

# Russian foreign direct investment economics essay



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The Russian Federation was part of the Union of Soviet Socialist Republics for the most part of the 20th century. In 1991 the USSR broke up into Russia and 14 other independent states, catalyzed by the glasnost and perestroika reforms instigated by President Mikhael Gorbachev (CIA, 2011). This period also marked the transition from a centrally planned economy to one that was more market oriented. Initially, the suddenness with which this took place caused the economy to decline during 1990 – 1995 due to a lack of competitiveness on the part of Russian companies (Wikipedia, 2010). However, the Russian economy grew continuously after that on the backs of growing domestic demand and rising oil and commodity prices in the world market. Russia averaged a GDP growth rate of 3.64% between 2006 and mid-2010 only offset by the negative growth rate of 7.9% in 2009 (annex table 1 & 2), due to the global financial crisis (World Bank, 2010). Russia has a total population of approximately 139 million and a per capita income of 15,900 US dollars in PPP terms (CIA, 2011).

## **2. Overview of the Country and Its Locational Advantages and Disadvantages**

Russia is the largest country in the world with an area of 17,075,400 square kilometers. It borders 14 countries which include EU countries, CIS countries, and Asian countries such as China and Mongolia (Wikipedia, 2010). As a part of the BRIC group of countries comprising of Brazil, India, and China, Russia's role as one of the major economic players cannot be ignored. Russia has much of what foreign investors are seeking in an investment environment (Ägütçü 2002; Kuznetsov, 2010).

The main advantage of Russia as a source of Foreign Direct Investment (FDI) is firstly its non-skilled labor which is cheaper in comparison to that of other Western European countries. Secondly, Russia has a high growth potential and contains a sizable middle class. It was averaging a growth rate was 6.7% between 1999 and 2006. Although, there was a drop in this number after the global recession of 2009, it is again expected to pick up. Thirdly, Russia is highly accessible from Europe and Asia, by land, sea, and air due to its vast size; a strong factor in consideration for cross-border joint ventures. Fourthly, its vast natural resources, which are suitable for resource-seeking FDI such as oil and mining sectors, are a big bonus. And finally, Russia has a large population of skilled and educated workforce making it suitable for service seeking FDI's, such as information technology and research and development companies (Rogacheva & Mikerova, 2003).

On the flip-side, however, corruption and unfavorable business environment has effectively curtailed efficiency-seeking FDI in Russia and most of the FDI is resource-seeking or market-seeking. (Rogacheva & Mikerova, 2003; Kuznetsov, 2010). This relates to the main disadvantages of doing business in Russia which are largely political and administrative in nature. Firstly, corruption and high level of political interference is a big concern to foreign investors, especially firms that are from more developed economies. Secondly, it has a weak and opaque legislative system and judiciary that is not very independent. This is a very big concern to investors who feel that legal protection extended to companies is weak in case of disputes. Thirdly, the taxation system is one of the most complicated in the world, which is the source of substantial administrative delays. Finally, the lack of adequate

physical infrastructure is the major concern cited by businesses that depend on movement of products from one place to another (FIAC, 2008). In World Bank's latest "Doing Business 2011" survey Russia's rank dropped 7 spots from 116 to 123 in comparison to the previous year (2011).

### **3. Current Government Regulations that Affect MNEs and FDI**

In 1991, growth in Russia and the remaining countries of former USSR was seen as a primary goal to ensure development. Most of these transition economies at the point of formation lacked capital, technical knowledge and business practices to compete with the west. The solution to this problem was to increase the level of FDI in the country. However, increase in inward FDI without checks/balances would have led to phasing out of noncompetitive domestic firms. A fine balance had to be maintained between the arrival of knowledge through FDI and maintaining competitiveness of the domestic firms. This scenario led to the creation of government laws to regulate FDI in the country (Kuznetsov, 2010).

Since 1991, the Russian government has passed many laws to aid and protect the economy. The Modern Russian FDI law passed in 1999 was to provide equal opportunities to both foreign and domestic investors in creating economic growth through joint ventures. Even though foreign firms received assistance to set up in the country, they were also subjected to additional checks than the domestic firms. A 2005 federal law introduced incentives to attract inward foreign FDI through the formation of special economic zones. These zones were designed not by the government but by the companies to ensure proper competitive usage of resources. The zones

varied from industrial to innovative zones. In addition, increase in the number of double taxation treaties (DTTs) signed by the Russian government also provides evidence in favor of increasing inward FDI (Kuznetsov, 2010). Despite all these positive moves, the 2008 law limited FDI in strategic sectors which include nuclear power, weapons, aircraft production and mass media. This law has caused a lot of concern among foreign investors about the legitimacy of these limitations and the possibility of protectionism on the government's part. In addition, to these laws, the political and bureaucracy component have acted as a deterrent to inward FDI. Concerns about unnecessary bureaucracy, barriers in customs and migration offices, and weak property rights have been an obstacle to foreign investors (Kuznetsov, 2010).

#### **4. Inward Foreign Direct Investment**

Russia has seen remarkable growth in the area of inward FDI from the early 2000s. In 2008, the country has seen its GDP grow 1.94 times its 1998 level (Kuznetsov, 2010). Despite this strong growth the country's inward FDI is lower compared to its counterparts from Europe. Russia in the 1990s had adopted a system of oligarchy whereby major soviet enterprises were broken down and sold to few powerful investors. This methodology of privatization acted as a deterrent to inward FDI. Violation of property rights, favorability of domestic enterprises and inability to acquire market share were seen as possible obstacles by foreign companies to investment. Currently the foreign investment is still less than 10% of gross capital formation.

Most of Russian IFDI can be linked to countries in the European Union (EU) and the Commonwealth of Independent States (CIS). These strong

relationships are primarily due to the proximity, common languages and business contacts from the soviet era. Recent data shows that Cypress provides 23% of inward FDI while Germany and Netherlands came in 2nd and 3rd with 16% and 12% respectively (BOFIT Weekly, 2010). The contribution from Cypress could be mainly due to the large number of Russian companies registered in that country. Similarly, a significant portion of the inward FDI can also be traced to countries in Latin America, Caribbean and the British Virgin Islands (Kuznetsov, 2010). These investments are mainly round-tripping investments from countries where Russian capital has been stored.

Inward FDI increased tremendously from the 1st quarter of 2003 and continued on the upward trend until 2008. The inward FDI took a sharp dip in 2009 mainly due to the impact of the world economy on the Russian economy and less due to the impact of advance financial instruments in the Russian bank sector (annex table 3).

Foreign companies play a key role in only a few Russian industries like beverages and tobacco. Inability to make large forays in the strategic sectors like oil & gas, sub-soil and other strategic sectors makes TNK BP the only significant joint venture with a foreign ownership greater than 50%. Table 4 provides a list of the principal foreign non-financial affiliates based on turnover.

In the period of 2003-2007, the services sector was the biggest sector accounting for 50-60% of the inflows into Russia. The main economic sectors of the total foreign investments include trade, manufacturing, mining and

quarrying, and real estate (Curtis, Griffin & Kornecki, 2010). Some of the key foreign MNEs operating in Russia are British Petroleum, Ford Motor and Auchan.

## **5. Outward Foreign Direct Investment**

The growth in Russian outward FDI has been as remarkable as in the case of its inward FDI (annex table 5). Among emerging economies, the total Russian outward Foreign Direct Investment (OFDI) was more than that of Brazil India and China (excluding Hong Kong) (annex table 6) in 2008 (Panibratov & Kalotay, 2009). Its total outward stock was \$203 billion, second only to Hong Kong, which had an outward stock of \$776 billion. The Russian investment trend abroad was averaging about \$43 billion per year from 2006-2009 (UNCTAD, 2009). Although, the global financial crisis has impacted this bullish trend, the Russian OFDI shows no sign of retreating (Panibratov & Kalotay 2009). Russia's OFDI stock in 2009 was \$249 billion, 25% higher than the previous year (UNCTAD, 2009).

The Russian multinational enterprises (MNEs) investing abroad are diverse. Both privately owned and government owned companies fall in this group. Among the private enterprises there are very efficient institutions as well as institutions with rent-seeking tendencies who are investing outside Russian borders. Similarly the state owned enterprises also contain a mix of efficient companies and unproductive ones (IMEMO-VCC, 2009). As of 2008, the top destination for Russian MNEs was Europe with 49% of its assets there. The Commonwealth of Independent States (CIS) and the United States accounted for 23% and 17% of the total share, respectively (annex table 7) (Panibratov & Kalotay 2009). The main factors that accounts for the foreign markets'

selection are geographical proximity as in the case of Europe and cultural proximity as in the case of CIS countries (IMEMO-VCC, 2009).

According to Andrei Panibratov and Kalman Kalotay, mergers and acquisitions (M&As) by Russian companies are the best way to learn about Russian OFDI due to a lack of quality data on the subject (2009). M&As seem to be more concentrated in the primary sector, accounting for 59%. Manufacturing and services accounted for 23% and 18% respectively (Panibratov & Kalotay 2009). A ranking conducted by SKOLKOVO-CPII (annex table 8) shows that the top 25 Russian MNEs accounts for 38% of the total OFDI of the more than 1000 firms investing abroad (2007). Most are relatively new since 18 of the 25 MNEs established themselves abroad only after 1999. From this list 12 or 50% of the companies are involved in resource-seeking FDI. This reflects in the fact that the top M&A transactions between 2005 and 2008 were for the large part resource-seeking deals and involved companies such as Norilsk Nickel, Evraz Group, Gazprom, and Lukoil (Panibratov & Kalotay). While four of the resource-seekers in the list are involved in the oil and gas sectors, the remaining ones are involved in the metal and mining sectors.

The key players in the oil and gas sectors are companies like Lukoil and Gazprom. Lukoil is the second largest privately-owned oil company in the world. It has exploration and operations in the CIS countries, Middle East, Latin America, and Africa. In addition it also owns downstream facilities such as refineries in the United States and the European Union. Gazprom on the other hand is a state-owned company and Russia's second largest. In contrast to Lukoil, Gazprom decision go global has come only recently



(Kalotay & Sulstarova, 2010). Companies such as Severstal, Rusal, and Norilsk Nickel, are the key players in metal and mining. Severstal is the third largest Russian transnational corporation and is also the largest steel producer in Russia. When it acquired Rogue Industries, an US steel industry, it also became a supplier to American auto manufacturers. Rusal is a leader in aluminum, and Norilsk Nickel has a heavy presence in non-ferrous metals such as cobalt, copper, nickel, palladium and platinum. Both maintain assets in several countries (Kalotay & Sulstarova. 2010).

Other key companies in the list include Sovcomflot in the transport industry; AFK Sistema and VimpelCom in the telecom industry; RAO UES in electricity; Eurochem in agro-chemicals, and; GAZ and OMZ in manufacturing. Sistema and VimpelCom are the seventh and eighth largest Russian MNEs in terms of foreign assets and their presence is mainly concentrated in the CIS countries (SKOLKOVA-CPII, 2007).

## **6. Conclusion**

The Russian economy has seen slow growth in the early 1990s to rapid growth in the early 21st century. According to the International Commission founded by the Bleyzer foundation “ the attractiveness of FDI in Russia was primarily due to notable improvements in the liberalization and deregulation of the business environment, improved corporate and public governance, removal of international capital and trade restrictions, and investment incentives” (Curtis, Griffin & Kornecki, 2010). However, for Russia to maintain productivity and competitiveness in the world economy it has to tackle corruption, political interference and a weak legislative system which are viewed as obstacles for foreign investment in Russia.

**Annex****Table 1: Real GDP growth (%) in Europe and Central Asia in 2010****Source: World Bank (2010), pg. 5****Table 2. GDP growth, labor productivity, unemployment and disposable income****Source: World Bank (2010), pg. 9****Annex****Table 3: Inward FDI flow to Russia from 1990-2009 (millions of US\$)****Source: UNCTAD Statistics Database (<http://unctadstat.unctad.org/>)****Annex****Table 4: Principal foreign non-financial affiliates (with at least 50% held shares), ranked by turnover, 2008 (millions of US\$)****Source: Kuznetsov (2010), pg. 14****Table 5: Russian OFDI stock for various years (billions US\$)****Source: Vahtra (2009), pg. 6****Annex****Table 6: BRIC countries' outward FDI flow from 1990-2009 (millions US\$)****Source: UNCTAD Statistics Database (<http://unctadstat.unctad.org/>)**

**Table 7: Numbers of mergers and acquisitions undertaken by Russian companies**

**Source: Filippov (2008), pg. 14**

**Annex**

**Table 8: SKOLKOVA-CPII ranking of the top 25 Russian multinationals, in terms of foreign assets, 2006 (millions of US\$)**

**Source: SKOLKOVO-CPII (2007), pg. 3**