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**Research Report**

## FDI in Russia in difficult times

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## **Columbia FDI Perspectives**

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### **FDI in Russia in difficult times**

by

Thomas Jost\*

The annexation of Crimea by Russia in March 2014 and Russian support of separatist groups in Eastern Ukraine provoked sanctions from the United States (US) and European Union (EU) on Russian banks, as well as restrictions on the export of military and dual-use goods. Negotiations about trade and investment issues in various fora halted. Russia responded with import restrictions, especially on food, and Russian politicians threatened to nationalize foreign assets, including foreign direct investment (FDI) projects.<sup>1</sup> The investment climate suffered as a result of increased political risk, reflected in a 50% decrease of inward FDI (IFDI) in the first half of 2014 (\$24 billion), as compared to the first half of 2013.<sup>2</sup>

Although the majority of the business communities in the US and the EU supported their governments' policy, they nevertheless hope that the economic ties they have built in the past two decades will not be destroyed. Several business representatives and economists also raised doubts about whether economic sanctions will have positive political effects, fearing that many companies could lose market shares to Asian competitors. Russia has already re-oriented its oil and gas policy to China.

Since the opening of Russia's economy in the early 1990s, trade and investment ties with Western economies have grown considerably. Russia is the EU's third largest trade partner, and the EU strongly depends on Russian energy, whereas Russia depends on Western imports of investment goods for the modernization of its economy. Russia's IFDI stock rose from virtually nothing in 1990 to US\$576 billion by the end of 2013.<sup>3</sup> But a large part of Russian IFDI is round-tripping capital that is channeled through Cyprus, Belgium, Luxembourg, the Netherlands, and Caribbean tax havens. Therefore, the real size of Russia's IFDI lags much behind IFDI into other post-Soviet economies like Poland and other emerging markets.

The low investments of Western multinational enterprises in Russia are due to its weak and uneven economic growth in the past two decades as Russia failed to diversify its

resource-driven economy. Additionally, corruption, bureaucratic barriers and weak infrastructure have hampered FDI inflows. Economic growth was already sluggish before the start of the conflict in 2014; with sanctions, the Russian economy is expected to contract by 3% in 2015.<sup>4</sup>

Despite many problems, Russia has been a reliable business partner for foreign investors in the past decade. To modernize its economy, Russia has created a solid FDI regime. The 1999 Federal Law No. 160 on foreign investment (the most important law), together with the 1991 Investment Code, guarantee that foreign investors have rights equal to Russian investors. The Russian constitution allows for nationalization only under very limited conditions. In addition, 54 bilateral investment treaties are in force. Russia is also a member of the International Centre for Settlement of Investment Disputes (ICSID), and Western firms do not depend on Russian courts before turning to ICSID. On the other hand, limits on foreign ownership in sectors that have strategic significance for national defense and state security, Russia's withdrawal from the Energy Charter Treaty, as well as the sluggish privatization process, prevented higher FDI from Western firms in the past.

From a long-term perspective, Russia's abundant natural resources and human capital should make it an interesting market for foreign investors. But its political problems and the uncertainty over harsher sanctions—causing perhaps a sanction spiral—are destroying trust, an essential requirement for FDI projects. Meanwhile, Russia has sent mixed signals. It still wants to attract Western FDI and has continued to relax investment barriers; but it has also threatened to impose new retaliatory measures or to shift toward Asia to replace Western investment.

Russian policy makers are also divided. In October 2014, a new draft law (the so-called “Rotenberg bill”) that would allow the confiscation of assets of foreign enterprises to compensate Russian citizens and companies for Western sanctions, passed a first reading in parliament's lower house with a slim majority. In November 2014, it was blocked by Russia's Supreme Court. Although the Russian Economy Minister had repeatedly warned that the law is counterproductive,<sup>5</sup> foreign investors are missing a clear signal from the Russian government that their investments are welcomed and safe.

In late 2014, the economic environment worsened, and a currency crisis led to an acceleration of the ruble's depreciation. FDI prospects further deteriorated. Although some companies (especially in the food industry) could increase FDI in Russia to circumvent trade barriers, the weakening economy and shrinking exports to Russia will dampen market and export oriented FDI for the majority of investors. In a recent survey of 300 German companies operating in Russia, 12% of the firms answered that they are planning to divest in Russia if the situation does not improve.<sup>6</sup>

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<sup>1</sup> See “Russia preparing Response to U.S. and EU sanctions“, *The Moscow Times*, March 6, 2014.

<sup>2</sup> See Central Bank of Russia, [www.cbr.ru/eng/statistics/?Prtid=svs](http://www.cbr.ru/eng/statistics/?Prtid=svs).

<sup>3</sup> See UNCTAD’s FDI database, <http://unctadstat.unctad.org>

<sup>4</sup> See The World Bank, *Global Economic Prospects, January 2015*, [www.worldbank.org/en/publication/global-economic-prospects](http://www.worldbank.org/en/publication/global-economic-prospects).

<sup>5</sup> See *Frankfurter Allgemeine Zeitung*, “Rußland wirbt um westliche Investoren”, [www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/interview-mit-russlands-wirtschaftsminister-uljukajew-13284410.html](http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/interview-mit-russlands-wirtschaftsminister-uljukajew-13284410.html).

<sup>6</sup> See “Wenn der Rubel nicht mehr rollt“, *Frankfurter Allgemeine Zeitung*, December 17, 2014, [www.faz.net/aktuell/wirtschaft/unternehmen/russlands-rubel-krise-wirkt-sich-auf-deutsche-unternehmen-aus-13327662.html](http://www.faz.net/aktuell/wirtschaft/unternehmen/russlands-rubel-krise-wirkt-sich-auf-deutsche-unternehmen-aus-13327662.html).

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