

FDI another day: Russian reliance on European investment

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Executive summary

Most foreign direct investment into Russia originates in the European Union: European investors own between 55 percent and 75 percent of Russian FDI stock. This points to a Russian dependence on European investment, making the EU paramount for Russian medium-term growth. Even if we consider 'phantom' FDI that transits through Europe, the EU remains the primary investor in Russia. Most phantom FDI into Russia is believed to originate from Russia itself and thus is by construction not foreign.

Over the last decade, three main factors have determined FDI flows into Russia. First, the energy sector (oil and gas) plays a predominant role in the Russian economy and dominates exports. It has become a major focus of investment flows, including investment in associated activities dependent on energy extraction. The high concentration of FDI in regions rich in natural resources is evidence of the significance of the energy sector for foreign investment.

Second, the high degree of uncertainty induced by a volatile exchange rate has discouraged foreign investment, while the ruble has been heavily affected by the changing oil price. The gradual evolution in the policy of Russia's central bank from exchange rate management to inflation targeting has helped macroeconomic stability in the medium term.

Third, FDI into Russia is affected by the wider trade and investment context, which in turn are affected by institutional structures, or the lack thereof. Sanctions have been a major obstacle to investment in recent years.

The EU's pledge to decarbonise places Russia in a difficult situation because oil and gas have long been at the heart of its economy, especially when it comes to external relations. Furthermore, the literature on the growth impacts of FDI highlights many of the benefits from technology transfers, which are often lacking when FDI is focused on fossil-fuel extraction.

The Russian economy needs more investment in higher-value added activities, which the EU is in a position to provide.

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1 Introduction and state of play

The Russian economy has been through a turbulent decade during which it was deeply affected by the global financial crisis and the collapse of commodity prices (especially oil) between 2014 and 2016. During this period, foreign direct investment into Russia saw a

2 Where does FDI into Russia come from?

In the last decade, FDI into Russia has seen a medium-high degree of volatility, in line with a tumultuous macroeconomic environment.

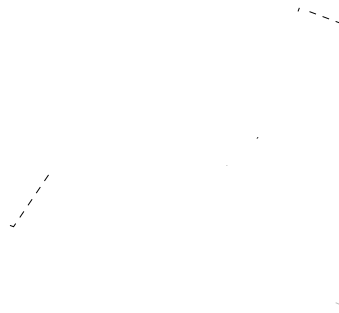
Figure 1 shows FDI stocks in Russia divided by the major international players. During the period examined (2009-2017), European investors owned between 55 percent and 75 percent of the Russian FDI stock (and regularly made up a large percentage of flows, as evident from Figure 1). Thus, Russian economic dependence on European investment is high. Notwithstanding recent efforts to diversify, Chinese investment remains orders of magnitude smaller. Figure 2 further breaks down stocks of EU FDI into EU countries or groups of countries.

It is important to note that in recent years, global FDI flows have been characterised by the prevalence of Special Purpose Entities (SPEs) and other conduits that are employed to minimise tax exposure and hide the ultimate origin of capital. This has resulted in relatively small countries registering FDI in flows and out flows that are many times greater than expected for such countries. A large percentage of these flows barely register an effect in the economies that host the SPEs – the flows merely transit through those economies. In 2017, the US (ytr) 11 (a) 7 (t) 11 (er) 11 el (ups Fies) 17.7 (i) 4 (g) 3 (ur) 15s (ews a2e 1 sho) 7 (ws FDI s) 2.1 (t) 1 (o) -2 (c) 5 (k) 1 (s in R) 17 (us) 2 (s) count 2b UIC, a (es) 27 (t) atned 1 eliaar

remains small compared to that of the EU (which is the origin of close to five times more FDI stock in Russia).

Finally, the values for investment from offshore sources are similar in reported data and UIC estimates. For example, even for FDI originating from the EU, estimated UIC values still show that a substantial part of FDI stocks originate from financial centres. This would indicate that the estimation method employed by Damgaard et al (2019) fails to identify UIC in some cases, especially when it relates to more opaque jurisdictions. It is plausible (indeed likely) that some of the investment in Russia from these financial centres originates from other countries, including Russia itself.

Figure 2: FDI stock as reported (left panel) and UIC estimates (right panel), EU breakdown, € billions

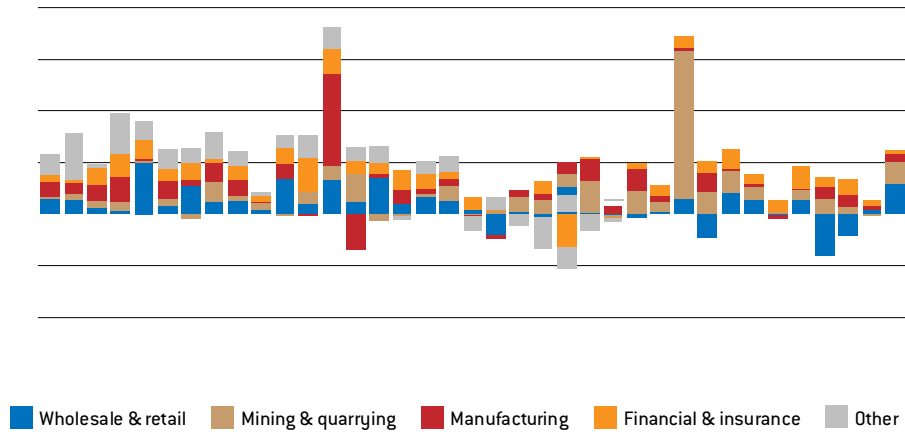


Source: Bruegel based on European Commission Finflows (Joint JRC-DG ECFIN database) and Damgaard (2019). Notes: EU countries have been grouped as follows: Baltics (Estonia, Latvia, Lithuania), CEE (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia), euro-area creditors (Austria, Belgium and Finland), euro-area debtors (Portugal and Greece) and financial centres (Cyprus, Ireland, Luxembourg and Malta).

With this in mind, perhaps the first insight provides a glimpse into the role of offshore investment in the EU's FDI stock in Russia. The data shows that a significant portion of the reported FDI stock originates from offshore sources, which is consistent with the UIC estimates. This suggests that the UIC estimation method may be missing some offshore investment, particularly from financial centres. The breakdown of the UIC estimates shows that a substantial part of the FDI stocks originate from financial centres, which is consistent with the reported data. This indicates that the UIC estimation method may be failing to identify UIC in some cases, especially when it relates to more opaque jurisdictions. It is plausible (indeed likely) that some of the investment in Russia from these financial centres originates from other countries, including Russia itself.

major sectors: wholesale and retail trade; mining and quarrying (which according to the guidelines consists almost exclusively of fossil fuels); manufacturing; and financial and insurance. In total, the Bank of Russia provides data for 22 sectors, but the remaining sectors play a fairly negligible role (in Figure 4 they are grouped as other). It should be noted that Russian GDP fluctuates quite substantially, contributing to some of the volatility seen in the graph.

Figure 4: Gross FDI flows per sector, % of GDP



Source: Bruegel based on Bank of Russia, IMF World Economic Outlook (April 2019). Notes: Quarterly FDI figures are divided by quarterly FDI.

Further central bank data on the regional distribution of FDI complements the picture. Excluding the wider Moscow area and, to a lesser extent, St. Petersburg, the oil and gas-heavy Tyumen region (not including its autonomous provinces) and the autonomous province of Yamalo-Nenets (Gazprom's main hub) received 45 percent of all remaining FDI in the first quarter of 2019. The rest was shared between the remaining 86 regions. The aforementioned oil-rich regions are fairly small, with little other economic activity outside the energy sector. Sakhalin Island and Krasnoyarsk Krai, where oil is also an important part of the local economy, also rank highly. This indicates that sectoral data could underestimate the importance of the energy sector for some regions. Some of the non-mining and quarrying investment appears to be going into businesses directly related to oil and gas extraction, but this is very hard to disentangle.

The concentration of FDI in natural resource sectors can negatively affect the GDP of the ultimate host country. Poelhekke and van der Ploeg (2013) showed that FDI in natural resources crowds-out FDI in other productive industries, and can result in lower overall FDI.

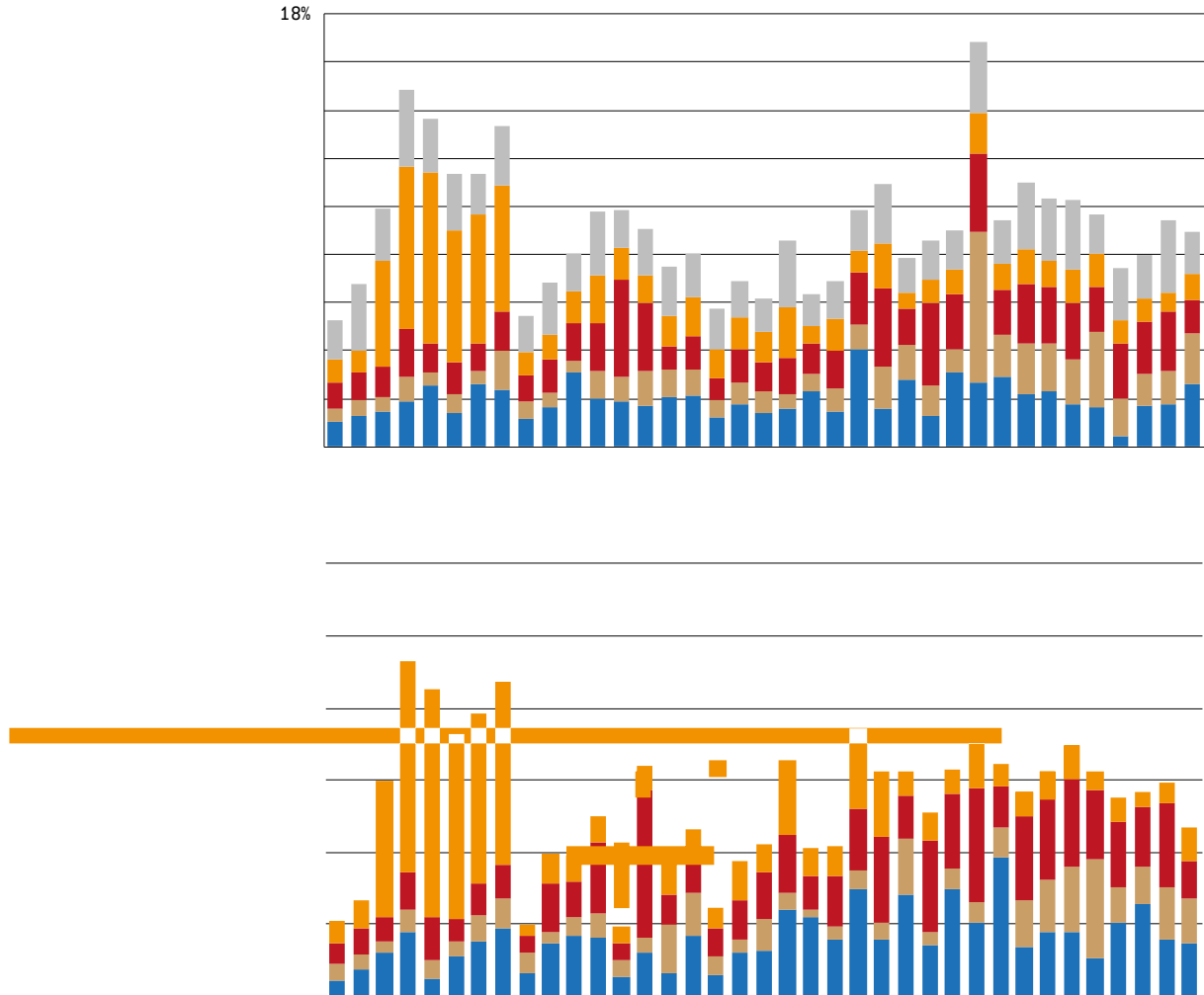
The impact is particularly evident when natural resources are first discovered. Hayat (2018) found that natural resources reduce the growth effect of FDI to the point that it can become negative. At the same time, there is a low level of spillover effect associated with natural-resource extraction, given that it is typically an activity that requires few local inputs. Thus the growth potential is low, in contrast with FDI in manufacturing and technology.

The values presented above underestimate the extent of FDI that enters and exits Russia regularly. Ultimately, gross flows (shown in Figure 4) represent the net acquisition of Russian assets by foreigners and as such can be negative (net flows would be the net acquisition of assets minus the net acquisition of liabilities)⁴. Given that FDI represents medium to long-term investment, this typically provides an accurate depiction of overall FDI activity. However, in the case of Russia, there is a fair amount of short-term FDI that partially stems from the fact that a non-negligible percentage of reported FDI in Russia ultimately originates in Russia itself, and has been re-routed through foreign entities. Figure 5 shows the gross acquisition of assets in Russia by foreign investors and gross sale of assets in Russia

4 See Claeys *et al* (forthcoming) for a more detailed explanation.

by foreign investors (which net out to the values in Figure 4). The size of these values is very large. The extent of financial-sector activity (both in gross acquisitions and gross sales) in 2010 and 2011 stands out in particular.

Figure 5: Gross foreign acquisition (top panel) and sale (lower panel) of Russian assets per sector, % of GDP



Source: Bruegel based on Bank of Russia, IMF (April 2019). Notes: Quarterly FDI figures are divided by quarterly GDP.

Finally, the ‘Dutch disease’ effect of natural resource exploitation has played a key role in the Russian economy. This term describes the phenomenon that arises when a natural resource windfall results in a rapid appreciation of the currency, worsening terms of trade for other exports and reducing the competitiveness of other industries. This hurts the wider economy. This phenomenon took place in Russia during the early 2000s, when increases in the price of oil resulted in a gradual appreciation of the ruble, reducing investment in non-fossil fuel sectors (which became increasingly uncompetitive in international markets).

Furthermore, beyond the immediate damage, the effects of this period persisted after the currency appreciation was reversed. The IMF (2017) reported that the bursting of the resource bubble did not lead to an easing of the effects of Dutch disease in Russia. Even

though oil prices and the ruble collapsed periodically during the last decade, a crowding out of manufacturing industries had already taken place when this downward trend started. This crowding out was enhanced by an incomplete economic transition in the 1990s and 2000s when state aid was ubiquitous. Economic activity had already become concentrated in the resource sector, a shift that could not be reversed easily when the terms of trade improved⁵.

The damage caused to other industries by years of focus on resource extraction meant many other industries could not be salvaged.

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currency, which had been already weakened by the oil collapse and sanctions. The central bank supported the currency with reserves (Figure 8) and made great use of the policy rate

the Russian currency fared fairly well throughout 2018 and was not heavily affected by turmoil and capital flight in other emerging economies is a testament to the credibility of this inflation-targeting system (especially as these times of turmoil coincided with rounds of sanctions against Russia).

Finally, it is worth pointing out that the oil sector in Russia remains fairly dollarised. Many contracts (both commercial and investment) are concluded in foreign jurisdictions and denominated in foreign currency; as such they are not devalued by fluctuations in the ruble. Similarly, energy companies hold fairly large shares of dollar debt (against largely dollar revenues). Therefore, FDI in the energy sector can remain relatively detached from movements in the currency. However, the insecurity that foreign exchange volatility poses to value chain management in multinational enterprises does cause uncertainty, while the associated political tensions deter foreign investors. Moreover, energy companies still depend on domestic revenues and costs. Therefore, an excessive degree of dollarisation (and especially a very large share of dollar debt) can make companies vulnerable to large fluctuations in the ruble by making it harder for them to service their dollar commitments and thus raising their probability of default. As said, there has recently been an evolution among Russian oil giants, which are establishing euro-denominated contracts. Rosneft, a state-controlled oil company that is one of the world's largest, announced in summer 2019 that all contracts would henceforth be in euro⁶.

3.3 International context

Finally, FDI is affected by the wider trade and investment context, which is itself affected by institutional structures, or the lack thereof, that facilitate cross-border operations. This sub-section explores the relationship between FDI and other economic ties, chiefly trade, and

for wider investment.

Furthermore, the Russian environment is characterised by a lack of institutional infrastructure and recent international hostility towards Russia, complicating the development of closer ties. First, the Russian Federation only entered the World Trade Organisation in 2012 and has concluded trade agreements with only 10 countries (mostly former Soviet states). In 2017, these free trade agreements covered only 11 percent of Russian exports, while EU28 trade accounted for more than half. The comparative advantages of the other members of the Commonwealth of Independent States are very similar to Russia's (chiefly natural resources), reducing the economic value of mutual trade⁹. More importantly, there is virtually no opportunity for knowledge transfer through FDI. Furthermore, according to the World Bank's 2018 *Doing Business* report, Russia has the highest cost of border compliance in its region (6.7 times the EU average for exports and 17 times the EU average for imports)¹⁰. These trade impediments, together with poor protection of property rights, exchange rate volatility and the very high level of corruption, make Russia an unattractive market for global manufacturing investment, despite its generally high level of education, post-Soviet industrial base and relatively large internal market.

Second, recent years have been characterised by political hostility between Russia and western countries, resulting in damaging economic sanctions (and the looming threat of more). These have reduced the attractiveness of the Russian market for foreign investors at a time of opportunities for diversification. The practical difficulties of investing have been growing (medium and long-term financing has been targeted by sanctions), while the increase in barriers to trade make Russia a less attractive manufacturing hub and damage the growth potential of the Russian economy. Sanctions and the related tensions have had a negative effect on FDI, especially outside the energy sector, reducing overall FDI and making the energy sector relatively even more important.

4 Outlook and policy challenges for the EU-Russia relationship

Russia has a window of opportunity to modernise its economy and progress up the value chain, or it will face significant economic headwinds given its fossil-fuel based ageing economy. Demographic change poses a major challenge to growth, while the dependency ratio is only contained by low life expectancy among men. Current economic activity relies heavily on European investment and the European market, yet natural resources remain at the core of the relationship. Given European efforts to go green, this source of activity could be highly threatened in the medium term. McGlade and Ekins (2015) estimated that up to 59 percent of gas reserves and 19 percent of oil reserves of former Soviet Union countries would be 'stranded' if policies to meet the Paris Agreement's two degrees Celsius goal are implemented. Rodrik (2016), meanwhile, argued that given the advancement of automation, manufacturing might soon cease to be a feasible basis for development. Furthermore, the opportunity to hedge European fossil fuel demand with Chinese demand remains limited (Zachmann, 2019). As said, Russia is well located to be a host of manufacturing outsourced from European economies. The EU can offer FDI in high value-added activities, while China remains a competitor at the lower and mid-levels of the value chain and the US is a net exporter of oil (with even greater foreign policy tensions with Russia)¹¹. However, foreign investment remains deterred by macroeconomic volatility, poor institutions and international isolation (in part because of sanctions).

Europe's strong advantage in high value-added sectors raises the value of European FDI. In the right investment climate, Russia could benefit greatly



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