Foreign Investors in Russian Regions: Seeking New Strategies in a Shrinking Market

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Starting 2014 the Russian economy has been experienced economic sanctions, fall in oil prices, twofold devaluation of the local currency, decrease in retail sales and consequently, drop in gross domestic product. These events led to the situation, which is of extremely high uncertainty both for domestic and foreign business. Comparing 2013, net FDI inflow decreased 10 times in 2015. Russian subsidiaries of MNEs revise investment plans. Here the words of Edith Penrose are worth recalling "the tree will not grow unless certain environmental conditions satisfied, but one never certify in advance whether the tree will or will not survive all possible vicissitudes" (The Theory of the Growth of the Firm).

The research aims to assess the transformation of foreign investors' strategies driven by new economic realities in Russia and to evaluate possible consequences for regions which heavily rely on foreign investment inflow. Twofold problem statement seems reasonable because the conflict of state and MNEs remains an issue. Countries face incentives not only to regulate the entry of firms, but also the possible exit, accompanied with the immediate loss of jobs and production.

There are varieties of theories which aim to explain *why* firms conduct FDI, and thereby become MNEs, and *where* firms should locate their FDI. First are related to the motives of MNEs, second – to the determinants of location choice (among countries and inside countries). Anyway both referred to the aims of the firm and follow one another. Among basic theories: The product life-cycle theory *(see Vernon, 1966)*, Uppsala model *(see Penrose, 1959; Johanson and Wiedersheim-Paul, 1975)*, Dunning's eclectic paradigm *(see Dunning, version of 1994)*, Spatial diffusion models *(see Hägerstrand, 1966; Schlunze, 1992)*.

In literature there is a tendency (that was firstly mentioned by Bruce Kogut in the early eighties) to view FDI as a decision made at a discrete point of time *(see Kogut, 1983)*. But the decision to act internationally is only one aspect of FDI; the other aspect is the series of sequential decisions within the countries where investments have been already made (not limited to hierarchical wavelike diffusion concept). This research offers specific inputs to the debate on the MNEs strategies in the changing environment, addressing the question: under certain conditions, whether the foreign investor is more likely to exit the market or undertake strategic and tactical measures of adaptation to new economic realities?

The motives of investing in Russia have changed over time. In the new history of Russia four major periods of internationalization may be distinguished: 1992-1998, 1999-2008, 2009-2013, and 2014-present.

In the case of Russia the initial optimism due to the liberalization and privatization of major industries was not followed by the expected high inflow of foreign investment *(see Castiglione et al., 2012)*. Compared to the GDP, FDI inflow was about 0.6 percent in 1992-1998, compared to 1.2 percent in the world at the average. However, several MNCs (Procter & Gamble Company, Knauf, Henkel and others) successfully established Russian manufacturing subsidiaries.

In the beginning of 2000th foreign investors (BP, Royal Dutch Shell) were seeking access to Russia's natural resources via the establishment of joint ventures, and acquisition of Russian companies. The natural resources abundance became the main determinant of FDI location decision. Sakhalin, Tyumen regions and Moscow concentrated the major amount of investment, until in 2008 the federal law limited FDI inflow in some strategic industries, including exploration and production of natural resources in federal subsoil areas.

The period 1999-2013 was characterized by rapid growth of the Russian economy. During the period, demand both from households and industries was affected by economic growth (GDP increased 1.92 times) and growth of real income per capita (increased 3.15 times) resulting in the raise of consumer market. Given the lack of domestic fast-moving consumer goods, construction materials, chemicals, and industrial services, foreign MNEs had a chance to fill in the niches. The booming growth of FDI was registered in the service sector, which was dominated by investments in wholesale trade. Ikea, Auchan, Leroy Merlin, Media Markt, Inditex, etc. have been estimated the untapped Russian market as very promising. Since 2007 Russian car fleet have increased 1.46 times and reached 40 million in 2013. In 2007-2013 Volkswagen, Toyota, Nissan, GM, Peugeot, Hyundai, Ford, Renault launched 10 new enterprises. By 2013 foreign companies provided more than 70 percent of cars produced and 52 percent sold in Russia.

But in 2014 the situation changed. The fall in oil prices and subsequent devaluation of the local currency led to accelerated inflation, contraction of disposable income, decreases in retail sales, and drop in investment demand. So, the key motive of investing in new assets in Russia – the market capacity – was jeopardized. According to The World Bank data net FDI inflow decreased from USD 69 billion in 2013 to 22 billion in 2014 and 6.6 billion in 2015 (back to the level of 2003). The increased volume of exported capital can be explained by the fact that payments on existing external debt due to reduced access to international capital markets were not balanced by new loans *(see Zagashvili, 2015)*.

However, in 2014-2015 many MNCs continued or even intensified their efforts to install new manufacturing facilities: 109 factories were opened in Russia *(see Gurkov, 2016)*. Depreciation of the local currency allows Russian subsidiaries of MNEs to gain several competitive advantages. Decrease of personnel costs, rental or building expenses, service charges, cost of electricity and other expenses nominated in local currency led to cutting of production costs.

Another striking feature of FDI in Russia is the spatial diversity within the country. Their distribution across regions demonstrates a strong regional concentration of FDI. According to Bank of Russia among 83 regions top five accumulated 80 percent of FDI inflows in 2013. Traditionally FDI are concentrated in the city of Moscow and Saint-Petersburg, the Moscow and Leningrad regions, Tyumen and Sakhalin regions. The mapping of FDI in Russian regions showed that in spite of the size of the country, foreign investors are driven more by population density and industrial structure than geography and distance. So, MNEs invest in regions endowed with natural resources or in wealthy urban agglomerations to exploit local demand.

To measure the significance of FDI we ranged the regions by such indicators as the share of production of enterprises with foreign capital, the share of employed at the enterprises with foreign capital, the share of FDI compared domestic fixed assets investment. As a result we determined 11 regions, which are highly influenced by FDI inflow *(also see Kouznetsova, 2016)*. But here one has to bear in mind the scale and scope of round-tripping FDI, i.e. inflow from Cyprus, Luxembourg, and the Netherlands, which characterized by high volatility due to the new Russian anti-offshore law adopted at the end of 2014.

The conducted analysis allows to formulate some conclusions regarding the significance of FDI in Russian regions and probable strategies of foreign MNEs in current realities. Examining different periods we can conclude that natural resource-seeking motive played a decisive role for transnational oil corporations in 1999-2008. During the next period companies operating in the automotive industry, food, tobacco, and telecommunications industries were driven by market-seeking motive, while technology companies were motivated by strategic asset-seeking, launching their corporate R&D centers. Current situation, characterized by depreciation of local currency and lowering of operational costs for MNEs, raises the role of efficiency-seeking motive.

In Russia in a whole the role of FDI comparing with domestic fixed asset investment isn't that high. Comparing GDP, the share of FDI was 0.7 percent, while the share of domestic fixed asset investment exceeded 20 percent in 2013. However, there are regions which highly (more than 20 percent share of foreign investment) depend on FDI. This poses certain threats in case MNEs decide to exit the region. But to date, in Russia there are not many examples of postponing investment plans, closing or divesting enterprises. On the contrary, MNEs continued or even intensified their investments to have their assets completed. This strategy presents clear advantages both for continuation of operations in case of demand recovery and for a possible exit from the market. Besides, once the initial investment is made the sequential inflow is comparatively lower.

Second possible strategy is connected with the raising of efficiency due to costs decrease. In case of shrinking domestic market parent MNE can make a decision to redistribute commodity flows and export to other markets, governing sister-subsidiaries competition.

Third strategy is represented by new type of industrial project known as “hence field project”, which are manufacturing facilities within the existing industrial sites of Russian firms *(see Gurkov, 2016)*. Moreover, the probability of import restriction by Russian government and need to decrease costs of imported components create the preconditions for co-location and localization of related manufacturing.

Overall, in current situation Russian economy can expect the reinvested earnings, but not new investment inflow or new investors’ entry. Large scale economy can be affected, but cannot rely on the foreign investments. On the contrary, stable economic growth, market capacity, and effective demand, may serve as a sign for foreign investors to join.