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An analysis of EU FDI inflow into Russia☆

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Abstract

This paper analyzes the trends and drivers of inward foreign direct investment in Russia between 2009 and 2019. The EU is the premier provider of FDI into Russia, even though we find that reported values overstate its role given the use of Special Purpose Entities (SPEs). Key drivers of Russian FDI flows are the price of oil and natural resource markets, macroeconomic volatility, monetary policy, sanctions and trade impediments. As FDI is highly concentrated in natural resource rich regions, we argue that a sectoral decomposition understates the importance of fossil fuel extraction. Based on this analysis as well as the literature on growth effects of FDI, we argue that Russia needs more investment into higher-value added activities.

Keywords: foreign direct investment, economic growth, Russian economic development.
JEL classification: E65, F21.

1. Introduction: State of play

The Russian economy has seen a turbulent last decade throughout which it was deeply affected by the Great Financial Crisis (GFC) and the collapse of commodity prices (especially oil) that begun in 2014 and did not fully stabilize until 2016. FDI during this period experienced a medium to high degree of volatility, driven by several key drivers. Firstly, the evolution of the oil market has been a key determinant: not only is oil Russia's core export, the oil industry is an important destination of FDI. Russia's dependency on oil has made direct investment highly vulnerable to changes in the oil price. At the same time, partially given the pressure that depreciating oil places on the currency and the wider

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economy, the macroeconomic environment has been highly unstable. Monetary policy has been paramount in mitigating these effects. In this regard, the evolution of the exchange rate regime has had an important influence, with mixed success. Additional effects on FDI relate to the wider role of the Russian economy internationally. This includes aspects such as trade, which remains closely interrelated with this category of investment, as well as Western sanctions (and Russian countersanctions) that heavily targeted medium-term financing capabilities.

This paper examines how Russian FDI inflow has fared in the last decade taking into account these core drivers of FDI flows, inherent to the Russian economy. With this in mind, before delving deeper into the dynamics behind FDI, it is worth establishing a more detailed picture of the Russian environment.

The recent evolution of the Russian economy has been largely discouraging: in the decade since the GFC (2008–2018), average annualized growth of Russian nominal GDP (in dollars) was in fact slightly negative. The GFC resulted in an important drop in GDP, even though the economy largely recovered quickly given the monetary and fiscal response. A second downturn took place between 2014–2015, spurred by the collapse of the currency (which in turn had been put under massive pressure by the oil price collapse and Western sanctions). The rouble lost over half of its value against the dollar, yet central bank efforts ultimately stabilized the currency and decreased inflation (which was at 2.5% in 2017 from 12.9% in 2015).[1]

At the same time, Russia faces important institutional challenges. Firstly, Russia has an ageing population which is expected to shrink by 7% by 2050.[2] Economic growth will be necessary to support the growing share of retirees with a shrinking labour force. Similarly, the business climate is also lacking, corruption is high (Russia was ranked 138th in Transparency International's corruption perception index[3] and 84th in the international property rights index[4]). That said, the World Bank *Doing Business* report has placed Russia an encouraging 28th in 2019.

Many of these systemic obstacles in the Russian business environment relate to the shift in corporate ownership during the transition to a market-based economy. Unlike other Warsaw Pact countries, Russia decided to privatize state-owned enterprises (SOEs) through first a voucher system and then a share-for-loans scheme. This resulted in a heavy domestic concentration of wealth and rendered FDI negligible (in contrast with countries like Poland which actively sought foreign investment).[5] A high degree of vertical integration of privatized former SOEs provided few opportunities for foreign companies; most FDI focused on extracting resources and as such resulted in very limited spillover. It remains concentrated in Moscow, St. Petersburg and oil-heavy regions.

Finally, Russian economic dependence on European investment is high, despite political attempts to diversify. Given growing EU decarbonization efforts, international isolation and structural issues it does not bode well for Russian investment and growth.

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[1] See Dabrowski (2019).

[2] OECD Historical population data and projections (1950–2050), https://stats.oecd.org/Index.aspx?DataSetCode=POP_PROJ#

[3] https://www.transparency.org/cpi2018

[4] http://internationalpropertyrightsindex.org

[5] See Di Bella et al. (2019).

2. Literature review

The Russian economy has received considerable attention in recent decades, with numerous studies delving into its systemic limitations and the drivers (and obstacles) of foreign investment. This section provides a brief overview of said literature.

Firstly, Kuznetsov (2010, 2012) analyses the geographical and sectoral division of FDI into Russia highlighting the primary focus on oil and gas and pointing to other industries important for FDI. Kuznetsov and Nevskaya (2017) explore flows from Visegrad countries, highlighting the role geographical proximity with certain Russian regions plays in this regard. Additionally, Kuzmina et al. (2014) find poor governance quality to have a significant effect on inward FDI into Russia.

A broader overview of the Russian economy is provided by the IMF's country report on Russia (IMF, 2017) including macroeconomic and microeconomic environment; it diagnoses the main causes of economic deterioration. Dabrowski and Mathieu-Collin (2019) also provide a detailed study of the recent performance of the Russian economy. This study focuses on the factors that have been a hindrance to growth, factors which have also reduced the attractiveness of the Russian economy to foreign investment. Some of the issues discussed include the poor demographic outlook and a business climate lacking many of the informal institutions conducive to growth. The authors also discuss the role played by the energy sector in the Russian economy and the effect of geopolitical isolation and Western sanctions. Similarly, Drobyshevsky et al. (2018) analyze Russia's growth rate and the underlying dynamics that have determined it. Hanson (2013) explores both supply and demand side limitations to Russian growth, while Di Bella et al. (2019) look at the role of the Russian state in the economy, the inefficiencies that arose because of the method of privatization after the fall of the Soviet system and enduring side-effects on the ensuing economic model of concentrated power where business and politics remain interrelated. Finally, Dabrowski (2019) analyses the performance of emerging markets during both the financial crisis and collapse of the commodity prices in 2014–2016 (the oil market fared particularly badly). Russia, as well as other former Soviet republics, are signalled out for having been unduly affected in both instances, the causes for this subsequently explored.

An important body of literature has centered around FDI's role in economies that rely heavily on energy exports (chiefly oil) as is the case of Russia. Poelhekke and van der Ploeg (2013) show that FDI into natural resources can cause a crowding-out effect that can greatly reduce FDI into other industries (going as far as reducing total FDI). They also find a large windfall to be particularly damaging (e.g. the discovery of new resources). Hayat (2018) finds that natural resources reduce the growth effect of FDI to the point that it can become negative. Krugman (1987) develops a simple trade model with learning-by-doing that explains how, through the "Dutch Disease", competitiveness in non-resource sectors can be lost permanently due to natural resources. Finally, Zimin (2013) explores the role oil has played in EU–Russia economic relations, with a specific focus on associated infrastructure.

On monetary policy and exchange rate volatility, the Central Bank of the Russian Federation (2013) provides an overview of the evolution of monetary

policy in Russia since the collapse of the Soviet Union, and the gradual transition from a heavily controlled exchange rate to an inflation targeting system.[6] Additionally, Korhonen and Nuutilainene (2017) take this gradual evolution in the monetary regime, to explore whether a significant change in the effects of monetary policy can be identified as a consequence. They find that early 2015, around the time the inflation-targeting system was introduced, was an important turning point, which is marked by a break of the estimated Taylor-rule. They further describe central bank efforts to mitigate capital flight during periods of economic (and currency) weakness.

3. Overview and origin of FDI inflows

In the last decade, FDI has seen a medium-to-high degree of volatility, in line with a tumultuous macroeconomic environment. This section will break-down the evolution of FDI inflows into the Russian Federation and its main points of origin.

Fig. 1 exhibits FDI stocks in Russia divided by major international players. During the period examined (2009–2017) European investors owned between 55% and 75% of Russian FDI stock (and regularly made up a large percentage of flows as evident in the graph) according to reported figures. Hence, Russian economic dependence on European investment is high. Regardless of recent efforts to diversify, Chinese investment remains orders of magnitude smaller. Fig. 2 thus breaks down stocks by EU member states or groups thereof.

That said, it is important to recognize that in recent years global FDI flows have been characterized by the prevalence of Special Purpose Entities (SPEs) and other conduits that are employed to minimize tax exposure and hide the ultimate origin of capital. This results in relatively small countries registering both FDI inflows and outflows many times those expected for a country of their GDP, flows that often do not "touch ground." A panoply of studies has arisen that look to identify Ultimate Investing Country (UIC) and Ultimate Host Country (UHC). In order to illustrate this possible divergence, the second graphs in Fig. 1 and Fig. 2 present the estimates by Damgaard et al. (2019), who identify genuine origin of foreign investments. While these graphs indicate that flows from the EU are somewhat overstated, it remains by far the premier provider of FDI into Russia.

At the same time, the significance of the EU is heightened when one considers that the second largest origin of FDI appears to be the Russian Federation itself. This investment is by construction not genuinely foreign; if subtracted from the total the EU becomes the consistent owner of over 50% of Russian FDI stock. Similarly, UNCTAD[7] has also sought to estimate the ultimate origin of flows using a different methodology (which nonetheless leaves the origin of 28.2% of inward FDI stock to Russia to be "Confidential/Unspecified").[8] This study does indicate that US values are understated: almost 8.9% of stock of inward FDI into Russia in 2017 is thought to have originated in the US, in contrast with the 3.2%

[6] The paper interestingly finishes with a debate on the latter which had, at the time, not been fully implemented.
[7] See Casella (2019).
[8] While Damgaard et al. (2019) estimate the UIC and UHC using firm surveys, UNCTAD does so using Markov chain estimations.

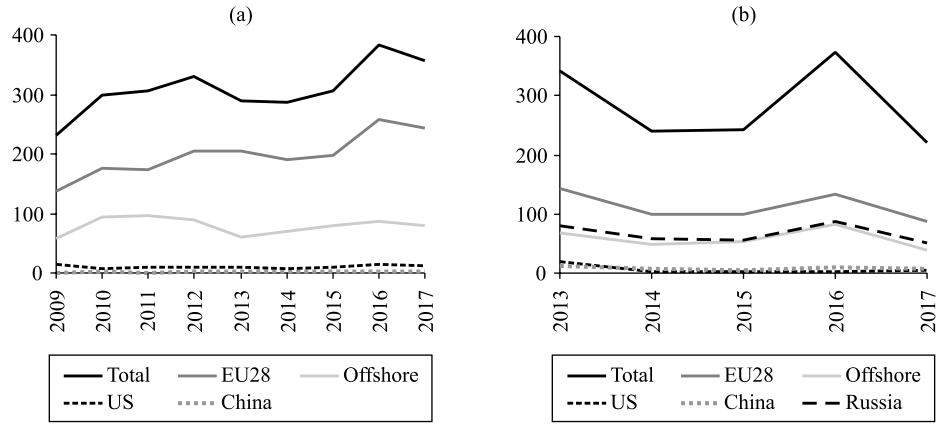

Fig. 1. FDI stock as reported (a) and ultimate investing country (UIC) estimates (b) (EUR billion).

Note: Offshore is the aggregate of UK Caribbean, the Bahamas, Bermuda, Panama and the Seychelles.
Sources: European Commission Finflows (Joint JRC-DG ECFIN database); Damgaard et al. (2019).

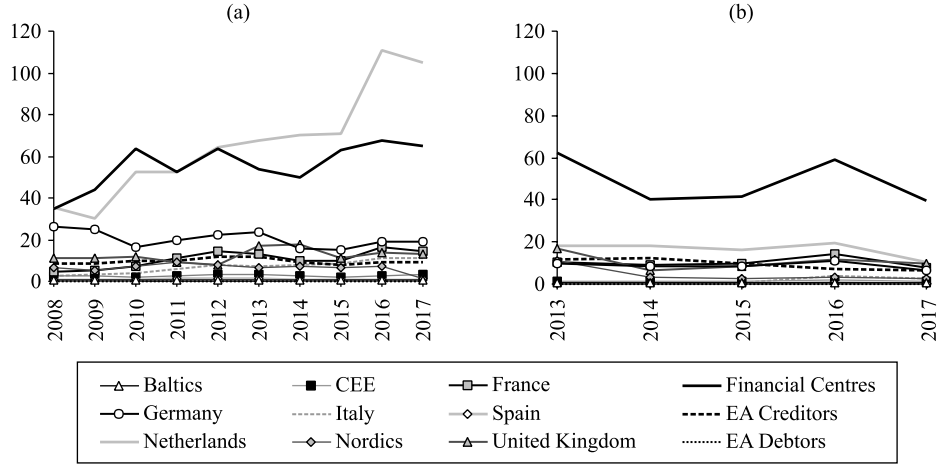

Fig. 2. FDI stock as reported (a) and ultimate investing country (UIC) estimates (b), EU breakdown (EUR billion).

Note: The following groups have been employed: Baltics (Estonia, Latvia, Lithuania), CEE (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia), EA Creditors (Austria, Belgium and Finland), EA Debtors (Portugal and Greece) and Financial Centers (Cyprus, Ireland, Luxembourg and Malta).
Sources: European Commission Finflows (Joint JRC-DG ECFIN database); Damgaard et al. (2019).

seen in reported data. However, this remains small when contrasted with that of the EU (which is the origin of close to five times more FDI stock).

Finally, offshore exhibits similar values when looking at reported data and UIC estimates. Even within the EU, after estimating the UIC a substantial part of FDI stocks still originate from financial centers, potentially hiding other origins. This indicates that while the estimation method implied managed to identify the UIC for some countries (like the Netherlands), it failed to do so for more opaque jurisdictions. It is plausible (indeed likely) that the majority of the investments coming from these financial centers originate from other countries, including Russia itself.

With this in mind, perhaps the first insight provided by the geographical breakdown of flows within the EU is the similarity in patterns between member states. While these member states operate from within the same regulatory framework (and often the same currency), bilateral relationships with Russia vary significantly and are affected by long-standing historical ties. Despite this (and leaving aside the differences in size) the trajectory followed by FDI inflows shows ample similarities between the exhibited groups (this is even more evident in data for flows than stocks), with key peaks and troughs being largely universal. This is a strong indication of the extent to which the volatility of the Russian environment dominates dynamics (be it through oil or macroeconomic instability) as well as, to a lesser extent, EU-wide geopolitical factors. Certain points of note include the small presence of Germany, only exacerbated in UIC estimates. In fact, German stock of Russian FDI has fallen gradually throughout the examined period. At the same time, French FDI stocks in Russia remain small, even though flows increased recently. The UK exhibits low stock values yet flows are volatile and prominent, as the absolute value of gross flows is large but fluctuating close to zero. This would indicate that these investments remain speculative and short-term. Part of this might be driven by Russian investors directing funds abroad through British entities.

At the same time, in line with our initial point, several member states clearly stand out for their outsized role, especially in officially reported figures. Firstly, the significance of the Netherlands is evident. While the Netherlands enjoy large net outflows of "genuine" FDI, they also hold a large number of SPEs which likely inflate official reported values. Indeed, UIC investment from the Netherlands is estimated to be much smaller, for a total stock of around 10.3 billion euro in 2017 (in stark contrast to the 105 billion euro found in reported figures). The financial centers category also plays a disproportionate role — the members of this group are chosen precisely because of their large balance sheets relative to GDP. Cypriot subsidiaries specifically host large amounts of assets for wider Russian entities, occasionally repatriated as FDI. However, these numbers remain within the same ballpark both for reported figures and the UIC estimates presented. It is plausible to assume that these flows are not originally from Cyprus, but hide capital from other countries, potentially from Russia itself.

4. Drivers of FDI flows

Following this geographical division, this section will tackle thematic drivers of the evolution of FDI. These are divided into three main subsections: the energy sector, macroeconomics and monetary policy, and the international context (from trade to institutional obstacles).

4.1. The energy sector

The energy sector, most notably oil and gas, plays a predominant role in the Russian economy (as the source of over half of exports and the vast majority of their foreign currency reserves) and is the focus of a significant percentage of FDI inflows. The two main episodes of declining FDI (2009 and 2014) happened at a time of collapse in the price of oil, which on both occasions lost over 50% of

Fig. 3. Brent crude oil price (U.S. dollars per barrel).

Note: Values after October 2019 reflect the futures market. The Brent benchmark is employed as a proxy for the oil market. In March 2020, after the submission of this paper, the price of Brent declined further.
Source: Bloomberg.

its value within the span of a few months. Furthermore, in 2011 (which represents another instance of declining FDI), the price of oil declined by almost a third, even though it recovered fairly quickly.

The fall in oil price during these episodes (especially in 2009 and 2014) was driven by declining global demand, which since 2014 appears to be structural (the oil futures market would indicate there is little expectation of a recovery, as evident in Fig. 3). This, combined with an ambitious pledge to turn towards green energy in the EU (the premier consumer market for Russian oil and gas), presents a discouraging medium-term outlook for FDI into Russia. Even though FDI flows saw some level of recovery in 2016 despite the new (lower) equilibrium oil price, this recovery appears to have since partially subsided.

Beyond these overall patterns, sectoral and regional distributions of FDI provide a greater insight into the role played by the energy sector. Fig. 4 shows data by the central bank on the sectoral distribution of FDI inflows for the four major sectors (while data for 22 sectors is provided, the remaining ones play a fairly negligible role and are all grouped in *other*). These four sectors are *wholesale and retail trade, mining and quarrying (which according to the guidelines consists almost exclusively of fossil fuels)*, *manufacturing* and *financial and insurance.* It should be noted that the growth rate of the Russian GDP fluctuates quite substantially, contributing to some of the volatility seen in the graph.

This picture is complemented by additional central bank data which distributes FDI inflows regionally. Excluding the wider Moscow area and, to a smaller extent, St. Petersburg, the oil and gas heavy Tyumen region (without its autonomous provinces) and the autonomous province of Yamalo-Nenets (Gazprom's main hub) accounted for 45% of all remaining FDI in the first quarter of 2019 (the rest is shared between the remaining regions). These regions are fairly small, with little other economic activity. Other regions such as Sakhalin Island and Krasnoyarsk Krai, where oil is also an important part of the local economy, also rank highly. This indicates that sectoral data could underestimate

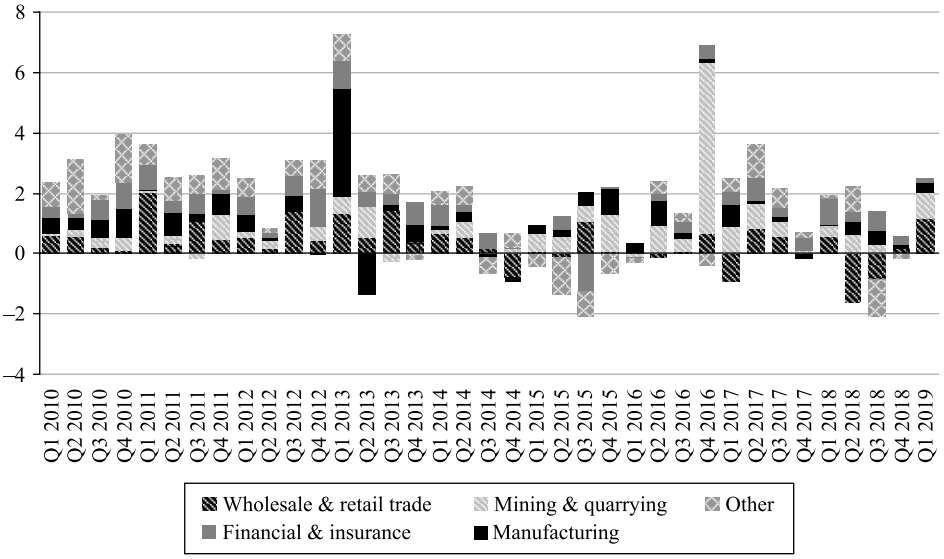

Fig. 4. Gross FDI flows per sector (% of GDP).

Note: Quarterly FDI figures are divided by quarterly FDI.
Sources: Bank of Russia; IMF (2019).

the importance of the energy sector when contrasted with regional data. Some of the non-mining and quarrying investments appear to be going into the businesses directly related to oil and gas extraction. After all, the extraction process is made up of many other required activities beyond explicit mining and quarrying, yet these are reflected in different sectoral categories and as such are very hard to disentangle.

The previous data indicates that a large proportion of overall FDI into Russia is directed to the oil and gas industry, especially when Russia's two large cities are excluded. This has important implications. Studies have shown that the concentration of FDI into natural resource sectors negatively affects the GDP of the Ultimate Host Country (UHC). Poelhekke and van der Ploeg (2013) not only show that FDI into natural resources crowds-out FDI into other productive industries, but also that this can be magnified to the extent of resulting in lower overall FDI. The impact is particularly poignant when natural resources are first discovered. Hayat (2018) finds that natural resources reduce the growth effect of FDI to the point that it can become negative. At the same time, there is a low spillover effect associated with natural resource extraction given that it is typically an activity that requires few local inputs. Thus the growth potential is low, in contrast with FDI into manufacturing and technology.

At the same time, these values underestimate the extent of FDI activity that enters and exits Russia regularly. Ultimately, gross inflows represent the net acquisition of assets by foreigners in Russia and as such can be negative (net flows would be the net acquisition of assets minus the net acquisition of liabilities).[9] Given that FDI represents a medium to long term investment, this typically provides an accurate depiction of overall FDI activity. However, in the case of

[9] See Claeys et al. (2019) for a more detailed explanation

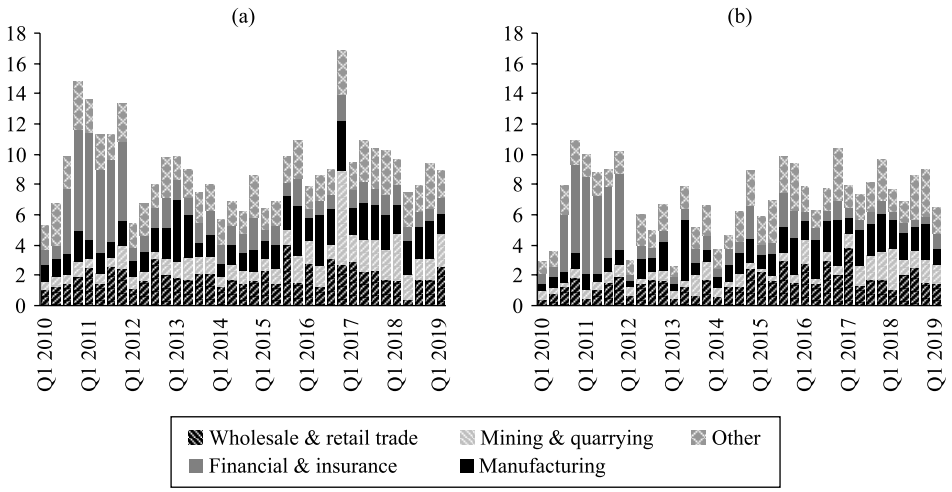

Fig. 5. Gross foreign acquisition (a) and sale (b) of Russian assets per sector (% of GDP).

Notes: Quarterly FDI figures are divided by quarterly FDI.
Source: Bank of Russia; IMF (2019).

Russia, there is a fair amount of short-term FDI that partially stems from the fact that a non-negligible percentage of FDI into Russia ultimately originated in Russia itself, but was previously re-routed through foreign entities, as well as the nature of FDI into sectors like oil which can be more volatile. Fig. 5 thus presents the gross acquisition of assets in Russia by foreign investors and gross sale of assets in Russia by foreign investors for the same time period (which net out to the values in Fig. 4). The size of these values is very large while the extent of financial sector activity (both in gross acquisitions and gross sales) in 2010 and 2011 stands out.

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

Furthermore, beyond the immediate damage, the effects of this period persisted after the currency appreciation was reversed. The IMF (2017) reports that the bursting of the resource bubble has not led to a reversal of the Russian Dutch disease. Even though oil prices and the rouble periodically collapsed in the last decade, by then a crowding out of manufacturing industries had taken place (enhanced by an incomplete economic transition in the 1990s and 2000s where state aid was ubiquitous). This concentrated economic activity in the resource sector. This could not be reversed easily when the terms of trade improved.[10] The damage caused to other industries by years of concentration of economic activity and investment in resource extraction meant many could not be salvaged.

[10] For a discussion of the mechanisms see Krugman (1987).

4.2. Macroeconomics and monetary policy

At the same time, the volatile macroeconomic environment and monetary policy have affected FDI flows. In this regard, it is first worth noting that FDI flows are traditionally considered less volatile than other forms of international capital flows, as they represent a much more substantial level of involvement in a particular entity that will be harder to exit and as such, less prone to speculation. That said, the role of the macro environment is not only relevant but heightened for FDI into the oil sector, as this remains more speculative given the degree of volatility in oil markets.

The rouble has been heavily affected by changes in the price of oil in recent decades. After all, oil exports contributed the largest share of dollar reserves for a country that until 2015 regularly intervened in foreign exchange markets in order to manage the exchange rate. This volatility of the rouble has heightened many of the FDI effects of fluctuations in the oil price, although monetary policy has helped mitigate the volatility of certain episodes. This section explores two different impacts of monetary policy: firstly, the efforts of the central bank and their mitigating effect; secondly the change from exchange rate management to inflation targeting that was formalized in 2014 and its consequences.

The Russian Central Bank has actively participated in foreign currency markets in the past two decades, and used monetary policy to pursue both exchange rate and inflation objectives. Between the year 2000 and today, the rouble exchange rate has evolved from being very tightly controlled (2000–2005) to being free-floating in an inflation targeting regime.[11] That said, even in its current state, the central bank reserves the right to intervene in foreign exchange markets and to prevent undue volatility. In this capacity, they have mitigated the worst effects of exchange rate fluctuations, often driven by movements in the oil price.

Following the GFC of 2008, the Bank of Russia identified downward pressure on the rouble caused by capital flight and the erosion of the country's current account balance. They allowed the gradual depreciation of the rouble by progressively widening the currency band and simultaneously supporting the rouble through market operations, depleting a third of central bank reserves in three months in the process[12] (this is not fully reflected in Fig. 7 as it exhibits yearly data; the fall was not only recorded between 2008 and 2009 but the periods preceding and following it saw reserve growth). Similar actions were taken in 2014, when intervention played an even larger role. This is because the announcement of exchange rate flexibility had increased pressure on the currency, already weakened by the oil price collapse and sanctions (as described below). During this episode, it became important for the central bank to assuage market fears that they had allowed the currency to float freely, both by supporting the currency with reserves but also by aggressive use of interest rate policy. Their aforementioned efforts during the rouble collapse of 2008–2009 and 2014–2015 are evident in the data, both from the point of view of the main policy rate (as can be seen in Fig. 6) and in direct intervention in foreign currency markets, that caused the reduction in reserves (Fig. 7).

[11] See Korhonen and Nuutilainene (2017).
[12] Central Bank of the Russian Federation (2013).

Fig. 6. Euro-ruble exchange rate.

Source: Bloomberg.

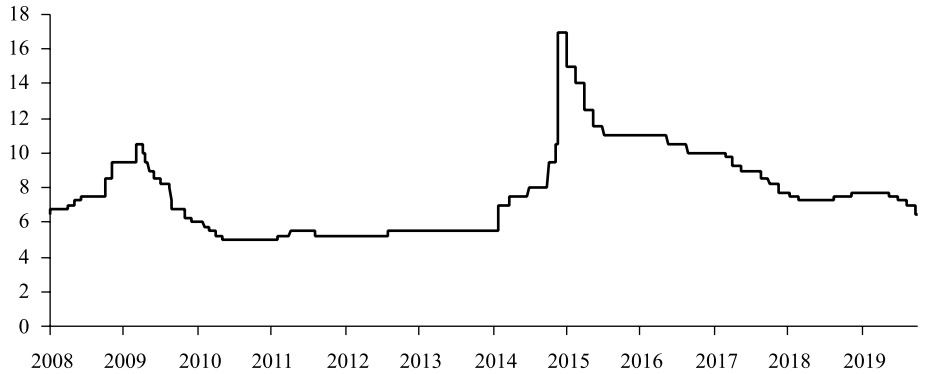

Fig. 7. One-week repo rate, percentage points

Source: Trading Economics; Bank of Russia.

At the same time, greater flexibility and the announcement in 2014 of the pursuit of a fully floating exchange rate and an inflation-targeting system had the opposite effect to the previously described policies. These announcements took place at a time when pressure on the currency was mounting and likely contributed to the heavy depreciation of the rouble. The implication that the central bank would allow the currency to float freely naturally weakened the rouble's credibility and caused a (mild) episode of capital flight. In fact, in the ensuing months the central bank went to great efforts to support the currency, partially subverting monetary policy to this end. While officially the exchange rate target was given up in November 2014, the central bank intervened heavily to prevent the collapse of the currency up to the end of 2014 and in the first weeks of 2015. Indeed, while the decline in reserves is the evidence of central bank efforts (its reserves fell by close to 30% between 2013 and 2015, see Fig. 8), this episode is characterized by the rapid rise of the policy rate as can be seen in the graph (see Fig. 7).

Overall, the effects of the currency's collapse (and ensuing negative effects on FDI) were undoubtedly mitigated by the rapid and largely thorough actions of the central bank. Furthermore, the fact that the Russian currency fared fairly well throughout 2018 and was not heavily affected by turmoil and capital flight

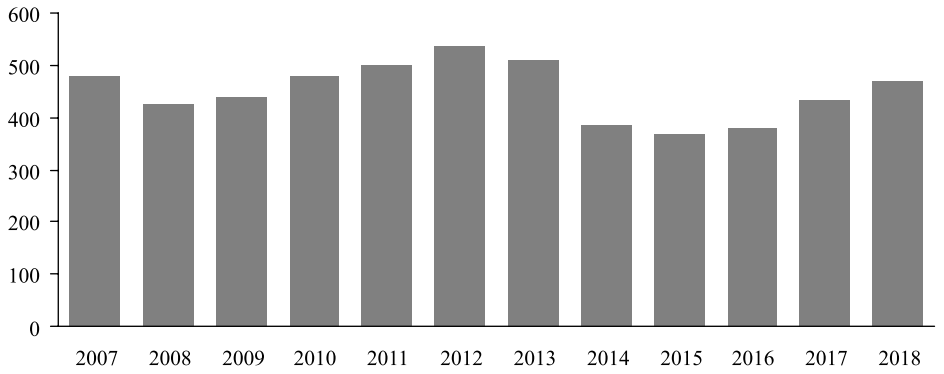

Fig. 8. Russian reserve assets (billions U.S. dollars).

Note: Reserve assets according to BMP6 (monetary gold, SDR holdings, reserve position in the IMF, currency and deposits, securities, financial derivatives, and other claims).
Source: IMF, International Financial Statistics.

in other emerging economies is a testament to the credibility of this inflation-targeting system (especially as these times of turmoil coincided with new rounds of sanctions as will be explored below).

Finally, it is worth qualifying this analysis by pointing out that while the impact of these effects is substantial, it is important to understand that the oil sector in Russia remains fairly dollarized — many contracts (both commercial and investment) are concluded in foreign jurisdictions and denominated in foreign currency. As such, they are not affected by fluctuations in the rouble. At the same time, energy companies hold fairly large shares of dollar debt (for largely dollar revenues). Therefore, FDI into the energy sector can remain relatively detached from movements in the currency, at least from the point of view of daily operations. However, the insecurity that foreign exchange volatility poses to value chain management of multinational enterprises does cause a certain degree of uncertainty, while the associated political tensions deter foreign investors. Indeed, it is worth noting that energy companies still depend on domestic revenues and costs. As such, an excessive degree of dollarization and, more specifically, a very large share of dollar debt will make companies vulnerable to large fluctuations in the rouble by raising their probability of default. At the same time, there has recently been an evolution among Russian oil giants who are widely concluding euro-denominated contracts. Indeed, Rosneft, one of the world's largest oil companies controlled by the Russian state, announced all contracts will henceforth be in euro.[13]

4.2.1. A comparison with other emerging economies, based on Dabrowski (2019)

The drivers of turbulence in Russian FDI are established throughout this paper. However, when analysing the environment of only one country, one can get lost in its inherent idiosyncrasies and lose sight of the wider picture. This paragraph seeks to avoid that by looking at how other emerging economies fared during the same time period: how their FDI inflow evolved (especially from

[13] https://www.reuters.com/article/us-rosneft-contracts-euro/rosneft-switches-contracts-to-euros-from-dollars-due-to-u-s-sanctions-idUSKBN1X31JT

the European Union) and how they were affected by the global macroeconomic environment (chiefly the aftermath of the financial crisis and the commodities prices collapse of 2014).

Firstly, it is worth laying out our choice of comparison countries. Besides the broader discussion of emerging markets, this section will establish a comparison between the situation in Russia and that of Brazil, India, Turkey and South Africa. These countries have been chosen for their similarities with Russia in several different general macro metrics; three of them are also members of the BRICS while Turkey shares Russian dependence on the EU and similarly close economic ties. All chosen countries have substantial commodity exports although, according to UNCTAD, Russia is the most dependent on commodities, which made up 76% of exports in 2017 (compared to around 60% for Brazil and South Africa, 39% for India and 22% for Turkey). The predominance of oil further enhances vulnerability to the oil price.

Secondly, it is worth looking at the overall evolution of emerging markets in the past decade. In this regard, it is important to note that this is thought to encompass a period of relative calm with no excessive contagion across countries or regions. In fact, Dabrowski (2019) finds former Soviet Union countries to be the only ones which seriously experienced "intra-regional" contagion, both in 2008–2009 and in 2014–2016. While average annualized growth of Russian nominal GDP (in dollars) was slightly negative throughout the period, it was in low single digits in Turkey, Brazil and South Africa. India vastly outperformed the others.

Thirdly, the relevance of the GFC remains significant throughout emerging markets, even though they were proportionately less affected than during past episodes. After all, the decline in global demand hurt commodity prices and the global surge towards safe assets caused large capital outflows from emerging economies, causing widespread depreciation. Turbulence in financial markets further raised risk premiums on emerging market debt. Dabrowski (2019) finds the former Soviet Union and Latin America to have been particularly affected, as was Turkey. Indeed, Russia, Brazil and Turkey saw significant falls in FDI inflows (as can be seen in Fig. 8 and will be explored below).

Additionally, the collapse in commodity prices in 2014–2016 had an important impact on emerging market economies, where commodity exports are on average a much larger percentage of economic output. While this signifies a period of important shock, Dabrowski (2019) does find that the economic fallout was more reduced than following previous episodes of oil price decline, largely given stronger macroeconomic fundamentals and the development of systems more adapt at dealing with these episodes (build-up of reserves, less constrained exchanged rates, etc.). That said, the shock was most severe for exporters of oil, which made Russia increasingly vulnerable.

Finally, these episodes had an important effect on FDI inflows into these countries; a closer look at the data is warranted. This analysis will focus on FDI from the EU for the sake of consistency. As is evident on Fig. 9, India and South Africa enjoy a much less developed investment relationship with the EU (in relation to their GDP) than Russia. This is unsurprising; the geographical and cultural ties between the EU and Russia have allowed for stronger commercial and investment flows. What remains more striking is the role played by Brazil. As of 2017, Brazil and Turkey remained *en par* in terms of EU ownership of their FDI stock, both

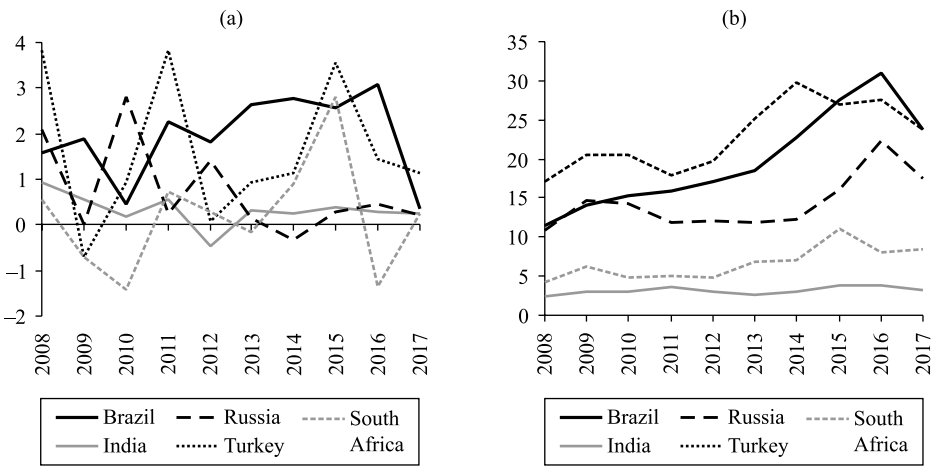

Fig. 9. EU FDI flows (a) and EU FDI stocks (b) (% of GDP).

Note: Data for Brazil, India, Russia, Turkey and South Africa.
Source: European Commission Finflows (Joint JRC-DG ECFIN database).

above Russia. In fact, while Brazil and Russia were at around the same values in 2009, Brazil has now surpassed Russia by around 7 percentage points (or over 30 percent). More generally, of the five countries, Russia is the one that sees the lowest growth in FDI stock. It grew by only 83% between 2008 and 2017, in comparison to 222% for Brazil or 303% for India.

At the same time, while the volatility of FDI flows can cloud underlying trends, of all the countries examined Brazil is the only one that receives positive gross flows every single year; values for the rest fluctuate with periods of negative flows (especially South Africa and Russia). This can explain Brazil's build-up vis-à-vis the rest. Finally, this comparison allows for an analysis of the relative volatility of FDI flows into Russia. By calculating the standard deviation of FDI flows, we can see that Russia (at 13.2 billion) ranks second in terms of volatility after Brazil (at 17.4 billion) and much higher than India or Turkey which stand at 4 billion.

Furthermore, the effects of the GFC of 2008-9 are evident for all the examined countries. Russia's values are fairly standard in this regard (albeit more pronounced in stocks than in flows). As was explained below, the effects were more strongly felt in EMEA (Europe, Middle East and Africa) and Latin America, which partially explains why India was the least affected. In contrast, Russia appears to be the most affected by the commodities price collapse of 2014. Given their much higher reliance on oil exports, this is unsurprising, especially when in tandem with the other previously described drivers. Only India also experienced a fall in flows that year, a fall which was much more limited. That said, South Africa did see a significant fall in 2016 which is thought to be partially attributable to the same episode. It is worth noting that their reliance on commodity exports is also high, albeit smaller.

4.3. International context

Finally, FDI is only one category of investment, which in itself is only one aspect of bilateral economic relations (the other prominent category being trade).

Economic relations are further affected by institutional structures, or the lack thereof, that facilitate cross-border operations. This sub-section thus explores the relation between FDI and other economic ties, chiefly trade, as well as how FDI has been affected by the institutional obstacles to a deeper relationship.

Firstly, it is important to mention that FDI and trade generally enjoy a deep level of interrelation, which has been widely established. After all, FDI provides foreign players with a domestic infrastructure that facilitates operations and can even serve as a substitute for trade when regulation so dictates. FDI can thus signal an investment into the medium-term commercial relation. Lukewarm FDI numbers between the EU and Russia are thus related to the fact that trade in goods between them has been falling for the past decade, with both gross imports and gross exports decreasing by almost a quarter between 2008 and 2018. Furthermore, in 2018 oils and mineral fuels[14] (one of the 97 categories established by the World Bank) accounted for over three quarters of Russian exports to the EU. This is in line with FDI patterns and another sign of the existence of few other areas of competitive economic activity in Russia.

At the same time, in the economic literature, the growth effects of FDI have been found to be mostly originating from knowledge transfers and spillovers.[15] A wide concentration of both trade and FDI in the energy sector indicates foreign players are clearly focused on this area. They are concerned almost exclusively with extraction, i.e. the acquisition of access to a raw material. This form of FDI rarely provides spillovers and as such has a much more limited effect on growth. On the contrary, FDI into manufacturing by multi-national enterprises could incorporate the Russian economy into global value chains and result in tacit transfers of knowledge and technology, for considerable growth benefits. Furthermore, FDI into other industries is likely to be less volatile as it will not be as heavily determined by the performance of the oil markets (as such, it should make a positive contribution to macroeconomic stability). It would further diversify exports from oil into higher value-added (and differentiated) sectors. Deepening trade relations in these sectors would then provide an opportunity to attract other forms of FDI, continuing the virtuous circle. However, Russia has high barriers to trade, mainly of non-tariff character, which means it offers little incentive for wider investments.

With that in mind, it is worth looking at the more institutional obstacles to economic relations. Overall, the environment is characterized by a lack of institutional infrastructure and recent hostility, complicating the development of closer ties.

Firstly, the Russian Federation only entered the WTO in 2012. It has also only concluded trade agreements with 10 countries, mostly from the Commonwealth of Independent States (CIS). In 2017, these free trade agreements covered only 11% of Russian exports, while EU-28 trade accounted for more than half of Russia's exports. The comparative advantages of the other members of the CIS are very similar to Russia's, with economies mostly exporting natural resources, reducing the economic value of mutual trade.[16] More importantly, given the context of this

[14] Full name "Mineral fuels, oils and products of their distillation", one of 97 categories in the first level of disaggregation of trade, World Integrated Trade Solution database.

[15] See Hayat (2018) for a discussion of the growth effect of FDI in natural resources.

[16] In 2017, minerals accounted for 25% of exports from Belarus, 61% of exports of Kazakhstan (Russia's two biggest trading partners among the CIS, recipients of roughly 80% of Russian exports under FTAs), compared to 58% of Russian exports. Source: The Economic Complexity Observatory.

paper, there is virtually no opportunity for knowledge transfer through FDI from these economies. Furthermore, according to the World Bank's *Doing Business* report of 2018, Russia has the highest cost of border compliance in its region, which is 6.7 times the EU average for exports and as high as 17 times the EU average for imports.[17] These trade impediments together with poor protection of property rights, exchange rate volatility, and the very high level of corruption mean that Russia, despite its generally high level of education, post-Soviet industrial base, and relatively large internal market, is often not an attractive market for foreign investment into global manufacturing.

Secondly, recent years have been characterized by political hostility between Russia and the West resulting in damaging economic sanctions (and the looming threat thereof) that reduced the attractiveness of the Russian market for foreign investors at a time that was presenting important opportunities for diversification. This was both because of the growing practical difficulties of investing (medium and long-term financing has been targeted), increased barriers to trade that make Russia a less attractive manufacturing hub and the overall damage to the growth potential of the Russian economy. Sanctions and ensuing tensions have a negative effect on FDI, especially beyond the energy sector, both reducing overall FDI and raising the importance of this sector further.

It is difficult to disentangle the effects of Western sanctions introduced following the annexation of Crimea in 2014 from the other factors. Nonetheless, the IMF (2015) found their immediate effect to be a 1–1.5% drag on GDP with a possible cumulative drag of 9% in the long-term (which others have estimated to be around 6%). Similarly, World Bank (2016) estimates indicate the removal of sanctions would have resulted in 0.9 pp. higher growth in 2017. Furthermore, the impact on the financial system was undoubtedly larger: the closure of international capital markets at a time of currency crisis for Russian banks aggravated the financial situation, resulting in large bailouts by the central bank and the National Wealth Fund.

The new rounds of US sanctions in 2018 had a limited effect but were targeted at Russian elites. Both episodes were followed by minor rouble depreciation, which nonetheless coincided with a time of generalized capital outflow from emerging markets. Finally, the possibility of future sanctions deters investors given the potential legal uncertainty.

5. Outlook and policy challenges for the EU–Russia relationship

Russia is facing a window of opportunity to modernize its economy and progress up the value chain, or it will face significant economic headwinds given its fossil-fuel based ageing economy. Demographic change poses an important challenge to growth, while the dependency ratio is only held back by a low life expectancy among men. Meanwhile, current economic activity relies heavily on European investment and the European market, yet natural resources remain at the core of the relationship. Given European efforts to go green, this source of activity remains highly threatened in the medium term (see Zachmann, 2019). McGlade and Ekins (2015) estimate that up to 59% of gas reserves and 19% of oil

[17] Drobyshevsky et al. (2018) estimate that the trade isolation is reducing Russian GDP growth rates by 1.1 percentage points per years.

reserves of former Soviet Union countries would be "stranded" with the implementation of the Paris agreement's 2° Celsius goal. At the same time, Rodrik (2016) argues that given the advancement of automation, manufacturing might soon cease to be a feasible base for development. Furthermore, the opportunity to hedge European fossil fuel demand with Chinese demand remains limited.

That said, Russia is well located to be the host of the outsourced manufacturing of European economies. The EU can offer FDI in high value-added activities, while China remains a competitor in lower- and medium-level segments of the value chain and the US is a net exporter of oil with even higher foreign policy tensions with Russia.[18] However, foreign investment remains deterred by macroeconomic volatility, poor institutions and international isolation (sanctions).

The new European Commission has stated its aim of becoming a "Geopolitical Commission." While geopolitics lie outside the scope of this paper, the challenge posed by Russia has been widely recognized. Large parts of Eastern and Central Europe will remain reliant on Russian fossil fuel exports for their energy needs in the near future, providing Russia with political leverage (as shown by Nord Stream 2 controversy) which it is free to exercise. That said, Russian economic dependence on Europe is very significant and provides the EU with substantial clout. Europe's strong advantage in high value-added sectors raises the value of European FDI. In the right investment climate, Russia could benefit considerably from this, which could form the base of a more sustainable growth. A higher diversification of the Russian economy would not only allow for the spread of knowledge and technology spillovers through manufacturing, it would also increase the stability of the macroeconomic environment and reduce pressure on the rouble from oil price fluctuations. It would also gradually wean Russia off a sector with very poor medium-term prospects.

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