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Highlights in this issue:

- **Russia has recovered from the recession of the 1990s.**
- **A major weakness of its growth model at that time was low investment and FDI...**
- **...but this has also recently changed.**

Foreign investment in Russia

*By Lúcio Vinhas de Souza**

Summary

Russia is now again one of the 10 largest economies in the world. Additionally, it is the EU's 3rd largest trading partner, and an essential energy supplier. This recovery makes Russia an economic – and political – actor in Europe that cannot be ignored.

This Country Focus describes Russia's much improved recent record as a destination for foreign investment, in which the EU, as by far the largest investor in Russia, has played a major role. It then examines how this recent development could be turned into a long-run trend, namely by improving the legal framework and investment climate in the country. The EU, as the main investor in Russia and largely dependent on it for energy (an industry in which a more liberal FDI framework is needed in some sectors), has a clear strategic interest in this process.

Growth recovery

Russia has had average growth of 6.7% per year since 1999.

Since the return of positive and strong growth after the 1998 financial crisis – growth rates averaged 6.7% of GDP in 1999-2006 and ECFIN's last 2007 growth forecast is 7.7%, or three and half times the growth rate of the euro area – Russia is now the largest non-EU economy in Europe and one of the 10 largest economies in the world. Russia's nominal GDP was worth over EUR 740 billion, or USD 1 trillion in 2006, roughly the size of Spain's. In PPP terms, it is almost 70% of Germany's (GDP in PPP are available only in USD). Clearly, Russia has fully recovered from the deep "transition recession" that plagued the country in the 1990s (see Charts 1 and 2).

Chart 1: GDP growth rate

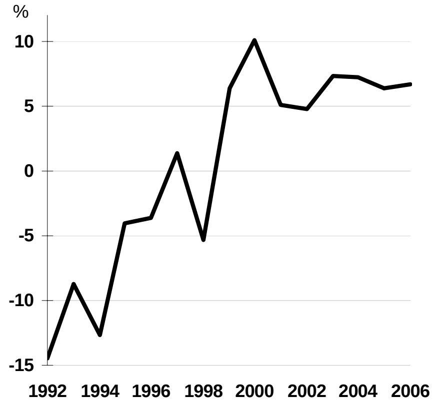
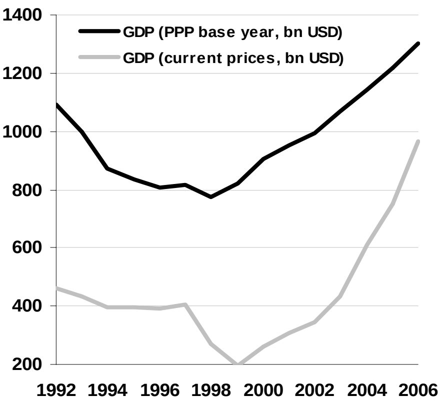


Chart 2: Russian GDP (PPP & USD)



Source: IMF, World Bank, Rosstat, author's calculations.

***Directorate International Affairs.**

For most of this period, the growth of Russia's output, driven primarily by private consumption, was made possible by a gradual increase in utilisation of the existing industrial capacity, rather than through a build-up of new capacities. The investment rate in Russia's economy throughout the first years of the current decade remained essentially stable, at 20-21% of GDP.[1] The situation seems to have been evolving since end-2006, with investments growing faster and playing a bigger role as a growth driver. This Country Focus will deal with one single aspect of this process of investment growth in Russia – Foreign Direct Investment (FDI). Indeed, FDI has been a substantial part of total investments in the country, in particular in some strategic sectors, like the hydrocarbon industry. It remains of fundamental importance for making the resumption of growth in Russia truly sustainable.

FDI in Russia

Until recently, total and per capita net FDI into Russia was very disappointing.

In 2006-2007, this suddenly changed.

Per capita FDI into Russia was, until recently, very disappointing: Russia had since the early 1990s been significantly under-performing with respect to comparable emerging economies as well as the other countries that have emerged from the Soviet Union. Chart 3 shows that Russia's net FDI per capita was substantially lower than the average of the Commonwealth of Independent States (CIS, the loose association of most of the former Soviet Union republics, bar the Baltic republics). In 2006 this situation changed abruptly, when net FDI per capita rose by almost 40 times the 2005 value, reaching around EUR 40 billion.

Chart 3: Net FDI per capita

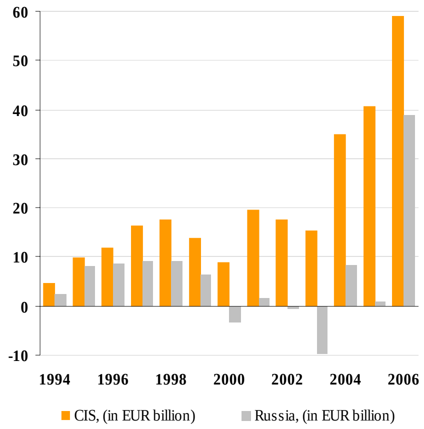
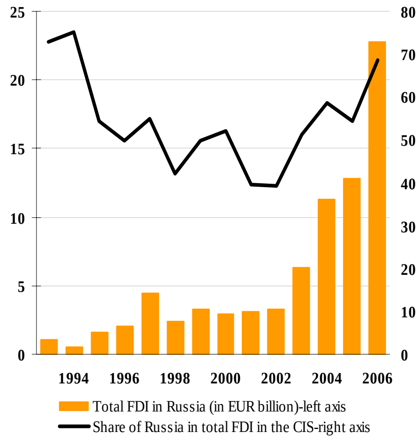


Chart 4: Total FDI in Russia



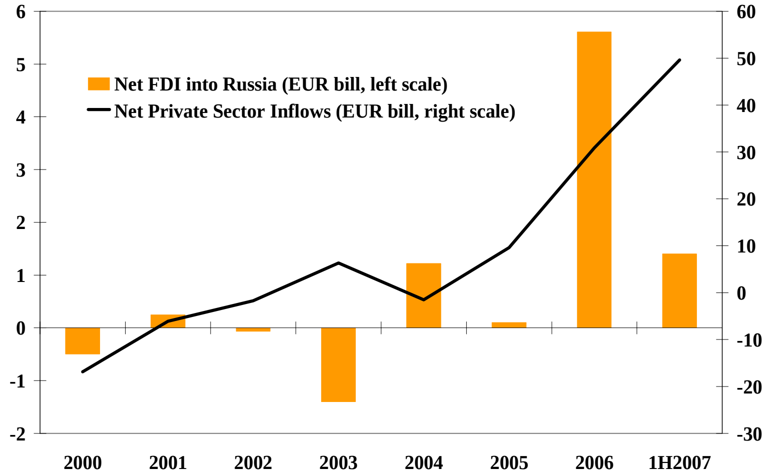
Source: WDI, UNECE, Central Bank of Russia (CBR) and Author's calculations.

This change reflects primarily a very significant increase in total FDI inflows (see Chart 4 above). FDI into Russia has grown since 2002 by almost 8.3 times, reaching around EUR 23 billion in 2006, or over 3% of GDP, which is more than three times the corresponding figure for 2002, and is comparable to the FDI share in China. Correspondingly, the share of Russia in total FDI in the CIS, which had fallen during most of the 1990s, jumped from below 40% in 2002 to almost 70% in 2006 (which is, however, still below Russia's current share of the CIS aggregate GDP, at around 76%).

The main change was the reversal of "capital flight".

Even more striking is another change observed in 2006 – the reversal of a long tradition of "capital flight" out of Russia[2] and a corresponding switch in the direction of net investment flows (see Chart 5 below). Net inflows of FDI rose from EUR 0.1 billion in 2005 to EUR 5.6 billion in 2006. The total inflow of net FDI and portfolio investment in that year exceeded EUR 15 billion.

Chart 5: Net FDI into Russia



Source: CBR and author's calculations.

This trend seems to have continued in 2007.[3] The estimates made by the Central Bank of Russia (CBR) indicate that total FDI reached around EUR 21 billion during the first half of 2007, while net FDI was about EUR 1.5 billion. The surplus of the Balance of Payments' capital and financial account reached EUR 45 billion during the first 9 months of the year. This increase in total inflows is partially explained by the launch of a number of large Initial Public Offers (IPOs) in the first half of 2007 (notably those of the two largest state owned banks, Sberbank and VTB, which each attracted around EUR 6.7 billion) and also by the auction of the remaining assets of Yukos. The size of capital inflows was forecast to abate during the remainder of 2007 even before the market turbulence of August 2007 (which seems to have had a very limited impact in capital inflows into Russia), due to more limited IPO-related activities.

Origins and destinations of foreign investment inflows

Origins of investment inflows

The EU is by far the main investor in Russia.

Who is behind this sudden increase in investment? While hard to quantify precisely, it is likely that a significant part of it is *Russian capital* returning to the country via tax havens for "tax optimisation" purposes.

Table 1: Origins of foreign investment inflows into Russia (%)

	1995	2000	2002	2003	2004	2005	2006	3Q2007
UK	6	6	12	16	17	16	13	24
Netherlands	3	11	6	6	13	17	12	20
Cyprus	1	13	12	14	14	10	18	14
Luxembourg	0	2	6	8	21	26	11	9
France	4	7	6	13	6	3	6	5
Germany	10	13	20	15	4	6	9	4
Virgin Islands (UK)	1	1	7	5	2	2	4	2
Switzerland	15	7	7	4	4	4	4	9
USA	28	15	6	4	5	3	3	2
Others	33	25	19	17	15	15	28	23

Source: Rosstat and author's calculations.

Table 1 shows the most important countries of origin of investments into Russia.[4] As much as 18% of all investment inflows in 2006, and 14% in the first half of 2007, originated in Cyprus, one of the smallest EU Member States (MS)[5]; nearly one third of total investment in 2006 and over a quarter in the first nine months of 2007 (and almost 35% of the total FDI stock by that date) originated in EU Member States or

EU-linked territories with similar conditions of taxation of capital (Cyprus, Luxembourg and the UK Virgin Islands). When economic conditions in Russia are perceived to be improving, there will be more inward investment, both "Russian" and genuinely foreign. In any case, the result is a consistently very high share of investment in Russia from EU countries and territories: by September 2007, over 80% of investment inflow (and a similar figure for the stock) was from the 8 most important EU-based investors.

The sectoral distribution of foreign investment in Russia roughly mirrors its GDP composition.

Destinations of investment inflows

Which are the sectors of the Russian economy that attract most FDI flows? As shown in Table 2 below, the services sectors have consistently been the largest receiver of foreign investment, with between 50% and nearly 60% of the total FDI inflows during 2003-2007. Among the industrial sectors, natural resource sectors and manufacturing attract roughly comparable amounts of investment. The investments in the energy sector had gone down sharply in 2005 following the Yukos affair.[6] They have since then (in 2006 and 2007) partially recovered. The weight of foreign investments in energy in total foreign investments is close to the weight of the energy sector in Russia's GDP. This is also the case for foreign investments into manufacturing, reflecting broadly the GDP share of the manufacturing sector.

Table 2: Destinations of foreign investment inflows into Russia (%)

	2003	2004	2005	2006	3Q2007
Agriculture, Hunting and Forestry	**0.5**	**0.3**	**0.2**	**0.6**	**0.3**
Mining and Quarrying	**19.3**	**24.5**	**11.2**	**16.6**	**17.3**
mining and quarrying of energy producing products	17.3	21.6	9.6	14.1	16.0
mining and quarrying, except of energy producing products	2.0	2.9	1.6	2.5	1.3
Manufacturing	**22**	**25.3**	**33.5**	**27.5**	**24.6**
manufacture of food products	3.4	2.3	2.2	2.5	2.5
manufacture of chemicals and chemical products	1.2	1.9	2.7	2.8	1.2
manufacture of metals and fabricated metal products	10.3	12.6	6.4	6.8	12.6
manufacture of transport equipment	0.7	2.1	1.8	2.6	0.9
manufacture of coke and mineral oil	0.6	0.2	15.1	7.2	3.8
Services	**58.2**	**49.9**	**55.1**	**55.3**	**57.8**
construction	0.3	0.6	0.4	1.3	1.2
wholesale, retail, repair activities	36.1	32.9	38.2	23.7	42.3
transport and communication	3.8	5	7.2	9.6	6.5
of which communication only	2.3	3.4	6.1	8.5	2.9
financial intermediation	2.6	2.5	3.4	8.5	2.4

Source: Rosstat and author's calculations.

On the other hand, the share of the energy sector on FDI seems to be considerably higher.

The share of the energy sector is much larger in FDI alone (i.e. without portfolio and "other investments"). Cumulated FDI in the energy sector in September 2007 represented one third of all FDI, slightly below the services sector. More importantly, the share of the energy sector in the FDI inflows in the period January-September 2007 was nearly two thirds of the total (64%). That said, we would once again stress the limitations of the Rosstat FDI data.

Available statistics do not fully allow the geographical origin of the investment inflows to be cross-referenced with their sectoral destination. However, the EU Member States seem to be the largest investors in almost all sectors of the Russian economy.

To ensure that the recent increase in FDI inflows — for which the EU is largely responsible — becomes a sustainable long-run trend, Russia still needs to improve the legal framework for FDI and also the overall investment climate in the country. This is the subject of the next section.

FDI legislation and business climate in Russia

The legal framework for FDI Russia is still being developed, and not necessarily towards restrictive practices. For instance, very significant progress has even been observed in the liberalisation of some energy-related areas, like the electricity sector (which is now attracting very large FDI inflows from EU companies, such as the

German E.ON Ruhrgas AG and the Italian Enel, which have become majority owners of parts of the Russian electricity generation industry). At the same time the natural gas sector, dominated by the State-controlled quasi-monopoly Gazprom, still remains mostly unreformed.[7] Outside the gas sector, arguably the main outstanding questions related to FDI are investment in so-called "strategic sectors" and the "subsoil law", and the long and tortuous process to approve the new laws for those two areas in Russia.

The main question concerning the legal framework for FDI is arguably not its restrictiveness, but its stability.

In July 2007, the Russian government submitted to the Duma — the Russian Parliament — the draft law "On the Rules of Foreign Investments in Enterprises Having Strategic Importance for the National Security of the Russian Federation". This legislation has been in preparation since the summer of 2005. It comprises the "Law on Strategic Enterprises" and also the "Amendments to the Law on Subsoil" (the latter first submitted to the Duma in 2005, and still awaiting a "first reading" there). The draft states that in sectors deemed "strategic" (currently 39, albeit many of those are just sub-sectors of an industry[8]), for foreigners to acquire *more* than 50% of the capital government authorisation (to be provided by a federal committee and within a maximum time limit of 3 months) would be necessary, while for subsoil, an authorisation for foreign *majority* ownership would be necessary for deposits larger than a certain size. Many international observers and enterprise associations (including the association of EU business in Russia, AEB) support these reforms as an attempt to centralise and clarify the legal framework that has otherwise remained largely ad hoc and dispersed among different organisations and administrative levels in Russia. At the same time, these observers note that the intended legislation has shortcomings. The major one in the current draft is a very broad definition of activities having "strategic significance for Russia's national security". Another is a lack of clarity on the potential retroactive effects of the new legislation. The government draft passed the first of the three necessary readings before the Duma in September 2007, but it was withdrawn before its second reading in early November, apparently for more amendments, delaying further its approval process. It is unlikely that the approval procedures will advance before the end of the current transition in political power by mid-2008. In the meantime, from an investor perspective, the fact that the legal framework is currently not stable may be an even stronger deterrent to investments than its relatively restrictive nature.

The investment climate still needs to be improved, especially in some "usual suspects" areas.

There are several other aspects of Russia's investment climate that could be improved, e.g. property rights or corruption. Yet the country does not perform particularly badly when compared with relevant regional or global benchmarks. According to the World Bank's latest global survey of business regulations and their enforcement, "Doing Business 2008", Russia ranks 106th out of 178 countries, above countries like Brazil and India but behind China. It is close to the average ranking of the CIS countries but above EU-leaning countries such as Ukraine. The areas where Russia performs worst are "licensing requirements", "dealing with workers" (where it stands at roughly the EU and OECD average) and "trading across borders" (export and import costs are comparatively high in Russia, which is partially related to the size of the country). On the other hand, it ranks *above* the OECD and the EU on items like "registering property" (45th) and "starting a business" (50th). The World Economic Forum's "Global Competitiveness Report 2007", a similar global benchmarking index, puts Russia 58th out of 131 countries (the highest rank of all the CIS countries covered, and above 3 EU Member States and Brazil, but below China and India). Russia's main weaknesses here are "institutions" (it ranks close to the bottom in "usual suspects" items like protection of minority shareholders and property rights) and in "goods market efficiency" (where it ranks much lower in some items related to FDI).

Conclusion

Russia has fully recovered from its "transition recession", with a very robust growth record since 1999. Nevertheless, a key weakness in this impressive growth pattern has been the relatively low level of investment overall and net FDI in particular. However, Russia has recently considerably enhanced its position as a (net) FDI destination – and even with all the limitations of the available data, it is clear that the EU, as by far the largest investor in Russia, has played a major role in this process.

This Country Focus argues that to ensure that this increase in net FDI and total net capital inflows is a sustainable long-run trend and not a temporary blip, Russia must still improve the legal framework for FDI and the investment climate in the country (although this paper also argues that Russia, when compared to relevant regional and global benchmarks, does not in fact fare particularly badly). This need is especially stronger in some (but not all) natural resource and energy-linked sectors. The EU, as the major investor in Russia and largely dependent on it for energy resources, has a clear strategic interest in this.

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[1] According to Russian National Accounts data.

[2] According to UNCTAD (2006), Russia had the third largest stock of outward FDI among emerging economies. Of course, outward FDI is not only "capital flight"; it also reflects the (positive) increased internationalisation of an economy.

[3] According to UNCTAD (2007b), Russia is now the 4th most attractive *prospective* destination for FDI in the world.

[4] There are two main primary producers of FDI data in Russia, the CBR and Rosstat, the National Statistical Office. Their foreign investment series are not comparable as their methodology and coverage are different. As Rosstat statistics are the only ones which can provide a breakdown by country of origin and sector of investment, they are used in Tables 1 and 2. Rosstat's longer foreign investment series classifies as "foreign investment" an aggregate of FDI, portfolio investment and "other investments" (this last item, in Rosstat's definition, includes "trade and other credits"; it has grown from 40% of all "foreign investment" in 2000 to almost 76% in 2007). Rosstat FDI and portfolio investment statistics are significantly lower than the statistics established by the CBR. Also, Rosstat FDI data with a sector/country breakdown was available to this author for 2006-07 only.

[5] The share of Cyprus in FDI stock at September 2007 was 31%. Crosschecking Rosstat data with data from the Central Bank of Cyprus (CBC) suggests that most of this is Russian capital "round tripping": the CBC only classifies as "Cypriot" investment capital from companies and individuals that satisfy some residence criteria, and the CBC data is equivalent to a mere 7.2% of the inflow that Rosstat labelled as "Cypriot" in 2005 (and the average for 2002-2005 was below 3.5%).

[6] After Yukos, formerly the biggest oil company in Russia, was declared bankrupt in 2004 due to alleged back tax claims, its assets were taken over by the Russian government and later auctioned, mostly to state-owned enterprises (SOEs).

[7] Part of Gazprom capital is held by foreign investors, and E.ON (3% of capital) has a seat on the board of the company. What the law "On Gas Supply", which regulates Gazprom, says is that the Russian State must own not less than *50% plus one share of its capital*.

[8] These are: hydrometeorological and geophysical industry, activities related to the use of pathogens of infection diseases, the nuclear and airspace industries, the coding/cryptographic and surveillance industry, the military industry and the production/sales of goods and services from "natural monopolies".

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States.
Chief Editor: Marco Buti, Deputy Director General, Economic and Financial Affairs.
Coordinating Committee: Gerrit Bethuyne, Heinz Jansen, Elena Reitano.
Layout: Yves Bouquiaux, Fabrizio Melcarne.
E-mail: ECFIN-CountryFocus@ec.europa.eu
Website: http://ec.europa.eu/economy_finance/publications