FOREIGN DIRECT INVESTMENTS IN RUSSIA

Foreign direct investments[1] (FDI) have very specific characteristics in Russia. This specificity is part of the complex relationship that the Russian economy has maintained since the beginning of its transition (over 20 years ago) with international capital transfers. Russia was first marked, in the 1990s, by the collapse of domestic investment and a massive flight of capital, combined with a very low capacity to attract incoming FDIs. Starting in the 2000s, the dynamic changed directions: domestic investment recovered its growth, accompanied by a return of foreign capital inflows; but this trend reversal was not observed regarding flights of capital, which are still considerable today and primarily motivated by tax evasion. These contrasting developments are not the only paradox when it comes to the Russian economy.

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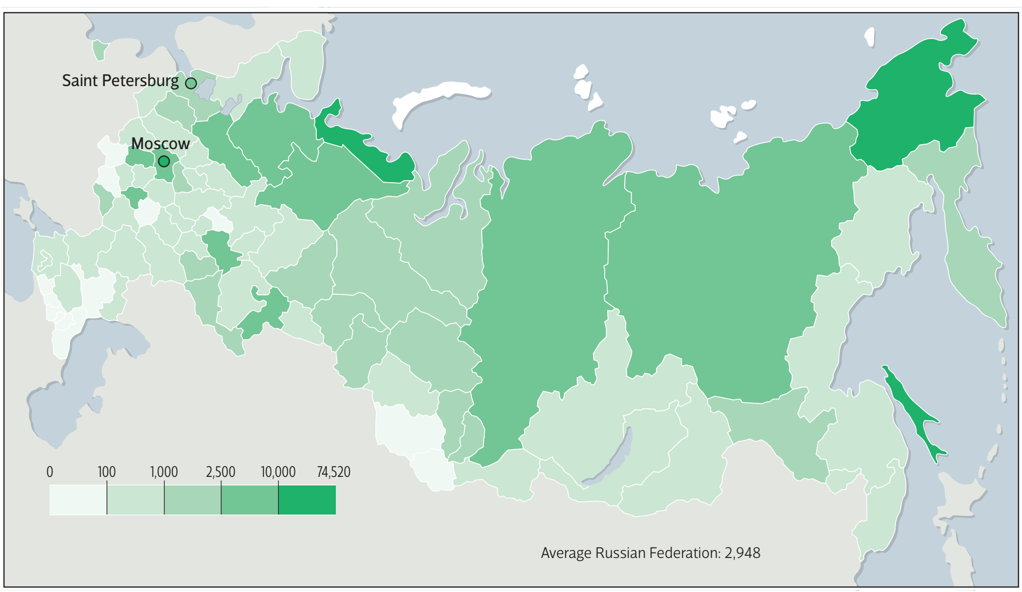
1. To be considered an FDI, an investment must be made with the objective of exerting a real influence on management of the target company. In practice, a foreign investment becomes an FDI when it involves over 10% of the targeted company's share capital. As soon as this threshold has been reached, future financial flows between the foreign company and the domestic company will also be considered FDIs. Foreign investments that do not fall into this category are considered portfolio investments and posted separately in the balance of payments.

Russian authorities seem to have a particular relationship to foreign capital flows: whereas in certain sectors that are considered strategic, legislation – especially its application in the field – affecting FDIs has gradually hardened, to the point where major projects brought by Western multinationals in the hydrocarbon sector were threatened; other industrial sectors that are not as politically sensitive as oil and gas have offered significant opportunities for foreign investors without provoking the intervention of public authorities. The first companies to benefit from these opportunities are now solidly implanted on the Russian market, and are helping to both modernize and revive its offer. Lastly, the attitude of Russian authorities differs from that of large emerging countries such as India and Brazil: these two countries have chosen to implement more liberal policies on FDIs than Russia has, while remaining relatively more restrictive in terms of short-term capital.

CUMULATIVE FOREIGN INVESTMENTS 2007-2010
(IN DOLLARS PER INHABITANT)

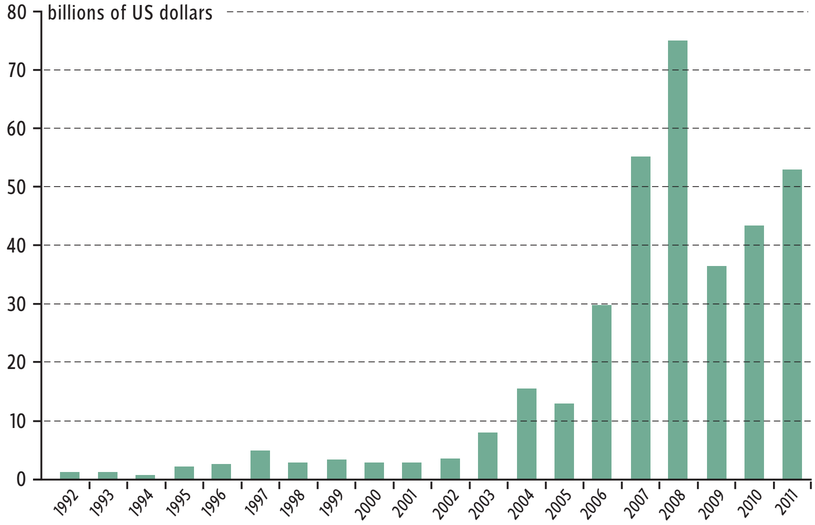


Source: Rosstat.

A LATE BUT SPECTACULAR BOOM

The rapid growth of FDIs after the August 1998 market crash was spectacular. During the period spanning 1992-1998, incoming FDIs in Russia did not exceed $1.4 billion a year. Thanks to the economic recovery that began in 1999, they started to flow in, making Russia one of the leading destinations worldwide during the mid-2000s. However, the 2008-2009 crisis put a halt to this trend. Since then, growth has resumed, but pre-crisis levels (*figure 1*) have not been reached. On the international level, Russia is favorably positioned. As of the second half of the 2000s, its rank as a destination for FDIs considerably improved, placing it in the top 10 worldwide since 2007. This matches its rank in terms of GDP in current dollars (*table 1*). Russia is now the leading destination for FDIs in Eastern Europe.

FIGURE 1. INFLOWING FDIs IN THE RUSSIAN FEDERATION, 1992-2011 (BILLION OF US DOLLARS)



Sources: UNCTAD and the Central Bank of Russia, 2012.

TABLE 1.
WORLD RANKINGS OF RUSSIA
ACCORDING TO FDI AND GDP LEVELS, 1999-2011

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Rank for FDIs	33	39	39	28	17	14	15	15	10	6	7	10	9
Rank for the GDP	22	16	16	16	16	16	14	11	11	8	12	11	9

Sources: After UNCTAD and the World Bank, 2012. GDP in current dollars.

THE SECTORIAL COMPOSITION OF FDIs

The breakdown of FDIs by sector has considerably changed over the last decade. Certain analyses have highlighted the fact that they only increased when oil prices took off[2]. But it would be unwise to conclude from this that the only sector that is attractive in Russia is the raw materials industry. On the contrary, FDIs have gradually turned toward new activities, such as services. During the last three years, the predominance of trade has asserted itself, driven by the growth of international retail distribution groups (Auchan, Ikea, Metro and REWE in particular). Financial activities are at almost the same level and this trend should be confirmed in the future. International banking groups are trying to position themselves to get a share of the pie, believing in the sector's gradual opening up in the framework of Russia's membership in the World Trade Organization (WTO). Other sectors attracting a significant proportion of incoming FDIs are real estate, information and communications, construction and the electricity and gas sectors (*table no. 2*).

2. D. Tarr, N. Volchkova, "Russian Trade and Foreign Direct Investment Policy at the Crossroads", World Bank Policy Research Paper, no. 5255, 03/2010.

TABLE 2.
BREAKDOWN OF INCOMING FDIs IN RUSSIA BY SECTOR, 2010-2012

	millions of dollars	% of the total
Total during the period spanning 2010 – first quarter 2012	112,265	100
Wholesale and retail trade	25,935	23
Banks and insurance	20,675	18
Mining	9,541	8
Manufacturing industry: metallurgy and steel	9,081	8
Other service activities	7,338	7
Real estate	5,826	5
Information and communications	5,254	5
Construction	4,178	4
Electricity, gas, steam and air	4,147	4
Manufacturing industry: food products, beverages, tobacco	4,099	4
Scientific, technical and professional activities	3,789	3
Manufacturing industry: other types of transportation equipment	2,252	2
Chemistry and chemical products	2,071	2
Not specified	1,714	2
Manufacturing industry: other non-metal mineral products	1,323	1
Computers, electronic and optical products	889	1
Transportation and storage	838	1
Manufacturing industry: mechanical engineering	669	1

Source: Central Bank of Russia, 2012.

High added-value industries – mechanical engineering, information technology, healthcare… – are for the moment absent from the list of priority sectors for FDIs, but transportation equipment should undergo rapid growth following the change in government policy. The agreement concluded in 2012 between Renault-Nissan and AvtoVAz illustrates this change in attitude. This was obviously prompted by the leading national Russian manufacturer's problems, which were aggravated by the repercussions of the 2009 crisis. Certain regional authorities have also been able to attract foreign car manufacturers by offensively using whatever leeway they had. This was the case in the Kaluga region, located 180 km from Moscow, which succeeded in creating a car cluster around Volkswagen, PSA and Mitsubishi, accompanied by Western automotive equipment manufacturers. Given this newfound diversification, mining activities now only represent the fourth largest category of incoming FDIs, on a par with metallurgy and the steel industry. Their share in total FDIs is half of what they were in the mid-2000s. A second reason for this change is the increasingly closed attitude of public authorities regarding foreign investors in the hydrocarbon sector, illustrated by the law of 2008 on strategically important activities (cf. below). The October 2012 agreement between Rosneft and BP, which put an end to several years of difficult relations between the British company and the Russian government on the subject of its Russian subsidiary TNK-BP, may be an indication that this period of political tension is coming to a close.

GEOGRAPHIC POLARIZATION OF FDIs

Regional FDI data is compiled by the Rosstat institute, which unfortunately does not include financial activities in its field of observation. It is nevertheless instructive to examine the geographic distribution of non-financial FDIs in Russia. To limit biases induced by isolated investment operations, we have chosen here to add up incoming FDIs over the period spanning 2009-2011. Analysis of these flows by region shows a strong geographic concentration of FDIs: by themselves, the city of Moscow and its immediate region represent 44% of the country's incoming FDIs. Considering the predominant position that the financial sector holds in the Moscow region's economy and in Russias FDIs, the concentration of total FDIs – including the financial sector – is probably higher than that shown by Rosstat's partial data[3]. More generally, two thirds of non-financial FDIs are concentrated in only eight of the Russian Federation's "subjects": in decreasing order, Moscow, the Moscow and Sakhalin regions, the city of Saint Petersburg and the regions of Kaluga, Chelyabinsk, Arkhangelsk and Leningrad.

3. A study published in 2011 places Moscow among the 10 leading European cities in terms of attracting FDIs. Ernst & Young, Growing Opportunities. Russia FDI Report, Moscow, 2011.

WHERE DO FDIs REALLY COME FROM? THE REAL-FAKE FOREIGN INVESTORS

The geographic origin of FDIs in Russia shows countries that are surprising in principle: out of the six largest foreign direct investors in Russia, five are offshore sites that are typically used as havens for companies evading tax obligations of their country of origin. They are Cyprus, the British Virgin Islands, Bermuda, the Bahamas and Luxembourg. By themselves, these tiny specks on the globe accounted for 58% of incoming FDIs in Russia in 2011. By comparison, the combined holdings of Germany, Holland, Sweden, France, Ireland, Great Britain, Austria, Finland and the United States only represented 32% of the total. This strange dystrophy regarding the FDIs' geographic origins is explained when we examine Russia's outgoing FDIs: in the leading positions, we find the same offshore sites as for the incoming FDIs (*table no. 3*). This indicates that the relevant capital flows are for the most part achieved through companies of Russian origin: having sheltered their holdings abroad, they reinvest part of them in their country of origin while using the links in capital they established between their companies on either side of the border to perform tax arbitrages to their advantage. Russian investors therefore make over half of Russia's incoming FDIs.

TABLE 3. BREAKDOWN OF FDIs IN RUSSIA BY COUNTRY, 2011

Stocks of incoming FDIs	2011	Stocks of outgoing FDIs	2011
TOTAL	455,904	TOTAL	361,738
Cyprus	128,816	Cyprus	121,596
Netherlands	59,745	Netherlands	57,291
British Virgin Islands	56,442	British Virgin Islands	46,137
Bermuda	32,547	United States	12,679
Bahamas	27,089	Luxembourg	11,599
Luxembourg	20,316	United Kingdom	10,662
Germany	18,741	United States	9,501
Sweden	16,088	Jersey	7,035
France	15,420	Germany	6,692
Ireland	8,893	Gibraltar	5,701

Source: Central Bank of Russia, 2012.

INSTITUTIONAL AND POLITICAL FRAMEWORK FOR FDIs

FDIs are covered, for the most part, by regulatory texts that have been adopted during the last 20 years (*box 1*). These texts guarantee equal treatment between foreign and domestic investors in terms of obligations and protection of their rights and interests. If a foreign investor holds more than 25% of the capital in a Russian company, the law protects this investor from unfavorable legislative changes (in particular: customs duties, federal taxes and contributions to extra-budgetary funds, legislative amendments and the introduction of FDI restrictions) that would occur during the first seven years of return on investment.

Since the law of 2008 was passed, foreign investments in "strategic companies" have been subject to restrictions. These companies are found in the following areas: the mining industry (on lands said to have "federal importance"), the aerospace industry, services provided by a natural monopoly, fishing, hydro-meteorological and geothermal activities, activities linked to the use of nuclear and radioactive materials, cryptology and activities related to the military-industrial complex. Foreign firms cannot acquire a majority share of capital in strategic companies nor can they participate in their boards of directors. Beyond a certain threshold – set at a minimum of 5%, but that depends on the sector and it was raised in late 2011 to 25% for mining – any increase in holdings by a foreign firm of capital in a strategic company is subject to approval of a special commission chaired by the prime minister.

BOX 1.
LEGISLATION AFFECTING FOREIGN INVESTMENTS

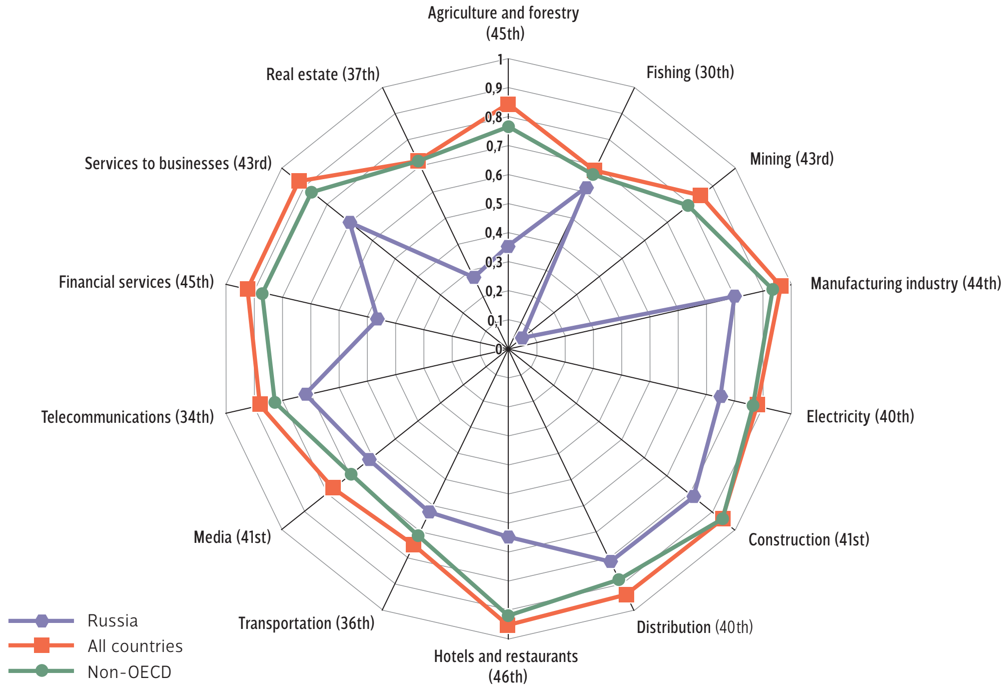
- Federal law of April 29, 2008, no. 57, "On the procedure for making foreign investments in companies having a strategic purpose for the defense of the country and the security of the state";
- Federal law of July 22, 2005, no. 116, "On the special economic zones within the Russian Federation";
- Federal law of December 10, 2003, no. 173, "On currency exchange regulation and control";
- Federal law of July 9, 1999, no. 160, "On foreign investments in the Russian Federation";
- Federal law of February 25, 1999, no. 39, "On investment activity in the Russian Federation, conducted in the form of capital investment";
- Federal law of April 22, 1993, no. 39-3, "On the stock market";
- Law of the RSFSR of June 26, 1991, "On investment activity in the RSFSR"; etc.

The tax regime of certain activities affected by FDIs includes exemptions and incentives. Imports of technological equipment that have no equivalent produced in Russia – and which are found on a restrictive list established by the government – are exempt from customs duties. Certain research and development expenditures are deductible from the tax on profits up to 150%. Other incentives pertain to software engineering, activities involving the improvement of energy efficiency, certain medical and educational activities, etc. On the regional scale, authorities have the right to reduce their share of tax on profits from 18% to 13.5%, the federal tax being 2%. They can also provide tax exemptions on property and land, with maximum rates at 2.2% and 1.4%. These incentives are offered by the Saint Petersburg and Kaluga authorities, among others.

Governed by a single federal law since 2005 (*box 1*), the 24 special economic zones (SEZ) of the Russian Federation are territories in which investors (both foreign and domestic) benefit from tax advantages: exemptions from customs duties, accelerated investment amortization and reduced social welfare contributions. In 2012, the minimum tax rate on profits was lowered from 15.5% to 2% (the federal rate) and 0% in innovation SEZs and tourist SEZs. The older Kaliningrad SEZ offers a special regime, with no taxes at all on property and profits during the first six years of operation. Located near Moscow, the Skolkovo innovation center also benefits from a special social and tax regime: for companies investing in a series of predefined technical and scientific activities, social contributions are reduced; during a company's first 10 years of operation, taxes on profits and property as well as the value-added tax are set at zero until the company's revenue reaches 300 million rubles (€7.3 million).

In 2010, the OECD proposed a synthetic evaluation of FDI regulations that covered four criteria: the share of capital that a foreign entity can acquire in a national entity; the administrative authorizations required to conduct an FDI transaction; the hiring of foreign personnel; other restrictions – pertaining to land ownership, access to financing and reciprocity requirements, in particular. The index places Russia in 44th position out of the 46 countries that were evaluated (OECD members plus 15 other countries): only China and Iceland have more restrictive FDI legislation. Figure 2 illustrates Russia's position relative to the OECD economies and the G20 members, according to activity sector. It clearly shows the restrictive nature of FDI legislation in the raw materials sector.

FIGURE 2.
FDI REGULATIONS IN RUSSIA:
BREAKDOWN BY ACTIVITY SECTOR, 2010



Reading: degree of liberalization of the legal regime regulating FDIs: from 0 (maximum restrictions) to 1 (no restrictions). In parentheses: Russia's rank according to the OECD's FDI restriction index (46 countries ranked).

Source: author's calculations based on OECD data, 2010.

THE "INVESTMENT CLIMATE" FOR FOREIGN COMPANIES

The quality of reception of foreign investments in a given country does not just rely on the laws that are passed in it, but also on the way these laws are applied. The "investment climate" is a multidimensional concept that attempts to take this reality into account by thoroughly measuring institutional and economic conditions that influence the decision to invest. In the best-known publications covering the subject, the investment climate concept is reduced to an evaluation that a "community of investors" makes regarding the attractiveness of a given country. On this scale, Russia is generally poorly ranked compared to countries with a similar GDP level per inhabitant: publications by the World Economic Forum, the World Bank and Transparency International, which are based on survey data, respectively rank it at 67th place out of 144 countries, alongside Sri Lanka and Iran (World Economic Forum, 2012), at 112th out of 185 countries, between Palau and El Salvador (World Bank, 2012) and 143rd out of 182 countries, on the same level as Nigeria and Timor (Transparency International, 2012). Over the last few years, Russian authorities have acknowledged on several occasions that it is necessary to improve the investment climate, but significant results have yet to be achieved in this area.

However, major biases in construction and interpretation affect the most commonly used indexes. Furthermore, their scope is very general by nature. A foreign company interested in setting up business in Russia would be mistaken in thinking that these indexes are sufficient to form an opinion regarding the viability of its project. The requirements of each investment project are specific and rankings resulting from this type of benchmarking do not take this into account. The only relevant transversal criteria, no matter what the project at hand is, are those that describe institutional stability and the country's macroeconomic prospects. From this perspective, renewal of the executive branch's "tandem" through the 2012 presidential elections did not surprise observers, nor did it cause any FDI reflux. Likewise, since 2010, the growth of Russia's economy has resumed at a pace less than half that of before the crisis, but very much above that of Western Europe. Russia has therefore risen in the world ranking of investment outlooks that are established on the basis of surveys with executive managers of multinational companies[4], and therefore appears more attractive in terms of investors' decisions than it does in their evaluations[5].

As for FDIs, Russia presents a paradox: considered to be largely corrupt by the business community, and not very reliable in terms of property rights

4. A. T. Kearney, Cautious Investors Feed a Tentative Recovery, 2012, http://www.atkearney.com/gbpc/foreign-direct-investment-confidence-index.

5. J. Vercueil, "Changing Investment Climate in Russia: an Institutional Approach", Journal of Euromarketing, 19(2-3), 04/2010, pp. 115-138.

or very respectful of the rule of law, it nevertheless ranks as one of investors' favorite destinations, even while considering the high proportion of true-false investors in the total of its incoming FDIs. This paradox may be explained by the following elements which appeal to foreign companies: a market consisting of 140 million consumers depicting strong growth, an active population with one of the highest education levels and natural resources that are unmatched in the world. No matter what the real or imagined risks involved are, investing in Russia is now a priority for large foreign companies.