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President Medvedev's Plans to Attract Foreign Investment

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Attracting foreign investment – not only the funds necessary to modernise industry and develop infrastructure, but state-of-the-art technology and know-how as well – features prominently in President Medvedev's plans to modernise Russia. Yet without a noticeable liberalisation of Russia's business environment initiatives such as setting up a Private Equity Russia fund will not fulfil the hopes pinned on them.

Medvedev's Modernisation Project. As he called in 2009 for across-the-board modernisation of Russia, Medvedev criticised the bureaucratic model based on exports of energy resources. The president perceives the modernisation of the economy (that is, an enhanced role of the private sector, reduced influence of giant state-owned groups and of the bureaucracy, less reliance on exports of energy sources, and fighting corruption) as a prerequisite for strengthening democracy and the civil society in Russia.

Addressing the Davos Economic Forum this January, Medvedev unveiled an action plan aimed at increasing Russia's attractiveness to investors. Foreign investment and the technology and know-how transfer that come with it are to drive the modernization of the Russian economy and to improve its competitiveness. The president announced investment in the development of infrastructure; measures to facilitate venture capital investment; and the setting up of a special investment fund with state participation to share with external investors the risks of engaging in projects that would modernise the Russian economy. Furthermore, the plan provides for expediting privatisation, for the development of the financial market (including the lifting of capital gain tax from the disposal of securities in connection with the implementation of long-term projects); for Russia's accession to the WTO and the OECD; and for the creation of a common economic space with the EU.

Foreign Investment in Russia. Even being part of the BRIC group with its high investment appeal has not freed Russia of the burden of its reputation as a high-risk country. Russia was ranked as the 18th most attractive foreign investment destination on the A.T. Kearney`s Foreign Direct Investment Confidence Index, while the other BRIC countries were ranked 1st, 3rd and 4th. In a World Bank's business environment ranking "Doing Business" Russia was placed 123rd (out of the 183 countries ranked). Its placing in the Heritage Foundation economic freedom ranking was also unimpressive: 143rd out of the 179 countries worldwide (and 41st out of 43 countries in Europe).

The principal causes of Russia's low investment attractiveness include the lack of investor-friendly laws (in particular in respect of minority shareholders' rights), no legislation on holding companies, no bilateral investment protection agreements, unclear procedures and arbitrary administrative decisions, excessive tax burdens, and aggressive competition from privileged (through their state connections) Russian oligarchs. Troubles of such powerful investors as Britain's BP, which is entangled in disputes with its TNK Russian partners, or a Hermitage fund which withdrew from Russia after the death in prison of its lawyer Sergei Magnitsky (who had earlier disclosed that people with affiliations to special services had been behind the takeover of the fund's daughter companies) have put off investors from doing business in Russia.

This discouraging investment climate was responsible for inward foreign direct investment in Russia having dropped by 13.2% in 2010 on 2009 – to US$13.8 billion, against over US$30 billion registered in 2008 immediately before the onset of the economic crisis. Foreign investment has gone chiefly into the extracting and processing industries, transport equipment industry, trade and the real property sector. The largest investors have included Cyprus, the Netherlands, Germany, Luxembourg, China, the U.K (except for the FRG and China, Russian capital coming home from countries where it enjoys lower tax burdens has accounted for the bulk of remaining inward foreign direct investment).

To improve investment conditions in Russia, Medvedev proposed this March the simplification of procedures for setting aside unlawful administrative decisions in respect of businesses; the appointment of regional investment plenipotentiaries to monitor the situation in the provinces; the expansion of the rights of minority shareholders; the provision of legislative support to investment in the strategic branches of the economy; and the reduction of social insurance contributions payable by businesses. He also announced that regional authorities would be brought to account for obstructing the inflow of foreign investment and he mentioned a plan to lift the requirement to secure approval of a government commission for the acquisition of less-than-25% stakes in resource companies.

Direct Investment Fund. In June 2011 the state-controlled fund Private Equity Russia is to be launched, its object being to attract long-term foreign direct investment to such key branches of the economy as the technology industry, energy, mining, the pharmaceutical industry, and the space industry. The Fund is meant to reduce the risk of investing in Russia for foreign investors. It is to be a subsidiary of Vneshnekonombank.

Plans are for the state to contribute US$2 billion on the Fund's commencing business. The remaining 80% of the Fund's proposed share capital is to be brought in by foreign private equity funds and state-owned sovereign wealth funds. The assumption is that the state will not involve directly in the management of the Fund and that it will withdraw from it after eight years. The Fund is meant to engage in investment projects to the tune of between 10% and 25%, a foreign investor's participation in each project being a necessary condition. The Ministry of Economic Development estimates that between US$60bn and US$90bn of foreign direct investment can be attracted over five years through the Fund's operations.

Prospects and Implications for Poland. The establishment of the Private Equity Russia Fund is meant to increase the flow of foreign investment and technology into Russia. Nearly all industries need huge investment outlays, as do transport and municipal infrastructure. The new Fund will complement the activities of the Skolkovo venture capital fund, established in 2010, which plans to invest by 2013 about US$1.28bn in start-ups and to set up in the vicinity of Moscow a counterpart of the U.S.'s Silicon Valley.

So far, no information has been available on the Private Equity Russia Fund's estimated profit performance, its investment strategy, powers to be vested in its managing company, its term, structure, or its governing law (the Russian law being hardly favourable for direct investment funds). Neither is a role allocated to foreign investors known, but it appears that – at the initial stage at least – they will have no say on the management of the Fund. Judging by the assumptions underlying it, the Fund will resemble the Gulf states' investment funds of the late 1990s; those, as it turned out, had had local players rather than foreign investors as partners.

The Private Equity Russia initiative has met with interest from foreign investors (the Apollo Management, Blackstone and Carlyle private equity funds; sovereign funds from the UAR and China). These investors count on the state's protection to spare the Fund at least some of the difficulties private investors have been groping with. Yet the Fund's non-transparency has made representatives of Western financial institutions tread cautiously. For instance, doubts have been voiced as to the extent to which the Fund will make competing with the local oligarchs on equal terms possible. Investment in Russia is regarded as having a high profit potential – and very high exposure to political risk. Western investors would like to be certain that a future president will support the idea of the Fund and will consistently remove obstructions to doing business in Russia.

Poland's economic relations with Russia are regulated essentially by EU legislation complemented by bilateral agreements. In connection with its accession to the EU Poland terminated the August 1993 Treaty on Trade and Economic Cooperation, but Russia has not yet ratified the 1992 agreement on support and mutual protection of investment. This has impeded Polish investment, for instance by doubling the cost of insurance. Now matters have been complicated by the entry into force of the Treaty of Lisbon and by transfer of the national powers in the field of foreign direct investment upon the EU. Relatively small-sized projects being of greatest importance to Polish investors in Russia, the benefits, if any, of the launch of the Private Equity Russia Fund will largely depend on the diversification of investment offer and on the inclusion in the portfolio of projects with lower capital input requirements.