The impact of the new ruble crisis on Russian FDI

Kalman Kalotay


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Abstract: This presentation explores the implications for both inward and outward foreign direct investment (FDI) of the new Russian crisis started in 2014. The two directions of FDI are treated together due to their interdependence, especially through round tripping. It is notable that Russia plunged into a crisis four times in a quarter of a century. The impact of the new crisis for FDI is compared with the effects of the other mostly home-made crisis, that of 1998. Parallels between the two episodes include a currency crisis, a massive increase of interest rates by the central bank chilling the economy, a negative fallout of the country’s overdependence on oil and gas revenues in a moment of falling prices, and a link with government over-spending due to a war. A main difference is that international reserves are much higher today; however the world is much more hostile towards Russian military action. The current crisis makes both inward and outward FDI fall, although through different channels. In principle, the devaluation of the ruble should prompt new inbound FDI but that effect is cancelled out by negative factors such as uncertain business prospects in Russia. Also in principle outbound FDI should suffer from devaluation but that may be partly counteracted by a strong push for exodus by Russian business. The decline of Russian FDI dampens the economic prospects of partner countries; however, it does not have a systemic impact, given the relative importance of the Russian economy and Russian FDI in today’s world economy.

JEL Codes: F21; F23; H12; N14

Introduction

In December 2014, the Russian Federation officially plunged into a crisis again, the fourth one in a quarter of a century (although signs of crisis were gathering during the whole year of 2014). In recent Russian history, crises came in pairs, just like earthquakes and aftershocks: 1992–1996, followed by 1998; then 2009, followed by the current one. The new crisis will affect the economic prospects of Russia and its partner countries through two main channels: trade and investment.

At the same time, the new crisis will not have a systemic impact on the world economy, because the role of Russia is, though important, not pivotal (to borrow and turn around Thomas Gomart’s expression originally developed for describing Europe’s place in Russian foreign policy) (Gomart, 2010). Before the outbreak of the crisis (2013), Russia was the 9th largest economy of the globe, producing about 3% of the gross domestic product (GDP) of the world. Its share in world exports was similar.
This presentation focuses on the impact of the crisis on foreign direct investment (FDI), as in those flows, both inbound and outbound, Russia plays a more prominent role. In the latest pre-crisis year (2013), inflows reached $69 billion, about 5% of world total, and outflows amounted to $87 billion, about 6% of world total. In both leagues, Russia is among the global top five (4th in inflows and 5th in outflows).

Main features of the new Russian crisis, relevant for FDI flows

The current crisis shows certain similarities with the ruble meltdown of 1998 (to be developed in this section). It is less comparable with the long transition-related decline of 1992–1996, or with the drop in the GDP in 2009, provoked by developments abroad (the subprime crisis of the Unites States, becoming a global crisis). It is to be noted here that history never repeats itself, and parallels have to be taken with caution.

This analysis highlights not only the main similarities, but also the main differences between 1998 and the current crisis. Spotlight main differences will allow us to prove that this time the drop in production will be more severe and the crisis is expected to last longer (at least two years), with a double-digit drop in GDP in the first quarter of 2015.

To start with, there are various similarities between the two crises (table 1):

- Both of them manifested themselves as a currency (exchange rate) crisis, coming to the surface by way of a massive fall of the ruble on a specific day (4 September 1998 and 16 December 2014). In 1998, the rate to the dollar dropped from 6 in early summer to 19.5 on 4 September and 21 by the end of the year. In 2014, the summer started with a rate of 33, and an accelerating decline reached a temporary peak of about 80 on 17 December, to bounce back after a massive central bank intervention, to 56 at the end of the year.

- Both crises resulted in a massive increase of interest rates by the central bank. In June 1998, interest rates were hiked to 150%. On 16 December 2014, the central bank increased its key interest rate from 10.5% to 17%. Both attempts prompted inflation and a drop in GDP.

- In both cases, the structural problem of relying on oil and gas production for revenues, combined with a decline of oil prices on world markets, made the Russian economy vulnerable to the shock. In the pre-crisis year of 1997, 26% of export revenue was derived from oil and gas, while between October 1997 and December 1998, the per barrel price of the UK Brent crude petroleum dropped from $20 to $10. Oil dependence decreased in 1998 but paradoxically bounced back and accentuated afterwards. Russian became the showcase of the country with an enormous scientific and technological potential not being
able to transform it into productive means. By 2013, the share of oil and gas in exports rose to 63%. The price of the same type of Brent oil started to drop in August 2014, from a peak of $100 and above, to around $50 by the end of the year.

- In both cases, the situation of public finances was aggravated by war. In the first case, the costly First Chechen War had just been concluded in 1996 and the country was heading towards a Second Chechen War. In the intermediate period, military costs remained high. In the second case, the annexation of the Crimea (March 2014), and alleged military involvement in the ongoing conflict in eastern Ukraine further added to the bill.

There are also at least two main differences between the two crises that in most cases make the second one potentially more severe (table 1):

- At the beginning of 2014, the reserves of the Bank of Russia were much higher than at the beginning of 1998: $510 billion versus $18 billion. In principle, it would be positive news. However, the increase margin of manoeuvre of the central bank also meant more spending on the defence of the exchange rate at the expense of structural measures to revive the economy. In 1998, reserves declined by $5.5 billion only; in 2014, by $121 billion (source: Bank of Russia data).

- In 2014, Russia faced a hostile world vis-à-vis its military actions, unlike in the 1990s, when the Chechen wars were considered by the international community as domestic matters (even if some human right groups expressed critical views, too). In 2014, the annexation of the Crimea and the (half open) intervention in Ukraine met an almost unanimous condemnation from the international community, encouraging the European Union (EU) and the United States to impose sanctions on the country. In principle, those sanctions would not necessarily hit a large country like Russia too deep; however, the equation is different if we consider those sanctions together with Russia’s structural vulnerability and the concomitant fragility of public finances.

Table 1: Main similarities and differences of the 1998 and 2014 Russian crises

<table>
<thead>
<tr>
<th>Features</th>
<th>1998</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Similarities</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Currency (exchange rate) crisis</td>
<td>Massive fall of the ruble on a specific day</td>
<td>Massive fall of the ruble on a specific day</td>
</tr>
<tr>
<td>Increase of interest rates by the central bank</td>
<td>Hike up to 150%</td>
<td>Key interest rate from 10.5% to 17%</td>
</tr>
<tr>
<td>Russian economy’s</td>
<td>1997: 26% of export</td>
<td>2013: 63% of export revenue from</td>
</tr>
</tbody>
</table>
Both inward and outward FDI fall; but why a deeper fall in inward FDI?

Over the past decade, both the FDI inflows and outflows of Russia underwent a major boom (figure 1). That boom was affected by the global crisis in 2008–2012, bringing about fluctuations, although both flows remained high. Then 2013 saw all-time record flows, followed by a sharp decline in 2014. Inflows fell to the lowest level since 2005; outflows the lowest level only since 2012.

Figure 1. FDI inflows and outflows of the Russian Federation, 2005–2014
(Millions of dollars)

Source: Author’s calculation, based on Bank of Russia data.

To explain the behaviour of FDI, we have to understand the main features and motivations of those flows. It is a challenging task because the FDI inflows and...
outflows of Russia show a broad variety of characteristics. This variation makes in principle the reaction of the various types of flows to the crisis very differentiated.

Inbound FDI includes privatization-related transactions which may in principle behave differently from non-privatization-related FDI. Within the latter category, natural resource-, market- and efficiency-seeking investors may show divergent motivations, and we should not forget about the specificities of round-tripped capital (money leaving the country and coming back) (Kalotay, 2012).

In outbound FDI, firms that the Pan-European Institute has classified as motivated by expansion abroad (Vahtra and Liuhto, 2004; Liuhto, 2005) may be hit strongly, especially natural resource-based firms suffering from a concomitant blow from the drop in oil prices. Outflows motivated by exodus (to use the twin term developed by the Pan-European Institute) could be deterred less, and probably round-tripped capital, too. In turn, another special form, namely transhipped capital (Kalotay, 2012), may face various problems, including the effects of international sanctions.

On balance, important drops are expected in both inward and outward FDI, to feed back to the crisis itself. The main channels of potential transmission can be summarized in a table 2.

**Table 2. Potential impact of the crisis of 2014 on different types of Russian inward and outward FDI**

<table>
<thead>
<tr>
<th>Type of FDI</th>
<th>Impact of ruble devaluation</th>
<th>Impact of Russian crisis on business prospects</th>
<th>Russian policy effects</th>
<th>Western policy effects (inc. sanctions)</th>
<th>Expected balance of effects</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inbound FDI</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Privatization-related</td>
<td>+</td>
<td>0</td>
<td>-*</td>
<td>-</td>
<td>-*</td>
</tr>
<tr>
<td>Non-privatization-related</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Natural resource-seeking</td>
<td>+</td>
<td>-/0</td>
<td>--</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Market-seeking</td>
<td>+</td>
<td>--</td>
<td>--</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Efficiency-seeking</td>
<td>+</td>
<td>--</td>
<td>--</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Round-tripped capital</td>
<td>+</td>
<td>--</td>
<td>--</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Outbound FDI</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Motivated by expansion abroad</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Natural resource-based</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Technology-based</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Motivated by exodus</td>
<td>-/+</td>
<td>+</td>
<td>+</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>Round-tripped capital</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Transhipped capital</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: * except in case of fire sales.
In principle, the decline of the ruble stimulates new inward FDI (although it hits already established affiliates), and discourages new outward FDI, especially by natural-resource-based firms, which are also plagued by the fall in oil prices. A potential exception is exodus capital wishing to establish safety nests abroad, although these actors, too, will have to pay more rubles for the dollars to be invested abroad.

The deteriorating prospects of the Russian economy will hit again most of the forms of FDI, especially market-seeking inbound FDI and natural-resource-based outbound FDI. Potential exceptions can be identified in privatization deals, which depend more on government decisions, natural-resource-seeking inward FDI, which will react more to international market prices of raw materials, and exodus capital.

In general, Russian policy towards FDI and its reaction to the crisis are expected to hinder all FDI but exodus projects. Natural-resource-seeking will continue to face all the restrictions of the strategic sectors law, and efficiency-seeking projects will be plagued by the skyrocketing prices of access to capital. Privatization will also probably stall, unless the country is obliged by the circumstances to engage in fire sales at artificially low prices (see the asterix in table 2).

Finally the increasingly hostile Western attitude towards Russia, including economic sanctions, will hinder both inward and outward FDI, with the exception of inbound round-tripping as it is carried out by foreign firms owned by Russians. In turn, certain transactions, especially by natural-resource-based State-owned and State-related firms (cf. Panibratov, 2013) put on the sanctions list, as well as outbound round-tripping and transshipment, which will be seen as attempts towards circumventing the sanctions, will face strong scrutiny and opposition in the EU and the United States. And if the clash with the West goes on for a longer time, even technology-based outbound FDI may face negative policy reactions in host countries.

These hypothetical observations would suggest a relatively even impact of the crisis on inward and outward FDI. However, preliminary data for 2014 indicate that inflows are more severely affected than expected and outflows seem to weather the crisis better (figure 2).
In 2014, the fall in inward FDI was surprisingly big. In 1998, inward FDI fell only by 13% compared with the pre-crisis three-year (1995–1997) average. In 2014, inward FDI fell by no less than 64% compared with the pre-crisis three-year (2011–2013) average (figure 2a). It can be hypothesized that the existence of international sanctions in 2014 can explain a large part of the drop. However, this is to be confirmed with more in-depth studies, including interviews with international firms.
Given the major difference between the two periods, it is very difficult to use the movement of inward FDI in the late 1990s and early 2000s as an indicator for the future movement of inward FDI. In that past period, inflows fluctuated between 86 and 104% of the pre-crisis average, before overcoming that level definitively in 2002. (That was then followed by a major jump in 2003 and 2004.) It is too early to tell now if this time the deep fall of 2014 will be followed by a quick recovery, and how many years will be needed to exceed to pre-crisis level. If sanctions are the main reason, they do not seem to fade away quickly as the crisis in eastern Ukraine seems to stay with us for the long term.

The fall in outward FDI is fairly similar in both periods: 19% in 1998 and 16% in 2014, compared with the three-year pre-crisis averages (figure 2b). If we use the standards of the late 1990s, recovery should be smooth and quick. In 1999, the pre-crisis average was already exceeded. However, one has to consider that the level of 2011–2013 will be more difficult to surpass as 2013 was an exceptionally record year. One also has to consider the long-term effect of the sanctions, which may deviate the trend line from the one experienced after 1999. In particular, major difficulties in the financing of outward FDI projects of Russian firms are expected if sanctions remain in place or become stricter. These sanctions may become strict because of the relative diplomatic isolation of the Russian Federation. It has to be recalled that in 2014, United Nations General Assembly Resolution № 68/262 on Ukraine's territorial integrity was adopted, and during that vote, despite Russia's all diplomatic efforts, only 11 countries voted against it (although as a consolation, Brazil, China and India abstained). It has to be considered that (in 2012) the bulk (95%) of the outward FDI stock of Russia was located in countries and territories that voted against Russia (Kalotay, 2014), including all major offshore financial centres that Russian firms use for transshipping and round tripping fell into this “unfriendly” category. This means that the almost totality of outward FDI can be subject to hostile measures.

In sum, there are uncertainties about predicting the depth of the crisis and the possible ways of recovery, both in general terms, and in the area of FDI. There are on balance reasons that may prompt us think that the difficulties of FDI will be at least as big as in the late 1990s. Many new studies on this question are required.

Implications for geopolitics: “a crack in the BRIC”

The new Russian crisis has geopolitical implications, and these implications are particularly pertinent in the area of FDI. Russia is a top 10 economy of the world, and in FDI, it was among the top 5 in the record years, sometimes competing with other emerging giants such as China. In fact, this parallel rise of China and Russia made in the near past the forecasts about the BRIC group becoming a leader of the world economy credible. That may change soon.

1 Only minor financial centres, such as St. Kitts and Nevis, Belize and St. Vincent and Grenadines abstained.
The new Russian crisis may worsen the prospects of the BRIC countries for overshadowing the Group of 7 in the global economic power game. It is difficult to see how matters of the world economy could be decided by a group in which one of the members is structurally vulnerable, and falls victim of crises relatively frequently. It does not mean that Russia could not count on solidarity of other BRICs, especially China. However such help will re-write automatically the bilateral power relations of the two countries. China can become a dominating partner in bilateral relationships.

Because of those changes in power balances, one can even wonder how internal cohesion of the BRIC group can be kept in the future. The new crisis also worsens the prospects for the Eurasian Economic Union, set up by Russian leadership as a counterbalance to the ever expanding Euro-Atlantic group (EU and NATO). It is no longer the question of who signs the treaty (Armenia, Belarus, Kazakhstan and, most recently, Kyrgyzstan, have done so; others such as Tajikistan may still consider joining), but who will provide the necessary leadership among partners and what kind of leverage the new Union will have in international economic matters. The Russian crisis does not augur well in those matters.

Conclusions

This presentation has raised some basic questions about the impact of the current ruble crisis on FDI in Russia. A more in-depth analysis of the situation would require more time and more information. The fact that the Russian Government prefers not talking about the crisis is understandable from the point of view of a strategy trying to avoid the creation of a self-fulfilling prophecy. However that approach does not eliminate the underlying weaknesses of the economy, nor the need for researchers to look at the phenomenon. The future of FDI flows is very difficult to predict. It is evident that the surge of the 2000s and the record year of 2013 belong to the distant past, and efforts are required, especially in FDI attraction, to re-establish the country's past standing. It is a novel situation as for decades it seemed that the Russian Federation, endowed by abundant natural resources and a big population, did not need to advertise itself among the international investor community. Could it be changed in the future? How would an investor promoting Russia look like? These are among the many policy questions future research should resolve.

References


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2 To be recalled that in the General Assembly vote the three other BRICs abstained.


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