



# POLITICAL RISK FOR FOREIGN FIRMS IN RUSSIA<sup>1</sup>

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Kari LIUHTO\*

## Abstract

*In this article the author discusses the political risks of foreign firms in Russia. Risks vary a great deal between the industries. Telecommunications is the most risky industry for a foreign firm at the moment. State consolidation in the oil and gas business has continued. When Russia experiences difficult times, foreign oil companies enjoy good times in Russia, and vice versa, and therefore, the latest crisis gives, at least, a temporary relief for foreign oil firms. I predict that the metal industry will also see its national champion. The production of electrical energy is a strategic sector, though it was not explicitly named in the law of strategic sectors, and foreign electricity firms operating in Russia may face surprises, if the Russian Government turns more nationalistic in the next decade.*

**Keywords:** Investment climate, political risks, foreign direct investment in Russia

**JEL classification:** F21, F23

## 1. Russia's foreign investment paradox: foreign investments have grown though political risks have increased in the 2000's

Russia is notoriously corrupt, and hence by definition, the state is an inefficient governor of any property. Despite this well-known fact state ownership in big business has widened (Troika Dialog 2008). "State-owned enterprises are found across a wide range of sectors and often occupy a dominant position in their industry. Furthermore, there is a pervasive blurring of the line between the public and private sectors, arising not only from the extensive role of state-owned enterprises but also by close ties between government (at all levels) and major private firms" (OECD 2009, 17).

The statement of Oleg Deripaska, once the richest businessman in Russia, gives an idea of symbiotic and simultaneously unnatural relationship between the state and big

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\* Director of the Pan-European Institute, e-mail : Kari.Liuhto@tse.fi

business. "If the state says we need to give it up, we'll give it up. ... I don't separate myself from the state. I have no other interests" (Lucas 2009, 59).

Even if the state involvement in the upper echelons of the economy has strengthened and as a consequence some foreign companies have lost their business, foreign corporations have multiplied their investments into Russia since the beginning of the millennium. Russia's investment paradox does not stop here. Though FDI inflows have grown significantly since the beginning of the decade, the position of foreign firms has become more restricted due to natural resource nationalism and the siloviki's stronger influence in policy making (Kryshantovskaya – White 2003)<sup>2</sup>.

It can be anticipated that the weaker foreign business influence inside Russia will get, the less open Russia becomes towards the international community. The less open Russia turns, the slower its politico-economic modernisation becomes. The slower the country is able to modernise itself, the more natural resources Russia has to put into its industrial system to maintain the consumption patterns learned in the early 21<sup>st</sup> century. Political risks materialise for foreign firms to their full extent, if Russia has not managed to modernise its industrial system, when the natural resources have been used in those regions, where they can commercially be exploited.

The aforementioned summarise why the discussion on the political risks in Russia is relevant. Before the industry-related risks, the author deals with Russia's political risks through Alon and Martin's (1998) macro political risk model (Table 1).

**Table 1** Normative model of macro political risk assessment

MACRO POLITICAL RISK		
	Internal	External
<b>Government-related</b>	Degree of elite repression Degree of elite illegitimacy Likelihood that regime change will affect policy	Likelihood of political violence Degree of involvement in international organisations Possibility of regulatory restriction on investment, capital or trade
<b>Society-related</b>	Degree of fragmentation →potential for social conflict Sense of nationalism, xenophobia, alienation or fundamentalism	World public opinion Disinvestment pressure Regional diversity and incongruent interests
<b>Economy-related</b>	GDP per capita growth Income distribution Likelihood that economic goals will be met	Future economic policies regarding FDI Likelihood of balance of payments problems Likelihood of currency convertibility/instability

Source: Alon – Martin, "A normative model of macro political risk assessment", *Multinational Business Review*, 1998.

<sup>2</sup> For a closer discussion on the weakened position of foreign firms in Russia see Liuhto (2007; 2008) and Liuhto – Vahtra (2009).

## **2. Russia's macro-political risk in the near future**

**Government-related risks:** Russia is still developing democracy and its party system has not found its final form. An overwhelming concentration of power and a lack of genuine political debate prevail in Russia. Political parties play a secondary role, whereas the political limelights are occupied by the key political figures, who do not always represent the interests of their electorate but rather the interest of the state; be it that of the presidential administration, the government or some of the many security-related organisations. This elite repression does not exist in a large scale, but the prolonged hegemony of the ruling party (United Russia) may create situation where real political alternatives are no longer available.

Gel'man (2007 12) aptly summarises the transformation of Russia's party system: "Russia's party system has swung like a pendulum from the one party control of the Soviet era, to the hyper fragmentation and volatility of the 1990s, to an attempt to restore centralized control in the 2000s. The danger of the new system is that it will cause the death of political opposition. Now Russia may be developing a 'Dresden' style political system, in which one main party controls several satellite parties that have little political power. Such a system could be in place for a long time, though it is unlikely to be permanent".

Should the political system remain unchanged for long, pressures to change ultimately become so high that they will explode in a non-controllable way. A non-evolving political system may become an extremely high political risk for foreign firms, if it is maintained for too long.

The United Russia party won clearly the latest parliamentary elections in 2007 and the opinion polls show that the approval ratings of both the president and prime minister are exceptionally high, and therefore, one should not argue that elite illegitimacy exist in Russia as such. However, the main source of the illegitimacy originates from the fact that the State Duma lacks true opposition with an alternative political direction, since both Just Russia and the Liberal Democratic Party of Russia are generally believed to be the Kremlin's satellite parties, and the Communist Party leans too much on the Soviet era instead of giving a real option for the younger generation. The absence of liberal opposition in Russia's political landscape does not allow one to be too hopeful for future development. Even if all the parties representing the liberal opposition would join together, it is very unlikely that they would go over the electoral threshold of seven per cent. Moreover, one should not forget that the tenure of the parliamentary term and presidency have been prolonged, pushing Russia's political system towards political immobility.

The likelihood of immediate regime change is extremely low, even if the crisis has touched the Russian economy hard. "Political risk has increased, reflecting the pressures created by the severe financial and economic crisis. The crisis, and the question of how to deal with it, is likely to put strains on the ruling 'tandem' between the president, Dmitry Medvedev, and the prime minister, Vladimir Putin, as well as to fuel disagreements within the government those who favour a statist solution to the crisis and those who are more liberally inclined. As prime minister, with ultimate responsibility for the economy, Mr Putin appears more exposed than Mr Medvedev to

a decline in his popular standing. There is also an increased risk of social unrest. Nevertheless, given the lack of a credible opposition, it seems doubtful that social discontent could threaten the leadership" (Business Eastern Europe 2009a, 3).

Despite the prime minister having been forced to take unpopular decisions, the crisis has not collapsed the prime minister's popularity. In fact, Putin is still more popular than the president.

Though I cannot foresee any true regime change in the near future, one should keep in mind that the statist approach has gained weight in Russia, and the political weight of the Deputy Prime Minister Igor Sechin in particular, has increased. Should Putin become the next president and Sechin the next prime minister of Russia, such a change should not be called as a regime change, though the change would probably strengthen the nationalistic and statist views in Russia's economic and foreign policies.

"The global financial crisis has strengthened the hand of Russian hardliners who want greater state control and less to do with the West, a key adviser to President Dmitry Medvedev said in an interview on Wednesday. Igor Yurgens, who chairs Medvedev's think-tank, the Institute for Contemporary Development, nonetheless told Reuters he believed the president was aligned with Russia's liberal wing and was making small, cautious steps towards reform. 'The crisis of course fortified the positions of the statist', Yurgens said. 'The ideology of this wing will be fortified'" (Guardian 2009).

The Caucasus has been a cradle of violence for centuries. Both the Chechen wars, increased instability in the neighbouring regions of Chechnya, and Russia's war with Georgia in August 2008 have increased the macro-political risk of Russia. Closson (2008 4) writes "*it is clear that the Georgia-Russia conflict and the recognition of South Ossetia and Abkhazia as independent states present challenges for ensuring stability across the Caucasus. Their recognition has spurred nascent movements for independence in Ingushetia and increased calls for the return of displaced Ingush to their lands in the Prigorodny district, now in North Ossetia.*" The Caucasus conflicts weaken Russia's image among foreign investors, though their impact on foreign direct investment inflows have so far remained modest.

Russia's involvement in international organisations is not to become more active in the near future, on the contrary. For instance, Russia's over 15-year long road towards WTO membership received a rather surprising turnaround in June 2009, when Putin informed that Russia will join the WTO as a part of a customs union with Belarus and Kazakhstan. Even if one may interpret this as playing for time (more room to conduct protectionist measures during the crisis) and a strengthening of Russia's negotiation position rather than a genuine accession strategy, this can be considered as a genuine drawback for Russia's interest to join international organisations. Russia's WTO decision also means an end (at least a temporary one) to the negotiations aiming towards the creation of the Common Economic Space between the EU and Russia. Furthermore, Russia's OECD membership does not seem very likely in the foreseeable future and Russia's membership in OPEC has been one of political lip service. The UN and its Security Council in particular will remain Russia's most important participation in international organisations.

Russia confronts the USA especially in NATO enlargement to the CIS and Russia's goal to implement its sphere of influence in the CIS. Correspondingly, Russia's relations with the EU has cooled down, particularly after the Georgian war and the gas dispute with Ukraine, which stopped the natural gas supplies to the EU for several days. At the same time, when Russia's relations with the West have deteriorated, Russia has tried to build closer ties with the East.

In May 2008, Russia introduced the law restricting foreign investment into strategic sectors (for more see Liuhto 2008). The law was not prepared with sufficient time, and even Russian experts admit that there are several weaknesses in the law. For instance, the law could lead to an absurd situation where foreign-owned oil companies stop exploring new oil fields, since if they will find too a big hydrocarbon field they should donate it to the state against a symbolic compensation. In addition, there are loopholes in the law that allow foreign entities to flout the government when buying into strategic companies. Some Russian authorities have acknowledged that the law touches unnecessary sectors and ownership restrictions are too strict, and hence, the authorities may increase the ownership stakes of foreign oil firms in strategic fields. Although it would be wise to re-consider the content of the law, one may only ask whether the possible liberalisation in the law lasts only during the crisis or whether foreign firms can really rely on the law in the longer run.

Due to the global financial crisis, it is extremely likely that Russia will build customs barriers to protect its own industries. Since Russia decided not to join the WTO in the foreseeable future, it is very likely that several protectionist measures will be maintained, even after the crisis has ended. *"Being outside the organisation for a longer period gives Russia more freedom to raise import or export duties. WTO-related obligations to cut tariffs on entry would have threatened plans to build up certain industries, such as automotive manufacturing. WTO accession might also have facilitated the takeover of domestic operators or their crowding out by foreigners, and this is politically sensitive in Russia"* (Economist Intelligence Unit 2009c, 16).

**Society-related risks:** though 80 per cent of the people living in Russia are ethnically Russians, one can argue that Russian society has become more fragmented and nationalism grows.

Pain (2007 5) analyses the development of nationalism in Russia as follows: "in the beginning of the 1990s, the minority non-Russian ethnic groups began asserting their rights. By the end of the 1990s, it was the majority ethnic Russians who had become vocal. Although the ethnic Russians became ethnically conscious later than the other groups, their feelings are quickly growing and now the ethnic majority considers itself to be more threatened than the minorities. From the beginning of 2000, the share of ethnic Russians who feel threatened by members of other ethnic groups living in Russia is almost twice the number of other groups. During the Soviet era, the ethnic Russians were the most tolerant of the ethnic groups in Russia.

The Russian's fear of other ethnic groups was particularly noteworthy after the series of terrorist acts in the summer of 1999 and the beginning of the 'second Chechen war' that fall. Initially, the feelings were directed against the Chechens, but after 2000, they spread to a variety of other ethnic groups. Since that time, approximately two-thirds of

respondents feel some form of antipathy toward other nationalities. Anti-Semitism grew particularly quickly and now the level of anti-Semitism among Russian nationalist leaders has even outstripped their anti-Chechen and anti-Muslim feelings.

Contemporary Russian nationalists stress the idea of rebuilding the Russian empire. However, their focus on the idea of 'Russia for the Russians' is incompatible with efforts to bring other ethnic groups together in one political entity. The authorities support Russian nationalist ideas, in the mistaken idea that they will be able to manage nationalist forces. In fact, the rise of Russian nationalism is likely to encourage separatism among other ethnic groups."

Russia's increasing nationalism means increasing investment risk for foreigner investors, since the authorities are not able to fully control nationalism, nationalism encourages separatism, and finally, foreign business is a stranger, i.e. a target for attack if the nationalistic waves ever overflow the dam.

Umland (2009 13) argues that "in recent years, various forms of nationalism have become a part of everyday Russian political and social life. Since the end of the 1990s, an increasingly aggressive racist subculture has been inflecting sections of Russia's youth ... It is generally acknowledged that a shrill anti-Americanism, as well as various other phobias, today characterize not only marginal groups, but also the Russian mainstream. ... Among the dozens of extremely anti-Western publicists and pundits present in Russian official and public life today, Aleksandr Dugin and his various followers stand out as a network of especially industrious political ideologues and activists who have managed to penetrate Russian governmental offices, mass media, civil society and academia. ... If Dugin's view becomes more widely accepted, a new Cold War will be the least that the West should expect from Russia during the coming years."

The prolonged and extended instability of Chechnya has turned the Caucasus into a fertile soil for Islamist fundamentalism, and therefore, it is likely that the assassinations and bombings will become more frequent. It should be clear to everyone that the independence of Abkhazia and South Ossetia is not sustainable, either politically or economically, and it will further fuel the instability in the region<sup>3</sup>.

Should the Russian Government be unable to normalise life in the Caucasus region (unemployment, for instance, in Ingushetia is around 80 per cent), one may anticipate that Islamist fundamentalism does not only spread inside the Caucasus, but fundamentalism may find its targets outside the Caucasus (Business Eastern Europe 2009c)<sup>4</sup>. With the current trend the Caucasus will soon become the Middle-East of Russia, where investments, be they domestic or foreign ones, are doomed to fail.

The world's public opinion towards Russia has become more reserved during this decade, when Russia began to rebuild its political and economic leverage in the post-Soviet territory. After three gas transit conflicts with Belarus and Ukraine the public image of Russia has particularly deteriorated in the West. After the war with Georgia

<sup>3</sup> *During this century, the Muslim population may form the majority of the Russian population.*

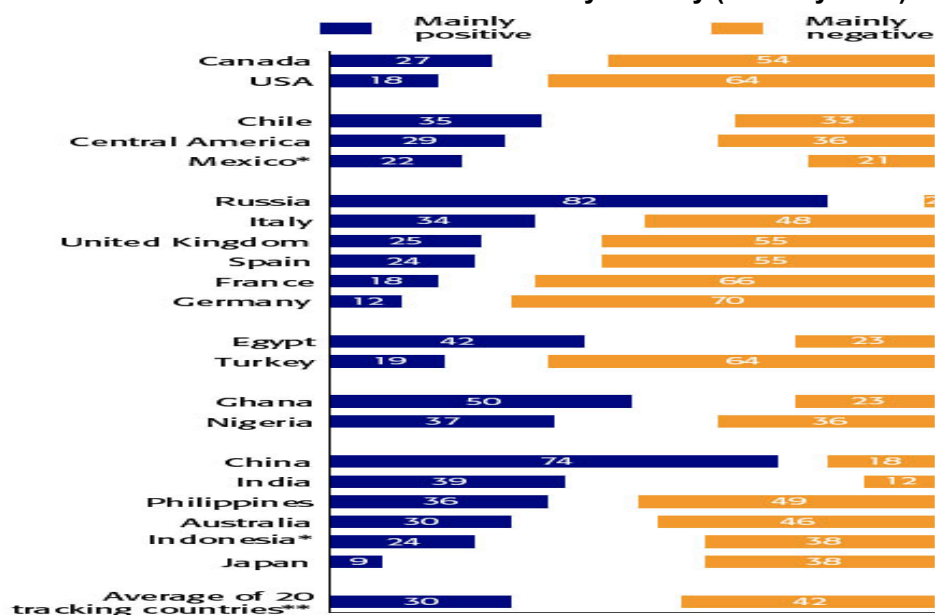
<sup>4</sup> *With the Russian economy facing a sharp contraction, the Kremlin is less able to throw money at the North Caucasus, and hence the more volatile the region becomes (Business Eastern Europe, 2009c).*

and the increased assassinations of journalists investigating the Chechnya conflict, public opinion on Russia has dropped to its record low.

According to a large international survey<sup>5</sup>, positive views have fallen 5 percentage points (30%, down from 35%) and negatives have risen sharply (42%, up from 34%). Positive views about Russia have deteriorated substantially, especially in Europe and the United States. In the United Kingdom, positive views have fallen 23 percentage points (25%, down from 45%), shifting the overall leaning to predominantly negative from positive. Negative views have worsened in France (rising from 50% to 66%) and Germany (rising from 56% to 70%). In the United States negative views have risen 28 points (64%, up from 36%), shifting overall views from mildly positive (45% to 18%) to strongly negative. The only countries to demonstrate significant improvement in positive views of Russia are Italy (34%, up from 23%) and Ghana (50%, up from 42%). Italy's several bilateral deals with Russia and Prime Minister Berlusconi's dominance over the media may explain a part of the aforementioned development (Table 2).

**Table 2**

**Views of Russia's influence in the world by country (January 2009)**



Source: BBC, Views of China and Russia Decline in Global Poll, 2009.

<sup>5</sup> The BBC World Service Poll has been tracking opinions about country influence in the world since 2005. The latest results are based on 13 575 in-home or telephone interviews conducted across a total of 21 countries (BBC 2009).

The survey administrator concluded that the more Russia acts like the old Soviet Union, the less people outside its borders seem to like it.

The Russian Government should take seriously the deterioration of public opinion on Russia around the world. It might well be that the prolongation of the crisis in the Caucasus and the cooling of Russia-Ukraine relations may lead to a situation that public opinion prevents some of the Western companies investing in Russia. Especially those Western companies, who are selling their commodities to a wider clientele, will be particularly sensitive since they do not want their public image to worsen (lose their main markets) because they are doing business in Russia.

**Economy-related risks:** Russia's GDP per capita growth has been remarkable in this decade. Until the crisis broke, the average growth was clearly above 5 per cent annually. Though the Russian GDP has nearly doubled in this decade, some citizens have been more equal than others in amassing prosperity. The richest 10 per cent of the Russian population earn over 30 per cent of all the income distributed in Russia, while the poorest 10 per cent earn less than three per cent. In fact, Russia's inequality in income distribution (the Gini index) is comparable to that of Burkina-Faso or Tunisia. On the other hand, the USA does not perform better than Russia in the Gini index (United Nations Development Programme 2008).

Differences among the Russian regions are notable. The regional GDP per capita comparison does not describe the situation accurately since the natural resource rich regions seldom receive the major part of the income from the exploitation of these resources. Despite the statistical deficiencies, one can safely conclude that Russia lives in three different centuries. Moscow and St. Petersburg are hectic metropolises of the 21<sup>st</sup> century, regional capitals and several industrial centres live in the past century, whereas some regions have degenerated back to the 19<sup>th</sup> century. The least developed regions are located in the Caucasus and nearby Mongolia.

The current crisis will add to regional inequality since there are hundreds of towns in which one corporation is practically responsible for the economic well-being of the whole city. The Russian Government has identified some 400 towns that rely almost exclusively on one employer. The substantial increase in regional unemployment, and hence, the considerable drop in economic well-being will obviously cause social turbulence Russia has not seen since the beginning of the 1990's. In addition to unemployment, the grey economy, absenteeism and criminality can be expected to increase in these monocities.

Besides regional inequality, societal inequality is wide. Elderly people particularly have suffered from the transformation from socialism to capitalism. One can even state that elderly people have been betrayed by both socialism and capitalism, since neither socialism nor capitalism has brought them the well-being promised. Although 'the lost generation' feels disappointed, it is too old to cause violent protests on the streets and too wise to re-elect the communists into power.

Even if the social pressure is to grow during the next winter, the social protests have so far remained mild. Lankina and Savrasov (2009, 6-8) concluded in May 2009 as follows: *"the number of social protests in Russia is growing, though the absolute number of participants remains relatively small. Overall, the authorities are*



*suppressing a smaller number of protests now than they were two years ago. Political protests are more numerous than economic ones and protesters are increasingly targeting national leaders, though protests against regional leaders have increased slightly. ... Significantly, among the most active protesting regions are Kaliningrad and Primorskiy Kray in the Far East."*

Russia, though no longer a planned economy, has still many unrealisable plans, policies and programmes. Many of the strategic economic goals cannot be met without a considerable re-direction of investments from natural resources to a knowledge economy, a true renaissance of entrepreneurship, and free and fair competition. One should not be fooled by the GDP growth of this decade, since the foundations of the growth originated from high natural resource prices and larger export volumes of the natural resources. If Russia is blind enough to start the arms race once again and not to invest the available financial resources into the modernisation of their society, Russia's economic well-being, together with its population size, shrinks dramatically after 2050. Should this dark scenario happen, Russia's political risks will multiply, as Russia will turn nationalistic and becomes more hostile towards its neighbours and foreign industrialists within the country.

The forthcoming couple of years will be extremely challenging for the federal budget. However, in the medium run, the situation will be relaxed, since the oil price will obviously climb after the crisis is over. On the other hand, Russia's economy is still relying too much on oil, and therefore, in the long run, Russia has to get a rid of this dependency before its reserves run out and the world reduces its hydrocarbon dependence. The window of opportunity is open for some decades, not for several generations.

As a conclusion of Russia's overall political risk, one can present the following risk assessment and to divide risks into 10 categories (Business Eastern Europe 2009b, 10-11): "OVERALL ASSESSMENT: ... *Russia has been badly hit by the global financial and economic crisis. In addition, there remain high operational risks associated with the opaque and corrupt administration, the threat of terrorism, increasing authoritarianism and the ill-functioning judiciary. The operations of companies in certain strategic sectors are particularly vulnerable to government interference. ...*

**SECURITY RISK:** While security risk may not be much higher in Russia's large urban centres than in some other European capitals, foreigners in the more remote Far East and the North Caucasus face more varying degrees of security risk. This is heightened by the fact that the police and judiciary cannot always be relied on for protection. ...

**POLITICAL STABILITY RISK:** The sharp economic downturn poses the greatest risk to domestic political stability in the short term, increasing the risk of serious social disturbances, and fuelling uncertainty over the effectiveness of the tandem governing arrangement. ...

**GOVERNMENT EFFECTIVENESS RISK:** ... Business in Russia struggles with unclear and overbearing regulation, arbitrary administrative decisions, corrupt officials and biased or incompetent judges. ... Corruption is still rife at most levels of

government and the legal system remains heavily skewed as a result of lobbying from industrial groups or powerful individuals. ...

**LEGAL AND REGULATORY RISK:** The judiciary is undefended, understaffed and slow-moving-recent reform efforts notwithstanding. ... Competition policy is underdeveloped and intellectual property is poorly protected. ...

**MACROECONOMIC RISK:** ... The Russian economy will be affected by reduced external demand, sharply lower commodity prices, especially oil, on which the economy remains overly dependent-and substantially constrained access to external financing, which is expected to persist throughout 2009. ...

**FOREIGN TRADE AND PAYMENTS RISK:** ... The authorities have increased import tariffs on a number of goods in recent months. ... there is a risk that protectionism will increase further. ...

**TAX POLICY RISK:** Tax reform was a relative success story of the Putin administration, and the risk previously associated with the country's extremely complex and cumbersome tax system has fallen over the past few years ...

**LABOUR MARKET RISK:** ... Although the economic downturn raises the risk of labour unrest, most trade union organisations are close to the government. ...

**FINANCIAL RISK:** ... In a best-case scenario, the banking sector will experience an orderly consolidation over the coming period. In a worst-case scenario, it could face a systemic crisis. ...

**INFRASTRUCTURE RISK:** Infrastructure risk varies widely from region to region. Companies in Moscow, St Petersburg and other urban centres have better access to transport and telecoms facilities than those operating in the far-flung regions, where business is faced with poor roads, electricity blackouts and cracking telephone lines" (Table 3).

**Table 3**

**Russia: Risk ratings (E=most risky, 100=most risky)**

<b>Risk category</b>	<b>Current rating</b>	<b>Current score</b>	<b>Previous rating</b>	<b>Previous score</b>
Security risk	C	54	C	54
Political stability risk	C	60	C	60
Government effectiveness risk	E	82	E	82
Legal & regulatory risk	D	70	D	70
Macroeconomic risk	D	70	C	55
Foreign trade & payments risk	C	57	C	57
Tax policy risk	C	50	C	50
Labour market risk	C	54	C	54
Financial risk	D	63	D	67
Infrastructure risk	C	50	C	50
<b>Overall risk assessment</b>	<b>D</b>	<b>61</b>	<b>C</b>	<b>60</b>

Source: Business Eastern Europe, Russia: Risk ratings, 2009b.

### **3. Political risk for foreign firms in selected industries**

Political risk varies a great deal across the industries, and therefore, one should analyse the sectors separately. I will start with telecommunications, since it is the hottest industry in terms of its political risk for a foreign firm at the moment.

**Telecommunications:** the sector faces its largest revolution since the break up of the Soviet Union. The main reason for turbulence is the Russian Government's decision to reorganise Svyazinvest, and to make it a state-owned national champion in telecommunications. According to the government's plan, Rostelecom becomes the centre of the new company, regional telecoms are integrated into this new entity, and the new company reinforces its position on the mobile market, either by merging the mobile units of the regional telecoms or through establishing control over one of the Big Three (MTS, VimpelCom or MegaFon) mobile operators (Troika Dialog 2009a).

Establishing control over one of the Big Three seems currently the most likely option. Antonova (2009, 7) describes: "Svyazinvest expects its planned reorganisation to make it a leading player on the mobile communications market, currently dominated by three private firms, Communication and Press Minister Igor Shchyogolev said Tuesday. It would be 'optimal' to merge Svyazinvest's mobile operators with one of the 'Big Three,' Shchyogolev said referring to Mobile TeleSystems [MTS], VimpelCom and MegaFon. A final decision on the model for the new provider will be made in the fall, he said, Interfax reported".

Some analysts consider that "it would be logical to see something between MegaFon [partially-owned by TeliaSonera] and Svyazinvest, since MegaFon, the smallest [of the Big Three] does not have a fixed-line unit" (Antonova 2009, 7). At the moment, it is too early to predict how the nationalisation of telecommunications in Russia proceeds and what will be the destiny of MegaFon's or Vimpelcom's ownership in Russia.

If the nationalisation of foreign ownership occurs it would mean that Russia has taken another step in destroying its investment climate. The government's takeover started with the oil business, and then continued to telecommunications. Foreign investors may only wonder which field will be taken next. If telecommunications faces nationalisation, one can no longer only speak about natural resource nationalism, since telecommunications is not linked with natural resources but rather it is linked with the security organisations' desire to control the telecommunications sector.

**Oil and natural gas:** the state consolidation, which started during Putin's first presidency, has continued. The consolidation proceeds in several ways. First, the state has increased its ownership stake in major oil companies, in Lukoil for instance. Second, Rosneft and Gazprom have eaten smaller units, such as Sibir Energy and Tomskneft. Third, regional oil companies are in danger of being swallowed up by large financial-industrial groups, which are likely to sell them further to the state companies. For instance, telecommunications firm Sistema is unlikely to keep their ownership in

the Bashkir oil company, Bashneft, in long run<sup>6</sup>. It remains to be seen what will be the future of Russia's 6<sup>th</sup> largest oil producer, Tatneft, the oil company of Tatarstan. Although Tatneft is a harder bite to be chewed than Bashneft, it well might be that the Russian leadership wants to put an end to the regional decentralisation of oil production.

The position of foreign oil firms varies. On one hand, the Russian Government offers some foreign oil companies (Shell and Total) stakes in new fields. Even if the aforementioned companies have managed to stay out of political troubles, they have also experienced harder times in Russia. For instance, Shell lost its control position in Sakhalin. Refusal in the aforementioned case might have resulted in operational difficulties for foreigners, i.e. the Russian Government made an offer the foreigners could not refuse.

On the other hand, the Government has pushed some foreign companies into a corner (BP). If BP cannot agree with Gazprom on the price of the Kovykta field, Gazprom may wait until the licence expires in 2017, and as a result, the field would become invalid for BP.

It seems when Russia experiences difficult times, foreign oil companies have good times in Russia, and vice versa, and therefore, the current crisis gives, at least, a temporary relief for foreign oil firms.

**Metals and mining:** both the Russian president and the prime minister publicly declared in the first quarter of 2009 that there is no immediate need to merge major metals and mining companies (Troika Dialog 2009c). Despite this clear signal from the political heights, I tend to believe the analysis of Norilsk Nickel Board Chairman Alexander Voloshin. He stated in May 2009 that it would make sense for the world's largest nickel miner to merge with other Russian metal companies after the financial crisis is over (Soldatkin 2009).

There are many factors, which support the above conclusion. First, the foundation of a national champion perfectly suits the Russian Government's strategic governance agenda, i.e. that strategic companies should be under direct state control or they should be controlled by Kremlin-loyal oligarchs. Second, the construction of a national champion around Norilsk Nickel was already under preparation when RusAl became one of its main owners prior to the crisis. Third, the government waits for correct timing because the wait-and-see method is an intelligent strategy since after the crisis it can patiently look which assets have fallen into the hands of state banks due to unpaid collaterals. Fourth, the government does not want to increase unemployment and social unrest in the peripheral regions by shaking these big employers in the middle of the crisis. Fifth, some close allies of the prime minister, such as the CEO of the state-owned conglomerate Russian Technologies, has expressed his interest in the metals merger.

<sup>6</sup> *It can be assumed that the negative reaction of the president of the Republic of Bashkortostan towards the centralisation is at least partially due to the acquisition of the main industrial assets of the republic, i.e. Bashneft. The president, Murtaza Rakhimov, went so far as to state that the level of centralisation is now "worse than in Soviet times" (Economist Intelligence Unit 2009b, 10).*

“The company [Russian Technologies] has already expressed an interest in taking a 40% stake in Norilsk Nickel if the government [state banks] fails to get its money back. Russian Technologies already owns Russia’s top titanium producer and a speciality steel producer, and reportedly wants to create a massive metals and mining conglomerate by also adding to the mix Russia’s largest iron ore company, currently controlled by a private owner” (Business Eastern Europe 2009d, 2).

In my opinion, the question is not whether the merger will be implemented but rather, when it will be carried out, which companies will be involved, and who will have control over the national champion. As a strong supporter of market economy, I only hope that the state’s role in the merger would be marginal. This would mean, in practice, that the state-owned banks, holding the shares of Russia’s major mining companies, would find a new private investor instead of selling these shares to the state corporations.

Even if the metals champion will be created its direct impact on the position of foreign metal companies is not tremendous. However, the selection of Russian Technologies to execute the merger might give a warning signal to private metals companies, since the first metal merger might be followed by other state-led metal mergers. In this context, one should remember that the Russian metal sector has so far been rather exclusively privately-driven, i.e. the share of the state in publicly-traded metal companies was only three per cent in 2007 (Troika Dialog 2008).

**Electricity:** it needs to be remembered that production of electrical energy is a strategic sector (in any economy – Russia is no exception), though it was not explicitly named in the law of strategic sectors.

So far, Putin has been the main guarantee that the electricity tariff liberalisation has progressed according to plan. The prime minister has repeatedly stressed that Russia will keep its promise to foreign investors, which have invested billions of euros to the Russian electrical sector. For instance, in April 2009, Putin stated “*we pulled in investors and had to keep the tariff [liberalisation], otherwise we would just deceive them*” (Troika Dialog 2009d).

Though industrial energy tariffs are to grow slightly slower than originally planned (Troika Dialog 2009e), it is not perhaps the main headache of foreign investors. The foreign firms have been more concerned about the overall consumption of electricity in Russia. Due to the economic downturn, the country’s electricity consumption declined by six per cent in the first half of 2009. In the Urals region, where the electricity unit of Fortum is located, electricity consumption contracted by nine per cent (Troika Dialog 2009f). Since the earnings of foreign investors have been smaller than budgeted, foreign electricity producers have started negotiations with the Russian authorities to postpone the building of electricity capacity, agreed prior to the crisis.

It is extremely difficult to anticipate how foreign investors are treated in 20 years from now since Russia’s contemporary leaders are probably no longer in their current positions, and strengthened nationalism in Russia might have turned the investment climate colder towards foreign investors. Even if major regime change is unlikely in the medium term, the regime may become less foreign business-oriented and that would be an undeniable risk for foreign investors in the electricity sector, since the

investments are gargantuan and a foreign firm is not able to take the electricity producing unit with him, if the company is squeezed out of Russia.

**Forestry:** the Ruukki Group also encountered difficulties with the authorities. In 2007, the group signed an investment contract with the Kostroma authorities concerning a pulp and saw mill. The deal was signed with the Kostroma governor. After the accidental death of the governor, the authorities started requiring changes to the contracts, and the Ruukki Group withdrew from the project since it was not able to receive felling rights without having to go to public auction for raw material.

This case provides three lessons to foreign investors. First, the company should check whether the regional decision-maker has the authority to take the decision. Second, personal relations are important, but relying on one person's backup is a major risk. And last, it is of the utmost importance to secure the supply of the main factors of production. For instance, it might be difficult for the Ruukki Group to find enough timber in Russia, though the country possesses a fifth of the global forest reserves. The situation reminds me of a Soviet anecdote which describes what would have happened if socialism would have been established in the Sahara. During the first 10 years nothing happens, and thereafter, there will be a shortage of sand.

Some foreign forest companies have invested considerably in Russia, and they have been relatively successful in their investments. However, this does not erase the risk that forests are widely considered as national prosperity among the Russians, and therefore, that foreign ownership would be extremely risky, particularly if nationalism raises its head. Furthermore, the inefficient road network in the forests makes the infrastructure risk notable.

Due to the crisis, Russia temporarily postponed the increases in export tariffs of round wood. Even after the crisis, it is very questionable whether Russia will be able to force the global forest companies to invest in the country by stopping timber exports with incredible timber export tariffs. The best way to make foreign forest firms invest in Russia is to create a system that guarantees a secure supply of round wood at competitive and predictable prices. Russia's zigzagging with the export tariffs of wood has hurt Russia's credibility as a reliable partner.

To conclude, Russia permits foreign firms in its strategic sectors for three main reasons: (1) they are valuable political chips in supporting Russia's bilateral ties; (2) foreign firms possess superior technology and knowledge; and lastly (3) foreign firms bring additional capital to large investment projects.

#### **4. Summary**

The probability of regime change is extremely low even if the crisis has touched the Russian economy hard. Though I cannot foresee any true regime change in the near future, one should keep in mind that the statist approach has gained weight in Russia.

The prolonged instability of Chechnya has turned the Caucasus into fertile soil for Islamist fundamentalism. Should the Russian Government be unable to normalise life in the Caucasus region, one may anticipate that Islamist fundamentalism does not

only spread inside the Caucasus, but fundamentalism may find its targets outside the Caucasus.

That Russian society has become more fragmented and nationalism grows. Increasing nationalism equals increasing investment risk for foreigner investors, since a foreign investor is a stranger and a target for attack if the nationalistic waves overflow the dam.

The world opinion of Russia has substantially deteriorated during the year 2008. The Russian Government should take seriously the deterioration of public opinion about Russia around the world. The prolongation of the crisis in the Caucasus and the cooling of Russia-Ukraine relations may lead to a situation where public opinion prevents some of the Western companies investing in Russia.

The substantial increase in regional unemployment, and hence, the considerable drop in economic well-being will obviously cause social turbulence that Russia has not seen since the beginning of the 1990's.

The aforementioned factors increase macro risk in Russia. In this context, one should remember that risks vary a great deal between the industries. Telecommunications is the most risky industry for a foreign firm at the moment. The main reason for turbulence is the Russian Government's decision to make Svyazinvest a state-owned national champion in telecommunications. If the state swallows up the ownership of Swedish-Finnish TeliaSonera (MegaFon) or Norwegian Telenor (Vimplecom), it would mean that Russia has taken another step in destroying its investment climate.

State consolidation in the oil and gas business has continued. The position of foreign oil firms varies. On one hand, the Russian Government offers some foreign oil companies stakes in new fields. On the other hand, the Government has pushed some companies into a corner. The oil and gas business in Russia more follows the logic of international politics than international business, and hence, every step in the sector is shadowed by political risks. When Russia experiences difficult times, foreign oil companies enjoy good times in Russia, and vice versa, and therefore, the current crisis gives, at least, a temporary relief for foreign oil firms.

I predict that the metal industry will also see its national champion in the aftermath of the crisis. The question is not whether the champion will be created but rather, when it will be carried out, which companies will be involved, and who will have controlling ownership in the national champion. Even if the metals champion will eventually be created, its direct impact on the position of foreign metal companies is not tremendous.

The production of electrical energy is a strategic sector, though it was not explicitly named in the law of strategic sectors. Even if major regime change is unlikely in medium term, the regime may become less foreign business-oriented and that would be an undeniable risk for foreign investors in the electricity sector, since the investments are large and a foreign firm is not able to take the electricity producing unit with him, if the company is squeezed out of Russia.

Some foreign forest companies have invested considerably in Russia, and they have been relatively successful in their investment. However, forests are widely considered as national prosperity among the Russians, and therefore, foreign ownership is risky, particularly if nationalism raises its head.

The following well describes the future development. "Many oligarchs will be unable to repay the loans. A significant redistribution of wealth in Russia will occur. Many companies will fall into either foreign or state ownership. It is uncertain what the landscape of Russian capitalism will look like after the crisis. Some oligarch-run companies will survive in reduced circumstances. Some reforms may open the way for a larger small and medium-sized enterprises (SME) sector from which new large firms will eventually spring. Strengthened state conglomerates are likely, as is increased foreign ownership in some sectors." (Economist Intelligence Unit 2009a, 11).

According to a Russian saying, who doesn't risk, never gets to drink champagne. On the other hand, one should keep in mind that risk maximisation is not synonymous with business maximisation, and therefore, the majority of the foreign businessmen would prefer to have a relaxed drink instead of playing Russian business roulette in order to get champagne.

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