russia
- Introducing reporting and transfer pricing documentation requirements
- Introducing special transfer pricing audits to be performed by federal tax authorities
- Introducing penalties for non-compliance with reporting requirements, as well as a penalty for failure to prepare transfer pricing documentation provided a transfer pricing adjustment is made by tax authorities
- Introducing unilateral and multilateral Advance Pricing Agreements (APAs) for companies registered as "large" taxpayers

When determining the market price for comparable transactions, the tax authorities often encounter difficulty, in particular, due to the lack of official data regarding market prices. In some cases, courts may deem as sufficient a document issued by the regional statistical board stating that no information about the market prices for a particular type of goods, works or services is available. However, the tax authorities may try to undertake a more comprehensive search for comparable data, requesting data not only from the statistical authorities, but also from the customs authorities, chambers of commerce and local administrations responsible for price monitoring and regulation. Often, however, it is difficult for the tax authorities to assess the impact of variables such as volume discounts, credit terms and quality differences in determining market prices even for commodities like metals and crude oil. It is even more challenging to address issues such as interest rates on intra-group loans, transactions involving intellectual property or intra-group services. The obligation to prove that prices do not meet the market price benchmark is the responsibility of the tax authorities. However, litigation on transfer pricing is becoming increasingly common, and the taxpayer still has to be prepared to provide the tax authorities or the courts with evidence that their market price estimations are reasonable.

2.2.6 Foreign exchange. Foreign exchange gains and losses are recognized for tax purposes on an accrual basis.

2.2.7 Tax computations. Russian provisions for the elimination of double taxation generally take the form of credit for taxes paid in other countries. For personal income tax and for corporate tax on dividends, credit is granted only if a double taxation treaty is in force.

2.2.8 Energy, utilities and mining specifics. Recognition of exploration expenses for profits tax purposes. Expenses connected with exploring and appraising mineral resource deposits (regardless of whether the results are positive or not) are deducted evenly over a twelve-month period. Expenses connected with preparing an area for mining activities and land reclamation are deducted evenly over a five-year period. At the taxpayer's discretion, expenses related to obtaining a subsoil license may be capitalized in the value of the license (and further depreciated), or they may be deducted within two years after the acquisition of the license.

Mineral Resources Extraction Tax (MRET). The method of MRET calculation depends on the type of mineral resource. MRET for crude oil is calculated using the amount of oil extracted and the MRET rate, determined based on a formula linked to world oil prices and the RUB/USD exchange rate. The MRET rate for 2012 is RUB 446 (approximately USD 15) per ton. For depleted oil fields, a special reducing coefficient can be applied to the standard MRET rate. A zero MRET rate applies to oil extracted from green fields located in certain regions of Russia (e.g., East Siberia, internal and territorial waters located in the northern polar zone, the Azov and Caspian Seas, and the Nenets and Yamal regions) during the initial stage of production, as well as for certain types of extravisous oil. The MRET for natural gas is calculated as the volume of extracted gas multiplied by the flat tax rate of RUB 237 (approximately USD 8) per 1,000 cubic meters of extracted gas. For other mineral resources, the MRET is calculated as the amount of the resource extracted multiplied by the respective ad valorem tax rates: 3.8% for potassium salt, 4% for coal, 4.8% for ferrous metals, 6% for products containing gold, 6.5% for precious metals other than gold, 8% for non-ferrous metals and diamonds, and 17.5% for gas condensate. A zero rate of MRET applies for some resources (e.g., underground water used for agricultural purposes, mineral water used for medical purposes, etc.).

Export duty. The export duty on oil is calculated using a special formula linked to the average global price of Urals blend monitored on a monthly basis. The export duty rate for crude oil for January 2012 is USD 397.5 per ton. Starting 1 December 2009, the Russian Government has established a zero rate export duty for oil produced in thirteen oil fields located in East Siberia (including Vankorskoe, Yurubcheno-Tokhoms koye and Talakanskoye).

Excise tax on oil products. A flat rate excise tax is charged on the sale and import of gasoline, diesel fuel and motor oils. The excise rates for main oil products are established for 2010 at the following rate:

- Gasoline with octane numbers not exceeding "80": RUB 2,923 per ton (approximately USD 99)
- Gasoline with octane numbers exceeding "80": RUB 3,992 per ton (approximately USD 136)
- Diesel fuel: RUB 1,188 per ton (approximately USD 40)

Starting in 2011, the excise on oil products will be levied based on five quality grades, and the rate on higher quality oil products will be reduced compared to lower quality oil products. For 2011 the excise duties are established at the following level:

- Gasoline compliant with standards Euro-5 and Euro-4: RUB 3,773 per ton (approximately USD 128)
- Gasoline of Euro-3 standard: RUB 4,302 per ton (approximately USD 146)

- Gasoline not compliant with any of the above standards: RUB 4,624 per ton (approximately USD 157)

Other payments. Payments for subsoil use depend on the size of the license area provided to the exclusive user of the subsoil, not including mining allotments” [24].

2.2.9 Other taxes. Social welfare taxes. “As of January 1, 2010, the Unified Social Tax was replaced by social security (payroll) contributions to the State Pension Fund, Social Security Fund, Federal Medical Insurance Fund and Territorial Medical Insurance Fund. A business is liable for the entire amount of social security contributions and no amount is withheld from employees. The recent implementation of the change in social welfare taxes has resulted in some confusion, as businesses and government offices make the needed adjustments to the new system. The social security contributions apply at the aggregate rate of 34% (26% in 2010) on an employee’s annual salary of up to RR 415,000 (the threshold may be adjusted in the future by the Russian Government); the portion of an employee’s annual salary in excess of this threshold is exempt from the social security contributions. Social security contributions are payable as follows: 26% to the State Pension Fund, 2.9% to the Social Security Fund, 2.1% to the Federal Medical Insurance Fund, and 3% to the Territorial Medical Insurance Fund. The social security contributions apply to all payments to individuals (including individuals applying a simplified system of taxation) even if made from net income. Importantly, salary or other payments to foreign citizens temporarily present in Russia (i.e., not having a permanent resident permit) are not subject to social security contributions. Social security contributions are paid on a monthly basis and the calculations of the social security contributions are filed with the State Pension Fund and the Social Security Fund on a quarterly basis. Reduced social security contribution rates apply to the following business categories: agricultural producers (20% in 2010, 20.2% in 2011-2012), companies located in special innovative technology zones (14% in 2010, 20.2% in 2011-2012). Workplace accident insurance is paid by the employer in addition to social security contributions. Rates vary from 0.2% to 8.5% depending on the established class of professional risk” [37].

Property tax. “The property tax base includes only the book value of fixed assets recorded on the taxpayer’s balance sheet (including property leased out). Intangible assets, inventories, work-in-progress and financial assets are not subject to property tax in Russia. The maximum property tax rate is 2.2%. Regional legislative bodies have the right to reduce the above rate, as well as to grant property tax exemptions.

Land Taxes. Local authorities may impose a tax on land according to its type and location. The rate is higher in Moscow and St. Petersburg than in some other cities and rural areas.

Excise. Excise taxes apply to the production and import of cars, tobacco, alcohol, petrol and lubricants. Special excise rates for each type of excisable good are established in the Tax Code.

2.2.10 Branch versus subsidiary. Financing. Provision of funds and assets to a branch is not subject to a profits tax. Contributions to a subsidiary are only tax free if they represent contributions to capital or the provision of funds/assets to a more than 50%-owned subsidiary.

Repatriation of cash. The repatriation of cash from a branch to the head office is made without restrictions after a corporate profits tax has been paid at the permanent establishment level. In contrast, the repatriation of cash by a subsidiary is subject to Russian withholding tax (15% on dividends, 20% on interest, etc.) unless exempt or taxed at a reduced rate under a double tax treaty.

Tax consolidation. The main advantage of doing business through a subsidiary with several subdivisions is the option of consolidating their profits and losses for tax purposes. Such consolidation is not allowed for branches of a foreign company unless the activities of branches form a unified technological process and special approval of the Ministry of Finance has been received (uncertain whether such approval is granted in practice). Consolidation of VAT is allowed for branches of both a subsidiary and a foreign company.

Allocation of expenses. Branches with the status of a permanent establishment in Russia are normally entitled to deduct general and administrative expenses incurred by the head office under a relevant double tax treaty, while a subsidiary cannot deduct expenses incurred by the parent company.

2.2.11 Holding companies. The Tax Code establishes a favorable tax regime for holding companies located in Russia. The tax rate for dividends received by Russian holding companies from foreign subsidiaries is 9%. A zero rate is applicable to dividends received by Russian holdings if the participation requirement is met regardless of who pays the dividends (please refer to section 2.1). The tax rate on dividends paid to foreign holding companies is 15% (tax must be withheld by Russian subsidiaries on each payment and may be reduced, in accordance with a relevant double tax treaty).

2.2.12 Thin capitalization rules. Interest on loans received from foreign shareholders (as well as their Russian affiliates, or loans guaranteed by foreign shareholders or their Russian affiliates) owning more than 20% of capital is deductible provided the loans do not exceed by three times the equity allocable to this shareholder (12.5 times for banks and leasing companies). If the loans exceed this limit, the excess part of interest on the loans will be qualified for taxation purposes as dividends paid to foreign shareholders. Such dividends are not deductible for profits tax purposes and are subject to withholding income tax at the rate of 15% (treaty benefits may apply to reduce the rate).

2.3 Taxation of individuals

2.3.1 Territoriality and residence. Tax residence. For both Russians and foreign nationals, tax residence is determined by the number of days a person is physically present in Russia. Under rules effective from 1 January 2007, individuals are tax residents if they spend more than 183 days in Russia, including the days of arrival and departure, during any twelve consecutive months (instead of 183 days within a calendar year, as under the previous rules). However, Ministry of Finance clarifications imply that an individual's "final" tax residence status will still be defined by counting the days spent in Russia within the relevant calendar year. Thus, the approach remains the same as under the previous legislation: in order to benefit from the 13% resident tax rate, a taxpayer should spend at least 183 days in Russia in a calendar year.

Registration. Generally, individuals do not have to register as taxpayers, unless they are obliged to file a Russian tax return, in which case registering as a taxpayer becomes necessary. Individual entrepreneurs do have to register. Foreign nationals staying in the country temporarily are not eligible to be considered entrepreneurs in Russia.

2.3.2 Taxable income. Taxable income is computed as gross income less exemptions and deductions. The following categories of income are subject to taxation:

- Income from employment
- Income from independent activities
- Income from property and property rights
- Income from capital
- Income from real estate transactions, and

- Other income

Tax residents in Russia are liable to tax on their total worldwide income received during the calendar year at a flat rate of 13% (except for dividends and other limited categories of income). Benefits in-kind (accommodation, the provision of a car for personal use, etc.) are treated as taxable income and are generally included at market value (including VAT). Tax residents pay 9% on dividend income and 35% on income derived from winnings, insurance benefits, “excess” interest on bank deposits and selected loans. The deemed “benefit” of receiving a loan at an interest rate lower than two-thirds of the Central Bank of Russia’s refinancing rate, for ruble-denominated loans, or lower than 9% for loans denominated in a foreign currency, is considered a “material benefit”. For foreign currency loans, taxable income is calculated as the difference between interest calculated at 9% and the amount actually paid, and is taxed at a flat rate of 35%.

2.3.3 Non-taxable income. Certain statutory allowances, state pensions, certain compensation payments, alimony, certain types of gifts and material aid are exempt from Russian taxation.

2.3.4 Deductions. There are a number of deductions and exemptions employed in arriving at taxable income for tax residents, the majority of which are immaterial in terms of the derived tax savings.

2.3.5 Taxation of non-residents. Non-tax residents pay 30% tax on income received from Russian sources, including income from working in Russia. Tax non-residents pay 15% on dividends from Russian sources. It may be possible to apply the relevant provisions of a double tax treaty to exempt certain types of income from Russian non-resident taxation.

2.3.6 Tax compliance. Obligations of withholding agents. Income tax should be withheld at source by the employer (the tax agent) on all remuneration paid to individuals. Under the current rules, the responsibility to act as a tax agent lies with Russian legal entities, individual entrepreneurs and foreign legal entities that have separate subdivisions in Russia. In addition to withholding obligations, employers must provide the tax authorities with information on income paid and tax withheld, and notify the tax authorities on income received by individuals from which tax could not be withheld at source.

Tax returns for individuals. An individual is required to file an annual tax return with the Russian tax authorities if they:

- Are self-employed
- Received income from which Russian tax was withheld at the incorrect rate
- Are a Russian tax resident and received income from sources outside Russia, or
- Are entitled to and intend to take an income tax deduction under Russian law.

Personal income tax withheld by a tax agent is credited against the final tax liability for the year” [24].

2.4. Value Added Tax (VAT)

“VAT is designed as a tax to be borne ultimately by consumers, but is collected on a basis similar to the European Union model. VAT is calculated on sales value and is applied at a uniform rate of 18% (before 1 January 2004, the standard VAT rate was 20%), except for certain foodstuffs, pharmaceuticals and children's clothes, which are taxed at 10%. Some products, such as certain financial services and medical equipment, are entirely exempt from VAT. As of January 1, 2008, in an attempt to bolster R&D and investment in technology, intangibles such as inventions, software, industrial designs and production know-how are exempt from the VAT.

Imports are also subject to VAT, calculated based on the customs value of the item plus customs duties and fees. In addition, import duties are assessed at specified rates, ranging from 5% to 30% (as of January 1, 2010, import duty rates for some goods increased with the introduction of the Customs Union between Russia, Belarus and Kazakhstan). They are assessed according to classification and are applied to the customs value of the imported goods, including shipping charges and insurance. Goods imported by foreign partners as in-kind contributions to the charter capital of a new enterprise may be exempt from import duties during a period specified in the charter documents and import VAT under certain conditions (e.g., the goods qualify as technological equipment which has no analogues manufactured in Russia).

In general, goods manufactured or assembled in Russia, whether by a Russian or foreign company, and then exported out of Russia, are not subject to VAT. If these goods are exported before payment is received, then no VAT should be collected. On the other hand, if payment is received before shipment, the exporter must pay the applicable VAT and then request a refund from the tax authorities. Changes in the method of VAT collection for certain entities such as diplomatic missions, effective January 1, 2010, have resulted in some confusion as businesses and government offices make the needed adjustments to the revised system” [37].

2.4.1 Scope of VAT. “All supplies of goods, works and services on Russian territory are generally within the scope of VAT. Goods imported to Russia, construction work done without engaging a third party, and transfers of property rights and goods (works, services) for a taxpayer’s own needs are also subject to VAT. The administrative authority is the Federal Tax Service.

Place of supply of goods. Russia is deemed to be the place of supply of goods when either of the following conditions is met:

- The goods are located in Russia and are not shipped or transported, or
- The goods are located in Russia when shipment or transportation begins.

Place of supply of services. The general rule is that works and services are supplied according to where the supplier has its place of activity. However, there are some exceptions:

- Works and services connected with most immovable and movable property (for example, repairs and maintenance) are deemed to be supplied in Russia if the property is located in Russia
- Services in the area of education, culture, art, tourism and sport are deemed to be supplied where physically performed
- Consulting, data processing, marketing, legal, accounting, advertising services; transfer of copyrights, licenses and similar rights; engineering services; types of provision of personnel and some agency services relating to procurement are deemed to be supplied in Russia if the buyer conducts its activity in Russia. The rules determining whether a business has its place of activity in Russia are complex and should be assessed on a case-by-case basis.

Import VAT. Goods imported into Russia are subject to import VAT. Import VAT is recoverable if the usual VAT recovery requirements are met. However, foreign companies that are not tax registered in Russia are not entitled to recover import VAT.

2.4.2 Zero-rating. A zero VAT rate is applicable (but is not limited to) to the following operations:

- The export of goods to a destination outside Russia;
- The transportation, loading/unloading and arranging of transportation, loading/unloading of exported goods performed by Russian organizations or Russian individual entrepreneurs;

- The transportation, loading/unloading and arranging of transportation, loading/unloading of imported goods performed by Russian organizations or Russian individual entrepreneurs (except for Russian railway carriers);
 - Works (services) related to the transportation of goods in transit;
 - Some goods and services supplied to foreign diplomatic missions.
- Applying a zero VAT rate gives taxpayers registered with the Russian tax authorities the right to input VAT recovery.

2.4.3 Exempt supplies. VAT exceptions apply to a broad range of goods and services, including:

- The lease of premises to foreign lessees or to organizations accredited in the Russian Federation (applies only when the corresponding foreign state offers a similar relief to Russian entities, or when stipulated by an international treaty (agreement));
- Certain banking transactions
- The sale of securities
- Transactions involving medical equipment and medical services
- The transfer of exclusive and non-exclusive rights to software, know-how, databases, inventions, and a range of other rights under a license agreement (trademarks are not covered by the exemption)
- Certain research and development services
- The sale of scrap and waste ferrous metals
- Assignment of loan agreements
- The import of technological equipment (including components and spare parts) that does not have a Russian equivalent

2.4.4 Taxable amount. The taxable amount is normally defined as the market value of goods (works, services) supplied inclusive of excise duty and exclusive of VAT. If the Russian tax authorities consider that the price deviates from the market value of identical goods (works, services) by more than 20%, they may charge additional VAT. When goods (works, services) are supplied free of charge, the price (and taxable amount) is defined as the market value of identical goods (works, services) excluding VAT. The taxable value for import VAT purposes is defined as the customs value (including freight, insurance and other costs incurred prior to the customs border), increased by any applicable customs and excise duties. Russian tax authorities have been focusing on the inclusion of royalty payments into the value of imported goods.

2.4.5 Non-deductible input VAT. The following supplies are specifically denied input VAT deduction:

- VAT on works or services deemed to take place outside Russia;
- VAT on expenses related to non-VATable activities;
- VAT on expenses related to transactions which do not constitute a supply.

VAT cannot be deducted by foreign entities that are not tax registered with the Russian tax authorities.

2.4.6 VAT incentives. Re-export. Goods declared for temporary importation may be granted full or partial relief from import VAT. When temporarily imported goods are re-exported or released for free circulation, import VAT paid under the partial relief regime is potentially recoverable as input VAT under the general rules.

0% VAT rate. The sale of certain goods (works, services) is subject to 0% VAT rate (for more details, please see section 4.2). Input VAT on purchases related to activities subject to a 0% VAT rate is generally recoverable.

VAT refund. If in a particular tax period there is an excess of input VAT over output VAT, the difference is subject to a cash refund or can be offset against current/future tax liabilities. In this case, however, the taxpayer will be subject to a mandatory desk tax audit. For more details, please see section 4.8.

2.4.7 Simplification measures. The entity should not fulfill a taxpayer's obligations if revenue for three subsequent months is less than RUB 2 million. It should be noted, however, that this rule is not applicable for entities performing the sale of excisable goods nor for the import of goods into Russia. Import VAT deferral is possible when importing perishable goods and when importing goods under international agreements.

2.4.8 VAT compliance. Registration. There is no separate VAT registration in Russia, but general tax registration includes registration for VAT purposes. Russian law provides each taxpayer with an identification number applicable for all taxes.

Information in VAT invoices. A VAT invoice containing all the necessary information must be provided in order to recover input VAT. Under the Tax Code, starting from 1 January 2010 minor errors in VAT invoices should not be a basis for Russian tax authorities to challenge input VAT. No separate invoicing requirements are established for export sales. A VAT invoice should be issued within five days after the shipment of goods (supply of goods and services). A duplicate copy of the VAT invoice should be registered in a sales book, and incoming VAT invoices should be recorded in a purchases book. By agreement of the parties, the payment obligation of the recipient may be denominated in a foreign currency. No electronic VAT invoices are accepted. The Russian state authorities are currently considering the possibility of using electronic VAT invoices.

VAT liability. VAT on sales should be recognized on an accrual basis. The time of supply for the supplier is the earliest of: the date of shipment (or, where the goods are not shipped, the date of the transfer of ownership) of the goods, the date of performance of the works or services, or the date of payment. For ongoing or continuous supplies of services, there are no specific rules determining the time of supply. In practice, the tax authorities look to associated documentation – such as certificates of acceptance between the parties – to determine the time of supply for services. For late payment, interest of 1/300 of the Central Bank of Russia refinancing rate is charged for each day of delay on the outstanding VAT amount. For non-payment of VAT, a fine of 20% of the outstanding VAT is charged. The fine can be increased to 40% if the tax authorities consider that the underpayment/non-payment of VAT was deliberate. The Russian tax authorities are entitled to check a taxpayer's activities for three years prior to the year in which a tax audit is initiated.

Reverse charge. The reverse charge (withholding) procedure is applicable to all goods (works, services, property rights) deemed supplied in Russia under the VAT place of supply rules. The Tax Code stipulates that taxpayers who are registered in Russia are obliged to act as tax agents when they acquire goods (works, services) in Russia from non-resident entities/individuals who are not registered as taxpayers in Russia or when they lease or purchase state property. The tax agent must calculate the VAT, withhold it from the payment to the supplier, and remit withheld VAT to the authorities. A Russian tax agent is entitled to recover withheld VAT if such VAT was actually paid by the respective tax agent to the budget and other VAT recovery criteria are met. Under Russian law, reverse charge VAT should be paid by the tax agent on the same day the payment to the foreign supplier is made. With respect to reverse charge VAT, the tax agent (i.e., the Russian buyer) is obliged to issue a VAT invoice on behalf of the foreign supplier.

Returns and payments. All taxpayers are required to file VAT returns on a quarterly basis. The deadline for filing a VAT return is 20 days from the end of the tax period (a quarter). Taxpayers have the option of paying VAT in three installments in the three months following the relevant quarter.

Refunds. VAT on goods and services (work) acquired in order to carry out VATable transactions should be recoverable. Input VAT related to both VATable and non-VATable activities should be allocated between these two types of activities. After allocation, input VAT related to non-VATable activities is generally not to be deducted, unless the related costs represent less than 5% of the total costs incurred by a particular taxpayer. If in a particular tax period there is an excess of input VAT over output VAT, the difference can be refunded or offset against current or future tax liabilities. It should be noted, however, that in this case the respective taxpayer will be subject to a mandatory desk tax audit. The desk audit should be completed by the tax authorities within three months after the submission of the respective tax return. If as a result of the desk audit the tax authorities do not identify any issues, then the offset/refund of input VAT should be executed. If, however, the tax authorities identify issues during the desk audit, the offset/refund is likely to take more time, and the taxpayer may have to sustain its VAT position in court. Starting from 1 January 2010, Russian tax law provides for a simplified procedure for VAT offset/refund prior to the tax authorities' finalization of the tax audit. There is no cross-border refund mechanism for nonregistered businesses. Only entities that obtain general tax registration in Russia are entitled to a VAT refund, provided other requirements for recovering VAT have been met.

Recovery of VAT on advances paid to suppliers. The Tax Code provides for the recovery of VAT on advances paid to suppliers for future supplies of goods (performed works, rendered services) and transfers property rights. This recovery can be made on the basis of VAT invoices issued by the seller, provided that the normal VAT requirements have been met” [24].

Chapter 11

Labor Hiring and Labor Relations

1. International human resource management

“Any organization in the simplest sense, be it a small grocery store or a large multinational corporation, is a combination of work positions, clusters of work positions and interrelations between these work positions. People occupying these work positions are a vital factor of how effectively the organization can achieve its objectives, preserve competitiveness and satisfy its founders. *Human resource management (HRM)* is an activity aimed at the attraction, selection, training, assessment, and rewarding of employees, while also overseeing organizational leadership and culture, and ensuring compliance with employment and labor laws. Human resource managers regardless whether they work for a national or an international company are responsible for the development of policy and procedures providing fulfillment of these tasks.

However, difficulties, which international entrepreneurs and managers encounter, surpass problems solved by their colleagues in national companies. In particular, cultural differences, differences in economic development and legal systems can demand that a company adapt a separate program of recruitment, dismissal, training and remuneration of labor for each country. Especially significant difficulties arise when the culture and laws of the home country are in contradiction with the culture and laws of the host country.

An international company also should determine what should be the origin of the labor force: from home country, from host country or from third countries. The optimal combination (mixed-manned) can be different depending on where the company does its business. It is necessary to take into account local legislation since it can impose some restrictions and dictate certain employment practices. For instance, immigration legislation can impose restriction on the number of visas issued for foreigners; other enactments can oblige a company to hire local nationals to do business in the host country. International companies also face more complicated tasks of personnel training and development. Finally, in different countries, conditions of employment can substantially differ therefore entrepreneurs and managers should adjust their compensation plans to the needs of labor market in each particular country. They have to take into account peculiarities of local laws which can demand, for instance, paying a minimum-wage or providing personnel with certain benefits like annual bonuses, annual and sick leaves or medical insurance.

Performance measurement and amount of compensation are important issues, which exercise influence both on each employee and the company as a whole. Therefore international entrepreneurs should have a thorough insight into these complicated issues before hiring their staff abroad and in their home country.

Performance measurement in the international business. Performance measurement is a process for collecting and reporting information regarding the performance of an individual, group or organizations. It can involve looking at process/strategies in place, as well as whether outcomes are in line with what was intended or should have been achieved. The fundamental purpose behind such measures is to improve performance. This measurement provides feedback to managers, who get an overview of efficiency; it also helps determine criteria for awarding the most effective employees and identify spheres where additional training and development are needed and areas of concern where an employee should be substituted.

Evaluating actual results of managerial activity the company can take into consideration volume of sales, profit margin, market share gains and any other criteria and indicators, which may be important for the company. If a subsidiary experiences difficulties perhaps it would be correct to measure performance according to contributions made by each manager in solving the problems. For example, a decrease in net loss or discontinuation of a market share which is fall could be a good result (at least in a short term perspective).

A company should compare expected and achieved results and find explanations for discrepancies between them. At this stage, there is an element of diagnostics: why is the performance of a manager acceptable? Are problems connected with insufficient skills of a manager? Or are problems associated with unanticipated factors? Does the headquarters bear responsibility for not providing the manager with appropriate training? Of course expectations can be affected by cultural values: in an individualistic culture general results of a company are distributed among individual managers to a greater extent than in a collectivistic society. Therefore measurement of performance is more difficult if an evaluator and the evaluated belong to different cultures.

Amount of compensation in the international business. Another important aspect of international human resource management is the determination of compensation for managers. To preserve competitiveness, companies should provide their managers with prevailing compensation packages. These packages can comprise salary and other payments, the amount of which is determined by such labor market factors as demand and supply of managerial human resources, form of activity, requirements of professional licensing, standard of life, state control, tax legislation and others. For example, in Germany, Great Britain and Russia companies provide their managers either with a company car or car allowance. Managers in Japanese companies, apart from this, receive lump sums for entertainment and business gifts.

The determination of compensation for expatriated managers is a more complicated issue. Most international companies believe that it is necessary to provide such managers with a differential payment allowing for sharp differences in currency value, standard of living, customs, etc. It is especially important when managers relocate from a cheap country to an expensive country or from a country with a high standard of living to a country with a lower standard. Table 11.1 demonstrates differences in the cost of living in cities with high international activity.

Table 11.1

Relative cost of living in some cities of the world

Rating	City	Index
1	Tokyo, Japan	126.1
2	Moscow, Russia	114.5
3	Osaka, Japan	112.2
4	Hong Kong	111.6
5	Beijing, China	105.1
6	Geneva, Switzerland	101.8
7	London, Great Britain	101.3
8	Seoul, South Korea	101.0
9	Zurich, Switzerland	100.3
10	New York, USA	100.0
11	Shanghai, China	98.4
12	St. Petersburg, Russia	97.3
13	Oslo, Norway	92.7
14	Hanoi, Vietnam	89.5
15	Copenhagen, Denmark	89.4

16	Ho Chi Minh, Vietnam	88.5
17	Milan, Italy	87.2
18	Shenzhen, China	86.7
19	Guangzhou, China	86.7
20	White Plains, New York, USA	86.2
<i>Source: Runzheimer International</i>		

Usually a local cost of living allowance is taken as a bench mark to determine the amount of compensation. This cost should compensate the difference between a subsistence minimum in the home and host country. If the subsistence minimum in the host country is lower than in the home country then there is no need for compensation. Sometimes the company should pay its managers more to persuade them to go to an unattractive place like Afghanistan or Columbia. This additional payment is called difficulty bonus or bonus for working abroad.

Finally, many companies should introduce a *tax equalization* system. When one is a taxpayer in one country, but works in another, one may be subject to different taxation than if one had worked in one's home country, or to double taxation, even taking into account tax treaties between countries. *Tax equalization* is the offsetting of any such difference so that working abroad is tax neutral for the worker. Usually the company's accounting department arranges for tax equalization.

International companies should provide their expatriated managers not only with additional payment but also with special benefits packages including medical insurance, annual paid leave, housing, education, trips to the home country and membership in various clubs. If a manager is going to be a permanent resident in the host country then company can buy his house at the fair market price and help him buy a house in host country. If the manager has family, the company can help his wife to find a new job and pay for the education of the children.

Non-managerial workforce management. Standard issues of human resource management related to non-managerial employees – recruitment, screening, training, remuneration of labor, etc. – completely depend on local legislation, the culture and the economic situation. To be successful in the host country, international entrepreneurs should arrange their work in a way desired by local nationals rather than in a way acceptable in their home countries. To make a long story short, when in Rome do as the Romans do.

Recruitment and screening. In foreign units of international companies, non-managerial positions, i.e. positions of production workers (“blue collar workers”) and clerks (“white collar workers”) usually are occupied by representatives of host country. In most cases there is an economic reason for this: the local workforce often is cheaper than the representatives of the parent or third country. Apart from this, local employees are hired because the local legislation very often demands this, although there are exceptions from the rule.

In any case, international entrepreneurs should develop and introduce a plan of personnel recruitment and screening in the host country market. This plan should include assessment of company's needs in human resources, sources of human resources, necessary skills and abilities of employees and their training needs. It also should take into account special circumstances existing in the market. Hiring local personnel an international company should know labor legislation and norms of host country.

Training and development. International entrepreneurs should evaluate needs for local employees training and development to help them fulfill their duties. Requirements for local

collectives training and development depend on several factors. One of the most important among them is the foreign company location. In the developed markets, companies usually can find qualified workers who only need to be acquainted with the company. In relatively underdeveloped regions needs for training can be much greater.

Performance measurement and remuneration of labor. Practice of compensation and measurement of performance of non-managerial employees significantly differs between countries depending on local laws, customs and cultures. In individualistic cultures like in the USA, evaluation is focused on individual results with consequent remuneration of labor. In cultures with group orientation like in Japan, more attention is paid to group training and development rather than to individual evaluation and remuneration. International entrepreneurs should develop and introduce a performance measurement system corresponding to the enterprise's location, type of work and cultural context. Remuneration practice also reflects local laws, culture and the economic situation. Compensation packages for non-managerial employees also include bonuses and benefits programs. Surveys have shown that the specific combination of salaries, bonuses and benefits is a function of national culture. For example, in 41 manufacturing industries in 4 Asian countries, salary accounts for 85 percent of the total compensation package for workers. In the same industries but in 5 "Latin-European" countries, salary accounts for only 56 percent. Correcting the structure of a compensation package international entrepreneurs try to achieve maximum efficiency for workers (and company) per each dollar.

Labor relations. Because of complexity of this element of human resource management, it is often segregated into a separate organizational function standing alone.

Character of labor relations in different countries. Labor relations in the host country usually reflect its laws, culture, social structure and economic situation. For example, in the USA, membership in trade unions has steadily declined in recent years and currently accounts for less than 15 percent of total labor force. In this country, labor relations totally are regulated by different laws encompassing both actions of management relating to workers and actions of workers relating to management. Apart from this, formal labor agreements – compulsory treaties with good standing in law – are concluded between firms and trade unions. Due to comprehensive regulation most of such agreements have a relatively formal and mechanical character: both parties rely on the letter of the law.

In many other countries the situation is exactly the opposite: the percentage of trade unions membership is very high in continues to grow. Outside the USA, over half of all the labor force is involved in trade union activity. In many European countries, trade unions are associated with political parties and their position strengthens or weakens depending on what party controls the government. In search of social support of their demands European trade unions often resort to temporary strikes.

Foreign companies trying to change prevailing labor relations can incur trouble. For example, chain stores *Toys "R" Us* did not want to enter into traditional for Sweden retail trade collective agreement which resulted in a three months strike and an expression of censure by trade union leaders who called the firm's behavior "illegal infringement of Sweden traditions". It is clear that it is not the public image that this company wanted to create. Similarly German trade unions arrange for short but frequent strikes trying to make Wal-Mart satisfy their demands.

In Japan, on the contrary, heartfelt labor relations prevail. Often enterprises themselves establish and run trade unions. Trade unions' leaders and companies' management cooperatively work aiming at common interests. Japan culture does not admit confrontation and hostility and this

attitude is manifested in labor relations. Disputes usually are solved in a friendly atmosphere through the search of solutions satisfying to both parties participating. Even in those rare cases when an intermediary is needed the accepted solution usually does not evoke bitter feelings or hostility. Because of this, strikes are relatively rare in Japan.

A *collective agreement* or *collective bargaining agreement (CBA)* is an agreement between employers and employees which regulates the terms and conditions of employees in their workplace, their duties and the duties of the employer. It is usually the result of a process of collective bargaining between an employer (or a number of employers) and a trade union representing workers. In the USA, as it was said above, the process of entering into collective agreements is completely regulated by law. However, the role of the state in all the rest related to labor relations is relatively passive. The agreement is concluded between the representatives of the trade union and the company's management. It determines labor relations between the parties until its expiration. As a rule, a separate collective agreement is concluded between each firm and each trade union. For example, *United Air Lines* enters into an agreement with the pilot trade union, the flight attendant trade union, the aircraft mechanic trade union, etc. Each of these trade unions enters into an agreement with each airline which employs workers whose interests this union represents.

In many other countries, the government interferes into the process of contract conclusion more actively. In some European countries, representative of several firms, trade unions and state agencies participate in this process. The result is an umbrella agreement applied to entire industries and groups of related trade unions. In Japan, the government usually participates in the agreement conclusion too but it is done at the level of firms rather than industries. Officials rather play the role of observers fixing achieved agreements and answering questions.

Influence of trade unions and co-determination. Influence of trade unions can manifest itself differently including membership, strikes and public relations. In Europe, the role of trade unions is based on the principle of industrial democracy – an idea implying that workers should have the voting right to take part in running the enterprise. In some countries, first of all in Germany, the influence of trade unions extends much further than traditional relations between management and workers. The German approach called *co-determination* promotes cooperation between the management and workforce in the issue of enterprise running.

“*Co-determination* is a practice whereby the employees have a role in management of a company. The word is a literal translation from the German word *Mitbestimmung*. Co-determination rights are different in different legal environments. In some countries, like the USA, the workers have virtually no role in management of companies, and in some, like Germany, their role is more important. The first serious co-determination laws began in Germany. At first there was only worker participation in management in the coal and steel industries (since 1947). But in 1974, a general law was passed mandating that worker representatives hold seats on the boards of all companies employing over 500 people. All such companies have not one but two boards of directors. Shareholders and trade unions elect members of a *supervisory board (Aufsichtsrat)*. The supervisory board is meant to set the company's general agenda. The supervisory board then elects a *management board (Vorstand)*, which is actually charged with the day to day running of the company. The management board is required to have one *worker representative (Arbeitsdirektor)*. The management board's head has the right to cast the deciding vote in instances of stalemate” [62].

The German model is the most conspicuous form of industrial democracy. Similar approaches are used in other countries including Sweden, the Netherlands, Norway, Luxembourg, Denmark and France. In these countries, the work collective should be represented on the company board

in one form or another. However in some other countries like Italy, Ireland, Great Britain, Spain, Greece and Portugal it is vice versa, i.e. compulsory participation of the work collective in the running of the enterprise is not or almost never envisaged.

However, the EU makes efforts to standardize labor relations and control employment and remuneration of labor in member-states. The result of these efforts is an ongoing introduction of a *social charter* (or *social policy*) comprising such issues as maternity leave, work-training and retirement. One of the major social charter motives is to decrease potential migration of the labor force from rich countries, like Germany and Belgium, to countries with low salaries and scarce benefits, like Portugal, Greece and Spain. Reforms of labor relations also have touched countries of the Asia-Pacific region. For example, in Singapore workers received more voting rights in running their company. Japanese workers, though having no rights to manage their company have the most power and control over everything related to their personal work” [29].

2. Labor relations and employment regulation in Russia

2.1 Labor relations

The Russian labor market remains fragmented, characterized by limited labor mobility across regions and the consequent wage and employment differentials. At the beginning of 2010, after the economy started to show signs of recovery from the 2008-09 financial crisis, the unemployment rate as defined by the International Labor Organization still hovered around 9%. By October, however, unemployment had fallen to 6.8%. Traditional, seasonal fluctuations led to mild increases into the beginning of 2011. Employers complain about the low quality of applicants’ skills and labor shortages outside of urban centers. This is due in part to weak linkages between the education system and the labor market. In addition, the economy suffers from a general shortage of highly skilled labor. Employers in regions outside Moscow and St. Petersburg contend with a dearth of available workers. Businesses in these areas are increasing their labor costs as the competition over a limited pool of workers intensifies, particularly in the agriculture sector. On the other hand, a large number of inefficient enterprises with high vacancy levels offer workers unattractive, uncompetitive salaries and benefits.

The government did not register any strikes in 2010. Independent commentators, however, noted 102 protests during that period, including 44 that involved the complete or partial cessation of work. The majority of labor disputes occurred in the manufacturing sector, particularly in machine-building enterprises. Disputes were also common in the transportation and metallurgy sectors. The primary causes of labor disputes were wage arrears, layoffs, and company reorganization or closure.

Labor Code. Employer/employee relations are governed by the Labor Code (which came into force on 1 February 2002) and other special laws. When adopted, it was meant to diminish the role of the government in setting and enforcing labor standards, with trade unions playing a role in representing workers’ interests. However, there are no clear enforcement mechanisms for an employer’s failure to engage in good faith collective bargaining. Revisions to the Labor Code since 2002 have included new procedures for investigating industrial accidents and the requirement that businesses employing more than 50 workers must establish a work safety division and create a position for a “work safety specialist.” The enforcement of worker safety rules continues to be a major issue, as enterprises are often unable or unwilling to invest in safer equipment or to enforce safety standards.

In 2006, the Labor Code was significantly amended (primarily to correct wording ambiguities), and in 2008 was supplemented with a section devoted to the work of athletes and coaches. The Labor Code establishes that the employment relations of all employees working in Russia are governed by Russian legislation (regardless of citizenship or status, or that of their employers,

unless otherwise stipulated by an international agreement). The Labor Code heavily regulates employer/employee relations. The law provides employees with minimum guarantees that cannot be limited by any employment contract or an employer's internal regulations. Any provision in an employment contract or internal policy that runs counter to these guarantees is illegal. There are safeguards to protect employees against dismissal or termination of their employment contract by the employer (prior notice, severance allowances), a harmful working environment and excessive working hours. Employment law makes it very difficult for the employer to dismiss an employee on disciplinary grounds.

Employers. Under the Labor Code, an employer can be an individual or a legal entity. In instances established by federal laws, the employer may be an entity which has been vested with the right to conclude employment contracts. Representative offices and branches are not considered employers.

Unions. Union activity is regulated under the Federal Law "On Professional Unions, Their Rights and Guarantees of their Activities". After the collapse of the Soviet Union and the formation of a market economy during the 1990s, the role of trade unions decreased significantly. Today, unions in Russia are becoming more active and wielding more power over employers. They are initiating collective negotiations and concluding collective bargaining agreements. Under the Labor Code, the employer should take the opinion of the trade union into account before adopting certain internal regulations (i.e., internal policies) or dismissing trade union members.

Approximately 45% of Russia's workforce is unionized. The Russian government generally adheres to International Labor Organization (ILO) conventions protecting worker rights, though enforcement is often lacking. In 2009, the Constitutional Court annulled the Labor Code provision that required employers to consult with a union's central leadership before dismissing elected local union leaders. In 2010, the State Duma amended the Law on Professional Unions in accordance with this decision. Simultaneously, however, the Duma ratified ILO Convention No. 135, which guarantees workers' representatives protection against any act prejudicial to them, including dismissal, based on their status or activities as a workers' representative, union membership, or participation in union activities. It was declared that the State Duma would consider a law on co-determination in 2012.

2.2 Working conditions

Wages and salaries. Salary must be paid in Russian rubles twice a month. Salaries may not be lower than the minimum monthly salary established by Russian law. The minimum wage is regularly adjusted. As of January 2012, the statutory minimum monthly wage (including for foreign nationals) is RUB 4,330 per month (approximately USD 147).

Employment contracts. A written employment contract setting out the terms of employment must be concluded with every employee and drawn up in two copies, each of which is signed by both parties. The employer must draw up the employment contract within three business days after the day the employee started work. The Labor Code establishes mandatory requirements for the content of employment contracts. As a general rule, employment contracts are concluded for an indefinite term. A fixed-term employment contract (no more than five years) may also be concluded, but only in those circumstances specifically prescribed by the Labor Code. An employee's job responsibilities must be defined in the employment contract. An employee cannot subsequently be required to perform tasks outside the scope of duties described in the contract. Employers are required to issue an internal order each time an employee is hired, transferred to a new job, granted a vacation, disciplined or dismissed, as well as in other

situations. Moreover, employers should adopt a certain set of internal regulations compliant with Russian law.

Probation. The probationary period under a contract may not exceed three months. For company heads and their deputies, chief accountants and their deputies, and heads of branches, representative offices and other subdivisions of legal entities, a longer probation period may be established but should not in any event, exceed six months.

Working hours.

- Employers are required to keep a record of all time worked by each employee, including overtime
- The standard working week in Russia is 40 hours over a five- or six-day week. For certain categories of employees, the number of working hours should be reduced (for example, for employees aged from 16 to 18, disabled employees)
- The law strictly defines the minimum payment for overtime and holiday/weekend work
- On the eve of public holidays, the working day should be one hour shorter
- Overtime work should not exceed four hours in two consecutive days and is limited to 120 hours per year
- An employee is entitled to receive pay during periods of sickness, and the employer is compensated for this with a reduction in social insurance liability
- Women are entitled to 70 calendar days' paid maternity leave both prior to, and after, giving birth. In addition, women are entitled to leave until the child reaches the age of three years (unpaid for the second 18 months) and during this period the employee is entitled to resume her job. Payment during periods of sickness and maternity leave is calculated on the basis of the employee's average salary

Paid holidays. All employees are entitled to a minimum of 28 calendar days of paid leave annually. Normally, employees may begin taking vacation time for the first year of their work after they have worked at a company for six months continuously.

Equal opportunities. It is prohibited to impose, directly or indirectly, any restrictions or privileges on the basis of gender, race, skin color, nationality, language, origin, material and social status, career position, place of residence (including whether or not a person is registered at his place of residence or place of stay) or other characteristics not related to employees' business qualities, except in instances prescribed by federal law. Any discrimination in the establishment and adjustment of salary rates is prohibited.

Termination of employment. An employer may terminate employment only on the specific grounds prescribed in the Labor Code and other federal laws. Employers must strictly comply with the procedures and documentation requirements of the Labor Code when terminating employment. The Labor Code gives additional protection to specific categories of employees, including minors, pregnant employees, employees with children, trade union members, and various other categories. Because of the detailed and varied termination requirements, legal advice should be sought before dismissing an employee. An employment contract can be terminated at any time by mutual agreement of the parties. An employee must give two weeks' notice of resignation upon termination of the employment contract at his own initiative.

In the event that the employment is terminated due to staff redundancy or liquidation of the employing company, the employee must be personally notified in writing at least two months in advance. In the event of staff redundancy, the employer must offer the employee another position that corresponds with that employee's qualifications, assuming a vacancy exists.

If employment is terminated due to the employee's unsuitability for the job, this must be confirmed by an internal review committee formed specifically for this purpose. However, this option should be approached with caution since it is often successfully contested in court.

If unsuitability arises due to the employee's poor health, the employer should transfer that employee (subject to his or her consent) to another position within the company more suitable in terms of health requirements. If the employee rejects the transfer, or if there is no such position available, the employment agreement can be terminated.

During the probation period, employment can be terminated due to an employee's unsatisfactory performance. Three days' written notice, describing the nature of the unsatisfactory performance, must be given. The employee has the right to challenge this decision in court. The employee is also entitled to terminate the contract during the probationary period with three days' written notice.

Social security. Coverage. Social and health security covers pensions, unemployment, maternity and child benefits, illness and other social services.

Employee contributions. Employees currently do not pay Russian social taxes; employers make all respective contributions.

Employer contributions. Currently, companies pay the following on employee compensation:

- *Obligatory Social Insurance Contributions (SIC)* have replaced Unified Social Tax (UST) with effect from 2010. A ceiling was set for the assessment and payment of insurance contributions in relation to an individual's income. The rates are flat. In 2010 the ceiling for calculating contributions was set at RUB 415,000 per annum, and the assessment rate remained at the maximum rates set for UST (26%). From 2011 the overall assessment rate reached 34%, and the ceiling was adjusted: 512,000 rubles since January 1, 2012
- *Obligatory Accident Insurance Contributions (OAIC)* are made against work-related accidents. Rates vary from 0.2% to 8.5%, depending on the level of professional risk associated with the employer's activity

Some key points to consider:

- Payments or other allowances under employment or civil law contracts with foreign citizens temporarily staying in Russia are exempt from SIC
- Payments or other allowances made by Russian organizations to foreign citizens working or doing business abroad are exempt from SIC
- Income paid to contractors is exempt from the Social Fund portion of the Obligatory Social Insurance Contributions and so effectively reduces the amount of SIC payable. Obligatory Accident Insurance Contributions (OAIC) are not payable if the civil contract does not stipulate accident insurance coverage

Liability for violation of the Labor Code. Violations of the Labor Code are subject to the following:

- A RUB 30,000-50,000 (approximately USD 1,000-1,700) fine for a legal entity
- A RUB 1,000-5,000 (approximately USD 35-170) fine for the company's officials
- Suspension of the activities of the legal entity for a period of up to 90 days

Violations of the labor legislation by a company official who has been previously penalized for similar offences may result in suspension for a period ranging from one to three years.

2.3 Foreign personnel

Accommodation and living conditions. Accommodation in Moscow and St. Petersburg often conforms to Western standards. There are many apartments or houses that can be rented or bought by expatriates to suit their needs. Foreign employees usually bring their families to live in Russia. Accompanying family members can obtain Russian visas on the basis of the employment status of the working spouse. There are also schools which cater to the children of expatriates.

Employment restrictions. There are no restrictions on how many foreign employees can work in a given company or how long they can be employed in Russia. However, there are some limits to the types of activities foreign employees can carry out (for example, a foreign individual cannot work in public service, e.g., as a civil aviation pilot). Foreign employees must obtain a work permit and a work visa prior to starting work in Russia. The Russian Government sets a quota for the number of foreign nationals that can be hired in a given year. The quota for 2009 was 3,976,747, while the quota for 2010, which has been approved by the Government, is only 1,944,356, (the sharp reduction is as a result of rising unemployment in Russia). If the quota has been filled, no work permits can be issued and, therefore, employing foreign nationals is prohibited. The RF Government recently approved a new simplified procedure for highly-qualified foreign personnel. Such personnel are defined as those who receive a salary of not less than RUB 2 million per year. For such expatriates, a quota is not required and the procedure is limited to only obtaining individual work permits. A company/employer is not required to obtain any additional permission to engage such expatriates; in addition, work permits and working visas for such expatriates can be obtained for up to three years.

Fiscal registration number. There is no requirement to obtain a fiscal registration number for a foreign employee.

Residence permit. Foreign personnel do not need residence permits to work in Russia; they are authorized to stay and work for as long as their work permit and work visa are valid.

Work permit and visa. Under Russian immigration law, expatriate employees have the right to work in Russia only if they hold individual work permits, and employers can employ foreign personnel only if they hold employment permits (i.e., have permission to employ foreign personnel). This requirement does not apply to foreign nationals permanently residing in Russia on a permanent residence permit or several categories of foreign employees engaged, for instance, in assembling technical equipment delivered to Russia. There are also certain exceptions for employees from CIS countries. Employers do not have to obtain an employment permit to hire these employees, but they should notify the state authorities of their employment.

Employment and work permits are generally issued for one year and for a particular region of Russia. They cannot be renewed and should be reapplied for when they expire. Russian immigration authorities will not issue employment or work permits on the basis of secondment agreements. The Federal Migration Service (FMS) has stated that this is due to the absence of any reference to such arrangements in Russian legislation. Only a direct employment contract governed by Russian labor law can be the basis for issuing employment and work permits. Work authorization documents are obtained on a quota basis. Companies intending to engage foreigners must submit a request for a quota every year before 1 May for the following year. Failure to apply for a quota may result in significant difficulties in employing foreign nationals. Each year the government issues a list of professions for which a quota is not required. Usually, the list includes the senior management of Russian companies and branch/representative offices, as well as less common professions such as IT security specialists. Obtaining work authorization documents takes up to three months and can begin only once a company has been duly established. Employment during the pending period is prohibited. Once a foreign employee has

obtained their individual work permit, they are entitled to stay and work in Russia on the basis of a work visa. Each time a foreign person enters or leaves Russia, the authorities must be notified. Notification can be provided either by the foreign person's landlord or by the company for which he/she works. The same applies for family members.

The immigration authorities have become more stringent in checking that foreigners' visas comply with the purpose of their stay in Russia. It is prohibited to work in Russia on a business visa. A business visa is issued specifically for business trips to Russia (e.g., conducting negotiations, concluding or extending business contracts, or participating in auctions, exhibitions and other business events). Foreign nationals are entitled to stay in Russia on a business visa for no more than 90 calendar days in a 180-day period; no such limitations apply for work visas. Accompanying family members should obtain separate work permits if they want to work. Family members receive special visas that are based on the work visa of the employed family member.

Work permits – highly-qualified specialists (HQS). From July 2010, a simplified system (enhanced in February 2011) has also been introduced for HQS. These are defined as foreign nationals with experience, skills or achievements in a particular area who receive remuneration from their local employment of no less than RUB 2 million per annum (approximately USD 67,000), and half of that amount for certain scientists and teachers. No lower limit applies to foreign nationals working in the *Skolkovo Innovation Centre*. Eligible employers include Russian legal entities, registered branches (but generally not representative offices) of foreign legal entities, health and education institutions (except religious institutions) and other organizations dealing with innovations, R&D, high-tech, etc. The benefits of the HQS procedure include:

- No quota restriction applies
- Maximum of 14 working days for approval/rejection of the application
- Work permit validity of up to 3 years (and possible extension for a further 3 years)
- Work permit may be valid in more than one region of Russia
- Eligible dependents include children and parents' spouses, grandparents and grandchildren
- Exemption from the registration requirement on arrival in Russia for a visit of up to 90 days (or up to 30 days at another location(s) within Russia).

The employer of the HQS has various obligations to notify the relevant tax authority concerning the employment and the grant or annulment of the work permit, and the FMS of the individual's tax registration, quarterly remuneration, unpaid leave of more than one calendar month a year and termination of employment.

Liability for violating the immigration legislation. There are significant fines for violating immigration law. Where the employer lacks the necessary permission to employ foreign nationals and employs them without a work permit or fails to notify the FMS, the tax authority or Employment Center about the employment, the employer risks fines of up to RUB 800,000 (approximately USD 27,000), or the suspension of its activities for up to 90 days. The employer's officials face fines of up to RUB 50,000 (approximately USD 1,700). The foreign national can also be fined up to RUB 5,000 (approximately USD 170), depending on the type of offence, and may be deported.

Chapter 12

International Marketing and Sales

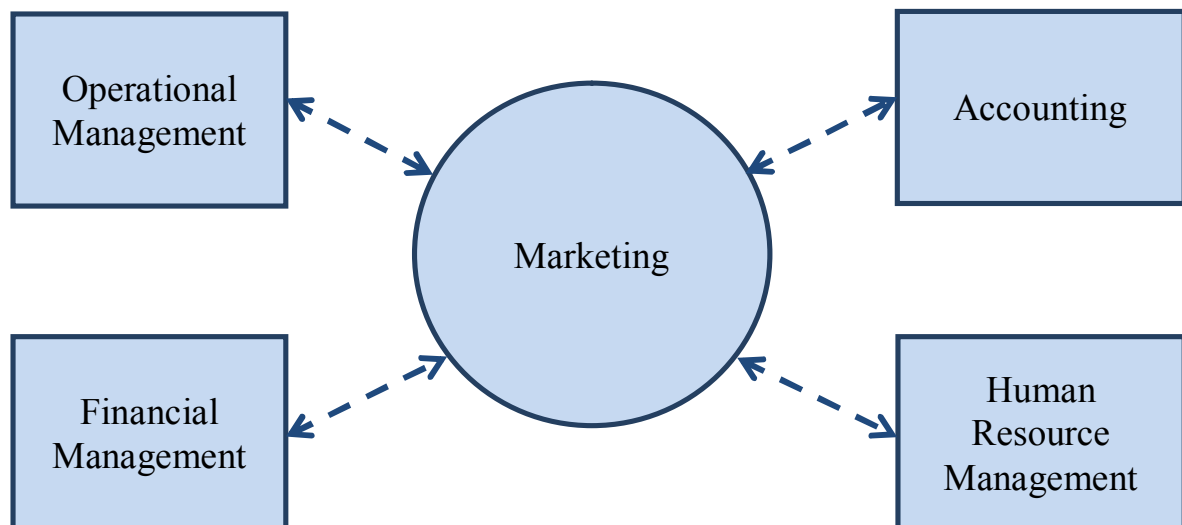
“*Marketing* is a system of company activities aimed at the exploration of the market and active stimulation of consumer demand to increase sales of the company’s products or services. International marketing is the extension of these activities into global markets. Penetrating new markets firms must deal with other political, cultural and legal systems, new economic conditions, means of advertising and channels of distribution. Additionally, international entrepreneurs face two tasks, which are not common to national markets: the use of synergy between different national markets and coordination of marketing activity in these markets. Synergy is important because it can be a source of additional income and opportunities for development. Coordination is important because it helps decrease the cost of marketing and carry out joint marketing efforts.

1. International marketing management

Very often marketing activity of an international company is organized as a separate and autonomous function within the enterprise. However, this function is influenced by practically all types of organizational activity and itself has an effect on other functions as it is shown in Fig.12.1.

Figure 12.1

International marketing as an integrated functional area



Such interrelations make international marketing management a critical element for success of an international business. International marketing management comprises the company’s efforts aimed at providing correspondence of its marketing activity to the corporate strategy, business strategy and other functional strategies.

International marketing and business strategies. The major complexity for international entrepreneurs is to apply such international marketing strategy, which would correspond to the general business strategy of company. The company’s business strategy can take one of the three following forms: differentiation strategy, overall cost leadership strategy and focus strategy.

A *differentiation strategy* is the demand from marketing managers to develop products and also tactics of pricing, promotion and distribution which differentiate the company's products and services from products and services of its competitors. The basis for this differentiation can be perceived quality, fashionability, reliability and other distinctive characteristics. Marketing managers of such goods as *Rolex* watches, *BMW* cars and *Montblanc* pens successfully demonstrate this. If one assumes that value of goods can be effectively positioned in the mind of the target market, a company then can charge high prices for its products or protect itself from the price competition on the part of less effective brands. For example, it is not necessary for *Rolex* successfully pursuing the strategy of differentiation to lower its price for its watches incrustated with diamonds (costing \$15,000) each time when *Timex* issues a new quartz model for \$19.95.

As a variant a company can pursue an international business *strategy based on its overall cost leadership*. Cost leadership can be pursued and achieved through systematic lowering the cost of production and marketing, operating with lower rate of profit, using cheaper materials and elements or any other means. Promotion in the company pursuing such strategy can be focused on advertising low prices and utilizing channels of distribution that allow keeping prices low: for example, selling goods through discount shops rather than fashionable boutiques. *Texas Instruments* calculators, *Hyundai* cars, *Bic* ball pens are promoted on the basis of overall cost leadership strategy. This approach helps *Timex* prosper in the vast market of inexpensive watches.

A company also can pursue a *focus strategy*. In this case, marketing managers concentrate their efforts on certain segments of consumer market or certain geographic areas and regions. International entrepreneurs should understand that the chosen target markets should receive proper and timely information about their company's goods and services. For example, marketing efforts of a Swiss watch company *Ste. Sisse Microelectronique et d'Horlogerie SA (SMH)*, producing the popular watches *Swatch* are focused on selling this inexpensive line of watches to young consumers from Europe, North America and Asia.

Congruence of the company's marketing efforts with its general business strategy is a critical element for success. *Timex*, *Rolex* and *SMH* (all are watch companies) chose different strategies but achieved success in the international arena owing to concurrence of their marketing efforts with their business strategies. *Timex's* strategy of overall cost leadership implies that the firm should search for cheap suppliers and sell its watches all over the world in discount shops like *Wal-Mart* and *Target* rather than in fashionable department stores like *Saks Fifth Avenue* or *Harrod's*. The *Rolex's* differentiation strategy based on carefully safeguarded image of the trademark can collapse if the firm sells its watches through the army of street vendors working near subway stations rather than through a few luxury and expensive watch shops located in the most prestigious streets of beautiful cities of the world. Similarly, *SMH* does not offer its *Swatch* watches in its advertising to representatives of the upper classes, who are 30-50 year old readers of such magazines as *Town and Country* and *Architectural Digest* or the male constituency of magazines *Field and Stream* or *Popular Electronics*. However, its production is advertised in the American, Chinese and French issues of *Elle* which have readers who are demographically similar groups – young and stylish girls – constituting the target segment for this company.

After deciding on a general international business strategy, a company should decide where exactly it will work. The decision on whether or not to penetrate one or another foreign market follows from the overall business strategy and should correspond to this strategy. For example, stable economic growth in such countries as Costa Rica, Namibia, Poland and Turkey, where population incomes vary from low to average, provide attractive business opportunities for *Timex* but not necessary for *Rolex*.

Because of budget and resource restrictions, international companies should carefully evaluate countries and rank them in accordance with their potential for companies' products. This potential can be influenced by such factors as culture, level of competition, channels of distribution and infrastructure maturity. Depending on the type of product and other circumstances a firm can decide to penetrate simultaneously all markets meeting certain criteria. For example, manufacturers of such consumer goods as *Nike* and *Coca-Cola* often offer new products practically over all territories of North America and Europe trying to maximize the effect of their advertising companies in mass media. On the other hand, companies can penetrate markets gradually in accordance with their potential. Such an approach, for example, is applied by *Caterpillar* since its marketing strategy is based not on attractive TV campaigns with participation of fashionable stars of music and sports but on establishing local dealer networks which is a long and difficult process.

Marketing mix. After making decision on penetrating a certain foreign market, a turn comes for other marketing decisions. In particular, international entrepreneurs should decide on the following issues:

- 1) how to develop the company's products;
- 2) how to determine product prices;
- 3) how to sell these products; and
- 4) how to distribute these products or deliver them to buyers.

In the aggregate, these elements constitute the so called *marketing mix* or *4P's* (*Product, Price, Promotion, Place*). Decisions in the international marketing mix are very similar to those made in internal marketing though more complicated. The spectrum of varieties which should be considered by international entrepreneurs is much broader and relations among them are more tangled. However, before discussing these complexities it is necessary to concentrate on another complicated aspect of international marketing: to what extent a company should standardize its marketing mix in countries where it operates.

Standardization or adaptation. Making a decision on whether to standardize or vice versa to adapt to the marketing mix marketing professionals usually choose one of the following three approaches:

1. Should a company accept the *ethnocentric approach*, i.e. just promote its goods abroad as it does this in the internal market?
2. Should a company accept the *polycentric approach*, i.e. adapt its marketing mix in accordance with specific needs of each market served?
3. Should a company accept the *geocentric approach*, i.e. analyze the needs of consumers all over the world and then develop a standardized marketing mix for all markets served?

To apply the *ethnocentric approach* is relatively simple. Some companies choose this approach only when they begin to penetrate a foreign market avoiding expenditures for developing new marketing methods and believing that the marketing mix that worked out at home should bring success in the foreign market too. Sometimes it does but the ethnocentric approach can be undesirable if a company loses in sales volume not taking into consideration the differing needs of local consumers.

The *polycentric approach* is more expensive for a company since in this case an attempt is made to adapt the marketing mix to each market. This approach often is used by international companies considering themselves as *multilocal corporations*³³. Entrepreneurs undertaking this

³³ This term applies to the organizational need to address both transnational and domestic challenges that boost productivity and profitability without sacrificing local customs, traditions, and related activity. Such organizations have strong roots in national or regional companies but often expand abroad because they have the resources to pursue mergers and acquisitions but only limited growth potential at home.

approach are sure that consumers more readily buy and agree to pay more for goods precisely satisfying their needs rather than any other goods. If applied correctly, this approach can generate higher income.

The *geocentric approach* implies standardization of the marketing mix; as a result a company offers one and the same product or service using worldwide one and the same promotion method. One of the first enterprises that chose this approach was *Coca-Cola*. This company sells its refreshment drink all over the world using practically similar packing, product and advertising ideas. Actually, *Coca-Cola* pinched waist bottle is the most recognizable image worldwide.

A compromise between standardization and adaptation is obvious. Standardization enables a company to increase efficiency of production, distribution and promotion and also simplify and straighten major operations. However, the company should put up with lower volume of sales if its products do not satisfy the unique needs of consumers in a certain market. Adaptation can adjust products to these needs; however, the company can sacrifice its economic efficiency. Actually, standardization is connected with the cost-based aspect of the income equation: cutting costs a company increases its income. Adaptation is connected with the profit-based aspect of the same equation: attending to the unique needs of consumers in each market a company gets opportunity to charge higher prices in each market and sell more of its products. Practically, many prospering companies apply a strategy “think globally, act locally” to avail themselves of the economy of scale from globalization of the marketing mix and at the same time preserve an ability to satisfy consumer needs in the markets of different countries. Even *Coca-Cola*, a pioneer of global marketing, began to encourage more local thinking within its global marketing system. For example, the company recently permitted one of its South Africa distributors to fill the drink into cans of three different sizes and began to produce sweeter Coke named *Iron Brew* in that country. Pros and cons of standardization and adaptation of marketing efforts are shown in table 12.1.

Table 12.1

Standardized international marketing

Advantages	Disadvantages
1. Cost of marketing is lower	1. Different consumers’ needs are ignored
2. Centralized control of marketing is higher	2. Peculiarities of local legislation are ignored
3. Efficiency of R&D employment is higher	3. Local buying patterns are ignored
4. Economy of scale is higher	4. Local marketing initiatives are suppressed
5. Capitalizes on formation of single global market	5. Other distinctions of local markets are ignored

Adapted international marketing

Advantages	Disadvantages
1. Different consumers’ needs are taken into account	1. Cost of marketing is higher
2. Peculiarities of local legislation are taken into account	2. Centralized control of marketing is suppressed
3. Local buying patterns are taken into account	3. Efficiency of R&D employment is lower
4. Local marketing initiatives are encouraged	4. Economy of scale is lower
5. Other distinctions of local markets are taken into account	5. Formation of a single global market trend is ignored

Product Policy

The first “P” in the international marketing mix is a *product*. A product is a tangible good or an intangible service. Also product here is understood as a combination of tangible factors (like a

good itself, its package, etc.) and numerous intangible factors (like image, conditions of installment, guarantees, credit terms, etc.). Successful development of a good's tangible and intangible properties which meet needs and wants of consumers in different national markets is a crucial factor of company's competitiveness in the global market.

Standardization and adaptation of products. A key decision which should be made by a company within the framework of its trade policy is to what extent the company's products should be standardized (common to all markets) or customized (unique to each market). The necessary degree of product adaptation varies depending on several factors. One of them is the nature of target buyers: whether they are industrial customers or individual consumers. Certainly, there are customized industrial products and standardized consumer goods. However, industrial products are being standardized more often than consumer goods. Raw materials and supplies usually are standardized too, for example: agricultural products, oil, computer memory chips, and chemicals. A general rule is: the closer a good is to the body, the higher the probability of its customization.

Legal regulation. Laws and norms of hosting countries also can influence the product policy of international firms. In some countries, for example, there are strict rules related to the information that must be on the packaging of consumer goods and to the safety of foods themselves; companies both national and international should strictly observe these rules. A variety of technical standards for such goods as electric appliances, transmission and telecommunication equipment that are in place in different countries also make companies adapt their products. For example, electric plugs of household appliances sold in Europe should be modified depending on the specific country in which they are sold since there are different standards for connecting to a power supply.

Influence of culture. International companies often are obliged to adapt their products to cultural distinctions of local markets. A typical adaptation of such a kind is the translation of information from packaging into the official language of host country. Sometimes a country culture can force a company to make changes in company products. For example, despite the popularity of American films, *HBO* Company has to edit the films before releasing them in conservative Asian countries.

Economic factors. Desired properties of goods can be influenced by the level of a country's economic development. Consumers from rich countries usually prefer more function intensive goods whereas consumers from poorer countries, who are more sensitive to the price, usually choose so called "empty" versions of the same products. The quality of country's infrastructure also can influence decisions on adaptations.

Brands. Firm's names of goods (brands) are the elements that more frequently are subject to standardization. In this case, a company can cut its cost of packaging, design and advertising. It also can benefit from utilizing the effect of moving its advertising messages from one market to another. For example, penetrating the Thailand market for *Avon* Company was easier because millions of Thai consumers had seen this company's commercials on Hong Kong TV.

Pricing policy

The second "P" of international marketing is pricing. The development of effective pricing policy is a crucial element for success of any company. Pricing policy directly affects the amount of company's sale revenue. It is also a powerful strategic tool allowing a company to form its competitive environment. Both national and international companies should develop their pricing policy providing for the profitability of their business operations but for the latter this task is more complicated. To begin with, expenditures for one and the same operation vary significantly

from country to country. Because of differences in cost of transportation and tariffs, the price of goods at the moment of delivery can be different. The final price also is influenced by differences in methods of distribution. In the USA, for example, because of intensive competition between distributors, the difference between manufacturer's prices and retail prices is minimal. In Japan on the contrary there is an ineffective multilevel system of distribution and the goods before getting to consumers come through a chain of mediators; as a result the price often increases. Currency exchange rate fluctuations can be an additional problem. When the national currency of an exporter becomes more expensive, a company should choose between preserving prices in the national currency (which makes its goods more expensive abroad) and preserving prices in the currency of the host country (which diminishes the amount of profit since the exporting firm gets less money in national currency from each sold unit of its production). International companies should take into account all these factors developing their pricing policy for the market of each country served by them. They should decide whether they want to offer a flat price for all markets or adapt prices to the needs of each market.

Pricing policy. International companies usually pursue one of these three policies:

- 1) the flat price policy;
- 2) the two-level price policy; or
- 3) market pricing.

An international company applying the geocentric approach to marketing accepts the *flat price policy* when the company fixes one price for all markets regardless where and to whom it sells its products. Usually firms trading top-selling and easily transported items choose this method. For example, if the company manufacturing microchips *DRAM* sets significantly different prices then some of its customers being in a more favorable situation could resell these chips to others who could find themselves in a less favorable situation. Considering the small size and high price of the microchips it would not be a problem. Companies selling raw materials in competing markets also resort to the flat price policy.

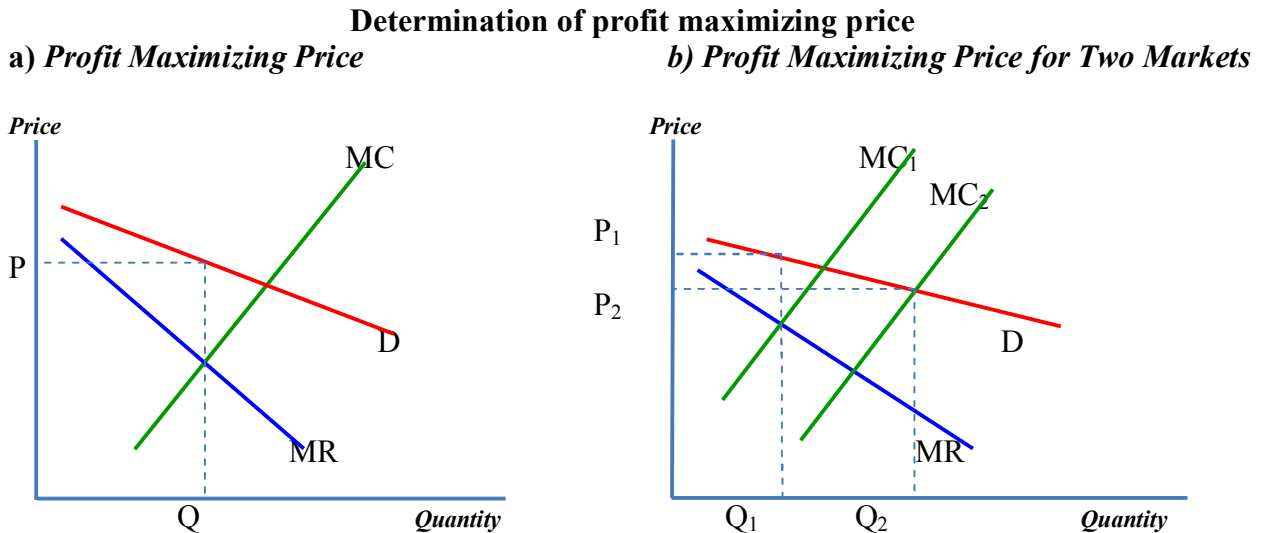
International companies following the ethnocentric approach to marketing adhere to the *two-level price policy* when one price is set for the internal market and another price for all international markets. In this case, all expenses related to R&D, overheads, capital depreciation, etc. are attributed to internal revenue. Then having got rid of the necessity to cover these expenditures the company sets flat price for its foreign markets. The only expenses that should be covered by overseas sales are the additional costs associated with disposal of commodities, namely unit cost, cost of transportation, tariffs and cost of distribution. Companies just beginning international operations often resort to the two-level price policy. However, companies accepting this policy take a risk of being accused of dumping.

International companies adhering to the polycentric approach rely on the *market pricing policy*. Market pricing is the most complex policy, however the most widespread one. The company that has chosen the market pricing policy differentiates its prices for each specific market trying to maximize its profit in each of them.

Let us recall from the course of Macroeconomics that the production quantity maximizing profit (the amount of product which a company should manufacture to get maximum profit) is determined by the intersection point of *marginal revenue curve* with *marginal costs curve*. The price maximizing profit (P) is determined by the point on the *demand curve* corresponding to the production quantity maximizing profit (Q). Fig. 12.2a shows that the curves of *marginal revenue (MR)* and *marginal costs (MC)* intersect in the point Q which is sought production quantity. If to draw the line from this point to the demand line (D) and then to find corresponding value on the axis y, we will get the price maximizing profit (P) or the highest price of realization of the

production Q . Precisely this is the price a company calculates and sets for each market where it operates pursuing market pricing policy. Fig. 12.2b shows the situation when a company has similar *demand curves* and *marginal revenue curves* in two markets but different *marginal costs curves*. In country 1 marginal costs (MC_1) are higher than in country 2 (MC_2) correspondingly price maximizing profit in the first country (P_1) is higher than in the second country (P_2)

Figure 12.2



For successful application of market pricing, two conditions should be observed:

- 1) In the countries, where a company sells its products, demand conditions and/or cost level should differ. This requirement is observed as a rule since different countries differ in taxes, tariffs, living standards, level of competition, the development and expenditures of infrastructure and many other factors.
- 2) A company should be able to resist arbitrage. The market pricing policy will be useless if consumers are able to buy the company's goods in "cheap" countries and sell them in countries with high prices capitalizing upon this. If price fluctuations between countries are insignificant, import tariffs, transportation costs and other operating expenses make arbitrage unprofitable. If prices differ significantly than arbitrage can be a serious obstacle for market pricing.

If the two above conditions are observed, advantages of a polycentric approach are obvious. A company can set high prices where markets can endure and lower prices where it is necessary to remain competitive. Apart from this, this approach allows one to correlate local cost with local sales revenue, which provides the opportunity to better allocate the company's resources. However this flexibility is not free. To capitalize upon market pricing, local international entrepreneurs should keep close watch over the volumes of sale and competitive situation and timely introduce proper corrections.

In addition to potential dumping charges, the market pricing policy comprises three other risks: 1) infliction of damage to trademark; 2) development of a grey market; and 3) consumers' resentment at discriminative prices.

A company should keep a wary eye on its prices since the prices fixed for one market can damage the image of its trademark in another market. For example, let us imagine that *Kirin* Company recommends for its North American and European brand managers to promote *Chivas Regal* as a premium class scotch at a high price but for Japan brand managers to sell it as a non-prestige brand at a dumping price. Because of such marketing approach in Japan, *Kirin* risks

losing the premium image of *Chivas Regal* trademark which it enjoys in North America and Europe.

A company pursuing the market pricing policy also is exposed to the risk of grey market for its goods because of arbitrage. A *grey market* or *gray market* also known as *parallel market* is the trade of a commodity through distribution channels which, while legal, are unofficial, unauthorized, or unintended by the original manufacturer. A grey market can appear when prices in one market are significantly lower than prices set by the company in another market, so entrepreneurs can buy goods in the cheap market and resell them in the expensive market. Grey markets appear when firms do not correct prices after significant fluctuations of currency rates. Such expensive commodities as cars, photo and video cameras, computers, watches and skiing gear very often are sold in grey markets. Apart from this, grey markets are more common in free market economies with very little government regulation. In the USA, according to a recent survey, the annual volume of sales in grey markets approaches \$130 billion. According to *Charles of the Ritz* its perfume *Opium* is sold by over 10,000 different distributors whereas only 1,300 of them have the official permission to do so.

The third jeopardy is consumer resentment. Consumers from the country with high prices can feel that they just are fooled. For example, the *Clinique* soap for face costs \$40 in Tokyo however in the USA the same soap is sold at price of \$10. *J.Crew* suggests its Japanese buyers pay \$130 for its wool sweaters while in the USA they cost \$48. This topic became a subject for debate in the Japanese mass media which asserted that foreign companies derived additional profit at the expense of Japanese consumers. Although representatives of different firms explained that the differences in prices were caused by high cost of doing business in Japan, malevolence of Japanese consumers by no means fostered the growth of sales.

Promotion policy

Promotion being the third “P” of the international marketing mix includes all efforts of an international company to increase the desirability of its products for potential consumers. Promotion more often is aimed at just consumers however successful entrepreneurs understand that communications also should be supported with distributors and the general public to foster a benevolent attitude to their companies and commodities. Since promotion represents communication with the audience from host country, it is the most culturally rich element from all the four “Ps”. A company should be sure that the message delivered to the audience in the host country is exactly what the company intended to pass on. In this respect, international entrepreneurs should efficiently combine and engage all four elements of the promotion complex – *advertising, personal selling, sales promotion and public relations*.

Advertising. For most international companies especially for those trading consumer goods and services, advertising is the most important element of promotion. Developing advertising strategy a company should take into account three elements:

- 1) the message to be delivered;
- 2) the mass media to be used; and
- 3) the desired degree of advertisement globalization.

At the same time, a company should take into account relevant cultural, linguistic and legislative restrictions existing in the markets of different countries.

Personal selling. The most common approach to the selling based on personal contacts is employment of trade representatives contacting potential buyers and trying to sell them the company’s products and services. Because of tight personal contact between the seller and buyer, firms often attract local nationals as a direct sale force. When a company only begins its international operations, it usually entrusts local sales agencies working with commodities of

several different firms to establish a system of personal selling. As the company grows and enlarges its clientele in the new market, it can form its own sales force. This force is more often used to sell industrial commodities rather than consumer goods since well-trained trade representatives often can deliver information about nuances of goods to customers better than mass media. However, this method is sometimes successfully used to sell consumer goods too.

Sales promotion includes special marketing activities such as coupons distribution, intra-shop actions, handing out samples of products, direct mail campaigns and participation in special exhibitions. Participation in international exhibitions is often recommended to companies as the first step toward the global market. The US Department of Commerce often renders assistance to small businesses within framework of programs for export development allowing small companies to participate in such exhibitions.

Public relations comprise efforts aimed at improving the company's reputation in the estimation of the wide public without accentuating separate goods or services. The major outcome of this work is common confidence that the firm is a respectable "corporate citizen" having a good reputation and deserving trust.

Place policy

The fourth "P" of the international marketing mix is *place* more often named *distribution*. *Product distribution* is the process of making a product or service available for use or consumption by a consumer or business user. (Distribution is also an element of international logistics; another element is material management). In this respect a company faces two main groups of questions:

- 1) physical transportation of goods and services from the place of their creation to different markets where they can be sold;
- 2) selection of channels of product distribution to different markets.

International transportation. An international company should decide on the type of transportation. This option implies a compromise between time and cost. Quick ways of transportation like air and trucking services are more expensive than slower ones like carriage by sea vessels, railway vehicles, pipelines and barges. However, the choice of transportation influences the cost of inventories, level of service and also effective shelf-life, probability of goods damage, demand for packaging. Slow ways of transportation increase time of the *international order period* (time from order placement to receiving goods) at any level of the prescribed inventory stocks.

Channels of distribution. International entrepreneurs should determine what channels of distribution to use for disposal of their commodities in each country of operation. Major types of the channels used by the majority of international entrepreneurs are shown in Fig 12.3.

As it is shown above, a distribution channel can include up to four major participants:

- 1) a manufacture producing a product or service;
- 2) a wholesale dealer purchasing goods and services from a manufacture and reselling them to retailers;
- 3) a retailer reselling goods and services to consumers; and
- 4) a consumer purchasing goods and services for final consumption.

Import agents also can act as mediators especially for small companies.

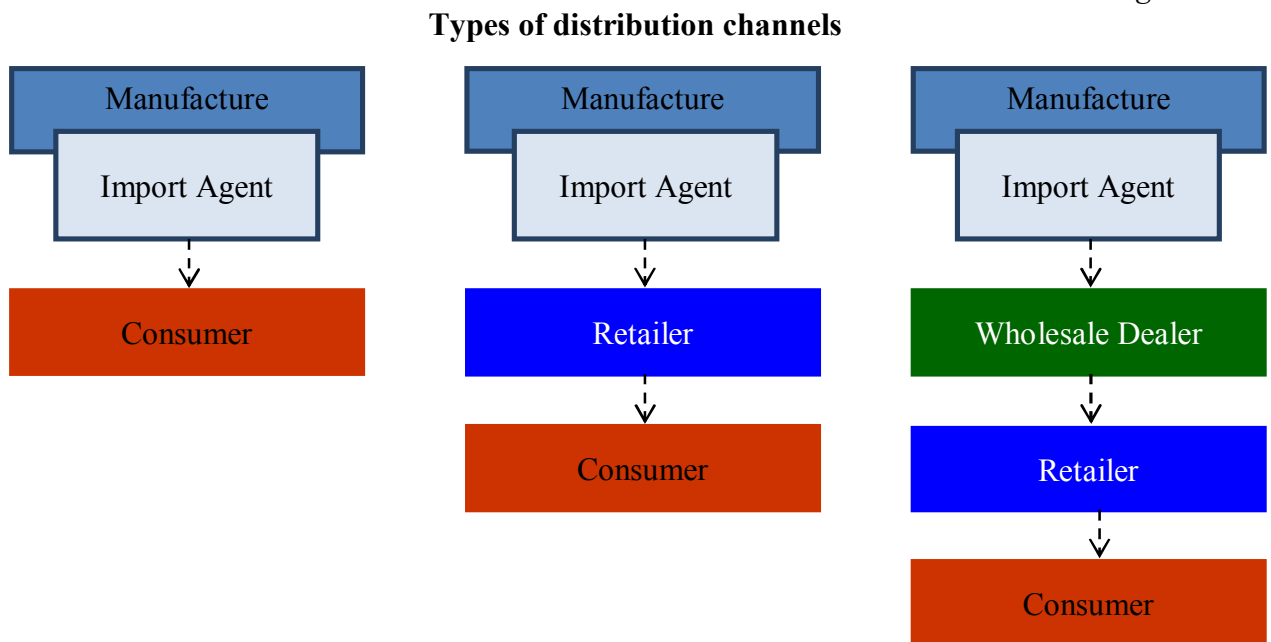


Fig. 12.3 reflects such an important factor as the length of distribution channel or the number of stages in distribution channel. When a company delivers its goods directly to consumers and the latter directly pay to the company, the company gets very short distribution channels. Such approach is called *direct selling*. *Dell Computer* began with such an approach receiving orders through free telephone lines. The advantage of the direct selling is that a company controls retail distribution of its products and gets all retail profit. On the other hand, the company bears all costs and risks related to retail trade.

The second approach (with retailers) is easier to implement in the market with high concentration of retailers. Sometimes international entrepreneurs are forced to work with small retailers. For example, both food and toiletry in the USA can be bought in giant supermarkets but European consumers usually buy food in small grocery stores near their homes but toiletry is not sold there. Therefore manufacturers of consumer goods are forced to use absolutely different approaches to distribution. Thus, in the USA, *Procter & Gamble* can directly deliver its products to supermarket *Kroger* and *Safeway*; it is a common practice for the latter to store hundreds of types of toothpaste in their warehouses. However a European retailer can find place only for several tubes of toothpaste on the counter and restricted room in his storage therefore direct selling to such shops becomes problematic.

The lengthiest distribution channel includes wholesale dealers. Wholesalers resale (sale without transformation) new and used goods to retailers, to industrial, commercial, institutional or professional users, or to other wholesalers, or act as an agent or broker in buying merchandise for, or selling merchandise to, such persons or companies. Wholesalers frequently physically assemble, sort and grade goods in large lots, break bulk, repack and redistribute in smaller lots. Wholesalers not only facilitate promotion of goods in countries with a small concentration of retailers but also allow a company to do with fewer salespeople. On the other hand, the amount of profit in this case is lower too.

An international entrepreneur's main task is to find optimal distribution channel harmonizing unique competitive advantages of his firm with the demands of each market served. Practically, as in the case with other elements of international marketing, most international firms stick to a flexible distribution strategy: they can use short distribution channels for certain markets and long channels – for other markets” [29].

2. Marketing and sales in Russia

“Nine (not so long ago eleven) time zones, dozens of peoples and languages, a huge quilt of mores, religions, buying habits, per-capita incomes, distribution infrastructures, etc. That is Russia. It has been making a ponderous U-turn to a market economy. After a long hibernation, Russia awoke to find its erstwhile fantastic business traditions lost. Anyway, it was quick enough to grasp the ABC’s of modern market operations. It has leapfrogged to plastic money, Internet, etc. On the demise of the USSR, Russia’s economy found itself in shambles, of necessity relying on oil and gas – a fact attracting greedy Western attention, uninvited Western advice (often based on a double standard), and Western lectures on “democracy” (especially funny when coming from some blatantly police states). What saddens many is the fact that Russia, a gold mine of scientific ideas, inventions and R&D expertise, does not benefit from it. This intellectual treasure lays idle because of the lack of commercialization skills and adequate marketing savvy. But things are improving.

Importance of marketing and advertising in Russia. Western companies that, like Xerox, normally rely on their efficient selling forces, are quick to discover that for them to extrapolate their tactics to Russia’s open spaces, they would need huge selling armies, which is impossible. They have to opt for marketing means. Thus, marketing and advertising in Russia are more important than elsewhere. Analysis of evidence gleaned over years shows that the quality of marketing and advertising is often a make-or-break thing for Russian companies. And the make-or-break issue is not only for Russian ones, for that matter. Russia is a classical marketing country.

Marketing. To be a practitioner of marketing and advertising in Russia is no easy task. Marketingwise, Russia is not a “country”; it is rather a huge sparsely populated landmass to which no unified marketing concept applies. For centuries it has been home for dozens of Slavic, Turkic, Finno-Ugric, and many other peoples, a melting pot of cultures.

If you superimpose that mosaic on a bizarre array of regional differences in traditions, ways of life, values, predominant occupations, buying habits, and what not, you will end up with a fascinating kaleidoscope of marketing patterns and recipes.

In practical terms that means that what sells perfectly all right in Moscow, may not appeal to buyers in St. Petersburg, and even less so in Siberia. The number of possible marketing situations you may find in Russia may baffle description. What is more, Russian markets are so dynamic that selling points that work today may become out of place tomorrow. You might imagine, with the country being like that, that skills of top-notch marketers and advertising agents must be in great demand. Nothing of the sort is the case.

Statistics. In Russia there are no reliable national statistics. The country used to be a very closed society. Information about people, media, distribution, material and labor resources, business laws, institutions and traditions was either unavailable to outsiders or did not exist at all.

Official data may be wildly inaccurate. One example is Russian income statistics. Few analysts trust it, for they know that fears of draconian taxes and organized crime have led to widespread under-reporting. Russia’s official information collection system often supplies data that is irrelevant and Soviet-style. Another problem: with things changing in Russia by the day, any information may become dated before going to press.

Because there is so little reliable data available about Russia for making predictions, marketing in Russia is mostly a qualitative rather than quantitative exercise. Emphasis is necessarily on

marketing as a craft, experience and intuition often being more productive than formal quantitative methods. This is for good and ill.

Distribution. In Western markets, firms are used to well-defined ready-made distribution channels. In Russia, they are just taking shape in some industries. Western firms seeking to establish their existences in Russia are well-advised to cultivate personal relations with agents, to proceed incrementally, and to retain a fall-back position should a relationship sour.

Experience has shown that perhaps the highest-risk strategy is to visit Russia once or twice, select an agent and grant him exclusive representation, and then move quickly to consignment or credit sales, without establishing a consistent track record first. Russian agents can help the foreign supplier by placing his products on store shelves, handling customs, transportation matters and other operations. It is only rarely that they can be entrusted with sophisticated marketing and advertising projects.

Internet potential. It is clear that in a “country” with nine time zones the Internet must hold huge promise. Unfortunately, the Russian Internet is not up to the mark, largely because it is still dominated by designers and programmers, as was the case in the USA before the dot.com bubble burst of 2000. Fortunately, things are improving as more and more marketers and copywriters are getting involved. The marketing quality of sites is getting better.

No marketing "academia". Ironically, being a late starter in a market economy has some good things about it – unlike the US, for instance, we do not have in Russia an army of ivory-tower marketing "academics" and no "learned" marketing journals – that frightful heap of unread junk. Russian magazines generally prefer down-to-earth “how-to” articles.

Advertising. The Russian advertising scene can be best described by the Biblical phrase: the blind leading the blind. Blind agencies leading blind advertisers. The quality of ads in Russia is horrible for two reasons. For one thing, most of Russian advertisers don't have the slightest idea of what good advertising is about. For the other, the same for the most part goes for Russian ad-makers (including those who man local branches of Western chain agencies). The ads they produce are all too often a waste of the client's money.

Oddly enough, you stand a better chance to find good, down-to-earth, advertising that sells not in Moscow, but in other parts of Russia. One reason is that provincial agencies are not spoiled by the huge ad budgets of the internationals, which is the case in Moscow. Of necessity, they have to supply the goodies to local manufacturers or retailers for their hard earned advertising monies.

Russian adfolks. Since its renaissance several years ago, Russian advertising has been attracting a wild assortment of characters: designers concerned with self-expression (at the customer's expense); printers who think that tinkering with ads are just easy and lucrative additions to their businesses. Unfortunately, advertising attracts all too few marketers and sales experts, account planners, and copywriters. There being no educators with practical experience, Russian advertising schools are attracting a crowd of ivory-tower scholars (psychologists, psycholinguists, cultural experts, etc.), and "artists."

CreAtinism. Most of Russian agencies still view advertising as an exercise in design and graphic arts. David Ogilvy used to call this disease art-directoritis. Alexander Repiev³⁴ calls it “creAtinism.” The disease worsened with the coming of fancy graphical computer packages, which enable a third-rate designer to get a motley background, reversed text or other ad-killing

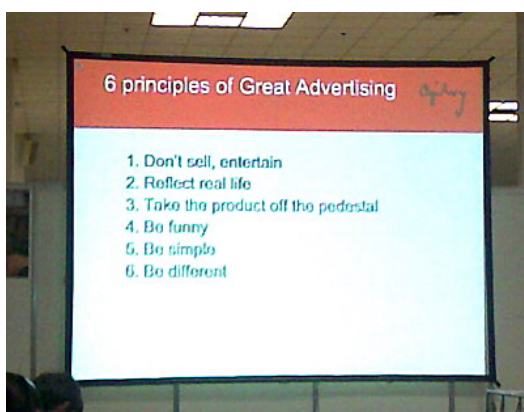
³⁴ President of *Mekka Consulting*: <http://www.repiev.ru/index-Eng.htm>

tricks in a matter of seconds. With nobody minding what they do. Those creatures believe that their task is simply to “beautify” with graphical frills some text provided by the advertiser. Only few understand that it is basically the *copy* that sells.

No copywriting of note. When A.Repiev was establishing his agency in 1995, they went out looking for copywriters. And found none! The Marketing Director of one prosperous agency volunteered that the market didn’t need copywriting and "selling" advertising in general. It was allegedly simply happy with “pretty pictures.” Copywriting is still a craft practically unheard of at a sizeable proportion of Russian agencies. Even at international chain agencies in Moscow they may have just some rudimentary copywriting. So, at *McCann Erickson Russia* they believe that copywriting is just about "Just do it!"-style sloganistics. What little copywriting the agencies have is generally relegated to underpaid ex-journalists or linguists absolutely innocent of things such as marketing and advertising. And even then it is mostly about thinking up some funny slogans. A new fad is the so-called SEO-"copywriting"³⁵.

Ad agencies. There are thousands of firms in Russia that call themselves advertising agencies. Most of those shops are basically design boutiques. They concentrate on logos, business cards, stationery, outdoor engineering structures, souvenirs, and other advertising marginalia. Their ultimate dream is to grab some prize at one of those ad contests. One sees so many around. Courtesy of those shows, some green Russian agencies found themselves involved in the award rat race. (D.Ogilvy³⁶: “The Lunatics Have Taken Over the Asylum.”).

Chain agencies in Russia. Dozens of Western agencies have opened their shops in Russia. Most offices of these international grandees have “all the signs of famous agencies which are moribund” (D. Ogilvy), perfect “ministries of advertising” housed in posh offices. Those outfits remind one of the infamous Soviet-style bureaucracy. Inefficient, expensive, and, well... “moribund.” They mostly don’t have to bother about recruiting advertisers in Russia: their worldwide clients who establish their presence in Russia simply fall into their laps. The bulk of their job is simply dubbing Western commercials and outdoor ads created in Alabama, Bavaria, Yorkshire, or elsewhere – it is supposed that advertising “gurus” there know better how to sell to a Russian housewife or a Russian shopkeeper. Sometimes their efforts have With funny results. Examples are legion. The chain agencies are just fond of enlightening green Russian ad folks, e.g., like this:



³⁵ *Search engine optimization (SEO) copywriting* is textual composition for web page marketing that emphasizes skillful manipulation of the page's wording to place it among the first results of a user's search list, while still producing readable and persuasive content

³⁶ David Mackenzie Ogilvy, (June 23, 1911–July 21, 1999), was an advertising executive. He has often been called "The Father of Advertising." In 1962, Time called him "the most sought-after wizard in today's advertising industry." He was known for a career of expanding the bounds of both creativity and morality.

Most of them follow these precepts themselves. Some believe David Ogilvy is turning in his grave.

"Branding". As the fairly technical "branding" of the mid-20th century (based on the AMA³⁷ definition of "brand") has gradually turned into the schizoid "branding" of our days, Russia, with its rudimentary marketing culture and psychological predisposition for wishful thinking, was severely hit by "brand hysteria." Just like elsewhere, nobody in Russia knows what the word "brand" means. Some believe that a good "brand" is just a good name, or a properly designed label on a bottle. (Some pay as much as \$400,000 for a vodka label, mostly to UK "brand" companies.) Why bother with client insights, product quality, ad policy, sales guides, etc.! At the same time, some Western companies are making good money in Russia with their "Russian" trademarks in cigarettes, beer, detergents, etc.

Western marketing & advertising in Russia. Western companies that have succeeded in Russia have done so through a combination of improvisation and innovation, combined with a substantial investment of time and ability to learn from mistakes. In Russia, international businesses have to show more flexibility and understanding. It is only at their peril that they can continue to behave the way most of them have behaved in their home markets. Unfortunately, some Western firms, especially mammoth blue-chips, continue to mechanically translate their marketing methods and advertising ideas to Russia – why bother, if you are a huge bureaucratic monster. Having squandered millions, they sit on the fence and wait for results. More often than not, nothing happens. They may wonder why methods that have worked perfectly all right in other places turned out to be useless in that funny market. Some, however, learn from their mistakes and revamp their marketing and advertising philosophies. There are several reasons for failures of those mechanical marketing grafts. Some are highlighted below.

Need to review the selling points. Years of experience with the Russian operations of major Western companies have taught us that a Western product's selling points have often to be re-considered for Russia. A company's solutions may have advantages that work all right in Europe or elsewhere, but not in Russia. On the other hand, some corporate or product features may appear to be excellent selling points in Russia. It is only rarely that Western companies do such a review. One example: our careful analysis of *Minolta* office equipment unearthed an impressive collection of advantages for Russia (which might be not that important elsewhere). A campaign "Minolta office equipment is ideal for the rigors of Russia!" stressed tolerance to faults, static electricity, bad power, low-quality paper, etc. In a country, where equipment is largely not grounded, where power supply is often horrible, etc., that fine-tuning sold many pieces, even to foreign representative offices in Moscow.

"Russifying". The popular practice of many Westerners in Russia is to have their ads hastily done into Russian. Some even do that in London. The consequences of that practice depend on the field. Whereas the bad Russian of high-tech brochures may simply amuse Russian readership and... still work, nevertheless; bad FMCG³⁸ commercials and outdoor advertisements are often above the heads of most Russians. Mechanistic, unimaginative "russifying" may appear to be a formidable task even linguistically.

The Russian language. With its host of suffixes and prefixes, and idiomatic flourishes, Russian is extremely colorful in fiction. On the other hand: (a) its words are generally longer than, say, in English; (b) its word-forming power is lower; (c) many words, especially in high technologies,

³⁷ American Marketing Association

³⁸ *Fast-moving consumer goods (FMCG)* – or *consumer packaged goods (CPG)* – are products that are sold quickly and at relatively low cost. Examples include non-durable goods such as soft drinks, toiletries, and grocery items.

can only be translated into Russian using two lines or so. Examples are “computing,” “networking,” “full-featured,” “sharing,” etc. In the body of a copy an experienced copywriter can handle this, but titles and headlines that include “problem” English words may look extremely cumbersome when translated. Even the nice English phrase “simply the best” will be a problem for a Russian translator.

Russia is now flooded with foreign names of products that tell absolutely nothing to an average Russian. Some of the names are excellent self-explanatory sellers in English – Deep Cleanser, Head-and-Shoulders, Wash-and-Go, Handy Stitch, Coldrex, etc., etc. Admittedly, those names are a problem in other languages, but most Europeans can at least work out their meanings. For Slavs nearly all of them are double Greek. To make up for that takes some talent.

Slogans. Some international companies come to Russia with untranslatable or meaningless slogans. Examples are galore. Nobody in Russia can properly translate Nike’s “Just do it,” Microsoft’s, “We are rolling out the wheels.” For Xerox, that pioneer of copying, we thought up and tested “We taught the world to copy.” We had the Russian, Ukrainian and Byelorussia versions of the line. It was replaced by “The Document Company.” In Russia, where it is used in English at that (!?), nobody can understand it. Besides, in the post-Soviet environment the phrase has a police connotation – in Russian the first meaning of the word *dokumenty* is ID.

Some Western marketing gaffes in Russia. The more bureaucratic and inflexible a foreign company is in Russia, the more likely it is to make mistakes, some of which can be quite expensive. The following are some of them.

Outlandish product categories. Sometimes international companies come to Russia with classes of products that are unheard of here or have had adequate substitutes for decades or even centuries. Instead of educating the market, those internationals may set out to promote their unknown products the way they do in places where those products are well-known and popular.

One example: in Russia, that vodka land, one sees outdoor whiskey ads produced for markets where those brands are just household names and need only some reminding. Headlines and straplines are often “blind,” not infrequently they are in English. Some ads do not even show the bottle, just the label. For instance, *Johnny Walker* hit Russia with an expensive “We are walking” campaign. Perhaps a stunning success in England (which I doubt), that far-fetched double-play (Walker – walking) dubbed into Russian was lost on nearly 100% of Russians, most of whom have never so much as tasted whiskey in their lives.

Improvised polls conducted by students reveal that a sizable percentage of Russians cannot even identify some Western product categories, let alone products. Why such a predictable waste!

Trademark awareness. A mark may be an “icon” in its home market, but... enjoy a low or nil awareness elsewhere. What should you do? Gauge the awareness at first, and make adjustments to your marketing? Or you may well plunge head on into the market with a million-worth marketing and ad project? Most foreign behemoths in Russia prefer the latter scenario. One example is *Nike*. When it came to Russia, which had largely been an Adidas land, its awareness here was as good as nil. Also, nobody in Russia was crazy about US athletic endorsers. But *Nike* began mechanically swooshing Russia all over. Why bother and fine-tune things! We are the big and great *Nike*!

Cultural differences. Some companies in Russia demonstrate contempt for cross-cultural approaches. Just one example – dozens of *Baccardi* billboards in Moscow showed a huge ugly bat. It may well be that in Calabria, the home of the *Baccardi* family, the bat is a symbol of

wisdom, etc. But in Russia it is... a repugnant monster. In addition, the company did not bother to explain rum to Russian vodka drinkers, specifically that it is not taken straight, the way Russians consume drinks. That didn't help the product along in Russia, to put it mildly. It looks like as if fewer and fewer Western companies err this way as time goes on.

Consulting. In Russia, when tax, legal and marketing problems are concerned, an ounce of prevention can be worth a pound of cure. A piece of seasoned advice early on can save you both aggravation and money down the road. In Russia you will find all the major consulting grandees, such as McKinsey. Overall, they are professional, efficient, and... expensive. They all have one problem: their stock-in-trade is off-the-shelf solutions, which may work just fine elsewhere, but not uncommonly they fail in Russia.

Russian consultants, on the other hand, may not be that impressive, but they have more local knowledge. Some of them are good one-hundred-odd-ball fixers. *Lloyd Donaldson*, a Westerner with years of experience in Russia's business, comments on getting advice in Russia: "What that boils down to is getting the right person for the job. A professional consultant with personal experience in observing marketing in practice could be the right choice. Such a consultant, using an experience-based model, would help you appraise your product and its entry into the Russian market on the basis of past successes. That could be the key that unlocks success in the Russian market for your firm." In Russia's marketing quilt, when penetrating some regional markets with major local differences, e.g., Muslim areas, it would be a good idea to get a local adviser. They have learned that the hard way, by trial and error. For example, *Mekka Consulting*³⁹ is a fusion of Western expertise with local knowledge.

Quo vadis? To survive in the new environment of hyper-competition Russian business will need new marketing thinking. Thank God, Russian marketing is improving. At the moment it's mostly experimenting with ready-made Western marketing concepts with funny results sometimes. There comes an understanding that some aspects of international marketing are unsuitable to the bizarre markets of Russia, so that Russian marketers should be coached somewhat differently.

Well, but how should marketing be taught to Russians, half-Asians – half-Europeans? In his famous poem "Scythians," the Russian poet Alexander Blok wrote:

Yes, Scythians we are, and Asiatics,
With slanting and devouring ogles.

...

We worship all – the flames of icy digits
And gifts of the angelic visions,
We fathom all – the spicy Gallic spirit,
And ominous Germanic genius...

Without any doubt sooner or later Russia will develop its own Eurasian school of thought in marketing & advertising, based on the best of the two worlds, the East and the West. But it is difficult to say whether or not Russia will become less of "a riddle, wrapped in a mystery"⁴⁰.

Retail trade laws. In Russia, there are several laws regulating retail trade, major among them are the Federal law of December 2009 "On the basics of state regulation of trade in the Russian Federation" and Federal law of December 2006 "On retail trade marketplaces". The main task of the these laws is to bring order to the relations connected with the establishment of trade activity

³⁹ Moscow, Russia, www.mekka.ru (7) 8 499 194-5221, info@horses.ru

⁴⁰ "Russia is a riddle wrapped in a mystery inside an enigma." – Sir Winston Churchill

in the Russian Federation in order to introduce a more transparent and predictable procedures, not vulnerable to the whimsical demands of local authorities, while also removing excessive administrative barriers to trade. The retail trade law has three essential features: (1) limiting the operation of chains to no more than 25 percent of total sales within particular geographic regions, i.e. prohibition on internal expansion or merger, (2) restrictions on the ability of suppliers and retailers to enter into slotting arrangements and other payments for shelf space, and (3) price controls on some subset of “socially-important” goods.

Telemarketing. “In Russia share of sales from telemarketing is growing from year to year. Telemarketing market share grows by 40% a year and is in top 3 in Europe based on rate of growth. It can be explained by the large potential of the Russian market. This type of sales is relatively new here and people are not yet tired getting constant calls with an attempt to sell something. As a result, a standard efficiency rate of telemarketing in Russia is around 14-15% with no extra effort. At the same time telemarketing is not used to its full potential in Russia. Many companies just do not yet understand the benefits of this sales method. We can confidently say that only one third of telemarketing resources is used. There is still a lot of room to grow profits with comprehensive use of telemarketing. One thing that should be remembered though is that Russians make most of their decisions (including purchase ones) on an emotional ground. You should include it in your sales strategy. At the same time you should also consider that many Russians would not trust proposals from some unknown vendors. Your task will be to convince them that you are real, legal, your products are of high quality and that you aren’t going to steal anything from them (however weird it might sound).

Direct Mail. Another extremely effective sales method in Russia is direct mail. Of course, you should have a relevant data base. It is also one of the most popular methods which makes it somewhat challenging. Each company gets dozens of mails with proposals, ads, invitations, etc. Most of it ends up on the secretary’s desk and then in the trash bin. Waste of money you might think. And you will be wrong. All you have to do here is to stand out. How should you do it? Use Russian mentality, the way Russians think and most importantly feel. Sometimes it pays off if you add a present to your mailing, something like a pen. In this case you can be sure that the top manager will at least get your mail. The rest depends on the way you have crafted your proposal.

Sometimes it also makes sense to follow up on your mailing with a call. It adds to the value and importance of the mailing and the secretary will in most cases forward it to her boss. With direct mails in Russia (probably in the rest of the world, too) it is like this – the more creative you are the more chances for success you will have. If you have problems with creative ideas you can always use the services of the companies specializing in this area, the so-called Direct Mail Agencies.

Promotional Activities. Mostly here we talk about the presentations of your product when the customers get a chance to taste it, to touch it, and to see it in use. Many companies arrange presentations in a supermarket or in large trade centers where customers have all the opportunities to test the product and leave feedback. Some companies launch seminars of different kinds to present their products to the target audience.

Distributors’ chains. While direct sales as a method has gained momentum still over 80% of companies use the services of distributors to sell their products. It allows the companies to cut their expenses in the area of promotion and advertisement of the goods and services they offer. Such method has both its pros and cons and its use depends largely on the nature of one’s production.

Trade shows. In Russia, over 2,000 trade shows take place annually. Some of them are more like fairs but a large number are professional specialized exhibitions and trade shows. Successful and thoroughly planned participation in these events can help you find new channels of sales, new clients, and exciting opportunities.

E-commerce. Internet sales in Russia are in their infancy period. Almost every day new online-stores appear. Some are large like *ozon.ru* and offer over 500,000 items and others are small and aimed at specific target customers. The problems appear when you have to ship your products. Most of the vendors can't afford to ship their goods within a day or two to every city in this large country. It takes time and undermines the entire meaning of e-commerce. This can explain why mainly citizens of large cities use online shops. As one can see, sales methods and techniques used by professionals in Russia are no different than those in other countries" [63].

"In 2010, e-commerce in Russia reached the \$9 billion mark in sales. The business-to-business segment increased to \$3 billion. The Internet advertising market reached \$400 million in 2010, with *Yandex Direct*, *Google Adwords* and *Rambler Begun* among the key players. The number of Russian Internet users has increased dramatically over the past five years, and varies from 32 to 50 million people according to different sources or 30-40% of the population nationwide. Internet penetration is estimated at 43.6% with an installed base of 69.1 million personal computers. Over 75% of these users are consolidated in the European part of the country. Future growth in Internet usage is expected to be significant. Payment mechanisms are developing quickly and offer a wide range of payment methods - SMS, credit card, payment aggregators, web-money and cash payments. The number of online shops in the Russian market has reached 20,000, selling almost \$4 billion worth of goods in 2010. Home appliances and electronics accounted for 50% of the sales, with the fastest growing subsectors being electronics and household goods. Many companies buy products from foreign E-commerce platforms, such as *Yahoo Auctions*, *Ebay* and *Alibaba*, and resell them in Russia, offering escrow services like *PayPal*.

Although the number of consumers with credit and debit cards is increasing rapidly, many Internet businesses in Russia still do not accept online payments but rather use their websites as a front end for the buyer to select goods and place an order to be delivered. Businesses offering goods or services that can be accessed immediately (electronic downloads and service account top-ups, for instance) offer credit card payment options most frequently. E-currency payments are also an option. The number of consumers with credit cards who are willing to use them online is constantly increasing and banks have begun offering various E-commerce payment products. Sales through these channels currently are sustaining rapid growth. The Russian government's "E-Russia" program is intended to stimulate the growth of Ecommerce throughout the country, using federal and local E-government initiatives as a catalyst. Another government initiative is the launch of the E-commerce platform www.zakupki.gov.ru and accreditation of several private e-commerce platforms such as Sberbank Ast, MMVB Information technologies and RTS Tender, which is aimed at centralizing government and municipal purchases and making them transparent. These sites consolidate all procurement inquiries from government agencies, and provide qualified suppliers an opportunity to sell products and services directly to the government" [37].

TV Advertising (Commercials) in Russia. "Russians dislike the content and format of today's TV commercials. About two-thirds of Russian TV viewers (questions were asked of those saying they have a TV set, or 99%) react negatively to commercials appearing on their TV screen; 51% of respondents say they switch the channel or even turn off the TV (4%), while 7% watch the commercials with the sound turned off. A quarter of the respondents (25%) do other things during commercials. Only 11% of those surveyed say they actually watch TV commercials.

Representatives of all age groups demonstrated the same general level of interest in TV commercials.

At the same time, a full 50% of respondents say that there are some TV commercials they do like (broken down into 47% who said that there are very few TV advertisements they like, and the 3% that believes that said that there are quite a few that are to their liking.) The share of those who dislike today's TV commercials is slightly less than a half – 44% (or 30% among young people).

The overwhelming majority of respondents (91%) say that today's TV commercials are too long, while only 6% of those surveyed are inclined to think that they are just the right duration (young people were more likely to express the last opinion – 11%). It is of no surprise that most Russians (nine tenth or 88%) approve of a bill limiting the duration of TV commercials that was recently passed by the State Duma, while only 2% disapprove of it, and 8% are indifferent about it.

Russians' negative attitude towards TV commercials certainly stems from complaints about their length or quality, but respondents have also taken active issue with the subjects of the advertisements. Only 11% of respondents believe that legitimate goods or services of any kind may be advertised, while three-quarters (74%) believe that only some legitimate goods and services may be advertised, advocating the exclusion of alcohol (38%), personal hygiene products (28%), tobacco (20%) and medications (16%).

The share of respondents ready to pay money in order to watch television without commercials (32%) may give us some indication of the depth of people's dislike of TV commercials. Half the respondents (52%), when given the choice of paying for commercial-free TV or having free, commercial-laden TV, opted for the latter choice (interestingly, there was no differentiation on this issue across social-demographic groups, except the apparent readiness of women to watch TV commercials, while men were most likely to pay money for having them disappear.)

We should note that according to more than half of the respondents, (55%) today's television cannot exist without advertising. One-third (32%) holds the opposite view" [64].

"In response to the economic crisis, many companies cut their advertising budgets. However, in 2010 the market started to recover rapidly and companies are now actively increasing their media and marketing budgets. Though traditional forms of advertising are still prominent in Russia, in the context of the crisis, advertising agencies reconsidered their approach to the communication mix and increased their share of nonstandard communication methods, including "below the line" (BTL), trade programs, ambient media, and flash mobs (publicity stunts). Advertising on the internet continues to be a growth industry. The following is a list of media outlets and print publications listed from highest to lowest penetration in Moscow:

TV Channels

ORT <http://www.1tv.ru>

NTV <http://www.ntv.ru>

Russia 1 <http://www.rutv.ru>

TNT <http://tnt-online.ru>

STS <http://www.ctc-tv.ru>

Radio stations

Avtoradio <http://www.avtoradio.ru>

Russian Radio <http://www.rusradio.ru>

Shanson <http://www.chanson.ru>

Europa Plus <http://www.europaplus.ru>

Retro FM <http://www.retrofm.ru>

Press

Daily newspapers

Metro <http://www.metronews.ru/msk>

Moskovsky komsomolets <http://www.mk.ru>

Iz ruk v ruki <http://www.irr.ru>

Sovetskiy Sport <http://www.sovsport.ru>

Rossiskaya Gazeta (“Russian newspaper”) <http://www.rg.ru>

Weekly newspapers

Teleprogramma <http://www.kp.ru/daily/tv>

Arguments and facts <http://www.aif.ru>

Extra M <http://www.extra-m.ru>

Komsomolskaya Pravda Tolstushka <http://kp.ru/daily/friday>

Monthly magazines

Caravan of stories <http://www.karavan.ru>

Za rulem <http://www.zr.ru>

Vokrug Sveta <http://www.vokrugveta.ru>

Cosmopolitan <http://www.cosmo.ru>

Lyubimaya Dacha <http://ldacha.ru>

Researching the market. As with any country, successfully marketing and selling goods and services in Russia requires adaptation to its commercial climate and business practices. Market research is required to identify opportunities and potential Russian business partners. The choice of a partner is key and should be done only after conducting sufficient due diligence to determine its reputation and reliability. Research of published information (desk research) to scope a market is becoming increasingly common as a means of carrying out market intelligence. General statistical data on Russia, *eg* gross domestic product, industrial production figures, consumption rates and international trade data can be found in business libraries or on the internet. Check publications such as country supplements produced by the *Financial Times* www.ft.com, the Russia Factsheet published by the *Economist Intelligence Unit* www.eiu.com and other relevant publications. For Russian news, see *The Moscow Times* www.themoscowtimes.com an English language newspaper and its companion paper *The St.Petersburg Times* www.sptimesrussia.com

The *U.S. Commercial Service* has services to assist with market research, identifying partners and conducting due diligence (http://www.buyusa.gov/russia/en/products_services.html). To view market research reports produced by the U.S. Commercial Service please consult the following website: <http://www.export.gov/mrktresearch/index.asp> and click on Country and Industry Market Reports. Please note that these reports are only available to U.S. citizens and U.S. companies. Registration for the site is required, and is free.

UK Overseas Market Introduction Service (OMIS) puts you directly in touch with staff in their three offices in Russia (Moscow, St Petersburg and Ekaterinburg), who are able to give you access to the country and sector-specific business advice, as well as offering support during your visits to Russia. They can advise on local business conditions and provide tailored information specific to your needs. OMIS is delivered online, giving you a direct link to local experts, with fast access to reports and advice, and allowing you to keep in touch wherever you are.

Pricing. “Russian consumers are attracted to bargains, but are increasingly able and willing to pay for quality merchandise. Foreign companies exporting to Russia should be prepared to offer competitive prices for their goods, knowing that in many areas they face inexpensive Russian,

Asian and strong European and other third-country competition. With a few exceptions, all goods and services sold in Russia are subject to a value-added tax (VAT) of 18%. Imports into Russia are subject to VAT, which is assessed on the CIF value of an imported shipment plus applicable duty. In addition, in many sectors with strong local and third-country competition, it will be necessary to spend money on advertising and brand promotion. All these costs should be figured into the exporter's pricing structure and become part of a long-term marketing and sales program" [37].

Income and cost of living in Russia. Government anti-crisis measures to bolster wages, pensions, and other benefits helped reduce the poverty rate in 2009 to an estimated 14%, bringing the number of people living below the subsistence minimum (equivalent to about \$169 per month) to below 20 million. The official poverty rate was estimated as 13.1% by the World Bank at the end of 2010. According to Russian statistics, the poverty level increased to 14.9% of the population in the first half of 2011 because of an increase in the official poverty threshold and because average real income fell slightly in 2011.

At the end of 2011, average annual income in Russia was around RUB 292,000 (\$9,700) or RUB 24,310 (\$810) a month (average annual income in the USA is about \$32,000). According to the *Boston Consulting Group* there were over 400,000 Russian households with assets over \$100,000 in 2006. The total value of the Russian households was \$540 billion in 2006 with an annual increase of 22.5%. According to *Renaissance Capital* about 7 million households in Russia have an income of over \$30,000 a year. The average pension in Russia was RUB 10,000 (\$333) a month in 2012.

Though the cost of living in Russia has increased over the last few years, everyday living costs remain comparably low. Apartments are affordable, transportation is cheap and convenient, utilities are inexpensive and local phone calls are free. Below are averages costs and prices for several basic necessities in Russia:

Buy apartment price

Price per square meter to buy apartment in city center	\$2,805.85 (\$1,446.76 – 7,882.42)
Price per square meter to buy apartment outside of center	\$1,978.38 (\$1,117.01 – 4,507.15)

Rent per month

Apartment (1 bedroom) in city center	\$590.21 (\$350.60 – 1,103.54)
Apartment (1 bedroom) outside of center	\$456.57 (\$250.71 – 889.61)
Apartment (3 bedrooms) in city center	\$1,066.35 (\$627.22 – 2,103.58)
Apartment (3 bedrooms) outside of center	\$781.71 (\$490.83 – 1,351.63)

Utilities (Monthly)

Basic (electricity, gas, water, garbage) for 85m ² apartment	\$93.00 (\$49.65 – 142.56)
1 min. of prepaid mobile tariff local (no discounts or plans)	\$0.06 (\$0.04 – 0.10)
Internet (6 Mbps, Flat Rate, Cable/ADSL)	\$16.96 (\$11.58 – 26.24)

Transportation

One-way ticket (local transport)	\$0.62 (\$0.39 – 0.93)
Monthly pass	\$35.73 (\$21.83 – 53.92)
Taxi start (normal tariff)	\$3.91 (\$2.29 – 6.56)
Taxi 1km (normal tariff)	\$0.50 (\$0.33 – 0.99)
Taxi 1hour waiting (normal tariff)	\$12.44 (\$5.79 – 22.52)
Gasoline (1 liter)	\$0.91 (\$0.81 – 1.00)
Volkswagen Golf1.4 90KW trendline (or equivalent new car)	\$20,260 (\$15 751 – 24 541)

Markets

Milk (regular), 1 liter	\$1.22 (\$0.95 – 1.58)
Loaf of fresh white bread, 500g	\$0.71 (\$0.54 – 1.00)
Eggs (12)	\$1.59 (\$1.30 – 1.92)
Fresh cheese, 1kg	\$9.33 (\$7.00 – 11.83)
Chicken breasts (boneless, skinless), 1kg	\$6.11 (\$4.29 – 8.26)
Apples, 1kg	\$1.91 (\$1.57 – 2.52)
Oranges, 1kg	\$1.78 (\$1.39 – 2.32)
Potato, 1kg	\$0.80 (\$0.48 – 1.18)
Lettuce (1 head)	\$1.02 (\$0.63 – 1.65)
Water, 1.5 liter bottle	\$0.99 (\$0.66 – 1.35)
Bottle of wine (mid-range)	\$8.93 (\$6.31 – 12.86)
Domestic beer, 0.5 liter bottle	\$1.25 (\$0.95 – 1.65)
Imported beer, 0.33 liter bottle	\$2.26 (\$1.58 – 3.51)
Pack of cigarettes (Marlboro)	\$1.68 (\$1.40 – 2.03)

Sales service/Customer support. “Good after-sales service, training and customer support can be a major competitive advantage for international companies especially for U.S. firms entering the Russian market, as Russian manufacturers are known for inadequate post-sale service. Similarly, buyers of sophisticated equipment of all types – from computers and process controls to medical and mining equipment – are keenly interested in training, as their employees may never have used particular products or brands. Foreign firms able and willing to offer training and support for products, particularly in remote sites, and can gain a significant advantage over competitors. Conversely, companies unwilling to make this commitment may find themselves at a distinct disadvantage to European or Asian companies, whose proximity facilitates training and service. After-sales service is also often an important component in leasing arrangements in Russia, and will play a larger role in the decision process as leasing continues to develop.

Distribution and sales channels. Well-organized distribution channels have developed significantly over the last few years, particularly in the major population centers, such as Moscow and St. Petersburg, and have begun to expand to the regions. In the consumer sector, some large-scale retail stores have recently emerged in Moscow that are able to buy in bulk and negotiate relatively long-term commitments. Large shopping malls have opened up on the Ring Road circling the capital and are giving the Moscow retail environment more of the characteristics of other European cities. Shopping malls and big box stores are common sights in St. Petersburg, Moscow and many other Russian cities.

By utilizing these domestic distribution organizations, the task of bringing goods to market in Russia has been greatly eased. However, their geographic coverage can be limited, and accessing markets in some of the regions can still be problematic. In these regions, foreign firms may encounter erratic distribution, unpredictable and tough competition, and word-of-mouth marketing. Although Russia boasts increasing numbers of western-style stores in major cities, much distribution and retailing still takes place through such informal channels as kiosks and open markets. Those who succeed do so through a combination of improvisation and innovation, combined with a substantial investment of time and a tolerance for early mistakes. Foreign companies with a long-term market development strategy may find regional markets well worth exploring.

St. Petersburg remains the main port of entry for a variety of consumer and industrial products for European Russia (Russia west of the Urals). Vladivostok is the main port of entry for the Russian Far East. In general, the transportation infrastructure in this vast country is still underdeveloped and in need of major upgrades. The majority of cargo moves by rail and the road

network is in need of expansion. Major western freight forwarders and express couriers are active in Russia.

International entrepreneurs have four basic options when choosing a distribution channel:

1) *Agents*. It is not a common practice in Russia for foreign companies to rely solely upon the services of an agent. Distributors and representative offices, however, often employ agents in the Russian regions in order to promote their products.

2) *Distributors*. The most common market entry strategy is to select a good distributor or several distributors (depending on the product). Foreign companies can consider a variety of national, regional and local distribution alternatives. In some product categories (e.g., apparel, cosmetics, packaged foods, alcoholic beverages, consumer electronics, and household appliances), foreign suppliers can choose from a growing number of established distributors. A good distributor will typically sell and deliver foreign suppliers' products to end-users and/or the retail market and provide a wide range of logistical support, i.e., customs clearance, warehousing, inventory management, etc. However, handling promotion and advertising campaigns exclusively through independent distributors can often produce disappointing results. Russian distributors normally handle products from multiple suppliers and are not typically dedicated to promoting a specific company's product unless the supplier provides substantial support for promotion and advertising. Russia's retail law also limits some types of promotional activities.

3) *Representative/Branch Offices*. Some foreign manufacturers, in addition to using distributors, have established their own representative offices. The major advantage of opening a representative office is that foreign companies have more direct contact with their end-users and control over the promotion and distribution of their products. However, under the Russian Civil Code, such offices cannot be directly involved in commercial activity. Instead, they typically oversee a network of distributors and/or agents that perform commercial functions. This approach affords greater control by the foreign supplier over the distribution process and helps to reduce risks. As Representative Offices may not take part in commercial activities, Branch Offices have become increasingly more popular. According to a 1999 foreign investment law, foreign companies may engage in commercial activities through their legally established branches. Branches are accredited for five years and must be registered with tax authorities and other state organizations. Both Representative and Branch Offices can be attractive to foreign businesses wishing to operate in the Russian market because there are fewer tax and other administrative burdens and currency control restrictions may not apply.

4) *Foreign Subsidiaries*. As has been mentioned in the chapter 6 some foreign manufacturers, particularly in the cosmetics, pharmaceuticals, consumer appliances, durables and industrial products sectors, have registered their wholly owned subsidiaries in Russia. They then sell directly to their own companies registered in Russia who import for their own account. This approach affords full control of the supplier over distribution and helps to further reduce possible risks from false invoicing and other irregularities sometimes committed by independent importers and distributors. Foreign exporters are advised to cultivate personal relationships with their Russian representatives and clients, to proceed gradually, and to ensure they have a contingency plan should problems arise. Since it is often difficult to find information on Russian companies, it is strongly recommended that foreign firms consider using the *International Company Profile* service to validate potential partners. The U.S. Commercial Service strongly advises against the risky practice of a company representative simply visiting Russia once or twice, selecting a representative, granting exclusive representation, and then moving quickly to consignment or credit sales without first establishing a payment and performance history. In addition, exporters are cautioned to take primary responsibility for registering their brand names in Russia and not to rely on a partner to do this. Finally, it is important to provide a Russian

partner with Russian language product information and marketing materials. These can be prepared at home or done jointly with a Russian partner. The U.S. Commercial Service provides assistance to U.S. companies in finding local partners through the *Gold Key Service*, *Pre-Service Market Assessment*, *International Partner Search*, *International Company Profile*, *Customized Market Research*, *Platinum Key* and other products and services. Information about these services can be found at http://www.buyusa.gov/russia/en/products_services.html.“ [37].

Driving factors for foreign business in Russia. “Below are compiled some of the most important factors which are contributing or can contribute in the near future to an intensification of foreign business in Russia:

Current success stories (GSK, Fuller’s, M&S, BP, IKEA, Sbarro, Pepsi, Coca-Cola, Danone, Ford, Toyota, Hyundai) – There is no shortage of well-known European, American and Asian companies which have moved onto the Russian market and are prospering. These success stories will serve as examples and inspiration for a plethora of SMEs to emulate their actions.

Simplified visa regime – Following the “reset” of Russia-USA relations, talk of a simplified or even visa-free regime with Russia has intensified in Europe. With the backing of key European states such as Finland and Italy prospects for a visa-free (or much simplified) visa regime between the USA, EU and Russia within the next 5-10 years are good.

Growing Russian middle class – Estimates vary, but according to many Russian sociologists between 15-25% of the country’s 142 million population belong to the middle class or middle class periphery. Most are concentrated in Russia’s two main cities: Moscow and St. Petersburg. The UNDP⁴¹ report on Russia’s regions notes that: “Personal incomes of Muscovites are around 20% of personal incomes in Russia, although the share of Moscow in the country’s population is only 7%” This disparity between the regions and the center represents a major opportunity for tenacious businesses as the regions try frantically to match the living standards of the center.

Decline of growth rates in the traditional EU, US markets – Growth rates in traditional markets have slowed in many cases and even stagnated in others with figures of below 1% becoming more and more commonplace. By contrast, Russia even after the economic crisis retains a relatively low ratio of per capita GDP to national debt and seems to be emerging from the crisis in a good position with continued focus on diversification to avoid the boom-bust cycles typical of resource-centered economies.

Sochi 2014 – The approaching winter Olympics to be held in the Black Sea resort of Sochi in 2014 promises a wealth of opportunities for foreign firms and investors. A total of 47 transport infrastructure construction and modernization projects are underway and there are also plentiful opportunities in terms of telecoms, energy and environmental protection. The 14 billion USD investment package in Sochi and the determination of the government to make the Olympics a domestic and international success make Sochi an attractive proposition.

WTO membership for Russia – Russia finally has been accepted into the WTO in 2011, solving problems with the organization on issues such as protectionism, state enterprises, the cost of oil/gas and intellectual property rights, and this means among other things that Russia will provide for improved market access for foreign firms and a much healthier competitive environment domestically. Through commitment to WTO rules and norms, trade with,

⁴¹ The United Nations Development Program (UNDP) is the United Nations' global development network. It advocates for change and connects countries to knowledge, experience and resources to help people build a better life. UNDP operates in 177 countries, working with nations on their own solutions to global and national development challenges.

investment in and expansion onto the Russian market will become much more predictable for foreign firms, thus reducing the “risk cost” of the entry ticket into the market.

A closer political relationship – With an emerging EU foreign ministry in Europe and 4 roadmaps for cooperation currently regulating EU-Russia cooperation, prospects for a closer political relationship are good. Some of the most powerful and influential EU states such as Germany, the UK and Italy all pursue very close ties with Russia and prize their business relationships with the country. The value of this relationship is clearly illustrated by the fact that the UK remains one of Russia’s main investors despite the plethora of political issues over the last years which could have de-railed this cooperation” [65].

Chapter 13

Business Risks and Insurance

1. Business Risks

“Just as there are reasons to get into global markets, and benefits from global markets, there are also risks involved in locating companies in certain countries. Some of the risks in international business are:

Political Risk: The political actions and instability may make it difficult for companies to operate efficiently in these countries due to negative publicity and impact created by individuals in the top government. A firm cannot effectively operate to its full capacity in order to maximize profit in such an unstable country's political turbulence. A new and hostile government may replace the friendly one, and hence expropriate foreign assets. This area also is affected by the currency exchange rate, government flexibility in allowing the firms to repatriate profits or funds outside the country. The devaluation and inflation will also impact the firm's ability to operate at an efficient capacity and still be stable. Most countries make it difficult for foreign firms to repatriate funds thus forcing these firms to invest its funds at a less optimal level. Sometimes, a firms' assets are confiscated and that contributes to financial losses.

Strategic Risk: The ability of a firm to make a strategic decision in order to respond to the forces that are the source of risk. These forces also impact the competitiveness of a firm. Porter defines them as: threat of new entrants in the industry, threat of substitute goods and services, intensity of competition within the industry, bargaining power of suppliers, and bargaining power of consumers.

Operational Risk: It is a very broad concept which focuses on the risks arising from the people, systems and processes through which a company operates. This is caused by the assets and financial capital that aid in day-to-day business operations. The breakdown of machineries, supply and demand of the resources and products, shortfall of the goods and services, lack of perfect logistic and inventory will lead to inefficiency of production. By controlling costs, unnecessary waste will be reduced, and the process improvement may enhance the lead-time, reduce variance and contribute to efficiency in globalization. Operational risk also includes other categories such as export-import risks, fraud risks, legal risks, physical or environmental risks.

Technological Risk: Lack of security in electronic transactions, the cost of developing new technology, and the fact that these new technologies may fail, and when all of these are coupled with the outdated existing technology, the result may create a dangerous effect in doing business in the international arena” [66].

The format of this manual does not allow considering in detail all these risks. Since strategic, operational and technological risks in the domestic market have much in common with the same risks in international markets and some of these and other risks often are included into the notion of political risks, attention here is focused mainly on political risks.

“In order to assess political environment in this or that country correctly, experienced international companies implement a *political risk assessment* – procedures for examining the political climate and social conditions of a particular country, region, or market to determine the level of political risk. They provide information pertaining to government stability, crime levels, currency convertibility, land rights issues, as well as other factors that would affect return on

investment. Broadly, political risk refers to the complications businesses may face as a result of what are commonly referred to as political decisions – or any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives. Practically, all political risks can be attributed to one of the following three categories:

- Ownership risk is a risk of losing ownership when a company can lose its property as a result of confiscation or expropriation
- Operational risk, when the company's current activity and/or its employees' security are at risk because of changes in legislation of the host country, tax code and environment protecting acts and also because of terrorism, armed revolts, *etc.*
- Transfer risk, when the government imposes restrictions on transfer of financial means to the host country or out of the country

As table 13.1 shows political risks can arise as a result of such actions of government as passing laws leading to expropriation of private property, increase in current outlays, devaluation of national currency, or restrictions on repatriation of profits. Apart from this, political risks can be caused by occurrences not pertaining directly to government actions, e.g. kidnapping, racketeering, and terrorism.

Table 13.1

Examples of political risks

Risk	Impact on Companies
Expropriation	Loss of future profits
Confiscation	Loss of property Loss of future profits
Campaigns against foreign goods	Decline in sales Increase in cost of Public Relations to enhance prestige of company in the estimation of the public
Compulsory laws on favorable wage conditions	Increase in current outlays
Kidnapping, racketeering, terrorism and other forms of violence	Breakdown in manufacturing process Increase in cost of security Increase in cost of administering Recession of performance rate
Civil wars	Loss of assets Loss of sales Breakdown in manufacturing process Increase in cost of security Recession of performance rate
Inflation	Increase in current outlays
Repatriation	Impossibility to transfer financial means between countries
Devaluation of national currency	Decline in repatriated profit converted into the currency of foreign company
Increase of taxation	Decrease in net profit

Political risks can either equally affect the activity of all companies doing business in the country or only damage the operations of some of them. *Macropolitical risks* affect all companies operating in the country; such risks can be exemplified by civil wars which lacerated Sierra Leone, Zaire, Zambia, Bosnia and Ruanda in 90's or by recent events in Afghanistan and Iraq. *Micropolitical risks* affect only a certain company or companies in a certain industry. Nationalization of the oil industry in Saudi Arabia in 70's is an example of political risk caused

by government activity. Non-governmental political risks also seriously affect companies' activity. Two companies, *Disneyland Paris* and *McDonald's*, became targets for numerous symbolic protest actions of French farmers who considered them as a convenient target to express their discontent with the agricultural policy of the USA. Sometimes protests can evolve into acts of violence which result in shutdown of enterprises belonging to foreign entrepreneurs. For example, in 2003, companies *TotalFina Elf SA*, *Royal Dutch/Shell* and *Chevron Texaco* temporarily stopped their operations in the mouth of the Niger River because of warfare between the government and local indigenous tribes.

Any company planning to penetrate a new market should have in its disposal main data about the country. To control company's political risks, it is necessary to figure out the political and economic structure of the target market. In doing so international entrepreneurs should find answers to the following questions:

- What is political system of the country: democracy or dictatorship? Is the power concentrated in the hands of one person or one political party?
- According to which principle are resources allocated in the country: according to the principle of market economy or the principle of state regulation? What contribution of the private sector does the government reckon on in the process of achievement of general economic goals? Does the government consider foreign companies as one of means of economic development or as a hurdle on the way to the achievement of economic goals?
- To what sector of the country's economy (private or state) do the company's consumers belong? If to the state sector, then will the foreign company be able to compete with state firms on equal terms?
- How does the government act in case of changing the country policy? Are these changes made as an act of arbitrariness or does the government stick to the principle of supremacy of law?
- How strong is the position of the acting government? In case of an acting government resignation, should you expect radical changes in the economic policy of the new government?

The majority of multinational companies continuously are tracking the changes in political conditions of host countries. In many cases, the best source of information is the company's employees. Regardless of whatever country's citizens the company's employees are (host country or home country) these people have first-hand information about the local political environment. That is why the company's staff is the best source of information about political risks. The local staff point of view can be complemented with the outside vision of people not working for the company. Officials from embassies and local representative offices of the *International Chamber of Commerce (ICC)*⁴² can be very useful sources of information. The representative offices themselves can provide very valuable information. As a rule, governments make public their political and economic programs during their election campaigns or in the course of war actions aimed at suppression of their opponents. After accession to power, governments continue to provide international companies with information about their current plans for the future. There are many consulting companies specializing on assessment of political risks⁴³. There is a range of print media which annually publish the results of their investigations of political risks in different countries⁴⁴.

⁴² <http://www.iccwbo.org/>

⁴³ For example, *Eurasia Group* is best known as the world's largest political risk consultancy with offices in New York, Washington, London, and Tokyo and more than 125 full-time employees. The company also employs a network of 500 experts in 80 countries in Asia, Latin America, Europe & Eurasia, and Middle East & Africa.

⁴⁴ For example, *Economist*, *Euromoney*, *Journal of International Business Studies*, *Journal of International Money and Finance*, etc.

The volume and character of information necessary for political risk assessment in this or that country depends on what business a company is doing and how long it plans to work in the host country. When the company has significant and long term of investments, then the political risk assessment should be more diversified.

A certain degree of political risk exists in all countries; however, political risks have their peculiarities in each country. Protests of French farmers just caused inconvenience for managers of *Disneyland Paris* and *McDonald's* whereas ethnic conflicts in some regions of the world completely destroyed the economic viability of foreign companies operating in those regions. In the process of political risks assessment as during making any other business decisions, it is important to find a reasonable balance between risk level and the profit which can be received from doing business in another country. If an international entrepreneur makes decision to invest into environment characterized with high level of risk, it is necessary to be sure that the rate of return in this market will compensate the risk of penetrating this market. Companies operating in countries with a high level of political risks can undertake measures aimed at protecting their operations in those countries. A company can lower the level of its financial vulnerability through reducing the volume of net investments in the local subsidiary. To implement this reduction, the company can transfer the subsidiary profit to the parent company accounts in the form of dividends; sell the subsidiary shares to citizens of the host country; use a short term lease of new fixed assets instead of outright purchasing them. Alternatively, a company could provide internal political support in the host country creating the image of a company with high civic responsibility. To achieve this, the company could whenever appropriate buy resources from local suppliers, hire citizens of the host country for key leading and administrative positions and take part in local charity events.

2. Insurance for international business

Political risk insurance. Practically in all developed countries, special state organizations are established the main task of which is to insure international companies from political risks they can suffer in other countries. For example, *Overseas Private Investment Corporation (OPIC)* provides insurance for US foreign investments in case of nationalization, rebellions or revolutions and also in case of inconvertibility of national currency. In 2002, OPIC sold insurance policy for political risks to *Decision Technologies International* to the tune of \$1 million which allowed the company to establish its unit in Nigeria to develop and sell its software products there. However, OPIC ensures only companies operating in countries with which the USA has concluded Bilateral Investment Treaties⁴⁵. *Multilateral Investment Guaranty Agency (MIGA)*, a subdivision of the *World Bank*, provides similar services on political risk insurance. Private insurance companies like *Lloyd's of London* provide political risk insurance too" [29].

Insurance for export and import businesses. "If your business is new to international trade, it is important to assess and plan for the different risks you will invariably face. When you evaluate the risks of your potential customers, remember also to look into risks associated with the countries in which they operate. As well as physical loss or damage to goods, you need to plan for problems of cashflow to allow for the time that goods are in transit or in bonded warehouses here or abroad and/or the heightened risk of non-payment by your customers. In some cases you also need to plan for risks associated with faulty goods or services.

⁴⁵ A bilateral Investment Treaty with Russia was concluded on 17 June 1992 but it is not yet ratified by Russia because of contradictions in negotiations on entering WTO
<http://www.unctad.org/Templates/Page.asp?intItemID=2344&lang=1>

Weighing up import and export risks. As an exporter of goods or services you will need to be aware of and consider insuring against the risks of:

- Loss of or damage to goods in transit
- Non-payment for your goods or services
- The cost of returning to your premises any goods that a buyer abroad refuses to accept
- Political or economic instability in the buyer's country
- A new customer's credit worthiness
- Currency fluctuations, and
- A fault that causes an end-customer to sue

If you are an importer, you may need to take into account:

- Possible loss of or damage to goods in transit
- Supplier problems, including failure to supply
- Transport delays and potential hold-ups at ports
- The risk of performance or health and safety problems
- Import duties
- Storage of goods in bonded warehouses, and
- Currency fluctuations

The responsibility for organizing insurance can be shared between the importer and exporter, or be taken on by just one of them. When you agree the terms of a contract, it is advisable to use one of 11 *International Commercial Terms (Incoterms 2010)*⁴⁶ – e.g., *Free on Board or Cost Insurance Freight*. Incoterms clearly clarify who has responsibility for freight, insurance and other costs. They also determine when ownership of the goods passes from buyer to seller.

Foreign currency and exchange risks. When you trade internationally, you should also take steps to protect your business against changes in the exchange rate. You will also need to consider when and how best to make or receive payments in currencies other than your national currency. Even a tiny variation in the exchange rate could cost your business thousands of dollars. There are many different types of currency hedging and your bank should be able to help you with the best solutions for your business. Some types of hedging are discussed in this manual – see the pages in this manual on forward foreign exchange contracts, buying currency options, *etc.* (Chapter 8). You may also consider opening a foreign currency account. Opening an account with a bank overseas could be beneficial if you will be making or receiving many payments in a foreign currency – especially many small payments.

Loss or damage of goods. The goods you export or import must have insurance coverage with either yourself or the buyer from the beginning of their journey until their arrival. In some cases you will absorb the cost of coverage, in others the cost is passed on to the buyer.

- *Insurance for exports.* Many exporters arrange insurance and freight but pass on the cost to the buyer. Where this is the case, your agreed terms are likely to be Cost Insurance Freight to a named destination port – in other words you are charging your customer for

⁴⁶ The *Incoterms* rules or *International Commercial Terms* are a series of pre-defined commercial terms published by the *International Chamber of Commerce (ICC)* widely used in international commercial transactions. A series of three-letter trade terms related to common sales practices, the Incoterms rules are intended primarily to clearly communicate the tasks, costs and risks associated with the transportation and delivery of goods. The Incoterms rules are accepted by governments, legal authorities and practitioners worldwide for the interpretation of most commonly used terms in international trade. They are intended to reduce or remove altogether uncertainties arising from different interpretation of the rules in different countries. First published in 1936, the Incoterms rules have been periodically updated, with the eighth version—Incoterms 2010—having been published on January 1, 2011. "Incoterms" is a registered trademark of the ICC [wiki].

the cost of goods as well as insurance and freight to the port or airport of their choice. Foreign buyers often insist on this service if insurance rates in your country are relatively cheap. The benefits: you can have greater control over the risk if your country insurance industry is highly regulated; you could win business from competitors who do not offer insurance. Remember that if you leave your buyer to arrange insurance, they will do so before paying for the goods. You may not be paid in full if there's a problem and they're not adequately insured. In addition, if the goods are rejected when they get to the port of entry or to the customer's premises, they won't be covered by insurance, and the responsibility will be back with you.

- *Insurance for imports.* You will minimize your risks if you arrange insurance of goods that you import. You'll know how much you are paying and what's included. Your supplier might not be able to give you full details of insurance cover they arrange, or if they do, the information may not be entirely reliable. The following types of coverage are available: *open coverage* – for all journeys; *specific (voyage) policy* – for one-off shipments; *seller's interest contingency* – back-up for physical loss or damage where you have not arranged the cargo insurance.
- *Where to get cargo insurance.* A specialist cargo insurance broker will find you a good price, ensure the coverage suits your needs and help you with claims. Search for a reliable cargo insurance broker. Some banks offer cargo insurance as part of a finance package. You can also ask your freight forwarder for a quote, so as to compare their costs and service with those offered by specialist brokers. You need to be aware that carriers, freight forwarders or third-party service suppliers will not automatically insure goods that are under their care or control. They can only do so if instructed in writing.

Product faults. In exceptional circumstances, a fault with the product supplied may result in an end user taking legal action against your business. Depending on the nature of your product or service, you may need to take out insurance to cover this risk. If you supply goods for export, you need to consider whether your product could, in very rare cases, cause damage to a third party – either a person or property. These types of risks are covered by *product liability insurance*. If you already have this insurance, check that the policy covers you for claims made outside your country. Many policies have restrictions on where they apply. You'll need a policy that protects you against: safety claims; manufacturing defects; spoilage costs; legal defense costs; and medical costs. A specialist broker will advise you on the best policy for your business. Note that product liability insurance does not cover you for claims against the supply of poor quality products or poor services. Introducing a rigorous system of quality control – *i.e.* checking that your products meet certain standards – can help you avoid producing poor goods.

Non-payment. You might not be paid in full for the goods or services that you export because: your customer can't or won't pay, war or a natural disaster prevents your goods from reaching the customer, or you from completing your contract; political reasons prevent you from completing your contract, such as an export license ban in your country, or import restrictions or a change in the law in the buyer's country; or currency problems prevent your buyer from getting the cash they need to pay you.

Insuring against non-payment. As an exporter, you can take out export credit insurance. This protects against non-payment and is an important tool in credit management. It means you can sell more goods or services on credit terms and increase your borrowing power. However, it should not replace good credit management practices. So search for a financial export credit insurer on your country's insurance brokers' association websites.

Export insurance policy. An export insurance policy insures an exporter against the risk of not being paid under an export contract. It may also cover the risk of not being able to recover the

costs of performing that contract because of specified reasons. Typically, such policies cover up to 95 per cent of the value of the contract and each policy will set out the risks it covers. You can purchase an export insurance policy from a private export credit insurer. If you have not been able to purchase an export insurance policy privately, you may be eligible to apply for one to your national export finance program, if you meet all of the established criteria.

Bond insurance. Many buyers abroad ask sellers for bonds or bank guarantees in case the seller doesn't keep to their side of the contract on quality or performance after receiving advance payments. Most export-related bonds are payable on demand, so pose a risk for exporters. Outbreak of war, for example, or overnight imposition of trade embargoes can lead to the calling-in of a bond. A bond insurance policy will protect you against these risks. National export finance programs offer bond insurance.

Tender exchange rate indemnity. This insurance will protect you against adverse exchange rate movements when tendering for contracts in a foreign currency. If the currency weakens between submission of your firm's tendering and winning the contract, you could lose a lot of money. Some private credit insurers offer this insurance.

Find an export credit insurer. Export credit insurance can be divided into two types - short and medium/long-term.

Consumer goods, raw materials and other similar items are normally sold on cash or short payment terms of less than two years. Your insurance broker or banker may be able to advise you on suitable insurers who will cover short-term risks.

If you plan to export capital or semi-capital goods or services with payment terms exceeding two years, you will need more specialist help. Specialist private sector insurance companies increasingly provide this kind of credit insurance. However, if you are unable to obtain export credit insurance from the private sector then you may be able to purchase government-backed export insurance from national export finance programs. Make sure that the credit insurer understands the market in which you are selling, and that they can cover all of the potential risks that you are likely to face. If you are new to exporting, get recommendations from other businesses, from your bank or financial adviser.

Export finance and insurance. A key problem all exporters face is cashflow – you need to offer credit to win customers, but you also need cash to finance growth.

There are a number of short-term finance options, which smaller exporters will need to access via their bank or a specialist insurance broker. As with any insurance policy – e.g. premises or employer's liability, you should obtain several quotations before choosing an insurer or a policy. Banks may offer a trade finance package, including cargo insurance.

In the first instance, you will have to decide whether to insure each order, or each part consignment as you dispatch it. Once you have more of an idea of your export turnover, you should consider negotiating a policy to cover your annual export turnover. Any premium will factor in whether you are exporting to one or several countries, the level of risk of each, including currency fluctuations and political unrest, the amount of time between your issuing an invoice and potentially receiving payment, as well as the level of risk associated with your sector and your buyers.

Documentary credit (DC). DC (commonly known in many countries as a Letter of Credit) is a fixed assurance from the buyer's bank in the buyer's country. It is issued on behalf of the buyer to

say that payment will be made for the goods or services supplied by your business, providing you comply with all terms and conditions established by the credit.

If it is a cash contract, the DC terms will provide for payment immediately upon presentation of conforming documents to the issuing bank – i.e. before goods are released to the customer. Until you are certain of a new customer's credit worthiness, it is best to aim for such payment terms.

If you have offered credit, the DC terms will state when payment is due, reflecting any extended payment terms you have granted. Your bank may be prepared to provide a short-term loan, for a percentage of the DC, prior to shipment to cover the temporary shortfall. They will then collect from the proceeds of the subsequent presentation of the DC. For more information, see this manual on letters of credit (Chapter 8).

Factoring. A factor enables you to receive cash within a few days of invoicing, by taking the ongoing responsibility for collecting your short-term debt. In some cases the factor will also take a percentage of the non-payment risk. This is called non-recourse factoring and means the factoring company won't come back to you if the payer defaults. Your bank can advise you on factoring.

Forfaiting. Forfaiting enables exporters to convert a credit sale into a cash sale. However, this is for larger projects and medium- to long-term financing.

Credit insurance facilities. As an exporter you can also obtain financing by assigning your credit-insured invoices to banks. In return the bank will offer up to 100 per cent of the insured debt as a loan. Ask your bank whether they offer this kind of support.

SMEs and export financing. Small and medium-sized enterprises can find it more difficult to obtain financing as thresholds may apply for certain types of policies. If your export turnover is below that eligible for a national export finance policy, the Factoring and Commercial Finance Industry may be able to offer you an insurance policy. These policies typically allow you to secure your financing by your underlying receivables or other assets not on the balance sheet.

Trade Facilitation Program for certain regions. If you trade with Russia, Eastern Europe or the Commonwealth of Independent States, you can benefit from special guarantees offered through the *Trade Facilitation Programme (TFP)*. The program, run by the *European Bank for Reconstruction and Development (EBRD)*, promotes trade with this region by offering 'confirming banks' – which finance exports – security against the commercial and political risks of non-payment by local 'issuing banks' – which finance imports.

Credit guarantees. The EBRD guarantees payments under the terms of trade-related finance instruments issued by local banks, including:

- Documentary letters of credit
- Standby letters of credit
- Advance payment bonds and guarantees
- Contract guarantees, such as performance or bid bonds, and
- Trade-related promissory notes or bills of exchange.

Simply put, the EBRD guarantees payments promised by local banks for your exports against political and commercial risks. This makes it easier for you to secure financing through your national banks to trade with this region. Note that the EBRD does not deal directly with importers and exporters, even though they are the final beneficiaries.

Goods and services covered. EBRD guarantees cover for financial transactions relating to consumer goods, commodities, equipment, machinery, power supply, and construction, technical and other services. The bank requesting an EBRD guarantee pays the fees for this service. No fees are payable by the importers and exporters.

Using the TFP. There are over 90 issuing banks in the 21 EBRD countries of operation. To help secure financing for a transaction in this region, contact an issuing bank in the country you're trading with to request support, or ask your buyer if their issuing bank can get an EBRD guarantee" [67].

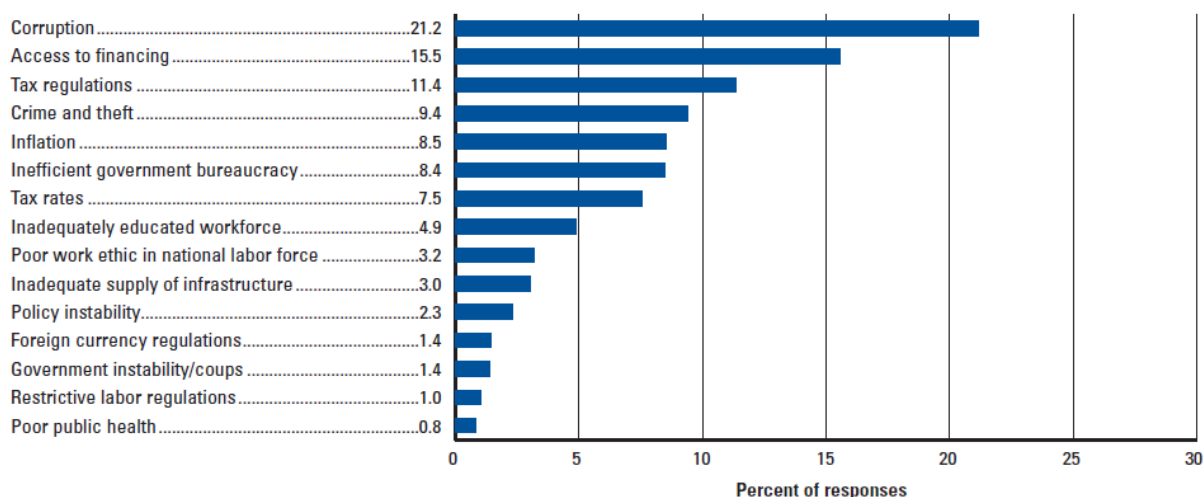
OPIC. "In an agreement ratified in 1992, the U.S. Overseas Private Investment Corporation (OPIC) was authorized to provide loans, loan guarantees ("financing"), and investment insurance against political risks to U.S. companies investing in Russia. OPIC's political risk insurance and financing help U.S. companies of all sizes invest in Russia. OPIC insures against three political risks: expropriation; political violence; and currency inconvertibility. To meet the demands of larger projects in Russia and worldwide, OPIC can typically insure up to \$250 million per project. The individual per project exposure limit for financing is \$250 million. The maximum combined (insurance and financing) exposure limit to OPIC on a single project is \$400 million. OPIC has no minimum investment size requirements. OPIC also makes equity capital available for investments in Russia by guaranteeing long-term loans to private equity investment funds. Detailed information about OPIC's programs can be accessed at www.opic.gov" [37].

3. Challenges of doing business in Russia

Bureaucracy. "Corruption, the rule of law, questions as to the independence of the judiciary, red tape and customs formalities are just some of the problems which can be located under the broad umbrella of bureaucracy. The enduring problems with bureaucracy increase the transaction costs of any potential venture on the Russian market and must be taken into account when planning" [19]. Below are the most problematic factors for doing business in Russia.

Figure 13.1

The most problematic factors for doing business



Source: WEF Global Competitiveness Report Russia, 2010-11

"Corruption continues to grow in Russia and its pervasiveness is acknowledged regularly both by Russia's highest officials and society at large. As such, corruption remains a major problem for businesses and investors in Russia. According to Transparency International (TI), Russia scored 2.1 out of 10 in 2010, down from 2.2 in 2009. In 2011, Corruption Perceptions Index, released on October 26, ranked Russia 154th out of 178 nations surveyed, far below its 2004 ranking (90th place). In PricewaterhouseCoopers' 2009 Global Economic Crime Survey, Russia came in last

place among the 54 countries surveyed, with 71% of respondents having reported experiencing incidences of fraud in the 12 months previous to the survey.

The NGO *Information Science for Democracy (INDEM)* continues to assert, as estimated in a 2009 report by that organization, that bribes and corruption annually cost Russia the equivalent of one-third of its GDP. In November 2011, President Medvedev announced that Russia is losing up to a trillion rubles (approximately \$33 billion) annually due to corruption in its state purchasing system. Nevertheless, there have been few prosecutions and/or dismissals of high-level corrupt officials that would send a clear deterrent message.

The Government of Russia has repeatedly designated the fight against corruption and the enforcement of law as priorities. Russia is a signatory to the UN Convention against Corruption and to the Council of Europe's Criminal Law Convention on Corruption. Neither President Medvedev's Council for the Fight Against Corruption, which was established in the spring of 2008, nor the anti-corruption legislation of December 2008 have yet been effective in reducing corruption. Insofar as the legislation is concerned, implementing regulations have not yet been drafted. Moreover, Transparency International – Russia, a Russian affiliate of the international network, has reported that the enforcement of most anti-corruption legislation to date is weak or non-existent. Russia is developing legislative amendments that could create the conditions for Russia's future accession to the OECD's Anti-Bribery Convention. Corruption, including bribery, raises the costs and risks of doing business. Corruption has a corrosive impact on both market opportunities overseas for U.S. companies and the broader business climate. It also deters international investment, stifles economic growth and development, distorts prices, and undermines the rule of law.

It is important for international companies, irrespective of their size, to assess the business climate in the relevant market in which they will be operating or investing, and to have an effective compliance program or measures to prevent and detect corruption, including foreign bribery. Foreign individuals and firms operating or investing in foreign markets should take the time to become familiar with the relevant anticorruption laws of both their home country and host country in order to properly comply with them, and where appropriate, they should seek the advice of legal counsel.

The U.S. Government, for example, seeks to level the global playing field for U.S. businesses by encouraging other countries to take steps to criminalize their own companies' acts of corruption, including bribery of foreign public officials, by requiring them to uphold their obligations under relevant international conventions. A U.S. firm that believes a competitor is seeking to use bribery of a foreign public official to secure a contract should bring this to the attention of appropriate U.S. agencies, as noted below.

U.S. Foreign Corrupt Practices Act: In 1977, the United States enacted the Foreign Corrupt Practices Act (FCPA), which makes it unlawful for a U.S. person, and certain foreign issuers of securities, to make a corrupt payment to foreign public officials for the purpose of obtaining or retaining business for or with, or directing business to, any person. The FCPA also applies to foreign firms and persons who take any act in furtherance of such a corrupt payment while in the United States. For more detailed information on the FCPA, see the FCPA Lay-Person's Guide at: <http://www.justice.gov/criminal/fraud/>

Other Instruments: It is U.S. Government policy to promote good governance, including host country implementation and enforcement of anti-corruption laws and policies pursuant to their obligations under international agreements. Since enactment of the FCPA, the United States has been instrumental in the expansion of the international framework to fight corruption. Several

significant components of this framework are the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (OECD Antibribery Convention), the United Nations Convention against Corruption (UN Convention), the Inter-American Convention against Corruption (OAS Convention), the Council of Europe Criminal and Civil Law Conventions, and a growing list of U.S. free trade agreements.

OECD Antibribery Convention: The OECD Antibribery Convention entered into force in February 1999. As of December 2009, there are 38 parties to the Convention including the United States (see <http://www.oecd.org/dataoecd/59/13/40272933.pdf>). Major exporters China and India are not parties, although the U.S. Government strongly endorses their eventual accession to the Convention. Russia signed the Convention on February 1, 2012. The Convention obligates the Parties to criminalize bribery of foreign public officials in the conduct of international business. The United States meets its international obligations under the OECD Antibribery Convention through the U.S. FCPA.

UN Convention: The UN Anticorruption Convention entered into force on December 14, 2005, and there are 143 parties (including Russia) to it as of December 2009 (see <http://www.unodc.org/unodc/en/treaties/CAC/signatories.html>). The UN Convention is the first global comprehensive international anticorruption agreement. The UN Convention requires countries to establish criminal and other offences to cover a wide range of acts of corruption. The UN Convention goes beyond previous anticorruption instruments, covering a broad range of issues ranging from basic forms of corruption such as bribery and solicitation, embezzlement, trading in influence to the concealment and laundering of the proceeds of corruption. The Convention contains transnational business bribery provisions that are functionally similar to those in the OECD Antibribery Convention and contains provisions on private sector auditing and books and records requirements. Other provisions address matters such as prevention, international cooperation, and asset recovery. Russia became a signatory in 2003, and completed ratification in 2006.

OAS Convention: In 1996, the Member States of the Organization of American States (OAS) adopted the first international anticorruption legal instrument, the Inter-American Convention against Corruption (OAS Convention), which entered into force in March 1997. The OAS Convention, among other things, establishes a set of preventive measures against corruption, provides for the criminalization of certain acts of corruption, including transnational bribery and illicit enrichment, and contains a series of provisions to strengthen the cooperation between its States Parties in areas such as mutual legal assistance and technical cooperation. As of December 2009, the OAS Convention has 33 parties (see <http://www.oas.org/juridico/english/Sigs/b-58.html>). Russia is not a party to the OAS Convention.

Council of Europe Criminal Law and Civil Law Conventions: Many European countries are parties to either the Council of Europe (CoE) Criminal Law Convention on Corruption, the Civil Law Convention, or both. The Criminal Law Convention requires criminalization of a wide range of national and transnational conduct, including bribery, money-laundering, and account offenses. It also incorporates provisions on liability of legal persons and witness protection. The Civil Law Convention includes provisions on compensation for damage relating to corrupt acts, whistleblower protection, and validity of contracts, inter alia. The Group of States against Corruption (GRECO) was established in 1999 by the CoE to monitor compliance with these and related anticorruption standards. Currently, GRECO comprises 46 member States (45 European countries and the United States). As of December 2009, the Criminal Law Convention has 42 parties and the Civil Law Convention has 34 (see www.coe.int/greco). Russia is a party to the Criminal Law Convention on Corruption and GRECO; it is not a party to the Civil Law Convention.

Free Trade Agreements: While it is U.S. Government policy to include anticorruption provisions in free trade agreements (FTAs) that it negotiates with its trading partners, the anticorruption provisions have evolved over time. The most recent FTAs negotiated now require trading partners to criminalize “active bribery” of public officials (offering bribes to any public official must be made a criminal offense, both domestically and transnationally) as well as domestic “passive bribery” (solicitation of a bribe by a domestic official). All U.S. FTAs may be found at the U.S. Trade Representative Website: <http://www.ustr.gov/trade-agreements/free-trade-agreements>. There is no free trade agreement between Russia and the United States. Russia is in discussions, however, with certain OECD members on developing free trade agreements. Russia in 2010 agreed to begin negotiations on such agreements with New Zealand and the European Free Trade Association.

Local Laws: U.S. firms should familiarize themselves with local anticorruption laws, and, where appropriate, seek legal counsel. While the U.S. Department of Commerce cannot provide legal advice on local laws, the Department’s U.S. and Foreign Commercial Service can provide assistance with navigating the host country’s legal system and obtaining a list of local legal counsel.

Assistance for U.S. Businesses: The U.S. Department of Commerce offers several services to aid U.S. businesses seeking to address business-related corruption issues. For example, the U.S. and Foreign Commercial Service can provide services that may assist U.S. companies in conducting their due diligence as part of the company’s overarching compliance program when choosing business partners or agents overseas. The U.S. Foreign and Commercial Service can be reached directly through its offices in every major U.S. and foreign city, or through its Website at www.trade.gov/cs. The Departments of Commerce and State provide worldwide support for qualified U.S. companies bidding on foreign government contracts through the Commerce Department’s Advocacy Center and State’s Office of Commercial and Business Affairs. Problems, including alleged corruption by foreign governments or competitors, encountered by U.S. companies in seeking such foreign business opportunities can be brought to the attention of appropriate U.S. government officials, including local embassy personnel and through the Department of Commerce Trade Compliance Center “Report A Trade Barrier” Website at tcc.export.gov/Report_a_Barrier/index.asp.

Guidance on the U.S. FCPA: The Department of Justice’s (DOJ) FCPA Opinion Procedure enables U.S. firms and individuals to request a statement of the Justice Department’s present enforcement intentions under the anti-bribery provisions of the FCPA regarding any proposed business conduct. The details of the opinion procedure are available on DOJ’s Fraud Section Website at www.justice.gov/criminal/fraud/fcpa. Although the Department of Commerce has no enforcement role with respect to the FCPA, it supplies general guidance to U.S. exporters who have questions about the FCPA and about international developments concerning the FCPA. For further information, see the Office of the Chief Counsel for International Counsel, U.S. Department of Commerce, Website, at http://www.ogc.doc.gov/trans_anti_bribery.html. More general information on the FCPA is available at the Websites listed below. Exporters and investors should be aware that generally all countries prohibit the bribery of their public officials, and prohibit their officials from soliciting bribes under domestic laws. Most countries are required to criminalize such bribery and other acts of corruption by virtue of being parties to various international conventions discussed above.

Anti-Corruption Resources. Some useful resources for individuals and companies regarding combating corruption in global markets include the following:

- Information about the U.S. Foreign Corrupt Practices Act (FCPA), including a “Lay-Person’s Guide to the FCPA” is available at the U.S. Department of Justice’s Website at: <http://www.justice.gov/criminal/fraud/fcpa>.
- Information about the OECD Antibribery Convention including links to national implementing legislation and country monitoring reports is available at: http://www.oecd.org/departement/0,3355,en_2649_34859_1_1_1_1_1,00.html. See also new Antibribery Recommendation and Good Practice Guidance Annex for companies: <http://www.oecd.org/dataoecd/11/40/44176910.pdf>
- General information about anticorruption initiatives, such as the OECD Convention and the FCPA, including translations of the statute into several languages, is available at the Department of Commerce Office of the Chief Counsel for International Commerce Website: http://www.ogc.doc.gov/trans_anti_bribery.html.
- Transparency International (TI) publishes an annual Corruption Perceptions Index (CPI). The CPI measures the perceived level of public-sector corruption in 180 countries and territories around the world. The CPI is available at: http://www.transparency.org/policy_research/surveys_indices/cpi/2009. TI also publishes an annual *Global Corruption Report* which provides a systematic evaluation of the state of corruption around the world. It includes an in-depth analysis of a focal theme, a series of country reports that document major corruption related events and developments from all continents and an overview of the latest research findings on anti-corruption diagnostics and tools. See <http://www.transparency.org/publications/gcr>.
- The World Bank Institute publishes Worldwide Governance Indicators (WGI). These indicators assess six dimensions of governance in 212 countries, including Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption. See http://info.worldbank.org/governance/wgi/sc_country.asp. The World Bank Business Environment and Enterprise Performance Surveys may also be of interest and are available at: <http://go.worldbank.org/RQQXYJ6210>.
- The World Economic Forum publishes the *Global Enabling Trade Report*, which presents the rankings of the Enabling Trade Index, and includes an assessment of the transparency of border administration (focused on bribe payments and corruption) and a separate segment on corruption and the regulatory environment. See <http://www.weforum.org/en/initiatives/gcp/GlobalEnablingTradeReport/index.htm>.
- Additional country information related to corruption can be found in the U.S. State Department’s annual *Human Rights Report* available at <http://www.state.gov/g/drl/rls/hrrpt/>.
- Global Integrity, a nonprofit organization, publishes its annual *Global Integrity Report*, which provides indicators for 92 countries with respect to governance and anti-corruption. The report highlights the strengths and weaknesses of national level anti-corruption systems. The report is available at: <http://report.globalintegrity.org/>.

Trade barriers. In general, foreign companies face a number of tariff and non-tariff trade barriers when exporting to Russia. A complaint frequently voiced by international companies is Russia’s complex system of standardization. Russia’s regime remains extremely complex due to its lack of clarity and transparency, and overall redundancy. While the system has improved somewhat, foreign companies are encouraged to obtain appropriate legal advice or assistance from experienced distributors or consultants, as well as the U.S. Commercial Service. Discrimination against foreign providers of non-financial services is, in most cases, not the result of federal law, but stems from abuse of power, sub-national regulations and practices that may violate Russian law. For example, a few foreign service providers have noted that they are forced to pay a range of fees to obtain licenses from local authorities, fees that domestic companies allegedly bypass via bribes.

The Land Code that was passed in 2001 allows equal treatment of domestic and foreign entities to buy land and buildings, although purchase of agricultural land by foreigners is still prohibited. Foreign entities are restricted from buying land close to federal borders and in areas that the President determines critical to national security. On January 12, 2011, Russia published a presidential decree listing 380 areas around the country, primarily along its borders, in which the sale of land to foreigners or foreign companies is forbidden. A ban on the ownership of real estate by foreigners has been in force in Russia's border areas since 2001, but the geographic scope of the ban had not been definitively established.

The government enacted the Strategic Sectors Law (SSL) in May 2008. The SSL introduced a list of 42 "strategic" sectors in which purchases of "controlling interests" by foreign investors must be pre-approved by the Russian government. The list of restricted sectors includes: enterprises in the nuclear industry or involved in handling radioactive materials; enterprises involved in work on infectious diseases; arms, munitions, and military equipment production, maintenance, or repair; the aviation and space industries; certain data-transmission (radio, television, telecommunications) infrastructure; production and distribution of encryption technologies and equipment; production and sales of goods and providing services under conditions of a "natural monopoly" (e.g., activities such as operating certain gas networks); newspapers with a circulation of more than one million; and natural resource extraction. Many observers, while welcoming more clarity on the rules of the game, have criticized the SSL for being overly broad in the number of sectors it covers, and have raised concerns regarding the transparency of the approval process.

Under the procedures created by the SSL, the Federal Antimonopoly Service conducts initial vetting of proposed foreign investments, and in some cases the Federal Security Service (FSB) conducts additional verification to determine whether the transaction would result in a foreign company gaining control over a strategic business. Once vetting is completed, the Government Commission on Foreign Investment, chaired by the Prime Minister, is charged under the SSL with reviewing proposed transactions and either approving or denying them, or deferring them for additional review. The Commission met eight times through the end of 2010 and declined very few proposed transactions. Many of the applications came from Russian-owned companies based offshore.

In conjunction with the SSL, amendments to the sub-soil legislation were also passed requiring governmental approval for foreign investment in excess of 10% in companies operating a "strategic" deposit, which includes major oil, gas, and other mineral deposits. While foreign oil and gas companies were concerned about the potential application of these provisions, so far implementation has not impeded any investments.

The Russian government may be reconsidering its policy of not entering into any further Production Sharing Agreements (PSAs), designed for energy projects that require high capital expenditures and a long period before profits or significant tax revenues are generated. In a December 2010 speech at the Duma, Energy Minister Shmatko raised the possibility of reintroducing PSA-type agreements, but did not give details or a timeline. The two remaining major PSAs are *ExxonMobil*-led *Sakhalin I* and *Total*-led *Kharyaga*.

After declining marginally in 2008 for the first time since 2000, oil production rebounded slightly in 2009, and increased by 2.2% in 2010, surpassing 10 million barrels per day. Limited tax breaks for oil production and new output from several major fields, primarily from state-owned *Rosneft*'s giant Vankor field, have helped recent production increases. However, many analysts and oil sector executives continue to predict oil production stagnation and decline

without further fundamental reforms to the sector's onerous tax structure. Oil taxes are levied on revenues, instead of on profits, hindering needed large investments in new fields.

Russia's power generation sector is in urgent need of modernization and extension of generation capacity. Further delay in expanding electricity output could result in a drag on industrial growth. Russia's Ministry of Energy estimates that the country must invest \$80 billion in the next 10 years to refurbish or replace aging generation assets, and that Russia must build 80 gigawatts of thermal power generation capacity in the next 20 years.

In aviation, many of the Russian-flagged carriers have aging fleets and use outmoded avionics and engines. Several are seriously considering significant purchases or wetleases of foreign aircraft in an attempt to be more competitive with Western airlines.

When purchases do occur however, the effect of tariffs, VAT, and customs handling fees on aircraft is equivalent to a 40% tax, making it virtually impossible for Russian airlines to afford to purchase foreign planes. That said, under the latest Customs Union decision related to aircraft tariffs, passed last fall, exemptions were created to facilitate key purchases for leading airlines. Regulations and tariff levels in this area remain subject to change and potential market entrants should check on current conditions.

New regulations have also been introduced for certain cargo aircraft. Previously, cargo aircraft were subject to general regulations and were not classified into separate categories. Under the new regulations, the customs duty rate applicable to cargo aircraft having a maximum take-off weight in excess of 370,000 kg depends on whether such aircraft have an installed cargo ramp. If a cargo aircraft has a maximum take-off weight in excess of 370,000 kg and an installed cargo ramp, it is subject to 20% customs duty. If such aircraft has no cargo ramp, it is subject to a 0% customs duty.

In January 2011, the Russian government extended the 2010 export tariff on timber into 2011, thus implementing part of Russia's December 2010 commitment with the EU that Russia would not change export duties on timber from the current level of 25% until Russia's WTO accession. Russia has reportedly agreed to lower its export duties on timber to 5%-15%, depending on the type of timber, following Russia's WTO accession. Previously, the Russian authorities had planned to introduce a prohibitive 80% export tariff (but no less than 50 euros per cubic meter), starting in January 1, 2009, and then delayed the increase to January 1, 2011.

The "The Russian Coordinating Center of the National Internet Domain" (the Coordination Center) issued a regulation, "Provisions on Priority Registration of Domain Names in the PΦ (RF) Domain" that stipulates that domain names must either reproduce or match word designations contained in trademarks. Trademark owners with a ".RU" (Russia) domain name can keep the ".RU," but now have the option of obtaining a ".PΦ" (RF). .PΦ domain names may be registered for a fee of approximately \$20 for a one-year period, with the possibility of subsequent renewal of the domain name's registration annually. During the priority registration phase more than 18,000 domain names were registered for government entities and trademark holders. Despite the early registration for trademark holders, there is still a potential issue with cyber-squatting. The Coordination Center did not specify that domain names that are derived from the trademark holders would be protected.

On November 11, 2010, the second stage of the registration for Cyrillic domain names began. Now any individual or legal person registered in the Russian Federation may obtain a domain name through the registration process. Priority registration for the Cyrillic domain name zone began November 2009 for government entities and trademark holders. Only Russian citizens and

businesses registered in the country are able to buy domains. The Coordination Center for the National Internet Domain registered 184,352 addresses for the general public on the first day of open registration. The .RU domain has over 500,000 registered addresses.

A law on electronic digital signatures went into effect on January 14, 2002. This law does not follow the Model Law on Electronic Signatures of the U.N. Commission on International Trade Law, but rather defines electronic signatures narrowly, making public-key technology the sole acceptable digital signature technology. It also requires that hardware and software used in digital signature authentication programs be certified in Russia. This requirement gives the Russian government the right to insist on the decompilation of electronic signature programs.

These requirements, in addition to the licensing requirements related to goods with encryption technology, present serious obstacles to trade in goods that Russia requires for further development of electronic commerce. Currently, any IT product requires a notification from the Russia's Federal Security Service (FSB), which a company should be able to obtain in 10 days. If the product contains low levels of cryptography, the FSB can grant authorization to import. If the product contains higher levels of cryptography, the FSB informs the importer of the need to apply for an import license from the Ministry of Industry and Trade. This permission and licensing process can take six months or longer to complete. Leading U.S. IT companies contend that the current system impedes imports, delays the creation of an innovation and knowledge-based economy in Russia, and hampers the further development of their R&D centers in Russia. Both Russian and foreign businesses frequently complain about so-called "raiding" ("reiderstvo"), a practice which refers to the criminal takeover of a business through corruptly obtained legal documents. Raids are often carried out by professional raiders, sometimes working in tandem with corrupt officials and former employees or business partners of the victim company. Raids can be difficult to protect against as they rely on legal documents and frequently result in the victim being tied up in litigation for extended periods of time while the assets are transferred through a series of shell companies to an ostensible good faith purchaser. To minimize the risk of such attacks, investors are urged to vet local partners, review all business documents and make sure that documents are properly secured.

As many details regarding the operation and implementation of the Customs Union (CU) are still being worked out, there is much confusion in many areas such as import licenses, customs procedures and IPR enforcement. As part of the CU preparations, the government is planning to standardize Russia's technical regulations with European ones. These proposed regulations will increase restrictions on trade practices and are likely to have a large impact on U.S. exports to Russia" [37].

Difficulty in raising capital. "Businesses continue to complain of strict credit terms and a lack of available credit from Russian banks. Interest rates remain high in comparison with Western counterparts and terms remain mostly short which makes locating capital for large, complex and time-consuming ventures difficult. The situation has improved somewhat with the entry onto the Russian market of leading European and Western banks such as *Barclays*, *HSBC*, *Raiffeisen* and others but this lack of capital still hampers small- and medium-sized enterprises especially. Tax evasion as a means to increase cash-flow still takes place among some Russian businesses.

The 1996 federal law "On Banks and Banking Activity" permits foreign banks to establish subsidiaries in Russia. However, Russia does not allow foreign banks to establish branches in Russia. The 1990 federal law on banking activities, last amended in 2006, specifically states that any quota or limitation on the size of foreign charter capital in the banking sector would require a new law to be put forward by the government of Russia and agreed to by the Central Bank of Russia. In November 2006, Russia and the U.S. signed their WTO Bilateral Agreement, a major

step in Russia's accession to the WTO. As part of this Agreement, Russia pledged to allow foreign ownership to account for as much as 70% of the country's total banking sector equity. Implementation of this provision will likely take place only after Russia's accession.

The Central Bank requires newly established banks, whether domestic or foreign subsidiaries, to have a minimum of 180 million rubles (\$6 million) in capital. Already existing banks are required to have a minimum capital of 90 million rubles (\$3 million). The government of Russia has tentatively approved a plan that has not yet become law for these minimum capital levels to increase in 2012 to 300 million rubles (\$10 million) and 180 million rubles (\$6 million), respectively. At least 75% of the bank's employees and 50% of the bank's management board must be of Russian nationality if the chairman is not a Russian citizen. Heads of foreign banks' Russian offices are required to be proficient in the Russian language.

In the insurance sector, foreign insurance firms are subject to a 49% equity restriction. Foreign firms that were active in Russia when this requirement came into effect, however, were grandfathered and are not subject to the foreign equity limit. Russia also has more generous operating provisions for insurance companies from the European Union, and has been permitting multinational companies to benefit from this more generous treatment provided they conduct their Russian investments via their EU-based offices. Once Russia becomes a WTO member and the United States grants permanent normal trade relations status, U.S. insurance companies will be allowed to operate through subsidiaries, including 100% foreign-owned non-life insurance companies, and will be able to open direct branches at the end of a nine-year transition period. However, as in the banking sector, Russia maintains the discretion to limit foreign sourced charter capital in the insurance sector and if the ratio of foreign-sourced to total charter capital in the insurance sector ever exceeds the 50% cap, Russia's regulators will have the discretion to take certain actions specified in Russia's WTO commitments.

Until Russia's accession, EU firms will continue to enjoy an advantage over their counterparts from the United States and elsewhere, since they can offer life and mandatory forms of insurance in Russia directly, without the requirement to work through a majority Russian-owned partner. Russian law currently requires that chief executives and chief accountants of foreign insurers operating in Russia be Russian citizens. In 2010 the law "On Private Detective and Security Activities" entered into force. The law states that no security company can be owned by a non-Russian entity, including a Russian subsidiary owned by a foreign entity, and includes restrictions on the use of foreign capital in the operation of such firms.

Finding the right partner. In numerous surveys of representatives of business, (when the question is included) difficulty in finding partners is nearly always listed as a key concern for foreign companies. The difficulty is not one which besets only small- and medium-sized enterprises but, in fact, has proved a decisive factor even for giants such as Walmart which recently closed (temporarily at least) its Russian office which had been engaged in trying to find a partner for the retail behemoth for years. Visa regulations for foreign workers have become stricter over the last years which makes finding local partners a more pressing need yet language problems, cultural differences and a lack of equivalency to Western/European standards all make the search for an effective partner a difficult affair. Salaries for local employees have risen significantly, especially in Moscow and St Petersburg. The pool of managers who understand Western accounting and business practices remains limited, as do those qualified, experienced Russians proficient in English. As a result, this group circulates among major companies, bidding up salaries. Recently, Russian authorities have taken steps to encourage international companies to rely more on local talent by tightening visa regulations for foreign workers.

Poor infrastructure in Russia. The Russian rail network is around 85,000km long, making it the second longest in the world and it is this network which handles the bulk of freight transports within the country. Major investment is occurring in Russian ports, especially in the Northern Sea route as this is a prerequisite necessary to support Russia's expanding role as an energy superpower and net exporter of resources, yet they remain inefficient. The situation with the ports is compounded by the fact that most rivers in the center of the country run from North to South/South to North rather than from East to West/West to East as may benefit the transport industry. Road density is very low at 40m per km² and the majority of roads are of low quality with asphalt used in many cases as an inferior alternative to the more expensive concrete. As a result average speeds achieved on the country's roads remain low and the frequency of accidents remains high. Moreover, there is an acute lack of roads throughout the country with many more remote areas being served by nothing more than dirt roads. There is also a lack of competition and know-how within the Russian logistics sector which can exacerbate the problems with infrastructure. All in all, across rail, roads, sea ports and airports there is a lack of efficiency and a dearth of modern facilities and practices.

The Russian telecommunications sector is governed by the Law on Communications, dated July 2003 and the law on "Information, Information Technologies and Information Protection," dated July 2006. The latter law's impact on competitive alternative telecommunications operators, many of which enjoy large foreign investment, has been substantial, since these companies now fall under tight government regulation. In particular, regulations on interconnection – the process by which alternative operators connect their networks to the Russian public telephone network – place interconnection contracts and fees under the regulatory authority of the Ministry for Communications and Mass Media. Alternative operators fear that these fees will be raised to subsidize network upgrades of government-owned and ministry-controlled local and long distance operators.

The "risk" factor. This commonly heard cliché refers to the idea that Russia is an inherently risky place to invest. Political stability has been achieved but it is young and widely criticized and the Russian government is known for making U-turns in policy and sometimes attacking the very foreign assistance it once encouraged, as in the case of BP and TNK in the late 90's/early 2000's. High-profile cases such as the *Yukos* affair highlight the sometimes capricious nature of the authorities and while progress has been made in the spheres of property rights and the rule of law, for example, a potential investor must carefully weigh the benefits and risks associated with any move onto the Russian market" [65].

Russia's credit ratings. "The Finance Ministry of Russia believes that Russia's sovereign credit rating is undervalued. This opinion is provided in draft for the main areas of the country's debt policy for 2012-14 that were posted on the ministry's web site. "Credit ratings issued to Russia by the world's leading rating agencies: BBB (positive outlook) by *Fitch*, Baa1 (stable outlook) by *Moody's* and BBB (stable outlook) by *Standard & Poor's*, show that our country is clearly undervalued," says the document. The document points out that Russia could be assigned a higher rating and will create conditions to have its rating raised to A.

Proceeding from the parameters determined in the forecast of Russia's socio-economic development in 2012-2014 and taking into account the scheduled amount of borrowing in the upcoming period, the country's debt stability indicators will remain outside the danger zone, the document emphasizes.

At the same time, existing "safety margin" of a number of parameters cannot be viewed as unconditional in terms of ensuring Russia's debt stability, the Finance Ministry of Russia points out. So, the growth rate of public debt and, consequently, related servicing expenses are very

high. Expenses incurred to service Russia's public debt in 2011 have climbed by 2.3 times in absolute terms against 2008, or by 40% as percentage of budget spending.

In addition, there are risks associated with a deteriorating macroeconomic environment, which will also impact the country's debt stability indicators respectively. In accordance with the budget projections, GDP and budget revenues in 2012-14 were calculated based on a favorable scenario that expects high crude prices and their annual growth: \$93 in 2012, \$95 in 2013 and \$97 in 2014. However, taking into account the fact that crude prices stay at their all-time highs one cannot rule out a scenario whereby crude prices will drop to the level that is far lower than that in the forecast. A possible decline in crude futures by \$10 could lead to a shortfall in budget revenues in the amount of around RUB 500 billion and, consequently, push up the budget deficit by 1% of GDP. Under this scenario all debt stability indicators deteriorate drastically.

In addition, the document points out that a quite likely scenario is that during the planning period Russia could lose one of the most important factors of financial stability, a "safety cushion" represented by the Reserve Fund. The Reserve Fund's amount, expected by January 1, 2013, will total RUB 1.6 trillion provided that crude prices don't fall below \$93/bbl in 2012 and RUB 164 billion will be wired to the Reserve Fund. The absence of the safety cushion will substantially increase the state budget's vulnerability, will raise the cost of borrowing and, as a consequence, will push up public debt servicing costs.

Language and culture. Language remains an obvious stumbling block for many would be entrepreneurs both from small and large companies. Competency in Russian as a foreign language remains relatively low in Europe and despite improvements in the English language competency of many Russians it is still to be expected that many firms will not communicate effectively in English. There are also some differences in corporate culture and etiquette which should be anticipated and researched thoroughly. The Russian business culture is considered in more detail in the next chapter of this manual.

Conclusions. Russia is no longer Churchill's "riddle, wrapped in a mystery, inside an enigma" but the market is certainly challenging. Much of the spectacular growth that has occurred has had more to do with catching up than with real dynamic processes within the country but this does not detract from the fact that a huge and tantalizing market awaits the bold entrepreneur. For most experts the transition period has come to an end and, regardless of one's views on the path of Russian democracy, from 1999 onwards we have seen a comparatively transformed climate for business and a resurgent population desperate to share in the nation's new-found wealth. The wealth is, however, not new-found; it has always been there awaiting efficient and strategic exploitation and the direction and wisdom from above necessary to see that an abundance of natural resources is only a stepping stone to long-term, sustainable prosperity. With the right assistance and preparation the Russian market presents numerous enticing opportunities for both small- and medium-sized enterprises as well as multi-national corporations. As we have seen throughout this manual, prospects in Russia are promising and the country is emerging from recession in a strong position but the pitfalls inherent to doing business here must be thoroughly researched, understood and planned for before any venture onto the market. However, as the cliché goes, "fortune favors the bold" [68].

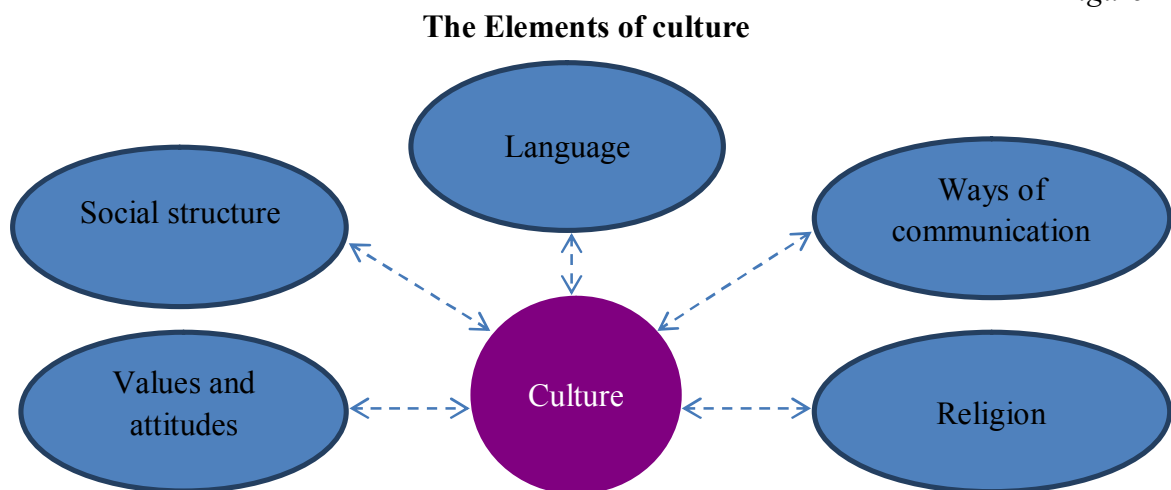
Chapter 14

Business Culture

1. International management and cultural differences

“The understanding of cultural differences is crucial for successful activity of companies involved into international business. The culture of a society exercises influence on political, economic, social and ethical rules which should be observed by a company doing business in this society. The culture of a society reflects its values, attitudes, beliefs, behavioral models, customs and mindsets. Culture consists of a range of elements. Cultural elements are interconnected and reinforce each other. The social structure of a society reflects cultural beliefs regarding the role of an individual in the society and also the importance of social mobility in the society. The language is another important element of any culture since it allows members of the society to communicate with each other. About 85 percent of the world population share various religious beliefs. Religion determines the attitude of believers to the job, savings, consumption, and personal responsibility for their behavior. Apart from this, religion can greatly influence formulations of the country’s laws. Interaction between these elements shapes the environment in which international companies operate. Fig 14.1 shows major elements of culture: social structure, language, ways of communication, religion, values and attitudes.

Figure 14.1



Language. Currently, according to specialist estimates, there are over 3,000 different languages and over 10,000 separate dialects in the world. International entrepreneurs should be aware that final results of their work can depend on the language used to describe the task. Thus, during one well known experiment conducted in Hong Kong 153 senior students speaking two languages (English and Chinese) were divided into two groups. One group was given an assignment written in English and another group received the same assignment but written in Chinese. The professor responsible for this experiment made every effort to guarantee high quality and preciseness of translation. Nevertheless, responses given by students of the two groups significantly differed. This fact witnesses that the language itself altered the character of information. Some countries have several official languages or ethnic groups speaking different languages. Experienced businessmen working in countries with a heterogeneous society adapt their methods of doing business and carrying out marketing activities to linguistic frameworks within which this or that language is used. Knowledge of foreign languages by international entrepreneurs gives an important competitive edge. Therefore students should study foreign languages. International entrepreneurs should be very careful with translation from one language to another. Incorrect translation very often leads to complete failure of the marketing efforts. A classic example is the

case with *KFC* slogan “Finger Lickin’ Good” which after translation into Chinese became “Bite off your fingers!” Such methods as back translation allows one to reduce significantly the possibility consumers of hearing distorted advertising.

Ways of communication. Ability to communicate with representatives of different cultures, regardless of whatever form it may take, is an especially important property which should reside in an international entrepreneur. Communication can be unsuccessful even between people belonging to one culture. The possibility of communicative problems substantially increases when intercourse is going on between people representing different cultural groups. In this case, the source of the information encodes it using his cultural code but the receiver of information decodes the message through his own filter. The result of using different cultural filters in many cases may be an incorrect understanding of the message and lead to aftermaths which can be very expensive to fix.

Nonverbal communication. Members of society communicate with each other not only through the use of words. Actually, according to some researchers about 80-90 per cent of all information is transferred between members of one cultural group through the use of nonverbal means. Nonverbal means of communication comprise such ways of information transmission as countenance, motions of hands, intonation, visual contact, body position and bearing. Although practically all members of society quickly perceive and understand very well nonverbal forms of communication which are common for the culture of this society, people not belonging to this culture have difficulties with perception such forms of information transmission. Some forms of nonverbal communication are specified in table 12.1.

Table 12.1

Forms of nonverbal communication

No	Forms
1	Hand gestures both intentional and unintentional (such as nervous rubbing one's hands)
2	Countenance (smiling, yawning, frowning)
3	Body position and bearing
4	Clothing and hare style (both clothing and hare style are objects of modern fashion)
5	Gait
6	Physical distance between communicators
7	Touching
8	Visual contact and direction of sight when hearing an interlocutor
9	Architecture of premises and design of interior
10	Artifacts and nonverbal symbols such as signs on coat lapels, canes and jewelry
11	Graphic symbols such as images depicting ladies and men toilets or inscriptions on boxes like <i>Handle with care</i>
12	Artistic and rhetoric forms (for example, wedding dance)
13	Odor and smelling including odor of body and perfume
14	Speech rate, tone and loudness
15	Color symbolic
16	Synchronization of speech and motion
17	Taste, feeding symbolic, communication with a cup of coffee or tea, smoking or chewing gum
18	Cosmetics: temporary (powder, lipstick) and constants (tattoos)
19	Different signs: fire signal system, police buzzer, factory whistle
20	Time symbolic: time of day when a call is made or friend is visited, duration of conversation or dinner on a visit
21	Verbal behavior: calculation of time and pauses
22	Silence

The use of nonverbal forms of communication in another country can lead to misunderstanding. For example, in the United States, people discussing business at the reception usually stand not closer than 20 inches from each other. In Saudi Arabia, normal distance between interlocutors is from 9 to 10 inches. When an American businessman communicates with his partner from Saudi Arabia at a business reception, the former politely tries to move away from his counterpart when the latter politely tries to come closer. Each of them is acting politely in the context of his/her own culture but these actions in the context of interlocutor are offensive.

There are also differences in interpretation of body language and facial gesture by different cultures. A vertical head nodding means “yes” in the USA and “no” in Bulgaria. In the USA, connecting thumb and index finger in a circle with the rest of the fingers straight means OK; the same sign symbolizes money in Japan, uselessness in France, points to homosexuals in Malta and implies some platitude in many regions of the East Europe. Therefore it is recommended that businessmen involved in international entrepreneurial avoid the use of gestures except the cases when they are sure that they can understand well the sense of this or that gesture in a specific culture.

Even silence has a certain meaning. Americans do not like to keep silence in meetings or in the course of private conversation since according to their opinion such silence means inability to keep the ball rolling or disclose one's point of view. In Japan, silence only means that the person speculates or the continuation of conversation is inappropriate. American businessmen often understand this silence incorrectly and make concessions to agree on contract to put the period to the pause in discussion whereas there is no need for this. The attitude to silence also influences the style of management. In the USA, a good leader is the manager who solves problems which arise himself. Therefore American managers often are eager to lead the process of collective discussion of problems and demonstrate, thus, their competence and leadership skills. In Japan, a good leader stimulates his subordinates to search for a solution which would be acceptable for all parties involved. That is why a Japan manager demonstrates his leadership skills through silence which, in turn, stimulates active participation of his subordinates in solving problems and also promotes achievement of consensus among members of group.

Gifts and hospitality. Giving gifts and hospitality is a way of communication of great importance in many business cultures. Japanese business etiquette demands showing attention and hospitality towards business partners. Exquisite food and drinks and diverse entertainment after business meetings are used to establish close links between participants of negotiations and also reach consensus in group of businessmen. Personal connections are strengthened more through giving gifts the content of which depends on the status of presenter and recipient.

Religion. Religion is one of the most important aspects of life in any society. Religion determines ways of establishing contacts between members of a society and also between representatives of different communities. About 85 per cent of the world's population, which amounts to over 7 billion, belongs to one or another religion. 72 per cent of the world population adheres to one of the four religions: Christianity, including the Roman Catholic faith (16.9%), Protestant faith (13.0%) and Orthodox faith (3.8%); Islam (19.2%); Hinduism (13.7%) and Buddhism (5.7%).

Religion determines the attitude of believers to their job, consumption, personal responsibility and future planning. In some Islamic countries women are prohibited from working because in accordance with Islamic norms the circle of a woman's contacts should be restricted exclusively by relatives. Apart from this, religion influences the structure of goods purchased by believers and the seasonable regularity of consumption. For example, during Christmas Holidays the level of productivity goes down substantially while consumption increases drastically. In Saudi

Arabia, all work is stopped five times a day when believers should pray to Allah. In some countries, Saturday is a holy day or interest payments are prohibited by religion.

Values and attitudes. Culture determines values and attitudes of members of society. *Values* are principles and standards of behavior accepted by society members; *attitudes* are actions, feelings and thoughts conditioned by these values. Attitudes to such factors as time, age, education and social status reflect cultural values and, in turn, determine the way of action of international companies in this or that cultural environment and also the existence of favorable conditions for the international business in this environment.

Time. Attitudes to time differ significantly in different cultures. In Anglo Saxon culture, the attitude *Time is money* prevails. Therefore American and Canadian businessmen believe that meetings should begin on time and it is very impolite to keep partners waiting. However, in the cultural environment of Latin America only a few business persons believe that it is abnormal when a business meeting begins in 45 minutes after the appointed time.

Age. There are important cultural differences in attitudes to age. In the USA, youth is an advantage. Many American companies devote much of time searching for young and talented people aspiring to make a good career. Young managers are entrusted to fulfill serious assignments such as conducting negotiations with foreign partners on the establishment of joint ventures. In Asian and Arab cultures, age is highly respected. Many foreign companies make a mistake when they their young representative to negotiate with Chinese state officials. The Chinese prefer to deal with older people or those holding higher positions in the hierarchical management system, therefore they can be offended with such an approach.

Education. The official system of state and private education reflects cultural values of the society and is an important vehicle to convey knowledge. For example, in the US primary and secondary schools, special attention is paid to the role of an individual in the society, cultivating his self-confidence and creativity, and lifting his self-assessment. The country is proud of its achievements providing ample opportunities for receiving higher education. In Great Britain, on the contrary only an insignificant number of students can get an elite education which is a result of the class structure of the society that existed in the past.

In Germany, a well-organized system of apprenticeship allows German to train new generations of qualified workers and operators for the industrial sector. In Japanese and French primary and secondary schools, the main attention is paid to verbatim learning.

Social status. Each culture has its own specific means to achieve this or that social status. In some societies, an individual inherits a social status as an associated result of wellness and rank of his or her ancestors. In other cultures, an individual earns his or her social status through personal and professional achievements. In some European countries, for example, belonging to nobility provide an individual with a higher status than the status that could be achieved through his or her professional success; therefore people who inherited wealth look down on so called the *nouveaux riches*. At the same time, in the United States, entrepreneurs who achieved a high social status through hard work are respected very much, though their children are treated with disdain if they do not manage to achieve the same status and dignity of their parents.

In Japan, the social status of a human being depends on the group status of which he is a member. Therefore Japanese businessmen introducing themselves say not only their names but also their group membership. In India, the social status of a human being depends on caste membership. Some of Indian castes are: *Brahmin* (priests and intellectuals), *Kshatriya* (the military and ruling class), *Vaishya* (business persons), *Shudra* (farmers and workers) and *Pariah*

(members of a low-caste group, formerly known as "untouchables" but renamed by the Indian social reformer Mahatma Gandhi as *Harijans*) who carry out the most dirty and non-prestigious work.

Dealing with cultural differences

Many students and newcomers to international business are in panic when they see how many nuances they should keep in mind – the French behave in one way, Arabs – in another way, etc. Fortunately many social scientists have tried to reflect on and systematize different cultural elements. The results of their investigation allow international entrepreneurs to better understand the culture of any country and also how elements of this culture influence their ability to run their companies. Below is a short analysis of investigation which shows the results of some scholars studying this problem.

Hall's contextual approach. One of the most effective methods of describing cultural differences is the contextual approach developed by Edward and Mildred Hall. In a low-context culture, information is conveyed between interlocutors in explicit or open form. A low context culture refers to a culture's tendency not to cater to "in-groups". An "in-group" is defined by the authors as being a discrete group having similar experiences and expectations, from which, in turn, inferences are drawn. Low context cultures, such as Germany or the United States make much less extensive use of such similar experiences and expectations to communicate. Much more is explained through words or verbalization, instead of context.

In a high context culture, the context in which a communication act occurs plays as important a role as the words and knowledge of cultural context which is very important for understanding the object of the communication act. In a high context culture, many things are left unsaid, letting the culture explain. Words and word choice become very important in higher context communication, since a few words can communicate a complex message very effectively to an "in-group" (but less effectively outside that group), while in a lower context culture, the communicator needs to be much more explicit and the value of a single word is less important.

Lower context cultures: American (Northern states), Australian, English Canadian, English, German, Irish, New Zealand, Scandinavia

Higher context Cultures: African, Arab, Brazilian, Chinese, Filipinos, Finnish, French Canadian, French, Greek, Hungarian, Indian, Italian, Japanese, Korean, Latin Americans, Persian, Portuguese, Russian, Spanish, Thai, Turkish

A cultural context does not rank as "high" or "low" in an absolute sense because each message can be presented on a continuum from high to low. Likewise, a culture (French Canadian) may be of a higher context than one (English Canadian) but lower context than another (Spanish or French). Likewise, a stereotypical individual from Texas (a higher context culture) may communicate more with a few words or use of a prolonged silence, than a stereotypical New Yorker who is being very explicit, although both are part of a culture which is lower-context overall.

The style of business behavior in high-context cultures differs in many cases from the style of business behavior in low-context cultures. For example, German advertising as a rule is oriented towards facts whereas the Japanese one – at emotions. In high-context cultures, while deciding on the worthwhileness of supporting contacts, interpersonal relations are given priority. In such cultures, preliminary business meetings are held to determine whether the parties can trust each other. In low-context cultures, the terms of a contract are more important. In cultures of such type (for example, in Canada, USA, Great Britain), lawyers often take part in business meetings

to protect their clients' interests. On the contrary, in high-context cultures (like Japan, Saudi Arabia, Egypt), presence of a lawyer especially in a preliminary meeting can be taken as a sign of distrust to partners.

Principle of cultural clusters. Identification of cultural groups (clusters) is another way of classification and evaluation of national cultures. There are many common characteristics among cultures of different countries that reduce to a certain extent the necessity to choose methods of doing business which take into account peculiarities of local cultures. Anthropologists, sociologists and scholars studying international business analyzed such factors as the extent of satisfaction with labor conditions, distribution of job-roles and workplace interpersonal relations to identify groups of countries with similar cultural values which can influence methods of doing business. Below are eight groups of countries identified by Simha Romen and Oded Shenkar. (As a result of this research four countries – Brazil, India, Israel and Japan were not attributed to any cultural group)

English cultural cluster: Great Britain, USA, Canada, Australia, New Zealand, Ireland, and South Africa. *Latin American cultural cluster:* Mexico, Argentina, Columbia, Chilly, Venezuela, and Peru. *German cultural cluster:* Germany, Austria, and Switzerland. *Scandinavian (North European) cultural cluster:* Denmark, Norway, Sweden, and Finland. *Latino-European cultural cluster:* Spain, Portugal, France, Italy, and Belgium. *Middle East cultural cluster:* Greece, Turkey, and Iran. *Arabic cultural cluster:* Saudi Arabia, United Arab Emirates, Kuwait, Abu Dhabi, Oman, and Bahrain. *Far East cultural cluster:* Hong Kong, Taiwan, Singapore, Indonesia, Philippines, Malaysia, Thailand, and Vietnam.

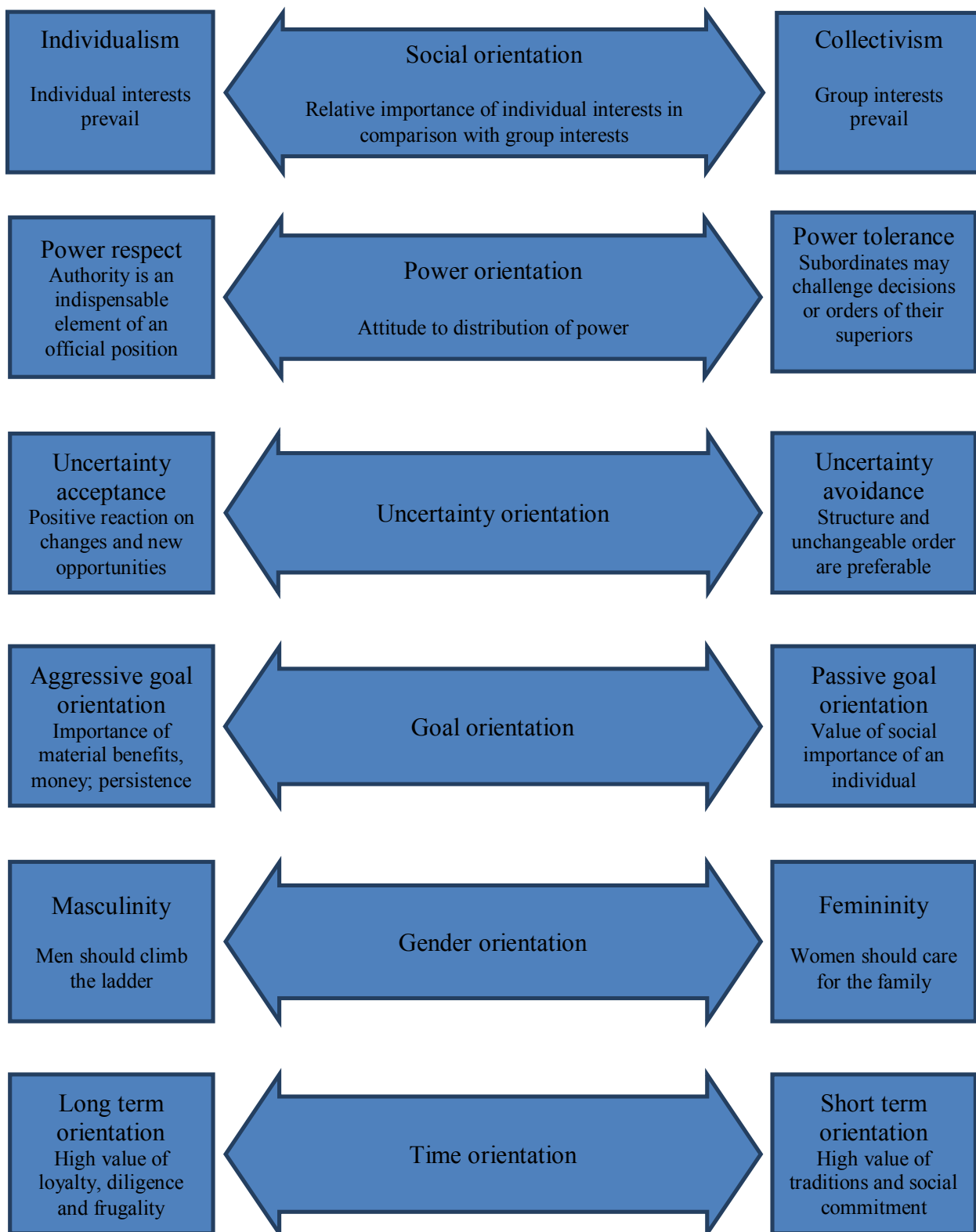
A cultural cluster comprises countries sharing many similar cultural values though preserving certain differences. Many cultural groups are identified accordingly with such attributes as a common language; English, German, Latin American and Arabic groups are attributed to this category of clusters; Scandinavian and European groups are to lesser extent depend on a common language. Spain and countries of Latin America share many cultural values; the same can be said about the USA and Israel.

Hofstede's cultural factors (The six dimensions model). The most comprehensive investigation in the course of which cultural differences have been analyzed and cultural characteristics have been generalized is a range of research conducted by Geert Hofstede. Geert Hofstede is a Dutch scholar who studied 116,000 people in dozens of countries. Hofstede's work was criticized for methodological drawbacks and the cultural bias of the researcher, however his investigation remains the most comprehensive and complex work in this field. Geert Hofstede is perhaps the best known sociologist of culture and anthropologist in the context of the applications for understanding international business. In his research, Hofstede identified six important factors (dimensions) which determine cultural differences among people (initially four factors and two additional factors later). These factors are shown in Fig. 14.2. It is worth paying attention to the fact that factors of national cultures identified by Hofstede only reflect trends existing in this or that culture and are not absolute notions.

Social orientation. The first factor or dimension identified by Hofstede is social orientation. Social orientation is a personal perception of the relative significance of an individual and social stratum to which he or she belongs. *Individualism* and *collectivism* the essence of which is concisely explained in Fig.14.2 are two extreme values of social orientation. Individualism is a cultural ideology in accordance with which the main role is intended for a man. Among the main values of individualists are sense of self-respect and independence of actions and judgments. Such people put their interests above the interests of their company. Inhabitants of the USA, Canada, Great Britain, Australia, New Zealand and Netherlands are prone to individualism.

Figure 14.2

Hofstede's cultural factors



Collectivism is a cultural worldview (adverse to individualism) in accordance with which the main role is intended for a group. The word collectivism in this sense has no political meaning: it refers to the group, not to the state. A society with high level of collectivism has a strict social structure comprising big families, clans and work collectives of companies. It is supposed that in

such society an individual puts group interests above his or her welfare, interests and success. Behavior of an individual in such environment depends largely on the sense of shame; when a group fails, all its members perceive this failure as their own and experience this feeling. According to Hofstede's conclusions inhabitants of Japan, Mexico, Greece, Hong Kong, Taiwan, Singapore, Pakistan, Peru, Columbia and some other countries are prone to collectivism.

Power orientation (Power distance index). The second factor determining differences between cultures is power orientation. Power orientation is perception by a cultural group of justification of power and its distribution between different levels of such hierarchical structure as a company. Some cultures are characterized by *power respect (or high power distance index)*. It means that people in such cultures are ready to accept and respect power and authority of a superior just because he/she occupies a higher position in a hierarchical system of management. Apart from this, representatives of such culture acknowledge the right of the superior to possess such power. Inhabitants of France, Spain, Mexico, Japan, Brazil, Indonesia and Singapore have respect for power. On the contrary, people in countries with *power tolerance (or low power distance index)* attach much less importance to position of an official in a hierarchical system of management. Such people are prone to challenge decisions or orders of their superiors or even refuse to fulfill them. They follow their instructions more readily if consider them correct or corresponding to their own interests rather than just because their superior possesses the right to give orders. According to Hofstede's conclusions inhabitants of the USA, Germany, Norway, Austria, Ireland, Denmark, Israel and New Zealand are prone to power tolerance.

Uncertainty orientation (Uncertainty avoidance index). This is the third factor identified by Hofstede. *Uncertainty orientation* is a society's tolerance for uncertainty and ambiguity. It reflects the extent to which members of a society attempt to cope with anxiety by minimizing uncertainty. People sharing a culture characterized by *low uncertainty avoidance* stimulate changes and opportunity to achieve success by virtue of exploiting new opportunities. Low uncertainty avoidance cultures accept and feel comfortable in unstructured situations or changeable environments and try to have as few rules as possible. Ambiguity of a situation is perceived as a context in which an individual can form and develop new opportunities and also utilize them through his hard work. In such cultures, certainty entails the sensation of monotony and routine in work and also involves the authoritarian character of managerial structure. In Hofstede's opinion *uncertainty acceptance* is incidental to inhabitants of the USA, Australia, Denmark, Sweden, Singapore and Hong Kong.

On the contrary, representatives of cultures with *high uncertainty avoidance* do not accept ambiguity and try to cope with anxiety by minimizing uncertainty. People in cultures with high uncertainty avoidance tend to be more emotional. They try to minimize the occurrence of unknown and unusual circumstances and to proceed with careful changes step by step by planning and by implementing rules, laws and regulations. Employees in such cultures tend to remain longer with their present employer. They prefer routine, and the structured and even bureaucratic performance of their duties. Hofstede believes that inhabitants of Japan, Austria, Italy, France, Germany, Israel, Columbia and Peru gravitate toward avoiding uncertainty whenever possible.

Goal orientation. The fourth Hofstede's factor – goal orientation – is a way of motivation of people to perform work to achieve certain goals. At the one end of the continuum, the *aggressive goal orientation or indulgence* is placed. People demonstrating an aggressive goal orientation are prone to set a value upon material benefits, money and insistence in achieving their goals. So societies with a high rate of indulgence allow hedonistic behaviors: people can freely satisfy their basic needs and desires. At the other end of the continuum of goal orientation, there are people with *passive goal orientation (restraint)*. Restraint defines societies with strict social

norms, where gratification of drives are suppressed and regulated. The main values for people in such cultures are relationships with other members of society, quality of life and taking care of close ones. According to Hofstede's conclusions inhabitants of Japan demonstrate relatively aggressive goal orientation while moderate aggressive goal orientation is incidental to many people in the USA, Germany, Italy and Mexico. People in the Netherlands, Norway, Sweden, Denmark and Finland are prone to relatively passive goal orientation. According to Hofstede people in cultures with aggressive goal orientation are prone to divide gender roles while people in cultures with passive goal orientation are not prone to do so.

Gender orientation. The distribution of emotional roles between the genders: masculinity vs. femininity. Masculine cultures' values are competitiveness, assertiveness, materialism, ambition and power, whereas feminine cultures place more value on relationships and quality of life. In masculine cultures, the differences between gender roles are more dramatic and less fluid than in feminine cultures where men and women have the same values emphasizing modesty and caring. In masculine cultures men are supposed to work and climb the ladder in traditionally male professions while women are expected to care for the family. As a result of the taboo on sexuality in many cultures, particularly masculine ones, and because of the obvious gender generalizations implied by Hofstede's terminology, this dimension is often renamed by users of Hofstede's work, e.g. to *Quantity of Life* vs. *Quality of Life*.

Time orientation. Long term orientation vs. short term orientation. First called "Confucian dynamism", it describes societies' time horizon. Long term oriented societies attach more importance to the future. They foster pragmatic values oriented towards rewards, including persistence, saving and capacity for adaptation. In short term oriented societies, values promoted are related to the past and the present, including steadiness, respect for tradition, preservation of one's face, reciprocation and fulfilling social obligations. People in Japan, Hong Kong, Taiwan and South Korea are prone to long term orientation. Pakistan and countries of West Africa can be attributed to cultures with short term orientation. Hofstede believes that the USA and Germany are characterized by the middle level of time orientation" [29].

2. Russian culture

Political changes, government reforms, a stable economy, vast natural resources and a large population have all led to Russia seeing enormous advances in their foreign trade links. However, Churchill's description of the country as a 'riddle wrapped in a mystery inside an enigma' still very much holds true for outsiders looking in. Gaining some basic insight into the Russian mentality, culture and etiquette is key for anyone doing business in Russia.

Geography and Culture. "Russia has part of its roots in European culture where the ideas of goodness, honor, and freedom are understood as in the West. The Viking raiders came from the North. Traders from Scandinavia also settled in Russia. They became the rulers of *Rus*, the city-principality of Kiev and forerunner of the Russian state. The other part of Russia has Asian roots. The Mongols (Tartars) conquered Moscow in 1234 and Kiev in 1240 and ruled with despotism, invaders unstoppable, making Russians their slaves. Russian blood is a mixture of Slavic, Finnish, and Tatar. Kievan Rus had converted to Orthodox Christianity in 988. When Moscow liberated itself from the Tartar yoke in 1480, the modern Russian state was born. Distant from Europe, the new state was cut off from Constantinople which in 1453 had fallen to the Muslim Ottoman Turks. The Russian Orthodox Church, isolated from the rest of Christianity, developed independently as a national church. Russia regarded itself as the third and Last Rome, successor to Rome and Constantinople, the two capitals of the Roman Empire which had fallen to barbarians and infidels. Its mission as the new center of Christianity was to unite the people of the East and West. The rulers of Russia began to use the title "Tsar", derived from Caesar. Remote from the West, Russia experienced none of the major developments which shaped

modern Europe. The Renaissance happened in the West, with its revival of classical influence and the flowering of the arts, development of modern agriculture and commerce, the scientific revolution, economic liberalism and recognition of individual rights, the beginnings of political liberty, and the growth of a strong middle class. In the West, the middle class was in the forefront of reform. Russia's failure to develop a strong middle class delayed reform. Russia remained a vast, backward, largely agriculture empire, regimented and ruled by an autocratic dynasty with a holy mission to defend its faith against the barbarians of the East and the heresies and pluralism of the West. Thus, to remote Russia, many things "Western" have come late - manufacturing, higher education, science, etc.

The Cold North. Living for centuries in a very harsh climate explains the Russians' strength, their ability to endure extreme hardship, and their bleak outlook on life. It also explains their patience and submission. Climate has also contributed to a cautiousness they exhibit.

Distance and Isolation. Russia is a great distance from other centers of civilizations; for example, 3,000 miles from Paris, a month's journey before railroads. It has only limited access to the sea, deterring development of a mercantile tradition. Geography also has made Russia vulnerable to wars, due to her lengthy borders which had no natural defenses. The Russian people see Russian expansion as a consequence of victories over foreign invaders. America's commercial experience and Russia's lack of a mercantile tradition have given the two countries different world outlooks. Commerce is by its very nature conducive to compromise. Nations raised on it instinctively seek a common ground for agreement, that exact point at which the other side might be prepared to make a deal. Compromise is native to America, but not to Russia. The oceans, moreover, have been bridges to America for cultures and ideas. The new has been welcomed in America; the old has been revered in Russia.

Communalism. Communal spirit and togetherness distinguishes Russians from Westerners. Individualism and competitiveness are more common in the West; they are esteemed characteristics. Russia has a history of the agricultural village commune, with the land held in common and decision-making determined by the assembly of heads of households. The objective was to find the collective will, which after discussion and opposition ceased, a consensus evolved which became binding on all households. This system endured until 1930 when it was brutally replaced by force into collective farms. The immediate result was famine and the death of millions in the countryside. The affinity for the group can still be seen today in everyday life, in group dating, and physical contact with strangers. Pushing and shoving in crowds bring no hard feelings. In restaurants Russians will not hesitate to join a table with strangers rather than dine alone. Men kiss men and show affection, women hold hands while strolling. Recreation is often arranged in groups, often with colleagues with whom they work. They prefer organized sports with set teams. Russians feel free to tell you if you or your child is not dressed warmly enough. In general, in a collective society, everybody's business is also everyone else's. Respect for authority was high. The concept of reward tied to performance was also alien, as was individual initiative. Many still view entrepreneurial activities as illegitimate.

Caution and Conservatism. Russians are more likely to be cautious and conservative defenders of the status quo. Their cruel climate, harsh history, and skeptical outlook on life has caused Russians to value stability, security, social order, and predictability, avoiding risk. The tried and tested is preferred over the new and unknown. Americans, as a nation of risk-takers, can have their patience tested by Russian caution, and anticipation of the negative. Americans expect things to go well and become upset when they don't. Russians expect things to go poorly and have learned to live with misfortune. The American habit of smiling all the time can get on the nerves of some Russians. Despite their pessimism, there is an admirable durability and resiliency about Russians, a proven strength and endurance.

Masculinity vs. femininity. In this motherland, women are strong, hard-working, nurturing, long-suffering, and the true heroes of Russia. Ninety percent are in the work force, where they occupy mostly secondary positions. Forty million Soviet men died in the three cataclysmic events of the Soviet era: 1) the collectivization of the agriculture, 2) the political purges, and 3) World War II (known as *The Great Patriotic War*) – creating a severe shortage of men for two generations of women.

Although Russian culture is very male-chauvinistic in flavor, usually the women of the society are the responsible ones. Research done by Co-Mission in 1994 indicated that there was a tendency for Russian men to feel an inner guilt for being irresponsible, in both family and social roles. Russian women contribute to the situation by being excellent naggers. Rather than working through the problems, men often retreat to hanging around together smoking and drinking vodka late into the night, perpetuating the irresponsibility. Women are forced to take hold of the responsibilities, but not given the authority in family or society.

Westerners and Slavophiles. Russians influenced by the West sought to borrow from the West in order to modernize. They were open to Western enlightenment, rationalism, and political thought that came along with the technology. Russian Slavophiles also sought to borrow from the West but were determined, at the same time, to protect and preserve Russia's unique cultural values and traditions. The West has been seen as spiritually impoverished and decadent, Russia as morally rich and virtuous.

The Russian Soul. The Russian soul has been described as: sensitive, reverent, imaginative, an inclination to tears (but not publicly), compassionate, submissive mingled with stubbornness, patience that permits survival in what would seem to be unbearable circumstances, poetic, mystic, fatalistic, with a penchant for walking the dark, introspective, sudden unmotivated cruelty, mistrust of rational thought, fascination - the list goes on. Russians maintain their integrity in a way that conforms to their inner notion of what a human being should be, with a blatant honesty and integrity seldom seen elsewhere in the world. Above all they have an appreciation for wholeness or complete commitment and faith, no matter to what that faith might be related.

The Bureaucracy. Russia has a history of power centrally concentrated in the economy, culture, education, media, religion, and citizens private lives. The law in Russia has served to protect the state and the community rather than the individual. The leaders had the tradition of being above the law. Recently, most Russians, though motivated by fear, do not take the law very seriously. With the fall of Communism, there are often conflicting laws on the books, enforceable as police so choose at a given moment. Initiative has been stifled in the process. Many officials in the USSR considered themselves a superior species, appointed to drive the herds of human cattle. Many Russians today still hold jobs because of nepotism, friendships, or former party membership. The result is often incompetence, sloth, conservatism, and a tendency to avoid responsibility by passing the buck to higher ups. Patience is the key thing to remember in dealing with the bureaucracy, and finding someone who knows the system, or better yet, someone who knows someone high up in the chain of command. Americans are often annoyed by the inconveniences caused by the seemingly inefficient and lackadaisicalness of the way things are done in Russia, including shopping, driving, poor planning in agriculture, etc.

Corruption. The assumption that "everyone steals" has erased the nation's sense of right and wrong. Many involved in bribery and embezzlement see it as the only way to survive. They feel justified since, "everyone else is doing it." The police are notorious for their corrupt behavior. While Americans generally trust "the law," Russians have a tremendous distrust of government, police and the military.

Nyekulturny (Bad Manners). *Nyekulturny* is the wrong way, uncultured, bad-mannered way of behavior. Some examples are: wearing coats in public buildings that have a cloakroom, standing with your hands in your pockets, sprawling in chairs, placing feet on tables, crossing legs while seated so as to show the sole of a shoe, sitting with legs spread wide, crossing arms behind the head, draping an arm over the back of a chair, eating lunch on park lawns, whistling at home or on the street, whistling during applause, public displays of affection, telling a Russian that you have to go to the restroom (you should just excuse yourself), and merely lounging or sitting on the steps of a public building. Nearly all of these things seem rather "normal" to Americans. (Which of these things haven't you done today?) Drinks are always served with something to eat, even if only a cookie. (In conservative church circles the list of unacceptable behavior goes on: Praying sitting, praying chewing gum, or with your legs crossed, women with their heads uncovered, etc.)

The New Russians. Russia has gone through several changes in the last few years. Visitors to Moscow just a couple of years ago would be very surprised at how "Western" downtown has become. Expensive shops line the main streets. International businessmen have rated Moscow as the most expensive city to conduct business, more costly than even Tokyo and New York.

The term "New Russian" has been coined for many Russian businessmen, some being quite well to do, even by American standards. This new pursuit-of-the-gold mentality is affecting the culture in general. Large screen TVs, VCRs, car ownership, remodels of city and country homes are now all commonplace. The zeal for the almighty dollar, or more accurately, less-than mighty ruble, is affecting everyone from the rich to the pensioner. Materialism has even roosted on Russian relationships. Russians have always had time for each other. Walks with friends, long conversations on the phone, and meals together were of great importance. With the pursuit of the microwave ovens and computers comes the requirement to work more hours, and for most Russians, at a variety of positions. While many Russians maintain their employ at their "main" job, such as being a teacher, or city employee, or doctor, they also have jobs on the side, such as tutoring, or selling things on the street, or developing a business. Recent observation is that many Russians have less time for walks and talks. Perhaps the days of several workers standing around idly will come to an end...certainly a welcome thing for improving efficiency. But will the superb Russian character of closely connected relationships be compromised in the process of the pursuit of "getting ahead"? The younger people are very open minded, well educated, and interested in new ideas.

Russian cities swarm with people. Most city dwellers live in small apartments in large multi-storied buildings rather than in detached houses. Around 15% still live in communal apartments with several families in one apartment. Shopping takes an inordinate amount of time, and most items are no longer scarce and hard to find. Hospitality is a great Russian virtue. An invitation to a Russian's home is a real treat and education into the true meaning of hospitality. Visit a small city or village to see the real heart of Russia. Visit stores, and churches, ride the Metro, go to a train station, In the big cities, experience the world class symphonies and ballets.

America and Russia Similarities. Both countries are multi-ethnic, continental, expansionist great powers, whose people tamed a wilderness, and settled it by a variety of diverse groups. Both regard themselves as chosen nations with a messianic mission, destined to bring their own versions of enlightenment to less fortunate people, They are both nuclear powers. The countries both think BIG, are energetic and inventive. The people appreciate casual, direct, and an often a blunt way of speaking, and both show heartfelt hospitality to visitors from abroad" [69].

Historical America and Russia Contrasts.

	America	Russia
Authority	Diffused from people, flows up	Centralized, flows down
Change	From below, individual	Imposed from above, society
Rights	Celebrated, protected	Subordinated for communal good
Diverse Views	Tolerance, pluralism	Consensus, single truth
Economy	Private free market	Government-centered
Cultural roots	Western Europe	Europe, Asia
Warfare	Wars fought mostly abroad, little/no devastation	Constant cruelties, wars, devastation, hardships

Russian cultural heritage. “Nowadays, Russian cultural heritage is ranked seventh in the *Nation Brands Index*, based on interviews of some 20,000 people mainly from the Western countries and the Far East. That's with the fact, that due to relatively late involvement of Russia in modern globalization and international tourism, many aspects of Russian culture, like Russian jokes and the Soviet Art, remain largely unknown to foreigners.

Literature. Russian literature is considered to be among the most influential and developed in the world, contributing many of the world's most famous literary works. Russia's literary history dates back to the 10th century; in the 18th century its development was boosted by the works of Mikhail Lomonosov and Denis Fonvizin, and by the early 19th century a modern native tradition had emerged, producing some of the greatest writers of all time. This period and the Golden Age of Russian Poetry began with Alexander Pushkin, considered to be the founder of modern Russian literature and often described as the "Russian Shakespeare" or the "Russian Goethe". It continued in the 19th century with the poetry of Mikhail Lermontov and Nikolay Nekrasov, dramas of Aleksandr Ostrovsky and Anton Chekhov, and the prose of Nikolai Gogol, Ivan Turgenev, Leo Tolstoy, Fyodor Dostoyevsky, Mikhail Saltykov-Shchedrin, Ivan Goncharov, Aleksey Pisemsky and Nikolai Leskov. Tolstoy and Dostoyevsky in particular were titanic figures to the point that many literary critics have described one or the other as the greatest novelist ever.

Architecture. Russian architecture began with the woodcraft buildings of ancient Slavs. Since Christianization of Kievan Rus' for several ages Russian architecture was influenced predominantly by the Byzantine architecture, until the Fall of Constantinople. Apart from fortifications (kremlins), the main stone buildings of ancient Rus' were Orthodox churches, with their many domes, often gilded or brightly painted. Aristotle Fioravanti and other Italian architects brought Renaissance trends into Russia. The 18th-century taste for rococo architecture led to the splendid works of Bartolomeo Rastrelli and his followers. During the reign of Catherine the Great and her grandson Alexander I, the city of Saint Petersburg was transformed into an outdoor museum of Neoclassical architecture. The second half of the 19th century was dominated by the Byzantine and Russian Revival style (this corresponds to Gothic Revival in Western Europe). Prevalent styles of the 20th century were the Art Nouveau (Fyodor Shekhtel), Constructivism (Moisei Ginzburg and Victor Vesnin), and the Stalin Empire style (Boris Iofan). After Stalin's death a new Soviet leader, Nikita Khrushchev, condemned the "excesses" of the former architectural styles, and in the late Soviet era the architecture of the country was dominated by plain functionalism. This helped somewhat to resolve the housing problem, but created the large blocks of buildings of low architectural quality, much in contrast with the previous bright architecture. After the end of the Soviet Union the situation improved. Many churches demolished in the Soviet times were rebuilt, and this process continues along with the restoration of various historical buildings destroyed in World War II. As for the original

architecture, there is no longer any common style in modern Russia, though the International style has a great influence.

Classical music. Music in 19th century Russia was defined by the tension between classical composer Mikhail Glinka along with his followers, who embraced Russian national identity and added religious and folk elements to their compositions, and the Russian Musical Society led by composers Anton and Nikolay Rubinstein, which was musically conservative. The later Romantic tradition of Pyotr Ilyich Tchaikovsky, one of the greatest composers of the Romantic era, whose music has come to be known and loved for its distinctly Russian character as well as its rich harmonies and stirring melodies, was brought into the 20th century by Sergei Rachmaninoff, one of the last great champions of the Romantic style of European classical music.

World-renowned composers of the 20th century included Alexander Scriabin, Igor Stravinsky, Sergei Rachmaninoff, Sergei Prokofiev, Dmitri Shostakovich and Georgy Sviridov. Soviet and Russian conservatories have turned out generations of world-renowned soloists. Among the best known are violinists David Oistrakh and Gidon Kremer; cellist Mstislav Rostropovich; pianists Vladimir Horowitz, Sviatoslav Richter, and Emil Gilels; and vocalists Fyodor Shalyapin, Galina Vishnevskaya, Anna Netrebko and Dmitry Hvorostovsky.

Ballet. The first ballet company was the Imperial School of Ballet in St. Petersburg in the 1740s. The *Ballets Russes* was a ballet company founded in the 1909 by Sergey Diaghilev, an enormously important figure in the Russian ballet scene. Diaghilev and his Ballets Russes' travels abroad profoundly influenced the development of dance worldwide. The headquarters of his ballet company was located in Paris, France. A protégé of Diaghilev, George Balanchine, founded the New York City Ballet Company in 1948. During the early 20th century, Russian ballet dancers Anna Pavlova and Vaslav Nijinsky rose to fame. Soviet ballet preserved the perfected 19th century traditions, and the Soviet Union's choreography schools produced one internationally famous star after another, including Maya Plisetskaya, Rudolf Nureyev, and Mikhail Baryshnikov. The Bolshoi Ballet in Moscow and the Mariinsky in Saint Petersburg remain famous throughout the world.

Opera. The first known opera made in Russia was *A Life for the Tsar* by Mikhail Glinka in 1836. This was followed by several operas such as *Ruslan and Lyudmila* in 1842. Russian opera was originally a combination of Russian folk music and Italian opera. After the October revolution many opera composers left Russia. Russia's most popular operas include: *Boris Godunov*, *Eugene Onegin*, *The Golden Cockerel*, *Prince Igor*, and *The Queen of Spades*.

Cinema. Russian and later Soviet cinema was a hotbed of invention in the period immediately following the 1917 revolution, resulting in world-renowned films such as *Battleship Potemkin*. Soviet-era filmmakers, most notably Sergei Eisenstein and Andrei Tarkovsky, would become some of the world's most innovative and influential directors. Eisenstein was a student of filmmaker and theorist Lev Kuleshov, who developed the groundbreaking Soviet montage theory of film editing at the world's first film school, the All-Union Institute of Cinematography. Dziga Vertov, whose kino-glaz ("film-eye") theory – that the camera, like the human eye, is best used to explore real life – had a huge impact on the development of documentary film making and cinematic realism. In 1932, Stalin made socialist realism the state policy; this somewhat limited creativity, however many Soviet films in this style were artistically successful, like *Chapaev*, *The Cranes Are Flying*, and *Ballad of a Soldier*. 1960s and 1970s saw a greater variety of artistic styles in the Soviet cinema. Eldar Ryazanov's and Leonid Gaidai's comedies of that time were immensely popular, with many of the catch phrases still in use today. In 1961–1968 Sergey Bondarchuk directed an Oscar-winning film adaptation of Tolstoy's epic *War and Peace*, which

was the most expensive film ever made. In 1969, Vladimir Motyl's *White Sun of the Desert* was released, a very popular film in a genre known as 'osterns'; the film is traditionally watched by cosmonauts before any trip into space. The late 1980s and 1990s were a period of crisis in Russian cinema and animation. Although Russian filmmakers became free to express themselves, state subsidies were drastically reduced, resulting in fewer films produced. The early years of the 21st century have brought increased viewership and subsequent prosperity to the industry on the back of the economy's rapid development, and production levels are already higher than in Britain and Germany" [70].

3. Russian business culture

Meeting and Greeting. "The typical greeting is often a (very) firm handshake with the appropriate greeting for the time of day – *dobrye utro* (good morning), *dobryy den* (good afternoon) or *dobryy vecher* (good evening). Even though it may sound a bit stiff it is commonplace when doing business in Russia to introduce yourself using only your surname. Before meeting your Russian counterpart ensure you find out if there are any titles they use as these are extremely important and should be used. If you are visiting Russia it is appropriate to refer to your counterpart by either "*gospodin*" (a courtesy title similar to "Mr.") or "*gaspazhah*" (similar to "Mrs." or "Miss") plus his or her surname.

On the whole Russians have three names. The first name is the given name while the last name is the father's family name. The middle name is a version of the father's first name, known as a patronymic; for a man, it ends with the suffixes "evich" or "ovich" meaning 'son of' (for example, *Vladimir – Vladimirovich*) For a woman, the patronymic is also the father's first name but with suffixes "evna" or "ovna" added, which means 'daughter of.' When doing business in Russia make sure you take a business card. It is always a good idea if you plan to maintain contacts in Russia to have one side translated into Russian. If you do so make sure you add your title and any degrees or qualifications you have.

The exchange of business cards is an essential step when meeting someone for the first time, so bring more than you need. You may not always get one in return. When presenting your card, ensure that the Russian side is facing the recipient. Smile and keep eye contact while accepting someone else's card, then take a few moments to look at it. Next, place the card on the table in front of you or into your card case.

Obtaining an appointment can be a tremendous challenge, so persistence and patience are essential. Once your appointment is scheduled, do everything you can to avoid cancellation. When making appointments, be sure to schedule them far in advance. It will also be in your best interests to confirm any appointment several times, as the scheduled date approaches. Don't attempt to schedule your trip to Russia near the end of July or during the month of August, because this is the time of year many people take their vacations.

Russian communication styles. English language levels vary enormously in Russia. Many younger entrepreneurs (especially in the cosmopolitan centers like Moscow and St Petersburg) have a fluent command of, not only English, but often several other European languages. Yet in other more provincial centers it is not unusual to meet business people who have little or no foreign language skills. Always check in advance whether interpretation is needed. If there is any doubt about the comprehension levels encountered in meeting situations, be sure to check and recheck by asking relevant 'open' questions at regular intervals. Outside Moscow and St.Petersburg most signs are written exclusively in the Cyrillic script and knowledge of this will go a long way on a trip to the more remote areas of Russia.

As with many other cultures (Mediterranean and Middle Eastern for example) much more emphasis is placed upon the spoken than the written word. People believe things when they have heard them from someone with whom they have a trusting relationship. Therefore, it is often much more efficient to hold face-to-face meetings at which issues can be fully explained, rather than sending information in a written format only.

There tends to be very little visual or verbal feedback during meetings in Russia. People listen silently and with little obvious body language being displayed. This does not, however, mean that the listener is disinterested or does not understand – it is merely a cultural characteristic which Russians share with, among others, the Finns and the Japanese. Russians will tend to wait and think before responding to a point made to them – do not be impatient. Allow the Russians the time and space needed to take part fully in the conversation (and remember that they are probably struggling with foreign language as well).

Russian Meetings. As might be expected in a country where managers are autocratic in style, meetings are often for the purpose of information dissemination, rather than for the open debate of current business issues. Formal meetings are often held to ratify decisions which have been made elsewhere and to give clear instruction on key tasks to be performed. Any open debate on the issues in hand will have been undertaken elsewhere in either one-to-one meetings or in smaller groups. It is in these 'background' meetings where much of the real debate is undertaken. Without access to these meetings, it can be very difficult to influence the flow of events and it is only through cultivating very close relationships that an outsider will ever be invited into these inner cabals. Formal meetings tend to be very structured and serious. The dour image associated with many Russian negotiators stems from the belief that a formal meeting is a serious affair and should be treated accordingly. Humor is seldom used in such serious situations.

Negotiating. Always be punctual when doing business in Russia. However do not take offense if your Russian counterpart is not. It is not unknown for Russian business people to turn up hours late. A good indication of how serious a meeting is taken is how punctual they are. Initial meetings are usually approached as a formality. It is at this stage that your credibility will be assessed. The best strategy is to appear very firm and dignified, while maintaining an air of warmth and approachability.

Pitches or presentations should be simple and straightforward. Generally Russians are not impressed by foreigners doing business in Russia who use special visuals, flashy PowerPoint presentations and the like. These do not sway decisions. The most critical element is demonstrating your knowledge, professionalism and expertise. "In Russia, much of business language is still new to Russian managers who often interpret the business terminology in their own way. Consequently, the underlying psychological meaning and emotional impact is either changed, blurred, or lost. Therefore check that the Russian counterpart indeed understands the presented proposals correctly.

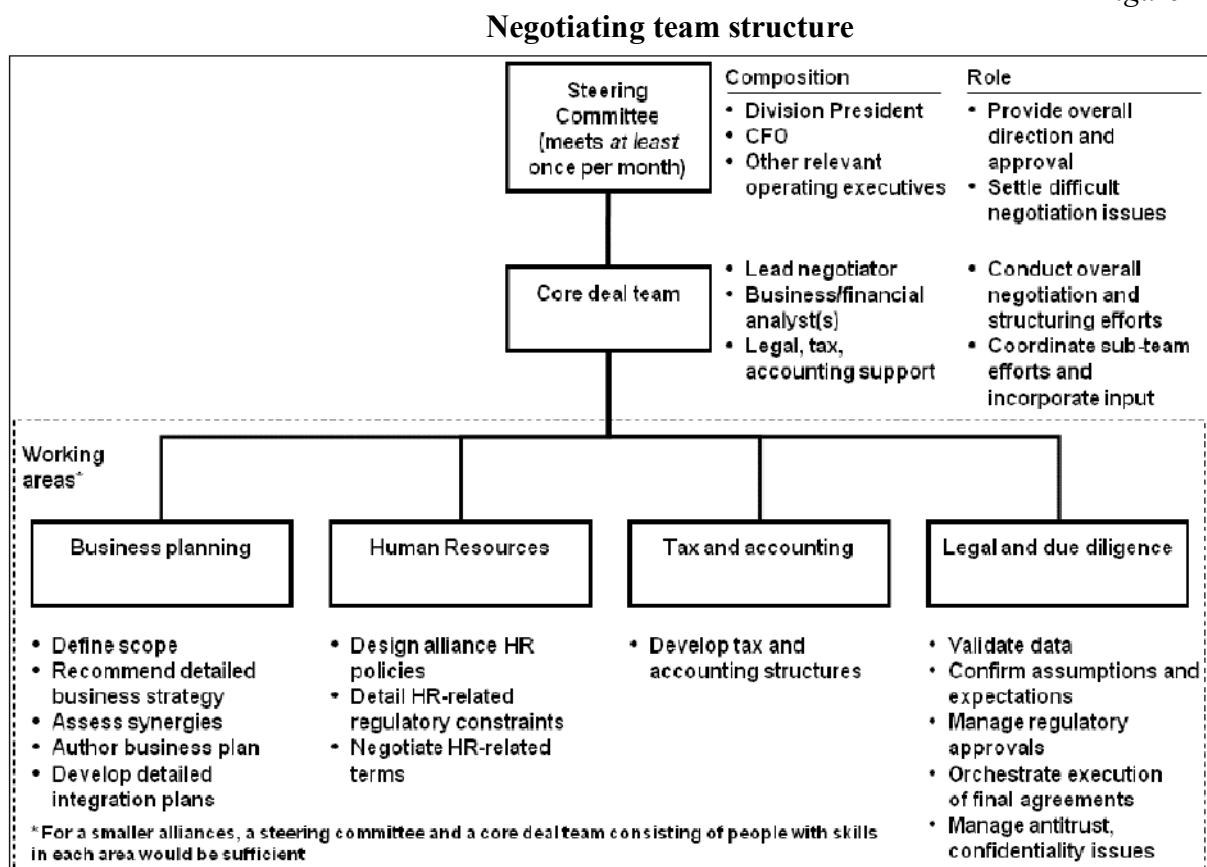
Negotiations are an interesting affair for anyone doing business in Russia. They are tough and like to indulge in a fair amount of theatre if necessary. Their main aim is to gain concessions so there will be a lengthy process of grinding you down. Caving in too early is a sign of weakness so stand your ground. If you do feel the need to concede ask for the gesture to be reciprocated in some way. Generally speaking, Russians view compromise as a sign of weakness. Don't be surprised by loss of tempers, walkouts, threats to end the deal, and similar incidents. It's all part of the fun. Success requires extreme patience in this country.

Russians generally employ a *polychronic* work style. They are used to pursuing multiple actions

and goals in parallel. When negotiating, they often take a holistic approach and may jump back and forth between topics rather than addressing them in sequential order. It is not unusual for them to re-open a discussion over items that had already been agreed upon. Negotiators from strongly *monochronic* cultures, such as Germany, the United Kingdom, or the United States, may find this style confusing, irritating, and even annoying. It is crucial to keep track of the bargaining progress at all times. If your counterparts appear to be stalling the negotiation, assess carefully whether their slowing down the process indicates that they are evaluating alternatives or that they are not interested in doing business with you. More often than not, though, this behavior indicates an attempt to create time pressure or ‘wear you down’ in order to obtain concessions.

The negotiating team’s composition and structure can play a decisive role in every negotiation. In Russia, which is often seen as “unpredictable”, the team composition and management can be used to diminish unpredictability and make the negotiation process more manageable. Depending on effort and expected outcome (e.g., M&A, JV, product sale, etc.), the negotiating team can vary in size and composition. Below is an example of the negotiating team, set-up by a western multinational during the acquisition process of the Russian oil field company.

Figure 14.3



In a large acquisition, a structure of this size (or larger) would be appropriate. For a smaller alliance, it would be sufficient to have a steering committee and a core deal team consisting of people with skills in each area. The most important element here is the role of people running the steering committee who must be key decision makers able to apply a veto and meet at least once per month. Moreover, the composition of the committee should remain constant throughout the time of negotiations (a high turnover of members can hamper the negotiation process). Therefore carefully select the delegation. Women and young managers may have a much harder time gaining the trust or respect of Russian managers. Try to clarify the authority of your counterpart.

Because the decisions can be made only by chief executives or director, that could delay negotiations” [71].

Russian teams. Teams work best together when the relationships amongst the group are close. There remains a general suspicion of strangers in Russian society and any attempt to bring together teams from different strands of an organization can be problematic. Once a team has been established and is working well together it is probably best to keep the team intact for as long as possible. Move the team wholesale from project to project rather than developing a fresh team for every situation. The team leader is expected to play a domineering role and to issue precise detailed instructions and then supervise ongoing progress. Those western managers who are more used to a 'hands off' approach will undoubtedly confuse local staff who will feel unsure of what is expected of them. An expatriate team leader needs to establish credibility through being decisive, clear and visibly in control.

Russian business structures. Autocracy and centralized decision-making are synonymous with the Soviet system in many people's eyes and this approach can certainly be seen to be manifested within large Russian business organizations. Russian companies tend to be driven by one strong central figure who will make strategic decisions with little or no consultation with anyone other than a handful of close trusted advisors. (Indeed this centralized decision-making process can be most clearly seen in the approach of recent Russian presidents.) Therefore, when dealing with potential clients or joint-venture partners in Russia, it is absolutely essential to make sure that one deals with the right person. Western companies who attempt to interface at inappropriate levels within an organization waste massive amounts of time and resource. Nowhere is the advice, 'Go straight to the top', more pertinent. The headlong rush from communism to capitalism has made people into entrepreneurs and centralized decision-making enables organizations to grab an opportunity when it arises. Thus, as in most developing economies, companies tend to have a short-term view of business activities and it is imperative that any potential partner can see the short-term benefits of collaboration.

Hierarchy is an important aspect of Russian business culture with status being linked to age and position. It is important to be aware of the fact that usually meetings are held with people of equal status. Decision making is commonly done by the most senior employees in the company. Showing respect for seniority is essential for maintaining strong business relationships when doing business in Russia.

Relationships and Respect. Russia's culture expects its members to have a sense of belonging to and conforming with their group. At the same time, it leaves some room for individual preferences. Building lasting and trusting relationships is very important and can be crucial for your business success. If Russians engage in business without first establishing personal relationships, proceed with great caution. They may be looking to take unfair advantage of you if they get a chance. Generally, it is best to give your counterparts time to become comfortable with you. This includes letting them see your personal side, as Russians often mistrust people who are 'all business.' Relationship building is normally a slow process here, since people dislike being rushed or having to follow the fast-paced western approach. Patience is of critical importance in this country.

Business relationships in Russia usually exist both at the individual and company level. Russians may want to do business only with those they like and trust. However, if you introduce someone else from your company into an existing business relationship, that person may quickly be accepted as a valid business partner. You may be able to establish trust by emphasizing common ground. For example, express your own distrust of authority or bureaucracy whenever there is an opportunity for it. However, refrain from praising or rewarding anyone in public. Unlike in many

other cultures, doing so may raise suspicion about your motives. In Russia's business culture, the respect a person enjoys depends primarily on his or her rank and status. Age and education are less important than in most other countries. Be careful never to come across as patronizing a senior Russian manager. Admired personal traits include firmness, sincerity and dependability.

Business dress. There is an old Russian proverb – "they meet you depending on how you're dressed and they say good bye depending on how wise you seem." It is important, for westerners to look smart and appear to be expensively dressed as this enhances credibility. From the safety standpoint, it is probably not advisable to wear very expensive watches or jewelry. Nowadays, Russian businesspeople pay a lot of attention to how they are dressed. Russian people in general probably spend more money from their family budget on clothing than any other nation in the world. Those who can't afford to buy top fashion brand clothing (such as *Versace*, *Armani*, *Gucci*, *Calvin Klein* or *Hugo Boss*) prefer to be dressed in cheaper but still well made suits rather than wear the fake products widely available in numerous markets across the country. Women mainly wear business suits or blouses and skirts. If you're a man, your best bet will be to wear a suit and tie (make sure not to wear the same ones every day) for all your meetings, whether it's in an office or restaurant. Dark colors and white shirts are only for special occasions. Otherwise, choose tones in light blue, gray, or brown. If you go to Russia during the winter, bring very warm clothes, including hats and gloves. In addition, pack a well-insulated pair of boots with good treads. Jeans and sneakers can be acceptable casual wear. Women must wear a long-sleeved blouse, a long skirt below the knees, and a head covering such as a scarf or hat, when visiting a Russian Orthodox church.

Women in Business in Russia. The communist system of Russia preached equality of the sexes but had far less success in achieving the objective than their counterparts in the People's Republic of China. Thus, although a high percentage of the Russian workforce is female, there are very, very few women in senior management positions. This situation shows little sign of changing other than in some of the offices of major multinational corporations stationed in the country. Western women working in Russia will be showered with old-fashioned courtesies but may find themselves ignored in meetings and treated as inferior in rank to male colleagues – whether they are or not!

Entertaining. The business breakfast is not a part of Russian business culture. Doing business, conducting meetings, making decisions, negotiating and getting to know each other is increasingly being done at dinner. It's also important to book an appropriate restaurant, that is, it shouldn't be loud with music or overcrowded. Spouses are rarely included on these occasions, although they are often invited to gatherings in homes. Women are discouraged from dining alone in restaurants. If your Russian counterpart decides to invite you out do not refuse the request as it would be rude. At the table center seats are used by the most senior attendees. As a guest you should be placed in the middle opposite your immediate counterpart. Remember Russians do like a drop or two of alcohol. Refusing to drink is unacceptable unless you give a plausible excuse, such as explaining that health or religious reasons prevent you from imbibing. Always bear in mind that you may be discussing so know your limit. Begin eating only after somebody says a toast; toasting is a very important part of dining. Note that Russians use the continental style of holding utensils, with the fork held in the left hand, tines down, and the knife in the right hand at all times.

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