FDI another day: Russian reliance on European investment

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Executive summary

MOST FOREIGN DIRECT investment into Russia originates in the European Union: European investors own between 55 percent and 75 percent of Russian FDI stock. This points to a Russian dependence on European investment, making the EU paramount for Russian medium-term growth. Even if we consider ‘phantom’ FDI that transits through Europe, the EU remains the primary investor in Russia. Most phantom FDI into Russia is believed to originate from Russia itself and thus is by construction not foreign.

OVER THE LAST decade, three main factors have determined FDI flows into Russia. First, the energy sector (oil and gas) plays a predominant role in the Russian economy and dominates exports. It has become a major focus of investment flows, including investment in associated activities dependent on energy extraction. The high concentration of FDI in regions rich in natural resources is evidence of the significance of the energy sector for foreign investment.

SECOND, THE HIGH degree of uncertainty induced by a volatile exchange rate has discouraged foreign investment, while the ruble has been heavily affected by the changing oil price. The gradual evolution in the policy of Russia’s central bank from exchange rate management to inflation targeting has helped macroeconomic stability in the medium term.

THIRD, FDI INTO Russia is affected by the wider trade and investment context, which in turn are affected by institutional structures, or the lack thereof. Sanctions have been a major obstacle to investment in recent years.

THE EU’S PLEDGE to decarbonise places Russia in a difficult situation because oil and gas have long been at the heart of its economy, especially when it comes to external relations. Furthermore, the literature on the growth impacts of FDI highlights many of the benefits from technology transfers, which are often lacking when FDI is focused on fossil-fuel extraction. The Russian economy needs more investment in higher-value added activities, which the EU is in a position to provide.

Recommended citation

1 Introduction and state of play

The Russian economy has been through a turbulent decade during which it was deeply affected by the global financial crisis and the collapse of commodity prices (especially oil) between 2014 and 2016. During this period, foreign direct investment into Russia saw a medium to high degree of volatility, for several reasons. First, not only are oil and gas Russia’s core exports, Russia’s oil and gas industry is a major target for FDI. Russia’s reliance on oil has made direct investment highly vulnerable to changes in the oil price. Second, in part because of the pressure that lower oil prices place on Russia’s currency and wider economy, the macroeconomic environment has been highly unstable. Monetary policy has been used to mitigate these effects. Finally, the international political and economic relationships between Russia and other countries have influenced FDI flows. Trade remains closely interrelated with this category of investment, while western sanctions that targeted medium-term financing capabilities have also been an obstacle to investments.

Recent economic developments in Russia have been discouraging. In the decade after the financial crisis (2008-2018), average annualised growth of Russian nominal GDP (in dollars) was slightly negative. The financial crisis resulted in an 8 percent drop in GDP, but the economy recovered relatively quickly supported by strong monetary and fiscal policies (Dabrowski and Collin, 2019). A second downturn in 2014-2015 was spurred by the collapse of the currency (under massive pressure from the oil price collapse and western sanctions). The ruble lost over half of its value against the dollar, though central bank efforts ultimately stabilised the currency and reduced inflation (which was at 2.5 percent in 2017 compared to 12.9 percent in 2015) (Dabrowski, 2019).

Russia also faces major structural challenges. Russia has an ageing population, expected to shrink by 7 percent by 2050, which must be supported by a shrinking labour force. Additionally, the business climate is problematic, corruption is high and the protection of property rights is poor (Russia was ranked 138th in Transparency International’s Corruption Perceptions Index and eighty-fourth in the International Property Rights Index). That said, the World Bank’s Doing Business report ranked Russia an encouraging twenty-eighth in 2019.

Many of these systemic obstacles in the Russian business environment relate to the shift in corporate ownership during the transition to a market-based economy. State-owned enterprises (SOEs) were privatised through schemes that resulted in a heavy domestic concentration of wealth and rendered FDI negligible (Di Bella et al, 2019). The high degree of vertical integration of former SOEs provided few opportunities for foreign companies; most FDI focused on extracting resources and as such resulted in very limited growth spillovers to the wider economy. FDI remains concentrated in Moscow, St. Petersburg and oil-heavy regions. Finally, Russian economic dependence on European investment is high, despite political attempts to diversify. This coupled with the EU’s growing decarbonisation efforts and Russia’s international isolation, as well as other structural issues, result in bleak prospects for Russian investment and growth.

Russia has a pressing need to diversify its economy away from resource extraction; EU investment could offer diversification and growth opportunities

Russia has a pressing need to diversify its economy away from resource extraction. European investment could provide an engine for the growth of higher value-added sectors and the subsequent boost to the overall economy. The EU could offer diversification and growth opportunities by investing in Russian manufacturing and value chain operations. European efforts to decarbonise will present a substantial challenge for Russia, given that oil and gas are at the heart of the EU-Russia trade and investment relationship. Increased Russian interest in euro-denominated contracts could also help increase the relevance of the euro in international commodities markets. Furthermore, given poor domestic protection of property rights, Russian elites frequently rely on EU capital markets, increasing the political significance of this economic relationship. Indeed, as the estimates in section 2 show, a main source of phantom FDI is Russia itself.

1 See https://www.transparency.org/cpi2018.
Where does FDI into Russia come from?

In the last decade, FDI into Russia has seen a medium-high degree of volatility, in line with a tumultuous macroeconomic environment.

Figure 1 shows FDI stocks in Russia divided by the major international players. During the period examined (2009-2017), European investors owned between 55 percent and 75 percent of the Russian FDI stock (and regularly made up a large percentage of flows, as evident from Figure 1). Thus, Russian economic dependence on European investment is high. Notwithstanding recent efforts to diversify, Chinese investment remains orders of magnitude smaller. Figure 2 further breaks down stocks of EU FDI into EU countries or groups of countries.

It is important to note that in recent years, global FDI flows have been characterised by the prevalence of Special Purpose Entities (SPEs) and other conduits that are employed to minimise tax exposure and hide the ultimate origin of capital. This has resulted in relatively small countries registering FDI inflows and outflows that are many times greater than expected for such countries. A large percentage of these flows barely register an effect in the economies that host the SPEs – the flows merely transit through those economies. In order to illustrate this, the second panels of Figures 1 and 2 show FDI stocks in Russia by ultimate investing country (UIC), as estimated by Damgaard et al (2019). When looked at this way, flows from the EU are likely overstated. However, the EU remains by far the premier provider of FDI to Russia.

The EU’s significance as the main investor in Russia becomes clearer when one considers that the origin of the second-largest stock of FDI appears to be the Russian Federation itself. This investment is by construction not genuinely foreign; when it is subtracted from the total, the EU returns to being the consistent owner of over 50 percent of the Russian FDI stock. Casella (2019) has also estimated the ultimate origin of flows using a different methodology to Damgaard et al (2019). The estimates by Casella (2019) indicate that United States values are understated: almost 8.9 percent of the stock of inward FDI into Russia in 2017 is thought to have originated in the US, in contrast with the 3.2 percent seen in reported data. However, this

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3 Casella (2019) nonetheless classified the origin of 28.2 percent of the inward FDI stock in Russia as 'Confidential/Unspecified'. Casella’s paper was done for the United Nations Conference on Trade and Development (UNCTAD).
remains small compared to that of the EU (which is the origin of close to five times more FDI stock in Russia).

Finally, the values for investment from offshore sources are similar in reported data and UIC estimates. For example, even for FDI originating from the EU, estimated UIC values still show that a substantial part of FDI stocks originate from financial centres. This would indicate that the estimation method employed by Damgaard et al (2019) fails to identify UIC in some cases, especially when it relates to more opaque jurisdictions. It is plausible (indeed likely) that some of the investment in Russia from these financial centres originates from other countries, including Russia itself.

Figure 2: FDI stock as reported (left panel) and UIC estimates (right panel), EU breakdown, € billions

Source: Bruegel based on European Commission Finflows (Joint JRC-ECFIN database) and Damgaard et al (2019). Notes: EU countries have been grouped as follows: Baltics (Estonia, Latvia, Lithuania), CEE (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia), euro-area creditors (Austria, Belgium and Finland), euro-area debtors (Portugal and Greece) and financial centres (Cyprus, Ireland, Luxembourg and Malta).

With this in mind, perhaps the first insight provided by the geographical breakdown of flows from the EU is the similarity in patterns between member states. While these member states operate within the same regulatory framework (and often the same currency), bilateral relationships with Russia vary significantly and are affected by long-standing historical ties. Despite this (and leaving aside the differences between EU countries in terms of size) the trajectory followed by FDI inflows into Russia shows ample similarities between the groups of EU countries (this is even more evident in data on flows compared to stocks); the peaks and troughs are largely replicated for all the groups. This would indicate that flows are largely driven by the volatility of the Russian environment and global geopolitics, as opposed to individual relationships with specific member states or developments in the countries of origin. Points to note include the small presence of Germany, which is even smaller according to UIC estimates. Germany’s stock of FDI in Russia fell gradually throughout the examined period. Meanwhile, the French FDI stock in Russia remains small, even though flows increased recently. For UK FDI in Russia, stock values are low but flows are volatile and prominent. This is because the absolute value of gross flows is large but periodically switches from positive to negative. This indicates that these investments remain speculative and short-term. This might be driven, in part, by Russian investors directing funds abroad through British entities.

Several EU countries clearly stand out for their outsized roles, especially in officially reported figures. First, the significance of the Netherlands is evident. While the Netherlands has large net outflows of ‘genuine’ FDI, the country hosts a large number of SPEs which likely inflate official reported values. UIC estimates show total FDI stock from the Netherlands to
be much smaller, at about €10.3 billion in 2017 (in stark contrast to the €105 billion found in reported figures). The ‘financial centres’ group of countries (Cyprus, Ireland, Luxembourg and Malta) also plays a disproportionate role - the members of this group were chosen precisely because of their large balance sheets relative to GDP. Cypriot subsidiaries in particular hold large amounts of assets for Russian entities, which are occasionally repatriated as FDI. However, these numbers remain within the same ballpark both for reported figures and UIC estimates. It is plausible to assume that these flows are not originally from Cyprus, but hide capital from other countries, including from Russia itself.

3 Drivers of FDI flows

Three main drivers have determined the evolution of FDI flows into Russia in the past decade: the energy sector, macroeconomics and monetary policy, and the international context (from trade to institutional obstacles).

3.1 The energy sector

The energy sector, most notably oil and gas, plays a predominant role in the Russian economy (as the source of over half of Russia's exports and the vast majority of its foreign currency reserves) and is the destination for a significant percentage of FDI inflows. The two main episodes of declining FDI (2009 and 2014) happened at times of collapse in the oil price, which on both occasions lost over half of its value within the span of a few months. Furthermore, in 2011 (which represents another period of declining FDI), the price of oil declined by almost a third, though it recovered fairly quickly.

Figure 3: Brent crude oil price [$]

Source: Bloomberg. Notes: Values after October 2019 reflect the futures market. The Brent benchmark is employed as a proxy for the oil market.

The fall in the oil price during these episodes (especially in 2009 and 2014) was driven by declining global demand. Since 2014, this decline appears to be structural (the oil futures market would indicate there is little expectation of a recovery, as shown by Figure 3). This, combined with an ambitious pledge to turn towards green energy in the EU (the premier consumer market for Russian oil and gas), makes for a discouraging medium-term outlook for FDI into Russia. Even though FDI flows recovered somewhat in 2016 despite the new, lower, equilibrium oil price this recovery appears to have since partially reversed.

Sectoral and regional distributions of FDI provide a greater insight into the role played by the energy sector. Figure 4 shows data from the Bank of Russia on FDI inflows for the four

![Figure 3: Brent crude oil price ($)](source)

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major sectors: wholesale and retail trade; mining and quarrying (which according to the guidelines consists almost exclusively of fossil fuels); manufacturing; and financial and insurance. In total, the Bank of Russia provides data for 22 sectors, but the remaining sectors play a fairly negligible role (in Figure 4 they are grouped as other). It should be noted that Russian GDP fluctuates quite substantially, contributing to some of the volatility seen in the graph.

**Figure 4: Gross FDI flows per sector, % of GDP**

Further central bank data on the regional distribution of FDI complements the picture. Excluding the wider Moscow area and, to a lesser extent, St. Petersburg, the oil and gas-heavy Tyumen region (not including its autonomous provinces) and the autonomous province of Yamalo-Nenets (Gazprom’s main hub) received 45 percent of all remaining FDI in the first quarter of 2019. The rest was shared between the remaining 86 regions. The aforementioned oil-rich regions are fairly small, with little other economic activity outside the energy sector. Sakhalin Island and Krasnoyarsk Krai, where oil is also an important part of the local economy, also rank highly. This indicates that sectoral data could underestimate the importance of the energy sector for some regions. Some of the non-mining and quarrying investment appears to be going into businesses directly related to oil and gas extraction, but this is very hard to disentangle.

The concentration of FDI in natural resource sectors can negatively affect the GDP of the ultimate host country. Poelhekke and van der Ploeg (2013) showed that FDI in natural resources crowds-out FDI in other productive industries, and can result in lower overall FDI. The impact is particularly evident when natural resources are first discovered. Hayat (2018) found that natural resources reduce the growth effect of FDI to the point that it can become negative. At the same time, there is a low level of spillover effect associated with natural-resource extraction, given that it is typically an activity that requires few local inputs. Thus the growth potential is low, in contrast with FDI in manufacturing and technology.

The values presented above underestimate the extent of FDI that enters and exits Russia regularly. Ultimately, gross inflows (shown in Figure 4) represent the net acquisition of Russian assets by foreigners and as such can be negative (net flows would be the net acquisition of assets minus the net acquisition of liabilities)\(^4\). Given that FDI represents medium to long-term investment, this typically provides an accurate depiction of overall FDI activity. However, in the case of Russia, there is a fair amount of short-term FDI that partially stems from the fact that a non-negligible percentage of reported FDI in Russia ultimately originates in Russia itself, and has been re-routed through foreign entities. Figure 5 shows the gross acquisition of assets in Russia by foreign investors and gross sale of assets in Russia.

\(^4\) See Claeys et al (forthcoming) for a more detailed explanation.
by foreign investors (which net out to the values in Figure 4). The size of these values is very large. The extent of financial-sector activity (both in gross acquisitions and gross sales) in 2010 and 2011 stands out in particular.

**Figure 5: Gross foreign acquisition (top panel) and sale (lower panel) of Russian assets per sector, % of GDP**

Finally, the ‘Dutch disease’ effect of natural resource exploitation has played a key role in the Russian economy. This term describes the phenomenon that arises when a natural resource windfall results in a rapid appreciation of the currency, worsening terms of trade for other exports and reducing the competitiveness of other industries. This hurts the wider economy. This phenomenon took place in Russia during the early 2000s, when increases in the price of oil resulted in a gradual appreciation of the ruble, reducing investment in non-fossil fuel sectors (which became increasingly uncompetitive in international markets).

Furthermore, beyond the immediate damage, the effects of this period persisted after the currency appreciation was reversed. The IMF (2017) reported that the bursting of the resource bubble did not lead to an easing of the effects of Dutch disease in Russia. Even
though oil prices and the ruble collapsed periodically during the last decade, a crowding out of manufacturing industries had already taken place when this downward trend started. This crowding out was enhanced by an incomplete economic transition in the 1990s and 2000s when state aid was ubiquitous. Economic activity had already become concentrated in the resource sector, a shift that could not be reversed easily when the terms of trade improved. The damage caused to other industries by years of focus on resource extraction meant many other industries could not be salvaged.

3.2 Macroeconomics and monetary policy
The volatile macroeconomic environment in Russia and Russia’s monetary policy have significantly affected FDI flows. FDI flows are traditionally considered less volatile than other capital flows (they represent a more substantial level of involvement in a particular entity that will be harder to exit and, as such, are less prone to speculation). That said, FDI into the oil sector is typically more speculative given volatility in oil markets. More generally, the high degree of uncertainty resulting from the volatile exchange rate has discouraged foreign investment. The ruble has been heavily affected by the price of oil in recent decades: oil exports provide the largest source of dollar reserves for a country that until 2015 regularly intervened in foreign exchange markets to manage the exchange rate. A change from exchange rate management to inflation targeting was formalised in 2014.

Figure 6: Euro-ruble exchange rate

Source: Bloomberg.

The Bank of Russia has actively participated in foreign currency markets in the past two decades. Since 2000, the ruble exchange rate has evolved from being very tightly controlled (2000-2005), to being free-floating in an inflation-targeting regime (Korhonen and Nuuttilainen, 2017). But the central bank still reserves the right to intervene in foreign exchange markets and prevent undue volatility. The bank has been able to mitigate the worst effects of exchange rate fluctuations, often driven by movements in the oil price.

Following the financial crisis of 2008, the Bank of Russia identified downward pressure on the ruble caused by capital flight and the erosion of the current account balance. The bank allowed the gradual depreciation of the ruble, progressively widening the currency band, yet simultaneously supported it through market operations that depleted a third of central bank reserves in three months (Central Bank of the Russian Federation, 2013). It should be noted that Figure 8 (which shows reserve assets) does not fully reflect this depletion. Figure 8 shows yearly data, yet the fall recorded between 2008 and 2009 was preceded and followed by episodes of reserve asset growth, mitigating the yearly fall. In 2014, intervention played an even greater role as the announcement of exchange rate flexibility increased pressure on the

5 For a discussion of the mechanisms, see Krugman (1987).
currency, which had been already weakened by the oil collapse and sanctions. The central bank supported the currency with reserves (Figure 8) and made great use of the policy rate (Figure 7). Their efforts during the ruble collapses of 2009 and 2014 are evident in the data.

**Figure 7: One-week repo rate, percentage points**

![Figure 7: One-week repo rate, percentage points](source)

Greater flexibility together with the announcement in 2014 of the pursuit of a fully floating exchange rate and an inflation-targeting system had the opposite effect to the previous policies. The 2014 announcements came at a time when pressure on the currency was mounting and likely added additional pressure, contributing to the heavy depreciation of the ruble. The implication that the central bank would allow the currency to float freely naturally weakened the ruble’s credibility and caused a (mild) episode of capital flight. In the ensuing months the central bank went to great lengths to support the currency and assuage market fears, partially subverting monetary policy to this end. While officially the exchange rate target was given up in November 2014, the central bank intervened heavily to prevent the collapse of the currency up to the end of 2014 and in the first weeks of 2015. While the decline in reserves is evidence of central bank efforts (reserves fell by close to 30 percent between 2013 and 2015), this episode was characterised by the rapid rise of the policy rate (to 1700 basis points). Korhonen and Nuutilainene (2017) explored whether a significant change in the effects of monetary policy can be identified as a consequence of the evolution in regime. They identified early 2015 as an important turning point, marked by a break in the estimated Taylor rule.

**Figure 8: Reserve assets, $ billions**

![Figure 8: Reserve assets, $ billions](source)

Overall, the effects of the currency’s collapse (including effects on FDI) were undoubtedly mitigated by the rapid and thorough actions of the central bank. Furthermore, the fact that
the Russian currency fared fairly well throughout 2018 and was not heavily affected by turmoil and capital flight in other emerging economies is a testament to the credibility of this inflation-targeting system (especially as these times of turmoil coincided with rounds of sanctions against Russia).

Finally, it is worth pointing out that the oil sector in Russia remains fairly dollarised. Many contracts (both commercial and investment) are concluded in foreign jurisdictions and denominated in foreign currency; as such they are not devalued by fluctuations in the ruble. Similarly, energy companies hold fairly large shares of dollar debt (against largely dollar revenues). Therefore, FDI in the energy sector can remain relatively detached from movements in the currency. However, the insecurity that foreign exchange volatility poses to value chain management in multinational enterprises does cause uncertainty, while the associated political tensions deter foreign investors. Moreover, energy companies still depend on domestic revenues and costs. Therefore, an excessive degree of dollarisation (and especially a very large share of dollar debt) can make companies vulnerable to large fluctuations in the ruble by making it harder for them to service their dollar commitments and thus raising their probability of default. That said, there has recently been an evolution among Russian oil giants, which are establishing euro-denominated contracts. Rosneft, a state-controlled oil company that is one of the world's largest, announced in summer 2019 that all contracts would henceforth be in euro⁶.

3.3 International context

Finally, FDI is affected by the wider trade and investment context, which is itself affected by institutional structures, or the lack thereof, that facilitate cross-border operations. This sub-section explores the relationship between FDI and other economic ties, chiefly trade, and how FDI has been affected by the institutional obstacles to a deeper relationship.

FDI and trade generally are deeply interrelated, as FDI provides foreign players with a domestic infrastructure that facilitates operations and can serve as a substitute for trade when regulation allows. FDI can signal an investment in the medium-term commercial relationship. Lukewarm FDI numbers between the EU and Russia could relate to the decline in trade in goods between them in the past decade, with gross imports and gross exports both decreasing by almost a quarter between 2008 and 2018. Furthermore, in 2018 oils and mineral fuels⁷ made up over three quarters of Russian exports to the EU. This is in line with FDI patterns and is another sign of the existence of few other areas of competitive economic activity.

The economic literature finds that the growth effects of FDI mostly arise from knowledge transfers and spillovers⁸. A concentration of both trade and FDI in the energy sector indicates this is the clear focus for foreign players. This trade and investment is concerned almost exclusively with extraction and associated activities. This form of FDI rarely provides spillovers and has a limited effect on growth. In contrast, investments by multinational enterprises in manufacturing could help integrate the Russian economy into global value chains and could result in the diffusion of knowledge and technology transfers, with considerable growth benefits. Furthermore, FDI into non-energy sector industries is likely to be less volatile, not as heavily determined by the performance of the oil markets (as such, it should make a positive contribution to macroeconomic stability). It would further diversify exports from oil into higher value-added (and differentiated) sectors. Deepening trade relationships in these sectors would then provide an opportunity to attract other forms of FDI. However, Russia has very high barriers to trade, mainly of non-tariff character, which means it offers little incentive.

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⁷ Full name 'Mineral fuels, oils and products of their distillation', one of 97 categories in the first level of disaggregation of trade, World Integrated Trade Solution database.

⁸ See Hayat (2018) for a discussion of the growth effect of FDI in natural resources.
Furthermore, the Russian environment is characterised by a lack of institutional infrastructure and recent international hostility towards Russia, complicating the development of closer ties. First, the Russian Federation only entered the World Trade Organisation in 2012 and has concluded trade agreements with only 10 countries (mostly former Soviet states). In 2017, these free trade agreements covered only 11 percent of Russian exports, while EU28 trade accounted for more than half. The comparative advantages of the other members of the Commonwealth of Independent States are very similar to Russia’s (chiefly natural resources), reducing the economic value of mutual trade. More importantly, there is virtually no opportunity for knowledge transfer through FDI. Furthermore, according to the World Bank’s 2018 Doing Business report, Russia has the highest cost of border compliance in its region (6.7 times the EU average for exports and 17 times the EU average for imports). These trade impediments, together with poor protection of property rights, exchange rate volatility and the very high level of corruption, make Russia an unattractive market for global manufacturing investment, despite its generally high level of education, post-Soviet industrial base and relatively large internal market.

Second, recent years have been characterised by political hostility between Russia and western countries, resulting in damaging economic sanctions (and the looming threat of more). These have reduced the attractiveness of the Russian market for foreign investors at a time of opportunities for diversification. The practical difficulties of investing have been growing (medium and long-term financing has been targeted by sanctions), while the increase in barriers to trade make Russia a less attractive manufacturing hub and damage the growth potential of the Russian economy. Sanctions and the related tensions have had a negative effect on FDI, especially outside the energy sector, reducing overall FDI and making the energy sector relatively even more important.

It is difficult to disentangle the effects of western sanctions introduced following the annexation of Crimea in 2014 from the other factors. Nonetheless, the International Monetary Fund found their immediate effect to be a 1 percent to 1.5 percent drag on GDP, with a possible cumulative drag of 9 percent in the long term (IMF, 2015) (others estimates are around 6 percent). World Bank estimates indicate the removal of sanctions would have resulted in 0.9 percentage points higher growth in 2017 (World Bank, 2016). The impact on the financial system was undoubtedly larger: the closure of international capital markets at a time of currency crisis for Russian banks aggravated the financial situation, resulting in large bailouts from the central bank and the National Wealth Fund.

New rounds of US sanctions in 2018 had a limited effect but were targeted at Russian elites. Sanction episodes were followed by ruble depreciation that was minor, especially when one considers that it coincided with a time of generalised capital outflow from emerging markets. Finally, the possibility of future sanctions deters investors, given the potential legal uncertainty.

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9 In 2017, minerals accounted for 25 percent of exports from Belarus, 61 percent exports from Kazakhstan (Russia’s two biggest trading partners among the Commonwealth of Independent States, recipients of roughly 80 percent of Russian exports under FTAs), compared to 58 percent of Russian exports. Source: The Economic Complexity Observatory.

10 Drobyshevsky et al (2018) estimated that trade isolation is reducing Russian GDP growth rates by 1.1 percentage points per year.
4 Outlook and policy challenges for the EU-Russia relationship

Russia has a window of opportunity to modernise its economy and progress up the value chain, or it will face significant economic headwinds given its fossil-fuel based ageing economy. Demographic change poses a major challenge to growth, while the dependency ratio is only contained by low life expectancy among men. Current economic activity relies heavily on European investment and the European market, yet natural resources remain at the core of the relationship. Given European efforts to go green, this source of activity could be highly threatened in the medium term. McGlade and Ekins (2015) estimated that up to 59 percent of gas reserves and 19 percent of oil reserves of former Soviet Union countries would be ‘stranded’ if policies to meet the Paris Agreement’s two degrees Celsius goal are implemented. Rodrik (2016), meanwhile, argued that given the advancement of automation, manufacturing might soon cease to be a feasible basis for development. Furthermore, the opportunity to hedge European fossil fuel demand with Chinese demand remains limited (Zachmann, 2019).

That said, Russia is well located to be a host of manufacturing outsourced from European economies. The EU can offer FDI in high value-added activities, while China remains a competitor at the lower and mid-levels of the value chain and the US is a net exporter of oil (with even greater foreign policy tensions with Russia)\(^1\). However, foreign investment remains deterred by macroeconomic volatility, poor institutions and international isolation (in part because of sanctions).

Europe’s strong advantage in high value-added sectors raises the value of European FDI. In the right investment climate, Russia could benefit greatly from this, potentially creating a basis for economic cooperation and more sustainable growth. Greater diversification of the Russian economy would allow for the spread of knowledge and technology spillovers through manufacturing, and would also increase the stability of the macroeconomic environment and reduce pressure on the ruble from oil price fluctuations. Diversification would gradually wean Russia off a sector with very poor medium-term prospects. Russia’s relevance in commodities markets could also make the euro more relevant in commodities, deepening the liquidity of euro-denominated products (one of the European Commission’s proposed steps to strengthen the international role of the euro\(^12\)). Russian oil contracts are increasingly euro-denominated.

Overall, EU capital markets are paramount both for the Russian economy generally and for Russian elites in particular. In the right climate, the EU could provide the basis for a medium-term shift in Russia into high value-added industries with greater growth prospects, a shift that will be necessary when Europe goes green.

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\(^1\) For a discussion of the potential of China-Russia trade and investment see García-Herrero and Xu (2019) and Zachmann (2019).

\(^12\) See https://ec.europa.eu/info/sites/info/files/strengthening_international_role_euro_swd_2019_en.pdf.
References


