

Russia's controlled opening to foreign investors The Kremlin's new strategy on foreign capital

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Over the last two years, the volume of foreign investments coming into Russia has increased substantially. 2007 in particular was a record year in this respect: according to estimates by the Central Bank of Russia (CBR), Russia received more than US\$ 52 billion in foreign direct investments during that year, i.e. over 60% more than in the previous year. Foreign capital has become more active in Russia in spite of the fact that many trends – which are negative from the investors' point of view - still prevail in the Russian economy (e.g. the state continues to strengthen its role in the economy). A certain change has occurred in the Kremlin's policy over the last two years, i.e. Russia has started to implement a controlled opening up to foreign capital. This process has been closely overseen by the authorities and has not caused the Kremlin to lose control of the key sectors of the Russian economy. This change in the Russian authorities' strategy on foreign capital seems to be the reason why foreign investors' activity in Russia has risen.

Influx of foreign investments to Russia

According to the Central Bank of Russia (CBR), the Russian Federation received over US\$ 52 billion of foreign direct investments (FDI) in 2007, compared to US\$ 32 billion in 2006. A dynamic growth (by 100%) has also been noted by the Federal State Statistics Service (Rosstat), although its statistics are less optimistic than the figures quoted by the CBR: according to Rosstat, Russia received around US\$ 28 billion in FDI in 2007, compared to US\$ 14 billion in the previous year (see the Annex for more information). As a result of this rising influx of foreign capital, in 2006, Russia already found itself in eleventh position in the global ranking of states attracting the highest FDI¹. Russia is also in third position after China and Hong Kong in the ranking of emerging economies.

The capital has been coming primarily from investors from Cyprus (it was mainly Russian capital returning to Russia), the Netherlands and the UK. Over the last three years (2005–2007), foreign investments have been concentrated in the Russian industry and trade sectors². The upstream sector has been the most attractive branch of industry for foreign capital (see Appendix).

¹ UNCTAD, World Investment Report, October 2007.

² These sectors accounted for around 40% of all investments.

Government policy on foreign investors

Since 2006, two apparently contradictory tendencies concerning foreign investors have been observed in the Russian economy. On one hand, strengthening of the state's role in the economy, started during Vladimir Putin's first presidential term, has been continued. The Kremlin has re-nationalised the most attractive assets, thus infringing the interests of foreign investors.

The Kremlin has opted for a controlled opening up of the economy to foreign investors. Minority stakes in enterprises attractive to investors are being privatised and foreign capital is being selectively admitted to the upstream sector.

Foreign companies who had gained access to the Russian oil and gas fields, mainly in the 1990s³, were discriminated against by the authorities, who tried to take back the majority stakes these companies had acquired in Russian projects.

On the other hand, the Kremlin chose to proceed with a controlled opening up to foreign investors in 2006. The authorities approved the privatisation of minority stakes

in the assets the investors were interested in (Rosneft, public banks), and selectively admitted foreign companies to the upstream sector. However, while opening up the economy to foreign capital, the Kremlin has retained control of the key sectors of the Russian economy.

³ Including Shell, ExxonMobile and British Petroleum

Factors restraining investor activity in Russia

Businesses involved in Russia were threatened by the Kremlin's repeated attempts to subordinate all state bodies (including courts), force private businesses to be loyal to the authorities (the Yukos case), gain control of the most important sectors of the Russian economy (re-nationalisation) and enable the takeover of economic assets by companies affiliated with the authorities. As a result, Russia has started to abandon the principles of market and free competition. In addition, the expansion of the state administration has further strengthened bureaucracy and corruption. At the same time, investors have had only limited possibilities to enforce their rights through the courts, which have remained under government control. As a consequence, a gap has widened between the laws officially in force, and their practical application.

Other negative factors from the investors' point of view include the legal restrictions on foreign capital's access to certain sectors of the Russian economy (the law of April 2008 concerning foreign capital's involvement in the strategic industries), or the arrangements concerning limits on foreign investments in the finance sector, made as part of the negotiations concerning Russia's membership of the World Trade Organization (WTO).

Factors contributing to the increase in investments in the Russian Federation

Russian authorities have not attached a high priority to improving their investment climate over the last five years. Nonetheless, the conditions for investing in Russia have improved to a certain extent. Russia has advanced to the 106th position (up six) in the World Bank ranking of the business-friendly states⁴ among the world's 178 economies.

⁴ Doing Business 2008.

Investors were particularly encouraged by:

- high profits achieved by investors already present in the market;
- good condition of the Russian economy, growing internal demand, displayed political stability and positive forecasts concerning further development of the political and economic situation in Russia (in particular, projections of retaining high fossil fuel prices). The long-term nature of these factors (noted since 2000) has been particularly important for investors;

- the potential of the Russian market, especially the abundance of natural resources, whose importance was increasing as their prices rose;
- economic changes implemented at the beginning of Vladimir Putin's first presidential term, i.e. the tax, budget, banking and social security reforms;
- adaptation of Russia's legislation to WTO standards, and in particular the reform of the customs system (lowering of barriers and simplification of custom procedures), as well as changes in the finance sector, meant to facilitate cross-border movement of capitals, etc.;
- rising spending, especially from public funds, on the development of infrastructure in Russia (including roads, energy grids or water supply and sewage networks);
- change in the Kremlin's strategy on private investors, consisting of a controlled opening up of the most attractive industries to foreign investors. This change seems to have contributed most to the activation of foreign capital.

Change in the Putin team's strategy on foreign investors

In 2006–2007, as the Kremlin strengthened its position and Russia shook off its dependence on international finance organisations aid, a certain change could be observed in the authorities' policy on private business. In this period, the Russian authorities agreed to privatise minority stakes in some public companies, including in the electricity, oil and banking sectors. In the electricity sector, private investors gained access to power generation⁵. The Kremlin also decided to admit foreign investors – in a controlled manner – to the Russian gas reserves. Among others, Italian companies took advantage of this possibility and acquired the auctioned-off gas assets of Yukos.

Initial Public Offerings (IPOs) of Russian enterprises, organised on a large scale since 2006, have offered the investors, including foreign companies, an opportunity of entering the Russian market. In 2007 alone, twenty five Russian companies (both public and private) made their stock exchange debuts, and their shares were bought by investors for a total of US\$ 23.6 billion⁶. According to official statements, the IPOs of Russian public companies made so far have only been the beginning of a new privatisation process. The Kremlin intends to sell minority stakes in many other companies⁷.

Another important change for investors was the definition of a 'strategic sector' by the Kremlin. The law on foreign investments adopted in April 2008 defined 42 branches of the Russian economy as strategic sectors with limited access for foreign capital. Foreign investments have welcomed the definition of the segments of the economy where they were permitted to act. However, the remaining provisions undoubtedly had a negative impact for investors. Nevertheless, the list of sectors attached to the law will allow foreign investors to develop their strategies for entering the Russian market in advance.

⁵ This concerns mainly gas-fired power plants.

⁶ Which puts Russia on the fourth position worldwide in term of the value of IPOs carried out.

⁷ Including members of Russian state corporations, such as AvtoVAZ.

Foreign investors are only offered minority stakes in projects, while they are obliged to import new technologies to Russia or to admit Russian companies to their projects outside Russia.

The limits of Russia's opening to foreign investors

The change noted in the Kremlin's strategy towards private capital, including foreign capital, has nevertheless many restrictions. First of all, the Russian authorities have no intention of losing control of the processes that take place in the

country's economy. For this reason, the opening up to foreign investments is strictly regulated. Foreign companies are only offered minority stakes in joint projects⁸. In the case of investments in the energy sector, foreign companies not only have no opportunity to control

⁸ 15% of shares in Rosneft and 23% of shares in Vneshtorgbank has been sold though an IPO.

a project (e.g. Germany's BASF was offered 25% in the Yuzhno-Russkoye field), but also are not supposed to independently export energy resources. The Kremlin's permission to admit a foreign company to Russia is usually subject to additional conditions, e.g. the company may be required to import new technologies to Russia⁹ or admit Russian companies to its projects outside Russia (by exchanging the assets)¹⁰.

The privatisation of the electricity sector in Russia may serve as a good example of the conditions offered to foreign investors. While foreign companies have taken over control of individual holdings in this industry, Gazprom remains the main player in the sector, with the objective of taking over around 40% of electricity generation. At the same time, Gazprom is the main supplier of gas, the basic raw material for the plants concerned. Although private investors have been granted access to Russia's internal electricity market, which remains strongly regulated by the state, in fact they have no opportunity to export the electricity generated. Moreover, the transmission infrastructure is still held by the state.

Conclusions

The rising influx of foreign investments to the Russian Federation is in line with a global trend. According to the most recent UNCTAD report, global FDI increased by nearly 40% in 2006 over the previous year, and amounted to more than US\$ 1.3 billion. Russia is among the states who can boast the highest FDI growth. A high rate of foreign investments coming to Russia has provided a strong impulse for the country's economic growth. It has had a positive effect on the modernisation and development of many sectors of the Russian economy. However, an obvious drawback of the foreign investments is their concentration in the upstream sector, which reinforces the Russian economy's dependence on fossil fuels. Having said that, current global economic trends and the processes taking place in Russia, make a further dynamic influx of capital to the Russian Federation very probable.

The positive trends observed in the Russian economy within the last eight years and the prospects of further development and achievement of high profits, have contributed to the increase in foreign investors' activity in Russia. However, it was the Kremlin's policy on foreign investors that has enabled Russia to take advantage of the investors' interest in its economy and to attract investments. The authorities have agreed to admit foreign investors to projects in Russia as minority shareholders (even though the investors had no right to independently export resources from Russia or influence key decisions concerning the projects in question). Under such conditions, minority stakes in public companies could get privatised and the upstream sector could be partially opened to foreign investors.

The dynamic increase in foreign investments coming to Russia demonstrates that foreign capital has adapted to the conditions of 'business a la Russe' and has worked up its ways of reducing business risks in this country.

Paradoxically, the Kremlin's decisions to tighten its grip on the economy have eventually enabled the increase in foreign investors' activity and made Russia more strongly tied with the international economy. At the same time, the character of these ties is changing. In recent years, the dependence of Russia's public finances on international financial aid has been replaced by the dependence of Russian companies on the situation in the international markets. Among other aspects, this dependence results from the fact that Russian companies have run up huge debts in foreign banks and their shares are traded in stock exchange markets worldwide. Thus, while the Kremlin seeks to control the process of opening Russia to foreign capital, it allows the Russian economy to become increasingly susceptible to factors uncontrolled by the state.

⁹ This refers for example to investments of France's Renault in AvtoVAZ.

¹⁰ Such an obligation has been imposed on Italy's Eni and Enel, and on BASF; such a condition is often imposed by Gazprom

APPENDIX

The statistics of the two main institutions gathering information on foreign investments in Russia, i.e. CBR and Rosstat, differ considerably due to the differences in methodologies applied (e.g. Rosstat statistics largely exclude investments in the banking sector; international finance institutions usually refer to data calculated on the basis of the CBR balance of payments).

Major investments involving foreign capital in Russia in 2006–2008

| Investor | Assets acquired | Value of investments (US\$ billion) | Year |
|---|--|-------------------------------------|-----------|
| Raiffeisenbank (Austrian capital group) | 100% in Impexbank | 0.6 | 2006 |
| Nordea (Finnish capital group) | 75.01% in Orgresbank | 0.3 | 2006 |
| Societe Generale (French capital group) | 50% in Rosneft | 2.3 | 2006–2008 |
| Initial Public Offering (IPO)/ only a portion of these shares was purchased by foreign investors | 15% Rosnefti | 10.7 | 2006 |
| Halliburton Co. (USA) | Majority stake in Burservis (oil and gas sector) | 0.7 | 2007 |
| E.ON (German energy company) | 60.7% in OGK-4 (Wholesale Generation Company No. 4) | 5.7 | 2007 |
| Enel (Italian energy company) | 59.8% in OGK-5 | 4 | 2007 |
| Enel i Eni (60:40) (Italian energy companies)/ Gazprom has a guaranteed option to purchase majority stakes (51%) in the gas assets of Gazpromneft and to buy back a block of 20% of the company's shares. | 20% in Sibneft (currently Gazpromneft) and gas companies Arcticgaz and Urengoil (gas assets of Yukos, the company brought into bankruptcy) | 5.8 | 2007 |
| BASF (German petrochemical company) | 25% in the Yuzhno-Russkoye oil and gas field (+ 1 privileged share corresponding to a 10% share in investments and profits) | 0.5 (proprietary estimates) | 2007 |
| IPO / only a portion of these shares was purchased by foreign investors | 23% in Vneshtorgbank | 8 | 2007 |
| IPO / only a portion of these shares was purchased by foreign investors | 4% in Sberbank | 3.2 | 2007 |
| Renault (French automotive company) | 25% in the largest Russian car manufacturer Avtovaz | 1 | 2008 |
| Fortum (Finnish energy compan) | 55.3% in TGK-10 (Territorial Generation Company No. 10 in Western Siberia) | 3 | 2008 |

Source: News agencies 2006–2008

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