

Foreign investment in Russia Acquisitions Monthly

Russia undoubtedly offers much to interest the foreign investor. It has one of the world's most important energy markets and it is a country rich in natural resources. However, a climate of risk still holds back foreign investors, who are reluctant to commit capital to an economy in which the Kremlin frequently interferes to preserve its own interests. Simply put, Russia is not a liberal democracy by any meaningful measure.

The risks that foreign investors associate with the country cost Russia dear as it has already missed out on large chunks of foreign direct investment (FDI). Comparatively, its share of FDI is very low (it attracts just two thirds as much FDI as the Czech Republic) - and for good reason. In its most recent report on global governance, the World Bank slammed Russia by putting it in the same league as Swaziland and Zambia.

Measured in terms of democratic conditions such as political stability and control over corruption, Russia ranked a pitiful 151st. For regulatory quality, Russia was ranked alongside Senegal and rule of law was as judged to be as ineffective as in Indonesia and Bangladesh. In other international surveys of corruption and ease of doing business, Russia consistently ranks near the bottom. It is not hard to find evidence of why it is held in such low regard.

Take the energy sector, for example. Although the country badly needs foreign capital to maximise its vast potential for production, it remains a hostile market for overseas investors. Ever since the Yukos debacle of 2004, political risk has been extremely high. A powerful elite within the Kremlin has explicitly stated that it wants to rid foreign investors from certain markets, including energy. As a result, the authorities have sought to re-establish control of important energy assets via state controlled groups such as Gazprom and Rosneft, who are operating with increasingly heavy hands in the domestic energy market.

The authorities are not afraid to step on the toes of even the biggest foreign investors. Only last month Russia's environmental watchdog, Rosprirodnadzor, after previously agreeing that the project was safe, warned that continuing work on Shell's flagship Sakhalin-2 would be "forbidden" until it complied with its ecological rules. Observers noted that the watchdog's u-turn came amid attempts by the state gas monopoly, Gazprom, to secure a 25 per cent stake in the project. This is just the latest example of how the Kremlin flouts the law to get it wants.

A high level of state involvement now exists not only in the energy sector but across a wide variety of markets, including automotive, aviation, and metals and mining. The government's behaviour in the banking sector has also been volatile. In principle the Kremlin says it welcomes the foreign investor but in practice protectionism rules.

Foreign investors were recently sent another chilling reminder of the 'wild west' business culture that pervades in Moscow when the reformist Russian central banker, Andrei Kozlov, was gunned down in an apparent contract killing. Kozlov's crime had been to pursue a campaign to clean up Russia's corrupt banking system.

How can Russia narrow the gap between its vast investment potential and the current reality of corruption, risk and instability? First the government must create the legal and

regulatory climate needed to create the predictable relationship between government and business that investors rely on. In the meantime, foreign investors must proceed with extreme caution or accept that they are playing the investment equivalent of Russian roulette.