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Russia:
Foreign Direct Investment And The BP-TNK Deal - The Broader Picture

As markets continue to digest the news of the major BP foreign investment deal in the Russian oil sector, it is crucial to stress that the overall and medium-term significance of this deal goes well beyond the oil sector and it could be of a major importance for Russia as a whole[1]. Apart from well-researched positive effects of FDI (e.g. improved corporate governance, higher productivity, trickle-down impact on other entities and sectors, an additional impetus for corporate restructuring) there are at least four key reasons for this.

1. The BP deal is a high profile and substantive way of confirming that Russia is now "open for business". If one accepts, as we do, that Russia's current performance is well below its potential, and given Russia's weak FDI record compared to its Eastern Europe neighbours, a first FDI deal of this size and along these lines has a positive, signalling effect on both strategic (greenfield or other FDI) and portfolio investors. Indeed, both the Russian bond and equity markets have reacted notably positively to the BP deal.

2. It will not be lost on the global corporate community that this very large FDI deal is coming from a company that has itself gone through a difficult experience with previous investment attempts in Russia in the 1990s. The deal now announced emphasises that despite previous difficulties, Russia's investment climate has moved on and it is now *increasingly* ready for large, strategic investments. The point is not that the BP deal is suddenly the start of a FDI avalanche any time soon - that would be a bridge to far. But this deal will now have a place as a major, large FDI pioneer in Russia, with broader and cumulatively larger FDI inflows, in a mix of greenfield and other FDI, likely to gradually start from 2004-05 (see more on this reasoning below).

3. Deals of this sort have potentially important spillover effects on other markets, including perhaps the starting point for further consolidation. For example, BP has said it is ready to assist their partners in this deal if they over time would like to consider an IPO of some kind. Furthermore, there have been some suggestions that the company created out of this BP deal could perhaps make other investments in Eastern Europe, indicating the regional and all-European, if not global, potential of some Russia-related entities and FDI projects[2].

Against the above background, it is notable that over the last days, e.g. Renault has indicated it will in coming weeks potentially decide on an industrial investment in Russia to set up production, and TotalFinaElf has indicated it is considering a USD 2.5-3 bn investment in an oil field in the Krasnoyarsk region. Finally, it is also important to note that this BP deal was

[1] For a our initial view on BP's investment as such, see the following comment by Schroder Salomon Smith Barney equity research: "BP venture with TNK/Sidanco – Initial view on BPs investment", February 11, 2003.
[2] For more on these points, see the interview with BP officials in *Opyt s 'SIDANKO' nas mnogomu nauchil*, Vedomosti, February 13, 2003.

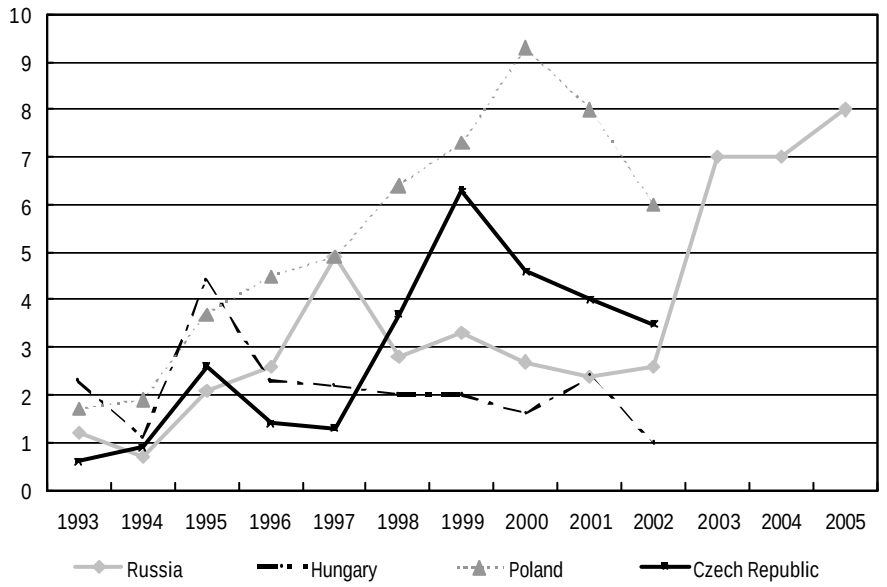
not done with any special government guarantees or exemptions, which have in fact been a key feature of much of the large FDI that has flowed into Central Europe over the last decade.

4. The sheer size of the BP investment highlights the potential for FDI inflows to Russia to at some point be much larger in nominal terms than what has been seen in Central and Eastern Europe. Our equity analysts estimate the equity consideration in the now announced BP deal to be nearly USD 7.4 bn. **Taken as one deal, it is the single largest FDI across Central and Eastern Europe over the last decade. This deal alone would be *several times larger* than the *annual* FDI inflows to Hungary or the Czech Republic at any given year over the last decade, and only somewhat lower than the total *annual* FDI inflow to Poland in the peak-FDI year of 2000.**

FDI in Central Europe and Russia: sizing up the flows

The graph below outlines annual FDI inflows to Central Europe and Russia between 1993 and 2002, plus our estimates for FDI to Russia over the 2003-2005 period, including the BP deal. The general idea is that the BP deal brings with it a sharp move upwards from the last years to a level (USD 7-8 bn per year) likely to be sustained in the 03-05 period (note that there is a chance Russia could also become a WTO member during this period), while at the same time a further step upwards in terms of annual FDI is more likely following the 04-05 period, beyond which at some point Russian total annual FDI inflows should climb above the Polish peak-year of 2000. As a regional phenomenon, note that the trend in Russian FDI could well be turning upwards, while FDI inflows to Central Europe have been cooling down over the last couple of years.

Figure 1. Foreign Direct Investments, 1993-2005 (estimates, annual inflows, USD bn)



Source: WIIW, Citigroup

This expected path of FDI into Russia anticipates ***cascading FDI flows***, driven by the extent of the improvement of the investment climate. To put it differently, FDI inflows to Russia are likely to go through several stages over the next decade or so***, as successive thresholds of the quality of the investment climate are passed***, ***at least in a constructive scenario***. This is the experience of the large FDI destinations in Central Europe. In Poland, e.g., FDI inflows went through a few such stages, with the first major breakthrough between 1994 and 1995, as annual FDI nearly doubled. In the following couple of years, inflows steadily increased, and then jumped again, by 30%, in 1998 over 1997, and jumped by 45% in 2000 over 1998, after

starting to level off. Given the size of the Russian economy, and the likely vast gap between Russia's current performance and its potential in the future, under a constructive reform scenario, Russia could well sustain much longer periods of fairly significant FDI.

In terms of official expectations before the BP deal, the Ministry for Economic Development and Trade, as part of the government's 2003-2005 macroeconomic projections and scenario analysis, has outlined two FDI paths, depending on underlying global economic scenario[3]. In a realistic-conservative scenario for the global economy, it is expected that FDI will be some USD 6 bn in 2003, USD 7.1 bn in 2004 and USD 7.8 bn in 2005. In a more positive scenario, it is expected FDI inflows will total USD 6.5 bn in 2003, USD 7.8 bn in 2004, and USD 8.5 bn in 2005. The increase in FDI inflows is expected as a result of an improved investment climate, further implementation of structural reforms such as legal reforms, corporate governance reforms, land reforms, and de-bureaucratization reforms.

The background: Russia's hitherto disappointing track record with FDI

As noted, the BP deal comes amidst a growing interest in investments in Russia, without necessarily large FDI having actually been made. Indeed, Russia's track record with FDI up until now has been clearly disappointing, in contrast to e.g. portfolio investments, which at periods during the last decade have been substantial. Currently, a significant jump in capital inflows to the private sector in the form of international borrowing has been underway since about November 2001, with such inflows dwarfing the FDI inflows. For the full-year 2002, FDI is estimated at USD 2.6 bn, only marginally higher than in 2001, when it was USD 2.4 bn[4]. In the 1999-2002 period, the share of FDI in total international inflows decreased from some 45%in 1999 to 27% in 2001 and yet further down to 21% in 2002. Russia's accumulated stock of FDI at the end of 2002 was the equivalent of just over 7% of GDP, compared to 24-43% of GDP for countries in Central Europe, but also lower than that for countries in Southeastern Europe and the Balkans, e.g. Macedonia (37.5% of GDP) and Romania (21% of GDP). At the same time, while there is no argument that FDI inflows to Russia have been small, there is also the perspective that the quite phenomenal experience with FDI inflows in Central Europe is rather exceptional for the region, and has had a lot to do with the prospect of being candidates for EU membership and integration[5].

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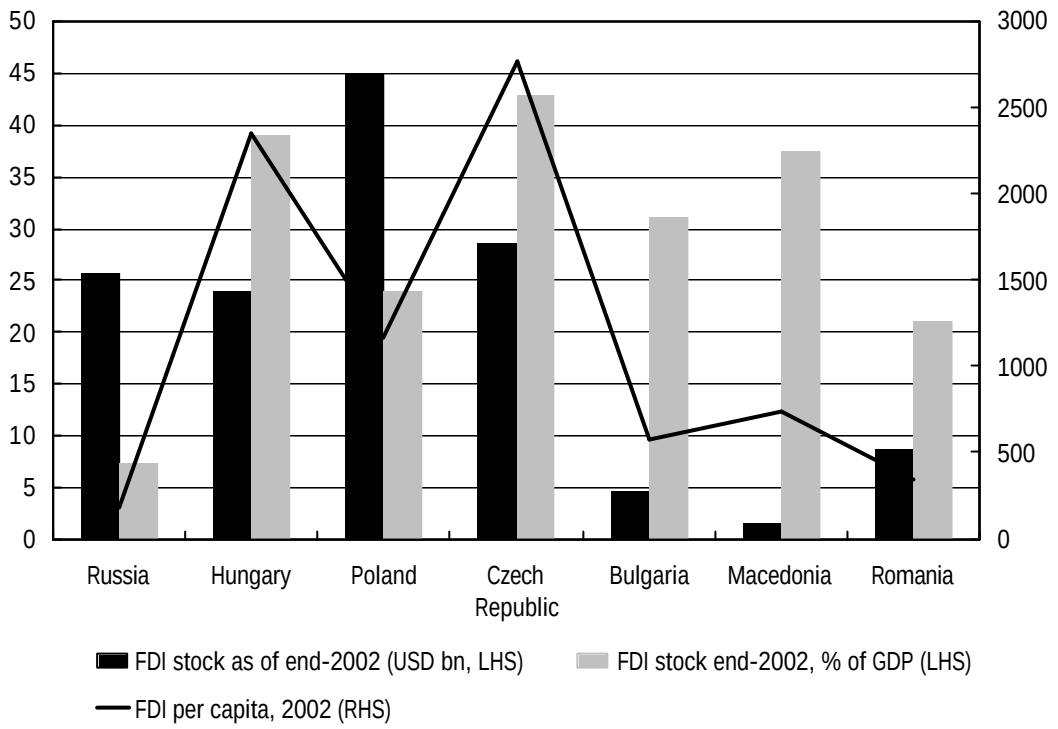
[3] See *Prognoz sotsialno-ekonomicheskovo razvitiya Rossiiskoi Federatsii na 2003 god i osnovnye parametry prognoza do 2005 goda*, the Ministry for Economic Development and Trade/the Russian government, mimeo.

[4] Russia's FDI inflow remains fairly regionally concentrated, with 44% of the first-half 2002 FDI inflow going to the City of Moscow area. After that, nearly 9% went to Omsk oblast, nearly 8% to Sverdlovsk oblast and 6% to St.Petersburg.

[5] The leading research institute tracking and analysing FDI trends in transition economies is the Vienna Institute for International Economic Studies. For recent analyses, see the excellent, G. Hunya, *Recent Impacts of Foreign Direct Investment on Growth and Restructuring in Central European Transition Countries*, Research Report No.284, May 2002, and P. Havlik et al, *Competitiveness of Industry in CEE Candidate Countries*, Final Report, July 2001. While Central Europe's experience with FDI has been phenomenal, it is still the case that also the Russian economy would structurally stand to benefit very substantially from a serious increase in FDI involvement. This is especially emphasized by the studies identifying notable positive productivity spillover effects from FDIs to domestic firms. For a recent study into this point, see B.K Smarzynska, *Does Foreign Direct Investment Increase the Productivity of Domestic Firms? In Search of Spillovers through Backward Linkages*, World Bank Policy Research Working Paper, October 2002.

Figure 2. Foreign Direct Investment Indicators, Russia and Eastern Europe



Source: Citigroup

At the same time, over the last years, capital *outflows* from Russia have consistently moderated, and since late 2001, Russia has seen a jump in private sector *inflows*. There might be more going on than first meets the eye, and we would suggest that that while still low, FDI inflows could indeed start to pick up in a few years' time and that the current phase could be a "preparatory phase". Developments such as a jump in corporate sector inflows, but still low FDI are accompanied by a preserved trend of decreasing capital outflows and continued (anecdotal) signs of a gradual return of some previous capital outflows[6] – as well as signs of business-motivated, foreign acquisitions by Russian companies. Furthermore, there are signs of a gradual increase in the importance of firms with foreign participation. Over the last year, almost unnoticed by the general discussion, statistics show that companies with foreign participation has increased their share of Russia's GDP and employment. According to Goskomstat, in the first half of 2002, companies with foreign participation accounted for 27% of GDP, up from 23.6% in the same period last year. These companies employ some 1.87 mn people, up from 1.44 mn in the same period 2001. Anecdotal indicators would suggest that much of this increase in foreign participation could well be in reality Russian capital, returning to the Russian economy in one way or other.

The common denominator behind all of these developments could be the process whereby the Russian corporate sector over the last 3 years has started to restructure and consolidate in various ways, and the process whereby Russian capital has started to expand into various domestic sectors: e.g. food industry, automotive sector, machine building, and transport. The capital flow trends mentioned above have partly financed this development, made possible by increasing corporate confidence in the direction of the Russian economy, economic policy

[6] There have been increasing signs of a return of previous Russian capital outflows/moderating capital outflows, to be invested in mainly domestic Russian sectors. As indications of this encouraging capital flow trend, one can point to the expansion into the Russian food industry by Interros, as well as by some oil companies, including an interest in Russian retail networks, and also the expansion into the Russian automotive industry pursued by large Russian metals companies. Another indication would be the strong position of "Cyprus" among the top foreign investors in Russia.

and institutional changes.

At the same time, as noted earlier, indications are that the interest and the fact-finding missions on behalf of large foreign direct investors are growing. Encouraged by the track record under President Putin, it is not unlikely that this interest will eventually result in a gradual increase of serious FDI, particularly after the next presidential elections in March 2004. It would in this context not be amiss to argue that while Russian capital would have been best placed to move in first to take advantage of gradually changing institutions and an improving investment climate in the real economy, if this track record is extended, one would expect the level of confidence also among the foreign investor community to rise and eventually, in the scenario where reforms continue, one would expect FDI to start rising to take advantage of the objective opportunities which exists (highly educated labour force, cheap labour costs, large domestic market but also over time manufactured exporting potential – all in the context of continued implementation of institutional, structural reforms and further international integration, e.g. WTO membership).

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