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Political risk for foreign firms in the Western CIS
An analysis on Belarus, Moldova, Russia and Ukraine

Electronic Publications of Pan-European Institute 18/2009

ISSN 1795 - 5076

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18/2009

Electronic Publications of

Pan-European Institute

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Introduction

Two decades ago, Belarus, Moldova and Ukraine were peripheral places in the eyes of foreign firms, and even investment opportunities provided by Russia were limited to opening a joint venture with a Russian factory. Foreign investment inflow remained practically non-existent until the collapse of the USSR.

Twenty years have passed but these countries pop into the headlines more often due to their political turbulence rather than to the business opportunities they offer. It is not generally acknowledged that 200 million consumers inhabit Belarus, Moldova, Russia, and Ukraine. In addition to their large population, these markets are rather conveniently located; the distance from Minsk to Berlin is almost the same as the journey from Berlin to London. Nevertheless, foreign firms have invested less than USD 400 billion in these countries (most of that to Russia), which is clearly below their potential. Political turbulence, along with market imperfections and peculiar business risks has kept many foreign corporations outside these markets.

The main goal of this report is to analyse the political risk of these four markets from a foreign firms' point of view. A special emphasis is placed on the analysis of the risks faced by Finnish firms. The report consists of four independent articles, which use a common conceptual approach in analysing the political risk of a foreign firm. Some economic background information on all these four countries has been gathered at the end of the report.

We wish to thank the ***Foundation for Economic Education*** (Finland) which has made it possible to conduct this report in its current form.

Turku, 19.8.2009

Kari Liuhto

Macro political risk

There exists considerable ambiguity concerning what political risk actually is and how it should be defined. According to a definition by Robock (1971), political risk in international business exists (1) *when discontinuities occur in the business environment, (2) they are difficult to anticipate, and (3) they result from political change*. These politically derived changes in the business environment must have the potential to significantly affect the goals of the company in order to constitute *risk*. Political fluctuations that do not change the business environment or are easily anticipated do not constitute political risk. Furthermore, some political fluctuations may cause political risk for one company albeit being irrelevant to another company.

Political risk is composed of two parts: the negative *impact* of an undesired event and the *probability* of its occurrence. It can range from frequent but less significant incidents of corruption to expropriation, which occurs rarely but will lead to total loss of assets (Wilkin 2001). Political risk should be considered as the "*combined probability of an entire set of unwanted events"* (Haendel 1979), or more precisely, their impact on business.

Literature on political risk offers several useful categorisations of the phenomenon. First of all, political risks can be divided into *macro political risks* and *micro political risks* according to their direction. Some unanticipated and politically motivated changes in the business environment are directed to all foreign companies (macro risk), whereas others only affect a selected field of business activity (micro risks). (Robock 1971) Secondly, it is also useful to distinguish between *internal political risks* and *external political risks*, as it helps to identify the origins of different types of political risk. Internal political risks have their roots within the society whereas external political risks can stem from, for example negative influences of regional political forces or dependence on a hostile major power. (Haner 1979) Finally, political risk can be categorised as *government-related*, *society-related* and *economy-related* according to its source (Simon 1982; Alon & Martin 1998).

In this study, political risks faced by foreign investors in Belarus, Moldova, Russia and Ukraine are assessed using the *normative model of macro political risk assessment* developed by Alon and Martin (1998). This model encompasses all the various categorisations introduced above and provides a broad perspective to assessing political risk. Political risks are divided into internal and external dimensions, and various government-, society- and economy-related variables can be considered using this framework. The model is directed to analysis of macro level political risks but can be easily applied to assessing micro level risks in a particular sector or macro level risks in different countries by changing the weight or importance of the variables. The model is presented in Table 1.

Table 1 Normative model of macro political risk assessment

MACRO POLITICAL RISK		
	Internal	**External**
Government-related	Degree of elite repression Degree of elite illegitimacy Likelihood that regime change will affect policy	Likelihood of political violence Degree of involvement in international organisations Possibility of regulatory restriction on investment, capital or trade
Society-related	Degree of fragmentation →potential for social conflict Sense of nationalism, xenophobia, alienation or fundamentalism	World public opinion Disinvestment pressure Regional diversity and incongruent interests
Economy-related	GDP per capita growth Income distribution Likelihood that economic goals will be met	Future economic policies regarding FDI Likelihood of balance of payments problems Likelihood of currency inconvertibility/instability

Source: Alon & Martin 1998.

Government-related factors: *The degree of elite repression and illegitimacy* reflect the extent to which a government uses force against its own citizens and its lack of respect from the people. These internal sources of government related political risk factors are linked with *the likelihood of regime change*, which is a potential cause of political risk, if it will bring about changes to economic policy. External sources of government related political risks are closely related to economic and political stability. *The likelihood of political violence* can be determined by evaluating potential future conflicts such as border disputes and terrorism. *The possibility of restriction on investment, capital or trade* represents the host country's tendency to place restrictions that will limit the operations of foreign firms. *The level of involvement in international* *organisations* can detract the appearance of political risks, because of the potential aid provided by these institutions for infrastructure or in times of crises.

Society-related factors: Internal society related factors are important to consider since they can lead to revolutionary events that will impact the investment environment. *The degree of fragmentation*, or the social diversity of a nation, can contribute to political risk by causing potential for social conflict. *Sense of nationalism, xenophobia, alienation or fundamentalism* can also stimulate social unrest. External social factors are difficult to control by governments as they transcend national boundaries. *World public opinion* as well as *regional diversity and incongruent interest* can create political instability and even lead to an outburst of a conflict.

Economy-related factors: *GDP per capita growth* and *income distribution* can be used to measure the standard of living in a country, the level of development and the size of the middle class. Poor performance on these economy-related factors and the inability of the government to achieve economic goals can bring rise to political unrest. *The likelihood of economic goals will be met* is dependent on the consistency of current policies to achieve stated economic goals. External economic-related factors are related to foreign trade and investment conditions. *Future economic policies regarding FDI* may include foreign ownership restrictions and discrimination and can thus have a major impact on operations of foreign firms. *The likelihood of balance of payments problems* such as trade deficits may lead to repatriation restrictions or tariffs. *The likelihood of currency inconvertibility or instability* can add on political risk through the problems linked to either a fixed currency rate or the extreme fluctuations of a floating currency.

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Who doesn't risk, never gets to drink champagne …

but how much one has to risk just to have a relaxed drink in Russia

Kari Liuhto

Contents

Prologue

"*Dissidents should be paid 13 months' salary for a year, otherwise our mindless unanimity will bring us to an even more hopeless state of stagnation. It is especially important to encourage unorthodox thinking when the situation is critical: At such moments every new word and fresh thought is more precious than gold*".

Boris Yeltsin, 1990, Against the Grain: An Autobiography, Summit Books; First Edition, p. 172.

1 Russia's foreign investment paradox: foreign investments have grown though political risks have increased in the 2000's

Russia is notoriously corrupt[2], and hence by definition, the state is an inefficient governor of any property. Despite this well-known fact state ownership in big business has widened in this decade (TD 2008)."*State-owned enterprises are found across a wide range of sectors and often occupy a dominant position in their industry. Furthermore, there is a pervasive blurring of the line between the public and private sectors, arising not only from the extensive role of state-owned enterprises but also by close ties between government (at all levels) and major private firms*" (OECD 2009, 17)[3].

The statement of Oleg Deripaska, once the richest businessman in Russia, gives an idea of symbiotic and simultaneously unnatural relationship between the state and big business. "*If the state says we need to give it up, we'll give it up. … I don't separate myself from the state. I have no other interests*" (Lucas 2009, 59).

Even if the state involvement in the upper echelons of the economy has strengthened and as a consequence some foreign companies have lost their business, foreign corporations have multiplied their investments into Russia since the beginning of the decade[4]. Russia's investment paradox does not stop here. Though FDI inflows have grown significantly since the beginning of the decade, the position of foreign firms has

[2] Kirill Kabanov (2009, 8), the Chairman of the National Anti-Corruption Committee, claims that *"corruption has become Russia's most profitable business. According to experts, the corruption market is worth $300 billion annually"*. The study conducted by Transparency International (2008) supports the aforementioned analysis. Its survey indicates that Russia ranks among 40 most corrupt countries in the world. As a comparison, China is the globe's 108th most corrupt country, being at the same corruption level as Bulgaria, the most corrupt country within the EU. One can only wonder what the economic growth in Russia could have been in this decade without such wide-spread corruption.

[3] *"The country risks losing competitiveness as foreign investment dries up and the global crisis prompts the government to raise its stakes in corporate stocks. State ownership of corporate stocks reached 45 percent at the end of 2008, the Institute of Contemporary Development said in a February report"* (Nicholson & Abelsky 2009, 7).

[4] The stock of foreign direct investment fell by more than half during 2008, ending the year at just USD 214 bn (BOF 2009a). In the first half of 2009, FDI inflows dropped by more than 50% year on year, to USD 17.3 bn, compared with USD 39.6 bn in the relevant period a year earlier (EIU 2009b). Despite the recent slump in FDI inflows, one should not forget that at the beginning of the year 2000, the Russian accumulative FDI stock amounted to USD 32 bn, whereas it was 10 times bigger at the end of 2007 (UNCTAD 2008; Appendix).

become more restricted due to natural resource nationalism and the siloviki's stronger influence in policy making (Kryshtanovskaya & White 2003)[5].

Table1. indicates that the relative significance of the extraction industries is on the decline, which would be a natural consequence of the strategic sector law. However, one should not jump to any firm conclusion yet, since the overemphasised share of the electricity sector in H1/2008 makes the drawing of any reliable trend impossible.

Table 1. The division of the annual FDI inflow by sector (%)

	2005	2006	2007	2008 H1
Tradable sector-total	**77.7**	**53.5**	**65.7**	**37.4**
Agriculture, hunting, forestry	0.9	1.4	0.8	1.7
Extraction industries	30.7	33.1	50.1	22.6
Manufacturing	46.1	19.0	14.8	13.1
Non-tradable sector-total	**22.3**	**46.5**	**34.3**	**62.6**
Electricity, gas, and water production and distribution	1.1	0.4	0.5	33.9
Construction	0.9	2	3.2	5.3
Retail and wholesale trade, maintenance of vehicles, home appliances	5.9	6.1	11.7	8.0
Hotels and restaurants	0.2	0.2	0.2	n/a
Transport and communication	1.9	2.8	2.1	1.5
Finance	4.5	11	4.0	1.3
Real estate operations, leasing, and services provision	7.1	23.5	11.8	11.9
Provision of other public utilities, social and personal services	0.6	0.4	0.5	0.5

Source: World Bank, 2008.

It can be anticipated that the weaker foreign business influence inside Russia will get, the less open Russia becomes towards the international community. The less open Russia turns, the slower its politico-economic modernisation becomes. The slower the

5 For a closer discussion on the weakened position of foreign firms in Russia see Liuhto (2007; 2008) and Liuhto & Vahtra (2009).

country is able to modernise itself, the more natural resources Russia has to put into its industrial system to maintain the consumption patterns learned in the early 21st century. Political risks materialise for foreign firms to their full extent, if Russia has not managed to modernise its industrial system, when the natural resources have been used in those regions, where they can commercially be exploited.

The aforementioned summarise why the discussion on the political risks in Russia is relevant. In this article the author discusses how the political risks of foreign firms operating in Russia has evolved since the law on strategic sectors was passed in May 2008. Before the sector-related risks (Chapter 3), the author deals with Russia's political risks through the macro political risk model presented earlier.

2 Russia's macro political risk in the near future

Government-related risks: Russia is still developing democracy and its party system has not found its final form. An overwhelming concentration of power and a lack of genuine political debate prevail in Russia. Political parties play a secondary role, whereas the political limelights are occupied by the key political figures, who do not always represent the interests of their electorate but rather the interest of the state; be it that of the presidential administration, the government or some of the many security-related organisations. This ***elite repression*** does not exist in a large scale, but the prolonged hegemony of the ruling party (United Russia) may create situation where real political alternatives are no longer available.

Gel'man (2007, 12) aptly summarises the transformation of Russia's party system: "*Russia's party system has swung like a pendulum from the one party control of the Soviet era, to the hyper fragmentation and volatility of the 1990s, to an attempt to restore centralized control in the 2000s. The danger of the new system is that it will cause the death of political opposition. Now Russia may be developing a 'Dresden' style political system, in which one main party controls several satellite parties that have little political power. Such a system could be in place for a long time, though it is unlikely to be permanent*".

Should the political system remain unchanged for long, pressures to change ultimately become so high that they will explode in a non-controllable way. In other words, a non-evolving political system may become an extremely high political risk for foreign firms, if it is maintained for too long.

The United Russia party won clearly the latest parliamentary elections in 2007 and the opinion polls show that the approval ratings of both the president and prime minister are exceptionally high, and therefore, one should not argue that ***elite illegitimacy*** exist in Russia as such. However, the main source of the illegitimacy originates from the fact that the State Duma lacks true opposition with an alternative political direction, since both Just Russia and the Liberal Democratic Party of Russia are generally believed to be the Kremlin's satellite parties, and the Communist Party leans too much on the Soviet era instead of giving a real option for the younger generation. The absence of liberal opposition in Russia's political landscape does not allow one to be too hopeful for future development. Even if all the parties representing the liberal opposition would join together, it is very unlikely that they would go over the electoral threshold of seven per cent. Moreover, one should not forget that the tenure of the parliamentary term and presidency have been prolonged, pushing Russia's political system towards political immobility.

The likelihood of immediate **regime change** is extremely low, even if the crisis has touched the Russian economy hard. "*Political risk has increased, reflecting the pressures created by the severe financial and economic crisis. The crisis, and the question of how to deal with it, is likely to put strains on the ruling 'tandem' between the president, Dmitry Medvedev, and the prime minister, Vladimir Putin, as well as to fuel disagreements within the government those who favour a statist solution to the crisis and those who are more liberally inclined. As prime minister, with ultimate responsibility for the economy, Mr Putin appears more exposed than Mr Medvedev to a decline in his popular standing. There is also an increased risk of social unrest. Nevertheless, given the lack of a credible opposition, it seems doubtful that social discontent could threaten the leadership*" (BEE 2009a, 3).

Despite the prime minister having been forced to take unpopular decisions, the crisis has not collapsed the prime minister's popularity. In fact, Putin is still more popular than the president. "*According to Levada Centre surveys, popular approval ratings for both Mr Putin and the president Dmitry Medvedev, remain high and are only slightly down on their ratings in 2008. In July 2009 they stood at 78% for Mr Putin and at 72% for Mr Medvedev. In any case, given the lack of a credible opposition, it seems doubtful that the rise in social discontent could threaten the leadership - Boris Yeltsin managed to survive politically through the crisis in 1998, despite being in a much weaker position. The liberal opposition in Russia is in disarray and the Communist Party of the Russian Federation (CPRF) is a declining force. … After more than a year of the 'tandem' between Mr Medvedev and Mr Putin there is no significant evidence of tension between the two leaders, although there are some signs of differences between the two teams surrounding them. The presidential team appears to follow a more liberal line on both economic and political issues. However, those in Russia and abroad who had been hoping for significant liberalising policy changes under Mr. Medvedev's presidency have so far been disappointed*" (EIU 2009b, 4).

Though I cannot foresee any true regime change in the near future, one should keep in mind that the statist approach has gained weight in Russia, and the political weight of the Deputy Prime Minister Igor Sechin in particular, has increased. Should Putin become the next president and Sechin the next prime minister of Russia, such a change should not be called as a regime change, though the change would probably strengthen the nationalistic and statist views in Russia's economic and foreign policies.

"*The global financial crisis has strengthened the hand of Russian hardliners who want greater state control and less to do with the West, a key adviser to President Dmitry Medvedev said in an interview on Wednesday. Igor Yurgens, who chairs Medvedev's think-tank, the Institute for Contemporary Development, nonetheless told Reuters he believed the president was aligned with Russia's liberal wing and was making small, cautious steps towards reform. 'The crisis of course fortified the positions of the statists', Yurgens said. 'The ideology of this wing will be fortified'*" (Guardian 2009).

The Caucasus has been a cradle of ***violence*** for centuries. Both the Chechen wars, increased instability in the neighbouring regions of Chechnya, and Russia's war with Georgia in August 2008 have increased the macro political risk of Russia. Closson (2008 4) writes "*it is clear that the Georgia-Russia conflict and the recognition of South Ossetia and Abkhazia as independent states present challenges for ensuring stability across the Caucasus. Their recognition has spurred nascent movements for independence in Ingushetia and increased calls for the return of displaced Ingush to their lands in the Prigorodniy district, now in North Ossetia.*"

The Caucasus conflicts weaken Russia's image among foreign investors, though their impact on foreign direct investment inflows have so far remained modest. On the other hand, should Russia's relations with Ukraine significantly worsen, that would obviously have a more profound negative impact on the investment inflows from the West. In mid-August 2009, Bovt (2009) argued that the war between Russia and Ukraine is a possibility.

Russia's ***involvement in international organisations*** is not to become more active in the near future, on the contrary. For instance, Russia's over 15-year long road towards WTO membership received a rather surprising turnaround in June 2009, when Putin informed that Russia will join the WTO as a part of a customs union with Belarus and Kazakhstan. Even if one may interpret this as playing for time (more room to conduct protectionist measures during the crisis) and a strengthening of Russia's negotiation position rather than a genuine accession strategy, this can be considered as a genuine drawback for Russia's interest to join international organisations. Russia's WTO decision also means an end (at least a temporary one) to the negotiations aiming towards the creation of the Common Economic Space between the EU and Russia.

Furthermore, Russia's OECD membership does not seem very likely in the foreseeable future and Russia's membership in OPEC has been one of political lip service. The UN and its Security Council in particular will remain Russia's most important participation in international organisations.

Russia confronts the USA especially in NATO enlargement to the CIS and Russia's goal to implement its sphere of influence in the CIS. Correspondingly, Russia's relations with the EU has cooled down, particularly after the Georgian war and the gas dispute with Ukraine, which stopped the natural gas supplies to the EU for several days. At the same time, when Russia's relations with the West have deteriorated, Russia has tried to build closer ties with the East.

In May 2008, Russia introduced ***the law restricting foreign investment*** into strategic sectors (for more see Liuhto 2008). The law was not prepared with sufficient time, and even Russian experts admit that there are several weaknesses in the law. For instance, the law could lead to an absurd situation where foreign-owned oil companies stop exploring new oil fields, since if they will find too a big hydrocarbon field they should donate it to the state against a symbolic compensation (Malkova 2009; Medetsky 2009b). In addition, there are loopholes in the law that allow foreign entities to flout the government when buying into strategic companies (Medetsky 2009a). Some Russian authorities have acknowledged that the law touches unnecessary sectors and ownership restrictions are too strict, and hence, the authorities may increase the ownership stakes of foreign oil firms in strategic fields. Although it would be wise to re-consider the content of the law, one may only ask whether the possible liberalisation in the law lasts only during the crisis or whether foreign firms can really rely on the law in the longer run (Argus 2009a).

Due to the global financial crisis, it is extremely likely that Russia will build customs barriers to protect its own industries. Since Russia decided not to join the WTO in the foreseeable future, it is very likely that several protectionist measures will be maintained, even after the crisis has ended. "*Being outside the organisation for a longer period gives Russia more freedom to raise import or export duties. WTO-related obligations to cut tariffs on entry would have threatened plans to build up certain industries, such as automotive manufacturing. WTO accession might also have facilitated the takeover of domestic operators or their crowding out by foreigners, and this is politically sensitive in Russia*" (EIU 2009c, 16).

Society-related risks: though 80 per cent of the people living in Russia are ethnically Russians, one can argue that Russian society has become more fragmented and ***nationalism*** grows.

Pain (2007, 5) analyses the development of nationalism in Russia as follows: "*in the beginning of the 1990s, the minority non-Russian ethnic groups began asserting their rights. By the end of the 1990s, it was the majority ethnic Russians who had become vocal. Although the ethnic Russians became ethnically conscious later than the other groups, their feelings are quickly growing and now the ethnic majority considers itself to be more threatened than the minorities. From the beginning of 2000, the share of ethnic Russians who feel threatened by members of other ethnic groups living in Russia is almost twice the number of other groups. During the Soviet era, the ethnic Russians were the most tolerant of the ethnic groups in Russia.*

The Russian's fear of other ethnic groups was particularly noteworthy after the series of terrorist acts in the summer of 1999 and the beginning of the 'second Chechen war' that fall. Initially, the feelings were directed against the Chechens, but after 2000, they spread to a variety of other ethnic groups. Since that time, approximately two-thirds of respondents feel some form of antipathy toward other nationalities. Anti-Semitism grew particularly quickly and now the level of anti-Semitism among Russian nationalist leaders has even outstripped their anti-Chechen and anti-Muslim feelings.

Contemporary Russian nationalists stress the idea of rebuilding the Russian empire. However, their focus on the idea of 'Russia for the Russians' is incompatible with efforts to bring other ethnic groups together in one political entity. The authorities support Russian nationalist ideas, in the mistaken idea that they will be able to manage nationalist forces. In fact, the rise of Russian nationalism is likely to encourage separatism among other ethnic groups".

Russia's increasing nationalism means increasing investment risk for foreigner investors, since the authorities are not able to fully control nationalism, nationalism encourages separatism, and finally, foreign business is a stranger, i.e. a target for attack if the nationalistic waves ever overflow the dam.

Umland (2009, 13) argues that "*in recent years, various forms of nationalism have become a part of everyday Russian political and social life. Since the end of the 1990s, an increasingly aggressive racist subculture has been inflecting sections of Russia's youth … It is generally acknowledged that a shrill anti-Americanism, as well as various* *other phobias, today characterize not only marginal groups, but also the Russian mainstream. … Among the dozens of extremely anti-Western publicists and pundits present in Russian official and public life today, Aleksandr Dugin and his various followers stand out as a network of especially industrious political ideologues and activists who have managed to penetrate Russian governmental offices, mass media, civil society and academia. … If Dugin's view becomes more widely accepted, a new Cold War will be the least that the West should expect from Russia during the coming years."*

The prolonged and extended instability of Chechnya has turned the Caucasus into a fertile soil for ***Islamist fundamentalism***, and therefore, it is likely that the assassinations and bombings will become more frequent. "*Responsibility for most of the terror attacks has been claimed by underground Islamic armed organisations, and especially the Chechen commander Dokka Umarov. The declared objective of the Islamic militants, who are likely associated with international terror organisations, is to overthrow the local authorities, separate the Caucasian republics from Russia and establish a Caucasus Emirate in their territories, with Sharia law as its legal system*" (EW 2009, 5).

It should be clear to everyone that the independence of Abkhazia and South Ossetia is not sustainable, either politically or economically, and it will further fuel the instability in the region[6].

Should the Russian Government be unable to normalise life in the Caucasus region (unemployment, for instance, in Ingushetia is around 80 per cent), one may anticipate that Islamist fundamentalism does not only spread inside the Caucasus, but fundamentalism may find its targets outside the Caucasus (BEE 2009c)[7]. With the current trend the Caucasus will soon become the Middle-East of Russia, where investments, be they domestic or foreign ones, are doomed to fail.

The world's public opinion towards Russia has become more reserved during this decade, when Russia began to rebuild its political and economic leverage in the post-Soviet territory. After three gas transit conflicts with Belarus and Ukraine the public image of Russia has particularly deteriorated in the West. After the war with Georgia

[6] During this century, the Muslim population may form the majority of the Russian population.

[7] With the Russian economy facing a sharp contraction, the Kremlin is less able to throw money at the North Caucasus, and hence the more volatile the region becomes (BEE, 2009c).

and the increased assassinations of journalists investigating the Chechnya conflict, public opinion on Russia has dropped to its record low.

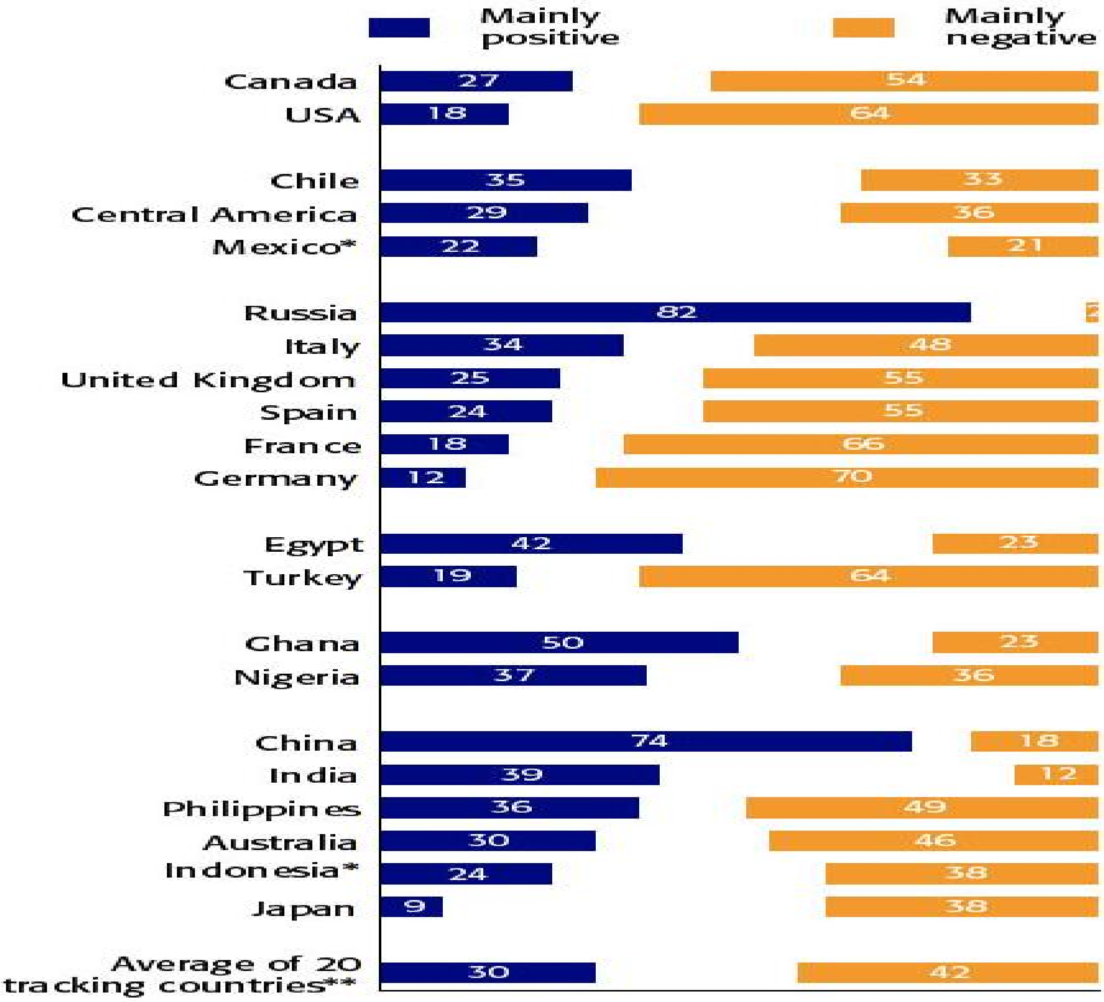
According to a large international survey[8], positive views have fallen 5 percentage points (30%, down from 35%) and negatives have risen sharply (42%, up from 34%). Positive views about Russia have deteriorated substantially, especially in Europe and the United States. In the United Kingdom, positive views have fallen 23 percentage points (25%, down from 45%), shifting the overall leaning to predominantly negative from positive. Negative views have worsened in France (rising from 50% to 66%) and Germany (rising from 56% to 70%). In the United States negative views have risen 28 points (64%, up from 36%), shifting overall views from mildly positive (45% to 18%) to strongly negative. The only countries to demonstrate significant improvement in positive views of Russia are Italy (34%, up from 23%) and Ghana (50%, up from 42%). Italy's several bilateral deals with Russia and Prime Minister Berlusconi's dominance over the media may explain a part of the aforementioned development.

The survey administrator concluded that the more Russia acts like the old Soviet Union, the less people outside its borders seem to like it (Table 2).

The Russian Government should take seriously the deterioration of public opinion on Russia around the world. It might well be that the prolongation of the crisis in the Caucasus and the cooling of Russia-Ukraine relations may lead to a situation that public opinion prevents some of the Western companies investing in Russia. Especially those Western companies, who are selling their commodities to a wider clientele, will be particularly sensitive since they do not want their public image to worsen (lose their main markets) because they are doing business in Russia.

[8] The BBC World Service Poll has been tracking opinions about country influence in the world since 2005. The latest results are based on 13 575 in-home or telephone interviews conducted across a total of 21 countries.

Table 2. Views of Russia's influence in the world by country (January 2009)



Source: BBC, 2009.

Economy-related risks: Russia's ***GDP per capita growth*** has been remarkable in this decade. Until the crisis broke, the average growth was clearly above 5 per cent annually. Though the Russian GDP has nearly doubled in this decade, some citizens have been more equal than others in amassing prosperity. The richest 10 per cent of the Russian population earn over 30 per cent of all the ***income distributed*** in Russia, while the poorest 10 per cent earn less than three per cent. In fact, Russia's inequality in income distribution (the Gini index) is comparable to that of Burkina-Faso or Tunisia. On the other hand, the USA does not perform better than Russia in the Gini index (UNDP 2008).

"*According to Russia's state committee on statistics, the figure for Russians living below the poverty line went up to 24.5 million during the first three months of this year – a steep increase from 18.5 million by the end of 2008*" (Harding 2009).

Differences among the Russian regions are notable. The regional GDP per capita comparison does not describe the situation accurately since the natural resource rich regions seldom receive the major part of the income from the exploitation of these resources. Despite the statistical deficiencies, one can safely conclude that Russia lives in three different centuries. Moscow and St. Petersburg are hectic metropoles of the 21st century, regional capitals and several industrial centres live in the past century, whereas some regions have degenerated back to the 19th century. The most backward regions are located in the Caucasus and nearby Mongolia (Dolinskaya 2002).

The current crisis will add to regional inequality since there are hundreds of towns in which one corporation is practically responsible for the economic well-being of the whole city. The Russian Government has identified 400 towns that rely almost exclusively on one employer[9]. The substantial increase in regional unemployment, and hence, the considerable drop in economic well-being will obviously cause social turbulence Russia has not seen since the beginning of the 1990's. In addition to unemployment, the grey economy, absenteeism and criminality can be expected to increase in these monocities (Pismennaya 2009; Vasilyeva 2009).

Besides regional inequality, societal inequality is wide. Elderly people particularly have suffered from the transformation from socialism to capitalism. One can even state that elderly people have been betrayed by both socialism and capitalism, since neither socialism nor capitalism has brought them the well-being promised. Although 'the lost generation' feels disappointed, it is too old to cause violent protests on the streets and too wise to re-elect the communists into power.

Even if the social pressure is to grow during the next winter, the social protests have so far remained mild. Lankina and Savrasov (2009, 6-8) concluded in May 2009 as follows: "*the number of social protests in Russia is growing, though the absolute number of participants remains relatively small. Overall, the authorities are suppressing a smaller number of protests now than they were two years ago. Political protests are more numerous than economic ones and protesters are increasingly targeting national leaders, though protests against regional leaders have increased slightly. … Significantly, among the most active protesting regions are Kaliningrad and Primorskiy Kray in the Far East.*"

[9] It should be remembered that some 12-20 % of the Russian population is calculated to live in these monocities. As the Russian Government has budgeted less than EUR 250 mn to aid these cities, it seems that it is prepared to use more stick than carrot to quiet the societal turbulence (ICD 2009; Nicholson 2009; Pismennaya 2009).

The Russian leadership are sensitive towards social protests in Kaliningrad, as the leaders may be afraid that the independence movement[10] in the region would grow in this Russian exclave sandwiched between Lithuania and Poland. However, up until now no major protests have taken place in Kaliningrad, though the situation will become more fruitful for protests in the winter, since the devaluation of the rouble has increased the living costs of the citizens, as a significant share of their daily goods are imported.

Russia, though no longer a planned economy, has still many unrealisable plans, policies and programmes. Many of the strategic ***economic goals*** cannot be met without a considerable re-direction of investments from natural resources to a knowledge economy, a true renaissance of entrepreneurship, and free and fair competition. One should not be fooled by the GDP growth of this decade, since the foundations of the growth originated from high natural resource prices and larger export volumes of the natural resources. If Russia is blind enough to start the arms race once again and not to invest the available financial resources into the modernisation of their society, Russia's economic well-being, together with its population size, shrinks dramatically after 2050. Should this dark scenario happen, Russia's political risks will multiply, as Russia will turn nationalistic and becomes more hostile towards its neighbours and foreign industrialists within the country.

Russia's ***balance of payment and currency stability*** is a multisided issue. Due to the global crisis, the prices of Russia's main export commodities have dropped, and hence, the country's massive foreign trade surplus is melting rapidly. Besides, Russia's budget deficit will be considerable in next few years. In addition, there still exists certain speculation about the possible devaluation of the rouble. "*Earlier this month [August 2009], Duma Deputy Anatoly Aksanov, a member of the Just Russia party and head of the Regional Banking Association, drew fire when he called for a 30 to 40 percent ruble devaluation to avoid tax increases in the face of a growing budget deficit.*" (Iosebashvili 2009, 9).

[10] The people supporting independence represent a small proportion of Kaliningrad's population. The young are an exception. According to Kortunov (2005), "*separatist sentiments are widespread among young people. A recent public [2004] opinion poll (conducted anonymously) revealed that almost 60 percent of the Kaliningrad Region's population below the age of 28 favors separation from Russia.*" As a whole, one could still argue that the citizens of the Kaliningrad region would like to have looser control from Moscow, instead of the region becoming fully independent.

The Russian leadership has stressed the importance of a stable currency and the country's international reserves are the third largest in the world (some USD 400 bn in the mid-August, 2009), and hence, the big devaluation proposed by Aksanov does not seem to be the most likely scenario. On the other hand, one should remember that the trust of the population in the rouble in times of crisis is extremely weak. Travin (2009) writes "*the problem is that in Russia, even after a decade of economic growth, there is no faith in the national currency, the ruble. In the autumn of 2008, faced with the growing crisis, banks and individuals began actively offloading rubles and investing in dollars and euros, which meant that the Central Bank was forced to resort to a slow devaluation of the national currency.*" In other words, the currency stability of the rouble seems to be artificial in the crisis conditions. It remains to be seen how the rouble reacts to the second wave of the crisis, which may begin if the companies are not able to pay their bank loans.

The forthcoming couple of years will be extremely challenging for the federal budget. However, in the medium run, the situation will be relaxed, since the oil price will obviously climb after the crisis is over. On the other hand, Russia's economy is still relying too much on oil, and therefore, in the long run, Russia has to get a rid of this dependency before its reserves run out and the world reduces its hydrocarbon dependence. The window of opportunity is open for some decades, not for several generations.

As a conclusion of Russia's overall political risk, one can present the following risk assessment and to divide risks into 10 categories (BEE 2009b, 10-11): "***OVERALL ASSESSMENT****: … Russia has been badly hit by the global financial and economic crisis. In addition, there remain high operational risks associated with the opaque and corrupt administration, the threat of terrorism, increasing authoritarianism and the ill-functioning judiciary. The operations of companies in certain strategic sectors are particularly vulnerable to government interference. …*

SECURITY RISK*: While security risk may not be much higher in Russia's large urban centres than in some other European capitals, foreigners in the more remote Far East and the North Caucasus face more varying degrees of security risk. This is heightened by the fact that the police and judiciary cannot always be relied on for protection. …*

POLITICAL STABILITY RISK*: The sharp economic downturn poses the greatest risk to domestic political stability in the short term, increasing the risk of serious social* *disturbances, and fuelling uncertainty over the effectiveness of the tandem governing arrangement. …*

***GOVERNMENT EFFECTIVENESS RISK**: … Business in Russia struggles with unclear and overbearing regulation, arbitrary administrative decisions, corrupt officials and biased or incompetent judges. … Corruption is still rife at most levels of government and the legal system remains heavily skewed as a result of lobbying from industrial groups or powerful individuals. …*

***LEGAL AND REGULATORY RISK**: The judiciary is undefended, understaffed and slow-moving-recent reform efforts notwithstanding. … Competition policy is underdeveloped and intellectual property is poorly protected. …*

***MACROECONOMIC RISK**: … The Russian economy will be affected by reduced external demand, sharply lower commodity prices, especially oil, on which the economy remains overly dependent - and substantially constrained access to external financing, which is expected to persist throughout 2009. …*

***FOREIGN TRADE AND PAYMENTS RISK**: … The authorities have increased import tariffs on a number of goods in recent months. ... there is a risk that protectionism will increase further. …*

***TAX POLICY RISK**: Tax reform was a relative success story of the Putin administration, and the risk previously associated with the country's extremely complex and cumbersome tax system has fallen over the past few years …*

***LABOUR MARKET RISK**: … Although the economic downturn raises the risk of labour unrest, most trade union organisations are close to the government. …*

***FINANCIAL RISK**: … In a best-case scenario, the banking sector will experience an orderly consolidation over the coming period. In a worst-case scenario, it could face a systemic crisis. …*

***INFRASTRUCTURE RISK**: Infrastructure risk varies widely from region to region. Companies in Moscow, St Petersburg and other urban centres have better access to transport and telecoms facilities than those operating in the far-flung regions, where business in faced with poor roads, electricity blackouts and cracking telephone lines."*

Table 3. Russia: Risk ratings (E=most risky, 100=most risky)

Risk category	Current rating	Current score	Previous rating	Previous score
Security risk	C	54	C	54
Political stability risk	C	60	C	60
Government effectiveness risk	E	82	E	82
Legal & regulatory risk	D	70	D	70
Macroeconomic risk	D	70	C	55
Foreign trade & payments risk	C	57	C	57
Tax policy risk	C	50	C	50
Labour market risk	C	54	C	54
Financial risk	D	63	D	67
Infrastructure risk	C	50	C	50
Overall risk assessment	**D**	**61**	**C**	**60**

Source: BEE, 2009b.

3 Political risk for foreign firms in selected industries

Political risk varies a great deal across the industries, and therefore, one should analyse the sectors separately. I will start with telecommunications, since it is the hottest industry in terms of its political risk for a foreign firm at the moment.

Telecommunications: the sector faces its largest revolution since the break up of the Soviet Union. The main reason for turbulence is the Russian Government's decision to reorganise Svyazinvest, and to make it a state-owned national champion in telecommunications. According to the government's plan, Rostelecom becomes the centre of the new company, regional telecoms are integrated into this new entity, and the new company reinforces its position on the mobile market, either by merging the mobile units of the regional telecoms or through establishing control over one of the Big Three (MTS, VimpelCom or MegaFon) mobile operators (TD 2009a).

Establishing control over one of the Big Three seems currently the most likely option. Antonova (2009, 7) describes: "*Svyazinvest expects its planned reorganisation to make it a leading player on the mobile communications market, currently dominated by three private firms, Communication and Press Minister Igor Shchyogolev said Tuesday. It would be 'optimal' to merge Svyazinvest's mobile operators with one of the 'Big Three,' Shchyogolev said referring to Mobile TeleSystems [MTS], VimpelCom and MegaFon. A final decision on the model for the new provider will be made in the fall, he said, Interfax reported*".

Some analysts consider that "*it would be logical to see something between MegaFon [partially-owned by TeliaSonera] and Svyazinvest, since MegaFon, the smallest [of the Big Three] does not have a fixed-line unit*" (Antonova 2009, 7). At the moment, it is too early to predict how the nationalisation of telecommunications in Russia proceeds and what will be the destiny of TeliaSonera's ownership in Russia. Obviously, some new moves will be seen by the end of the year (TD 2009b).

Another major manoeuvre in this reorganisation concerns the Norwegian telecommunications company, Telenor, which has conducted a major investment in VimpelCom. It seems unavoidable that Telenor loses its stake in VimpelCom as a result of a long fight with its partner Russian Altimo, which is owned by a major Russian player, Alfa Group. It is evident that the business divorce is unavoidable between Telenor and Altimo, but now foreign investors are interested how the divorce is carried out. It has been aptly stated that "*the case is being closely watched as a guide to the climate for foreign investors in Russia, coming after the shareholder battle last year that forced management and personnel changes at BP's Russian oil joint venture, TNK-BP*" (MT 2009b, 7).

If the nationalisation of foreign ownership occurs it would mean that Russia has taken another step in destroying its investment climate. The government's takeover started with the oil business, and then continued to telecommunications. Foreign investors may only wonder which field will be taken next. If telecommunications faces nationalisation, one can no longer only speak about natural resource nationalism, since telecommunications is not linked with natural resources but rather it is linked with the security organisations' desire to control the telecommunications sector.

The Telenor case is extremely complex from a point of view of political risk, since one should not forget that the Norwegian state oil company StatoilHydro is one of the owners of the giant Shtokman field in the Barents Sea. Some speculations have linked the Telenor case with Shtokman, though both the Norwegian leadership and the StatoilHydro's management have strongly denied any connection. An essential question here is how important StatoilHydro is for the implementation of the Shtokman field.

Whatever the reality behind the curtains, it is clear that the political risks of all the strategic sectors have significantly increased. One may even argue that the Russian Government has stopped implementing economic policy, and now instead, it implements political economy.

Oil and natural gas: the state consolidation, which started during Putin's first presidency, has continued. The consolidation proceeds in several ways. First, the state has increased its ownership stake in major oil companies, in Lukoil for instance (Argus 2009g). Second, Rosneft and Gazprom have eaten smaller units, such as Sibir Energy and Tomskneft. Also Russneft may drop into the hands of Rosneft or Gazprom, if RusAl is unable to pay loans to the state bank, where they are held as collateral. Third, regional oil companies are in danger of being swallowed up by large financial-industrial groups, which are likely to sell them further to the state companies. For instance, telecommunications firm Sistema is unlikely to keep their ownership in the Bashkir oil company, Bashneft (Argus 2009i)[11]. It remains to be seen what will be the future of Russia's 6th largest oil producer, Tatneft, the oil company of Tatarstan. Although Tatneft is a harder bite to be chewed than Bashneft, it well might be that the Russian leadership wants to put an end to the regional decentralisation of oil production.

Though the top management of both Rosneft and Surgutneftegaz deny all the merger plans between these two, I would not exclude the merger option in the longer run, since it would make the united company more influential in the global market. In this context, one should note that the CEO of Surgutneftegaz, Vladimir Bogdanov, became a board member of Rosneft in June 2009. As far as I am concerned, companies usually do not nominate the CEO of a rival to its strategic management (Argus 2009e).

The position of foreign oil firms varies. On one hand, the Russian Government offers some foreign oil companies (Shell and Total) stakes in new fields (Argus 2009f). Even if the aforementioned companies have managed to stay out of political troubles, they have also experienced harder times in Russia. For instance, Shell lost its control position in Sakhalin. Similarly, Total and StatoilHydro were forced to sell a 10%-stake in the Kharyaga project to Russian Zarubezhneft. Refusal in the aforementioned cases might have resulted in operational difficulties for foreigners, i.e. the Russian Government made an offer the foreigners could not refuse (Argus 2009d).

On the other hand, the Russian Government has pushed some foreign companies into a corner (BP and MOL). If BP cannot agree with Gazprom on the price of the Kovykta field, Gazprom may wait until the licence expires in 2017, and as a result, the field would become invalid for BP (Argus 2009h). Since Russian Surgutneftegaz, the biggest single owner of MOL, felt that the Hungarian authorities mistreated it, the Russian environmental authorities have harassed MOL's operations in Russia (Argus 2009b). It seems that both BP and MOL have become pawns in political chess, where political reasoning counts more than economic rationality. At the end of the day, it is not an option to be excluded that BP and MOL will withdraw from upstream operations in Russia.

The US ExxonMobil has been treated with both the stick and carrot, i.e. the Russian Government pushes it to sell the natural gas obtained from Sakhalin 1 to Gazprom.

[11] It can be assumed that the negative reaction of the president of the Republic of Bashkortostan towards the centralisation is at least partially due to the acquisition of the main industrial assets of the republic, i.e. Bashneft. The president, Murtaza Rakhimov, went so far as to state that the level of centralisation is now "*worse than in Soviet times*" (EIU 2009b, 10).

Simultaneously, the Russian Government offers ExxonMobil access to a new field in Sakhalin 3 (Argus 2009c).

I expect to see more active participation by Asian oil companies in Russia. Particularly, Chinese corporations have been interested to secure the energy appetite of the industrial giant. Chinese companies have so far been mainly interested in the pipeline projects carrying hydrocarbons to the vast Chinese market. The recent failure in price negotiations might be a temporary hiccup in Russian-Chinese energy collaboration.

Oil and gas business in Russia more follows the logic of the international politics than international business, and hence, every step in the sector is shadowed by political risks. On the other hand, the crisis has made Russia’s petroleum sector weaker, which makes acquisitions of smaller units feasible. For instance, a Canadian SNC-Lavalin Group seized the day and acquired 48 per cent of the Russian oil engineering company in August 2009 (MT 2009c).

It seems when Russia experiences difficult times, foreign oil companies have good times in Russia, and vice versa, and therefore, the current crisis gives, at least, a temporary relief for foreign oil firms.

Metals and mining: both the Russian president and the prime minister publicly declared in the first quarter of 2009 that there is no immediate need to merge major metals and mining companies (Paxton & Budrys 2009; TD 2009c). Despite this clear signal from the political heights, I tend to believe the analysis of Norilsk Nickel Board Chairman Alexander Voloshin. He stated in May 2009 that it would make sense for the world’s largest nickel miner to merge with other Russian metal companies after the financial crisis is over (Soldatkin 2009).

There are many factors, which support the above conclusion. First, the foundation of a national champion perfectly suits the Russian Government’s strategic governance agenda, i.e. that strategic companies should be under direct state control or they should be controlled by Kremlin-loyal oligarchs. Second, the construction of a national champion around Norilsk Nickel was already under preparation when RusAl became one of its main owners prior to the crisis. Third, the government waits for correct timing because the wait-and-see method is an intelligent strategy since after the crisis it can patiently look which assets have fallen into the hands of state banks due to unpaid collaterals. Fourth, the government does not want to increase unemployment and social unrest in the peripheral regions by shaking these big employers in the middle of the crisis. Fifth, some close allies of the prime minister, such as the CEO of the state-owned conglomerate Russian Technologies, has expressed his interest in the metals merger.

"*The company [Russian Technologies] has already expressed an interest in taking a 40% stake in Norilsk Nickel if the government [state banks] fails to get its money back. Russian Technologies already owns Russia's top titanium producer and a speciality steel producer, and reportedly wants to create a massive metals and mining conglomerate by also adding to the mix Russia's largest iron ore company, currently controlled by a private owner*" (BEE 2009d, 2).

In my opinion, the question is not whether the merger will be implemented but rather, when it will be carried out, which companies will be involved, and who will have control over the national champion. As a strong supporter of market economy, I only hope that the state's role in the merger would be marginal. This would mean, in practice, that the state-owned banks, holding the shares of Russia's major mining companies, would find a new private investor instead of selling these shares to the state corporations. However, one should not be overoptimistic.

Even if the metals champion will be created its direct impact on the position of foreign metal companies is not tremendous. However, the selection of Russian Technologies to execute the merger might give a warning signal to private metals companies, since the first metal merger might be followed by other state-led metal mergers. In this context, one should remember that the Russian metal sector has so far been rather exclusively privately-driven, i.e. the share of the state in publicly-traded metal companies was only three per cent in 2007 (TD 2008).

Electricity: it needs to be remembered that production of electrical energy is a strategic sector (in any economy – Russia is no exception), though it was not explicitly named in the law of strategic sectors.

So far, Putin has been the main guarantee that the electricity tariff liberalisation has progressed according to plan. The prime minister has repeatedly stressed that Russia will keep its promise to foreign investors, which have invested billions of euros to the Russian electrical sector. For instance, in April 2009, Putin stated "*we pulled in investors and had to keep the tariff [liberalisation], otherwise we would just deceive them*" (TD 2009d).

Though industrial energy tariffs are to grow slightly slower than originally planned (TD 2009e), it is not perhaps the main headache of foreign investors. The foreign firms have been more concerned about the overall consumption of electricity in Russia. Due to the economic downturn, the country's electricity consumption declined by six per cent in the first half of 2009. In the Urals region, where the electricity unit of Fortum is located, electricity consumption contracted by nine per cent (TD 2009f). Since the earnings of foreign investors have been smaller than budgeted, Fortum along with other foreign electricity producers have started negotiations with the Russian authorities to postpone the building of electricity capacity, agreed prior to the crisis (HS 2009; Lundén 2009).

It is extremely difficult to anticipate how foreign investors are treated in 20 years from now since Russia’s contemporary leaders are probably no longer in their current positions, and strengthened nationalism in Russia might have turned the investment climate colder towards foreign investors. Even if major regime change is unlikely in the medium term, the regime may become less foreign business-oriented and that would be an undeniable risk for foreign investors in the electricity sector, since the investments are gargantuan and a foreign firm is not able to take the electricity producing unit with him, if the company is squeezed out of Russia.

As Fortum’s investment to Russia exceeds the investments of all the other Finnish companies together since 1987, the electricity sector is a sensitive industry in any country, and the Russian Government’s behaviour towards foreign firms has been unconstructive, I consider Fortum’s political risk to be the highest among the Finnish investors in Russia (Table 4, 5 and 6).

Perhaps, Fortum's main armour against the political risks is the investments of German and Italian companies in the Russian energy sector. In other words, the political leverage of Germany and Italy on Russia also give a certain protection to Fortum against the overall nationalisation of the sector. To put it differently, I doubt that the Alfa Group would have acted against Deutsche Telecom as aggressively as it has done against Telenor.

Table 4. Top 10 foreign acquisitions in Russia in 2008

Buying company	Target	Share	Est. value USD mn	Sector
1) Fortum Oyj	TGK-10	93%	3 726	Utilities
2) E.ON AG	Severneftegazprom	25%	2 523	Oil & gas
3) Inure Enterprises; Ltd PPF Group NV; Quotan International Limited	Polymetal	69%	2 100	Metals&mining
4) PepsiCo	Lebedyansky	76%	1 357	Food&beverage
5) Enel Investment Holding BV	OGK-5	16%	1 005	Utilities
6) Renault SA	AvtoVAZ	25%	1 000	Machinery
7) Bank of New York	Uralkali	4%	903	Chemicals
8) Barclays Bank	Expobank	100%	745	Financial services
9) ArcelorMittal	Berezovskaya Mine Pervomayskaya Mine	98% 100%	720	Metals & mining
10) KanAM Grund Kapitalanlage-gesellschaft	Business Center Citadel	100%	600	Real estate

Source: Ernst & Young, 2009.

Table 5. The largest Finnish employers in Russia in 2007

Company	Activities	Personnel 2007
1) Fazer	5 bakeries, several AMICA caterings	3 700
2) Stockmann	4 department stores, Seppälä, Hobby Hall	2 640
3) YIT	Construction	2 154
4) Rautaruukki	Ventall, service centre	2 100
5) Stora Enso	2 saw mills, 3 packing factories	1 950
6) Sanoma	Journals, kiosks, newspaper distribution	1 820
7) PKC-Group	2 assembling factories	1 820
8) Atria	Meat product factory	1 500
9) Kesko	8 construction material supermarkets	1 440
10) UPM	Saw mill, plywood factory, logging company	1 210
11) Kemira	6 Tikkurila paint factories, logistics centre	1 200
12) Lemminkäinen	Several construction projects, Kaluga industrial park	1 000

Source: Ostint Oy, for reference see KL (2008).

Table 6. The largest Finnish acquisitions in Russia in 2008

Acquiring company	Target	Share	Est. value USD mn	Sector
1) Fortum Oyj	TGK-10	93%	3 726	Utilities
2) Itella Corporation	National Logistic Company	90%	313	Logistics
3) Oriola-KD Corporation	Vitim&Co Moron Ltd	75% 75%	134 n.a.	Pharmacy chains
4) Atria Group Plc	CampoMos	n.a.	117	Food & beverage
5) Sampo (If)	Region	100%	27	Insurance
6) Sanoma Magazines	LuxMedia	100%	n.a.	Media
7) Rautakirja	KP Roznitsa	100%	n.a.	Media
8) Olvi Plc	Lidskoe Pivo	51%	16	Food & beverage

Source: Ernst & Young, 2009.

On the other hand, Finland's own possibility to protect Fortum's investment is relatively limited, if the Russian authorities focus their harassment particularly towards Fortum, as was the case with the Finnish logistics company, Containerships, in Kronstadt in 2006-2007. The public information available does allow one to make a fully reliable analysis of the Containerships case, but the background is more or less as follows.

Containerships rented the site of its terminal in Kronstadt near St Petersburg for 50 years. It was promised a nearby lot on which to expand. However, Rostroy (a Russian construction authority) also wanted that lot. Rostroy argued that truck traffic to and from the nearby port was hindering a construction site, but the Containerships management said that it is simply a strong-arm tactic to take control of a piece of disputed land. When a Russian logistics major bought a 50%-share in the Finnish company, the situation was solved. Whatever the true reason behind this case, it is clear that the Russian authorities and their unruly behaviour is a risk factor to any foreign investor since competitors use authorities sometimes as their own employees (TE 2007).

Forestry: the Ruukki Group also encountered difficulties with the authorities. In 2007, the group signed an investment contract with the Kostroma authorities concerning a pulp and saw mill. The deal was signed with the Kostroma governor. After the accidental death of the governor, the authorities started requiring changes to the contracts, and the Ruukki Group withdrew from the project since it was not able to receive felling rights without having to go to public auction for raw material.

This case provides three lessons to foreign investors. First, the company should check whether the regional decision-maker has the authority to take the decision. Second, personal relations are important, but relying on one person's backup is a major risk. And last, it is of the utmost importance to secure the supply of the main factors of production. For instance, it might be difficult for the Ruukki Group to find enough timber in Russia, though the country possesses a fifth of the global forest reserves. The situation reminds me of a Soviet anecdote which describes what would have happened if socialism would have been established in the Sahara. During the first 10 years nothing happens, and thereafter, there will be a shortage of sand.

Some foreign forest companies have invested considerably in Russia, and they have been relatively successful in their investments[12]. However, this does not erase the risk

[12] ”*A Finnish forestry company, Koskisen Oy, this summer saw its mill project make it onto the government's list of priority status projects. Under the new forests act, companies that seek to invest at least 300 million roubles in a forest project may be eligible for priority investment*

that forests are widely considered as national prosperity among the Russians, and therefore, that foreign ownership would be extremely risky, particularly if nationalism raises its head. Furthermore, the inefficient road network in the forests makes the infrastructure risk notable.

Due to the crisis, Russia postponed lifting export tariffs of round wood. However, this has not inspired foreign forest majors to invest in Russia. Foreign firms have mainly established saw mills instead of erecting expensive pulp mills. Even after the crisis, it is very questionable whether Russia will be able force the global forest companies to invest in the country by stopping timber exports with incredible timber export tariffs. The best way to make foreign forest firms invest in Russia is to create a system that guarantees a secure supply of round wood at competitive and predictable prices. Russia's zigzagging with the export tariffs of wood has hurt Russia's credibility as a reliable partner, but on the other hand, one should not stumble over a pinecone if one aims to enjoy the riches of the forests.

Banking and insurance: despite the huge number of bank-like institutions (over 1000)**,** the Russian banking sector is concentrated and the state-dominated 50 largest banks cover 80 per cent of the banking sector assets, and over 60 per cent of the market capitalisation of the banks belongs to the state (TD 2008; BOF 2009b).

One may anticipate that due to the crisis the number of banks will be significantly reduced. Putin stated in January 2009 as follows: "*if you look at the number of banks in Russia and the number of banks in a developed economy, there are just too many of them [in Russia]. … Many enterprises at the local level are used to working with regional banks, therefore we do not plan, without prior arrangement, to artificially enlarge and merge them*" (Pinchuk & Humber 2009).

Though the share of the non-performing loans has increased, I do not, at the moment, foresee a second wave of the crisis, which might collapse Russia's whole banking system like a house of cards. It is obvious that certain small banks will disappear, but it is evident that the state will use all its available financial resources to stop the collapse of any of the largest state-owned banks.

Travin (2009) intellectually writes "*might the major banks who have decided to please Putin by being so obliging not actually collapse as a result? No, unlike the small banks,*

status, which confers the right to lease forest lands at reduced rent and avoid the competitive bidding process" (BOF 2009c).

they will not collapse. The Russian economy has one little trick up its sleeve. The government always helps its chosen few. It supports Sberbank, VTB, and Gazprombank. It finds money for Gazprom, Rosneft, the Volga Car Works, and a few other companies. So in responding to Putin's call for them to reduce their interest rates, the bankers are sure to know that the Central Bank is prepared to provide them with the necessary liquidity in the event of a second phase of the crisis."

Although the financial crisis arrived to Russia from the West, Russia does not aim to close their doors to foreign banks, vice versa Russia aims to attract foreign banks and bankers to the country, since its goal is to make Russia one of the financial centres of the globe (Popova 2009a). It seems that the crisis has not stopped the entry of foreign banks into Russia completely, though the mother banks' weakened financial position has slowed their move to Russia. In June 2009, HSBC, for instance, opened a handful of new banks in Russia (Weaver 2009a).

One case from the insurance business gives a good lesson for foreign investors. "*In May 2009, Basic Element, the investment vehicle of Russian billionaire Oleg Deripaska, is refusing to transfer its controlling stake in local insurer Ingosstrakh to insurance major Generali (Italy). … The Italian company was allegedly ready to buy out Ingosstrakh, held by Czech private equity fund PPF Investments (PPFI), but only after establishing a joint venture with Basic Element. Negotiations apparently ended when the parties were unable to agree on the size of Generali's stake in the venture and the price*" (BEE 2009e, 9).

A lesson to be learned; teaming with oligarchs is a major risk, since sometimes they obey the government's orders, which might be irrational from a business point of view. Second, their influence is so great that often the balance of power between the partners is on their side, and a foreign partner will be kept in the joint business only as long as the oligarch needs a foreigner. Naturally, the oligarchs' political influence has diminished since the Yeltsin era, but nevertheless, due to their wide connection network they are more equal than others within Russia.

To conclude, Russia permits foreign firms in its strategic sectors for three main reasons: (1) they are valuable political chips in supporting Russia's bilateral ties; (2) foreign firms possess superior technology and knowledge; and lastly (3) foreign firms bring additional capital to large investment projects (MT 2009d; Popova 2009b).

Despite the crisis, foreign firms have continued entering the Russian market, though the speed has slightly decreased, as can be seen from the FDI statistics (Appendix). As an example one can name the following cases: PepsiCo plans to invest USD 1 bn over three years time (BEE 2009f). Coca-Cola sees the current economic downturn as an opportunity to expand into Russia, and expects Russia to become its fifth largest market by 2014 (BEE 2009g), McDonald's plans to invest USD 140 mn in 2009 (Weaver 2009b). Carrefour is to open three and Auchan six stores in 2009 (BEE 2009h; MT 2009g). Finnish SOK aims at having 15-20 stores in the St. Petersburg region within a couple of years (Kiuru 2009). Microsoft plans to invest USD 300 mn over the next three years, and John Deere USD 500 mn by 2015 (Weaver 2009c).

Even if some of the foreign investment projects may be delayed due to the crisis, they show that the Russian market is not dead, though the buying power of the Russians has diminished due to the increased unemployment and the rouble devaluation. The lesson of the above is that the crisis of some is a business opportunity to others. On the other hand, Russia will not be an easy market for foreigners, not even after the crisis.

4 Summary

The probability of regime change is extremely low even if the crisis has touched the Russian economy hard. Though I cannot foresee any true regime change in the near future, one should keep in mind that the statist approach has gained weight in Russia.

The prolonged instability of Chechnya has turned the Caucasus into fertile soil for Islamist fundamentalism. Should the Russian Government be unable to normalise life in the Caucasus region, one may anticipate that Islamist fundamentalism does not only spread inside the Caucasus, but fundamentalism may find its targets outside the Caucasus.

That Russian society has become more fragmented and nationalism grows. Increasing nationalism equals increasing investment risk for foreigner investors, since a foreign investor is a stranger and a target for attack if the nationalistic waves overflow the dam.

The world opinion of Russia has substantially deteriorated during the year 2008. The Russian Government should take seriously the deterioration of public opinion about Russia around the world. The prolongation of the crisis in the Caucasus and the cooling of Russia-Ukraine relations may lead to a situation where public opinion prevents some of the Western companies investing in Russia.

The substantial increase in regional unemployment, and hence, the considerable drop in economic well-being will obviously cause social turbulence that Russia has not seen since the beginning of the 1990's.

The Russian leadership has stressed the importance of a stable currency and the country's international reserves are notable. However, the currency stability of the rouble seems to be artificial in the crisis conditions. It remains to be seen how the rouble reacts to the second wave of the crisis, which may come if companies are not able to pay their bank loans.

The aforementioned factors increase macro risk in Russia. In this context, one should remember that risks vary a great deal between the industries. Telecommunications is the most risky industry for a foreign firm at the moment. The main reason for turbulence is the Russian Government's decision to make Svyazinvest a state-owned national champion in telecommunications. If the state swallows up the ownership of Swedish-

Finnish TeliaSonera (MegaFon) or the Norwegian company (VimpelCom), it would mean that Russia has taken another step in destroying its investment climate.

State consolidation in the oil and gas business has continued. The position of foreign oil firms varies. On one hand, the Russian Government offers some foreign oil companies stakes in new fields. On the other hand, the Russian Government has pushed some companies into a corner. The oil and gas business in Russia more follows the logic of international politics than international business, and hence, every step in the sector is shadowed by political risks. When Russia experiences difficult times, foreign oil companies enjoy good times in Russia, and vice versa, and therefore, the current crisis gives, at least, a temporary relief for some foreign oil firms.

I predict that the metal industry will also see its national champion in the aftermath of the crisis. The question is not whether the champion will be created but rather, when it will be carried out, which companies will be involved, and who will have controlling ownership in the national champion. Even if the metals champion will eventually be created, its direct impact on the position of foreign metal companies is not tremendous.

The production of electrical energy is a strategic sector, though it was not explicitly named in the law of strategic sectors. Even if major regime change is unlikely in medium term, the regime may become less foreign business-oriented and that would be an undeniable risk for foreign investors in the electricity sector, since the investments are large and a foreign firm is not able to take the electricity producing unit with him, if the company is squeezed out of Russia.

Some foreign forest companies have invested considerably in Russia, and they have been relatively successful in their investment. However, forests are widely considered as national prosperity among the Russians, and therefore, foreign ownership is risky, particularly if nationalism raises its head.

Although the financial crisis arrived to Russia from the West, Russia aims to attract foreign banks and bankers to the country, since its goal is to make Russia one of the financial centres of the world. Foreign banks' weakened financial position has, however, slowed their move to Russia.

The following well describes the future development. "*Many oligarchs will be unable to repay the loans. A significant redistribution of wealth in Russia will occur. Many companies will fall into either foreign or state ownership. It is uncertain what the* *landscape of Russian capitalism will look like after the crisis. Some oligarch-run companies will survive in reduced circumstances. Some reforms may open the way for a larger small and medium-sized enterprises (SME) sector from which new large firms will eventually spring. Strengthened state conglomerates are likely, as is increased foreign ownership in some sectors.*" (EIU 2009a, 11).

According to a Russian saying, who doesn't risk, never gets to drink champagne. On the other hand, one should keep in mind that risk maximisation is not synonymous with profit maximisation, and therefore, the majority of the foreign businessmen would prefer to have a relaxed drink instead of playing Russian business roulette in order to get champagne.

Epilogue

"*The situation is practically unchanged. The majority of these [public] services not only require a fee, but they're expensive and monopolistic. There's virtually no way around these structures … There's also a tendency to split these services into several parts, with each part requiring a separate payment. It's starting to look like every movement by a civil servant must be compensated".*

Dmitry Medvedev, Comment in the meeting on the development of small and medium-sized businesses, August, 2009, for reference see MT, 2009a, 2.

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Appendix Foreign direct investment inflow to Russia (USD million)

	2007	2008					2009
	Total	Total	Q1	Q2	Q3	Q4	Q1
TOTAL	**47,853**	**62,978**	**18,851**	**20,714**	**14,340**	**9,073**	**8,448**
CIS countries	**131**	**47**	**31**	**-54**	**32**	**38**	**5**
ARMENIA	-5	5	2	1	1	0	0
AZERBAIJAN	101	35	11	12	10	1	0
BELARUS	1	26	2	0	1	22	2
KAZAKHSTAN	78	15	10	-13	7	11	2
KYRGYZ REPUBLIC	3	4	2	0	1	0	0
MOLDOVA	-1	2	0	0	1	0	0
UKRAINE	-46	-39	3	-54	9	3	0
UZBEKISTAN	0	-2	-1	-1	0	0	0
Non-CIS countries	**47,721**	**62,931**	**18,820**	**20,767**	**14,308**	**9,035**	**8,442**
AUSTRIA	324	598	-16	239	195	180	229
BAHAMAS, THE	354	-600	-431	-621	-48	501	525
BELGIUM	81	282	54	37	36	155	11
BELIZE	56	153	54	37	68	-5	5
BERMUDA	8,369	10,764	2,312	2,638	2,522	3,293	907
CANADA	19	19	7	-4	1	15	-2
CHINA	112	61	20	17	9	14	49
CYPRUS	10,594	17,891	4,813	10,348	1,292	1,438	-142
CZECH REPUBLIC	88	130	31	18	72	10	33
DENMARK	126	77	21	32	51	-27	107
DOMINICA	53	60	2	0	57	1	1
ESTONIA	70	2	-2	12	-16	8	-6
FINLAND	677	1,414	273	416	585	139	253
FRANCE	414	572	170	80	179	143	249
GERMANY	7,626	3,446	825	1,028	665	928	962
GIBRALTAR	873	947	358	55	237	297	149
GREECE	98	6	0	0	2	4	1
HONG KONG	8	55	16	17	18	5	1
HUNGARY	61	66	5	53	7	0	23
INDIA	3	19	0	17	-1	2	3
IRELAND	-200	52	1	0	33	18	21
ISLE OF MAN	-143	-30	-8	-7	-8	-8	-5
ITALY	432	153	17	31	83	21	17
JAPAN	80	195	20	0	91	83	68
JERSEY	104	28	26	30	-43	15	16
KOREA, REPUBLIC OF	120	308	28	76	151	53	169
LATVIA	49	35	11	3	20	1	0
LIBERIA	69	34	14	10	14	-3	8
LIECHTENSTEIN	51	56	8	72	-44	19	-10
LITHUANIA	32	37	-17	38	2	14	2
LUXEMBOURG	-2,064	1,116	87	333	430	266	759
MONACO	-21	0	0	0	0	0	0
NETHERLANDS	10,035	10,692	5,878	1,242	3,106	465	1,206
NORWAY	1,302	340	189	144	-90	97	33
PANAMA	37	128	7	118	44	-41	-1
POLAND	29	185	49	58	9	70	31
PORTUGAL	4	8	0	1	6	0	0
ROMANIA	2	6	1	2	2	1	2

SERBIA, REPUBLIC OF	1	0	0	0	0	0	1
SEYCHELLES	-442	73	33	28	13	-1	9
SINGAPORE	19	7	-14	12	3	7	-5
SLOVENIA, REPUBLIC OF	90	73	20	21	0	31	2
SPAIN	366	315	10	21	13	271	5
SWEDEN	529	1,049	297	-14	225	541	347
SWITZERLAND	254	922	114	759	-119	168	300
TURKEY	124	137	6	53	13	64	-13
UNITED ARAB EMIRATES	11	6	5	2	-8	7	7
UNITED KINGDOM	656	909	543	-450	610	207	395
UNITED STATES	1,535	1,821	95	1,448	500	-221	177
VIRGIN ISLANDS, BRITISH	2,218	6,972	2,345	1,928	3,055	-357	1,032
Other countries	108	367	124	74	67	103	134
Not allocated geographically	1,300	974	419	318	196	41	377

Source: Central Bank of Russia, 2009.

Winds of change in Ukraine

The implications of politics for foreign investors

Marika Heikkilä

Contents

Prologue

"Ukraine is a post-totalitarian state. --- In fact, the barracks constructed 70 years we were forced to rebuild as normal house in 18 years. Despite the fact that all elements of design were meant to be barracks, and architects got used to build only barracks. --- In last five years Ukraine has done, of course, much. We have changed. We are free and democratic country. The system of political censorship and persecution has become the thing of the past. The opposition has come to power twice in a free election. This is the real evidence and a fait accompli for democracy and freedom. Further. Ukraine was recognized a market economy. We joined the World Trade Organization, got rid of discriminatory trade restrictions, which had been there for last fifteen years. We have overcome tremendous distance in the relations with the European Union. --- Gradually, we are joining the European space in all the important areas - from energy to education."

Victor Yushchenko, Address on the occasion of the 18th anniversary of Ukraine's independence, September, 2009, for reference see Yushchenko, 2009.

1 Foreign interests in the politically unstable Ukraine

Ukraine is one of the most interesting emerging markets in Europe. It is the home of 47 million consumers and a well-educated, competitive workforce. Furthermore, Ukraine is situated in a geopolitically strategic gateway location between Asia and Europe - at the very cross-roads of East-West and North-South trade routes. Ukraine is, however, equally known for its tumultuous political life since the break-up of the USSR.

Corruption and a shadow economy - which allowed the wealth of the country to cumulate in the hands of a few - were characteristic of the decade under president Kuchma's somewhat authoritarian rule. In 2005, the people of Ukraine marched to the streets protesting a rigged election in a peaceful demonstration, which would be known as the Orange Revolution. In the height of the Orange Revolution, Ukraine seemed to have shed its authoritarian past and moved toward a more democratic future.

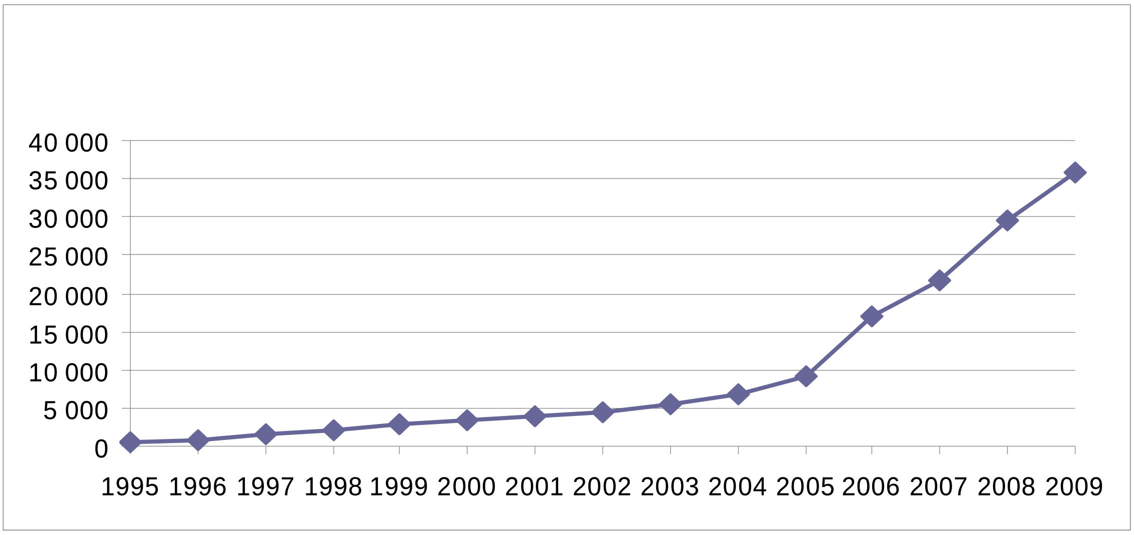
The current economic and political situation in Ukraine is far from stable. Increasing political instability, coupled with a full burst economics crisis, poses new threats for foreign firm operating in this market. Therefore, there is an acute need for an analysis on how the increasing political instability will affect the business prospects of foreign investors in Ukraine. This article is dedicated to studying the political risk faced by foreign investors in Ukraine by examining the political, social and economic development of the country in recent years. The article begins with a review of the development and structure of foreign investment in Ukraine.

The absolute volume of inward foreign direct investment to Ukraine has remained relatively low (Figure 1.). The FDI stock of Ukraine in the beginning of the year 2009 amounted to USD 35.7 billion. Foreign capital begun to flow into Ukraine more widely in 2005, presumably on the grounds of increasing investor confidence brought by the Orange Revolution. Financial and trade related activities have been the most attractive destinations of FDI (Table 1.). The global financial crisis is expected to halt FDI inflows into Ukraine momentarily.

The largest foreign investors in Ukraine have been Cyprus (20%) and Germany (20%), followed by The Netherlands (9%), Austria (7%), The United Kingdom (7%) and Russia (5%). Finnish direct investments in Ukraine are also on the rise, but the absolute value is modest, only USD 16.9 million in the beginning of 2009 (Ukrstat 2009). Approximately 80 Finnish firms operate in the Ukrainian market. Finnish firms with production in Ukraine include e.g. Ruukki, Kone Cranes, Tikkurila and Sanitec Group. (Spiridovitsh 2009). Potential sectors for future foreign investment in Ukraine include:

- projects related to EURO-2012
- wood processing and paper industry
- textile and clothing industry
- agriculture, foodstuff and retail
- energy sector, supply of electricity and alternative energy, and
- ICT and high tech.

Figure 1. Development of FDI stock of Ukraine (USD mn)*



Source: Ukrstat 2009. * at the beginning of the year.

Table 1. Division of foreign direct investment in Ukraine in 2007

Sector	Share %
Financial activities	16
Wholesale and trading intermediation	9
Transportation and machine building	8
Real estate operations	8
Metallurgy and metal working	6
Food production	6
Construction	5
Chemical and petrochemical industries	3
Others	39

Source: Blyakha 2008.

2 Government- and society-related sources of political risk

Ukraine has a history of political illegitimacy. Politicians fighting for power have used, at least, questionable measures to secure their positions. President Kuchma faced allegations of serious wrongdoings during his second term in office and state media censorship prevailed during his presidency. The victory of the present opposition leader Yanukovych in the 2004 presidential elections was cancelled due to serious vote rigging. Even the incumbent President Yushchenko, an eager promoter of democratic values, has faced allegations of corruption in his inner circle (EIU 2008). Recently, the two largest parliament factions, the Yuliya Tymoshenko Bloc and The Party of Regions, headed by Prime Minister Tymoshenko and the opposition leader Yanukovych respectively, almost reached an agreement, which would have entailed large–scale changes to the constitution, including the president to be elected by parliament instead of a nation-wide vote (Prystayko 2009). This could be interpreted as an attempt on their part to secure power positions in case of a drop in popularity among the electorate.

The Orange Revolution marked the beginning of a new political atmosphere in Ukraine. The new government announced plans to stabilise the country's development and reform the economy. Some of the main aims were to establish a functioning judicial system, enhance democracy and free media and to fight corruption. EU-integration was declared as a strategic objective (Finn 2005). Some four to five years later, many of these aims are yet unfulfilled. The judicial system is flawed, democracy is weak, the media lacks full independence, corruption is widespread and political bickering has delayed economic reforms.

Ukraine is facing continuous political paralyses caused by political infighting. The old allies of the Orange Revolution, Yushchenko and Tymoshenko, have become arch enemies and political instability is increasing as the political elite are struggling for power. This political infighting dates back to a change in the constitution that transferred power from the presidency to the parliament, but left the division of authority unclear (Wagstyl & Olearchyk 2009). Consequently, the current power elite are barely capable of solving the country's economic problems, whilst the opposition is unwilling to make moves in fear of getting the blame on the threshold of a presidential election. A likely scenario for Ukrainian politics, therefore, is the continuation of political struggles, lasting instability and a lack of consistency in policy making (Boyarchuk, Skarshevsky & Dubrovskiy 2009).

The Orange Revolution provided a ground for the emergence of a civil society in Ukraine, but democracy is yet not fully entrenched. The main achievements of this peaceful public demonstration were increased freedom of speech and an enhancement of democratic values. According to BBC News (2009), the influence of state and media owners on editorial policy weakened after the Orange Revolution, but partisan attacks on political opponents are still made via TV channels, in newspapers or on websites. Furthermore, major media outlets are owned by businessmen who have their own political interests. In the time of crisis, some steps backward in democratisation may occur, as politicians strive to ensure their positions in power. This might give room for growing elite illegitimacy in the form of media bias, but actual acts of elite repression are not expected.

Politics and business are intertwined in Ukraine. Ukrainian Members of Parliament are often also involved in business and their political positions allow them to contribute in decision making concerning not only the economy but individual firms as well (Pullola & Pajarinen 2008). In reality, some of the MPs are businessmen, who advocate their own interest instead of a political ideology. Oleksandr Paskhaver, President of Kiev's Centre for Economic Development, describes the situation: *"Our business is very tightly intertwined with politics and bureaucracy, much more so than in developed countries. They influence not only through their assets and political instruments but also through the bureaucracy"* (Olearchyk 2009a). In addition, corruption is widespread and developing in a negative direction. In the Corruption Perception Index, maintained by Transparency International, Ukraine was ranked 134th least corrupt countries along with Nicaragua, Pakistan and Comoros. There was a significant drop compared to the previous years, 118th in 2007 and 99th in 2006 (TI 2006-2008).

The presidential election, scheduled on January 17th in 2010, will most likely bring a change of political regime in Ukraine. According to a recent opinion poll, Yanukovych is now leading the race with 22.6% of the votes, while Prime Minister Tymoshenko scored 13.8% of the votes and the incumbent president collected only 7.5% of the votes. The former parliamentary speaker, Arseny Yatsenyuk, is emerging as a significant challenger with 12.1% of the votes (Kyivpost 2009a). The battle for the Ukrainian presidency will be between Yanukovych and Tymoshenko. Yanukovych, supported by oligarchs and the East Ukrainian electorate, will most likely win the election, since Tymoshenko's popularity has suffered from shortcomings in managing the economy in time of crisis. She is, however, known for her ability to win the public onto her side and the situation may change under the campaign period. Furthermore, the consequences of possible political alliances are difficult to predict.

The presidential election will play an important role in the future direction of Ukraine's foreign policy and is therefore prone to carry a significant geopolitical impact. The result of the presidential election is expected to dictate whether Ukraine will continue on its path of integration to the West or return to the Russian sphere of influence. Yushchenko gave a dramatised comment on the meaning of the presidential election: *"The discussion is about where Ukraine will be in a year's time --- in Europe or in Asia. Either a European policy of collective security will prevail, a policy of a unified market, unified values or Ukraine will once again be turned into an enclave"* (Kyivpost 2009b).

President Yushchenko is an advocator of close EU-integration as well as NATO membership. Tymoshenko is also in favour of integration to Europe but stresses the importance of retaining good ties with Russia. Yanukovych is considered as the most Russian friendly presidential candidate, partly because in the 2004 presidential election he was backed by the outgoing president, Kuchma, as well as the Russian president, Putin (BBC News 2007). As the president of Ukraine, he would most probably work to restore the Russia-Ukraine ties, which have been deteriorating during the post-Orange Revolution period of liberal pro-Western politics. He is, however, also in favour of approaching the EU, but objects to any cooperation with NATO. According to opinion polls, most Ukrainians share his view on the NATO agenda (Wagstyl & Olearchyk 2008).

Cooperation between the EU and Ukraine will continue, and new possibilities for deeper integration arose when Ukraine was accepted into the World Trade Organization. WTO membership is generally a positive development for the business environment of Ukraine, although it preceded 15 years of integration and harmonisation efforts and will not have dramatic impact per se. More importantly, membership in the WTO enabled the beginning of the negotiation of a free trade area between the EU and Ukraine (Skarshevsky & Dubrovskiy 2008). Ukraine was also invited to cooperate with the EU through its Eastern Partnership Programme aimed at improving political and economic relations with neighbouring post-Soviet states (EC 2009).

The state of Russia – Ukraine relations seem to be at their worst since the collapse of the USSR, indicating a growing threat of external political violence in Ukraine. On August 11th, Medvedev released a special letter to Yushchenko, where he accused

Ukraine of anti-Russian actions e.g. supplying weapons to Georgia, NATO aspirations, measures to impede the operations of the Russian Black Sea Fleet in the Crimea, signing a gas memorandum with the EU and violating the rights of Russian investors. Moscow also suspended the departure of the new Russian ambassador to Kyiv (Górska 2009). According to Bovt (2009), the two countries are closer to war than ever before during the post-Soviet period and Russia could use military power to prevent Ukraine from falling into the sphere of Western influence. Rumer and Kramer (2009) remind us that the situation between Russia and Ukraine resembles that of Russia and Georgia on the eve of war and disclose the possibility that Medvedev's letter could be a signal of Russia preparing to take drastic action in order to e.g. reclaim the Crimean peninsula. However, the stakes for Russia in a war with Ukraine are considerably higher than in the case of Georgia. For instance, 80% of Russian gas deliveries to Europe go through Ukraine (Vahtra 2009), and interruptions in these deliveries would yield substantial economic losses.

The Ukrainian nation is historically divided into two divisions: the Russia-leaning East Ukraine and Europe-leaning West Ukraine. This division dates back to Ukraine's past of existing as a frontier region between neighbouring powers (EIU 2008). The Ukrainian national sentiment is strongest in western Ukraine, which has close ties with European countries, especially Poland. The industrialised eastern Ukraine, on the other hand, populates a significant Russian minority (BBC News 2009). The polarisation of the nation has not been a source of social unrest, but regional differences can be seen in the voting patterns of the people and this will be especially eminent in the approaching presidential election.

3 Economy-related sources of political risk

A period of fast economic growth has quickly turned into a slump as the global financial crisis spreads to Ukraine. Ukraine's economy began to grow in the beginning of the current decade and - despite some annual fluctuation - economic growth remained high until the beginning of 2008. The annual GDP growth during the years 2001-2008 averaged a little over 7%. However, the global financial crisis has pushed the Ukrainian economy into a deep recession. Ukraine's GDP is estimated to plunge sharply in 2009, followed by a slow recovery in 2010 (IMF 2009, see also Appendix 2).

The economic crisis puts considerable pressure on the state budget, the balance of payment and currency stability. Ukraine's economy is vulnerable to external shocks. The demand and market prices for Ukraine's most important export articles have reduced as a consequence of the global economic downturn, causing the value of exports to diminish. The value of imports has been growing faster than exports in recent years, mainly because of the rising price of Russian energy. Consequently, the current account balance is increasingly negative. The Ukrainian domestic currency, the hryvnya, has experienced a substantial fall. It had lost around 41% of its value against the US dollar at the end of 2008. Intervention from the National Bank of Ukraine has brought stability to the currency, but the hryvnya remains considerably weaker in 2009 compared to the previous year (EIU 2009). Heavy private-sector borrowing in foreign currency complicates the situation further, as both individual and corporate lenders are facing significant troubles settling their instalments.

Government ineffectiveness to tackle the economic crisis leads to growing discontent from the people. The government is struggling to meet the set economic goals, due to the growing budget deficit. It faces difficulties in paying wages and pensions, which may prove to be fatal for the sitting politicians in terms of re-elections. The IMF stand-by loan alleviates budgetary problems but will not allow the government to maintain all the welfare programmes at their current level. The economic crisis and the unrealised promises of the Orange Revolution have yet not been enough to spark any major street protest. The people are disappointed in the political and economic situation, but have so far accepted it with relative calm (Wagstyl & Olearchyk 2009). The risk of significant social unrest will, however, grow due to the scale of economic problems combined with the underlying weaknesses of the political system (EIU 2009). The leaders of the country seem unable to tackle the economic crisis and focus on political bickering and planning for the elections instead (Bremmer 2009).

Short-term planning and decision-making are characteristic of Ukrainian politics and creates a lack of consistency over policy-making. Short-lived governments are not committed to proceed with the previously defined policies, which leads to further delays in implementing reforms (Pullola & Pajarinen 2008). As a consequence, there is some uncertainty over how the rules of doing business in Ukraine will change and develop. Political struggles have delayed necessary economic reforms, such as a friendly tax code and removal of red tape (Olearchyk 2008). The tax system lacks predictability and transparency, and sudden changes are possible (BEE 2009). Past changes in tax legislation have resulted in retrospective tax payments also for foreign investors (Pullola & Pajarinen 2008).

The economic hardship may increase the tendency of the government to interfere in the economy. The government's interference in the market mechanism, e.g. imposing price ceilings, has reduced the confidence of foreign investors (Pullola & Pajarinen 2008). The government may implement resuscitation methods that have a negative impact on foreign investors. The attempt to prevent capital flight by imposing capital controls has driven away foreign investors (O´Brien 2009).

The privatisation process of large state-owned firms in Ukraine is still unfinished, but has remained stalled in the past years. The economic crisis provides a new incentive to privatisation. The government is hoping to improve the budgetary situation by selling its share in the Odessa Port Plant (EIU 2009). The legitimacy of some of the past privatisation deals has been questioned, since a number of lucrative state assets have ended up in the hands of private persons under dubious conditions, and pressure for re-privatisations grew after the Orange Revolution. The metallurgical giant Kryvorizhstal was renationalised and then sold in an auction to Mittal Steel Germany Gmbh for USD 4.8 billion, which was six times more than the original tender only a year earlier in 2004 (Dubrovskiy, Paskhaver, Verkhovodova & Blaszczyk 2007). This type of activity could reduce the willingness of investors to engage in privatisation deals, especially if they are done in the midst of the economic crisis to finance the cash-strapped government. Furthermore, the participation of foreign investors in the privatisation of so-called "strategic" enterprises and monopolies requires the approval of the Parliament and the Cabinet, but no legal definition of these strategic sectors exists (Dubrovskiy et.al 2007). It is also important to note that influential economic agents are active in the political process, fighting over the control of resources, which means that the privatisation process will not be transparent (UCIPR 2009).

4 Conclusions

The **government-related political risk factors** relate to the legitimacy and effectiveness of political processes and the development of international relations. The authoritarian past, combined with some recent attempts of consolidating power, signal a weak state of democracy in Ukraine. The unrealistic goals of the Orange Revolution failed to some extent, but the prerequisites for democratic development are in place.

Political instability remains elevated at the threshold of the presidential election and the prerequisites for government effectiveness are thus poor. The pursuit of power has become the number one objective of politicians. This has a negative impact on the business environment, and the development of the society as a whole, because structural reforms are delayed by political bickering.

The forthcoming presidential and parliament elections will bring a change in the regime and reduce some of the political instability. Yanukovych will most likely be elected the next president of Ukraine. The formation of new political alliances is possible, but their effectiveness will remain low. Differing views on foreign policy will remain a source of conflict in domestic politics and sustain political instability.

Cooperation with the EU will continue and deepen. Tensions in relations with Russia continue to emerge and this poses an external security risk. The threat of war is more present than formerly. Yet, the realisation of this threat is improbable, considering the economic losses inevitably induced by it.

A major factor in **society-related political risk** is the growing discontent of the Ukrainian people on its political elite and their inability to lead the country toward a more stable political and economic condition. The situation in Ukraine is increasingly sensitive for social unrest, due to the severity of economic problems. Political violence will not occur, but people are more willing to participate in organised (or paid) public demonstration. The people of Ukraine clearly desire a change in politics and this will show in the elections. Regional dividedness leads to differing views among the people on the future directions of the country.

Economy-related political risks are closely linked with the worsening economic situation and structural challenges in the business environment. The government will increase its involvement in the economy, due to the financial crisis, and this may have a negative influence on the operations of foreign firms.

A major source of political risks derives from the close linkage between politics and business. This interconnectedness, coupled with widespread corruption, effectively maintains non-transparency in the operations of the authorities. This is, however, more problematic to local firms than foreign investors. Influential businessmen continue to be able to affect the rules of doing business. Political risks are especially imminent in privatisation, which continue to be transparent. The chances of foreign firms to participate in the privatisation process are limited.

Foreign firms that desire to invest in Ukraine must prepare for a set of political risks related to political instability and the unpredictability of future business conditions. Despite the risks, many foreign investors have reaped significant earnings on their investments. Vice president of Kraft Foods reveals that since 1995 the company has invested in Ukraine USD 150 million, grown over 100-fold and posted revenues of over USD 400 million in 2008 (Olearchyk 2009b). Therefore, Ukraine will remain an interesting investment opportunities also in the future, after recovering from the current economic crisis.

Based on the analysis in this article, it can be concluded that the political climate in Ukraine is clearly unfavourable to foreign investment but not to the extent that it would prevent or seriously restrict the possibilities of operating in the market. Political risk is only one of the high risk categories of operational risk in Ukraine[13] and challenges for foreign firms in the Ukrainian market are caused, above all, by the generally undeveloped business environment. Political risk remains elevated in the medium term, but these risks are balanced by the potential for higher than average returns on capital.

[13] See Business Eastern Europe (June 29, 2009) for a complete operational risk assessment.

Epilogue

"The main summary of the half-year political period is simple: the current power could not protect the people from the crisis… We need to solve key issues to prevent catastrophe. We recommend: To protect people and increase minimal salaries and pensions. Support domestic producers which provide jobs and contribute to the budget. Free business from an excessive tax pressure. Restore normal and mutually beneficial relations with Russia. Bring back the strategic partnership."

Viktor Yanukovych, Address, July, 2009, for reference see Yanukovych 2009.

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Cosmetic changes toward economic liberalisation?

An analysis of political risk in Belarus

Marika Heikkilä

Contents

Prologue

"But we intend to involve as much foreign investment as possible in the economy, exactly because the economy is going very fast, and we need additional resources to keep it going.

Therefore, we make important steps to attract more foreign investment. In the course of the last year, we started to revamp our rules of the game in the economy. We did a lot in this area for the World Bank, for example, to recognize Belarus in 2008 as one of the top five fastest reforming economies in the world. We continue to work on that. Last year, we were elevated 30 positions up in the International World Bank index of conditions for doing business.

But that is not enough for us. We want to be within the top 30 positions. We continue with the economic reform. In January 2009, the government adopted an important reform plan consisting of 52 important reform elements. So, we will continue the reforming of the economy, also for involvement of foreign businesses."

Sergei Martynov, Interview, April, 2009, for reference see Martynov 2009.

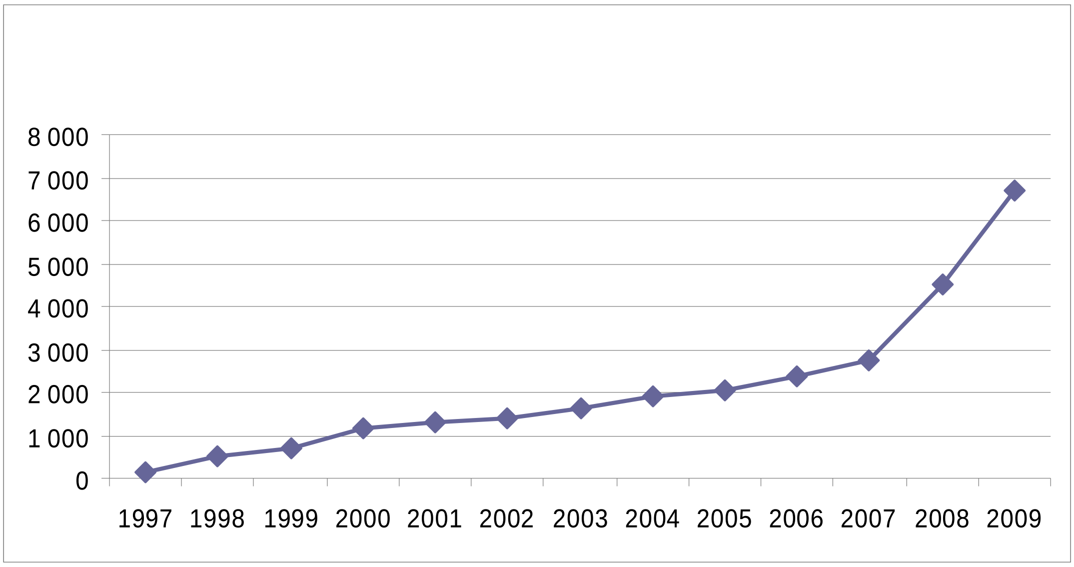
1 The role of foreign capital in the Belarusian economy

The path of Belarus since independence in 1991 till today has been somewhat different from other former Soviet states. Belarus has avoided political and economic turmoil by having a Soviet-style strong government and practising a type of market socialism. This strategy has brought stability, but also kept desirable foreign capital outside the country.

The current economic crisis will challenge the Belarusian economic model of strong state interference and reveal the negative effects resulting from postponing economic reforms. Belarus is slowly liberalising its economy in hopes of integration to the world economy and more independence from Russia. Foreign direct investment could play an important role in the modernisation of the Belarusian economy. Therefore, there is an acute need to analyse the political risk faced by foreign firms in Belarus.

This article examines the recent political, social and economic development of Belarus in order to identify the main political risks faced by foreign investors in this market. The analysis begins with a review on the current state of foreign direct investment in Belarus.

Figure 1. Development of FDI stock of Belarus (USD mn)*



Source: NBRB 2009. * at the beginning of the year.

Belarus has attracted very little foreign direct investment. The absolute value of inward FDI stock in Belarus at the beginning of the year 2009 was only USD 6.7 billion (NBRB

2009). FDI inflows to Belarus have been growing moderately since the end of 1990's. A sudden peak of FDI was measured during 2007 and 2008 (Figure 1), as a consequence of a couple of larger acquisitions. The rapid growth of FDI into Belarus will inevitably stall due to the global financial crisis, but the positive trend could continue once the Belarusian economy recovers from the current crisis.

The largest foreign investor in 2008 was Russia (33%), followed by Switzerland (19%), Austria (15%), Great Britain (11%) and Cyprus (9%) (MFA 2009). Foreign direct investment into Belarus is mainly directed to industry and commerce (Table 1.). Examples of the largest Belarusian firms with foreign capital include (Spiridovitsh 2009):

- Maersk Medical (production of disposable health care products)
- MAZ-MAN (lorry production factory)
- Slavneft (oil industry)
- Zeiss BelOMO (optics)
- MTS (telecommunications)
- Coca Cola Beverages Belarus (beverages)
- Bacco Instruments (metal industry)
- Sirob (robotics)

Table 1. Division of foreign direct investment inflow in 2007

Sector	Share %
Industry	43
Commerce	30
Communication	7
Transport	7
Trade and public catering	6
Others	7

Source: Laaksonen 2009.

Finnish firms have directed only a little foreign direct investment to Belarus. Approximately ten firms with Finnish capital are currently operating in Belarus. These firms include e.g. Bang & Bonsomer, Tietoenator and Olvi (Spiridovitsh 2009). According to Spiridovitsh (2009), opportunities for foreign investors lie in developing the IT sector, modernising the energy sector, developing alternative sources of energy, as well as in the wood processing, machinery and clothing sectors.

2 Government- and society-related sources of political risk

President Lukashenko has ruled Belarus since 1994. A referendum on lifting the two-term limitation on his presidency was passed in 2004, allowing him to stand in the presidential election for a third time in 2006. Official sources announced that Lukashenko collected 83% of the votes, while the main opposition candidate, Aleksandr Milinkevich, scored only 6% of the votes. However, the result of the election was widely perceived as rigged in the West (BBC News 2009). The opposition argues that the same pattern continued in the parliamentary election in 2008, when candidates loyal to Lukashenko won all the 110 parliamentary seats. A report by the Organization for Security and Cooperation in Europe suggests that the opposition was not allowed to communicate its message to the people (Levy 2008).

The level of democracy in Belarus is scanty at best. The opposition is weak, consisting of small parties[14], which lack a unified front. The fact that the Belarusian media is strictly controlled by the state leaves the opposition with very limited resources to have its voice heard. An independent press is almost non-existent and TV is entirely controlled by the state (BBC News 2009). A new media bill, which prohibits the media from accepting funds from abroad, entered into force in the beginning of this year. This bill could effectively restrict the functioning of independent media in Belarus, since foreign grants were a major source of funds for non-state media (EW 2009a). Freedom of assembly by critical independent groups is limited and public demonstrations typically lead to the arrests of participants (FH 2008). Frequent acts of political repression have occurred under Lukashenko's rule. Prominent members of the country's political opposition and investigative journalists have been sentenced to prison or have simply disappeared (BBC News 2009).

Lukashenko has been referred to as Europe's last dictator. This may be justified considering that he not only retains tight control over regional administrators, military, security and law enforcement bodies, but also uses this control to prevent any attempts to dislodge him from his position (EIU 2009a). Concentration of power to the presidency has reduced the role of political parties in the Belarusian political system.

[14] Opposition parties include the United Civic Party (UCP), Belarusian Popular Front Revival (BPF), the Party of Communists of Belarus (PCB), the Belarusian Social Democratic Party (BSDP) and the Christian Conservative Party (CCP) (EIU 2009).

Even the pro-presidential parties[15] have only a formal function, and the National Assembly serves mostly as a rubber-stamp body (FH 2008).

Having a strong central government has made Belarus stable compared to e.g. neighbouring Ukraine, and this has brought Lukashenko genuine popularity among the people of Belarus. He has been able to secure almost full employment and to ensure that wages and pensions are paid on time (Spiridovitsh 2009). Belarus is among the highest income level CIS countries and has one of the lowest poverty rates in the Europe and Central Asia (ECA) region (WB 2009). It is difficult to assess the nation's actual support for its leader, because objective opinion polls do not exist. In addition, no respectable alternatives to Lukashenko's administration exist at the moment. Therefore, it is justified to state that political illegitimacy remains a problem until a functioning political party system, an independent media and free elections are established.

A sudden change of regime appears unlikely even though the present economic hardship imposes pressure on Lukashenko's administration. A drop in the standard of living would reduce Lukashenko's popularity among the electorate and this could force him to return to heavy-handed tactics in order to ensure his position in control (BEE 2009). Lukashenko will step down eventually, but the shift in power is expected to be gradual and smooth (Ehrstedt & Zashev 2009). The next presidential election will be held in 2011 followed by a parliamentary election in 2012. Elections in Belarus seem to follow a carefully planned manuscript, and a peaceful demonstration such as the Orange Revolution in Ukraine is not likely to cause regime change in Belarus. In the meanwhile, the administration may take some tentative liberalisation steps aiming at maintaining Lukashenko in power, but it will bring only cosmetic change (EEM 2009a).

The world public opinion on Belarus - especially the Western world's attitude toward the Lukashenko administration - is rather negative. Belarus is well known for the lack of democracy and violations of human rights. This does not have a direct impact on foreign investment in the form of disinvestment pressure, but it has placed Belarus in international isolation, especially from the West. The USA and the EU have both imposed sanctions against the government.

[15] Pro-presidential parties include the Communist Party of Belarus (CPB) and the Agrarian Party (EIU 2009).

Relations between Russia and Belarus remained tight after the collapse of the Soviet Union. In 1996, the two countries signed a treaty on the creation of a Union State to enhance political, economic and military cooperation between them (Stratfor 2009a). Progress in this area has taken the form of military cooperation, while economic and political integration has been moderate. Nevertheless, Belarus has remained an important ally of Russia and has a significant role in Russia's western defence. While some other former Soviet states have pursued NATO membership, Belarus has not announced such aspirations. Russia has rewarded Belarus for its loyalty with cheap energy, an open market for Belarusian products and notable stabilisation loans. These economic privileges have enabled Lukashenko to practice social and economic policies that supported his image as the indispensable leader of Belarus in the eyes of the electorate (EIU 2009).

Lately, relations between Russia and Belarus have suffered from regularly arising disputes over economic conflicts. Russia's decision to reduce some of the economic privileges enjoyed by Belarus, including increases on the price of gas sold to Belarus, acted as the trigger to the worsening of economic relations. The price of Russian gas to Belarus has tripled since 2004 but is still only 70% of European prices. The Russian side is planning to increase the gas price for Belarus to 90% of European prices in 2010 (BEE 2009). Therefore, Russia is clearly re-assessing the value of loyalty from Belarus and is less willing to subsidise the Belarusian economy. Nevertheless, preferential economic treatment from Russia to Belarus will continue, although it is set to slowly diminish. Regular conflict such as the recently experienced "milk war"[16] will emerge.

Belarus strives to diversify its international relations. Russia will remain the main strategic partner for Belarus, although the relationship is clearly not developing toward a union state (Haukkala & Moshes 2007). Rather, the disputes with Russia over trade policy have forced Belarus to develop closer ties with other countries. Belarus has invested in developing ties with Venezuela, Iran, China and some other Latin American and Arab countries, but these relations are not sufficient to free Belarus from economic dependence on Russia (Haukkala & Moshes 2007). More importantly, the problems in the Russia – Belarus relations have provided an incentive to develop closer ties with the West.

[16] On June 6th, Russia banned imports of Belarusian dairy products to Russia, whose share of Belarusian dairy products' exports is 90%. This was interpreted as Russia using economic sanctions as a tool of political pressure to Belarus (EW 2009c).

Belarus has recently undertaken measures to improve its image in the West. These measures include e.g. releasing political prisoners. Against all expectations, Belarus did not follow Russia in its recognition of Abkhazia and South Ossetia, but has instead postponed the decisions for months. Naturally, the recognition of these disputed regions would seriously harm relations with the West. These image improvements have yielded some positive results for Belarus in EU-Belarus relations. The EU responded to the minor liberalisation of Belarusian society by lifting the travel ban, imposed on Lukashenko and some other high ranking state officials after the ballot rigging in the 2006 presidential election and invited Belarus to join the Eastern Partnership Programme.

In search for alternative markets for its products, Belarus is warming up to the EU's attempts to increase political and economic cooperation in the former Soviet states and has agreed to become a member of the Eastern Partnership Programme (Stratfor 2009c). Belarus clearly recognises the potential benefits of cooperation with the EU, which could be a source of new technologies, credit and investment (Kyivpost 2009). However, the warming of relations between the EU and Belarus is unlikely to result in deep integration, since it is contingent on democratic reforms. These reforms would ultimately lead to a decrease in the power enjoyed by Lukashenko and are highly unlikely to be realised (Stratfor 2009b). Therefore, Russia will remain the main strategic partner for Belarus because of the economic dependence and resulting links to Lukashenko's success as a political leader.

3 Economy-related sources of political risk

The economy of Belarus is tightly under the government's control. The Ministry for Foreign Affairs of the Republic of Belarus describes the Belarusian model of socio-economic development as "*evolutionary, based on active government involvement in overseeing market relations*" (MFA 2008). The president of Belarus has wide authority over the economic policy of the country. In practice, Lukashenko has the authority to manage state-owned property, to set taxes, duties and customs regulations and to seize land and property.

Economic growth in Belarus in the 21st century has been impressive, reaching an average annual GDP growth rate of over 8% during the years 2001-2008. Since then, the economic crisis has extended to the export-oriented Belarus, and the prospects for 2009 are negative. Moderate growth is expected to begin in 2010 (IMF 2009).

The current account balance has been increasingly negative most of the decade, due to rising energy prices and a strong demand for imported products. Recession in important markets has resulted in a sharp decline of Belarusian exports (BEE 2009). Exports in January-June 2009 were only 54% of the same time reference in 2008 (NBRB 2009). The value of imports is also reducing because of the economic crisis. Nevertheless, the current account balance remains negative (BEE 2009). The Belarusian authorities are trying to fight the negative current account balance by temporarily increasing import duties[17] (EW 2009b). The rubel has depreciated substantially and was devalued in January by 20.5% against the US dollar. The value of the rubel continues to weaken substantially during 2009 despite the intervention of the National Bank (BEE 2009).

The economic hardship increases the potential for protest. The popularity and legitimacy of the government derives from the prioritisation of social goals, such as full employment and the equitable distribution of income. The country is e.g. practising overproduction in order to keep unemployment at a low rate (Lehtonen 2009). Under the current economic strains, the government is, however, forced to cut back on some of the subsidies to producers and consumers. Unemployment will inevitably grow, while wage growth is likely to stall or reverse (EEM 2009a). Therefore, discontent with the government is likely to grow.

[17] 25-40% higher import duties on consumer goods and 180% higher import duties on vegetables largely cultivated in Belarus (EW 2009b).

Belarus is economically overly dependent on Russia which constitutes a significant weak point of the economy. Belarus's economy is based on Russian demand for its export products and imports of inexpensive Russian gas and oil. This grants Russia considerable control over the Belarusian economy and a tool for political pressuring. Recent trade conflicts and changes in the terms of energy imports have shown that Belarus cannot blindly depend on Russia in economic matters. The opposition leader Milinkevich (2007) writes: "o*il and gas conflict with Russia has showed that the Belarusian economy is not ready at all to operate with world prices on gas and oil. Belarus is becoming an appendix of raw material-based economy of Russia. Some prosperity that we have achieved has been mainly based on oil products exports and cheap gas price*". According to him, the economic privileges from Russia have been used to strengthen the Belarusian regime instead of developing the country's economy.

The current economic difficulties of Belarus clearly signal the need for economic reforms, but the government is likely to avoid far-ranging economic restructuring or deregulation, because it could be politically risky (BEE 2009). The government is blaming external market influences for the economic troubles, although one of the underlying causes for the severity of the crisis is the market socialism practiced under Lukashenko's rule. The government's solution to the situation seems to be to delay the necessary reforms by borrowing from abroad (Chubrik 2009). The International Monetary Fund has granted Belarus a stabilisation loan of nearly USD 2.5 billion to overcome the economic crisis. The terms of this loan, however, require Belarus to liberalise its economy by e.g. increasing the independence of the central bank, ceasing central regulation of prices and wages as well as preparing the economy for large-scale privatisation (EW 2009d). Therefore, the current economic troubles could actually have a positive impact on the economic development of Belarus in the long term.

The share of the private sector is relatively modest in Belarus. Lukashenko has been reluctant to privatise large state owned firms. In his view, the common good is better served if the state holds a dominant share in the company (Spiridovitsh 2009). The economic crisis has, however, given a new incentive to privatisation and the Ministry for Foreign Affairs of the Republic of Belarus has announced government plans to e.g. create over 500 joint stock companies through privatisation (MFA 2008). Open privatisation transactions would, however, allow Russian investors to take over Belarusian assets, and therefore it is highly unlikely that strategic petrochemical and machine-building firms would be offered for sale (EW 2009e).

Belarus is attempting to increase foreign direct investment and has adopted a list of liberalisation measures aimed at smoothing the running of a business and to simplify the requirements and regulations for business. A number of regulatory reforms took place in 2008 resulting in major improvements in the ease of doing business (WB 2009), but many challenges continue to restrict investment opportunities in Belarus. The investment climate in Belarus suffers from several problems regarding e.g. the legal system, tax regime, price controls and lack of an independent judiciary. Belarusian courts are subject to significant governmental control and the right to a free trial may not be respected, especially in cases with political overtones (FH 2008). Belarus is one of the worst performing countries on the Corruption Perception Index of Transparency International. In 2008, Belarus was ranked 151st, along with Central African Republic, Côte d´Ivoire, Ecuador, Laos and Papua New Guinea (TI 2008). In order to attract more foreign direct investment, Belarus needs to improve its investment climate with streamlined taxation and effective protection of property rights (EBRD 2009). Belarus began negotiations on acceding to the World Trade Organisation in 1995, but progress on this area has been limited. At the moment, it seems impossible that Belarus would enter the WTO in the near future.

4 Conclusions and a summary of political risk in Belarus

Government-related political risks are closely linked to the concentration of political power and unbalanced foreign relations. Authority over the economy is concentrated to the presidency and economic decisions are sometimes made for political reasons. Guarantees for the consistency of economic policies are low, and the worsening economic situation increases state interference in the economy. Therefore, risks of somewhat arbitrary action from regulatory authorities are very much present in Belarus.

Reforming the economy has not been a priority in Belarus. The current economic hardship may have a positive impact in this respect, as it gives an incentive to launch economic reforms. However, economic liberalisation will take place only to the extent that it does not threaten the position of the Lukashenko administration. The West should bear in mind that the Lukashenko administration will not make continuous concessions, and commitment to economic reforms is low.

Diversification of foreign relations would benefit Belarus, but integration to the West requires liberalisation of the society and is not a viable option for the Lukashenko administration. Russia will thus remain the main strategic partner of Belarus, but occasional tensions in the relations between the two countries will continue to emerge. Subsidies from Russia are important to Lukashenko and relations with Russia remain a number one priority in foreign policy.

Belarusian society is relatively stable compared to many other former Soviet states and do not pose major **society-related political risks.** However, some of the necessary support pillars of Lukashenko's position in power are eroding. On one hand, this means growing pressure on regime change and potentially growing political instability. On the other hand, it could lead to growing elite repression. It seems unlikely that the weak opposition would be able to generate sufficient political resistance to change the prevailing political order. Therefore, sudden changes in the political system are improbable.

Economy-related political risks derive from the underlying weaknesses of the economy and economic dependence on neighbouring Russia, which have made the economy vulnerable to outside shocks, such as the global financial crisis.

A summary of the main political risk factors in Belarus is illustrated in Table 2.

Table 2. Political risk factors in Belarus

SUMMARY OF MACRO POLITICAL RISK IN BELARUS		
	Internal	**External**
Government-related	Authoritarian regime and high concentration of political power. High degree of elite il-legitimacy. Frequent acts of elite rep-ression directed to the political opposition.	Deteriorating relations with Russia have an impact on the economy and security of Belarus. Integration to the West is dependent on democratisation and thus international isolation is likely to continue under Lukashenko's rule.
Society-related	Lack of independent media and considerable media bias. Weak and fragmented op-position.	Widely viewed in the West as a dictatorship and known for human rights violations.
Economy-related	Economic crisis will make it difficult to meet economic goals and increase the potential for social conflict. Economy is based on a type of market socialism and reforms will progress slowly. Economy vulnerably to ex-ternal shocks.	Concentration of authority on economic policy. Low guarantees for consis-tency of future economic policies regarding FDI. Economic growth dependent on cheap energy from Russia. Diversification of foreign trade necessary but challenging.

All in all, Belarus is politically and economically more stable than many other CIS countries, such as neighbouring Ukraine. Therefore, the political risk of a foreign investor in Belarus is related to the centralisation of authority over economic policy - rather than political instability - and the lack of guarantees for the consistency of the rules of doing business. Foreign firms operating in Belarus need to prepare for insufficient guarantees of fair and effective procedure from the government's side. Political risk for long term investment projects in Belarus is extremely high. Despite this, the actual level of FDI in Belarus may be below its potential and is likely to grow rapidly in the future.

Epilogue

"There could not be due respect for private property in an authoritarian state. Until Lukashenka is in power no foreign investor, coming from either West or East, cannot be guarantied that his property will not be expropriated… Opening our economy to foreign investment, technologies and business culture should be one of the main tasks of reform-oriented forces. Besides, this is the only way for a small and export-oriented economy like Belarus to survive in highly competitive environment."

Aleksandr Milinkevich, Keynote address, 2007, for reference see Milinkevich 2007.

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The curious case of Moldova

Looking to the future, stuck in the past

Eini Laaksonen

Contents

Prologue

"Moldova is a product of history made through the people's will. History is the main author of our Independence."

Serafim Urecheanu, The President of the Alliance Our Moldova (AMN), Independence Day speech on August 27th 2009, for reference see AZI 2009c.

1 Introduction

The Republic of Moldova is a landlocked country in Eastern Europe, located between Ukraine and Romania. The population of the country is 3.57 million, of which approximately 40 % live in cities and 60 % in rural areas. Moldova is the last country in Europe that has been led by a communist party (Spiridovitsh 2008).

Corruption, heavy bureaucracy, an unsettled legislative system, and an enormous need for restructuring are factors that hinder FDI flows to the country. Despite the existing problems, the government has put efforts towards attracting new FDI to the country. Also some international financial institutions, such as the World Bank, the IFC, and the EBRD, have increased the amount of their projects in Moldova, which is assumed to attract foreign investors to the country. In addition, the EU-membership of neighbouring Romania may have had positive effects – because of membership, the wage levels in Romania have risen and regulations tightened, and the investments are again moving eastward, to Moldova (Spiridovitsh 2008).

However, investors may face many kinds of challenges on this developing market. Next we shall discuss what kinds of political risks companies may face when starting a business and operating in Moldova. We shall start with government-related issues, then move to the conditions of the society, and finally to the economic situation of the country. At the end, we shall present conclusions of the analysis, with some future prospects.

2 Government-related issues

2.1 The parliamentary elections

The political environment in Moldova has been rather unstable during the past year. Parliamentary elections were held on the 5th of April in 2009, and the Communist Party (PCRM) received the majority of the votes. The party has ruled the country for eight years (Klussmann 2009), currently led by the former President Vladimir Voronin. However, the results of the elections were not accepted by the opposition. The counting of votes is seen to have been fair, but the electoral lists included over 300 000 people more than in 2005, even though Moldova's population has been shrinking. (Popescu 2009) The vote was followed by a violent crisis, and in addition, the new parliament could not decide about the following president, due to the opposition's strong boycott.

All this resulted in repeat elections on July 29th. This time the four opposition parties, the Moldovan Liberal Democratic Party (PLDM), the Liberal Party (PL), the Democratic Party of Moldova (PDM), and the Alliance Our Moldova (AMN) won altogether 53 seats, and the Communists collected 48 seats – they lost their majority in the parliament. According to the Central Election Commission, these elections were valid (UPI 2009), and consequently in Moldova **elite illegitimacy** should not be a problem at the moment. The liberal parties formed a coalition entitled Alliance for European Integration (AEI) and intend to achieve five major goals: restore the rule of law; overcome the socio-economic crisis and foster economic development; decentralise the government and promote local autonomy; achieve Moldova's territorial reintegration; achieve Moldova's European integration; and follow a balanced, consistent and responsible foreign policy (AZI 2009b).

These plans sound promising, and there are possibilities for a positive **regime change**. However, the new parliament is still far from realising them. First of all, as President Voronin in September 2nd resigned as acting president after serving the maximum of two presidential terms (MT 2009), the choice of the new president is right ahead, but there are fears of a new deadlock if the Parliament again fails to reach a consensus. Neither the Communists nor the four pro-Western parties will be able to elect a new Moldovan president on their own, as they lack votes of the 61-vote parliamentary majority needed to replace the outgoing head of state. Will for cooperation is needed from both sides, and unfortunately there does not seem to be much interest in that, especially from the Communist Party which lost its leading position. In August 21st, a month after the elections took place, the PLDM leader Vlad Filat handed over the invitation to dialogue to President Voronin, but he rejected it (Stratfor 2009; AZI 2009h). According to the head of Communist Party's electoral headquarters, Mark Tkachuk, the PCRM is ready to be in the opposition to spare the country another early parliamentary election, but when being asked if the Communists will provide the eight votes necessary for electing a new president, he only answered: *"The eight votes will be available only if the Party decides so"* (AZI 2009g).

In addition, even the AEI is internally quite divided. All the four parties wish to build tight ties to the EU and especially to neighbouring Romania, but being pro-European is not the same as being pro-NATO. The PLDM leader Vlad Filat is looking forward to holding a referendum on integrating Moldova into NATO, whereas the PL and PDM are committed to Moldova's neutrality, and the AMN is technically pro-Western but still has strong ties to Russian powers within Moldova. If Filat tries to bring this idea further and the other coalition members back out, it could be the end of the AEI (Stratfor 2009).

The Communists seem rather reluctant to negotiate with the AEI, and plan to create a left-centrist anti-crisis coalition of their own, which would include the PCRM and the PDM and left-wing parties that are outside the Parliament. They aim at building a closer relationship to the West, but they also aim at building a strategic partnership with Russia. In the Communists' opinion, the AEI is incapable of taking Moldova out of the crisis, and according to the former President Voronin, the AEI members stick together because the Western countries promised them quick financial assistance. In addition, the Communist Party demands to be the one inviting the liberal parties into a dialogue, one by one, and is not willing to cooperate with the AEI coalition (AZI 2009a). When it comes to the question of electing the new president, the Communist Party wants to make up its own mind and not to follow the suggestions of the AEI. *"Even if the Pope of Rome asks us, we will not accept him as a candidate of the minor liberal parties in the Parliament"*, the PCRM declared in August 24th. However, during the same day it announced that the PCRM would vote for the PLDM leader Marian Lupu, if he is fielded for the post of head of state by the left-wing coalition, not by the AEI (AZI 2009e).

This announcement sets some light at the end of the tunnel – Marian Lupu could be a person accepted by both sides. He was a member of the PCRM till June 2009, when he left the Party saying that it was unable to reform itself, and started to lead the PDM in July. However, as no one is willing to give up in this power struggle and there is no will for dialogue from the Communists' side, the situation remains very complicated. The PCRM is to put the AEI's unity into test.

For investors the uncertainties about the new Parliament's future and about the new president create risks related to the government's future courses of action. The Parliament's starting point for cooperation is challenging, as especially the Communist Party seems to be willing to pursue its own interests over common ones. This hinders the Parliament from starting to solve, for example, the economic problems that the country is facing.

2.2 Transdnestrian conflict

A major risk issue that can possibly cause **political violence** in Moldova is the Transdnestrian conflict. Transdnestria is an area on the Ukrainian border of the country, where about 17% of all Moldavians live. Moldova's heavy industries and energy production are mainly located in Transdnestria. The area got its name from the river Dnestr, which flows to the Black Sea – from the point of view of the capital Chisinau, the area is located behind the river Dnestr. The biggest city of Transdnestria is Tiraspol (TS 2003; 2008).

Moldova, in the 1800s known as Bessarabia, has for decades been the object of arguments between Romanians and Russians. In the late 1980s, support for the Romanian side among Moldovans started to increase. In Transdnestria, however, there was still a Russian majority. When the Soviet Union collapsed, Transdnestria was afraid of Moldova sooner or later joining Romania, and consequently the area broke away from Moldova in 1990. The rebels and Moldova fought a short war in 1992, after which there have been Russian military forces in Transdnestria, about 1200 soldiers still today. Russia and Transdnestria see the Russian soldiers there as peacekeepers, but in Moldova's opinion, no Russian soldiers should be inside its borders (GF 2009). The conflict has strained Moldova's relations with Russia.

Currently Transdnestria, or The Moldavian Trans-Nistrian Republic (MTR), works as an independent country with its own government, currency, police, army, and flag, but it still officially belongs to Moldova (GF 2009). No country has recognised its independence. Transdnestria has been led by President Igor Smirnov since the independence declaration in 1990, and he aims at establishing a Belarusian authoritarian model of presidential rule in Transdnestria. However, a growing governmental instability can also be sensed in Transdnestria, as the division between the parliament and President Smirnov is deepening (Eastweek 2009).

Moldova has offered the area a broad cultural and political autonomy, but for Smirnov that is not enough (HS 2006). Moldova cannot let Transdnestria break away, as it is the country's industrial centre. Without Transdnestria, Moldova would be destitute and left with an almost completely agrarian economy. (Stratfor 2008) According to the Transdnestrian government, in the referendum in 2006, over 97% of Transdnestrians voted for the area's independence and for the future formation of a confederation with Russia (Regnum 2006; TS 2008; GF 2009). In fact, elections of the President of the Russian Federation on March 2008 took place in Transdnestria as on the territory of Russia. In April 2009 on elections of the Parliament of the Republic of Moldova, the Tiraspol administration did not allow the opening of any polling stations on the territory of Transdnestria (BSTRC 2009). Since 2003, Transdnestria has been in blockade by Moldova. Chisinau refuses to issue customs documentation to any Transdnestrian companies that have not registered with the government and do not pay Moldovan taxes (Stratfor 2005). The relationship between the two parties of the dispute has become very complicated.

There have been several attempts to find a solution to the conflict. Moldova, Transdnestria, Russia, Ukraine and the Organisation for Security and Cooperation in Europe (OSCE) have taken part in the negotiations, the EU and the USA participating as observers. In March 2009, however, Russia showed to the West who is in control over the situation and managed to convince Voronin to sign a document which was not seen as advantageous for Moldova. Voronin signed a declaration, according to which OSCE is to take over the peace keeping function in Transdnestria, but only after a future political settlement, the realisation of which is, in practice, totally up to Russia. Russia can keep its troops in Transdnestria as long as it thinks it is necessary, simultaneously funding and politically supporting Tiraspol under its peacekeeper guise. In addition, Voronin came home from Moscow with Russia's promise to send him some 50 000 tonnes of diesel fuel for the spring's agricultural needs. Because of Moldova's dependence on Russia, Voronin has not managed to get Transdnestria any closer to Moldova, and this declaration of March 2009 is a powerful argument in Russia's hands – in fact, Russia now has permission from Moldova to keep its troops in Transdnestria. The Kremlin's influence still seems to be stronger than that of Brussels and Washington (Minzarari 2009c).

Transdnestria has become a large political problem. It is not only a question of Moldova and the breakaway region – Russia, the EU, and international organisations have become involved as well. The continuing conflict seems to be about political issues between Russia and the West, and at the moment there are no signals of solution.

2.3 International relations

The former President Voronin, despite being a communist, has been anti-Russian and willing to direct Moldova towards the West, and has led the country to join **international organisations**. Moldova is a member, for example, of the following international organisations and associations:

- Council of Europe,
- Commonwealth of Independent States (CIS),
- An organisation of Georgia, Ukraine, Azerbaijan and Moldova (GUAM),
- World Trade Organisation (WTO),
- Central European Free Trade Agreement (CEFTA),
- The International Monetary Fund (IMF), and
- The European Bank of Reconstruction and Development (EBRD).

The government strategy also includes the prospect of Moldova joining the EU, which, however, requires plenty of work in many areas for the country to meet the preconditions for membership (Business guide 2008). As was mentioned before, NATO membership is also being pursued by some parties. However, both the EU and NATO have explicitly stated that the question of Transdnestria has to be resolved before the memberships can even be considered. Russia is reluctant to let Moldova join the EU or NATO, and consequently it aims at staying firmly in Transdnestria and is not really willing to get the conflict resolved. That way Russia makes it impossible for Moldova to join those international organisations (Stratfor 2007). For Russia an isolated Moldova is a more potential political ally. Moreover, according to some opinions, Russia's priority might actually be Ukraine. Although Russia has shown that it still has a hold over Ukraine's eastern regions, Moscow hopes to show Kiev that its reach extends to the other side of Ukraine, boxing the country in the middle of Russian power. That is another important reason for Russia to keep control over Transdnestria (Stratfor 2008).

When Moldova and Ukraine began implementing customs regulations in accordance with international norms in 2006, Russia hit back by banning Moldovan access to its markets, especially for Moldovan wine, saying that the product was of poor quality.

Moldova relies heavily on wine sales, and consequently this action of Russia hurt the country's economy. Russia has also threatened to start charging Moldova market prices for energy supplies, with special exemptions for Transdnestrian residents. Small Moldova does not have many options – Voronin understands that reunification with Trasdnestria will not be possible without Russian assistance. To make Moscow rescind the economic sanctions, Moldova is likely to be forced to let Russians stay on the country for another decade (Stratfor 2005; 2007; 2008). Moldova seems to be quietly becoming the next subject of power disputes between the West and Russia.

Unfortunately for the EU, the democratic transition in Moldova has not so far proceeded fluently, mainly because of the lack of a united and strong democratic opposition and the general political passivity of the people (Kononenko 2005). The EU has started several projects and opened negotiation channels to increase cooperation with Moldova, but the Eastern influence has enhanced itself during the past few years, and a stronger authoritarian wave is visible in Moldova – in practice in the deterioration of independent justice, a free media, a transparent and predictable decision-making process, and political opposition protected by law. The political leadership in Chisinau is forced to listen to Russia as long as the West will not be able to provide enough support to assist Moldova in getting on its feet. Currently Moldova is dependent both on the EU and Russia, and neither the transition nor the negotiations about Transdnestria's status seem to be going forward (Kononenko 2005; Minzarari 2009a; 2009b).

Involvement in international organisations stabilises Moldova's investment environment, but at the same time there are clear political tensions in the country's foreign relations. Moldova is and always will be located between the East and the West, and consequently the tensions will continue to exist, even if the country managed to choose its side.

2.4 Re-nationalisations

Privatisation has been one of the cornerstones of the economic reform plan. The latest round of privatisation started in 2007, but still many enterprises, such as the thermal energy plants, the two energy distribution networks, and a roads building company, were excluded from the privatisation process. The reasons for prohibiting the privatisation of these companies are not clear, and these gestures can be seen as **restricting investments** in certain sectors. Among the most politically sensitive are also the wine and tobacco industries. Nonetheless, through the privatisation rounds, for example, Union Fenosa, Lafarge, Mabanaft, and Knauf have entered the Moldovan market (Expert Group 2009).

However, some re-nationalisations have taken place, and this is the phenomenon where **elite repression** can clearly be sensed. For example, in February 2009, the European Court of Human Rights (ECHR) decided that the Moldovan Government will have to pay more than EUR 7 million to a Belgian investor, whose hotel was re-nationalised without any compensation. The Dacia Hotel in Chisinau was privatised and bought by the foreign investor at the end of 1990's. In 2001, the Communist Party nationalised the hotel under the pretext of violations made in the privatisation process – the hotel had been sold at less than for its real cost. The investor considered that his rights were violated, and finally appealed to the ECHR (AZI 2009d).

This was the largest sum that has been fixed by the ECHR as a punishment for Moldova, and the country is the leader in Europe in the sums paid per capita on ECHR decisions (AZI 2009d). Another quite notorious example was the experience of the American company Europharm in Farmaco. In 1998, Europharm Inc. purchased 81% of shares of the state-owned pharmaceutical plant JSC Farmaco. The value of the purchase was USD 2.1 million. However, in 2001, the Department of Privatisation asked the company to sell 29% of the shares back to the state. The investor did not agree, and finally the litigation was solved by the end of 2002 by the state collecting all the shares bought by Europharm, and the investor received nothing back (Popa 2008). Unfortunately, there are also several other controversial re-nationalisation cases, such as the case of Soroca granite quarry, which was re-nationalised in 2007.

A somewhat different case was that of Bimer against Moldova, also solved by the ECHR. The Bimer joint-stock company was registered in the republic of Moldova, and its assets were owned by investors from Moldova, the USA and the Bahamas. The company obtained two licenses for opening a duty free shop and a bar at the Leuseni border for an unlimited time, but in April 2002, the Customs Code was amended so that duty free economic entities should only be opened at international airports. Bimer was in trouble and had to quit the business even though the amendments were not supposed to have a retroactive effect and for foreign investors there was supposed to be a status quo in the application of laws for 10 years. The ECHR concluded that company's rights were violated, and the Government of Moldova had to pay compensation (Popa 2008).

After these cases, it is no wonder why foreign investments in Moldova have remained at a rather modest level. Re-nationalisations, government intervention, bureaucracy, and a lack of transparency are not attractive characteristics of a business environment. The country seriously requires reforms and a government that acts fairly with the much needed investors.

3 Conditions of the society

Moldova is a multi-ethnic state, as within the country there are people representing 30 nationalities. The most significant of those are Moldavian/Romanians (78%), Ukrainians (8%), Russians (6%), and Gagauzs (4%) (CIA 2004). In addition, the society is politically strongly polarised, some towards the West, some towards Russia. In February 2009, approximately 800 000 of Moldova's inhabitants had applied for Romanian citizenship, and these people also wish Moldova to join the EU with the help of Romania (Klussmann 2009). In Transdnestria, however, people strongly support Russia. The regional diversity between these two areas and the incongruent political interests of their citizens result in **fragmentation of the society** and create considerable tensions, as was seen in practice after the elections in April 2009. Thousands of protestors gathered on the streets of Chisinau after the Communists had won the elections, and the demonstration burst into a violent conflict.

Potential for social conflict remains because of strong political polarisation and because of the worsening economic conditions. In repeat elections in July 29th, the people's support for liberals was more than for communists for the first time since 1991. However, according to the European Parliament delegation observing the elections, which were evaluated to have been fair, the campaign was still negatively affected by subtle intimidation and media bias, and consequently could not restore public trust (European Parliament 2009). Moreover, as the Parliament parties have problems with cooperating with each other, the conditions of the society are not taken care of in the best way they could be. And if Filat's wish for a referendum about NATO membership would come true, the society's reactions could be unpredictable. The vote could fail, Transdnestria might strengthen its struggle for independence, and Russia could also show its opinion through the economic ties that it has to Moldova (Stratfor 2009).

Many Moldavians have not been satisfied with the Communist governance. The conditions of the society have not been improving fast enough, and hundreds of thousands of people have left the country to work abroad. However, because of the global crisis, the migrants are now returning home, the remittances will decrease, and there will be no jobs available for the returning migrants. Consequently, the living standards of many Moldavians might get even worse. At the moment, almost 30% of Moldova's four million citizens live below the poverty line (Bisca 2009). There is a social assistance system and a pension system, but they are insufficient and in serious need for development, and the education system does not produce the labour that is on demand in the markets. (Expert Group 2009). In addition, for example, human trafficking, money laundering, and arms smuggling are severe problems, especially in Transdnestria (Ciobanu 2008).

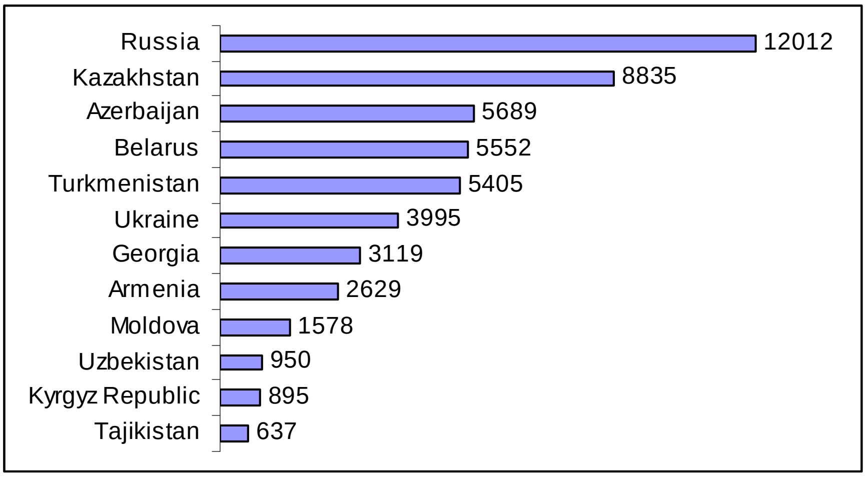
There are plenty of problematic issues concerning the society, such as the strongly polarised political views, poverty, and criminality. The former government was rather helpless in front of all these issues, and many Moldavians are hoping for the liberal parties to have solutions to these problems. The elections in July 29th showed that most Moldavians want to give a chance for the four pro-Western parties to show what they have got to give for the country. However, if the new Parliament fails to get the reforms forward and improve the living conditions of the people, the threat of social conflict remains topical.

4 Economic situation

4.1 *The economy in general*

An economic decline followed the collapse of the Soviet Union, but GDP growth started in 2000 with a growth of 2.1%, and reached 7.2% in 2008 (NBS 2009). The **GDP and GDP per capita** growth figures can be seen in Appendix 2. However, Moldova's GDP is still under its pre-transition level, and the GDP per capita is one of the lowest among the CIS countries, as can be seen in Figure 1.

Figure 1. GDP per capita in the ex-USSR (excluding the Baltic States) in 2008 (USD)



Source: IMF World Economic Outlook Database, 2009.

The economic growth in 2008 was impressive, but in 2009 the country has again faced an economic decline because of the financial crisis, and the short-term perspectives do not look promising. Constantly high inflation has been following the economic growth – during the past few years it has remained above 10%. However, the favourable development in 2008, such as the decrease in oil prices and a good agricultural harvest, led to a decrease of inflation to 7.2%, but deflation is not expected to last long. In addition, as a result of the decrease in foreign currency inflows caused by the decrease in volumes of remittances, FDI, and exports, it is expected that **the national currency**, the Moldovan Leu (MDL), will depreciate by almost 20% until the end of 2009 (Expert Group 2009).

Another cause of pressure is the **budgetary deficit**. A decrease in consumption and the effects of a shrinking economy in the real sector will cause a dramatic decline in public revenues, which will affect the government's capacity to meet its expenditure responsibilities. The state budget deficit in seven months from January to July 2009 was over EUR 112 million, which already was more than three times the sum that was projected for the whole year. The new forecast for this year's deficit is at least EUR 250 million, and it is not yet known how it will be covered. Privatisations and some unpopular reforms, such as an increase in taxes and excises, a reduction of infrastructural development projects, and diminishing transfers to local governments and other institutions, are to be expected. Help in the form of loans is expected from international organisations, such as the IMF and the World Bank. Without help, Moldova could face a serious economic crisis, as the payment of salaries and pensions would be blocked (AZI 2009f; Expert Group 2009).

Currently Moldova is one of Europe's poorest countries, and the economic conditions are not very favourable, especially for some parts of the society as the **wealth is not distributed equally** – as was mentioned before, almost 30% of Moldavians live under the poverty line (Bisca 2009). Simultaneously, Moldova is an agricultural country, for which wine as well as fruit and vegetables are among the most important export products (Spiridovitsh 2008). 23% of the GDP is produced by the agricultural sector, 21% by industry, and 55% by the service sector, and actually the purpose of many of the industrial units is to satisfy the demands of agriculture (Sallai 2007). The fact that agriculture accounts for such a significant share of GDP is a risk for the whole country's economy as the amount of production depends largely on the weather (Spiridovitsh 2008). However, the role of agriculture is slowly shrinking, and the service sector is growing, led by transport and communication, real estate transactions, IT, and recreational activities (Expert Group 2009).

The environment in terms of taxes, regulations and business licensing is somewhat complicated. Penalties for errors in tax returns are severe. The number of permits and approvals that businesses need to obtain is expensive and time consuming. The mortgage market is still underdeveloped. Although many basic policies are in place and meet international standards, their enforcement is sporadic. Resolving commercial disputes can be challenging when there is corruption in legal institutions. Bureaucratic procedures are not always transparent and they often take unnecessarily long, providing room for corruption (USDS 2008; EIU 2009). According to the Corruption Perceptions Index 2008 by Transparency International, Moldova's ranking was 109 out of 180 countries. The position was better than that of Russia, Ukraine and Belarus, but worse than that of, for example, Turkey, Romania and Bulgaria (CPI 2008).

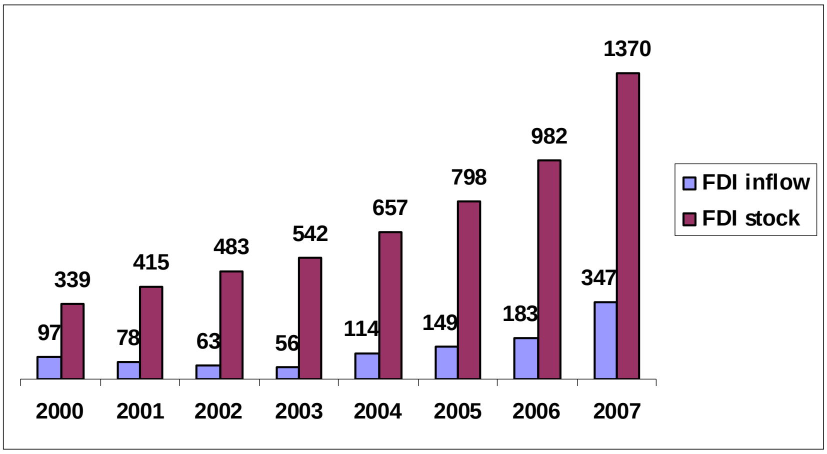
The government has tried, even though not very successfully, to create some rules to the game. Regulatory framework reform started in 2004, the major goal being the elimination of repetitive and ineffective business regulations which create obstacles for investment and enterprise development. Several regulatory changes and principles have been introduced, but most of them remain unimplemented. Because of all the shortfalls, so far the USA and the EU have not yet recognised Moldova as having a market economy. Moldova is clearly still in the process of transition, both in terms of economic output and institutional building (Expert Group 2009).

Foreign companies investing in Moldova will currently face a corrupted business environment with complicated regulation and taxation systems. Because of the decreasing consumption and the already high budgetary deficit, the government has difficulties in meeting its expenditure responsibilities, not to mention the improving of the business climate, regulation, and infrastructure.

4.2 FDI today and tomorrow

The FDI growth has been stable since the year 2000. The development of FDI inflows and stock can be seen in Figure 2.

Figure 2. FDI inflow and stock development in Moldova (EUR million)



Source: World Investment Report 2008, UNCTAD.

Even though the investment volumes have been rather modest, economic growth has been quite investment-led since 2007 (Finpro 2008, 11). The growth of FDI may be due to the improved domestic business climate, but also to the fact that the FDI inflows have increased in the whole of Eastern Europe in 2008. In 2007, the share of FDI inflows of GDP was 10.4%, placing Moldova in fourth position according to this indicator among the transition countries in Eastern Europe. In 2008, the FDI/GDP ratio increased to 11.8% (Expert Group 2009). However, the GDP has stayed at a rather low level – according to the National Bank of Moldova it was EUR 3.9 billion in 2008 – which explains the large FDI/GDP results (Finpro 2008, 11).

The structure of FDI in terms of sectors and countries of origin can be seen in Table 1.

Table 1. Structure of FDI by sectors (stock in 1994–2007) and countries of origin (inflow in 2008)

Sector		**Country of origin**	
Wholesale and retail trade	21 %	Netherlands	21 %
Processing industries	11 %	Russia	11 %
Energy, gas and water	10 %	Italy	10 %
Finance	10 %	Cyprus	10 %
Real estate transactions	8 %	Spain	8 %
Transport and communications	5 %	UK	5 %
Construction	2 %	Germany	5 %
Others	33 %	Others	31 %

Source: Moldovan Investment and Export Promotion Organisation (MIEPO), 2009.

Most of the FDI has been targeted to the trade sector, but in the next few years, the growing service sector (especially banking) is likely to be the most interesting investment target for foreign investors. From Finland there have been investment flows, at least to the telecommunications sector. In 2003, Fintur Holdings BV, the shares of which TeliaSonera owns some 60%, bought 23% of the shares of Moldcell. Following that, in the same year, Fintur Holdings increased its ownership of the company to 100 %. (Finpro 2008, 11)

Moldova has developed some policies to increase FDI, even though more would be needed. The main legislation regulating FDI in Moldova is the Law on Investments in Entrepreneurial Activity, which was enacted in 2004. Under this law, Moldova provides full security and protection to all investments, and guarantees equal rights to local and foreign investors. At the moment there are six Free Economic Zones (FEZs) in Moldova, in which investors enjoy a special customs and tax regime. The total number of companies registered in FEZs in January 2009 was 147, and the investments to these zones totalled EUR 13.3 million in 2008. Reinvested earnings are an important indicator of investor trust, and the amount of reinvested earnings in Moldova has been growing over the past few years. They have been exempt from corporate income tax since 2008, and the share of reinvested earnings of total cumulative investments increased from 1.9% in 2000 to 11.6% in 2008. This reflects the long-term confidence that investors have had in Moldova (MIEPO 2009).

According to the Moldovan Investment and Export Promotion Organisation (MIEPO), the major foreign investors are as shown in Table 2.

Table 2. The major foreign investors in Moldova

Company	Country	Sector
Société Générale	France	Banking
Lukoil Europe Ltd.	Russia	Petroleum products
Union Fenosa	Spain	Energy distribution
Lafarge	France	Construction materials
France Telecom MI	France	Telecommunications
Veneto Banca	Italy	Banking
METRO Group A.G.	Germany	Wholesale trade
Danube Logistics	The Netherlands	Shipping & logistics
Mabanaft A.G.	Germany	Petroleum products
WNISEF	USA	Food industry, glass bottles, banking sector
KNAUF	Germany	Construction

Source: Foreign Investment Guide 2009, MIEPO.

In these sectors foreign investors have found profitable opportunities in Moldova, but political risk is also present there. For example, in the banking sector there are signals of increased state intervention power, as the Parliament in June 2009 approved amendments to the Law on Financial Institutions and the law on the guaranteeing of deposits of individuals – especially Chapter IV, entitled Forced liquidation of the bank, aroused some sceptical discussion (ADEPT 2009). In the construction sector, the 20 % Value-Added Tax was introduced in January 2008 on construction works, which put significant pressures on real-estate prices. In addition came the prohibition to sell unfinished apartments and houses to the final consumer, and consequently enterprises are now forced to channel more money into finishing the apartment before selling, whereas in recent years the dominant share of real estate has been sold in the grey variant (Expert Group 2009).

On an international scale, one of the risk issues is the Moldovan energy sector, which is heavily dependent on Russian and Ukrainian imports and consequently rather vulnerable to external shocks and international disputes (Spiridovitsh 2008). For example, in the first quarter of 2009, about 73.2% of the imported energy resources came from Russia, natural gas being all Russian (National Bank of Moldova, for reference see Preasca 2009). Another example is the unsettled political dispute in Transdnestria, which creates risks in the logistics sector as the most important routes from Moldova to Russia and other East European markets go through the breakaway region (TDWS 2006). Also, in the telecommunications sector, the mobile phone business has suffered from Transdnestria keeping on jammers which prevent the mobile phone connections from working (Lotila 2004).

After a steady economic growth, Moldova has faced the global economic crisis, which also is to be felt in FDI flows. For investors the Moldovan market is not very attractive as the country is struggling with serious economic and political problems. In addition, the threat of governmental intervention and somewhat unpredictable regulatory changes set challenges for foreign investors. Stability is what Moldova needs to become a more attractive destination for FDI.

5 Conclusions

In conclusion, every investor investing in Moldova has to deal with the governmental, societal and economic risk issues that the country is facing. The risks are summarised in Table 3.

Table 3. Political risk factors in Moldova

SUMMARY OF MACRO POLITICAL RISK IN MOLDOVA		
	Internal	**External**
Government-related	The communist leadership has not had the people's full support. Election of a new president is ahead – can the Parliament cooperate? Is the following head of state communist or liberal? What are his goals? The unpredictability of the future continues. Is the threat of re-nationalisations still topical?	Government tries to please the East and the West at the same time. Disputes with Russia have had a negative influence on the economy. Regulatory reforms do not seem to proceed, despite the help of international organizations. The status of Transdnestria remains unsolved and has become an international issue.
Society-related	Strong political polarisation in the society. Worsening living conditions. Possibilities for continuing social unrest.	Global economic downturn forces large amounts of migrants to return home. Moldova is a hub of international crime and human trafficking.
Economy-related	The country is in a worsening economic crisis. Uncompleted privatisation, bu-reaucracy and corruption. The country is still in transition – business framework remains complicated.	Problems with balance of payments and currency instability. Global crisis – returning migrants and the decline in foreign trade and investments – reduces the state's resources to develop the country.

Currently there are considerable tensions in Moldova's political atmosphere. The shift of parliamentary power from communists to liberals creates possibilities for a change in Moldova's course of development, but if the liberal coalition cannot cooperate and if the Parliament fails to elect a new president, there is a high risk for the need of repeating the elections again. This could even be a new chance for the Communists to win back the majority of seats. However, in my opinion it seems likely that the liberal coalition will maintain power, and eventually the parties will be able to cooperate when necessary. This argument is based on the two following issues.

Firstly, the actions of the former government were not very predictable as it tried to please both the West and Russia at the same time. In addition, the needed reforms did not proceed as hoped, and the government did not seem to have the tools for raising its country up from the economic crisis. Consequently, voters turned to the liberal parties, and if repeat elections were to take place again, the Communists might lose even more seats. Therefore they need to avoid the elections and start to cooperate, and moreover they may have to accept a compromise presidential candidate, such as Marian Lupu, who can at least in some way be considered as "one of us" from both of the opposing sides. Or, there might appear candidates that are neither from the liberal parties nor from the Communist party; candidates who are also seen as "equal" for both the AEI and PCRM.

Secondly, I believe that the AEI will be able to stand united in front of the PCRM as it will not easily give up the power that it finally managed to gain. The liberals will not easily let the repeat elections take place either, because they are not willing to give the Communists a chance to win back the majority of seats, which could, in theory, be possible as well.

As a consequence, the AEI and PCRM are somewhat forced to cooperate to maintain their current positions. In addition, it seems to have been recognised by both the AEI and PCRM that it is time to be most concerned about the country's crisis situation and not to waste time in political disputes.

In fact, difficult problems remain to be solved for the new Parliament. From the economic point of view, the coming years do not look very promising due to the recent global trends. The decline of remittances, the moderation of domestic consumption, and the decline in the external demand have resulted in a slowdown of GDP growth. The government does not have much to spend in improving the conditions of their society, infrastructure, and so forth. Because of the political polarisation and quickly worsening economic conditions, there are increasing possibilities for social unrest. In addition, because of the dependency on both the West and the East, Moldova seems to be quite handicapped in solving the Transdnestrian conflict, which again is a threat to the country's security and economy. No matter whom the new president will be, this person is, together with the Parliament, hoped to find some kind of a balance between the Western and Russian dependencies – to choose the direction in which Moldova is to go, even though both the East and West will always have a strong influence in the country's development.

For foreign investors, political risks are significant in this politically hectic and unstable situation. Privatisation and regulatory reforms are still in process, and doing business in such a corrupted environment sets challenges for investments. In addition, the re-nationalisation cases are still fresh in the mind. For example, in the sectors of energy and telecommunications, foreign investments are highly welcomed, but is the threat of re-nationalisations still topical? As a consequence of the large budget deficit, privatisations might increase, and consequently this is a very important question – no investor wants to buy a privatised company and afterwards give it back for nothing. At the time of the new Parliament, whose goal is to make Moldova a truly democratic country, I do not see signs of the continuation of re-nationalisations in the future, but I still cannot say that the risk does not exist.

Moldova needs a government that can create a stable business environment where domestic and foreign investors can benefit from the country's gateway position between the East and West. I assume that in any case, changes for the better will not take place very fast because of the strong governmental, societal and economic ties that Moldova has to its past. However, if the new democratic coalition manages to get the Parliament functioning, despite the currently cooperation-reluctant Communist Party, there is a chance for a turn to better. Determined and democratic governance is needed so that the country can leave its past behind, look to the future, and start anew.

Epilogue

“18 years it is when a person comes of [man’s] age. We realize that we grew up making many mistakes, being naives and allowing many persons to decide our fate. We are already adults and are able to decide our destiny ourselves.”

Vladimir Filat, The President of the Moldovan Liberal Democratic Party (PLDM), Independence Day speech on August 27th 2009, for reference see AZI 2009c.

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APPENDIX 1 Operational risk ratings of the Western CIS

	Belarus		Moldova		Russia		Ukraine	
	Rating	Score	Rating	Score	Rating	Score	Rating	Score
Security risk	B	32	B	36	C	54	C	43
Political stability risk	C	55	C	60	C	60	D	65
Government effectiveness risk	E	93	D	79	E	82	E	82
Legal and regulatory risk	E	90	D	70	D	70	D	72
Macroeconomic risk	D	75	C	50	D	70	D	70
Foreign trade and payments risk	D	75	C	43	C	57	C	57
Tax policy risk	C	50	B	38	C	50	C	50
Labour market risk	C	50	C	54	C	54	C	54
Financial risk	D	71	D	71	D	63	D	71
Infrastructure risk	D	69	D	69	C	50	D	75
Overall risk assessment	**D**	**66**	**C**	**57**	**D**	**61**	**D**	**64**
Note: E = most risky; 100 = most risky								

Source: Business Eastern Europe 2009.

APPENDIX 2 Socio-economic development in the Western CIS

Population development in 2002-2008 (million persons)

	2002	2004	2006	2008
Belarus	10,0	9,8	9,8	9,7
Moldova	3,6	3,6	3,6	3,6
Russia	145,2	144,2	142,8	142,0
Ukraine	48,5	47,6	46,9	46,4

Sources: Belstat, Molstat, Rosstat, Ukrstat.

Annual GDP growth in 2001-2014 (%)

	2001	2002	2003	2004	2005	2006	2007	2008	2009*	2010*	2014*
Belarus	4,7	5,0	7,0	11,4	9,4	10,0	8,6	10,0	-4,3	1,6	5,7
Moldova	6,1	7,8	6,6	7,4	7,5	4,8	4,0	7,2	-3,4	0,0	5,0
Russia	5,1	4,7	7,3	7,2	6,4	7,7	8,1	5,6	-6,0	0,5	5,0
Ukraine	9,2	5,2	9,6	12,1	2,7	7,3	7,9	2,1	-8,0	1,0	6,0

Source: IMF – World Economic Outlook 2009. *** estimates**

GDP per capita (PPP) 2006-2008 (USD)

	2006	2007	2008
Belarus	9 900	10 700	11 800
Moldova	2 200	2 300	2 500
Russia	14 000	15 200	15 800
Ukraine	6 600	7 100	6 900

Source: CIA - The World Factbook (estimates).

APPENDIX 3 Foreign trade of Belarus

Development of the foreign trade of Belarus in 2000-2007 (USD billion)

	2000	2001	2002	2003	2004	2005	2006	2007
Exports	7,3	7,5	8,0	9,9	13,8	16,0	19,7	24,3
Growth %	-	1,7	7,6	24,0	38,5	16,0	23,5	23,0
Imports	8,6	8,3	9,1	11,6	16,5	16,7	22,4	28,7
Growth %	-	-4,2	9,7	27,1	42,7	1,3	33,8	28,4
Balance	-1,3	-0,8	-1,1	-1,6	-2,7	-0,7	-2,6	-4,4

Source: Belstat.

Structure of Belarus' foreign trade in 2007 (%)

Exports		Imports	
Mineral products	36	Mineral products	36
Machinery, equipment, vehicles	22	Machinery, equipment, vehicles	25
Chemical products	15	Metals and metal products	12
Metals and metal products	8	Chemical products	12
Products of food industry and raw materials	8	Products of food industry and raw materials	8
Other	12	Other	8
Export partners		**Import partners**	
EU	44	Russia	60
Russia	37	EU	22
Ukraine	6	Ukraine	5
China	2	China	3
Brazil	2	USA	1
Others	10	Others	8

Sources: Invest Belarus, EC.

APPENDIX 4 Foreign trade of Moldova

Development of the foreign trade of Moldova in 2000-2007 (USD billion)

	2000	2001	2002	2003	2004	2005	2006	2007
Exports	0,5	0,6	0,6	0,8	0,9	1,1	1,1	1,3
Growth %	1,7	19,9	13,8	22,7	24,7	10,8	-3,6	27,6
Imports	0,8	1,0	1,0	1,4	1,8	2,3	2,7	3,7
Growth %	32,4	26,5	5,7	35,1	26,1	29,6	17,5	37,0
Balance	-0,3	-0,4	-0,4	-0,6	-0,9	-1,2	-1,6	-2,4

Source: Molstat.

Structure of Moldova's foreign trade in 2007 (%)

Exports		Imports	
Foodstuff products, tobacco	21	Mineral products	21
Textiles	21	Machinery and mechanical appliances	15
Vegetable products	12	Chemical products	9
Base metals	8	Base metals	9
Machinery and mechanical appliances	7	Vehicles, transport equipment	8
Other	31	Other	38
Export partners		**Import partners**	
Russia	17	Ukraine	19
Romania	16	Russia	14
Italy	10	Romania	12
Belarus	6	Germany	9
Germany	6	Italy	7
Others	45	Others	39

Source: Molstat.

APPENDIX 5 Foreign trade of Russia

Development of the foreign trade of Russia in 2000-2007 (USD billion)

	2000	2001	2002	2003	2004	2005	2006	2007
Exports	105,0	101,9	107,3	135,9	183,2	243,8	303,9	355,2
Growth %	27,4	-3,0	5,3	26,7	34,8	33,1	24,7	16,9
Imports	44,9	53,8	61	76,1	97,4	125,4	164,7	223,1
Growth %	-28,3	19,8	13,4	24,8	28,0	28,7	31,3	35,4
Balance	60,1	48,1	46,3	59,8	85,8	118,4	139,2	132,1

Source: Rosstat.

Structure of Russia's foreign trade in 2007 (%)

Exports		Imports	
Mineral products	65	Machinery, equipment and transport means	51
Metals, precious stones and articles thereof	16	Foodstuffs and agricultural raw materials	14
Chemical products, rubber	6	Chemical products, rubber	14
Machinery, equipment and transport means	6	Metals, precious stones and articles thereof	8
Wood, pulp and paper products	4	Textiles and footwear	4
Other	3	Other	9
Export partners		**Import partners**	
EU	53	EU	52
Turkey	6	China	13
Ukraine	5	Ukraine	5
China	5	Japan	5
USA	5	Belarus	4
Others	26	Others	21

Source: Rosstat, EC.

APPENDIX 6 Foreign trade of Ukraine

Development of the foreign trade of Ukraine in 2000-2007 (USD billion)

	2000	2001	2002	2003	2004	2005	2006	2007
Exports	18,1	19,8	22,0	27,3	38,0	40,4	45,9	58,3
Growth %	-	9,4	11,1	24,1	39,2	6,3	13,6	27,0
Imports	15,1	16,9	18,2	24,5	31,1	39,1	48,8	65,6
Growth %	-	11,9	7,7	34,6	26,9	25,7	24,8	34,4
Balance	3	2,9	3,8	2,8	6,9	1,3	-2,9	-7,3

Source: Ukrstat.

Structure of Ukraine's foreign trade in 2007 (%)

Exports		Imports	
Non-precious metals and articles	42	Mineral products	28
Agricultural and food products	13	Engineering products	18
Engineering products	10	Chemical products	9
Mineral products	9	Non-precious metals and articles	8
Chemical products	8	Agricultural and food products	7
Other	18	Other	31
Export partners		**Import partners**	
EU	31	EU	45
Russia	22	Russia	25
Turkey	8	China	8
Bulgaria	4	Turkmenistan	6
Belarus	3	Turkey	2
Others	33	Others	14

Source: Ukrstat, EC.

APPENDIX 7 Foreign direct investment in the Western CIS

Development of foreign direct investment in 2000-2007 (USD million)

		2000	2001	2002	2003	2004	2005	2006	2007
Belarus	Inflow	119	96	247	172	164	305	354	1 772
	Stock	1 306	1 397	1 646	1 899	2 057	2 383	2 734	4 500
Moldova	Inflow	128	103	84	74	151	197	242	459
	Stock	449	549	639	717	869	1 056	1 300	1 813
Russia	Inflow	2 714	2 748	3 461	7 958	15 444	12 886	32 387	52 475
	Stock	32 204	52 919	70 884	96 729	122 295	180 313	271 590	324 065
Ukraine	Inflow	595	792	693	1 424	1 715	7 808	5 604	9 891
	Stock	3 875	4 801	5 924	7 566	9 606	17 209	23 125	38 059

Source: UNCTAD.

Structure of inward FDI stock by country in 2007 (%)

Belarus	
Switzerland	53,3
Russia	14,4
Cyprus	8,5
Germany	4,1
Great Britain	1,9
-	
Others	17,8

Source: MFA.

Moldova	
Russia	15,6
USA	9,5
Spain	8,6
The Netherlands	8,3
Germany	5,3
France	4,3
Others	48,4

Source: NBM.

Russia	
United Kingdom	21,8
Cyprus	17,1
The Netherlands	15,5
Luxemburg	9,5
France	5,5
Switzerland	4,4
Others	26,2

Source: Rosstat.

Ukraine	
Cyprus	20,1
Germany	20,1
The Netherlands	8,5
Austria	7
United Kingdom	6,7
Russia	5
Others	32,6

Source: Ukrstat.

Statistical sources

Belstat; National Statistical Committee of the Republic of Belarus

CIA - The World Factbook; Central Intelligence Agency of United States of America

EC; European Commission

IMF - World Economic Outlook 2009; International Monetary Fund

Invest Belarus; National Investment Site of the Republic of Belarus

MFA; Ministry of Foreign Affairs of the Republic of Belarus

Molstat; National Bureau of Statistics of the Republic of Moldova

NBM; National Bank of Moldova

Rosstat; Russian Federal State Statistics Service

Ukrstat; State Statistics Committee of Ukraine

UNCTAD; United Nations Conference of Trade and Development

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