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Abstract

Since the global crisis of 2008-09 Russian government policy statements have become more favourable to foreign business. At the same time measures of the business environment in Russia continue to depict it as poor. In 2010 and early 2011 the net outflows of private capital from Russia, observed in 2008-09, continued. Is the institutional setting for inward foreign direct investment in Russia being improved in line with policy objectives? In this paper evidence from official statistics, surveys and case-studies is brought together to provide an answer to this question. JEL F21, F23, P16

KEYWORDS: Russian economy, innovation, foreign direct investment

The questions addressed in this paper are the following. Has the new priority for 'modernization' in Russian policy led to an improvement in the business environment for foreign direct investors? If it has not already had this effect, is it likely to generate some improvement in business conditions in the near future? To answer these questions we will look first at the background to the new priority and at some recent policy developments, then at the contribution that technology transfer from abroad could make, and then at evidence of changes in business conditions and foreign direct investment flows. The evidence considered comes chiefly from statistics of capital flows and surveys of business conditions. The experience of several companies is cited to illustrate more general propositions

1 THE GLOBAL CRISIS AND RUSSIAN POLICIES

The emphasis in Russian policy on economic diversification and technological upgrading is not entirely new, but it appears to have been stepped up as a result of the global financial crisis of 2008. Russia's experience of that crisis was brief but harsh. GDP fell for four consecutive quarters, between mid-2008 and mid-2009. The decline in output between the two years, at 7.8%, was the largest experienced by any G-20 nation. This followed a period of almost a decade of growth averaging 7% a year (GDP) and appreciably faster growth than this in real personal incomes.[2] The change in fortunes produced by the crisis was more dramatic for Russia than it was for other large economies..

The 2008-09 recession has been followed, not by a return to pre-crisis rates of growth, but by expansion at about 4% a year. This is widely expected to be the rate of growth for at least a few years to come.[3]

[2] Rosstat data. See http://www.gks.ru/free_doc/new_site/vvp/tab2a.xls , last accessed September 2, 2011. The higher rate of growth of gross domestic income than of GDP, and therefore of personal real incomes and consumption, was sustainable as long as Russia's terms of trade continued to improve. This meant (approximately) that domestic prosperity could rise faster than domestic production as long as oil prices continued to surge.

[3] See for example the World Economic Outlook database of April 2011 (http://www.imf.org/external/pubs/ft/weo/2011/01/weodata/index.aspx , accessed September 2, 2011). The IMF projects growth at around 4% through 2016. A double dip recession in the developed world, or simply a prolonged period of very slow growth there would tend to worsen projections for Russia.

Together, the shock of the crisis and the disappointment of a comparatively modest rate of recovery have prompted some shifts in economic policy, as set out by the leadership. A heightened priority for something called ‘modernization’ can be traced back to Medvedev’s September 2009 blog, ‘Go, Russia!’[4] This was read by many as a rallying cry for a broad social, political and economic liberalization. The emphasis, however, is economic. The president asked, ‘[S]hould a primitive economy based on raw materials and endemic corruption accompany us into the future?’ He went on to say the following.

> *In the coming decades Russia should become a country whose prosperity is ensured not so much thanks to commodities but by intellectual resources: the so-called intelligent economy, creating unique knowledge, exporting new technologies and innovative products.*

Both Prime Minister Putin and President Medvedev now head commissions on modernization. The original ‘Putin’ strategy for growth to 2020, published in 2008, is being revised. An interim expert report on the new strategy was released in August 2011 (Interim Report 2011; it runs to 517 pages).

That report notes (p. 28) the desirability of raising inward foreign direct investment (IFDI), not merely in absolute terms but as a share of total fixed investment. This objective was already implicit in policy initiatives associated (mainly) with President Dmitrii Medvedev: the reduction in the number of enterprises classified as strategic (and therefore not readily open to foreign involvement) and the encouragement of foreign firms to invest in the ‘Russian Silicon Valley’ project at Skolkovo. The sharp upward revision of privatization plans, approved on August 1, 2011, may also be seen as an opportunity for foreign strategic investors to acquire stakes in several leading, hitherto state-controlled, companies such as the VTB bank, the Alrosa diamond company, the oil company Rosneft and others, though it remains to be seen how open these asset sales will be (Tovkaylo, Lyutova and Kostenko 2011).

The Interim Report calls for (amongst many other things) a reduction in corruption, the removal of barriers to market entry and better protection of property rights. All of these objectives would, if achieved, facilitate foreign investment. All are part of the litany of reforms that liberal critics of the present system have been calling for in recent years.

[4] http://eng.news.kremlin.ru/news/298, accessed 17 February 2011.

What is new, it can be argued, is that more members of the policy elite now see such reforms as desirable, and the task of revising the growth strategy has been given to economists of the Higher School of Economics and the Academy of the National Economy, whose views are on the whole liberal.

2 TECHNOLOGY TRANSFER AND INWARD FOREIGN DIRECT INVESTMENT

It is reasonable to suppose that a state bent on ‘modernization’ would want to encourage inward foreign direct investment (IFDI). Such investment can assist an emerging economy to move towards the productivity levels of advanced economies. It may not be an absolute necessity: after World War II Japan caught up with the developed West while remaining largely closed to IFDI. But IFDI is at least potentially helpful, and Japanese circumstances may have been exceptional.

Technology transfer in some form is by definition part of the catching-up process. Labor productivity and hence (other things equal) average levels of prosperity in any nation can be raised by a number of influences: new natural-resource discoveries, economies of scale, the building-up of more physical capital per worker with unchanged technology, improved skills and training, better management, the movement of labour and capital from less to more productive lines of economic activity – and by the adoption and diffusion (increasingly wide use) of previously unused production processes: previously unused, that is, in the country in question.

Russia in 2009 had productivity levels that were far behind those of Western Europe or North America. Here are some numbers to illustrate this.

TABLE 1. GDP PER EMPLOYED PERSON, 2009, IN ‘000 US PURCHASING POWER PARITY (ppp) $

Russia	30.5
Germany	69.9
USA	100.9

Sources: IMF World Economic Outlook (WEO) database of October 2010, with Russian employment numbers from http://www.gks.ru/bgd/regl/b10_01/1ssWWW.exe/Stg/d12/3-2.htm, accessed April 20, 2011.

Part of the process by which Russian labour productivity could and should rise (and has been rising) in the long run is to do with the domestic factors listed above. Another part of the gains in productivity over time, however, could and should come from the diffusion to and within Russia of technologies originating in other countries. This might come about through IFDI, through the installation of foreign machinery embodying new technologies, through the purchase of licences and through copying, with or without industrial espionage. Russia, as a medium-developed country, can absorb a great deal from abroad – an advantage that the handful of advanced economies that are already on or close to the world technology frontier do not have.

Russia is already, regardless of leadership policies, absorbing a great deal of foreign technology in the form of equipment imports. Around four-fifths of all equipment installed in recent years has been imported. A comparison of Russian Customs data for machinery imports (from all sources) and Rosstat data on machinery and equipment investment suggests that at least that proportion of machinery investment consists of imported machines.[5]

Such arm's-length acquisition of foreign technology on a large scale requires chiefly the capacity to purchase large amounts of equipment and incentives to invest in superior equipment. It might reasonably be supposed that technology transfer through IFDI, bringing in foreign management skills and intangible know-how as well as hardware, could at least potentially add to the gains from equipment imports.

Russia does indeed attract a fair amount of IFDI. There are however some odd features of Russian IFDI in recent years. Unusually for a large, emerging economy, it is almost matched by the scale of outward FDI; and a significant part of the inward flow is Russian-controlled investments from offshore tax havens (Hanson 2010). While many foreign firms have prospered in Russia, there is little doubt that there would be greater flows of 'genuine' (non-Russian) IFDI if the business environment were more encouraging, with better protection of property rights and fewer impediments to competition and, in particular, market entry

[5] What time-lag to assume between import and installation? For 2010 I get equipment investment of $69.5bn (www.gks.ru/free_doc/new_site/business/invest/inv-str10-oper1.xls, accessed April 20, 2011, gives R2,109bn , converted to $ at the average annual exchange rate of R30.37 =$1) as against $87.2bn of imported machinery (www.customs.ru/ru/arhiv-stats-new/trfgoods/popup.php?id286=749, accessed April 20, 2011, subtracting cars from the total of machinery and equipment imports), so more was imported than installed, apparently, in that year.

3 THE RUSSIAN BUSINESS ENVIRONMENT

The starting-point is a set of economic institutions that have been hostile to competition and open markets. Russia is in World Bank terminology an 'upper middle-income country'. Of the 46 countries in this category whose business environment is assessed in the Ease of Doing Business (EoDB) rankings, Russia comes 38th. Overall, in the 2011 rankings, it is 123rd. A large part of the EoDB rankings is based on surveys of company experience – quantifiable and empirically-based. Table 2 shows the EoDB assessments under nine headings, with Russia compared with a weak EU member-state, Greece, and a comparatively strong emerging economy, Turkey.

TABLE 2. WORLD BANK EASE OF DOING BUSINESS RANKINGS FOR GREECE, TURKEY AND RUSSIA, 2011 (n = 183)

	Greece	Turkey	Russia
Starting a business	149	63	108
Dealing with construction. permits	51	137	182
Registering property	153	38	51
Getting credit	89	72	89
Protecting investors	154	59	93
Paying taxes	79	75	105
Trading across borders	84	76	162
Enforcing contracts	88	26	18
Closing a business	49	115	103
OVERALL	109	65	123

Source: http://www.doingbusiness.org/data (accessed 10 December 2010)

Other surveys depict the Russian business environment in similarly gloomy terms. In the World Bank's governance rankings for 2009 Russia was 189th out of 213 countries on the 'rule of law' indicator.[6] The OECD's measure of product market regulation, in which a higher score indicates more impediments to open competition, puts Russia at 3.094, against an OECD average of 1.840.[7] The overall OECD product market regulation scores are derived from 18 measures under three separate headings: state control; barriers to trade and investment; barriers to entrepreneurship.

Despite the difficult institutional arrangements within which business has had to operate in Russia, the country's attractions to IFDI have been clear: a large market,

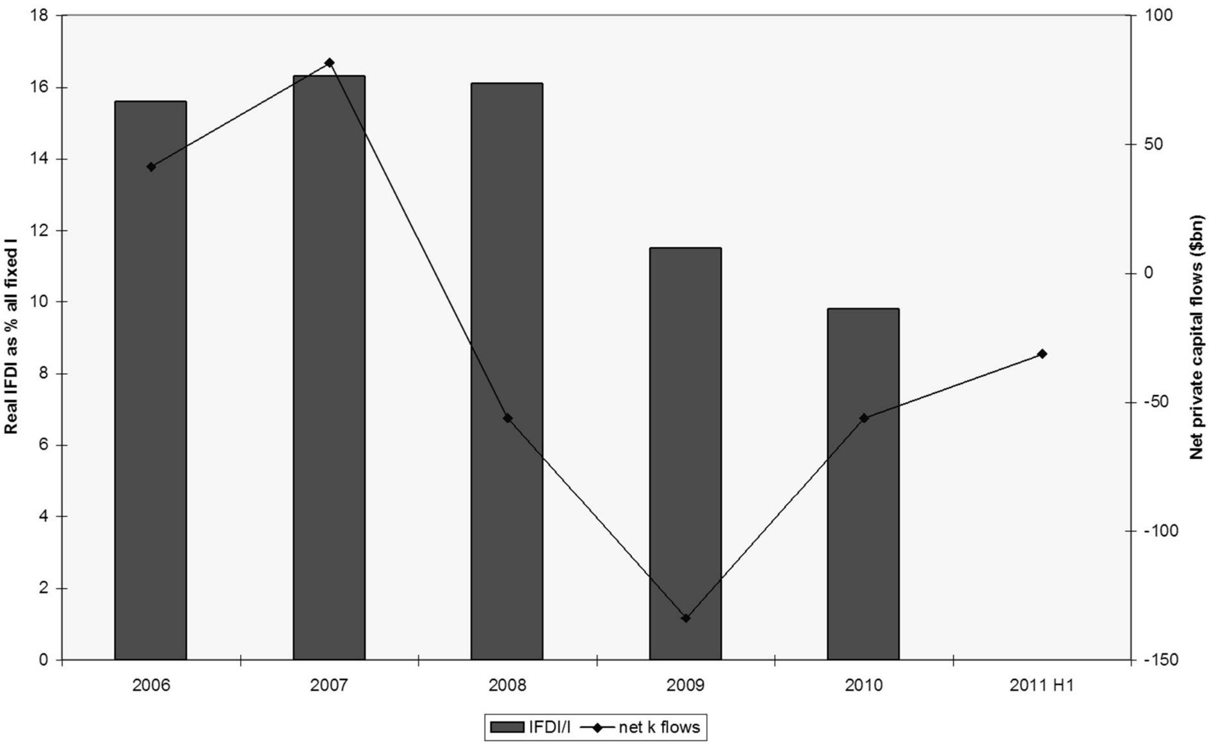
[6] http://info.worldbank.org/governance/wgi/pdf/wgidataset.xls, accessed December 3, 2010.
[7] www.oecd.org/dataoecd/33/12/42136008.xls accessed December 8, 2010

rapid growth (until 2008), abundant natural resources, and a well-educated labor force. The point is that institutional reforms could make the country substantially more attractive to foreign direct investors than it has been.

4 IFDI: SOME EXAMPLES OF SUCCESS

The last few years have been difficult both for Russia and for most of the companies that invest, or might consider investing, in Russia. This is reflected in the aggregate data. Chart 1 shows new capital created by IFDI forming a decreasing share of total fixed investment after 2008 and private capital outflows outweighing inflows from 2008 through mid-2011. Meanwhile total Russian fixed investment remains a modest part of GDP, around 20-22% – at least in part because of the weakness of property rights in Russia.

CHART 1. THE CONTRIBUTION OF REAL INWARD FOREIGN DIRECT INVESTMENT TO TOTAL FIXED INVESTMENT IN RUSSIA (%) AND THE NET FLOW OF PRIVATE CAPITAL IN (+) OR OUT (-) OF RUSSIA ($bn), 2006-2011 H1



Note: Real IFDI is that part of total IFDI that increases the capital stock of the host nation. It therefore excludes mergers and acquisitions and loans to affiliates.

Sources: Derived from Rosstat (http://www.gks.ru) and Central Bank of Russia (http://www.cbr.ru) data. Capital flows from http://cbr.ru/statistics/print.aspx?file=credit_statistics/capital.htm&pid=svs&sid=cvvk accessed September 4, 2011

At the same time, the foreign firms that have established subsidiaries or joint ventures in Russia have in many cases contributed to the process of 'modernization', whether or not their activities have been seen in that light by the Russian leadership. Some examples follow. The selection is guided by the aim of illustrating diverse lines of business and diverse modes of technological influence.

The first area is food retailing and catering. IFDI in this sector began with McDonalds. The requirement of uniform, reliable supplies of ingredients, and later of food more generally for retail chains such as Auchan, helped to develop a better-organised agri-business sector (Belaya and Hanf 2010). Whatever the exact influence of IFDI in this case, it is noticeable that the development of Russian retail chains has been robust: X5, Sed'moi Kontinent, and so on. Wal-mart sought to enter the Russian market but decided to suspend its efforts for the time being. It looks as though local enterprise and management have been effective, but with a great deal of learning from foreign practice – a form of tacit, low-cost technology transfer. Azbuka Vkusa is modelled, according to its own spokesmen, on Waitrose, and has hired British designers and consultants.[8]

The second area is oil and gas. Under the 2008 law on investment in industries of strategic significance, the default role of foreign capital in the development of substantial oil or gas fields is severely limited, though exceptions can be made. Even before the passing of that law, the resistance of incumbent Russian companies and regional and federal politicians to the entry of international oil companies (IOCs) to the sector was strong. Yet, for example in the case of gas, adjustments were made when foreign technology and project-management skills were needed. Thus Rosneft has sought investment and participation in offshore development from ExxonMobil in the Black Sea and in the Kara Sea.[9] In the words of one industry specialist:

> *Partnership with IOCs has been reserved for more technically challenging fields such as Shtokman in the Barents Sea, or for projects where Gazprom has little previous market or technological experience such as the Sakhalin 2 LNG [liquefied natural gas – PH] scheme* (Henderson 2010: 176).

[8] *Financial Times,* 1 December 2010; http://www.ft.com/cms/s/0/e4f2f7ac-f95d-11df-a4a5-00144feab49a.html#ixzz1JtNVl6Ej: 'Bags of opportunities as companies expand into region.'
[9] www.bbc.co.uk/news/business_12298081 ,January 27, 2011 On the August deal with ExxonMobil see Stanovaya 2011.

It is no surprise therefore that Russia's first LNG plant was created by Shell (with Mitsui and Mitsubishi) or that, even after Gazprom used administrative pressures to muscle into Sakhalin Energy and become the controlling stakeholder, Shell still manages the project.

A third example of technology transfer by means of IFDI comes from aerospace: the development of the Sukhoi Superjet 100, a medium-range airliner, by Sukhoi and Alenia. Sukhoi was inserted into the state-controlled United Aircraft-Building Company in 2006. Alenia is a wholly-owned subsidiary of the Italian Finmeccanica. The SSJ 100 joint project began with a memorandum of understanding between Alenia and Sukhoi in August 2005. This pre-dates the law on foreign investment in strategic industries, but even before 2008 international involvement in Russian aircraft development had been minimal, and it was widely understood that this was a 'strategic' industry.

The project has experienced some delays, as aerospace projects do everywhere, but there are now some SSJ 100s flying, and quite a large number of orders for them have been placed, by foreign as well as Russian airlines. In general, the project looks successful. A balanced ownership and control structure helps: Alenia has a blocking stake (25% + 1 share) in the Russia-based production company but a 51% stake in the Italy-based marketing company – and the commercial success of the project rests on international sales.

So far as technology is concerned, the contributions from the Russian side are dwarfed by those of the foreign suppliers. The airframe and 'half the engine' are Russian: the engine was developed by Saturn of Russia and Snecma of France. The rest is foreign: auxiliary power units by Honeywell, avionics by Thales, control systems by Liebherr, landing gear by Messier-Dowty, unspecified consulting by Boeing. Production is at Komsomol'sk na Amure, Novosibirsk and Voronezh, but much of the work involves installing foreign-made sub-assemblies. One assessment is that only a third of the plane is 'Russian'; another Russian source puts it at a fifth. How any such calculation might be made is not specified: value added at purchasing-power-parity dollars? What is clear is that a lot of foreign technology is involved.[10]

[10] Information in this paragraph is from the Sukhoi website, http://sukhoi.org/eng/planes/projects/ssj100/, accessed August 1, 2010, which is far more informative than that of Alenia, and Russian press sources, including Alisa Fialko and Aleksey Nikol'skiy, 'Mestnyy tol'ko inter'yer,' *Vedomosti*, August 16, 2010.

5 THE RUSSIAN BUSINESS ENVIRONMENT AS A SOURCE OF PROBLEMS

Alongside these success stories – indeed sometimes forming part of the same story – are many examples of the trials and tribulations experienced by foreign direct investors in Russia. Those trials and tribulations come sometimes from the Russian state, including the courts and the law-enforcement agencies, and sometimes from Russian firms, most conspicuously in their role as business partners.[11]

One pattern is the use of administrative leverage, through back-tax demands and allegations of infringement of either licence conditions or environmental regulations to obtain assets from a foreign investor. Examples include the successful pressure on Shell, Mitsui and Mitsubishi to allow Gazprom to buy a controlling stake in the Sakhalin-2 project (Sakhalin Energy), and the pressure on TNK-BP to relinquish control of the Kovykta gas field in Eastern Siberia. In such cases due process is absent: laws and regulations are used selectively and instrumentally to wrest control of an asset from its original owners.

Another pattern is the use of the Russian state by Russian companies either to acquire assets from a foreign company or to change the terms of a partnership with a foreign firm. This quite often involves the complicity of a Russian court or members of the police-force or both.

Agreements between a Russian and a foreign stakeholder in a business to settle any disputes through foreign courts might seem to provide some protection for the foreign investor, but there are ways round this. One is the intervention of a small minority shareholder who claims to be unrelated to the Russian partner and who brings suit against the foreign partner or otherwise seeks to diminish their stake in the business. This has happened twice to the Norwegian telecoms company Telenor in their partnership with Altimo in Vimpelcom, Russia second-largest mobile phone company.

In the first dispute, starting in 2005 and finally resolved in 2010, Telenor, the holder of 29.9% of Vimpelcom was sued by Farimex Products, a British Virgin Island-registered holder of a 0.002% stake. Farimex claimed that Telenor's resistance to the take-over by Vimpelcom of a very small Ukrainian company, was the source a a huge loss of

[11] The examples that follow are drawn from Hanson 2010 except where other sources are indicated.

potential profit by all Vimpelcom shareholders. A court in Omsk awarded $1.73bn damages against Telenor, which would have wiped out its Vimpelcom stake.

In the end this attempt failed, probably because Telenor pursued through US courts the question of Farimex's possible links with Altimo.

In the second dispute, in 2011, Telenor objected to the terms of a Vimpelcom acquisition of the Egyptian Wind Telecom. As planned initially, this acquisition would significantly dilute Telenor's stake in Vimpelcom because there was no provision for an issue of additional stock. .Altimo's counter to this was that a small stakeholder in Vimpelcom had already invested in Wind Telecom and, because this small investor was related to Altimo, the rules did not allow an issue of new shares as part of the deal (Dzyadko 2011).

Altimo is the telecoms arm of the Alfa Group. That group is also part of the Alfa-Access-Renova (AAR) consortium that owns the Russian half of the TNK-BP 50-50 joint venture. In 2008 a small minority shareholder in TNK-BP, Tetlis, brought suit against BP, and this assisted the removal of a number of BP specialists and, ultimately, the BP-nominated chief executive officer of TNK-BP, Robert Dudley. In August 2011 BP's Moscow offices were raided by court bailiffs following a Tyumen' court ruling in favour of six small investors in TNK-BP who sought damages from BP on account of profits allegedly forgone by TNK-BP through BP's attempt to form an alliance with Rosneft. (Gavshina 2011). A Russian lawyer, Konstantin Tapaidze, cited by Gavshina, drew attention to the similarities amongst these 'manipulations of legal levers' by Alfa Group companies. What makes such manipulations possible is the readiness of Russian courts to support extremely dubious claims.

The problem is so widely known that it has been acknowledged in a most unlikely source: the prospectus for a $1 billion Eurobond issue by the state-controlled railways company, RZhD. The issue was in March 2010, and the prospectus was required to give necessary risk information to potential purchasers of the bonds. Its warnings included the following: Russian state organs can be unpredictable and corrupt; Russian courts are also corrupt, and are neither independent nor competent, and their decisions are often not implemented (Nepomnyashchii and Mazneva 2010).

6 CONCLUSION: ARE THINGS GETTING BETTER?

To illustrate the weakness of the rule of law and the large bureaucratic impediments to business in Russia is one thing. To establish whether those circumstances are changing for the better, or can be expected to change for the better, is another.

It is often argued that Russia's consistently low and often deteriorating ranking in international measures such as the EoDB assessments is enough to demonstrate that conditions are getting no better or are in fact getting worse. One might, in that vein, cite the fall from 116th to 123rd place between the 2010 and 2011 EoDB overall rankings.

The fall is certainly not encouraging, but it is not conclusive. If other countries are reducing the numbers of bureaucratic procedures and the length of time involved in getting a construction permit or arranging export or import documentation, and are doing so faster than Russia, then Russia's ranking on those indicators falls; yet it is entirely possible that Russian arrangements may be getting no worse or even improving, but comparatively slowly.

In Table 3 EoDB measures of time taken and procedures required in Russia for five out of the nine business activities (all those for which such numbers are available), and selected other measures for the four remaining activities, are shown for 2006 (the earliest year for which these measures are all available), 2010 and 2011. The last two years' rankings reflect conditions in 2009 and 2010, respectively. The importance of these bureaucratic impediments is two-fold: the larger they are, the more the damage to economic performance even if no corruption is involved; and the larger they are, the more scope they offer for the extraction of bribes.

TABLE 3 CHANGES OVER TIME IN BUREACRATIC IMPEDIMENTS TO BUSINESS IN RUSSIA, 2006-2011

Ease of Doing Business assessments, 2006, 2010 and 2011: numbers of days & procedures required, and some other measures, under nine headings

	2006	2010	2011
To start a business:			
days	35	30	30
procedures	10	9	9
Dealing with constr. permits:			
days	671	653	540
procedures	64	63	53
Registering property: days	52	43	43
procedures	6	6	6
Getting credit: strength of legal rights index (0-10)	3	3	3
Protecting investors: strength of protection index (0-10)	5	5	5
Paying taxes: n payments p.a.	15	11	11
hours spent p.a.	448	320	320
Trading across borders:			
days to organise export	8	8	8
days to organise import	13	13	13
Enforcing a contract: days	281	281	281
procedures	37	37	37
Closing a business: years	3.8	3.8	3.8

Source: http://www.doingbusiness.org/Custom-Query/russia accessed September 4, 2011.

The numbers in Table 3 suggest the following. First, on these measures, Russian bureaucratic impediments have not been getting worse. Second, there has been some improvement between 2006 and 2011 in four of the nine areas. Third, only one area, dealing with construction permits, shows an improvement between the 2010 and 2011 rankings. The likelihood therefore is that Russia's failure to improve its overall ranking reflects a slow and patchy reduction in bureaucratic impediments, compared with other countries, rather than an absolute deterioration. At the same time there is little evidence – over an admittedly very short period – of improvement since the banner of modernization was hoisted. Certainly the likes of Telenor and BP have not seen an improvement in their partners' behavior.

Should we expect such an improvement, nonetheless? The main ground for optimism is simple: the defects of a system that favors incumbent firms with good political connections and which thrives on bribery, are being discussed more openly than before, and one of the people talking in this way is President Medvedev.

The grounds for skepticism come down to this: the intertwining of business and officialdom in Russia is part of a system based on informal networks that by-pass the legal code and from which many leading politicians and senior officials derive personal benefit. That system will not readily be altered without fundamental political change, and fundamental political change will not come easily.

Meanwhile foreign companies can and do operate successfully in Russia. They find various ways to navigate the existing system. If there were to be fundamental reform, however, there could be more foreign companies in Russia and they could be operating far more effectively.

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