

Perspectives of Russian–American Investment Cooperation: Tendencies, Mechanisms of Support, Recommendations

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Abstract

This article examines the various foreign trade policies of Russia and the United States in comparative perspective. It pays particular attention to the ways that the governments and non-governmental sectors of the two countries seek to support investment.

Introduction

Foreign investment is one of the key driving forces of the globalization process. Considerable research demonstrates that foreign investment and trade expand cooperation between countries across a range of sectors. In recent years, the world economy has been under the strong influence of capital growth, heightened economic integration and the effects of financial crises as countries become more dependent on each other.

This article considers the following issues: global investment tendencies, features of investment in Russia and the United States, investment risks and barriers for Russian and American investors, governmental and non-governmental support mechanisms for investors, investment practices in the U.S. and Russia and recommendations for future Russian–American cooperation.

Investment Tendencies

The investment market from 2008 to 2011 was shaped by difficult conditions.

According to an UNCTAD report, due to the crisis from 2009 to 2011, global foreign direct investments were reduced to \$1.2 trillion. However, over the long term, revival of the investment market is expected to increase foreign investment to \$1.9 to \$2 trillion.

Currently, the U.S. is both the largest exporter and importer of foreign investment in the world.

From 1960 to 1980, American investments abroad exceeded volume of foreign investments in the country by 3.5 times. In the 1960s, the U.S. received only \$5 billion. From 1970 to 1980 the U.S. received \$41 billion. In the 1990s, the situation changed to active growth. The peak of foreign direct investment in the U.S. occurred in 2000, when volume of FDI reached \$314 billion.

In Russia, the active stage of investment cooperation began in the 1990s in connection with the changes in the political and economic systems. From 1992 to 1999, Russia received \$25.5 billion of foreign direct investment.

Since 2000, foreign investments in Russia have continued to grow, and by 2011 had reached a record \$191 billion. In 2011, foreign direct investments were \$18.4 billion. The total accumulated volume of foreign direct

investment in the Russian economy was \$139 billion in 2011.

Russia is focusing on importing investments from abroad. In 2011, the volume of accumulated direct foreign investments was more than double those investments made by Russia.

According to the 2011 UNCTAD, Russia was seventh in the world in terms of attracting direct investments. The basic reasons for investing in Russia largely have remained constant: to obtain access to natural resources (primarily hydrocarbon raw materials) and the domestic consumer market.

An analysis of Rosstat statistics, as well as current economic relations between Russia and the United States, shows that apart from the oil and gas sector, the following sectors are most promising for bilateral investment:

- Trade and retail
- Food industry
- Aircraft industry
- Space industry
- Automotive manufacturing
- Information technology

In the December 2011 Russian Survey, investors were asked, “Which sector of the Russian economy would you be willing to invest in, apart from fuel and energy?” The results were: 14.9% of respondents preferred manufacturing, food and hospitality each received 10.5%, 8.8% of investors were interested in construction and 7.9% in the transportation sector (see Figure 3 on p. 23).

Profitable markets in Russia where American companies already are working include: food (Mars, Coca-Cola, PepsiCo), automotive manufacturing (Ford, General Motors, Caterpillar) and information (IBM, Microsoft). For example, Russia is the fifth largest market in the world for Procter & Gamble, and in 2011, the Russian market was among the 35 most profitable for General Motors.

For Russian investors in the U.S., the following areas have been top priorities in the first half of 2011:

- Iron and steel industry, 65% of investments (\$5.1 billion)

- Telecommunications, 14% of investments (\$1.1 billion)
- Financial sector, 17% of investments (\$1.3 billion)

The activity of Russian metallurgical companies in the U.S. market has increased significantly since 2008. In 2008, the volume of foreign direct investments quadrupled in comparison with 2007. The major Russian investors are: Evraz, New Lipetsk Metallurgical Industrial Complex (NLMC), Norilsk Nickel and Severstal.

In addition to these sectors, other prospective areas for investment in the U.S. are the chemical and pharmaceutical industries and information technology.

Foreign investments in the U.S. market tend to concentrate on the service sector, attracting 62.1% of total foreign investments. The manufacturing industry attracts about 33.9%. Consequently, the U.S. service sector is a very interesting and potentially important area for Russian investors.

From a regional point of view, in the U.S. the most attractive states for foreign investors are California, New York and Texas. According to the U.S. Bureau of Economic Analysis, 30% of jobs created by foreign companies are concentrated in these states.

Russia's leading regions for attracting investments from the U.S. are Moscow and surrounding region, St. Petersburg, the Arkhangelsk region and the Krasnodar region. These areas currently attract 82% of all U.S. investments.

Over the past five years, accumulated investments in Russia from the U.S. have ranged from \$7 to 9 billion. Before the world financial crisis, the total volume of U.S. investment reached a record \$8.8 billion in 2008.

Table 1: Foreign Investments from the U.S. to Russia (billion dollars)

Indicator	2006	2007	2008	2009	2010	2011 (1 st half)
Total Investments of the U.S. in Russia	7.7	8.5	8.8	7.2	7.3	7.0
including Direct Investment	4.6	3.6	3.2	3.0	3.3	3.2

In recent years, there has been significant growth in total and direct Russian investment in the U.S. From 2006 to 2011, investments in the U.S. increased by 13 times. Despite the global financial crisis, the volume of Russian investments in the U.S. grew to \$7.7 billion in 2011.

It is important to note that since the early 1990s, the economic situation has changed, and the potential for investment cooperation between Russia and the

United States has improved. But because of existing problems and barriers, this cooperation still is weak and insufficient.

Table 2: Foreign Investments from Russia to the U.S. (billion dollars)

Indicator	2006	2007	2008	2009	2010	2011 (1 st half)
Total investments of Russia to the U.S.	0.6	1.2	5.4	6.5	7.7	7.7
including Direct Investment	0.6	1.1	4.7	5.4	6.5	6.5

Investment Risks and Barriers

What prevents the development of investment cooperation between Russia and the U.S.? First, there are general problems common to all foreign investors. Second, there are problems specific to Russia and the United States.

The first group of concerns for foreign investors in Russia includes unnecessary government interference in business relations, corruption, foreign exchange market instability, high level of inflation, a lack of transparency and imperfect legislation. In addition, there are a number of other barriers to doing business in Russia:

- Limited access to strategic sectors (raw materials, energy, telecommunications, etc.)
- Difficulties with access to infrastructure
- Problems securing workers (e.g. permits to engage a labor force)

Russia and the United States have different legal systems. The U.S. relies on a case law system, while Russia has a codified legal system. The countries also have different standards of accounting and taxation. And unlike the U.S., Russia has a strong system of state regulation and a very weak private sector.

The largest projects in Russia (e.g. Innovation Center Skolkovo) usually are undertaken with significant government support. Major banks (e.g. Sberbank, VTB) and state corporations (Gazprom, etc.) also require a huge share of governmental capital.

Problems with the investment climate in Russia are connected closely to a large number of licensing procedures and long terms of adjustments. For example, according to the World Bank's 2011 "Doing Business," the U.S. was ranked fourth of 183 countries, while Russia ranked 120th.

In the U.S., the basic obstacles to investment are low profitability, high labor costs, high level of taxation and a large external debt.

We also can compare the profitability of capital in bank deposits in Russia and the United States. The Bank

of America offers an annual interest rate of 0.5 to 1% on deposits of more than \$100,000. In Russia, the rate for deposits in dollars varies from 6 to 7%. It is necessary to take into account existing risks and inflation, but business is business and profit is profit.

Similar to the regulation of access to strategic sectors in Russia, the Committee on Foreign Investment in the U.S. has the ability to control and limit direct foreign investment in accordance with the 2007 “On Foreign Investment and National Security” act. This is also a form of barrier to foreign investors in the United States.

The second group of issues includes restrictions in trade between the U.S. and Russia, connected with the Jackson-Vanik amendment of 1974. It denies most-favored-nation treatment in trade and also provides for the use of discriminatory tariffs and fees. However, it is possible that this issue will be resolved following Russia’s admittance to the World Trade Organization.

According to the results of the World Bank survey, Russia’s WTO accession would generate a short-term gain in foreign investments of about \$53 billion annually, and in the long-term, up to \$177 billion. From this point of view, the transparent and broad access to Russian markets is among the important benefits for investors.

Governmental and Non-Governmental Support Mechanisms for Investors

The main purposes of investment policy in Russian–American investment cooperation should be creation of favorable conditions for increasing the volume of mutual investments, formation of an effective system of interaction among foreign investors and improvement of mechanisms to protect the rights and interests of foreign investors.

At the international level, a specialized agency of the United Nations—the World Bank Group and its divisions (the Multilateral Investment Guarantee Agency [MIGA], International Finance Corporation [IFC], International Center for Settlement of Investment Disputes [ICSID])—plays a key role in protecting investors. In addition, the U.N.’s investment coordination and information-analytical function is performed by UNCTAD.

Taking into account the high risks for investors in Russia, it is important to take advantage of MIGA’s services, especially insurance. MIGA also mitigates political, currency and other risks, in addition to securing guarantees for infrastructure investment projects. Russia is not a member of ICSID (as signed in the Washington Convention of 1992, but which has not yet been ratified.)

In the U.S., the Department of Commerce implemented the Select USA program (previously known as Invest in America) to encourage foreign and domestic

investment. With the help of the U.S. State Department’s Office of Investment Affairs (OIA), the government conducts a wide range of activities, including protecting U.S. investments abroad and promoting market-based investment standards. The OIA also is responsible for interaction with the WTO, Organization for Economic Cooperation and Development, North American Free Trade Agreement, Asia-Pacific Economic Cooperation, etc.

The Overseas Private Investment Corporation (OPIC) was created in 1975 and provides direct support to American investors and represents their interests abroad. The Export-Import Bank of the United States (Ex-Im Bank) also provides different kinds of support to investors (e.g. export credits).

The U.S. private sector plays a significant role in issues related to foreign investment. The American Chamber of Commerce and the Department of Commerce monitor the access of U.S. exporters and investors to foreign markets. The U.S.–Russia Business Council (USRBC) also is engaged in developing bilateral cooperation between the countries, uniting more than 200 major companies from the U.S. and Russia. In addition, there are about 7,600 trade associations in the United States.

In Russia, the state plays the most important role in investment development. Major coordinating functions belong to the government and the Ministry of Economic Development of the Russian Federation. Private-sector interests mainly are represented by Opora Russia, Business Russia and the Russian Union of Industrialists and Entrepreneurs (RSPP). The Foreign Investment Advisory Council (FIAC) was founded by the government to provide investment support.

From 2010 to 2011, an ombudsman was created to help resolve investment disputes. This mechanism also works at the regional level. In addition, development corporations have been created in some territories of Russia (e.g. Kaluga and Samara regions.) However, non-governmental support mechanisms for investment in Russia remain weak and need great improvement.

Investment Practices in the U.S. and Russia

The Russian market, due to its profitability and despite the difficulties in doing business there, remains attractive to foreign investors. Over the past two decades, U.S. companies have started a number of new investment projects in Russia’s most competitive sectors.

PepsiCo was the first American company to start doing business in the Soviet Union, entering the Russian market in 1974. The company’s first facility opened in Novorossiysk; it now operates nine in Russia. In the past 38 years, PepsiCo has invested more than \$3 billion dollars and created more than 30,000 jobs.

Table 3: Major U.S. Investors in the Russian Economy

Company	Total Investment	Start Date
ExxonMobil	\$ 10 billion	2000
Boeing	\$ 5 billion	1992–2009
Chevron	\$ 4 billion	1994–2011
ConocoPhillips	\$ 4 billion	2004
Coca-Cola	\$ 3 billion	1991–2011
PepsiCo	\$ 3 billion	1974–2011
McDonald's	\$ 1 billion	1990
Mars	\$ 1 billion	1994
Alcoa	\$ 0.76 billion	2005–2010
International Paper	\$ 0.7 billion	1998
General Motors (GM)	\$ 0.35 billion	2006
Procter & Gamble (P&G)	\$ 0.3 billion	1991
Kimberly Clark	\$ 0.15 billion	2010
Caterpillar (CAT)	\$ 0.1 billion	1994/2000–2010
Total	\$ 33.4 billion	1974–2010

In the gas and oil sector, Shell, Conoco-Phillips, ExxonMobil, Chevron and some other companies are making huge investments. Conoco-Phillips, ExxonMobil and Chevron account for approximately 50% of all U.S. direct investment in Russia.

Boeing serves as a good investment example in Russia's aviation industry. Since 1992, the company has invested more than \$5 billion in Russia. It is continuing to develop its investment program and plans to invest \$27 billion over the next 30 years.

In January 2012, McDonald's was operating 310 restaurants in Russia. By comparison, in 2003 there were

74 McDonald's in 23 Russian cities.

Pursuing greater profitability, Subway has become active in the Russian market. By the end of 2011, it had exceeded the number of McDonald's restaurants and had become the largest company in this sector in Russia. By Feb. 1, 2012, Subway had opened 322 restaurants in the country.

Among the main problems facing American investors in Russia are the complexity of planning and the additional expenses connected with their projects. For example, ExxonMobil spent five years resolving numerous geological and legal problems. Also, there is a problem of acquiring property, such as participation in privatization.

Consequently, American companies investing in Russia are afraid of risks and prefer sectors with fast return on their investment and a low degree of complexity. These tend to be industries such as catering, food and the financial sector.

Among U.S. companies in Russia, there are three main types of investment strategies:

- *Limited investment strategy*: flexible approach with minimal risk. This strategy is based on historical trade with and export to Russia (Caterpillar, General Electric)
 - *Medium incremental strategy*: recognition of the growing market, usually is focused on services (IBM, AT&T, Big Four accounting)
 - *Heavy initial investment strategy*: optimistic view and high risk, struggle for a competitive market (Coca-Cola, PepsiCo, McDonald's, Gillette, as well as oil and gas companies ExxonMobil, Chevron, Texaco.)
- With Russia's accession to the WTO, it is possible to expect expansion of mergers and acquisitions. World practice of recent years shows that foreign companies prefer this method of access to foreign markets rather than opening overseas branches.

Table 4: Strategic Approaches of American Investment Companies in Russia

Strategic FDI Typology	Investment Characteristic	Examples
<i>Limited Investment</i> Historical export strategy Toehold strategy	High flexibility, risk avoidance, strong market presence, slow to invest directly High flexibility, risk avoidance, limited initial competition, less developed markets	Caterpillar, General Electric General Motors, Pratt & Whitney
<i>Medium Incremental</i> Reverse incremental strategy Medium incremental strategy	Flexibility, reaction to changes in legal and political environment Flexibility orientation, recognize increasing market, receptivity of localized markets, service-based	IBM AT&T, Chase Manhattan, Big Four accounting
<i>Heavy Initial Investment</i> Voluntary heavy initial strategy Forced heavy initial strategy	Optimistic view, high risk, extensive global competition No choice for global players, no flexibility, high risk, few big global competitors	Coca-Cola, PepsiCo, McDonalds, Gillette ExxonMobil, Chevron, Texaco

Source: adapted from *FDI and Strategic Alliances in Europe*, Robert E. Morgan and Eleri R. Thorpe

Russian companies prefer to invest in U.S. markets mainly by expanding export opportunities. For example, in 2008 the metallurgical company, Severstal, bought the American companies Esmark, WCI Steel and PBS Coal Corporation. Another Russian company, NLMK, acquired for \$3.5 billion the largest manufacturer of tubular products, the John Maneely Company, which includes 11 enterprises in the U.S. and Canada.

Russia's Norilsk Nickel company has acquired a 51% stake in the U.S. company, Stillwater Mining, which is the sole producer of platinum group metals in the United States and the fifth largest producer in the world. Severstal also acquired Rouge Steel, which ranked fifth among U.S. companies in the steel market.

After the acquisition of U.S. assets in 2009, Mechel Bluestone was included in the five world leaders in production of hard-coking coal.

Lukoil owns a network of more than 2,000 gas stations in the U.S., purchased from American companies Getty Petroleum and ConocoPhillips.

The U.S. has a stable economic system with minimal risks to business and a favorable investment climate, which makes it interesting to foreign investors to develop their activities in American markets. Plus, there is a good possibility for mutual benefit and investment cooperation.

Recommendations

1. In order to improve the investment climate in Russia and for wider adoption of international investment dispute resolution mechanisms, it is necessary to accelerate integration of the Russian economy into

the WTO and OECD. It will increase the inflow of foreign capital to Russia, as well as provide additional opportunities for protecting the rights of foreign investors at the international level.

2. Considering the high political and economic risks of investing in Russia, it is recommended that use of the World Bank be increased, including the Multilateral Investment Guarantee Agency (MIGA), with respect to insurance of infrastructure projects and guarantee mechanisms.
3. To improve Russian investment law, it is necessary to increase the transparency of procedures in privatization policy and, more generally, in Russian strategic sectors. When Russia joins the WTO, it also will increase disclosure of information for investors. To enhance investment cooperation between the U.S. and Russia, it is necessary to consider cancelling the Jackson-Vanik amendment.
4. In view of the weakness of a private sector with strong state regulation, the Russian government should support the non-governmental sector in creation of trade associations and develop means to improve communication with foreign investors.
5. In order to diversify investment from the oil and gas sector, it is important to pay attention to the service sectors in Russia, such as telecommunications, transport, trade, insurance and banking.
6. In line with global investment trends, we recommend foreign partners consider the possibility of acquiring existing companies, instead of opening new overseas branches.

About the Authors

Konstantin Borisov (Ph.D. in Economics, 2006) is an expert with a strong background in foreign investment and trade for over 12 years. He took part in the evaluation of investment projects of the Investment Fund of the Russian Federation, the Bank for Development and Foreign Economic Affairs (Vnesheconombank), the European Bank for Reconstruction and Development and World Bank. He cooperates with the Foreign Investment Advisory Council (FIAC). Before joining the Ministry of Economic Development in his current role, he worked as General Director of the Prom-TekhImport, Ltd. (2007–2009). In 2006, he was a director for foreign trade of the Far East Maritime Foundation, Inc. From 2003 to 2006, he was the Expert of the Foreign Investment Department of the Primorsky Region and the Pacific Center of Economic Development. He has more than 25 published papers. In 2000, he received a scholarship of the President of the Russian Federation as a young scientist. Borisov currently is pursuing a degree in International Law at the Russian Foreign Trade Academy at the Ministry of Economic Development.

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GRAPHS

FDI Statistics

Figure 1: Foreign Direct Investment in Russia, bn US\$

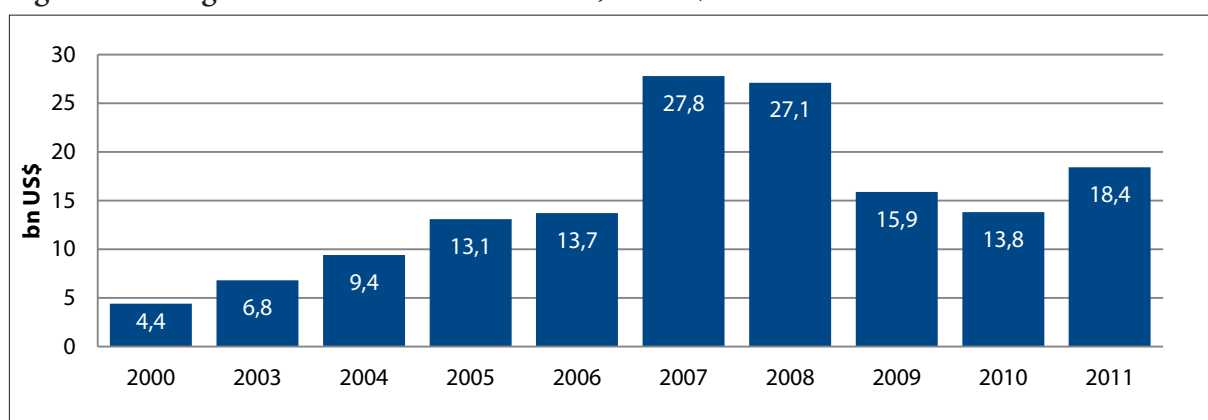
Source: Rosstat, www.gks.ru

Figure 2: Foreign Direct Investment in the USA, bn US\$

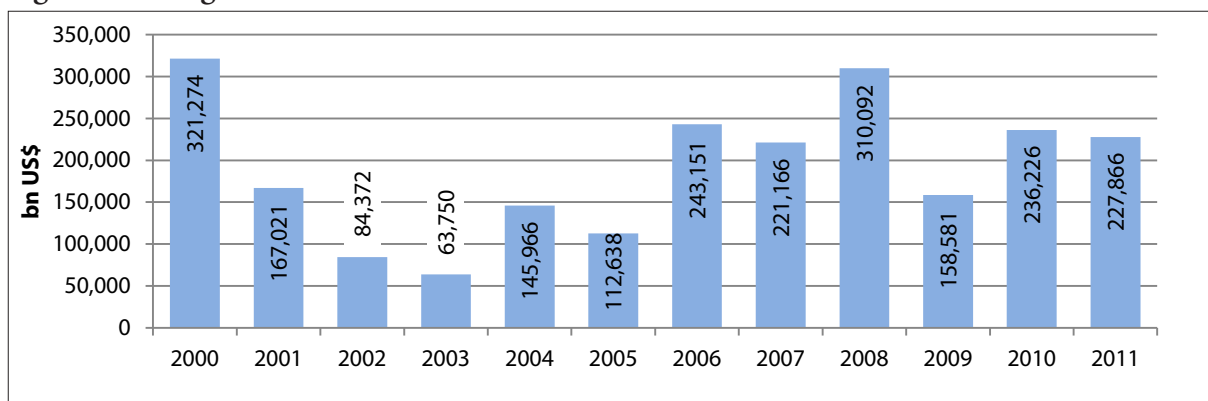
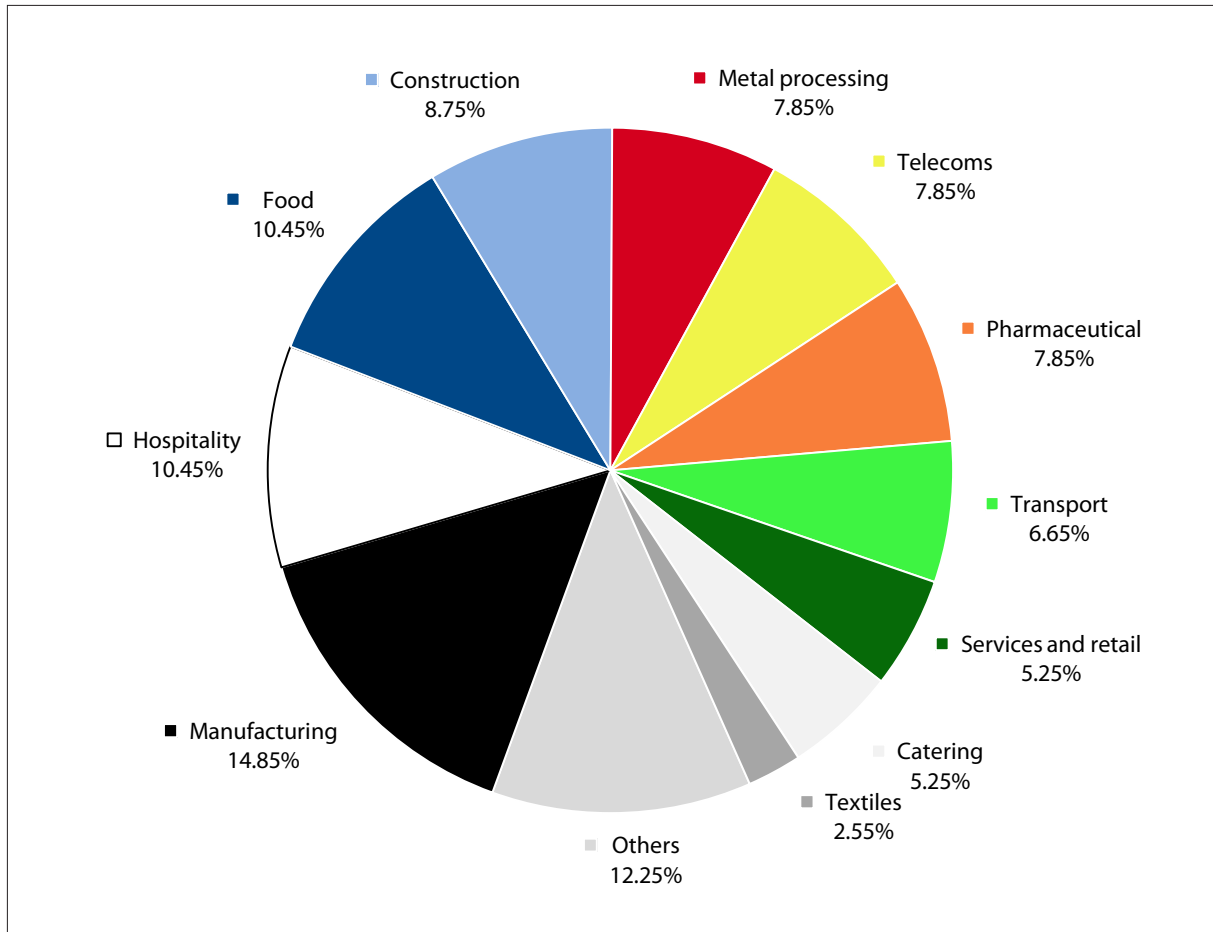
Source: Bureau of Economic Analysis, www.bea.gov

Figure 3: Which Sector of the Russian Economy Would You Be Willing to Invest In, Apart From Fuel and Energy?



Source: Russian Survey, December 2011, www.russian-survey.com