The Great Transformation: Russia’s Return to the World Economy

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Abstract

Since the 1998 financial crisis the Russian economy has been growing rapidly, and seems set to go on doing so in the coming years, recording healthy balance of trade surpluses and surpluses on the public sector accounts. At the same time, under President Putin, market-type reforms have gained renewed momentum. Surveys show that the business environment in Russia has changed in recent years, but from “very bad” to “bad”, but for foreign investors, the existing business conditions are fair and getting better. Foreign investment levels have remained relatively low for much of the 1990s, usually little over $2 billion per annum, but recently inflows have increased – including returning flight capital – and there are prospects for far higher levels of FDI in the future. FDI to date has been relatively broadly-based by sector: oil and other natural resources provide the headline projects, but investment in hotels and catering, food, drink and tobacco, and other services, have been large and growing. We expect industrial restructuring in selected lagging sectors of manufacturing to present massive opportunities to foreign investors, notably vehicles. Overall, while noting various problematic areas for the business community, and the usual uncertainties in any medium- to long-term forecasting exercise, we remain broadly confident that Russia’s economy will continue to grow quite rapidly, and that the opportunities for foreign investors in an increasingly wide range of branches will steadily expand.

Keywords: foreign direct investment, trade, Russia, transition

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Russia’s Return to the World Economy

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January 2004
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Foreign Direct Investment in Russia

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The views expressed in this paper are those of the authors alone.
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Executive Summary

- Since the 1998 financial crisis the Russian economy has been growing rapidly, and seems set to go on doing so in the coming years, recording healthy balance of trade surpluses and surpluses on the public sector accounts. At the same time, under President Putin, market-type reforms have gained renewed momentum.

- Exports have been dominated by primary produce, notably oil and gas, but also various minerals (incl. diamonds), forestry products, etc.

- Surveys show that the business environment in Russia has changed in recent years, but from “very bad” to “bad”, so there is still a long way to go. Business start up rates are still low, so there are far too few SMEs. However, for larger firms and foreign investors, the existing business conditions are fair and getting better.

- Foreign investment levels have remained relatively low for much of the 1990s, usually little over $2 billion per annum, but recently inflows have increased - including returning flight capital from Cyprus and elsewhere - and there are prospects for far higher levels of FDI in the future. Aside from Cyprus, the three largest foreign investors in Russia are the USA, the Netherlands and the UK. Germany and Japan are not far behind.

- FDI to date has been relatively broadly-based by sector but concentrated by region. Oil and other natural resources provide the headline projects, but investment in hotels and catering, food, drink and tobacco, and other services, have been large and growing. Regionally, most FDI has been going to Moscow, St Petersburg, and a few others areas mostly important for oil and gas. But we expect big changes in the coming decade.

- Specifically, we expect industrial restructuring in so far lagging sectors of manufacturing to present massive opportunities to foreign investors. Aside from food processing that has already attracted much interest, vehicles is another sector with great promise. There are many others.

- Russia is nearing the end of negotiations to join the WTO though some sticking points are delaying a conclusion. These include demands for continuing subsidies for key sectors the Russians wish to protect, such as cars. We do not favour such subsidies, and these sectors will fare much better if the Russians abandon such demands and go for an FDI-based strategy instead.

- Likewise, until very recently Russia was thought to be on the point of signing up to Kyoto, enabling the treaty to come into effect world-wide. This is now in doubt as Russian growth will soon bring Russian emissions above their 1990 reference levels. However, we do not accept the Russian concern that accepting Kyoto might drastically slow down growth, since growth with low emissions will boost demand for lots of energy-saving and pollution-reducing technology. Such a strategy would offer very attractive opportunities to foreign investors.

- Looking forward, we expect continuing growth at a rate of at least the current 4-5% per annum. The opportunities offered by this growth will depend on a few key factors of which we highlight: (a) developments in energy pricing; (b) demographic trends; (c) Russia as a Pacific Rim power, not just a European one; and (d) the possible impact of the recent Yukos affair on foreign investment.

- Overall, while noting various problematic areas for the business community, and the usual uncertainties in any medium to long-term forecasting exercise, we remain broadly confident that Russia’s economy will continue to grow quite rapidly, and that the opportunities for foreign investors in an increasingly wide range of branches will steadily expand.
Introduction: Setting the Scene

The former Soviet Union abandoned communism at the end of 1991 and disintegrated to form 15 new states. The largest of these, both in terms of population and in terms of land area, was the Russian Federation.

The 1990s was a decade of extremely mixed fortunes for the Russian Federation. Under its first President, Boris Yeltsin, the country experienced a massive collapse of output, enormous inflation, especially in 1993 and 1994, and then eventually, the beginnings of economic growth. However, this was interrupted by the 1997-98 financial crisis that forced the devaluation of the ruble. Since the crisis, the economy has finally embarked on steady growth at impressive rates. By 2003, the economy should be about 30% larger than it was at the trough of the recession in 1996.

![GDP in Russia, 1990=100](image)

Source: Goskomstat and authors’ calculations

Other macroeconomic fundamentals suggest that this growth is sustainable, at least in the short run. After the burst of inflation following the devaluation of the ruble, the rate of price increases has dropped steadily, and various forecasts suggest inflation for 2003 should end up at 12-13%. Unemployment peaked at almost 13% in 1999, and is now closer to 8%. The fiscal situation is so strong that the government looks set to run a budget surplus in 2003 for the fourth year running. The result is that economic prospects for the country now are better than they have been since the painful transition to a market-type economy commenced. Meanwhile, on the policy front, while many important economic reforms were enacted during the Yeltsin presidency, since 2000, under President Putin, Russia has embarked on a new wave of reforms based around the government’s new economic programme, led by the principal Economy Minister, German Gref.
Sources: Goskomstat; IMF
Structural change and economic reform started well before the resumption of economic growth. In its very first year of existence as an independent nation, Russia embarked on a massive programme of privatisation. Sales and leases of small shops and retail trade outlets have been extensive, largely successful, and not very controversial. Far more controversial have been the privatisation programmes for large industrial enterprises. Roughly speaking, there have been two separate programmes pursued. The first is the “mass privatisation” programme that was started by the Russian reformers almost immediately upon the establishment of Russia as an independent state, and largely completed by the mid-1990s. It is often but somewhat misleadingly termed a “voucher privatisation”; although the public could and did participate via distributed vouchers and auctions of shares, the bulk of shares were essentially given away to the managers and workers of most industrial enterprises. The political calculation of the reformers was that private property had to be created at any cost, and the way to do this was to buy off those in a position to block it, namely enterprise insiders.

The second strategy, pursued in parallel with the first, was to selectively sell off strategic portions of Russia’s industry to Russia’s emerging business class in less-than-transparent circumstances. The most famous of these sell-offs was the “Loans for Shares” episode of 1995-96, when the Yeltsin government put up shares in key enterprises that had hitherto remained state-owned as collateral for loans from private Russian banks. This took place in the run-up to the election of 1996, when the Yeltsin government needed the support of the private sector to stave off the electoral challenge of the Communists. The government’s original intention of repaying these loans was doubtful at best, and indeed the end result was that large and very valuable enterprises were effectively sold off at knock-down prices to favoured businessmen, or, as they became known, “oligarchs”. Russia’s oil industry - LUKoil, Yukos and Sidanko - was privatised in the “Loans for Shares” programme.

The result of the privatisations of the 1990s was to create a dual structure of private ownership: large numbers of firms owned largely by the people working in them, and a small number of hugely valuable firms owned by the oligarchs and the business groups and alliances they created. Ownership of firms has not, however, remained frozen at the point of privatisation. Enterprise workers and managers have been gradually selling off their shares to interested outsiders, including both to oligarchs building their empires and to foreign investors; and some of the oligarchs themselves have been selling as well as buying.

Meanwhile, structural change in Russia has been ongoing since the start of transition, and it is often not appreciated just how deep the changes have been. The extent of change can be seen by comparing the structure of employment in 1990 with the structure in 2002, as illustrated in the pie charts below. The scale of change has been vast. Under central planning, Russia was overindustrialised, with far too few people employed in market services such as retail trade and finance, and far too many employed in industry. By 2002, employment in industry and construction had fallen by 12 million people, a decline of over one-third; indeed, labour shedding in industry combined with the resumption of economic growth means that the time of writing, value added per worker in industry has now recovered to its pre-transition level. At the same time, employment in services increased by 5 million, a rise of roughly 40%. (Increases in unemployment and people leaving the labour force account for most of the remainder.) Russia currently employs almost as many people in market services as it does in industry.
For most of the 1990s, largely due to exports to the West of oil, gas, mineral products, and raw materials such as timber, Russia enjoyed very large trade surpluses, of the order of US$20-30 billion per year by the end of the decade. Such surpluses have continued up to the present. Despite this very strong trading performance, Russia has faced significant difficulties in servicing its external debt at times, and has frequently sought - and been granted, largely due to the country’s geo-political significance - large amounts of assistance by the International Financial Institutions (IFIs), including a degree of debt re-scheduling. We are unconvinced that such relatively favourable treatment by the IFIs was ever justified, at least in part because we strongly suspect that economic reforms might well have been pushed faster, and with greater overall consistency, had Russia not been “rescued” so readily by outside creditors.
Russia’s external accounts were not helped by the massive capital flight that has characterised the country, estimated at around USD15 billion per year for many of the transition years. At the same time, foreign direct investment (FDI) into Russia has been on a small scale, with most of what has occurred being in hotels and related services (e.g., Western food chains such as McDonald’s, Pizza Hut, etc.), the oil and gas sectors, and a scattering of other activities. Outside the energy sector, most FDI has occurred in Moscow and St Petersburg, and in the oblasts (regions) surrounding these major cities.

Against this constantly evolving background, this paper focuses on an assessment of the environment for FDI in Russia - now, and prospectively over the next decade or so. In order to make such an assessment, we sketch how we see the current business environment in the country, since that is obviously critically important for domestic investors and foreign investors alike. Clearly, the combination of capital flight and low rates of FDI strongly suggest that the business environment has serious deficiencies, and we attempt to highlight the main problems. We then move to characterising the main features of FDI in Russia to date. Our main point is that, although it is the oil deals that have dominated the headlines, FDI in Russia to date has been driven as much or more by the attractions of the large and growing Russian domestic market. We then consider the issue of foreign trade. Next, we note that Russia has a peculiar industrial structure inherited from central planning - large plants but small firms - and we explore the implications of this for FDI in the context of two specific industries, automotive manufacture and food processing.

Investors, on the whole, are not simply interested in where Russia is “today”. Rather, they need to form a view about the likely shape of the Russian economy 5-10 years ahead, in order to assess the prospects for any proposed new investment. While we would naturally want to be quite cautious in offering forecasts for a rapidly changing country such as Russia, we outline some possible scenarios for the country and then sum up our main findings.
The Business Environment and FDI

Russia’s business environment

Russia’s business environment is evolving all the time, and on the whole improving. This is confirmed by the joint EBRD/World Bank BEEPS Survey that looked at the business environment in most transition economies by surveying individual firms and asking about eight different aspects of business conditions. Sure enough, the survey results published in the EBRD’s Transition Report 2002 showed that on virtually all dimensions, Russia’s environment had indeed improved since the last survey carried out in 1999. One should not be too complacent, however, for on a scale running from “dreadful” to “excellent”, this improvement is really only from “very bad” to “bad”. In other words, change is in the right direction, but there is still a long way to go.

An indication of how far Russia still needs to progress before one would consider the business environment to be that of a well-functioning market-type economy is the following simple statistic: as of the late 1990s, Russia had about one firm for every 55 inhabitants, while developed market economies have about one firm for every 10 inhabitants. Hence quite aside from official surveys of the formal business environment, we shall know for sure that the Russian economy has truly come to life when it supports several times as many businesses as it currently does.

This observation also raises a lot of questions about the factors that might be strongly discouraging business start-ups at present. Sometimes people think in terms of cultural or historical factors, offering such explanations as “Russians are simply not entrepreneurial”, or “after 70 years of central planning, what else could one expect”. But in our view, it is all too easy to use explanations like this to avoid addressing the real problems, which have much more to do with institutions and practices that can be changed just as soon as people - mostly the authorities at various levels - decide to do so. The real story of low business start-up rates relates to:

- Continuing protection of many old firms, both state-owned and privatized, through tax reliefs, subsidies, toleration of wage arrears, rolled over credits, and other generally undesirable and inefficient means. Such protection amounts to the continuation of so-called soft budget constraints in Russia. Protection of existing firms inhibits new starts by firms that might be far more productive and have more growth potential.

- Protection of markets by regional and local authorities to assist “their” firms, i.e., firms based in their region. For instance, a firm producing dairy products in one oblast’ might have its sales in the local market protected, with the local authorities seeking to ban or restrict “imports” from other parts of Russia. This kind of local protection seriously damages the competitive environment; it is generally illegal both in terms of existing Russian law and in terms of anything that might be agreed as a set of conditions for Russia’s WTO entry (see below). But in practice it proves hard to stop.

- Complex micro-level regulation of business, with far too many permits needed to get started (with associated opportunities for bribery), too many arbitrary inspections (also opportunities for bribery). Businesses either don’t start at all, or they operate in the informal economy. Sometimes this brings them under the influence or “protection” of local mafia-like groups, but this is often regarded as an improvement over operating in the official economy!
The legal environment for investment and FDI

Amongst the various components of the business environment, a poor legal environment is considered to be one of the major obstacles to FDI in Russia. Weak protection of property rights, the complexity of the tax system, the frequent appearance of mutually exclusive provisions in different legislative acts, and ambiguities in the separation of the spheres of authority of regional and federal government and agencies are usually included among the deficiencies of legal regulation that still discourage business development in Russia.

Russia’s legal framework for economic activity is only twelve years old, and was created almost from scratch. This transformation has not been smooth and easy. Loopholes in laws or the absence of legal regulation in some areas have created many opportunities for rent-seeking and asset-stripping. The new Insolvency Law, introduced in 1998, is a striking example. The minimum debt level required to start a bankruptcy case was initially set very low, with the result that it was widely used as a mechanism for the redistribution of property - once a bankruptcy becomes active, the court can enforce any of a variety of outcomes - rather than a means for creditors to assert their property rights in an orderly fashion, regulated by the rule of law. It is interesting to note that after several years, during which time the spheres of interest of the major Russian business groups stabilised, these groups started lobbying for a change in the law that would require a higher debt level to initiate insolvency proceedings. A draft law along these lines was vetoed by the President and sent back to the parliament for revisions in the summer of 2002; a modified version came into effect that December.

The Constitution of 1993 guarantees equal rights and obligations for foreign and Russian citizens, including property rights and freedom of entrepreneurial activity. Trade and investment activities in Russia are regulated mainly by three legal acts: the Civil Code, the Law on Joint Stock and Limited Liability Companies, and the Insolvency Law. There is a law “On Foreign Investment in the Russian Federation”, which sets out the priority of international agreements, guarantees compensation in case of nationalisation and has a so-called “grandfather” clause (“Guarantees to Foreign Investors and Companies with Foreign Investment against Unfavourable Changes in the Russian Legislation”). There are certain limitations on the applicability of this clause in terms of investments.

In general, Russian legislation is not very restrictive vis-à-vis foreign investors. Major formal restrictions apply only in the cases of banking and insurance: the share of foreign capital in the total capital of the sector is not supposed to exceed 12% in banking and 15% in insurance. Insurance companies that are more than 50% foreign-owned are neither allowed to sell life insurance, nor any kinds of mandatory insurance, nor work with state-owned companies. In addition, there are separate legislative provisions regulating the natural monopoly sectors, such as the key public utilities. These regulations are established on a case by case basis.

Most observers agree that the progress made since 1992 in improving the legal framework for business has been substantial. According to a recent OECD study on the investment environment, Russia has an adequate, rules-based set of regulations for investment. Although Russian legislation still needs to be strengthened, it is not considered to be the main source of problems. The big gap remaining to be filled is that between business law de jure and business law de facto; thus what often appears reasonable on paper - in terms of the formal laws “on the books” - is all too often weakened by poor implementation and enforcement.

The regulatory system currently in place in Russia is in many aspects more favourable to businesses than that of the major Eastern European countries. The World Bank’s “Doing Business” project provides some supporting evidence for this. This project has assembled comparable measures of

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business regulations across more than 130 countries. The figure below shows the relative position of Russia compared to three leading Central European transition countries and EU accession candidates, and the UK. For instance, starting a business in Russia apparently requires 29 days as opposed to 88 in Czech Republic, and costs the equivalent of 9.3% of gross national income per capita as opposed to 64.3% in Hungary.

![Diagram showing business regulations across countries](image)


Where Russia is the furthest behind these countries is in implementation of the rule of law. A separate World Bank project, the Quality of Governance survey, collected data from almost 200 countries to try to characterise, amongst other things, the ability of governments to set out and implement sound policy. The survey shows that Russia ranks in the bottom quarter world-wide in the rule of law and the control of corruption Russia, and rather better - close to the median - in terms of government efficiency and regulatory quality. Nevertheless, these “strengths” are only relative to some rather weak competition, as is evident if we again compare Russia to the three Central European countries and the UK. Russia has very far to go before the quality of governance approaches current Central European levels, let alone those observed in a modern Western market economy.
It is worth noting that some current research suggests that the rule of law in Russia is especially ineffective at the regional level, because companies can often influence regional legislation and get preferential treatment. The researchers were actually able to measure this by counting the number of legal acts that gave advantages to particular companies. Interestingly, one of the major impacts of this “legislative capture” was the creation of obstacles to small business growth.²

FDI in Russia:  
More than just oil and natural resources

Russia started the transition with very little FDI, for fairly obvious reasons, and it was only in the mid-1990s that FDI inflows moved above $2 billion annually. The surge in inflows in 1997 was almost immediately reversed in the wake of the 1998 financial crisis, after which inflows averaged about $2-3 billion per annum. At the time of writing, the total stock of FDI in Russia is about $26 billion: large by East European standards, but small for a country of this size. According to Unctad (2003), although Russia ranked fourth at the end of 2002 in absolute terms of FDI stock among East European countries (Poland was first with $45 billion), Russia came last in relative terms: the stock of FDI was still only 7% of GDP, one-third of the regional average.

In the past year or two, however, there has been a turnaround in the attitudes of foreign investors towards Russia, and this has been reflected in the scale of FDI inflows, as shown in the figure. Despite continuing shortcomings in the general business environment, as outlined above, foreign investors clearly feel more secure about Russia than they did even just a couple of years ago. A recent indication of the more favourable attitude to Russia was the October 2003 decision of Moody’s to raise Russia’s government bond rating just enough to bring it up to investment grade for the first time. The move can be justified by the recent strong economic growth exhibited by Russia - expected to continue for the next few years at least - and by the determined monetary and fiscal rectitude displayed by the Russian authorities after their fingers were so badly burned in the 1998 financial crisis. However, other rating agencies see uncertainty ahead, since the next Presidential election is due in Spring 2004 - they may not adjust their ratings of Russia until then, even though at present one would have to say that President Putin’s political position must be considered close to unassailable.
Six countries account for three-quarters of total FDI in Russia: Japan, Germany, the UK, the Netherlands, the United States ... and Cyprus. The latter, of course, represents Russian flight capital coming home. The “Cypriot” investments, along with smaller FDI flows from other offshore investment capitals, mean the FDI figures are somewhat overstated, but also provide a useful little signal of the confidence of Russian domestic investors in their own economy: in the first three quarters of 2003, inflows from Cyprus jumped as much or more than those originating in the other major investing countries.

Source: Unctad, Goskomstat and authors’ estimates

The regional patterns of FDI in Russia also conform more or less to stereotype: Moscow has taken the bulk of the inflows, partly because it is the economic capital with the headquarters of many companies, and partly because it is itself booming; Sakhalin island has a major oil field development involving BP, Rosneft and TNK, and is developing gas fields and gas processing involving Shell; Krasnodar region is a major recipient of FDI inflows through the Caspian pipeline consortium.

Source: Broadman and Recantini (2001), Goskomstat and authors’ calculations
In 2003, the major new commitments of foreign investors that have grabbed the headlines have been concentrated in the energy sector. BP has spent £4.63 billion to acquire Tyumen Oil (though the financing of this deal essentially involved a transfer between two UK banks, so it might never appear in official FDI figures), Shell expects to be spending around £5 billion in the next few years on both oil (the Salym fields in western Siberia) and gas (the world’s largest liquefied natural gas plant to be constructed on Sakhalin Island by 2006), and Exxon-Mobil, originally in talks to take a major stake in YukosSibneft, is likely to be interested in some of the pieces, now that the proposed merger is being unravelled in the wake of the Khodorkovsky affair.

These recent developments conform to a general picture that is widely held - FDI opportunities in Russia are largely concentrated in the energy and raw materials sectors. Yet is this actually the case? The importance of FDI in the energy sector is undeniable, and this will be particularly obvious when the very recent oil deals feed into the statistics on actual FDI disbursements. But in fact energy and raw materials are not all, or even most, of the Russian FDI story. Russia differs in two key respects from the other transition countries of Eastern Europe and the former USSR. One of these is its endowments of raw materials; but the other is the sheer size of its economy. Russia has a population of 144 million, and on top of this is its role as a gateway to the rest of the CIS. Its domestic market is large and growing - the increase in GDP over the past 6 years is roughly comparable to adding a bit more than two Hungarians, or a bit less than one Poland, next to the EU. It is therefore of major interest to foreign investors in its own right.

A simple but powerful way to demonstrate this is to compare the sectoral structure of FDI with the sectoral structure of Russia exports, as is done in the figure below. The common misperception that FDI in Russia is mostly energy-related is due partly to the headline oil deals cited above, but also to the fact that Russia is the world’s second-largest oil exporting country (after Saudi Arabia) and the world’s largest exporter of natural gas. About half of Russia’s exports are oil and gas, and roughly another quarter are raw materials such as metals, diamonds, and timber. Manufacturing exports are a small fraction of the total.

Yet when we look at the sectoral structure of FDI, we find a quite different pattern. Energy and raw materials-related FDI is indeed the single largest category, but according to Goskomstat statistics, as of the third quarter of 2003 it accounted for only one-quarter of total cumulative FDI. FDI related to food processing made up about 15% of the total as did FDI in trade and catering, and FDI in telecommunications and transport, at about 20% of the total, was almost as large as FDI in energy. Cumulative investment in all services sectors together was close to half of all FDI in Russia. The energy share will likely increase as the recent oil deals show up in the figures, but the general picture will not change: the Russian FDI story is just as much a story of targeting a large and growing domestic market as it is a story of oil and natural resources.
The bulk of FDI activity in Russia to data can be placed in three categories:

1. **Export-oriented raw materials sectors.**

The largest of these sectors is oil, but there are also substantial foreign investments in sectors such as metals, forestry and wood products, etc. The attractiveness of these sectors to foreign investors is, naturally, the potential export earnings. The sectors in which FDI has taken place were privatised in the mid-1990s and were largely owned by major domestic Russian shareholders or intermediaries controlled by them. These private owners have been open to working in partnership with, or selling off their stakes to, foreign investors. The big exception is gas, which remains largely state-owned and in which FDI activity has been limited.

2. **Services and consumer-oriented manufacturing**

Russia started the transition with a very poorly developed consumer goods and services sector, and at the same time a taste for Western consumer goods. This meant major opportunities for Western investors in these sectors. Food, drink and tobacco and trade and catering are sectors in which marketing is important (brand, packaging, advertising) and where Western companies, compared to domestic Russian producers, have both vast experience and established reputations with consumers. A recent example is IKEA, which already had two very successful stores in Moscow and opened its first in St Petersburg on December 12th 2003. This store pulled in 90,000 customers in its first three days of business, and IKEA plans to open its fourth Russian store in Kazan in 2004.

3. **Technology and infrastructure investment**

The largest such sector for FDI is telecommunications, but there has also been FDI activity in transport. Russia started the transition with a poor level of physical infrastructure, and the demand for infrastructure investment meant FDI opportunities.

If we look at British FDI in Russia in particular, we see that the bulk of British FDI falls under the
first two categories and is less present in the third. According to the official statistics, the UK is the fourth-largest investor in Russia (the third-largest if Cyprus isn’t counted), with most investments in fuel and energy and trade and catering. The UK will (would) probably jump to first place in the total FDI rankings once (if!) the BP-TNK deal shows up in the numbers. Notable other examples of British investments in Russia are Scottish and Newcastle (major shareholder in Baltika beer, the number one Russian brand), BAT and Gallaher (Ligget-Ducat) in tobacco, and Fleming Family & Partners in aluminium.

Data on the variety of forms that FDI takes in Russia is hard to come by. Anecdotal evidence suggests that the most common pattern is majority or 100% ownership by the foreign investor, but 50:50 joint ventures are also employed. Minority stakes held by foreign investors that are more than just portfolio investments are less common. Occasionnally, joint ventures are pursued with regional or local governments, but usually the Russian partner is a private entity, at least nominally.
FDI and Trade

WTO

Russia first applied to join the World Trade Organization (WTO) in the early 1990s, but progress was very slow under the Yeltsin Presidency. When Putin came to power in 2000, one element of the economic programme announced by his Economy Minister, German Gref, was a renewed commitment to accelerate Russia’s negotiations with WTO, with a view to securing agreement to early accession for the country. Progress towards the WTO was aided by Russia’s late 2001 support for the US-led coalition that undertook military intervention in Afghanistan following the terrorist attacks of September 11th 2001. This led both the US and the EU to declare that they would treat Russia like a normal market-economy country in the event of trade disputes, instead of as a non-market or state-trading economy. However, despite rapid progress in the past two-three years, and many encouraging statements by world leaders welcoming the expected Russian accession, the WTO process seems to have run into the sand for the time being, with some quite serious outstanding problems still unresolved.

First, in the short run at least it is not altogether clear what Russia gains from being in the WTO, since its exports are mostly primary produce (energy products, timber, diamonds, metals, etc.) and the country enjoys a massive trade surplus of $20-30 billion per year, as noted above. It does, however, face restrictions for a few exports, e.g. steel and steel products; food and agriculture products, and has been subject to many anti-dumping actions over the years. In these respects, WTO membership might well prove helpful.

In the longer term, Russia would undoubtedly benefit from WTO membership since it will expect energy and other primary exports to start to decline, while manufacturing exports gradually pick up and accelerate to form a growing share of Russian exports. Then issues of access to markets and related matters will assume far greater importance. But this sort of development is far away in the future, at least a decade away and quite likely far longer. So it is hard to see this as an urgent priority for the present Russian government. However, if the improving investment climate results in much larger inflows of FDI, then many sectors could be transformed quite quickly, and high quality manufactured exports could then increase more rapidly.

More immediately, there are strong sector lobbies that want parts of the Russian economy to enjoy continued protection and/or to have controls over foreign participation, in ways that might prove difficult for WTO negotiators to accept. Such sectors include:

- Agriculture
- Aircraft production
- Vehicles, especially cars
- Steel, aluminium, etc.
- Banks and other financial institutions
- Business and other services

The energy sector is also problematic for a different reason, namely due to concerns over Russian domestic pricing in the sector. The US and EU were urging Russia for a while to set domestic energy prices at world market levels. However, this was never a justified demand, partly because the relevant world market prices are not themselves especially clear, partly because Russia enjoys some market power in parts of the energy market, such as the market for natural gas in Europe. Moreover, while it is certainly correct that Russia’s policy of supplying energy to domestic firms and the population at below-cost prices is economically foolish, this does not entail a switch to world market price levels (however these may be defined). Rather, Russia should ensure that its domestic
energy prices at least cover estimated long-run marginal costs, since pricing at this level provides producers with the revenues they need to invest in domestic networks and supplies (currently suffering serious neglect after a decade with very little investment), and discourages energy-using businesses from undertaking even more investment in projects that use energy excessively. Of course, it is impossible to implement such a pricing policy without parallel measures of social support to the population, since people must have enough income to pay for energy in order to cope with the harsh Russian winter.

EU enlargement, due in May 2004, brings eight Central and Eastern European countries into the EU, including the three Baltic States. For the most part, this process will simplify somewhat Russia’s trading relations with these eight countries, since they will all adopt the common tariff policy of the EU (so Russia will no longer have to deal with eight separate trade policies in the region), and in relation to Russia they will become partners in the existing Partnership and Co-operation Agreement (PCA) between Russia and the EU. While covering lots of issues outside the scope of this paper, on trade the PCA provides for largely tariff-free trade between Russia and the EU, except in specified sensitive areas such as food and agriculture, steel, etc. In this context, WTO accession would largely put in place measures and policies that the EU would like to see anyway, so the PCA and WTO processes are mutually supportive.

Russia and the Kyoto Agreement

The Kyoto Protocol was an agreement reached to curb emissions of greenhouse gases around the world, initially signed by 171 nations in 1997; and it comes into effect when countries responsible for at least 55% of the world’s emissions in the reference year, 1990, have formally ratified it. So far, 70 or so countries accounting for 44% of 1990 emissions have ratified the Protocol. In March 2002, the US declared that it would not sign up, creating widespread fears that the whole deal would unravel, exposing the world to a situation with no agreed checks on global emissions of carbon dioxide and other greenhouse gases. In this context, it was hoped that Russia, with 17% of world emissions in the reference year, would readily sign up to take us past the critical 55% mark.

Now this is not so clear. Russia’s initial enthusiasm for Kyoto was based on the simple fact that after 1990, the Russian economy basically collapsed, measured GDP falling by about half and industrial emissions of the sort addressed by the Kyoto Protocol falling correspondingly. Hence without any serious effort or domestic spending, Russian emissions during the 1990s declined to levels way below those agreed at Kyoto, with the result that Russia was expecting to be able to use its Kyoto “headroom” to sell carbon credits to deficit nations. Thus for Russia, Kyoto was expected to prove a virtual goldmine: the country could be seen to behave well internationally in environmental terms, while simultaneously raking in the proceeds from nations less able or less willing to cut their emissions. A good deal all round!

So what has gone wrong with all this? The problem is Russia’s rapid economic growth since the 1998 financial crisis, for this has resulted in Russian emissions rising very rapidly once more. In just a few more years, Russian emissions are likely to be back above their 1990 levels, leaving Russia with a need to buy carbon credits rather than sell them to others. This is why Russia’s enthusiasm for Kyoto is waning, with President Putin in recent speeches on the matter being notably cautious and equivocal to say the least. In early December, some of Putin’s senior advisers made public statements to the effect that Russia will not sign up to Kyoto, though formally it is for the Duma (the Russian Parliament) to take this decision, and the matter has not been put to them as yet. Hence the matter remains unclear, and unresolved.

The expansion of the Russian economy has not been accompanied by significant investment in energy-saving technology, and within the energy sector itself production is also quite inefficient, with large losses in distribution and production (e.g. leaky oil and gas pipelines, gas wastefully
flared from oil wells because Gazprom will not allow it to use Gazprom pipelines, big losses in
electricity distribution, etc.). This observation takes us back to an earlier point, namely the
prevailing practice in Russia of setting domestic energy prices below cost, relying on export
proceeds to enable producers to make some money.

The question is, how to persuade Russia that such dreadfully inefficient and damaging practices
need to be stopped. This is important for Russia quite aside from whether the country eventually
signs up to Kyoto or not.
A wider perspective - industrial restructuring and industrial structure in Russia

The standard view of the Russian inheritance of central planning is that, amongst other ills, Russia started the transition with too many large firms and too few SMEs. This implies, on the one hand, that large firms should be downsizing, and hence in transition Russia we should see unbundling, demergers, and so forth, and on the other hand, that the small firm sector should be dynamic and a source of growth. Were this to be the whole picture, it would suggest opportunities for foreign investors in snapping up pieces of firms, and acquisitions of units disposed of by large privatised Russian firms. It does not necessarily imply anything regarding FDI in the sector of SMEs, since SMEs are usually too small to attract much interest from foreign investors. However, it is worth remarking that even by 2000 the number of SMEs that were known to be functioning in Russia (i.e., officially registered) was still incredibly low for the size of the country. As we saw above, some recent studies suggest that the country “ought” to have at least five times as many SMEs, for the overall structure of the economy by size of firm to appear “normal”.

There is some truth in this standard view, but it misses an important feature of the Russian industrial landscape that is directly relevant for foreign investors. The legacy of central planning in Russia is not gigantic industrial firms, but gigantic industrial plants, and, conversely, a scarcity of small plants. Typically these large plants were relatively vertically integrated compared to those found in Western economies, with a large portion of components manufacture done in-house and little outsourcing. The second key ingredient to understanding the evolution of market structure in Russia is the way privatisation was done in the 1990s, with respect to both voucher privatisation and loans-for-shares and other special deals: most of the firms that were privatised were basically privatised as single-plant firms. The result was to create a Russian industrial landscape very different from that found in mature market economies. When the main round of privatisation was completed in the mid-1990s, Russia did indeed have many large plants and relatively few small ones, but it also had very few large firms.

The largest firms in the West have many plants, frequently operating in many different countries. These huge companies dwarf even the largest Russian firms. For example, the largest Russian automotive manufacturer, Avtovaz, employs about 100,000 people, mostly in one location and under basically under one brand, and its annual output is about three-quarters of a million vehicles. General Motors, by contrast, employs about 350,000 people world-wide in dozens of locations around the globe, and produces 10 times as many vehicles under a wide array of brands: Chevrolet, Pontiac, Cadillac, Opel, Vauxhall, Holden, Isuzu, and Saab, to name but some. The implications of this are that we should see two trends in the evolution of industrial structure in Russia: the creation of conglomerates and horizontally-integrated firms, and the growth not only of independent SMEs but also of firms that consist of aggregates of small units.

3 The branding of Avtovaz’s models is actually somewhat confusing. Originally, the cars were sold in the USSR under the brand “Zhiguli”, and marketed abroad under the brand “Lada”, apparently because when Avtovaz decided to enter Eastern European market in 1973, it was felt the word “Zhiguli” sounded unpleasant in some other languages. Subsequently, however, the Lada brand name became used in the Russian domestic market as well. Currently the company is producing models in several ranges, but with names such “Vaz 2108” (in the “Samara” range) and “Vaz 2120” (in the “Niva”) range. The company now uses primarily the brand names “Vaz” and “Lada” together with the names of the model ranges ... but most Russians still use the term “Zhiguli”.
We expect mergers and acquisitions to take place in Russia over an extended period and on a large scale, as the Russian industrial landscape gradually moves towards a more standard market economy form. Local Russian businessmen, most famously the “oligarchs”, have been and are building multiplant firms and conglomerates through acquisitions of single plants, and foreign investors are doing the same, but the process is far from complete.

Where this pattern of the “Westernisation” of Russia’s industrial structure will probably proceed least quickly is in vertical dis-integration. As noted above, Russia’s inheritance from central planning includes plants that are, by Western standards, excessively vertically integrated. However, a strong brake on the reversal of this feature and the development of outsourcing is the Russian business environment. Problems of contract enforcement mean that development of reliable outsourcing arrangements will proceed slowly, and this applies to FDI investors as well as to domestic Russian owners. Indeed, in a recent survey of 14 foreign investors, the main obstacles to business cited by the interviewees was not legal instability or the government authorities, but problems with Russian partners, and in particular their reliability over the fulfilment of contracts.

**A tale of two sectors**

In this section we illustrate some of the trends we have been analysing with a discussion of two sectors, autos and food processing.

The pace of restructuring in the automotive industry has been painfully slow, with limited moves towards horizontal integration by the oligarchs and alliances that dominate the sector, e.g., Basic Element’s bus manufacturer RusPromAvto, and continued, albeit diminishing vertically-integrated production. The second-largest car manufacturer during the Soviet period, the Moskvich plant, stopped production after several years of generous subsidies from the Moscow government and the complete failure of a new model line. This leaves the Russian car industry dominated by Avtovaz, a company whose top management is unchanged from Soviet times. Demand for passenger cars has grown rapidly during the transition, but this has been satisfied more by imports (including used cars) than by domestic manufacturers. Russian car firms enjoyed state protection for all the transition period, successfully lobbied the government for aid in the form of trade protection, implemented as a steep tariff (35%) on imported cars, including second-hand models. Despite this protection, imports continue to grow (24.8% growth for the first 10 months of 2003, and these are just the officially recorded imports), and domestic production has been declining.

At the WTO, the Russian negotiators have been lobbying for the right to continue such protection, while the key firms in the sector have also been demanding help with investment to restructure and upgrade their production. In many ways, therefore, the policy is not unlike that pursued unsuccessfully by the UK in the 1970s, when we sought to protect the then British Leyland. Just as in the UK, the Russian policy will almost certainly fail. However, there must be a good chance that the more forward-looking vehicle companies will realise that FDI is really the only way to get their product quality up to the world level. Once this is acknowledged, there could be massive investment opportunities in the sector both to produce the cars themselves, and to upgrade component suppliers. The resulting output will supply both the Russian domestic market, surrounding CIS countries, and - taking a longer term, optimistic view - the wider European market (cf. the hugely successful impact of Volkswagen on Skoda cars produced in the Czech Republic). There are signs that this is starting to happen: in 2003, GM and Avtovaz announced a $100 million joint venture to produce Opel-Vauxhall Astra sedans, the second such large-scale venture between these two manufacturers. An interesting development to look out for will be whether the businessmen who own these producers will “cash out” and sell off their pieces of the sector to foreigners.

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4 Launched with very patriotic brand names such as “Jurii Dolgorukii”, the legendary founder of the city of Moscow in the 12th century; this would be like a British car maker naming a model “William the Conquerer”.
One of the major inputs in car production is steel, and as the car industry is transformed it will place increasing quality demands upon the Russian steel industry. Rising investment across the economy - including in major infrastructure projects such as renewing and extending oil and gas pipelines - will also increase the domestic demand for steel. Hence even in the presence of continuing problems of access to the world market for steel, Russian steel producers have a promising future. But much current production is highly polluting, extremely energy intensive, and lies well inside the technological frontier in terms of best practice production. Here again, therefore, there is potential for substantial foreign investment to modernise and expand production, especially in a variety of special steels in which Russian production has traditionally been rather poor.

Russia’s food processing sector has undergone an amazing transformation in the past decade, to an extent that points the way for the transformation of other sectors: the number of firms operating in the sector has tripled compared to the number when the transition started, and - unlike many other sectors - a majority of these firms are profitable. Yet it started very badly, with Russian consumers deserting the home industry in droves at the start of the 1990s, in favour of high quality, branded - and inevitably quite expensive - imported produce ... much as they did in the car market. So how has the sector managed to stage such an impressive turnaround? Essentially, the domestic industry now falls into two categories (simplifying a little, of course). There is a cheap, low quality end of the market where not much change has yet occurred, where packaging and presentation are poor, and where there are few recognisable brand names. Firms are mostly small, and they mostly supply local markets; most would not meet EU health and safety standards, technical standards, etc. On the other hand, there is a large and growing segment of the market that has modernised product lines, improved marketing, established new brands and won back the loyalty of the Russian consumer. This has happened with the help of substantial FDI, and indeed food, drink and tobacco is probably the sector where foreign ownership is most dominant. Foreign investors have not simply brought foreign brands in with them, but have also purchased and built up domestic Russian brands.

A successful example of this is BAT, which produces cigarettes under foreign brands such as Pall Mall and Kent, but also under the domestic Yava brand. BAT has expanded the domestic branding by launching the new “Golden Yava” brand, aiming at the higher end of the market and marking it as a “home grown” Russian product, while undercutting the foreign brands on price; the new brand is now a market leader in Russia. BAT’s ownership of a number of manufacturing plants also illustrates the trend towards horizontal integration mentioned above. There is clearly potential for much further development along similar lines as Russian incomes rise and consumer expectations improve.
FDI - the Next Decade and Beyond

Short-run macroeconomic developments

Russia’s macroeconomic prospects in the short run appear fairly rosy. Buoyed by continued high world prices for oil, the economy grew by 4-5% per annum in 2001-02, and is expected to grow another 6%-7% in 2003. Russia will record both budget and trade surpluses in 2003. The financial crisis of 1998 is becoming a distant bad memory.

Nevertheless, Russia does face short-term macroeconomic challenges that foreign investors will need to be aware of, and these go beyond the simple but obvious - and obviously important - question of what will happen to the world oil price. Possibly the most important of these, and one that is directly relevant to the topic of this paper, concerns capital flows. The chief economist of the World Bank’s Moscow office, Christof Ruehl, argued in an influential paper in mid-2003 that Russia may be at the beginning of a boom-and-bust cycle. Russian capital flight has diminished steadily since the financial crisis of 1998, and there are signs (not the least of which is the role of Cyprus as a major foreign investor, cited above) that Russian money is starting to come home. On a modest scale, this would be good news - Russian businesses funding Russian investment - but the problem, as usual with Russia, is one of scale. Russian capital kept abroad is estimated to be well in excess of $200 billion. Flows of Russian money back to Russia amounted to about 5% of GDP in 2002, and Ruehl argues that annual inflows of 10-15% are conceivable.

The problem is that the Russian financial sector is ill-equipped to absorb such flows. One possible outcome is a boom, during which Russian banks lend freely and not always sensibly, and at the same time asset prices are bid up, followed by a bust, with a (another) bad debt crisis in the banking sector and asset price deflation. The Russian banking system is still poorly regulated and relatively unreformed, and consequently is not well equipped to deal with this potential challenge. How realistic is this scenario? Russian money abroad may be less tempted to come home following the Yukos affair, but if, as we suspect, the Yukos episode is primarily part of a domestic political battle with limited implications for business (see below), the scale of Russian repatriated capital could still be large, and the danger of boom-and-bust still a real one.

Medium-run macroeconomic forecasts: energy, and trade

The Russian energy strategy to 2020 and recent statements by the Finance Minister, Alexey Kudrin, suggest average GDP growth of 5.6% p.a. (optimistic scenario). In contrast, the International Energy Agency (IEA) projects envisage growth over the period 1997-2020 averaging 2.9% p.a. These rates are as plausible as any for the purpose of long-run upper and lower projections. Within aggregate GDP, we expect the share of investment to rise to make growth more sustainable, and hence aggregate consumption will grow a bit more slowly than GDP as a whole. The IEA expects an improvement of 1.4% p.a. in energy efficiency, while Russia’s Ministry of Energy expects 26-27% improvement by 2010, which is over 3% p.a. We do not think the latter is very plausible unless energy prices are raised rapidly to cover all costs, and even then it would entail quite a big shift in investment patterns.

Clearly, improving energy efficiency is important both from the standpoint of reining in pollution levels in Russia (notably, emissions of greenhouse gases), and from that of sustaining and even increasing Russia’s energy exports. At least for the next decade or so, Russia will continue to be a substantial exporter of oil, though studies of the sector do indicate that without major development of substantial new fields, and improved technology to improve recovery rates in established fields, it will be very difficult to avoid declining production before very long. The same could be true for
gas, given the low levels of investment during the 1990s. Moreover, pressure on the gas sector could increase if, as expected, the EU switches some of its energy demand away from coal and towards gas, hence raising its demand for Russian gas in particular. For Russia to meet such additional demand, it will need to improve energy efficiency at home sooner rather than later. Moreover, while some observers have claimed that focusing on energy efficiency might be bad for growth in Russia, this might not be true. For there will be a rapidly increasing demand for all sorts of investment in a whole range of items - from relatively basic things such as equipment to meter energy use by firms and households, domestic and industrial boilers, etc., to energy efficient technology in almost every sector of the economy. Hence massive opportunities here both for Russian firms and for foreign investors.

At the same time, the EU’s need for gas might also encourage the EU - perhaps through the PCA consultation mechanisms - to encourage Russia to open up the gas market both by privatising all or part of Gazprom, liberalising the market, and encouraging foreign investment. That might prove a highly effective approach to avoiding energy shortages in the next decade or two.

Clearly world energy prices are critical for Russia’s overseas accounts and also public finances. We would expect energy prices - notably for oil, but also for gas - to remain at or above current levels. In the very long run they have to increase, and this will both encourage energy savings, promote new discoveries, make economic the exploitation of fields known but not currently in use, and stimulate new technologies/new sources of energy. Demand from China is rising fast, India is also coming up, and these two big economies make it highly unlikely that energy price falls will be more than temporary lulls. A big uncertainty in the energy sector is coal - the world has lots of it (not always in the right places, admittedly) and it is fairly cheap as much of it can be strip mined, but it is also highly polluting. Nevertheless, it is not impossible to envisage a world in which oil and gas shortages push many countries back to increased use of coal.

In our view, the other large potential structural change on the horizon is the possible emergence of Russia as a major manufacturing exporter. We expect the structure of Russia’s trade to change quite a bit in the next decade or two, with manufacturing exports in several sectors coming up from almost nothing to a significant share of the total by 2010, and even more by 2020. One plausible scenario is for manufacturing to rise to 25% of exports by 2010, and 50% by 2020, based on the assumption of large inflows of foreign investment to modernise key sectors.

Medium-run macroeconomic forecasts: demographic trends and HIV

The interest of foreign investors in Russia has so far been driven in large part by the size of the domestic market and its potential for growth. Demographic trends are therefore particularly important for assessing the attractiveness of Russia as place to invest, and here the picture is much less rosy.

Russia’s population has fallen from about 148 million persons in 1990 to about 144 million today. This simple figure of a decline in population of 4 million understates the problem, however, because it includes the impact of net migration. Following the collapse of the Soviet Union, Russians living in ex-Soviet countries returned to Russia in large numbers: according to official estimates, net immigration into Russia during this period amounted to almost 4 million persons. Had it not been for these people, the population decline in Russia would therefore have been 8 million, not 4. Moreover, the supply of Russians abroad is finite, and not surprisingly, net immigration rates have fallen sharply over the past couple of years, from an average of over 300,000 per year in 1990-2000 to only 75,000 per year in 2001-02.

Unlike the situation in Western Europe, the population problem is not simply one of falling birth rates. These have indeed declined, from about 15 births per 1000 in 1970s and 1980s, to about 8-10
during the 1990s through to today. This is not far from the West European average of about 10 births per 1000 persons. What makes Russia different, and is just as important in driving the population decline, has been a sharp rise in the death rate, from 9 to 11 per 1000 persons prior to the collapse of the USSR, to 13-16 per 1000 since. Nor has the death rate shown any sign of coming down during the recent period of economic growth - if anything, the death rate has actually risen during this period. Russia’s last reported crude death rate of 16.3 per 1000 persons gives it a rate as high as that found in sub-Saharan Africa, the region with the world’s highest death rate. In Russia, this is largely a male phenomenon: female life expectancy has been fairly steady at about 72 years for the past decade or so, whereas male life expectancy has actually been falling, and stood at just under 59 years in 2002.

In some sense, the fact that the rising death rate has been a key factor in the population decline is cause for some encouragement when making medium/long run forecasts. We do not expect the death rate to keep rising, and as health care standards rise as the rest of the economy grows, and tastes in alcohol continue to shift away from spirits and towards beer and, more recently, wine, male life expectancy should bottom out and death rates start to fall. The possibility of a further fall in fertility rates is a real one, but the big demographic question mark is HIV-AIDS. The number of reported HIV cases in Russia is still relatively small, but the rate of growth of HIV cases in Russia is one of the fastest in the world, and the suspicion is that the true number of cases could be 5 times the reported number - one estimate puts the total number of HIV cases at about 1 million. The bad news is that transmission rates in Russia are high (due in part to widespread needle-sharing amongst drug users); the good news is that the problem is starting to be taken seriously - in April 2003 the World Bank approved a $150 million loan aimed at controlling tuberculosis and AIDS. Hopefully the worst-case scenarios will be avoided.

Russia as a European vs. a Pacific Rim power

From the perspective of observers based in the UK, it is natural to think of Russia as a European power, with most of its trade directed towards the West. While not wholly misleading, this standpoint misses out some increasingly important features of Russia’s position in the world. In particular, Russia itself has to look both East and West. It is a Pacific Rim power, albeit still only a small player in that part of the world. Also, the country is conscious of the rapid rise of China, set to become the largest economy in the world in not much more than a decade or two. Hence the “Asian dimension” of Russian trade policy - and economic policy more generally - although somewhat outside the limited scope of this paper, is certain to assume increasing importance in the medium term.

The business environment, the Yukos affair, and FDI

At the time of writing, the Yukos-Sibneft merger, which had been almost completed and would have created the largest oil company in Russia, was unravelling following Sibneft’s recent decision to “suspend” its proposed merger with Yukoil, which in turn followed the recent arrest of the chief executive of Yukos, Mikhail Khodorkovsky, on charges of fraud and tax evasion. This arrest sent shockwaves through the foreign investor community in Russia, led to an immediate sharp fall in the Russian stock market, and has stimulated renewed questioning about business and government relations in the new Russia. The announcement on October 30th that the 44% of Yukos shares controlled by Mr Khodorkovsky were being “frozen” by the Russian government makes such questioning even more urgent. Such heavy-handed intervention from the Kremlin is another demonstration that the implementation of business law and regulation in Russia still falls well short of what we find in Western countries. The way in which the Yukos leaders were pursued (beginning with Yukos shareholder Platon Lebedev in the summer), the freezing of Mr. Khodorkovsky’s shares
despite the fact that they were technically the property of two international companies, the apparent direct involvement of the government, all cannot but send a very worrying message to the whole investment community, including many potential foreign investors.

Will this, in fact, deter foreign investors in the short run to any significant extent? We think this is unlikely. The Yukos affair appears to be an altercation between politicians and domestic business, and indeed the latest in a series of such altercations: first Boris Berezovsky, who left Russia in 2000 for self-imposed exile in London after falling foul of the Kremlin, and media baron Vladimir Gusinsky, who lost his independent television channel in the process, and now Mr Khodorkovsky. This is essentially a domestic quarrel, and it’s in the interest of none of the parties involved to put off foreign investors. Indeed, some of the oligarchs may react to the Kremlin’s programme by cashing out, and foreign businesses are amongst the obvious buyers. This would be a paradoxical but quite plausible short-run outcome - a worsening of the general business environment and at the same time an increase in FDI opportunities.

The Yukos affair is clearly a step backwards in the development of a modern set of economic institutions in Russia. To take one example, Yukos was a leader in promoting business transparency in Russia, a standard ingredient in good corporate governance. Some reports, however, suggest that this openness by Yukos made it easier for the prosecutors to find what they were looking for. Even if unfounded, other Russian businesses will not be encouraged to emulate Yukos in at least this respect, and corporate governance in Russia will take a knock as a result. The bigger question concerns the longer run. There is a general consensus amongst Western economists and analysts that a sound business environment is a necessary ingredient for sustainable growth. So long as the Russian reality of the rule of (business) law remains this far from the ideal, large question marks will remain over whether Russia can maintain high growth rates through this decade and beyond.
Conclusions - Investing in Russia

In this paper we have outlined Russia’s economic reforms during the 1990s and have reviewed the still evolving business environment, noting that while still far from perfect, the environment is getting better all the time. Russia’s public finances are stable, the country’s trade regularly turns in big surpluses, and most business has been in private ownership since the mid-1990s.

Against this generally positive background, levels of FDI have been rather low, rising a little in the late 1990s, falling back again in the wake of the 1998 financial crisis, and only very recently picking up strongly. 2003 is turning out to be record year for FDI, and we expect the higher levels of capital inflows to continue.

The headline deals have mostly been in the energy sector, mostly in oil but with some large deals coming along in the gas sector, too. However, the prominence of the energy sector has tended to mask the diversity of investment in other sectors such as retailing, food processing, hotels, and the like. In the coming years, we expect Russia to offer massive opportunities for foreign investors, not only in these familiar sectors, but also in major sectors of manufacturing such as vehicles, aircraft, steel, and various high-technology branches. These are sectors that Russia will need to develop in order to produce manufactured goods that can compete in the world market, and our view is that Russia’s leadership - although still influenced sometimes by sector lobbies demanding protection - understands that openness to FDI will prove the most effective way towards successful development for Russia.
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Biographies

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