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The Future of Foreign Direct Investment in Russia
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THE FUTURE OF FOREIGN DIRECT INVESTMENT IN RUSSIA

By

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Abstract

Foreign direct investment fosters cross-border economic relationships across the globe and influences economic development, trade, and modernization. Levels of foreign direct investment and the Russian economy overall have both endured significant volatility since the Russian Federation began its transition toward a market economy in the early nineties. Everchanging laws and regulations, government scandals, and a lack of understanding of the Russian economy all contribute to the capriciousness of foreign investment in Russia. This study analyzes trends in Russian politics and the changing economic landscape to provide insight their relationship with foreign direct investment in Russia.
Acknowledgement

I wish to express my deepest gratitude to my thesis director, Dr. Lisa Ryoko Wakamiya, and my thesis committee members, Dr. Robert Romanchuck and Professor LJ Mahon, for their continued support throughout my thesis composition and defense process.

I would also like to thank Stuart Lawson, Michael Hollomon, and Sergey Mityakov for their invaluable guidance in my research process.
List of Acronyms and Abbreviations

BRIC – Brazil, Russia, India, China
BRICS – Brazil, Russia, India, China, South Africa
CBR – Central Bank of Russia
CFC – Controlled Foreign Company
CRIEEA - Countering Russian Influence in Europe and Eurasia Act
FBK - Fond Bor'by s Korrupciej (Russia Anti-Corruption Foundation)
FDI – Foreign Direct Investment
GDP – Gross Domestic Product
MNE – Multinational Enterprise
NWF – National Welfare Fund
OCCRP – The Organized Crime and Corruption Reporting Project
OFC – Offshore Financial Center
SEZ – Special Economic Zone
UNCTAD – United Nations Conference on Trade and Development
USD – United States Dollar
YoY – Year over Year
Chapter 1: Introduction

After the fall of the Soviet Union in the early 1990’s, Russia began its long journey out of a planned economy towards a Western style free enterprise system. As the President of the Russian Federation, Boris Yeltsin led this fundamental shift, or perekhod, from a command to free market economy. By 1993, 43% of all the state-owned businesses had been taken private with share vouchers distributed to citizens so they would have ownership in the newly formed joint-stock companies. Beyond mass privatization, Yeltsin eliminated other communist era economic policies, such as price fixing and compulsory state purchases. Such a swift change in economic policy proved to be disastrous for many Russian companies that relied heavily on the government for smooth operation. Between the end of the Soviet Union and 1998, the Russian Gross Domestic Product (GDP) dipped over 50% lower than its level under communist rule, resulting in the deaths of millions of people and an unemployment rate over 20%.

Despite the economic shock brought on by the perekhod, the privatization of the Russian economy allowed foreign investors to enter the market. This foreign direct investment (FDI) was essential to the success of the economic reforms as well as in creating a place for Russia in the world economy. One investor was Bill Browder, the founder of Hermitage Capital. In 1996, his firm began by purchasing share vouchers for oil, mining, and utility companies from Russian citizens. Hermitage Capital went on to become a successful 1.2 billion dollar firm

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4 Ibid. 168
through its investments in Russia. In 1997, further foreign investors flowed into the country to purchase short-term debt issuances as the Russian economy seemed to stabilize. This allowed them to outperform all other emerging markets, but these investors quickly disappeared in the financial crisis of 1998. Overall, between 1992 to 1999, Russia was only able to attract a total of $19.8 billion USD in foreign direct investments. Vladimir Putin’s terms as president from 2000-2004, 2004-2008, and 2012-2018 led to significant increases in GDP, decreases in unemployment, and increases in the stock market indexes. These indicators allowed foreign investors to once again enter the Russian market and FDI increased up to over $37,176,000 in 2016, before falling to $13,332,000 in 2018.

FDI is a significant way that the rest of the globe can foster economic relationships with Russia to expand economic development, trade, and modernization across Eastern Europe. Additionally, investors benefit from FDI in Russia, because of the significant growth opportunities that emerging markets provide. However, foreign investment and the Russian economy overall have both endured significant volatility since the Russian Federation began its transition toward a market economy in the early nineties. Everchanging laws and regulations, government scandals, and a lack of understanding of the Russian economy all contribute to the capriciousness of foreign investment in Russia over the past twenty years. The purpose of this research is to study the current Russian economic policies, investment landscape, and emerging industries and provide an overview on current and future foreign investment in Russia.

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8 Letiche, John M. Russia Moves into the Global Economy. Routledge, 2007. Print. 3-11
Literature Review

Paul Fischer’s Foreign Direct Investments in Russia provides a detailed study on foreign direct investments, covering everything from global FDI theories, case studies in other emerging markets, analysis of key Russian industries in the 1990s, and long-term FDI strategy. Fischer’s introduction highlights Russia as the largest supplier of “natural gas, minerals, precious metals and forests products” and suggests that it has the potential to “become a major producer of food products, consumer goods, chemicals and plastics, and machinery” with increased investment.11 Fischer also suggested targets for FDI enhancement in which “annual FDI inflows could be raised to US$6-8 billion starting from 2000-2, and even up to US$10 billion after 2003.”12 The research in this five-hundred page study provides valuable information regarding the global market for foreign direct investments in the nineties as well as specific market information about Russia. I will be considering projections that Fischer made in 2000 when his book was published in relation to the real events that occurred.

Nathalie Fabry and Sylvain Zeghni’s 2002 study “Foreign Direct Investment in Russia: how the investment climate matters” explores the reasoning behind Russia’s lack of attractiveness in the context of FDI globalization despite being the largest country in the region laden with natural resources and a huge workforce. Fabry and Zeghni discuss the effects that the political climate, lack of protection in property rights, and method of privatization have created a “poor competitive environment for business in Russia.”13 They also empirically tested the determinants of foreign investment in Russia to determine whether or not both the “sad

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12 Ibid 454
investment climate” and the “few opportunities given to foreigners to act as insiders in the transformation process” were factors in Russia’s scarcity of FDIs. Much like Fischer’s, this study serves as historical evidence for my research on current foreign investment.

Igor Makarov and Alexandra Morozkina’s study “Regional Dimension and Foreign Direct Investment in Russia,” published in 2015, is a more modern approach to the topic of FDIs. This paper focuses on the inflows and outflows of Russian-related investments between Russia, Europe, Eurasia, and the Asian-Pacific region. Makarov and Morozkina point to Western style commerce industries such as finance, insurance, retail, and construction as the biggest draws for recent FDIs rather than natural resources. Additionally, they touch on Russia’s policies and financial incentives related to FDI outflows and inflows. These points will all prove useful in my research. Since this is a more recent text, my research will serve as a continuation of Makarov and Morozkina’s analysis.

John Connor’s Out of the Red: Investment and Capitalism in Russia provides less analysis and more of an academic view on foreign investment in Russia. John Connor wrote this book to bring the context of politics, macroeconomics, and the business environment to investing in Russia. He provides the risks and rewards associated with foreign investment that may affect an investor’s decision regarding FDI in Russia. Connor further discusses emerging industries as well as traditional Russian industries such as metals and mining, oil and gas, and energy.

Due to the age of many publications on Russian FDI, a majority of my sources are more recent news articles, research papers, and international organizations.

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Since much of the economic statistics published by the Russian government are doctored, there are not many trustworthy sources providing accurate information. Gathering economic information from various third-party sources has provide more clarity on the current financial standing of Russia. Some of my analysis utilizes foreign direct investment data provided by the Central Bank of Russia (CBR). I insured the accuracy of this data by making comparisons between the overall FDI data reported by the CBR and the UNCTAD. A comparison of the CBR and UNCTAD data is included in Chapter 3: Breakdown of Inward FDI. Further comparison can be found in the appendix.

As can be seen from the literature provided in this review, there is a serious lack of published research on foreign investments in Russia in recent years. The majority of books and studies centered on FDI in Russia were written in the early 2000s and information about current Russian economics and investments is not being publicly analyzed. Thus, as investor interest has increased in emerging markets in South America, Asia, and India, lack of information on Russian investment has caused it to lag. With additional information about their current investment landscape, Russia could rejoin the ranks as an attractive investment opportunity. Beyond investor education, it is important that foreign direct investment data is recorded, because changes in foreign investment help us better understand the turbulent relationship between the Russian economy, political turmoil, and international opinions.

**Research Development**

I have utilized several research methods in my data collection for this thesis. My initial method of research was qualitative analysis of a variety of written work. I used published journal articles, research studies, and books to cross reference information and come up with the
least biased version of events. I also conducted background research on each author to be aware of any cultural bias they may possess. Since there are very few published studies and books solely discussing foreign direct investment in Russia, much of my research came from texts based on broader economic information about Russia with sections about FDI. This research has provided the basis for my information on historical foreign investments in Russia, qualitative information in the overview of the current Russian economic landscape, and information surrounding successful industries in the Russian economy.

Beyond my qualitative research into studies related to foreign direct investments, I have also researched journal articles, news articles, and studies based on ongoing political and legal issues in Russia as well as macroeconomic trends. Since many political news articles are opinion based, I cross checked these facts across several news websites before including them in my research. Additionally, I have included information from press conferences and interviews with Putin and other world leaders in response to Russian actions, for example in their conflict with Ukraine. On legal issues, such as laws affecting foreign investors, I have accessed original or translated documents from the Russian Judiciary. In regard to the macroeconomic events, I have utilized the forecasts of well-respected economists in their published research.

In addition to the qualitative analysis, I have conducted significant quantitative research. Due to the untrustworthiness of many economic and political reports coming from the Russian government, I have been very conscious of where I have collected my quantitative data. For comparative data in Chapter 2, I have used information from the United Nations Conference on Trade and Development, which is a well-respected and trustworthy international organization. I have also gathered data through third party statistics. The United Nations Conference on Trade and Development also creates various investment fact sheet pages, including one regarding
foreign direct investment flows and stocks since 2005. Russia is also included in the Special Economic Zones publication that the United Nations Conference on Trade and Development produces each year. The World Bank publishes a report on the Russian economy twice a year with a variety of qualitative and quantitative information on recent developments, risks, and industry updates. These two organizations are just a few examples of the many unbiased and reliable public sources that publish economic information on Russia.

I have developed my analyses with information drawn from my own personal interviews with experts in the fields of business, finance, and economics that have had significant experience in Russia. I have conducted these interviews with Stuart Lawson and Michael Hollomon over the phone with a set list of interview questions prepared prior to the phone call. These interviews have provided a direct look at the experiences of foreigners and foreign investors in Russia. From these interactions, I have gained a better understanding of the current economic landscape in Russia from the perspective of an expert as well as indications of particularly strong emerging industries. I have also inquired about any legal or political issues they encountered through their business dealings in Russia. Brief biographies of the interviewees can be found in the appendix.

I have also conducted a linear regression analysis on the relationship between political relations and foreign direct investment inflows through Stata, a statistical data analytics software. The political relations data collected by Sergey Mityakov shows the percent of agreement each country has with the political decisions of Russia from the period of 2008 to 2017. The foreign direct investment inflows data was collected by the Central Bank of Russia and is divided into inflow of FDI investment from each country.
In this thesis I hope to address the issue of foreign direct investment in Russia, so the place of FDI in the Russian economy can be understood in regard to the current market environment, legal and political influences, and attractive industry investments. I have analyzed the changes in foreign investments over time in post-soviet Russia and given an educated opinion on the future of FDI in the Russian economy.
Chapter 2: Overview of Foreign Direct Investment

Foreign direct investment (FDI) refers to cross-border investment, in which an investor makes an investment of lasting interest and secures great influence over an enterprise through the investment. Achievement of lasting interest and influence is determined by an ownership of 10% or more by the investor. Foreign investments of less than 10% of a firm are considered portfolio investments. This distinction ensures that the foreign investor has enough voting power in the enterprise to demonstrate influence over business decisions. The indicators used to track FDI are stocks, flows, and income. These three indicators are recorded for both inward and outward movements.\(^\text{15}\) The inward values refer to investment in a country, while the outward values look at the investments the particular country makes abroad.

As I am researching the foreign direct investment made in Russia, I will be primarily discussing and analyzing inward FDI flows and stocks. Inward FDI stock measures the total value of direct investment in a country at a specific time.\(^\text{16}\) Inward FDI flow measures the value of direct investment transactions, such as equity transactions, reinvestment of earnings, and intercompany debt transactions, flowing into a country over a specific period of time. The inward flow accounts for decreases in FDI by subtracting transactions decreasing foreign investment in enterprises from transactions resulting in increased foreign investment.\(^\text{17}\) The total value of stock at the end of a period should equal the value of the stock at the beginning of the period plus the total flow over the period accounting for changes in price and exchange rate.


\(^\text{16}\) Ibid.

grouping%2F9a523b18-en
Thus, as inward flows increase over a period, inward stock at the end of the period should increase proportionately. In this thesis, I will be using FDI data collected by the United Nations Conference on Trade and Development (UNCTAD) and the Central Bank of Russia (CBR). The FDI stock and flow values I will be using are yearly calculations in US dollars.

**International Drivers**

According to the 2019 UNCTAD World Investment Report, global FDI flows have decreased between 2016 and 2018, most recently showing a 13% decline from $1.5 trillion in 2017 to $1.3 trillion in 2018. The United Nations attributes the plunge to changes in international policy, economic factors, and the structure of international business. One highlighted policy factor is the uncertainty of future trade relations due to the recent changes in unilateral trade policies affecting the timing and feasibility of foreign investment projects. From an economic standpoint, the decrease in the average rate of return expected in foreign investments from 8.1% in 2012 to 6.7% in 2017 could be a major deterrent from engaging in foreign investment. Further, improvements in technology have diminished the need for multinational enterprises (MNEs) to invest large amounts of capital in heavy assets to penetrate global markets.

**Differentiation of Russian FDI**

One important thing to note in discussing changes in FDI is whether or not the changes track the global economy. Global trends and issues have an effect on foreign direct investment internationally, but I am exploring the extent that foreign investment in Russia exceeds or

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ignores the norm. I pulled information regarding foreign direct investment inflows and stock in Russia from 2008 to 2018 from the United Nations Conference on Trade and Development (UNCTAD) to compare the percent change in FDI over these ten years.

Comparison of Global and Russian FDI Stock

Figure 1: YoY Percent Change in FDI Stock Between Russia and Global Average

This data shows that Russia has a much greater change in both inflows and stock each year than the world average. Notably, between 2008 and 2009 there was a 73% increase in Russian FDI stock, while the world increased only 17%. In 2014, during the annexation of Crimea and many initial sanctions against Russia, Russian FDI stock fell 38% from the previous year. Conversely, the world average of FDI stock increased 5%. After a continued decrease in 2015, 2016 shows a substantial increase of 50%, which is a 43% higher increase than the world average of 7%. Overall, the change in FDI stock in Russia and the Global average only moved in the same direction 70% of the time over the ten year span.
Comparison of Global and Russian FDI Inflows

Figure 2: YoY Percent Change in FDI inflows Between Russia and Global Average

Comparing inflows between Russian and World average FDI reveals a similar, but slightly less pronounced trend. The extreme increase in stock in 2016 is backed by the 214% increase in inflows in that year, which is in direct conflict with the 6% decrease in inflows across the globe. However, deviations from the norm are slightly less pronounced in years such as 2010, 2011, and 2017.
Comparison of BRICS and Russian FDI Stock

Figure 3: YoY Percent Change in FDI Stock Between Russia and BRICS

In Figure 3, I have used UNCTAD data to compare the percent change in FDI stock between Russia and the BRICS average. BRICS refers to Brazil, Russia, India, China, and South Africa. It is the grouping of five emerging economies that have been deemed to be the fastest growing economies in the 21st century. Thus, it could be assumed that global trends would affect the foreign direct investment rates in these countries most similarly, as they would all attract a growth investor with a comparable risk profile. Figure 3 shows that YoY changes in Russian and BRICS FDI stock move in the same direction 80% of the time over the ten-year span, which is a 20% increase from global averages. However, Russia still sees exaggerated changes in comparison to BRICS in many years. Russia exceeded BRICS YoY change by 29% in 2009 and 31% in 2016, as well as sustained 36% larger decline in stock in 2014.

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Comparison of BRICS and Russian FDI Inflows

Figure 4: YoY Percent Change in FDI inflows Between Russia and BRICS

Figure 4 shows the comparison between BRICS and Russian YoY change in inflows. As with the global average, the changes in inflows of BRICS and Russia move in the same direction more often than the changes in stock. The change in inflows between BRICS and Russia move in the same direction 100% of the time over these two years. However, as seen in the previous charts, the percent changes in Russia are more significant than those in the BRICS average. For example, Russian inflows increased 202% more than BRICS in 2016.

Extent of Differentiation

The comparison of changes in Russian FDI with that of the global average and the BRICS countries shows that while global trends may lead to decreases and increases in FDI each year, the changes in Russian FDI frequently exceed or contradict global and BRICS averages. This leads to the conclusion that there are Russia-specific events causing these changes, rather than world-wide trends or occurrences in the emerging markets.
Chapter 3: Breakdown of Inward FDI

From this section onward I will be using FDI numbers provided by the Central Bank of Russia (CBR). The UNCTAD does not provide a breakdown of Russian inward foreign direct investment by partner country or industry, so the CBR data is essential for further analysis. It is important to note that the FDI numbers calculated by the UNCTAD and the CBR differ slightly, especially in recent years. This is due to the differing calculation methods used in calculating FDI. The numbers provided by the Central Bank exclude several sources that the United Nations includes in their figures. Business News Europe attributes this discrepancy to the exclusion of the reinvestment of earnings that foreign companies make in their Russian ventures. However, my analysis of the reported FDI inflow breakdown by investment instruments between UNCTAD and CBR data shows that the discrepancy lies primarily in the different treatments that the United Nations and the Central Bank give what they label “other capital” and “debt instruments,” respectively. Figure 5 below compares these values.

Figure 5: FDI Inflow by Investment Instrument

* UNCTAD numbers don’t add up (reported 13 total, known number is 13.3, but the numbers provided in the WIP 2019 actually add up the 14)
The equity and reinvestment values show minimal differences in calculation. In 2016, the reinvestment data for UNCTAD and CBR is 17 and 17.2, respectively. However, the “other capital” and “debt instruments” segments, named other in Figure 5 for ease of comparison, cause a majority of the difference between the overall UNCTAD and CBR numbers. In 2016, the other capital reported by UNCTAD is 1, while CBR reports debt instruments as -3.2. This inconsistency accounts for a significant amount of the difference between the total 2016 FDI inflows of 37 shown by UNCTAD and 32.5 from CBR.

**Top Ten Investors**

An important piece of the analysis of Russian FDI is the origin country of the capital being invested in Russia. Data from the Central Bank of Russia regarding the amount of investment from its partner countries is shown below in Figure 6. This is measured by the amount of stock each country holds in Russia at a given time. Cyprus leads with $159.9 billion in FDI stock and the Netherlands follows with $55.9 billion.

**Figure 6: Top Ten FDI Investors**

<table>
<thead>
<tr>
<th>Top Ten by CBR Stock (June 30th, 2019)</th>
<th>Top Ten Minus Conduits and Sinks</th>
</tr>
</thead>
<tbody>
<tr>
<td>(millions USD)</td>
<td>(millions USD)</td>
</tr>
<tr>
<td>1. Cyprus</td>
<td>1. France</td>
</tr>
<tr>
<td>159,505</td>
<td>20,986</td>
</tr>
<tr>
<td>2. Netherlands</td>
<td>2. Germany</td>
</tr>
<tr>
<td>55,903</td>
<td>20,114</td>
</tr>
<tr>
<td>3. Luxembourg</td>
<td>3. Finland</td>
</tr>
<tr>
<td>50,147</td>
<td>7,218</td>
</tr>
<tr>
<td>4. Bahamas</td>
<td>4. Austria</td>
</tr>
<tr>
<td>28,817</td>
<td>6,820</td>
</tr>
<tr>
<td>5. Ireland</td>
<td>5. Italy</td>
</tr>
<tr>
<td>28,154</td>
<td>5,312</td>
</tr>
<tr>
<td>23,667</td>
<td>5,052</td>
</tr>
<tr>
<td>7. United Kingdom</td>
<td>7. United States</td>
</tr>
<tr>
<td>23,518</td>
<td>4,561</td>
</tr>
<tr>
<td>8. France</td>
<td>8. China</td>
</tr>
<tr>
<td>20,986</td>
<td>3,502</td>
</tr>
<tr>
<td>20,114</td>
<td>3,313</td>
</tr>
<tr>
<td>10. Switzerland</td>
<td>10. South Korea</td>
</tr>
<tr>
<td>16,424</td>
<td>3,274</td>
</tr>
</tbody>
</table>
FDI stock by country is not always an accurate measure of the origin of FDI, because the presence of Offshore Financial Centers (OFC) can obscure where the investment was initially made. OFCs are commonly identified as jurisdictions that attract a level of foreign investment greatly exceeding the size of the local economy, through low taxes and lenient regulation.\textsuperscript{21} Research from the University of Amsterdam has identified 24 common sink-OFC, which act as tax and regulation shelters for foreign investors, and 5 conduit-OFC, which act as intermediaries between investors and sink-OFCs.\textsuperscript{22} Small island countries like Cyprus, the Bahamas, and Bermuda are notoriously used to shelter corporate money, but lesser known sinks like Taiwan and Luxembourg also play a part. UNCTAD has estimated that between 30% and 50% of global FDI goes through conduit countries before being reinvested from sink-OFCs.

Several of the top FDI investors in Russia are well-known conduit countries and tax havens for multinational enterprises (MNEs) and wealthy individuals. Figure 6 also shows an edited list of the top ten foreign investors in Russia excluding all known sink and conduit countries. The exclusion of OFCs displays that significant foreign direct investment is reported from several Western Europe, the United States, and Asia. Of the top ten outlined in Figure 6, Cyprus, Luxembourg, the Bahamas, and Bermuda are categorized as sink-OFCs and the Netherlands, Ireland, the United Kingdom, and Switzerland are known conduit-OFCs. Although for many sink countries, the flows of foreign investments greatly outweigh the local economy and strengthen the idea that the money is not coming from the sink itself, the FDI stock from conduits like the Netherlands, the UK, and Switzerland are a mix of foreign money sheltered in

\textsuperscript{22} OFC Meter. Universiteit Van Amsterdam. \url{https://www.ofcmeter.org/}
these countries and investments with legitimate roots. Thus, FDI stock from these countries cannot be fully dismissed as untraced.

**Effect of OFCs on Russian FDI**

In 2017, the UNCTAD estimated that 6.5% of the inward Russian FDI stock from sink-OFCs originated in Russia, adding up to nearly $28.7 billion.\(^{23}\) This phenomenon is widely referred to as round tripping, in which Russians transfer funds abroad and then reinvest a majority of the capital back into Russia.\(^{24}\) Motivations for round tripping include tax avoidance, higher regulatory freedoms abroad, arbitrage opportunities through government financial incentives for foreign investment, laundering money, or obscuring investor identity.\(^{25}\) Round tripping skews the overall amount of foreign direct investment, because the motivations of Russian re-investors are unrelated to the political and economic trends that would affect true foreign investors.

The UNCTAD developed a method for tracing money from sinks and conduits back to their original countries called the Casella model. They found that European and US investments in Russia were understated and estimated that US FDI in Russia was close to $39.2 billion in 2017. Comparatively, without tracing the true country of origin, the Central Bank of Russia reported that the level of US FDI in Russia in 2019 was merely $4.5 billion. Thus, one must take into account the misrepresentation of the investment levels of various countries in Russia as well as the presence of Russian money sheltered abroad being brought home.

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\(^{25}\) ibid
**FDI Industry Breakdown**

Figure 7 shows the ten industries with the highest levels of FDI stock on June 30th 2019.

**Figure 7: Top Ten Industries by FDI Inflow**

<table>
<thead>
<tr>
<th>Rank</th>
<th>Industry</th>
<th>Inflow  (millions USD)</th>
<th>Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Mining and Quarrying</td>
<td>114,553</td>
<td>21.3%</td>
</tr>
<tr>
<td>2</td>
<td>Manufacturing</td>
<td>114,142</td>
<td>21.3%</td>
</tr>
<tr>
<td>3</td>
<td>Wholesale and Retail Trade</td>
<td>84,619</td>
<td>15.8%</td>
</tr>
<tr>
<td>4</td>
<td>Financial and Insurance Activities</td>
<td>69,356</td>
<td>12.9%</td>
</tr>
<tr>
<td>5</td>
<td>Professional, Scientific and Technical Activities</td>
<td>48,528</td>
<td>9.0%</td>
</tr>
<tr>
<td>6</td>
<td>Real Estate Activities</td>
<td>33,748</td>
<td>6.3%</td>
</tr>
<tr>
<td>7</td>
<td>Transportation and Storage</td>
<td>17,898</td>
<td>3.3%</td>
</tr>
<tr>
<td>8</td>
<td>Administrative and Support Service Activities</td>
<td>12,224</td>
<td>2.3%</td>
</tr>
<tr>
<td>9</td>
<td>Information and Communication</td>
<td>11,618</td>
<td>2.2%</td>
</tr>
<tr>
<td>10</td>
<td>Electricity, Gas, Steam and Air Conditioning Supply</td>
<td>11,008</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

Mining and Quarrying and Manufacturing each account for around 23% of total FDI stock in Russia followed by Wholesale and Retail Trade. Mining and Manufacturing make up a large portion of Russian GDP, so higher levels of investment in these areas is expected.

**Figure 8: Share of Genuine and OFC Investment**

![Share of Genuine and OFC Investment](chart.png)
Figure 8 breaks down investment in the top four industries by OFC countries and countries with genuine investments. OFC countries make up the majority of foreign direct investment in Russia, especially in the Mining and Manufacturing sectors.

**Figure 9: Percent of Total FDI Inflows**

<table>
<thead>
<tr>
<th>Percent of Total FDI Inflows</th>
<th>OFCs</th>
<th>Genuine Investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mining and Quarrying</td>
<td>22.76%</td>
<td>16.28%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>22.10%</td>
<td>18.28%</td>
</tr>
<tr>
<td>Wholesale and Retail Trade</td>
<td>13.46%</td>
<td>24.03%</td>
</tr>
<tr>
<td>Financial and Insurance Activities</td>
<td>12.05%</td>
<td>16.06%</td>
</tr>
</tbody>
</table>

As can be seen in Figure 9, OFCs invest a higher percent of the total inflows into the mining and manufacturing industries, while investments from non-OFC have a more even distribution of investments among the top four industries.
Chapter 4: Political and Legal Issues

It is not possible to pinpoint one specific factor to explain all of the foreign direct investment decisions that investors make, but the political environment in Russia has a significant impact on the amount of foreign direct investment the country is able to attract and sustain. Political stability is a signal to investors of the potential of a worthwhile return on investment without debilitating risk. Currently, there are several political trends in Russia that could cause an increase in political uncertainty and therefore a drop in foreign direct investment. The annexation of Crimea has led to increasingly tense relations between Russia and several leading countries. Sanctions, corruption of both political and business leaders, and re-domiciliation efforts by the Kremlin have affected the Russian political environment and the risk foreign investors must be willing to take on.

Sanctions

In the aftermath of Russia’s annexation of Crimea in 2014, the United States and European Union imposed their first sanctions against Russia with the intention of increasing Russia’s political isolation and causing damage to the Russian economy. These initial sanctions froze the assets of several Russian companies and individuals with ties to the Kremlin in addition to prohibiting US citizens from engaging in business with them. The US sanctions also sought to restrict financial transactions with Russian companies in the financial services, energy, and defense sectors as well as oil-related exploration and production. In years following, the initial sanctions were repeatedly extended and additional sanctions were levied in response to further

27 ibid
conflict, including the US election meddling and the poisoning of Sergey Skripal. \(^\text{28}\) In 2017, the US sanctions against Russia were codified in the Countering Russian Influence in Europe and Eurasia Act (CRIEEA). \(^\text{29}\)

As a result of these sanctions, a number of US companies operating in the targeted industries were forced to suspend or adjust Russian operations. The oil industry was heavily targeted by the sanctions, causing companies like ExxonMobil to halt their Russian oil explorations. \(^\text{30}\) Not only have the sanctions prevented many companies from continuing their Russian business operations, it has also deterred US registered companies from attempting to enter the Russian market due to the number of blocked industries and the uncertainty of future sanctions. The discouragement caused by the sanctions can be seen in the sharp decline of FDI inflows in late 2014 and 2015 at the height of the sanctions. Conversely, with no new sanctions levied against Russia by the US in 2019, investor uncertainty of the future is declining, and foreign direct investment is recovering. The Central Bank of Russia reported that the FDI inflow for 2019 was more than $26.9 billion. \(^\text{31}\)

**Corruption**

Boris Titov, the Entrepreneur's Rights Commissioner, has labeled corruption as the “biggest problem” facing Russian entrepreneurial growth and the Russian government estimates

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\(^\text{31}\) Xoljavko, Anna. “Prijamye inostrannye investicii vernulis’ na stabil'nyj uroven’ (Foreign direct investment has returned to a stable level.)” Vedomosti. 19 January 2020 [https://www.vedomosti.ru/economics/articles/2020/01/19/820931-inostrannie-investitsii]
that corruption has cost Russia over $2.5 billion between 2014 and 2017.\textsuperscript{32} The Transparency International Organization ranks all 180 countries and territories in their yearly Corruptions Perceptions Index based on perceived levels of corruption from business people and international experts. In 2019, on a scale from 0 being most corrupt and 100 being the cleanest, Russia scored a 28 and ranked at 137 out of 180 countries.\textsuperscript{33} Russia has implemented the Russian Federal Anti-Corruption Law, but corruption by top officials persists. The Russian Anti-Corruption Foundation (FBK), which was developed by opposition leader Alexey Navalny in 2001, seeks to investigate and expose corruption of high-ranking Russian officials.\textsuperscript{34} A FBK spokesperson stated that despite the apparent efforts by the Kremlin to curb corruption, “a real fight against corruption is impossible under Putin. His whole system is built around it.”\textsuperscript{35} The persistence of bribery and corruption in the Russian business culture could act as a deterrent for foreign investors, because of the difficulty of doing clean business in a corrupt nation.

Further, the judicial system in Russia is notorious for its bias towards the state and it has proven this predisposition in several recent publicized and seemingly unfounded cases against foreign nationals in Russia.\textsuperscript{36} Michael Calvey, a US investor and founder of the prominent Russian-based hedge fund Baring Vostok, was detained and charged with financial fraud in February 2019.\textsuperscript{37} Calvey has been a strong advocate for the potential of foreign investment in Russia in the 25 years since founding Baring Vostok. Calvey and his colleagues are accused of

\begin{itemize}
\item \textsuperscript{32} Maynes, Charles. “New Reports Highlight Russia’s Deep-Seated Culture of Corruption.” VOA. Jan 26, 2020. [link]
\item \textsuperscript{33} Transparency International. 2019. [link]
\item \textsuperscript{34} Maynes, Charles. “New Reports Highlight Russia's Deep-Seated Culture of Corruption.” VOA. Jan 26, 2020. [link]
\item \textsuperscript{35} “2019 Investment Climate Statements: Russia.” U.S. Department of State. [link]
\item \textsuperscript{36} “Russian Court Freezes Assets of US Investor Michael Culvy.” Financial Times. [link]
\end{itemize}
embezzling $39 million from Vostochny Bank in a recent transaction. Baring Vostok has spoken out against these claims, speculating that the false charges were brought on by Artem Avetisyan, a wealthy Russian businessman and Kremlin advisor, for control of Vostochny. After a Russian court ordered Baring Vostok to sell a 10% stake in Vostochny, Avetisyan’s company Finvision made plans to purchase that stake in the upcoming London arbitration court. Calvey believes that his “opponents abused the law” in their ability to press charges against Calvey in criminal court rather than in commercial arbitration. Many Western companies fear that Calvey was targeted as a successful American businessman and that corrupt charges against other foreigners could follow. Calvey is not the first international businessman to be targeted. In the mid-2000s, Bill Browder’s hedge fund Hermitage Capital was the victim of a widespread tax fraud scam orchestrated by corrupt police and corporate raiders. These raiders forged documents using Hermitage Capital’s seals and stamps stolen during police raids to claim $230 million in fraudulent tax rebates on Hermitage subsidiaries. Bill Browder’s visa was revoked during his work with his lawyer Sergey Magnitsky to uncover the tax fraud operation and the corrupt police involved. As Magnitsky put together evidence against these intricate financial crimes, he was arrested for tax evasion by the police known to be involved in the operation. He died in their custody after months of deplorable living conditions, interrogation, and coercion to take

38 “Russian Court Freezes Assets of US Investor Michael Culvy.” Financial Times. https://www.ft.com/content/09c26e7e-e5f3-11e9-9743-db5a370481bc
responsibility for the fraud. The lengths that corrupt officials in the Russian judicial system have gone in covering up their organized crime could be discouraging to many potential foreign investors.

**Re-domiciliation**

As previously discussed in the Inward FDI Breakdown section, round tripping and the registration of Russian owned companies in OFCs are common ways for Russians to avoid taxes and gain regulatory freedoms. The Kremlin has taken several measures to encourage the return of offshored wealth to Russia. In 2015, Russia introduced the Controlled Foreign Company (CFC) rules. These tax code changes, also known as the deoffshorization law, required that any foreign company owned by a Russian citizen must pay profit tax. The addition of profit tax on any company with a Russian ownership of greater than 25% decreased the allure of sheltering money in tax haven OFCs. In 2017, Putin announced a continuation of his 2015 decision to grant amnesty to capital repatriated to Russia in addition to granting them exemption from the 13% income tax. In 2018, Putin introduced another re-domiciliation effort in which Russian offshore companies could re-register their companies with Russia in areas on the Oktyabrsky and Russky Islands while maintaining their status as an international company. The effectiveness of these policies is doubted by many critics as only three Russian companies returned to Russia.

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32
from Cyprus through the re-domiciliation policy between 2018 and 2019. However, the UNCTAD attributed some of the 2017 and 2018 decline in FDI inflows to the re-domiciliation efforts.

The complicity of Western financial institutions in laundering and transferring money out of Russia serves as an impediment to the Kremlin’s re-domiciliation plan. In 2014, the Organized Crime and Corruption Reporting Project (OCCRP) exposed a $20.8 billion laundering scheme dubbed the Russian Laundromat, in which internationally recognized banks including HSBC, Danske, Bank of China, and UBS participated. A full list of the banks involved is included in the appendix. Despite the emphasis of money laundering controls in these banks, there are likely many more schemes and accounts linking back to Russia. It will not be possible for the Kremlin to effectively limit capital flight and money laundering without the cooperation of international financial institutions.

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Chapter 5: Linear Regression

Theoretical Estimations and Modeling

In this study, I am attempting to understand the effect that the political relations have on the level of FDI inflows that countries make in Russia. The dependent variable is FDI inflows into Russia between 2008 and 2017 measured in USD, as reported by the Central Bank of Russia divided into geographic and economic areas. The analysis is controlled for GDP and population, because countries with higher GDPs and populations are more likely to have a large number of investors with enough capital to make foreign investments. Data from 157 countries was included based on countries contained on the Correlates of War country code list that had an FDI inflow number greater than 0 between 2008 and 2017. To be included on the Correlates of War country code list, a country must have a population greater than 500,000 and receive diplomatic missions from two major powers. This excludes many island countries such as the Cayman Islands, the British Virgin Islands, and Jersey. In addition to not meeting the population requirement, the foreign direct investments made from these countries are primarily in the function of sink-OFCs and there are no relevant political relations between these countries and Russia.

As highlighted in the political trends discussed above, I expect that political relations between Russia and an investor’s country of origin would have a significant effect on the amount of foreign direct investment flowing into Russia. There is a positive correlation between a country’s political relations with Russia and the amount of FDI, so when relations with Russia are good, more foreign direct investment with Russia should be reported.
The model for FDI is:

\[ FDI_{it} = \alpha + \beta_1 PR_{it} + \beta_2 GDP_{it} + \beta_3 POP_{it} + \epsilon_{it} \]

Where,

FDI = FDI measured in USD divided by output-side real GDP at chained PPP

PR = The political relations between a country and Russia (the percent agreeableness)

GDP = Log of output-side real GDP at chained PPP (measured in millions 2011 USD)

POP = Log of country population (in millions)

\( it = \text{country } i, \text{ year } t \)

**Empirical Results**

**Figure 10: Linear Regression**

|                        | Coef.       | Std. Err.   | t      | P>|t| |
|------------------------|-------------|-------------|--------|------|
| Political Relations    | 0.1235393   | 0.0581075   | 2.13   | 0.034|
| GDP                    | -0.0150903  | 0.0217609   | -0.69  | 0.488|
| Population             | 0.0313115   | 0.060595    | 0.605  | 0.605|

Figure 10 displays results from the regression showing political relations to be significant at the 5% significance level. The P>|t| of political relations highlighted in the red box, confirms significance, because 0.034 is less than the 0.05 significance level. The positive coefficient indicates that an increase in positive political relations would increase foreign direct investment. This supports my hypothesis that changes in foreign direct investment are directly connected to changes in political relations. Thus, if political relations with a country deteriorated, such as
relations between Russia and the US in the post-sanction environment, then foreign direct investment should also decrease.
Chapter 6: Economic Trends

Just like any investment, the attractiveness of foreign investment is determined by the risks and rewards. Thus, the outlook of the Russian economy and the returns investors are seeing on current foreign investments have an impact on the continuing inflow of FDI into the country. Foreign Direct Investment seems to strongly track GDP as can been seen in Figure 11. Here I will discuss recent economic trends in Russia and their perceived impact on FDI.

**Figure 11: Russian GDP to FDI Stock**

![Russian GDP to FDI Stock](image)

In the few decades since Russia transitioned to a market economy, Russia has made great strides to become the world’s 11th largest economy. However, the economic slowdown and dependence on commodities make Russia a less attractive investment opportunity for many investors than other developing nations.
Economic Slowdown

GDP growth rates and projections are important indicators for investors. As a growth economy, Russia has been attractive to investors seeking growth, but in the past decade Russian GDP growth rates have declined. Figure 12 shows a comparison of the growth rates in all of the BRICS countries. China and India had 2018 growth rates of 6.6% and 6.8%, respectively, while Russia lags behind at 2.3%. Stuart Lawson cites this as a main problem in Russia, saying that Russia has “now hit a 1.5 – 2% growth rate, which is just not good enough for this sort of market. It means the business plans being created don’t generate the payback periods for incremental capital investment, especially in light of cross border risk.”

Figure 12: GDP Growth Rate in BRIC Countries

Demographic Shifts

Changes in demographics have been hard on the economy. Uncertainty in the 1990’s led to lower birthrates. Thus, as baby boomers are reaching pension age, the Russian workforce is

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declining with not enough young workers to replace those retiring.\textsuperscript{50} Between 2015 and 2019 the number of Russians in the working age bracket fell from 85.4 million to 81.3.\textsuperscript{51} Researchers at the Analytical Credit Rating Agency have found that the decrease in workforce along with lower levels of migration could decrease potential economic growth by 0.4 percent each year.\textsuperscript{52} With this decline, the number of workers providing tax revenues for pensioners has dropped from 2 to 1.\textsuperscript{53} That in part has driven the need for the pension reform and the value added tax (VAT) increase.\textsuperscript{54} In 2018, Russian lawmakers passed a law to raise retirement age by 5 years between 2020-2028 and proposed a 2\% increase in VAT.\textsuperscript{55} The World Bank indicates that the increase in the Russian retirement age could add 0.3-0.4 percentage points to economic growth rates in this period.\textsuperscript{56}

**Dependence on Commodities**

Russia is incredibly rich in natural resources and has long relied on oil production and other commodities to bolster GDP growth. According to the World Bank, in 2019 Russian

\begin{itemize}
\item \textsuperscript{51} Ibid
\item \textsuperscript{52} Balmforth, Tom. “Another Worrying Sign For Russia's Dire Demographics.” RadioFreeEurope. Sep 27 2017. \url{https://www.rferl.org/a/russia-population-decline-labor-oreshkin/28760413.html}
\item \textsuperscript{54} Lawson, Stuart. Personal Interview. Nov 8 2019.
\item \textsuperscript{55} “Russian lawmakers back higher retirement age in preliminary vote.” Reuters. July 19 2019. \url{https://www.reuters.com/article/us-russia-pensions/russian-lawmakers-back-higher-retirement-age-in-preliminary-vote-idUSKBN1K9252}
\item \textsuperscript{56} Fadeichev, Sergei. “Law on raising retirement age in Russia comes into effect on January 1, 2019.” TASS. Dec 31 2018. \url{https://tass.com/society/1038728}
\end{itemize}
production of aluminum, crude oil, natural gas, and platinum was the second highest in the world. Fuel exports make up 60% of Russia’s total exports.  

The dependency of the Russian economy on oil was especially apparent in the 2014 recession. The 2014 crisis, dubbed the Great Recession, was brought on partially by sanctions and exasperated by the devaluation of the Ruble and decline in oil prices. Crude oil prices dropped sharply from an average of $105 a barrel to $60 a barrel at the end of 2014. Figure 13 shows the similar movement of GDP and the Brent Crude Oil rate, including the severe drop into the recession in 2014 and 2015.

**Figure 13: Yearly Russian GDP and Brent Crude Oil Average Price**

![Yearly Russian GDP and Brent Crude Oil Average Price](image_url)

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Despite apparent efforts to reduce dependency on oil, the Rosstat update of the industrial production index from the 2010 base year to 2018 shows that in 8 years the share of raw materials industry in overall production increased from 34.3 to 38.9%.\footnote{"Rosstat obnaružil rost zavisimosti ekonomiki Rossii ot nefti i gaza. (Rosstat has discovered a growing dependence of the Russian economy on oil and gas.)" RBK. 17 feb. https://www.rbc.ru/economics/17/02/2020/5e4a79d49a79471aa1e28c38

\textsuperscript{59}}

\textbf{Economic Diversification}

In the face of continued reliance on commodities, the Russian government is making economic diversification a priority in government spending by increasing spending on education, health, and infrastructure.\footnote{"The World Bank in Russia." The World Bank. 2019. https://www.worldbank.org/en/country/russia/overview
\textsuperscript{60}} Additionally, the Russian government established several special economic zones (SEZs). These zones provide investors with special benefits and incentives to encourage innovation in industrial, technological, logistic, and touristic activities.\footnote{"Special Economic Zones in Russia." Ministry of Economic Development in the Russian Federation. http://www.ved.gov.ru/eng/investing/sez/\textsuperscript{61}} The six techno-innovative SEZs hosted 374 residents and created 14,000 jobs by 2018.\footnote{"World Investment Report 2019." UNCTAD. 2019. 149 https://unctad.org/en/PublicationsLibrary/wir2019_en.pdf \textsuperscript{62}} Of the 26 total SEZs in Russia, 60\% of the investments have been made by foreign affiliates.\footnote{"World Investment Report 2019." UNCTAD. 2019. 166 https://unctad.org/en/PublicationsLibrary/wir2019_en.pdf \textsuperscript{63}} The SEZ in Grand Baikal has attracted significant investment from China due to its focus on tourism.\footnote{"World Investment Report 2019." UNCTAD. 2019. 167 https://unctad.org/en/PublicationsLibrary/wir2019_en.pdf \textsuperscript{64}} Another initiative in Moscow called the Skolkovo Innovation Centre is tasked with driving alternative sources of innovation and has had similar success. If Russia can successfully diversify and separate its economic growth from commodities, then there may be potential for increased growth in the next ten years.
Adjusted 2020 Economic Outlook

The original growth estimate for the Russian economy in 2020 was 1.5 percent; however, the COVID-19 pandemic has rocked global economies due to international increases in unemployment levels, lower consumer purchasing power, and a significant drop in oil prices. Since the Russian economy greatly relies on oil exports in economic growth, Moody’s has revised the expected 2020 GDP growth level down to 0.5 percent to account for the impact. In March of 2020, oil prices hit four year lows at $27.83 compared to the average level of $42.4 used in Russia’s 2020 budget. If the slide in oil prices continues, the Russian economy could be in a 2020 deficit with oil revenues more than $39.5 billion lower than anticipated. Russia’s National Welfare Fund (NWF) has reserves of $125 billion, which will allow Russia to weather low oil prices for six to ten years. It is unknown what effect this expenditure would have on the previously announced $400 billion 6-year stimulus plan with lofty goals for expansion in previously neglected areas such as infrastructure, scientific research, and education. If stimulus spending is cut, future predictions on GDP growth may need to be adjusted downward to account for both the drop in oil prices and the lack of growth previously expected in other areas on the economy.

Chapter 7: The Future of Foreign Direct Investment

Several recent trends in Russian politics coincide with shifts in FDI. The sanctions imposed by the United States and the European Union initially came into effect in 2014 at the beginning of the 2014 recession. As fear of further sanctions has decreased moving into 2020, investor outlooks have improved. Corruption and negative sentiment towards foreign investors are a continued fear of potential investors. Actions taken against Bill Browder and, more recently, Michael Calvey have inflamed this fear. The Kremlin will need to expand Russian Federal Anti-Corruption Law, move up on the Corruption Perceptions Index, and place more serious scrutiny on judicial officials to lessen the fear of corruption in the future. Although Redomiciliation efforts decrease the amount of FDI inflow, Putin’s expanded efforts to discourage round-tripping are good for Russian FDI, because they increase the proportion of genuine foreign investment entering the country and allow taxation of otherwise round-tripped money. The linear regression analysis between political relations and inward FDI proved to be statistically significant. Thus, the relationship between political relations and FDI is evidenced to be more than correlation. It is imperative that Russia focuses on repairing its international relationships in order to see an improvement in inward FDI.

Acknowledging the current economic slowdown in GDP growth as well as a shrinking workforce, Russia must expand the economy into higher growth sectors and continue to create legislation to maintain the workforce and the government’s ability to pay pensions. The Kremlin has recognized the importance of government stimulus in economic areas outside of commodities and it is essential that they proceed with the $400 billion stimulus package even in light of the current 2020 economic downturn. If oil prices continue to drop, the government will feel increased pressure to expand the economy in other areas to compensate for a smaller amount
of oil export revenue. If Russia can increase its growth rate beyond current 0.5 – 1.1% projections, the returns may become attractive enough to draw further foreign direct investment.
Appendix

Comparison of CBR and UNCTAD FDI Data

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<th>Year</th>
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<th>CBR</th>
<th>Difference</th>
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<td>75856</td>
<td>74783</td>
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</tr>
<tr>
<td>2009</td>
<td>27752</td>
<td>36583</td>
<td>(8831)</td>
</tr>
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<td>31668</td>
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<td>(11500)</td>
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<td>(18216)</td>
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<td>50588</td>
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<tr>
<td>2017</td>
<td>25954</td>
<td>28557</td>
<td>(2604)</td>
</tr>
<tr>
<td>2018</td>
<td>13332</td>
<td>8785</td>
<td>4548</td>
</tr>
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</table>

YoY % change

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<th>UNCTAD</th>
<th>CBR</th>
</tr>
</thead>
<tbody>
<tr>
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<td>-63.4%</td>
<td>-51.1%</td>
</tr>
<tr>
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<td>14.1%</td>
<td>18.0%</td>
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<td>2012</td>
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<tr>
<td>2013</td>
<td>-59.3%</td>
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<tr>
<td>2014</td>
<td>213.5%</td>
<td>-374.8%</td>
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<tr>
<td>2015</td>
<td>-30.2%</td>
<td>-12.2%</td>
</tr>
<tr>
<td>2016</td>
<td>-45.4%</td>
<td>-69.2%</td>
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Banks Involved in the Russian Laundromat Scheme

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<tr>
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<tr>
<td>Trasta Komercbanka</td>
<td>Latvia</td>
<td>Ukio Bankas (closed)</td>
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<tr>
<td>Privatbank</td>
<td>Ukraine</td>
<td>BiznesInvestBank</td>
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<td>Danske Bank</td>
<td>Denmark</td>
<td>United Overseas Bank</td>
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<td>Victoriabank</td>
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<td>Latvia</td>
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<td>Seb Bank</td>
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<td>Abu Dhabi Commercial Bank</td>
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Biography of Interviewees

Stuart Lawson

Stuart Lawson has 36 years of banking experience with both major Western banks and Russian owned banks, including 16 years as CEO/Chairman of banks in Russia. He has led both Citi and HSBC's Russian operations and for four years to 2009 was nominated one of Russia's leading bankers by the Central Bank, the Banks' Associations and the Ministry of Finance. Stuart has established a strong position in consulting and is responsible for activities of the Russo British Chamber of Commerce in Russia, is the Chairman of Finance and Investment and deputy chairman of banking committees at Association of European Businesses, Co-Chairman for Russia Stream at TheCityUK, and a member of the supervisory board of Independent Directors Association.

Michael Hollomon

Michael Hollomon currently serves as the CEO of Missouri Cobalt. He has 25 years of experience in the global commodities and mining industry with significant experience in Russia, including work with the world's largest commodities trading and mining conglomerate, Glencore, as well as Gunvor SA, a Swiss-based oil and gas trader and upstream mining group.
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