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Comparative analysis of FDI determinants in China and Russia

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Abstract

This paper attempts to offer an explanation to the fact that China has been more successful in attracting foreign direct investment than Russia. The focus of the paper is on the recent years rather than on the outset of the economic transformation in both countries. For this purpose the paper first presents a set of factors that affect the attractiveness of a location to FDI and then analyzes and compares these factors in China and Russia. The FDI determinants that are chosen for the analysis have been grouped into two categories, those that are "natural" and those that can be controlled by the authorities. The subsequent analysis of both groups of factors reveals that they as a whole appear to favour FDI inflows much more in China than in Russia, even though variations exist between them. This offers a possible explanation as to why China attracts more FDI than Russia.

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1. Introduction

In today's globalized world, foreign direct investment (FDI) has become an important engine of integration into the world economy, bringing capital, technology, managerial skills, goods and services to the host countries, promoting growth and reducing poverty. All countries compete to attract foreign investors, yet some have proved to be more successful than others. There is a variety of factors that influence the attractiveness of a location to FDI, some of them can be affected by the government actions and some are outside of the authorities' control. This paper investigates and compares the determinants of FDI inflows to two major emerging economies of Russia and China. The main question the paper attempts to answer is

Why does China attract more FDI than Russia?

FDI is measured here in absolute values at current US dollars. China opened up its economy in 1979 and the first year that FDI data is available for from UNCTAD and the World Bank databases is 1980.[1] The first year data is recorded for FDI by UNCTAD in Russia is 1992, yet the foreign direct investment was allowed already in 1987 with the passing of a Joint Venture Law in the Soviet Union. Hence China had a head start of six-seven years, which however does not prevent us from saying that China has been more attractive to foreign investors judging by the volume of FDI inflows to these countries (see Figure 1). The advantage of an earlier openness to FDI is largely counterbalanced by the fact that Russia became an open country to FDI from the very start of its economic integration, whereas China was opening up to foreign investors gradually. Even though FDI data before 1992 does not exist in UNCTAD FDI database, we can assume that FDI inflows to USSR/Russia in this period were miniscule, as by the end of 1991 Eastern European countries had only attracted 9.6 billion FDI in stock, where more than half of that amount went to Hungary.[2] The focus of the paper is on the determinants of FDI to both countries in recent years rather than at the outset of their economic openness.

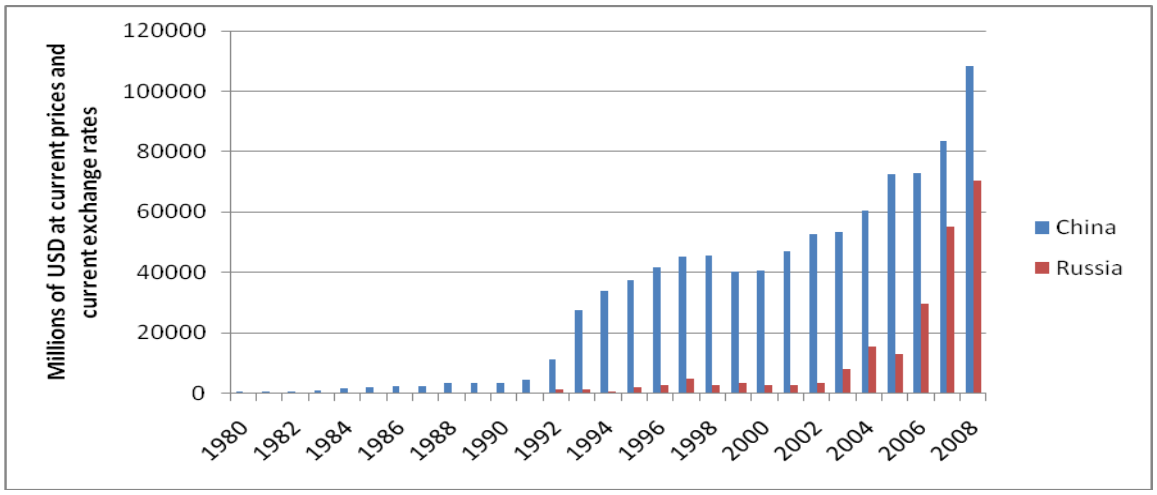
The choice of the countries is not a random one. Both represent large and dynamic emerging economies that play an important role in the world economy today. Both countries are among the most successful hosts for FDI and have been in the top ten among the most

[1] UNCTAD and WDI Online

[2] Wang (1995), p.67

attractive destinations for foreign direct investors for a number of years.[3] Today both Russia and China are members of what is called the Golden BRIC, a group of rapidly developing emerging markets including Brazil, Russia, India and China. Yet, between China and Russia, the former has been far more successful in attracting FDI, which is evident from the figure below, particularly in the 1990s and the beginning of the twenty first century. In recent years Russia has been catching up with China, a process which will be analysed later in the paper. However, a significant gap in the volume of FDI inflows remains.

Figure 1: FDI inflows to China and Russia at current prices and current exchange rates.



Source: UNCTAD FDI database; Central Bank of Russia, balance of payments, www.cbr.ru

This paper seeks to offer an explanation to this development and find reasons why Russia is lagging behind China when it comes to attracting FDI.

Another interesting aspect of both countries is that they shared the same political and economic systems in the past where the Communist Party in both countries had a solid grip on power and the economic decisions were motivated by central planning rational.

However, eventually the weakness of rigid directive planning in socialist countries became obvious as it brought a lack of quality, innovation and efficiency to the economies. Both countries adopted a market-oriented approach to their economic policies with varying results. As Russia trying to replicate the western democratic standards embarked on a radical

[3] The attractiveness of a location is measured here by the results of a number of perception surveys, like the World Investment Prospects Survey and A.T.Kearney Foreign Direct Investment Confidence Index.

political development choosing a path of democratization, the Communist Party in China has managed to keep its grip on power up to this day.

The structure of the thesis is the following. First a theoretical framework is presented which will serve as a point of reference and explanatory tool for the subsequent analysis. Here I will use Dunning's eclectic paradigm of international production. In the next section I will outline some facts and the latest trends of FDI flows on the global basis and to the countries in question. The following part of the thesis will be devoted to analyzing the selected FDI determinants in both countries followed by a conclusion.

It is important to mention that I have extensively used UNCTAD, World Bank, OECD sources for information as data collected by the authorities in both countries is known to be less reliable. However, I did use the balance of payments statistics of the Central Bank of Russia as it is one of the primary sources of data for UNCTAD.[4] In Russia data on FDI is reported by two sources: The Central Bank of Russia (CBR) and the Federal Service of State Statistics (Goskomstat). There are significant differences in the methodology of FDI reporting used by these agencies, resulting in differences not only in scale, but also in trend.[5] CBR's methodology is in accordance with the one used by the IMF[6], so I relied mostly on the CBR as a source of FDI data. The Federal Service of State Statistics was used as a primary source of other types of data on Russia. With regards to the data on China, FDI statistics are reported by MOFCOM, the Ministry of Commerce. I used the website of the Investment Promotion Agency of the Ministry of Commerce, www.fdi.gov.cn to obtain the necessary data on FDI in China.

[4] World Investment Report 2009, p.244, UNCTAD

[5] Lucio Vinhas de Souza, European Commission Directorate General for Economic and Financial Affairs. Presentation from OECD-Russia Expert Meeting on Russia's Investment Policy on 9April 2008, Moscow, Russia

[6] Set out in the Balance of Payments Manual, 5th edition, 1993

2. The Theoretical Framework for FDI

In this section the theoretical framework for the paper is presented, upon which further discussions will be conducted in later sections. I will start with the definition of FDI and multinational enterprises (MNEs) that engage in FDI, shortly describe the types and general characteristics of FDI and then I will introduce the OLI eclectic paradigm as a framework for discussing FDI determinants.

2.1. General characteristics

We are living in an increasingly globalized world and multinational enterprises (MNEs) have become major forces of the economic integration today. In fact, on a global basis, MNEs are responsible for almost half of the world industrial output and account for about two-thirds of world trade[7], employing about 77 million people worldwide in 2008.[8] Dunning defines multinational enterprise as "an enterprise that engages in foreign direct investment and owns or controls value-adding activities in more than one country".[9]

So what is foreign direct investment (FDI)? According to the IMF definition FDI is an investment that involves "a long-term relationship" reflecting a "lasting interest" of the investor in an enterprise operating outside of the economy of the investor.[10] The objective of the investment is to exercise control over the management of the enterprise. This does not imply absolute control; however, the foreign investor must have an effective voice in the management of the company. According to OECD, such influence on the management of a foreign company is possible when foreign investor owns at least ten percent of ordinary shares.[11]

Hence, the idea is to exercise control of the enterprise and this is what makes FDI different from portfolio investment. Portfolio investment represents transfer of capital which can easily be disinvested and has no significant influence on the management of the firm. It represents the investor's choice to rely on the existing management of the firm and it aims to

[7] Gooderham & Nordhaug (2003), p.7

[8] World Investment Report (2009), p.xxi, UNCTAD

[9] Dunning (1992), p.3

[10] IMF balance of payments manual (5th edition), quoted by Dunning (1992), p.5

[11] Benchmark definition of foreign direct investment, 3rd edition, OECD, quoted by Navaretti & Venables (2006), p.2

earn dividends and gain capital appreciation. FDI entails not only transfer of capital, but also competences, capabilities, technology, management skills and is aimed at taking active management of the company.[12]

Companies can engage in FDI and become multinational in a few different ways. First it is important to note that there are two important aspects to multinationality. One is the fact that firm's activities take place in more than one country. The second is the ownership of these activities, the internalisation of the company's operations. Firms can organize their activities in a foreign country through licensing or subcontracting to local firms. However, the act of FDI occurs only when the activities are kept in-house.[13]

An MNE can split its home production in a few ways and each way has its costs and benefits. One way is to take a horizontal approach when the similar products are produced both in the home and in the host country. Such approach entails the loss of economies of scale, but only at the plant level, not the firm level. Firm specific assets in the form of headquarters' staff, R&D expenditures or even the intangible assets like brand name or reputation are a source of firm-based economies of scale that can be freely shared by all of the production facilities of an MNE, home and abroad. Firms that enjoy high firm-level economies of scale and low plant- level economies of scale are most likely to engage in horizontal FDI.[14]

Another way of splitting production is to take the vertical approach. It entails moving a part of the production process abroad. The result of this type of split is the disintegration of the production process and consequently loss of efficiency (but not the economies of scale).

However, each way has its own benefits. A horizontal FDI is characterized by the fact that most of the output of the host country production facilities is sold in the host country. Hence the main motive for horizontal FDI is access to foreign markets. By duplicating their operations in the host country, MNEs avoid trade costs associated with supplying the market through exports called tariff jumping. Other benefits to be gained with horizontal FDI are better knowledge of customer needs and possibilities of quick response to changes in the

[12] Dunning (1992), p.5,62; Herbert Stocker quoted in Chen (2000), p.116-117

[13] Navaretti & Venables (2006), p. 15

[14] Navaretti & Venables (2006), p. 25,26

market conditions that otherwise would have been forgone without the presence in the market.[15]

By contrast, vertical investment is motivated by lower factor costs available in some locations. Relocating a certain factor-intensive part of the production to a location where that factor is cheap and abundant can provide MNE with significant cost saving benefits. It is important to notice that it is not only the cost of the factor that is important, but also its quality.[16] Trade costs are also important for vertical FDI, but they have an opposite effect on vertical FDI compared to the horizontal one. While high trade costs in the form of import tariffs and transport costs seem to encourage horizontal FDI as a way to circumvent them, vertical FDI is discouraged by them as the nature of this type of FDI entails that inputs often have to be imported and final products exported.

Vertical FDI is therefore typical for developing countries as they offer cost saving opportunities for international companies and horizontal for the developed ones as they offer well developed markets. Yet, some developing countries are also a target for horizontal FDI as they offer significant market potential along with cheap factors of production.

It is important to note that often there is no clear distinction between horizontal and vertical FDI. Even when an exporting firm decides to locate some of the production destined for foreign markets abroad, the headquarters still remain in the home country, adding a vertical element to the investment. Likewise, moving the production of a component abroad due to lower costs of production in the host country may not necessarily entail that the production of that component will not be duplicated in some way in the home country adding a horizontal element to essentially vertical investment.

Besides market seeking FDI, one can identify other motives for investing abroad. Resource seeking FDI is one of such motives. Cheap factors of production as a motivation for FDI have been already mentioned. Often firms engage in resource seeking FDI in order to secure the supply of inputs, like it happens in resource extracting industries. Another motive behind resource seeking FDI is the acquisition of technology, information, specialized management and/or organizational skills. Dunning refers to resource seeking FDI by firms

[15] Navaretti & Venables (2006), p.28

[16] Navaretti & Venables (2006), p.29

from developing countries into developed countries as an example of such a motive.[17] Resource seeking FDI is often export oriented.

Some MNEs can engage in FDI due to efficiency reasons. It involves investments across different locations that are aimed at optimizing the benefits rising from those investments. Such benefits can be diversifying risks, realising economies of scale and scope, taking advantage in differences in countries' cost of factor endowments.[18]

Strategic asset seeking FDI involves FDI motivated by strategic considerations of an MNE. These may be aimed at preventing a competitor to enter the market or taking market shares at the early stages of market development.[19]

Other motives may be escaping the restrictive home investment environment, as it happened for example to Japanese banks in Europe that provide a wider range of services to their customers than they are allowed in their home country.[20]

Another aspect of FDI is the way it is financed. There is a number of ways to do it. Funds can be provided by an MNE itself through intra-company loans or reinvested profits, a company can issue new shares by going to the stock market or turning to the credit market to obtain a credit. All three ways have different interest costs and risk profiles. Often a combination of the three is used as an optimal solution to minimize risk for a given return.[21]

Entry of foreign capital can happen either as a joint venture or a fully owned subsidiary. Joint venture is an agreement between two or more companies to produce a product together. All of the partners provide some capital to the joint company and other resources at their disposal. Choosing the right partner can be a difficult, time and resource consuming process, yet an extremely important one that often determines the success of the joint venture. Teaming up with the right local partner can provide the benefits of sharing risk and rapid entry into the market. Local partner often possess the unique market knowledge, established reputation, developed customer base; have the necessary political connections that can

[17] Dunning (1992), p. 57, 110-114

[18] Dunning (1992), p. 59-60

[19] Dunning (1992), p.60-61; Foreign Direct Investment in China: Challenges and Prospects for Regional Development, OECD, 2002, p.25

[20] Dunning (1992), p. 61

[21] Chen, (2000), p.21

facilitate business operations.[22] In many countries/sectors joint venture is not a choice, but a necessity as government regulations impose joint venture as the only way of entering a market. These types of regulations are mostly common for developing countries that in addition often possess weak non-transparent legal systems, making partnering with local firms especially important. Hence, joint ventures are the most common form of inward FDI into developing countries.

The establishment of a fully owned foreign subsidiary may take place in one of two ways. Either as a greenfield investment, where a new plant is set up from scratch, or as a merger with or acquisition of an existing firm (M&A). Mergers often happen willingly between the companies, while acquisitions are often a result of a hostile take-over. The benefits of M&A as a form of market entry are numerous, like the acquisition of already existing distribution channels, customer base, rapid access to the market, established connections etc. As a potential challenge one can mention problems with integrating the acquired unit into the corporate culture especially if the acquisition happened unwillingly and employees have a hostile attitude towards the new parent company.[23]

In case of a greenfield investment one does not have a problem of integrating two different companies. Yet, greenfield investment is a form of market entry that still carries a lot of risk as it takes longer to establish a new factory than to buy one and a start-up usually requires the greatest contribution of resources. We observe start-ups in industries that are characterized by high level of technical expertise as it is often less costly to transfer specific knowledge to a new company than to an acquired one as the latter may have a different method of absorbing and processing knowledge.[24]

Generally, fully owned foreign subsidiary represents a way to keep the company specific competencies internal instead of sharing them with a partner in a joint venture and thus taking a risk of theft of knowledge capital by an unreliable partner who may even turn into a competitor later on. However, it often involves greater cost of entering the market.

[22] Gooderham & Nordhaug, 2003, p.18

[23] Gooderham & Nordhaug, 2003, p.19; Bjorvatn & Kind, 2001, p.4

[24] Gooderham & Nordhaug, 2003, p.19

2.2. Dunning's eclectic paradigm of international production

Economists have tried to explain the existence of FDI for a long time and the last half of the twentieth century has seen the emergence of a number of strains of theories each aiming to explain different aspects of MNE's activities. Some of them took a macro-economic perspective with a focus on countries' involvement in FDI with a main attention to location-specific variables; others drew more on the theory of a firm or the theory of industrial organization. Trade theories and theories of international portfolio capital movements in the 1950s addressed only the location of the international production and not the ownership aspect of it as it was assumed that markets did not have any transaction costs.[25]

The first theory that allowed for market imperfections was put forward by Stephen Hymer in his PhD thesis in 1960. Hymer argued that MNEs must possess some kind of advantages before the domestic firms, specific to the firms, in order to outweigh the disadvantages of operating in an unfamiliar foreign market. Those advantages could be access to raw materials, economies of scale or reduced transaction costs that arise when replacing market transactions by an internal firm transaction.[26]

Among other attempts to explain foreign production one can mention the product life cycle model developed by Vernon, the risk diversification hypothesis put forward by Agmon and Lessard and work of other scholars.[27]However, none of the theories mentioned above could offer a holistic, general approach to explaining the determinants of international production. The first theory that sought to offer one was the Internalization theory. This theory was concerned with why business transactions take place within a firm rather than between firms through market transactions. Firm specific advantages mentioned by Hymer are necessary, but not sufficient condition to engage in FDI. The firm can serve the foreign market through exports or licence a domestic firm to produce. Yet, some firms choose to make use of their advantages themselves. The main hypothesis of the theory is that due to market imperfections firms would prefer internalization of their operations to market transactions.[28]

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[25] Dunning, 1992 , p. 66-68 ; Ivar Bredesen, Associate Professor, Oslo University College, Power Point Presentation of his lecture on FDI. http://home.hio.no/~ivar-br/fag/intecon/FDI%20Krakow%202.ppt

[26] Dunning (1992), p. 69

[27] Dunning (1992), p.70-73

[28] Dunning (1992), p. 75-76

The theory of internalisation was long regarded as the main explanatory tool of foreign production. Yet, some economists suggested that it did not offer a sufficient explanation and it was necessary to integrate location-specific variables in order to offer a more holistic theory of MNE activity.

Such general approach was offered by John H. Dunning in his eclectic paradigm (which was originally called eclectic theory) in 1976 at a Nobel Symposium in Stockholm. Years of work preceded this event starting with his PhD thesis, where Dunning explored the differences in productivity of US and UK manufacturing firms.[29]

The eclectic paradigm has now been the leading explanation of the extent and pattern of multinational production activity for over three decades and "can be used to explain all types of FDI" according to Dunning.[30]It accepts the traditional trade theory and its explanation of distribution of some output. Yet, it builds upon a notion that there are two types of market failures when explaining the ownership of that output and the type of output that requires resources that are not equally accessible to all firms. The presence of market failures is a necessary requirement for the act of FDI to occur, as otherwise in a perfect market participants would use arm's length agreements to organise their activities.

The first type of market failure is a *structural market failure* that refers to entry barriers and other barriers to competition, which are often exogenous to the firm, say as a result of government intervention; or endogenous as firms create entry barriers to exploit monopoly power through scale economies, distribution networks, knowledge advantages etc.[31]However, even in the absence of structural market failure, foreign production would still occur if the costs of market transactions in intermediate product markets are higher than a hierarchy would incur. This second type of market failure is called by Dunning *transactional market failure*. It often occurs because market participants do not possess complete information about the transaction costs or the market does not allow for price discrimination or there is uncertainty about the quality and reliability of supplies etc.[32]As a result of these market imperfections, it is more efficient for an MNE to internalize transactions of intermediate products than to use the market mechanism.

[29] Dunning in Cantwell & Narula (2003), p.25

[30] Dunning (1988), p.9

[31] Dunning (1988), p.44-45; Dunning (1992), p.78; Lorraine Eden in Cantwell & Narula (2003), p.283

[32] Dunning (1988), p.23; Dunning (1992), p.78-79

The major idea of the paradigm is that a firm will engage in FDI when it is able to exploit assets called ownership, internalization and localization advantages. To put it in other words, a firm will start foreign production when it possesses some firm specific advantages over its competitors and finds it in its best interest to make use of these advantages itself rather than to sell the right of their use in the open market; it must also find it economically beneficial to locate at least part of the production in a foreign location rather than at home.[33]

A firm that considers engaging in FDI is positioned at a disadvantage compared to its local competitors at the outset of its operations due to additional costs it is likely to incur in the foreign market. These additional costs may be due to the lack of knowledge of local market conditions; legal, cultural or language differences as well as extra costs of operating at a distance. In order to be able to compete with the indigenous firms, it must possess certain firm specific assets not available to its competitors that offset the above mentioned disadvantages. These firm-specific assets are called *ownership advantages* in Dunning's paradigm. By "assets" Dunning meant assets "capable of generating a future income stream", which refers not only to tangible assets, but intangible assets as well, like managerial skills, brand name, technology, organizational systems etc.[34] These advantages must be easily transferrable within the firm and across national boundaries.

Ownership advantages can be broken into three types:

1) Advantages that has nothing to do with the multinational nature of the firm. These are advantages that come from a possession of assets that any firm can have. Such advantages could be the size of the firm, monopoly power, possession of intangible assets like trademarks, patents, management skills; access to markets or raw materials not available to competitors etc.

2) Advantages which are usually enjoyed by a branch plant of a national enterprise over a new company producing in the same location. While a branch plant can enjoy the benefits of being a part of multinational company in the form of access to cheaper inputs, market knowledge and centralized accounting procedures at very low cost, a new company would have to bear the full cost of establishing its business.

[33] Dunning (1992), p.79; Dunning (1988), p.9-10

[34] Dunning (1992), p.77

3) Advantages that come specifically from multinationality of a company, attributed to its ability to benefit from the differences between economic environments in which the company operates.[35]

Dunning introduced also another distinction between ownership advantages, namely between those that arise as a consequence of the possession of specific assets not available to other companies, and those that arise from the common governance of these assets, like, for example, the ability to communicate effectively within the firm and coordinate its activities across the national boundaries, yielding certain transactional benefits. The former group was called the asset advantages and the latter the transaction advantages.[36]

Assuming the enterprise possesses the above mentioned advantages, in order to engage in foreign production, it must be more beneficial to the enterprise possessing these advantages to use them itself rather than to sell or lease them to foreign firms. These advantages of hierarchical control are called by Dunning *internalization advantages*. These are advantages that arise as a result of the above mentioned market failures, structural and transactional, that make it more attractive for a firm to internalize its value-added chain rather than engage in market transactions, like selling or licensing their use. According to Dunning, it is also important that an enterprise is of sufficient size and scope to make use of these advantages.[37]

Some MNEs seek and enjoy the benefits of different locations when setting up their operations. These benefits may arise from location specific assets available to all firms. Whenever a foreign firm finds it more profitable to exploit these benefits abroad instead of its home country, we witness the act of FDI taking place as opposed to trade. These location specific assets, which Dunning calls *location advantages* may be factor endowments or markets available in that particular location, or government policies and investment regime, making this location more attractive than others.[38]

Hence, the main proposition of the paradigm is that the more ownership advantages over its competitors an enterprise possesses, the more profitable it finds it to internalize their use

[35] Dunning (1981), p.27; Lorraine Eden in Cantwell & Narula (2003), p.281; Dunning (1988), p.42

[36] Dunning (1988), p.42

[37] Dunning (1988), p.23; Dunning (1992), p.79

[38] Dunning (1992), p.76-81

rather than use the market and the more attractive a foreign location is to use the above mentioned advantages, the more likely is the enterprise to engage in foreign based production.

To put it in another way a country is likely to attract FDI when the following conditions are satisfied: foreign enterprises possess ownership advantages over local firms, when the extent and nature of market imperfections make it more beneficial for those foreign enterprises to internalize their activities rather than to sell them to the local companies and when the host economy offers better conditions for investment than other countries.

It is necessary to mention that these three set of advantages are dynamic in nature and the attractiveness of a country as an FDI destination can change when the ownership advantages of its/foreign enterprises' change relative to each other, when the attractiveness of its location assets relative to those of other countries' change, and when the perceptions of foreign firms regarding the extent to which the use of these location assets are best organized internally rather than by the market change. For example, the improvement in the location specific advantages of a country may also help local firms to develop their own ownership advantages, thus diminishing the importance of the ownership advantages of foreign firms.

2.3. Country determinants of FDI: natural assets and government induced advantages

The satisfaction of the above mentioned conditions is however a function of a set of factors which can be influenced by the authorities and which are outside of their control.

The former represent a great variety of measures that can be undertaken by the authorities with an aim of attracting foreign investors' interest. Some of those measures are proved to be effective and the usefulness of others is open to doubt. The detailed analysis of a number of such measures will follow below.

The latter are natural assets, like geographical location, resource availability, population size and other variables that are to a large extent outside of the government control. They too determine the attractiveness of a country as an investment target.

2.3.1. Natural assets

The availability of abundant n*atural resources* is an important basis for resource seeking FDI. According to the World Investment Prospects Survey 2009-2011 conducted by UNCTAD between February and May 2009, access to natural resources was found to be the most important location factor for companies in the primary sector and some commodity

intensive manufacturing activities.[39] This result is, not surprisingly, consistent with the result of the previous survey, conducted a year earlier.[40]

Natural asset in the form of abundant, well-qualified and cheap *labour force* is also very important for resource and efficiency seeking FDI. Availability and price of labour determines where this kind of FDI flows. But it is also the skills of the human capital that are of great value to MNEs.[41] In fact, the latter appears to be even more important to potential investors than cheap labour, as the World Investment Prospects Survey 2009-2011 can report. Location factor *cheap labour* scored less in the importance hierarchy than the *availability of skilled labour and talents*.[42] It is important to consider both the cost and the quality of labour as foreign investors are interested in the most optimal combination of the two. In this context it is important to note that the skills of human capital are a direct consequence of the educational infrastructure in the country which in turn is a subject to the government influence.

Geographical location of the host economy is of major importance as well as most of economic activity including FDI is determined by a "gravity" relationship which makes the amount of FDI flows into a country a direct function of a number of factors like the distance between the host and home economies, cultural proximity (which often results from the geographical proximity), the fact that two countries share a common border or language.[43]

Another aspect of geographical location is that it may favour access to major markets offering low transportation costs to other important locations in the proximity of the host country.[44]

The size of the market is important for horizontal market seeking FDI. Most FDI flows towards large markets. As investing in production facilities implies large fixed costs, MNEs are willing to invest if the potential sales are large enough to at least cover the fixed cost of the investment. Market size can be measured by the size of the GDP and income per capita as

[39] World Investment Prospects Survey 2009-2011, p.44

[40] World Investment Prospects Survey 2008-2010, p.39

[41] Navaretti & Venables (2006), p.140

[42] World Investments Prospects Survey 2009-2011, p.44

[43] Navaretti & Venables (2006), p.135

[44] Bjorvatn & Kind (2001), p. 20

the latter gives an estimate of the purchasing power of the population. Like the availability of the educated work force, market size depends to a large extent on the actions of the government as it is the economic policy of the state that affects the income available to the population. Yet, I choose to place *market size* into the category of the factors outside of the authorities control as changing the market size through the economic policies is a long process that is not easy to control in the short run.

Market size is found to be a fundamental factor in attracting MNEs in a number of empirical studies. Studies by Markusen and Maskus found a large elasticity between the affiliate sales destined to the local market and the host country's GDP.[45] There are other studies that support a positive correlation between FDI inflows and gross domestic product, for example by Daniels and Quigley, who found this to be a very important variable in explaining FDI flows to Latin American countries.[46]Market access can be good because the country itself has a large high-income population, or because the country is well-located to access to such markets. The importance of large markets is also reflected in a number of international surveys. In the World Investment Prospects Survey 2009-2011 *size of local market* was determined by the respondents as the most important location criterion, especially for companies involved in manufacturing and services sectors. Along with this criterion, *growth of market* and *access to international/regional markets* were on the top of the list of factors that determine investors' choices. Potential of the market, reflected in the former is more typical for developing and transition economies and size of the market is more typical for the developed ones.[47]

2.3.2 Government induced advantages

The authorities actions or inactions can and do affect FDI flows. These measures may specifically target FDI creating favourable investment regime or they may be of more general type, affecting however, location's attractiveness to foreign investors. The number of factors that can and do attract foreign investors and are at the same time under the control of the authorities is numerous. I choose to investigate the following: political and social stability, the functioning of the legal system, social and physical infrastructure, bureaucracy and

[45] Navaretti & Venables (2006), p. 141; Navaretti & Vanables (2006), p. 33

[46] Franklin Mixon, Jr., Dharmendra Dhakal & Kamal Upadhyaya (2007), p.2

[47] World Investment Prospects Survey 2009-2011, p. 44, 56

corruption, the degree of government intervention and regulation of the economy, macroeconomic environment.

Political and social stability

Political instability and volatile social situation with unpredictable outcomes represent a great risk for foreign investors. Countries where attitudes towards foreign ownership can change without warning and there is a possibility of nationalization of a firm's foreign assets are not very likely to be chosen by foreign investors.

Geopolitical risks like wars and political instability are generally perceived as very damaging with regard to companies' decision to invest abroad as reported by the latest World Investment Prospects Survey 2009-2011, yet quite unlikely to occur in the short term.[48] Having said this, it needs to be mentioned that according to the World Investment Prospects Survey 2008-2010 issued a year earlier, the geopolitical risks were considered to be the greatest risk for companies' investments in the medium turn with 43 percent of respondents considered geopolitical risks as "very important". Companies were also concerned with such issues as the threats to personal and business safety, related to the social stability.[49]

One might wonder whether the type of regime has an impact on FDI flows. Michael L. Hess in his paper "Foreign Direct Investment and Political Stability: Why Investors Like Democracy…and Stable Autocratic States" has conducted a study analyzing this issue and interestingly reached a conclusion that autocratic regimes can be just as attractive to FDI as democratic ones as long as they provide a certain stability.[50]Political instability is a strong deterrent to FDI for both democracies and autocracies alike.

Legal system

A well functioning legal system that protects the property rights of the investors is definitely a significant location advantage. The issue of intellectual property rights protection is especially pronounced in the developing countries. The unreliable legal system with non-transparent dispute-settling mechanisms that are often bias towards foreign investors is most likely to discourage investors from that particular location. Yet, the effect of a poor

[48] World Investment Prospects Survey 2009-2011, p. 14

[49] World Investment Prospects Survey 2009-2011, p. 18

[50] Michael L. Hess (2004)

enforcement of the rule of law can be twofold. On the one hand it can be a deterrent for FDI, but on the other, it can in fact lead to an increase in FDI inflows as foreign investors will not be in a position to rely on the fulfilment of contracts with the local subcontractors and will choose to internalize their activities instead.

Bureaucracy and corruption

Extensive and ineffective bureaucracy apparatus that leads to a slow moving decision process impedes business operations acting like a deterrent to FDI. The situation is worsened if bureaucracy is crippled by corruption. The issue of corruption is old. Some people might argue that corruption has utilitarian consequences, helping to overcome structural problems in developing economies. Yet, the dominant view of corruption by the international community is that it is damaging to the economy and society and distorts the economic development in the long run. Indeed, the ramifications and extent of bribery and corruption are stunning. As the Global Corruption Report 2009 published by Transparency International shows, the corrupt practices of politicians and government officials cost the developing and transition economies between twenty and forty billion USD annually. Two out of five respondents in the survey by Transparency International have been asked to pay a bribe when dealing with public institutions. Corruption raises project costs by estimated ten percent.[51]

Governmental intervention

Government can and do intervene into the economy pursuing various objectives. Government regulations can have tremendous effect on the way the economy functions, on profitability of business operations and consequently on the probability of investment projects to be undertaken by foreign investors. Government regulations concern labour and product markets, competition rules, profit remittance procedures, import restrictions, taxes, quotas, tariffs etc.

Wage rates are an important component of production cost. Countries' authorities can affect the profitability of the investment project by setting up regulations regarding a minimal wage in the country. This is especially important for labour intensive vertical investments seeking cost saving production processes abroad.

Intermediate products often have to be imported to the host country. Transport costs of intermediate and final products are to a large extent affected by the government regulations

[51] Global Corruption Report 2009, p.xxv

through different types of trade barriers. Import tariffs and export duties are examples of such barriers. These sorts of barriers encourage horizontal market seeking FDI as a way of circumventing them, often called tariff jumping. Tariffs make vertical FDI less attractive as this type of FDI means that both intermediate and final products have to cross national boundaries.

Financial regulations governing financial markets in the host country are also of the utmost importance for an FDI project as they impact the cost and risk of obtaining financial support for the project.

All governments require taxes as a source of budget revenues. At the same time, the level of tax burden and the design of tax policy, directly influence business costs and returns on investment. It has been shown in some empirical studies that the location of FDI is indeed influenced by tax policies. Hines for example finds that an elasticity of – 0.6 of FDI to taxes is quite common.[52]It is important to mention that it is not just the average corporate tax rates that have impact on investment, but also the design of the tax policy that can affect MNEs ability to shift profits by transfer pricing that is of major importance.

Governments also often design specific policies that target FDI, creating regulations that either attract FDI or limit it in some areas. Needless to say, these sorts of FDI regulations have a significant impact on the investment attractiveness of a location.

Macroeconomic stability

Even though FDI is less sensitive to short-term adverse situations than portfolio investments, as the current economic downturn has shown us, FDI is indeed dependent on stable macroeconomic environment. Macroeconomic environment can be characterized by such indicators as inflation, exchange rate, external debt and others.

Appreciation of the real exchange rate of the host country's currency against the home country's currency leads to increased cost of labour and capital in the host country, acting as a deterrent to FDI. The opposite effect of currency devaluation of the host economy increases FDI inflows as production inputs and assets become cheaper to foreign investors whose capital is in foreign currency. There are a number of empirical studies that show that the relative exchange rate is an important determinant of FDI flows. For example, the one conducted by Xing and Wan, where the Japanese FDI in Asian manufacturing is investigated

[52] Navaretti & Venables (2006), p.34

with regards to fluctuations in exchange rates.[53]Other studies argue that exchange rates volatility is detrimental to FDI, even if the volatility leads to the weakness of the host country's currency.[54]The adverse effect of exchange rate fluctuations is also expressed in the World Investment Prospects Survey 2009-2011, which reports that MNEs are "especially concerned" about the probability of large exchange rates fluctuations.[55]As a way to deal with exchange rates volatility, MNEs often use hedging mechanisms to reduce their risks.

High inflation erodes investors' confidence that leads to the reduction of FDI inflows. In case of high inflation the relative costs of production rise, making export from the host country less profitable for export oriented FDI. This has been supported in a study by Schneider and Frey who found that MNEs find countries with high inflation less attractive investment targets.[56]Deflation, however, can lead to loss of profitability and even bankruptcy of the domestic enterprises, making their assets a target for foreign investors.[57]

Infrastructure

Efficient infrastructure is essential for economic development and integration into the world economy. It is also an important factor in determining the location of economic activity including FDI. Well-developed infrastructure can reduce distance related costs in the economy, bringing together economic agents in distant markets. Infrastructure helps to allocate production factors in an efficient way, reducing costs of operating in a country. There are different types of infrastructure. It can be physical, related to communication, like roads, railroads, air transport, which helps entrepreneurs to get their goods to the market. But infrastructure can also be social, related to health and education levels of human capital. Financial infrastructure related to the degree of efficiency and development of country's financial institutions is no less important. Well-functioning financial institutions allocate resources to their most productive use, providing foreign investors with additional ways of obtaining capital.

[53] Xing and Wan (2006)

[54] Agnès Bénassy-Quéré, Lionel Fontagné, Amina Lahrèche-Révil (1999)

[55] World Investment Prospects Survey 2009-2011, p.13

[56] Schneider and Frey quoted in Franklin Mixon, Jr., Dharmendra Dhakal & Kamal Upadhyaya (2007), p.2

[57] Ivohasina Razafimahefa & Shigeyuki Hamori (2005), p. 2

Quality of infrastructure is identified by respondents of the World Investment Prospects Survey 2008-2010 as middle important for all the sectors of the economy, more important than, for example, cheap labour or the government incentives.[58]

[58] World Investment Prospects Survey 2008-2010, p.44

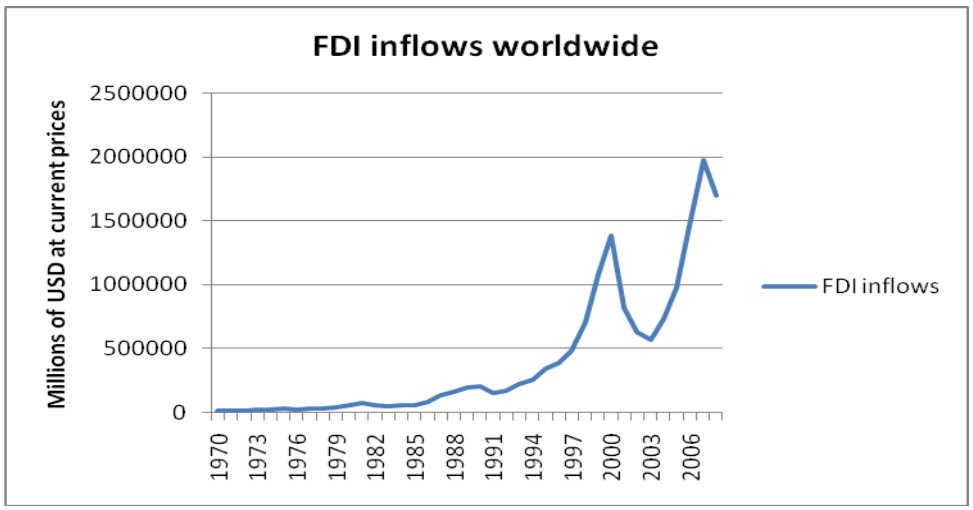
3. FDI flows into Russia and China

This section presents basic facts and latest trends of the FDI flows worldwide as well as specifically in China and Russia.

3.1 FDI on the world basis

As processes of globalization and integration were picking up pace in the second half of the twentieth century, FDI flows were accelerating along. In fact, FDI flows were increasing at a much higher rate than trade and GDP, becoming one of the main vehicles of globalization in the world economy.[59]Between 1985 and 1999 FDI inflows worldwide increased by 17.7 percent per year, while real GDP increased by 2.5 percent and exports by 5.6 percent.[60] For instance, in 1970, the first year when UNCTAD reported FDI flows in its FDI database, the figure was a modest 13 billion USD[61]. In 2007 FDI flows reached their highest level yet of 1.979 billion USD.[62] As one can see from the figure below, FDI growth has been impressive with few setbacks along the way.

Figure 2: FDI inflows worldwide, millions of USD at current prices.



Source: UNCTAD FDI Database

After a record high level in 2007, the world saw a 14 percent decrease of MNEs activities in 2008 to 1.697 billion USD in FDI flows following the worst economic crisis since

[59] Navaretti & Venables (2006), p.3

[60] Navaretti & Venables (2006), p.3

[61] UNCTAD FDI database

[62] World Investment Report (2009), UNCTAD

the Great Depression.[63] The global economic downturn affected different parts of the world in an uneven manner, hitting hard the developed countries first, reducing FDI inflows to this part of the world with 29 percent in 2008, mostly due to the falling cross-border M&A activity. It all started with the subprime crisis in the United States in summer 2007 that progressively led to the deterioration of the investment climate, reducing FDI flows to and from the developed countries in the beginning of 2008, compared to the corresponding period in 2007. The crisis gained speed in autumn 2008 following the collapse of major financial institutions in the US and together with the ensuing economic recession in major developed countries depressed FDI flows even further. The crisis reduced FDI inflows by reducing companies' capacity to invest due to lack of finance because of tighter credit conditions and reduced corporate profits. It also affected companies' propensity to invest as many companies became more risk-averse in these uncertain times and expected the worst yet to come.[64]

Developing and transition economies were not affected in the beginning, supported by high commodity prices and less close ties with the financial institutions of the developed countries, resulting in a growth of FDI inflows of 17 percent and 26 percent for developing and transition economies respectively.[65]But the global financial downturn caught up with the developing world in the end of 2008 and the beginning of 2009 following the reduced demand from major export markets. FDI flows to both developed and developing economies are expected to have fallen significantly in 2009. According to the preliminary data from UNCTAD FDI inflows in the first quarter of 2009 were down by 44 percent compared to the corresponding period in 2008. UNCTAD expects FDI flows to recover slowly in 2010, taking off again in 2011.[66]

Most of FDI flows go to the developed countries as these countries represent large markets, which is an important determinant of FDI. The share of the developed ones has been rising following the Asian crisis[67] and has reached 43 percent of the total volume in 2008 giving a significant reduction of FDI flows to the developed world in the aftermath of the

[63] World Investment Report 2009, p.3, UNCTAD; Assessing the impact of the current financial and economic crisis on global FDI flows, UNCTAD, 2009

[64] World Investment Report 2009, p.3-7, UNCTAD

[65] Assessing the impact of the current economic crisis on global FDI flows, UNCTAD, 2009, p.3-5; World Investment Report 2009, p. 3-15, UNCTAD

[66] World Investment Report 2009, p.3 UNCTAD

[67] Navaretti & Venables (2006), p.9

global economic crisis.[68]The United States remains the largest host of FDI in the world in 2008, with China being third and Russia taking the fifth position.[69]

When it comes to the mode of FDI, mergers and acquisitions account for the dominant share of FDI, even though, not unexpectedly, share of M&A is larger when it comes to the developed countries. Greenfield investment is more common for the developing economies reflecting a lack of takeover targets in that part of the world. This is confirmed by the World Investments Prospects Survey 2009-2011, which found that M&A are the most favoured mode of entry into developed countries, whereas greenfield investments are commonly used for entering developing economies.[70]

Both modes of investment were affected differently by the ongoing crisis. The decline in the value of M&A, which proved to be less resilient than greenfield investments to the crisis, has been driven by falling stock prices and increased cost of debt financing of M&A transactions. Greenfield investments were on the rise for the most of 2008, buy starting from September 2008 many MNEs announced the cancellation of their investment projects.[71]

If we look at the distribution of FDI inwards stocks in 2007, the share of services was 63 percent, that of manufacturing was 27 percent and the primary sector accounted for the remaining share of 7 percent.[72]It is important to note, however, that even though the services sector still accounts today for the largest share of global FDI flows, the primary sector has seen a relative increase of FDI inflows in recent years while the share of manufacturing has been in decline.[73]

Given the unusual magnitude of the crisis it is not easy to predict the exact impact it will have on FDI flows. One thing is certain – FDI flows are in decline and will continue to follow this trend in the short term. Medium-term FDI prospects are brighter as sooner or later new investment opportunities in the form of cheap assets and industry restructuring will turn up. This is also confirmed by in the World Investments Prospects Survey 2009-2011 which

[68] World Investment Report 2009, p.3-7, UNCTAD

[69] UNCTAD FDI database

[70] World Investments Prospects Survey 2009-2011

[71] World Investment Report 2009, p.11-12, UNCTAD

[72] UNCTAD FDI database

[73] World Economic Situation and Prospects, 2009, p.68, UNCTAD

reports that MNE respondents are quite optimistic with regard to the global business environment for 2011 and intend to resume their FDI projects moderately already in 2010, gaining speed in 2011. For example, half of MNE respondents expect to increase their FDI expenditures to a higher level in 2011 than in 2008.[74]

3.2 Russia

The opening of Russian economy started after 1985 when the president of the Soviet Union at the time, Mikhail Gorbachev, initiated reforms that would push the country towards liberalization and greater openness. The first FDI flows started to come to the country after the Law on Joint Ventures with Firms from Capitalist Countries was passed, that allowed the establishing of joint ventures with foreign partners. In 1991 the establishment of wholly-owned subsidiaries was allowed.[75]

With its large population, educated workforce and enormous natural resources Russia appeared to be an attractive target for foreign investors. However, Russian performance with regards to FDI inflows turned out rather disappointing in the beginning coinciding with the poor development of the Russian economy in general. From UNCTAD FDI database we can see that Russia attracted on average just above 2 billion USD per year during the 1990s.[76] For comparison the Chinese FDI inflows during this period constituted around 30 billion USD per annum. Inward FDI stock in Russia in 2000 was only US 32.2 billion while China's inward FDI stock in 2000 was US 193 billion.[77]The reasons for this weak performance will be explored in later chapters.

Things started to turn around in the beginning of the 2000s when under the presidency of Vladimir Putin Russian economy began to recover following the adoption of market oriented reforms and the apparent strive of the government to open the economy to foreign investors even more. FDI inflows to Russia doubled from 2002 to 2003.[78]

In the following years Putin's drive to strengthen the government control of the Russian economy and his power struggle with the oligarchs culminated in the arrest of the owner of a

[74] World Investments Prospects Survey 2009-2011, p.3

[75] Yudaeva K., Melentieva N., Ponomareva N. (2000), p.6

[76] UNCTAD FDI database

[77] UNCTAD FDI database

[78] UNCTAD database

giant oil company Yukos on tax evasion charges. These events delivered a hard hit to the investors' confidence resulting in the drop of FDI inflows in 2005 compared to 2004. This is also reflected in A.T. Kearney's FDI Confidence index 2005 as Russia felt from the eighth to the eleventh position as the most attractive destination for FDI.[79]

However, already 2006 saw a sharp increase in FDI inflows to 29.7 billion USD with Russia taking the 6th position in the above mentioned index. Large investments were made into the petroleum and gas extraction sectors as well as manufacturing and retail sectors.[80]

In the following years FDI inflows to Russia were increasing at a fast rate reaching the all time high in 2008 of 72.8 billion USD[81], thus becoming the fifth largest FDI host that year (with China ranking third with 108 billion USD) and the second among the emerging markets.[82] The stock of FDI which measures the value of accumulated FDI in the country in 2008 amounted to 213.7 billion USD (China had 378 billion USD). In relative terms, *i.e.* FDI per head and as a share of domestic investment, Russia even managed to outperform China in 2006. However, the degree of FDI penetration, measured by the ratio of FDI inward stock to GDP, remained still lower in 2006 in Russia (9.5) than in China (25.7).[83]

Year 2008 has been quite controversial with regards to the effect of the world financial crisis on FDI flows to the emerging markets. As mentioned before, the impact of the global economic downturn became noticeable in the developing countries only in the end of the year. For instance, in the first three quarters of 2008 FDI inflows to Russia increased by around 60 percent compared to the same period in 2007, driven by restructuring and liberalization of power generation industry, high oil prices as well as investments in the automotive and real estate industries. However, the last quarter of 2008 saw a decrease of 30 percent in FDI inflows compared to the last quarter of 2007, as the economic slowdown hit Russia hard, reducing demand, oil prices and access to capital. According to the Central Bank of Russia,

[79] A.T.Kearney FDI Confidence Index 2004

[80] A.T.Kearney FDI Confidence Index 2005, p.20

[81] The Central Bank of Russia, balance of payments, www.cbr.ru

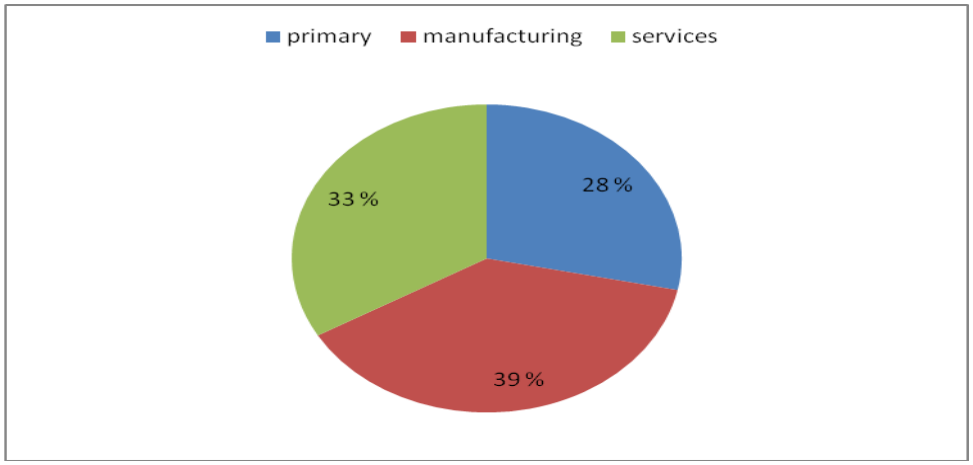
[82] World Investment Report 2008

[83] OECD Investment Policy Reviews Russia, 2008, p.17-18

FDI inflows in the first half of 2009 reached the amount of only 19.2 billion USD compared to 43.7 billion USD in the first half of 2008.[84]

Inward investment in Russia is concentrated in all sectors of the economy. The decomposition is shown in the figure below.

Figure 3: Sector decomposition of FDI stock in Russia in 2007



Source: The Federal Service of State Statistics. www.gks.ru

Primary sector, represented by mining and quarrying in oil and gas industries takes a prominent position in the FDI decomposition. In fact, FDI inflows into this sector comprised around 40 percent of all inflows to Russia between 2004 and 2007.[85] Share of agriculture as part of the primary sector is miniscule accounting for less of one percent of all FDI stock in 2007.

Manufacturing is mainly represented by manufacturing of basic metals which comprises roughly half of all FDI cumulative stock into the sector.

Tertiary sector is represented mostly by real estate and trade, which correspondingly take 11 percent and 8 percent of FDI stock in the Russian economy.[86]Financial services' share in FDI flows has been quite volatile, increasing from 3.7 percent of FDI inflows in 2004 to 10 percent in 2006 and dropping to 6.3 percent in 2008.[87]

[84] My Calculations based on data from the balance of payments of the Central bank of Russia, www.cbr.ru

[85] My calculations based on the Federal Service of State Statistics data, www.gks.ru

[86] Federal Service of State Statistics

[87] My calculations based on the Federal Service of State Statistics data, www.gks.ru

Russia's FDI flows come from a limited number of partners: in 2007, two of the largest investors, Netherland and Cyprus were responsible for 47 percent and 21percent of FDI inflows respectively. For comparison, in 2000 the largest investor to Russia was the United States with 30 percent share.[88]

Most of the capital coming from the largest investment source countries to Russia is actually Russian capital returning home, seeking to avoid domestic regulatory restrictions, representing round-tripping flows. Particularly, the surge of FDI from countries like the Netherlands, Cyprus, Virgin Islands, and Luxembourg started in the beginning of 2000's when relative stability in Russia prompted many Russians to invest their capital in their home country. On the other side, it shows again that the amount of truly *foreign* direct investment is even lower than the official statistics would suggest. Apart from obviously round-tripping inflows, Russia is most popular among European investors like Germany, France and the UK.[89]

In a paper "Where has all the investment gone in Russia?" for the World Bank in 2001 it was stated that over half of the investment that Russia attracted in 2001 went to four regions in the western part of the country. These regions accounted for only 22 percent of Russia's gross national product and only 13 percent of Russia's population.[90] The observed regional variation in FDI flows in Russia was attributed by the authors of the article to market size, infrastructure development and the policy environment. As it turns out, the situation has only changed to the worst since then. Today, investments are strongly concentrated in Moscow city, which is the first destination for FDI in Russia attracting 56 percent of all FDI inflows in 2007, followed by Sakhalin, which is an area in Russian Far East rich in oil and gas (13.6 percent of FDI) and the Moscow region that attracted 7.5 percent of FDI in 2007.[91] Notwithstanding the attractiveness of Moscow as a FDI destination, a share of the recorded FDI flows to the city probably reflects the location of the headquarters of most foreign companies. It is however important to notice that Moscow traditionally has been the most important city in Russia in different respects as most of economic activity was required to go through the city in one way or another.

[88] The Federal Service of State Statistics

[89] The Federal Service of State Statistics

[90] Broadman and Recanatini, 2001

[91] The Federal Service of State Statistics

3.3 China

Foreign direct investment has been one of the most significant features of China's economic development and integration with the world economy. For the last three decades, China has gradually liberalised its FDI policy regime, reduced restrictions and barriers to FDI, and improved the overall investment environment. With its potentially huge and fast-growing domestic markets, relatively well educated population and low-cost labour force, China has become one of the most attractive destinations for FDI in the world. In fact, China has topped the list of most attractive host economies for FDI since 2002 according to the responses by foreign investors in FDI Confidence Index reports issued by A.T.Kearney. In comparison, Russia went down to the ninth position in the latest 2007 report from the all time high in 2005, when it occupied the sixth place.[92]

China opened its economy to foreign investors in 1979 when the first "special economic zones" were established along the coast in South-East of the country. Gradually these zones were expanded to include more coastal cities and regions. Foreign investors enjoyed special tax treatments as well as simplified regulations regarding permits, licenses etc in this area. The expansion of economic zones where foreign capital was allowed was happening gradually by principal adopted by the Chinese authorities of "crossing the river by feeling the stones". This way the Communist Party could evaluate the success of the market reforms and potential costs of failed projects could be contained.[93]

Despite this cautious strategy China made a tremendous progress in attracting FDI. During the first nine years of open-door policy, China's foreign investment reached about 17 billion USD whereas FDI in Russia after the same period of time since its opening to FDI was only around 8 billion USD.[94]Already in 1995 China became the second largest recipient of FDI in the world.[95]

Foreign investors set up a lot of export-oriented manufacturing facilities in the open economic zones, primarily in the provinces of Guangdong and Shanghai. In the 1980s most of foreign capital, primarily from Hong Kong and Taiwan, went to labour-intensive low-wage

[92] A.T.Kearney FDI Confidence Index 2002-2007

[93] Wang (1995), p.33-50

[94] UNCTAD FDI database

[95] Tse & Pan & Au, (1997)

industries like clothing, textiles, foodstuffs processing. However, as western investors grew more confident, the 1990s saw more high value-added and large-scale projects involving advanced technology initiated by the world largest MNEs.[96]

As World Investment Report 2009 showed, China attracted a record high 108 billion USD in 2008, becoming the third largest host economy that year and the first one among the emerging markets. The end of 2008, however, saw a decrease of FDI inflows to China as the global economic downturn finally caught up with the developing countries. In 2009 FDI is expected to continue to fall in China along with the rest of the world. In fact, China received 21.7 billion USD in the first quarter of 2009 compared to 27.4 billion USD in the first quarter of 2008.[97]

Despite the crisis, the World Investment Prospects Survey 2009-2011 respondents still ranked China as the most attractive location for FDI and medium and long-term prospects of FDI to China remain promising.[98]

In the beginning of China's economic reforms foreign investors were often kept out from the Chinese market through various regulations by the authorities, investing mostly in export oriented manufacturing. However, the situation gradually changed as the Chinese government is keen to attract more high-tech quality foreign investment to service and explore the huge market potential of the country and also complying with the requirements of WTO accession of 2001.[99]This is confirmed by the World Investment Report 2008 that states that inflows to China increasingly targeted services, high-tech industries and high value-added activities. For example, the cumulative number of foreign-invested R&D centres in China exceeded 1200 in 2008, up from 700 in 2004; the number of MNE regional headquarters in Beijing and Shanghai alone reached more than 220 in 2007.[100] This trend shows that MNEs view China not only as a low cost production zone, but as a large and competitive market.

[96] Wang (1995), p.115

[97] World Investment Report 2009, p.51, UNCTAD. (Data excludes the financial industry)

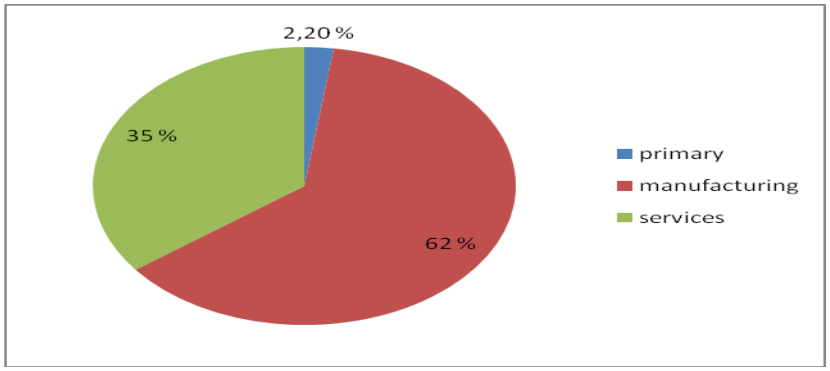
[98] World Investment Prospects Survey 2009-2011

[99] OECD Investment Policy Reviews China, 2008, p.38

[100] Word Investment Report 2008

Sector composition of FDI in China is heavily skewed towards the manufacturing sector. It is illustrated below.

Figure 4: Sector composition of FDI stock in China in 2007



Source: Ministry of Commerce, www.fdi.gov.cn

Primary sector plays a far less important role in FDI composition in China, in stark contrast to Russia. Agriculture attracts more or less the same insignificant amount of FDI, around two percent of all FDI.[101]However, mining takes about 0.43 percent of FDI stock in China in 2007, whereas in Russia it is 28 percent. Primary sector has been quite restricted to foreign investors despite its early formal opening. With WTO accession one expects that FDI flows to the primary sector will increase as China removes some of the restrictions on foreign capital in this sector.

Manufacturing, however, stands for the lion share of accumulated FDI, representing the importance of this sector to foreign investors as well as its general role in the Chinese economy. Its share is 62 percent of accumulated FDI in 2007 compared to 39 percent in Russia the same year. Manufacturing also receives the most of FDI inflows in recent years, yet its share has fluctuated a great deal during the last 30 years. For example, during 1984 to 1986 share of manufacturing in FDI inflows declined to around 30 percent, reaching 80 percent between 1989 and 1991. Within the sector, labour-intensive industries stand for 41 percent of FDI between 1983 and 1999, while capital-intensive industries and technology-intensive industries stood for 25 and 33 percent respectively.[102]

The service sector accounted for 35 percent of FDI stock in 2007, quite equal to the share of this sector in FDI stock in Russia. Real estate segment represents almost half of FDI stock

[101] Ministry of Commerce, www.fdi.gov.cn

[102] OECD (2002), p.350

within the sector, or 16.5 percent of all FDI stock in the Chinese economy in that particular year.[103]The services sector has been quite closed to foreign investors and is the last one to open up to FDI. This sector has a great potential as it is being gradually liberalized following the implementation of Chinese commitments to WTO.

The largest source of FDI to China is Hong Kong, although it is difficult to assess how much of FDI actually originates in Hong Kong and how much just passes through originating in the western countries which use Hong Kong as a convenient and reliable base for operations in China. There is a great deal of round tripping Chinese capital coming via Hong Kong as well to rip the tax benefits provided to foreign capital. The Chinese authorities are working on the removal of incentives for round tripping FDI by, among other measures introducing a unified business tax rate which I will discuss in later chapters. As a result, the proportion of FDI coming from Hong Kong has been in decline from as much as almost 70 percent in 1987 to 33 percent in 2007.[104]When it comes to the accumulated stock of FDI, as of 2007, 39 percent of it originated in Hong Kong, 9 percent in Virgin Islands, around 8 percent in Japan and the USA each. Ten Asian countries stood for 50 percent of all FDI inflows to China in 2007, reflecting the appeal the country holds among Asian investors.[105] As mentioned above, China, like Russia, has a problem of round tripping FDI, which does not allow to estimate accurately the true amount of foreign direct capital entering the country.

OECD report on FDI to China "Challenges and Prospects for Regional Development" issued in 2002 reported about a very uneven FDI distribution that in many respects reflected the uneven economic development of the country. For instance, the same report says that the eastern coastal region of China, where the first open economic zones were established, accounted for 88 percent of total FDI between 1978 and 1999, while the central region attracted only 9 percent, "without any significant catching up by the central and western regions".[106] This is confirmed by the World Investment Report 2009 that says that four-fifths of the accumulated inflows by the end of 2008 were located in the eastern region.[107]Yet, the

[103] Ministry of Commerce, www.fdi.gov.cn

[104] Ministry of Commerce, www.fdi.gov.cn

[105] Ministry of Commerce, www.fdi.gov.cn

[106] OECD 2002, p.17

[107] World Investment Report 2009, p.52

vast territories inside the country are endowed with great potential to foreign investors like cheap labour, land, minerals, livestock etc.

Some steps to develop this potential have already been taken by the Chinese authorities, like the implementation of "the Great Western Development" programme by the central government. As a result, more and more MNEs choose to locate their production facilities in the western and central parts of the country. The World Investment Report 2009 could report that the growth rates of FDI in this area have been even higher than in the eastern region.[108] In addition, wages in the coastal regions have been going up, making investors look for cheaper labour in the western parts of the country that can now also offer much better infrastructure facilities than before.

Regarding form of FDI, wholly-owned enterprises dominate the picture, raising their share from 60 percent of inflow value in 2002 to 70 percent in 2007. The share of joint ventures which predominated in the 1980s and 1990s has subsequently continued to contract.[109]This is also confirmed by A.T.Kearney FDI confidence index 2007 report. With improvement and maturing of the business environment, foreign investors, who have now gained long experience of operating in China, have become less dependent on local partners.[110]

[108] World Investment Report 2009, p.52

[109] Ministry of Commerce, www.fdi.gov.cn

[110] A.T.Kearney FDI confidence index 2007

4. Analysis of FDI determinants

This section will analyze in detail the set of factors outlined in section 2.3. These factors determine the attractiveness of a location to FDI and comparing these FDI determinants in China and Russia will hopefully offer an answer to the main question of the paper. The number of potential factors that can have an impact on FDI in any given country is large. For this paper I have chosen a number of determinants that either have been empirically proven to have an effect on FDI or rest on solid theoretical foundations. Yet, it is perfectly clear that this sample of determinants alone cannot offer a complete explanation. Another important aspect of the comparison of FDI determinants is the fact that I had to rely mostly on the results of public opinion surveys which offer the perceptions of the respondents rather than objective and solid facts. However, when possible, other sources of information have been used to support or undermine the results of the surveys.

The FDI determinants analyzed in this paper can explain not only the amount of FDI inflows, but they also impact the sector distribution of FDI in both countries as will be shown below.

Another thing to note is that the separation of the determinants in two groups according to the degree they are affected by the government actions is very relative. Those factors that are to a large degree outside of the authorities' control are referred to as natural assets. Among those factors are natural resources, labour force, the geographical position of the country as well as the market size and its growth. However, some of these factors can be changed by the authorities in the long run. The size of the market can be changed through the economic development of the country, its growth rate can be affected by the economic policy of the government, the size and quality of the workforce are subject to the demographic, immigration and education policies of the authorities, the abundance of natural resources can be changed by the extensiveness of their extraction, which is within the control of the government.

4.1 Natural assets

4.1.1 Natural resources

As mentioned in section 3.2 the primary sector, first and foremost extraction of natural resources, attracts almost third of all FDI in Russia, which is an indication of attractiveness of the country to resource seeking FDI. This is not surprising as Russia is one of the richest

countries in the world in raw materials. It is important to mention that almost all FDI (93 percent) in the primary sector is concentrated in the extraction of gas and oil resources and extraction of other raw materials receives very little FDI.[111]

FDI in China, on the other hand, is not as concentrated in the resource extraction sector as in Russia, with only 2 percent in the primary sector. Yet, China possesses very large reserves of natural resources, extraction of which is yet to increase through participation of foreign investors.

According to the latest data from the Energy Information Administration, which is the statistical agency of the U.S. department of energy, Russia is the second largest oil producer in the world, extracting about one-fifth of the global total in 2008 and the world largest producer of natural gas, responsible for more than one-fourth of the world's total natural gas output the same year. It is also the world's second largest oil exporter and the largest natural gas exporter in the world.[112] Extensive pipeline networks connect production sites, which are mainly located in the West Siberia to all regions of the country, as well as neighbouring states and large consumer markets in Europe.

China is the fifth largest oil producer and the 13th natural gas producer in the world according to the same source. Along with the rapidly growing economy China has become the second largest energy consumer and the third largest net importer of oil opposed to Russia which is a net exporter of oil. In fact it is projected that China will be responsible for one-fifth of world energy demand by 2030.[113]

According to Oil and Gas Journal's 2008 survey, Russia has approximately 60.000 billion barrels against China's 16.000 of proven oil reserves that are commercially recoverable given current economic conditions and technology.[114]

China's existing oil fields are matured and have already passed their peak production making the Chinese authorities count on the exploration of oil fields in the western part of the country and offshore fields. Another aspect of the Chinese oil reserves is that due to some

[111] Calculations based on The Federal Service of State Statistics data for FDI stock in 2007

[112] Energy Information Administration of the U.S. department of energy. http://tonto.eia.doe.gov

[113] Exploring market opportunities in China (2004), International Business Student Project, p.33

[114] Energy Information Administration of the U.S. department of energy. http://tonto.eia.doe.gov

geological attributes, Chinese crude oil is of inferior quality which has affected poorly the attractiveness of oil reserves to international companies.[115]

However, it was not just the oil and gas reserves as such that proved to be unattractive to foreign investors. Very often their participation was limited by the Chinese authorities as the latter considered the energy producing sector as strategically important to allow foreigners to be a major part of it. Often foreign companies were offered only small and unpromising basins for exploration which were not interesting to large MNEs.[116] Cooperation with the foreign companies is governed by production-sharing contracts that contain provisions that are quite unfavourable to the foreign investors, like the one that states that "in case of commercial discovery, the Chinese state company can take up to 51 percent equity in the project without paying any exploration costs". According to another provision the Chinese state company can "take over the operatorship of the field if the foreign partner has recovered his development costs".[117]

China made some significant reorganization of its state owned oil companies in 1998 creating two regionally focused companies, the China National Petroleum Corporation (CNPC) and the SINOPEC, where the first would have its operations in the north and the second in the south. Another state owned company, the China National Offshore Oil Corporation (CNOOC) would operate offshore. All three companies attracted foreign capital through IPOs between 2000 and 2002, but only the minority stakes were offered. The minority stakes were acquired by western companies like Shell, BP, ExxonMobil. None of these companies had been given any major voice in corporate governance.[118]

Oil and gas sector in Russia suffered from a decreased production volumes following the fall of the Soviet Union. Since 1999, however, the surge in oil output began, following privatization of the oil industry and adoption of legislation on Production Sharing Agreements in 1995. Such an agreement would provide details for private capital participation in oil and gas exploration and extraction with regards to taxation, profit sharing, development costs

[115] Foreign Investment in Exploration and Production in China, Dr. Philip Andrew-Speed, 2003

[116] Foreign Investment in Exploration and Production in China, Dr. Philip Andrew-Speed, 2003

[117] Foreign Investment in Exploration and Production in China, Dr. Philip Andrew-Speed, 2003

[118] Exploring market opportunities in China (2004), International Business Student Project, p.79

recovery by the private investor etc.[119] The law opened a door to foreign investors into the sector.

As we can see today from FDI composition, foreign investors have found the exploitation of energy natural resources in Russia quite attractive. It is important to mention, however, that the attitude of the Russian state towards foreign participation in the sector has gradually become more restrictive. This trend has been characteristic for the present political regime in Russia, which has made strengthening of the power of the state an important objective. Following this objective, the establishment of so-called "strategic corporations" have taken place in the most important sectors of the economy. The state increased its stake in the largest gas producing company Gazprom and in the oil industry the state-controlled company Rosneft achieved the dominant position. This often happened in a controversial way forcing foreign firms like TNK-BP and Shell out of promising projects, acquiring their assets at a low price.[120] In Mai 2008 a Law on Strategic Sectors was adopted that restricted foreign participation in the sector through making it necessary to obtain government approval in case a foreign investor wants to acquire control in a oil or gas enterprise. The threshold for foreign control has been set even lower than for companies operating in other strategic sectors, namely ten percent for foreign private investors and five percent if a foreign investor is a state-owned company.[121] Hence a partnership with a Russian state-controlled enterprise is the only possible way for foreign investors to be present in the Russian gas and oil industry.

Russia is also rich in other natural resources that represent interest to foreign investors. For example, coal resources are particularly extensive with Russia ranking second in the world in respect to the reserves of coal. China occupies the third position.[122] China, however, produces more coal than Russia, occupying the first position among coal producing countries with Russia being the fifth in 2006.[123] China has been more open recently to FDI in its coal extraction industry following an objective to modernize the industry with advanced technology. The presence of foreign companies in coal industry in Russia is also a fact, with

[119] Foreign Direct Investments in Russia, Peter Westin (1999); OECD Investment Policy Review Russia, 2008, p.40-42

[120] OECD Investment Policy Review Russia, 2008, p.45

[121] OECD Investment Policy Review Russia, 2008, p.43

[122] Energy Information Administration of the U.S. department of energy. http://tonto.eia.doe.gov

[123] Energy Information Administration of the U.S. department of energy. http://tonto.eia.doe.gov

companies like ArcelorMittal, Coeclerici, China Datang Corporation allowed to own mines in the country.[124] As the crisis was unfolding, some foreign firms like ArcelorMittal decided to close down part of their production, but received strong warnings from the local officials trying to combat growing unemployment that their licenses may be revoked without compensation if they laid off workers.[125] This proves yet again the unreliability of the local authorities in Russia in their relationship with the foreign investors.

Among other resources of commercial importance it needs to be mentioned that Russia has the world's largest forest reserves providing a basis for lumbering, pulp, paper, and woodworking industries. More than two-fifths of Russia is forested, and the country has more than one-fifth of the world's total forests.[126] Entire foreign ownership is rare in the Russian forest sector.[127]

The fishing industry plays a significant role in both the Chinese and Russian economies. Russia produces about one-sixth of the world's iron ore and between one-tenth and one-fifth of all nonferrous, rare, and precious metals.[128]It is important to note that distance, climate and terrain often offer formidable challenges to exploitation of these resources.

Summary

Russia appears to have more commercially exploitable resources than China especially with regards to the energy sector, like oil, gas and coal industries. Yet, Russia's potential for attracting FDI into this sector is far from being fully exploited. According to World Investment Prospects Survey 2009-2011 the most important location factor to foreign investors in the primary sector is access to natural resources. When it comes to the availability of commercially important natural resources Russia is better positioned than China. However, the restrictive policies of both Russian and Chinese governments limit access to natural resources. The second most important location factor for investors in the primary sector is "stable and business-friendly environment" and here neither country scores particularly high.

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124 http://steelguru.com/news/index/2009/11/15/MTIwNDgz/Update_on_foreign_investment_in_Russian_coal_sector.html

125 http://www.reuters.com/article/businessNews/idUSTRE5691DK20090710

126 Encyclopedia Britannica

127 http://www.balticdata.info/russia/micro_economics/russia_micro_economics_industries_forest_industry.htm

128 Encyclopedia Britannica

Being attracted by high returns and high oil prices, foreign investors target Russian oil and gas industries, explaining why the large portion of FDI goes into the primary sector. However, tightening of state control over the resources and especially energy sector can threaten the stability of FDI inflows into this sector in the future.

4.1.2 Labour force

Russian population is 141.9 million people as of 1st of September 2009 according to the Federal Service of State Statistics.[129] This makes Russia the ninth populous country in the world. China is the largest country in the world in terms of its population with 1.3 billion people living within its borders.

Since the breakup of the Soviet Union, Russia has been experiencing a negative demographic trend as population has been gradually declining due to high mortality and lower birth rates. According to the Federal Service of State Statistics Russian population comprised 147.6 million people in 1990 and today it is 141.9 million. The decrease in the number of births has increased the share of elderly people in population, reducing the labour force. Since 2004 Russian authorities have implemented measures to attract more migrant workers mainly from the near abroad (mostly former Soviet republics) to compensate for the decreasing labour force. These policies have been somewhat successful as in period between January and August 2009 the natural decrease in population was compensated by 93.7 percent by influx of immigrants.[130]It is yet unknown whether this policy is sustainable over the long term. It is estimated that Russia will need an influx of roughly one million working age migrants since 2007 annually to fill the gap for the decreasing working population.[131]

Opposite of the demographic situation in Russia, China until recently has been struggling with a fast growing population. Suffering from food shortages and declining standards of living the authorities introduced a one-child policy trying to get the situation under control. Today growth rate of population is 0.65 percent.

The share of the urban population in Russia is 73 percent, whereas in China it is only 43 percent. In China there is an increasing trend of people moving to the urban areas.

[129] In this section data for Russia is taken from the Federal Service of State Statistics and data for China from the World Factbook

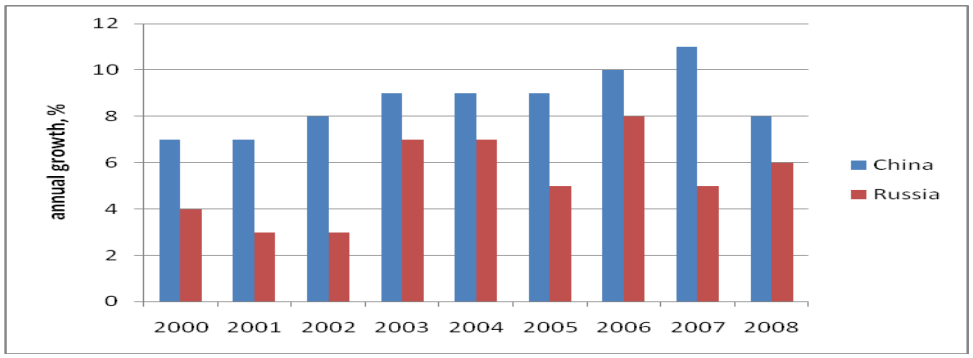
[130] Federal Service of State Statistics www.gks.ru

[131] The World Bank. Russian Economic Report 16, June 2008, p. 20

According to World Investments Prospects Survey 2009-2011 "cheap labour" as a location factor for FDI was ranked as the third most favourable factor for foreign investors. In Russia for comparison it was ranked as one of the least favourable. This is an indication that cheap labour is far more attractive location factor in China than it is in Russia. Indeed, global-production.com, Inc., which is a business economics consultancy based in Switzerland, has constructed an hourly wage cost index of the emerging economies in 2008, benchmarking the compared countries against South Korea (it had a value of 100). According to this index, Russia had a value of 53.3 with China that of 29.2, hence an hourly wage cost in Russia is nearly twice as high as it is in China.[132] This indication is supported by an Investment Climate Assessment Study of productivity and competitiveness in Russian manufacturing conducted by the World Bank and the Moscow Higher School of Economics in 2005. The study found that an average productivity in Russia is quite low relative to labour costs compared to other emerging countries, including China. If value-added per worker is about the same as in China, labour costs are much higher. For each dollar in wages, an average Russian worker produces half of output of a Chinese worker. This finding is also consistent with the findings of Mark Schaffer and Boris Kuznetzov in their analysis of Russian manufacturing.[133]

The change in labour productivity is shown in the figure below. Here labour productivity is measured as GDP per person employed.

Figure 5: GDP per person employed, annual growth



Source: WDI Online database

It is however important to mention that there are significant geographical disparities when it comes to the cost of labour in Russia and China. The cost of labour has become much

[132] www.global-production.com

[133] Chapter 2 "Productivity" by Mark Schaffer and Boris Koznetzov in "Can Russia compete?", Raj M. Desai and Itzhak Goldberg, World Bank, 2008, p.21-22

higher in the eastern part of China as this is where the economic opening started and this is where most of manufacturing is located. The cost of labour is much lower in the inner parts of the country and as mentioned before, western MNEs are starting to relocate their labour intensive facilities to those areas.

The cost of labour in Russia has been rising during the 2000's together with the booming economy. In fact, the real wages have been growing at almost 13 percent in the period between 2003 and 2007.[134] Following the crisis, Russian workers have been forced to deal with lower wages, but this is a transitory factor. Within Russia there are considerable differences in the cost of labour. Workers in the biggest cities, especially in Moscow are much better paid than those residing in the other parts of the country. For example, wages for senior executives in Moscow are quite comparable to the wages of their counterparts in the Western countries.[135]

As I noted in section 2.3.1 skills of labour can be even more important to foreign investors than the cost of labour. The above mentioned global-production.com, Inc. measured the skills of labour among the emerging economies by using Harbinson-Myers Index values for enrolment in secondary and tertiary education. Index values were converted to score values ranging from 0 to 1. Russia scored much higher than China, achieving a score of 0.787 compared to China's 0.269. This is not surprising as higher education was given a priority in the Soviet Union.

This finding is confirmed by the World Competitiveness Report 2009-2010 where Russia has higher values for enrolment in secondary and tertiary education than China. Interestingly, China scores higher than Russia when it comes to the quality of primary education. This is likely due to the government efforts to increase the quality and extent of primary education in recent times, for example, through a program of implementing a basic nine years' education.[136]That can explain China's advantage in manufacturing as it has a huge pool of labour with an acceptable level of education for this sector, which does not require large numbers of employees with secondary and tertiary education.

[134] The World Bank Russian Economic Reports No. 16-19

[135] Doing business and investing in the Russian Federation, 2009. PriceWaterHouseCoopers report

[136] OECD Economic Survey China (2005), p.17, 33

Summary

When it comes to labour force China has a clear advantage in all aspects of this criterion. It possesses far more numerous, cheap and productive labour force than Russia. In addition the situation is deteriorating in Russia due to a negative demographic trend which reduces its labour force even further. Russia has more educated workforce as the enrolment in secondary and tertiary education is higher. However, the quality of primary education is better in China giving the country a competitive advantage, especially with regard to its manufacturing sector.

4.1.3 Geographical position

Geographical position of the country determines to a certain extent the nature of its economic activities including FDI. China is geographically and culturally closer to the Asian countries; hence it is reflected in the origins of FDI inflows as noted in section 2.3.1. Most of FDI originates in Hong Kong. Russia on the other side is closer to the European Union both geographically and culturally, consequently receiving more than half of its FDI inflows from the EU. This is also reflected in the A.T. Kearney FDI Confidence index which states that investors in Europe and Asia prefer to invest in their region.[137]

In this respect it is important to mention a large number of overseas Chinese who often direct some of their capital back to the home country.

The size of the country is important as well and Russia being the largest country in the world is again at a disadvantage to China as long distances coupled with poor quality infrastructure make transportation of goods more costly than in China.

4.1.4 Market size and market growth

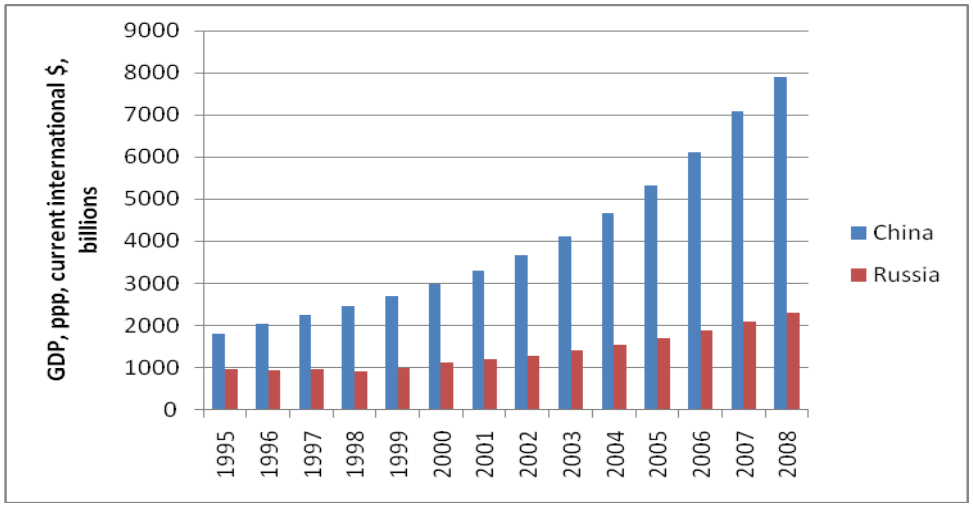
Market size has been mentioned by foreign investors as the most important location criterion for investing in China and Russia.[138]Indeed, both countries possess large populations whose needs are endless. As the transition to market economies picks up pace, the market opportunities in both countries will increase accordingly. Hence it is important for MNEs to be present in those markets as soon as possible in order to rip the benefits of huge market potential.

[137] A.T.Kearney FDI Confidence index 2007

[138] World Investments Prospects Survey 2009-2011, p.44

China has a tremendous advantage when it comes to GDP as a measure of market size. As we see from the picture below, China's GDP has been consistently much higher than that of Russia.

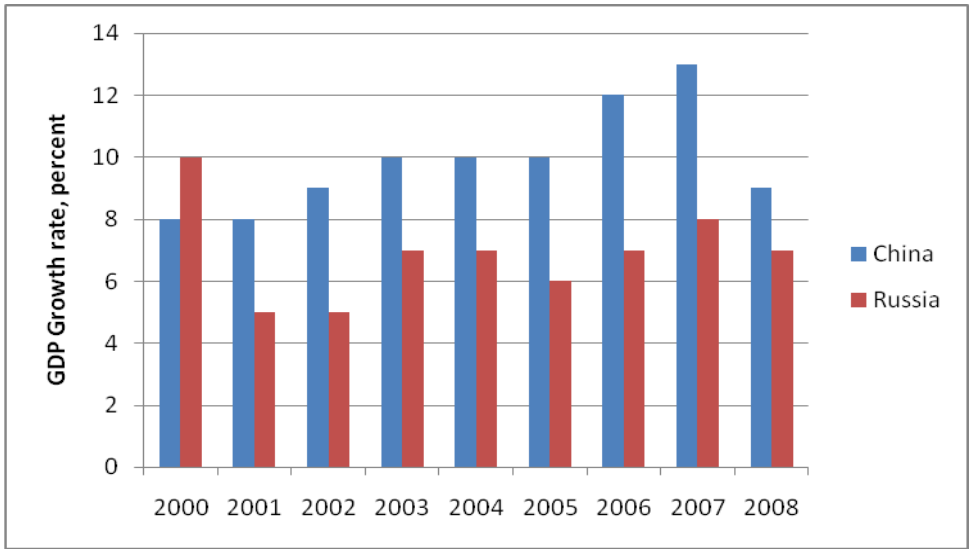
Figure 6: Gross Domestic Product of China and Russia, PPP adjusted, current international billions USD



Source: WDI Online database

When it comes to the market potential measured by the rate of growth of GDP, China outperforms Russia as well. This is evident from the figure below.

Figure 7: GDP growth rate, China and Russia



Source : WDI Online database

Russia has made an impressive progress in the past ten years with its economy growing at an average annual rate of seven percent fuelled by a consumption boom, drastically reducing poverty and changing living standards for millions of people. However, it has been successful in its economic development only for the past ten years, while China has been growing at an average ten percent annually for the past thirty years.

The economic crisis has hit Russia hard, sending the output of the country into a steep decline, impoverishing people and reducing their purchasing power. Growth is projected to be -6.8 percent, while China's growth, although reduced, still is projected to be at 7.7 percent in 2009.[139] The ability to resist global economic downturns has been proved to be much stronger in China than Russia, which makes it a far more stable destination for market-seeking FDI.

GDP per capita in China is lower than in Russia due to China's large population. However, let us consider the most advanced areas of China, like Pearl River Delta and Yangtze River Delta, which in 2007 had a combined population of 130 million (quite comparable to Russia's 140 million) and accounted for almost 30 percent of nation's GDP. According to WDI Online database Russia had a GDP (measured in current prices) of 1.290 billions of US dollars in 2007. Thirty percent of China's GDP constitute 1.014 billions USD. As we can see, the difference in GDP per capita between Russia and the most advanced areas of China is not so great. Taking into consideration the fact that income is very unevenly distributed in Russia, the real market potential of the country, even if measured in GDP per capita, may be less than in China.[140]

The greater importance of China's market potential is also reflected in the World Competitiveness Report 2009-2010 which ranked China as the number two in the world as far as its domestic market size is concerned, while Russia achieved only the 8th rank.[141]

Summary

Both economies have great market potential and are very appealing to foreign investors for that reason. Yet, the market size of China and more importantly its prospects are far more impressive than those of Russia. China has more potential consumers and its market size has

[139] OECD Economic Outlook no.85, June. volume 1/2009

[140] Calculations based on WDI Online and "3 Mega-city regions in China", CBRE Research Asia, p.73 published in "Connecting cities: China" A research publication for the 9th World Congress of Metropolis (2008)

[141] World Competitiveness Report 2009-2010

been growing consistently over the past 30 years and at a much higher rate than in Russia. Russia has managed to increase its market only during the times of high oil prices for a period of ten years. Its growth has proven to be much less robust than China's as has become evident during the ongoing crisis. China has managed to keep up the growth while Russia is experiencing a severe recession. Hence, it is reasonable to conclude that China has an advantage regarding market size and market growth.

4.2 Government induced advantages

4.2.1 Political and sociable stability

Russia and China differ a great deal with regards to the nature of the political regimes that govern them. Russia is a young democracy with a number of shortcomings facing a lot of challenges. China is an authoritarian state controlled by the Communist Party. Being essentially different with regards to the political systems, both countries also have a common feature with regards to the ruling regimes that they have little tolerance towards opposition and political freedom. This often provides a certain political and social stability as social discontent is suppressed and political opposition that could potentially destabilize political situation in the country is not tolerated, even though this stability is achieved at the expense of democratic values. And this is exactly this stability that attracts foreign investors, while the type of regime plays a less important role.

After the fall of the Soviet Union, Russia was plunged into economic and political disarray. The power of the state was weak and the ruling regime had to rely on oligarchs' money to stay in power in its struggle with other political parties, notably the Communist Party that had a significant support with large parts of the population. The conflicts that undermined the political and social stability in the country were numerous, ranging from the military conflict in Chechnya, armed standoff with the Parliament in 1993 to a generally dissatisfied and angry mood among the broad parts of population resulting in frequent strikes and demonstrations.

After Putin took over the power in the country Russia came to experience the political and social stability not seen during the previous decade. Putin strengthened the state and the economy and managed to create a feeling of stability that allowed businesses to operate and plan ahead. The impressive economic growth averaging 7 percent annually between 1999 and

2008[142] made him very popular in Russia providing him with the necessary support to continue his dominance of the Russian politics even after he stepped down as the President of the country. In addition to the post of the Prime Minister, Putin is also the head of the dominant political party in Russia which holds the majority of the seats in the Parliament thus giving him control of the legislative branch of power in the country. Hence, Vladimir Putin together with today's President Dmitry Medvedev is expected to remain a major political force in Russia over the long term and the political and sociable stability that came with him is likely to be present in the times ahead.

Having said this, there is still a certain amount of political risk when investing in Russia. Political and social stability goes hand in hand with the economic situation in the country. In fact, the former is a direct consequence of the latter. The current regime has derived its high popularity ratings among the population from its economic achievements. However, the ensuing economic crisis that has brought a sharp increase in unemployment and a drop in real wages can put strains on the continued public support to the policymakers in Russia. The risk for social unrest, demonstrations and general discontent among ordinary Russians who have seen their living standards deteriorating is certainly higher compared to the pre-crisis period. Some large scale demonstrations have already taken place on the 9th of December 2008 following an unpopular government move to increase tariffs on imported cars. The authorities reacted by squashing the unrest by force with mass arrests among the demonstrators.

Approval ratings for Putin and Medvedev took a serious hit in February and March 2009 as reported by a monthly survey conducted by the Yuri Levada Analytical Center.[143] The disapprovals ratings reached the all-time high in this period. Short-term political risk rating of Russia reported by the Business Monitor International ltd. (BMI), an independent company specializing in country and industry risk assessments, felt significantly from its high in July 2008 to the lowest value in May 2009. It is important to mention that this rating has picked up again in the latest report by BMI on Russia, reflecting improving economic indicators as the severity of the crisis is starting to subside. And despite the falling approval ratings, both the President and the Prime Minister have maintained quite high levels of public support throughout the crisis.[144]

[142] OECD Economic Surveys Russia (2009), p.21

[143] Reported in Business Forecast Report Russia Q3 2009 by Business Monitor International Ltd., p.11

[144] Business Forecast Report Russia Q4 2009, p.12

Another source of political risk in Russia is its complicated and strenuous relations with its neighbouring pro-Western countries like Ukraine and Georgia and as well as elevated tensions with the European Union and the United States following a war with Georgia in August 2008. This can delay the achievement of some foreign policy objectives including membership in the WTO and OECD. Worsening political relations with the Western countries can and do affect the business of those countries' companies in Russia. A case in point is the pressures exerted by Kremlin on the UK oil company British Petroleum and its Russian venture TNK-BP following a dispute between the two countries over a number of issues. BP's foreign staff had problems renewing its visas, a major audit of the firm's operations was conducted following allegations of industrial espionage. Actions like these certainly cause anxiety in the international business community and represent political risk for doing business in Russia.

Another example of unpredictability of the current regime is the controversy surrounding oil company Yukos and its forced bankruptcy by the authorities following allegations of tax evasion. The case demonstrated to the international economic community that seemingly politically stable regime in Russia is only stable and predictable as long as its power is not threatened. Yet another case undermines the notion of political stability and reliability of the Russian authorities when following a decision by ArcelorMittal, the world largest steel company, to close down parts of its operations in Russia and lay off workers, the local authorities threatened to withdraw its license to operate in the country.

The lack of political opposition in the country creates certain political stability in Russia as the power of the present regime is not challenged. This is likely to continue in the times ahead as the political leadership under Putin remains in control. However, there is a different side to this problem. If Russian's discontent with their government cannot result in the change of that government, given the deteriorating conditions in the economy, a potentially explosive situation may arise that would threaten the political stability in the country with unpredictable consequences.

After its economic opening in 1979 China has gradually adopted market economy principles achieving impressive growth rates. Yet, despite the market-oriented economy, China remains a one-party communist authoritarian state. The reason why market reforms in China were introduced at a gradual, slow pace was for the Communist Party in the country to make sure that the development does not get out of its control. And as of today, the Chinese authorities maintain tight control over the society, not tolerating any type of political opposition, cracking down on any types of social discontent and unrest. The most famous case

of the authorities' reaction to political demonstrations is the Tiananmen Square incident when a large scale student demonstration in 1989 was dispersed by opening fire on the unarmed civilians killing hundreds of people. The latest example of social unrest of the Muslim minority in the north-west of China left nearly 200 hundred people dead. Tibet uprising fifty years ago had a far higher death toll reaching thousands. These are just the most well-known revolts against the ruling regime. In addition to the above mentioned incidents, instances of the social unrest on minor scale (yet, involving thousands of people) are quite frequent and all of them result in harsh measures from the Chinese authorities.

This tough policy towards the demonstrations of social discontent creates an atmosphere of zero tolerance which until now has kept the ruling party in power and created a sense of political stability. However, even this authoritarian rule would have difficulties to be sustained and remain effective if the discontent in the Chinese society were to spread to the broader parts of the population. The reason this has not happened yet is the remarkable economic development of the country in the past thirty years which has raised standards of living of ordinary Chinese, lifting millions of people out of poverty. The ruling regime has derived its legitimacy from its economic achievements very much in the same manner as it is in Russia.

Yet, the ongoing crisis has not spared the Chinese economy. Exports, which are an important part of the Chinese economy (40 percent of GDP) are starting to slow down in pace with the global demand. Result is large-scale layoffs of workers that coupled with weak social safety net can cause growing dissatisfaction with the local authorities and even the government in Beijing.

Even though there are signs of recovery, a worsening of the economic situation in the country could lead to mass protests quickly spreading in China. If the scale of the protests is very large it may be difficult to quash them. Economic crisis alone may not be the only reason for unrests as a broader range of issues are causing social problems in China, like the widespread corruption, social inequality and environmental degradation.

According to World Bank's Government Indicators report released in June 2008 which is based on a number of international surveys and expert opinions, with regards to political stability China received a score of -0.32 and Russia -0.62 on a scale from -2.5 to + 2.5 (OECD average was +0.96).[145] Another recognized indication of political stability measured by Eurasia Group's Global Political Risk Index for emerging markets issued every month, has

[145] www.worldbank.org/governance

ranked Russia and China consistently very close to each other with regards to political stability.[146]

Summary

Both countries have managed to create a stable political environment that attracts foreign investors, yet to a large extent at the expense of free and democratic societies. China's experience in achieving this stability has been more extensive as Russia's as it lasted for thirty years now. The unstable and turbulent times of the 1990s are still fresh in the minds of Russian people and the existing stability in the framework of sharp economic slowdown appears to be more fragile than in China. As economic surveys indicate, both countries are not far away from each other in political stability rankings, yet China tends to have a certain advantage. This leads me to conclude that China has a slight comparative advantage before Russia with regards to this determinant of FDI.

4.2.2 Macroeconomic stability

After the fall of the Soviet Union the Russian economy was plunged into chaos with GDP falling at an average annual rate of 6.3 percent between 1990 and 1998[147], consumer prices growing at an astonishing average rate of 245 percent between 1993 and 1998, rouble losing nearly 50 per cent of its value between 1997 and 1998 accompanied by rise in unemployment and poverty. The economic collapse culminated in 1998 crisis which saw the Russian government defaulting on parts of its debt.

However, the sharp depreciation of the rouble (see figure 8) created favourable conditions for the local producers that together with an increased productivity due to the utilization of spare production capacity and available labour resources increased their competitiveness. Steadily increasing prices of oil, Russia's main export product, gave rise to large revenues that boosted the consumer demand and brought ten years of impressive economic growth and macroeconomic stability to Russia. In this period real output almost doubled.[148] The share of people living beneath the level of absolute poverty fell from 29 percent in 2000 to 13.4 in 2007 bringing millions of people out of poverty. [149]

[146] Global Political Risk Index, Eurasia Group, http://www.eurasiagroup.net/

[147] Here and in the rest of the sentence: calculations based on WDI Online database

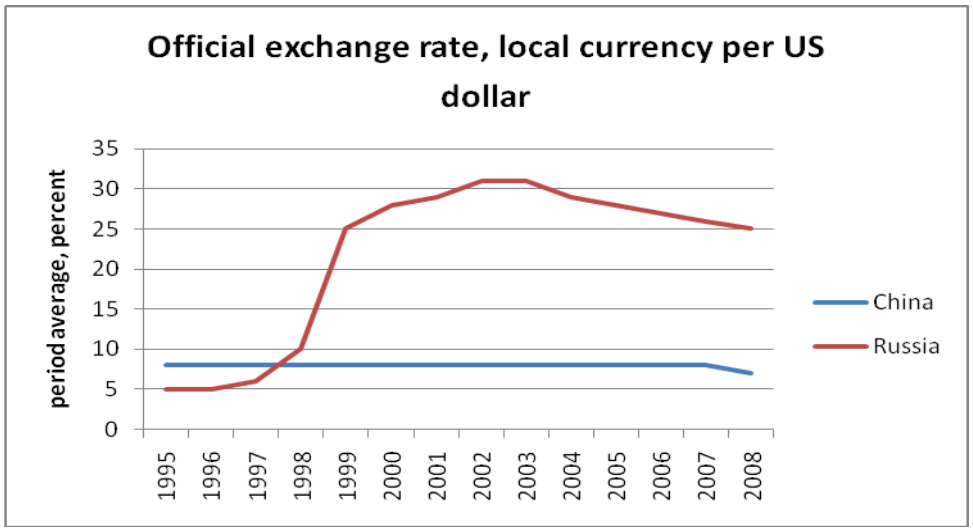
[148] OECD Economic Survey, Russia. P.11

[149] Federal State Service for Statistics, www.gks.ru

Russia has managed to pay off large portions of its public foreign debt that plunged from 100 percent of GDP in 1999 to 10 percent in 2006.[150] At the same time the external private debt soared due to improved credit ratings and low borrowing spreads in the international capital markets.

Due to constantly rising oil revenues and consequently large current account surpluses Russia accumulated the third largest foreign currency reserves after China and Japan that peaked at 598 billion USD in early August 2008. Inflation has been on a decline trend from its peak in 1993 of 875 per cent to just 9 per cent in 2006 as can be seen from figure 9 below. The exchange rate in Russia has been managed against a euro-dollar basket. As follows from the figure 8 from its sharp depreciation in the end of the 1990s, it was appreciating against the dollar during most of the next decade due to high oil prices, despite the government attempts to insulate the economy from the excess oil revenues via the creation of Oil Stabilization Fund. However, when the oil prices slipped putting downward pressure on the rouble, it lost almost 30 per cent of its value between September 2008 and January 2008. The Russian Central Bank was trying to support the rouble from sharp depreciation fearing the worsening of the liquidity situation for many Russian companies that had accumulated large foreign debts. This action resulted in spending of almost a quarter of the currency reserves.[151]

Figure 8: Official exchange rate, local currency per US dollar

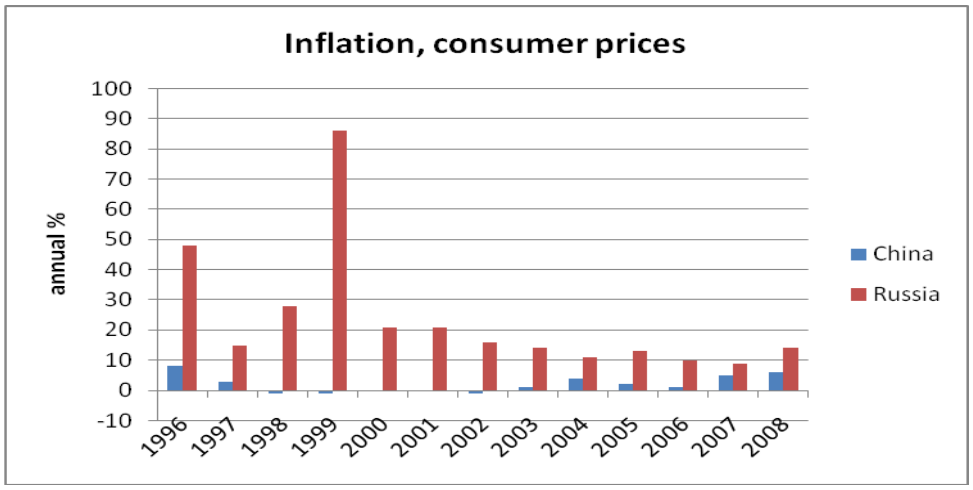


Source: WDI Online

[150] WDI Online database

[151] OECD Economic Survey Russia 2009, p.37

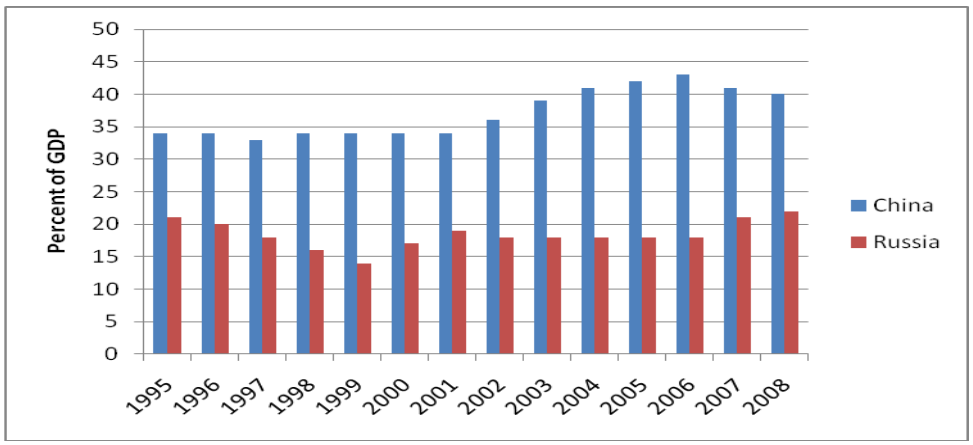
Figure 9: Inflation, consumer prices, percent annual



Source: WDI Online

However, this ten year growth was driven mainly by transitory factors like high oil prices and the availability of idle resources, capital and labour in the economy. In 2008 Russia's economy was overheating as it was approaching its productive capacity limit that could not keep up with the increasing aggregate demand. Both industrial capacity utilization and labour utilization were reported by some enterprises to be above ninety percent with unemployment as low as 6.1 percent in 2007.[152]Indeed, gross fixed capital formation both in terms of foreign and domestic capital, as a per cent of GDP was rising during the growth years, yet remained constantly lower than in other emerging economies, like China, as can be seen from the figure below.

Figure 10: Gross fixed capital formation as a percent of GDP



Source: WDI Online database

[152] The World Bank in Russia. Russian Economic Report 16, June 2008

Oil prices rose sharply from 16 USD per barrel of Brent Crude oil in January 1999 to 147 dollars per barrel in July 2008.[153] Oil and gas comprise about two thirds of Russia's exports and generate about half of government revenue.[154] Even though the federal budgets have had surpluses since 2001(with the exception of 2009), the non-oil budgets were running increasingly higher deficits.[155]

Another transitory factor was the improvement of Russia's risk ratings that gave Russian companies access to international markets at a relatively low cost, especially considering constantly appreciating rouble that made dollar-denominated borrowing very attractive. The interest rates in advanced countries were also falling and so were the spreads on emerging market Eurobonds making borrowing less costly.[156]As a result foreign borrowing by Russian private sector soared to very high levels in 2006-2007.

The excessive reliance on transitory growth factors and failure to create a diversified economy, less dependent on commodity prices have proven to be catastrophic to Russia with the start of the financial crisis. Oil prices fell sharply by three-quarters by December 2008 from their peak in July 2008 and despite a certain recovery in 2009, their average remained much lower than a year before.[157] The prices of other commodities that are important exports for Russia were also falling. The global credit crunch limited the access of the Russian corporations and banks to international capital markets and lending by Russian banks slowed down reducing the domestic demand even further. As a result of this negative developments real GDP fell by – 10.4 percent year-on-year in the first half of 2009 and Russian economy was in deep recession.[158]

The Russian authorities responded quickly to the crisis providing liquidity to the banking sector and major corporations in an attempt to boost the demand. As reported by OECD "the quantifiable measures announced in the beginning of the crisis amounted to 13

[153] The Association for the Study of Peak Oil and Gas, newsletter No 99, December 2008

[154] OECD Economic Survey Russia 2009, p.30

[155] OECD Economic Survey Russia 2009, p.54-56

[156] OECD Economic Survey Russia 2009, p.24-25

[157] OECD Economic Survey Russia 2009, p.29

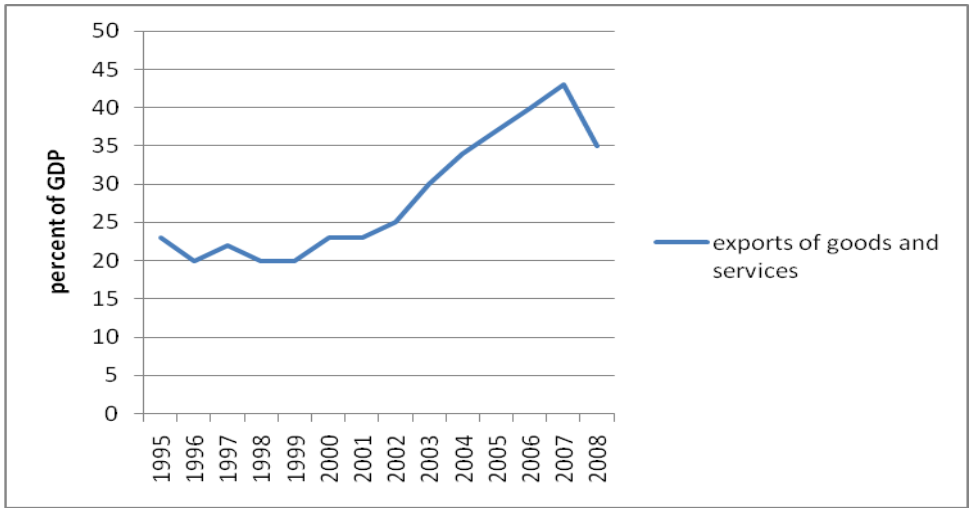
[158] World Bank in Russia 20, p.2

percent of GDP".[159]The ample foreign currency reserves and resources accumulated in the stabilization funds allowed these measures to be undertaken. However, as it has become evident, these measures have not prevented the Russian economy from sliding into recession. The macroeconomic stability ended proving to be too vulnerable to external shocks.

After its opening in 1979 China embarked on a series of market reforms that would dramatically change its economy. First the agricultural sector was subjected to reforms and other sectors soon followed. Price controls were reduced, competition encouraged and the size of the private sector gradually increased. The transition was happening in a controlled gradual manner allowing the government to experiment and contain the consequences of erroneous decisions.

Foreign trade was giving a major role in the Chinese economic transformation. Since the opening of the economy, exports have comprised a large portion of China's GDP as can be seen from the figure below.

Figure 11: Exports of goods and services as a percent of GDP in China



Source: WDI Online database

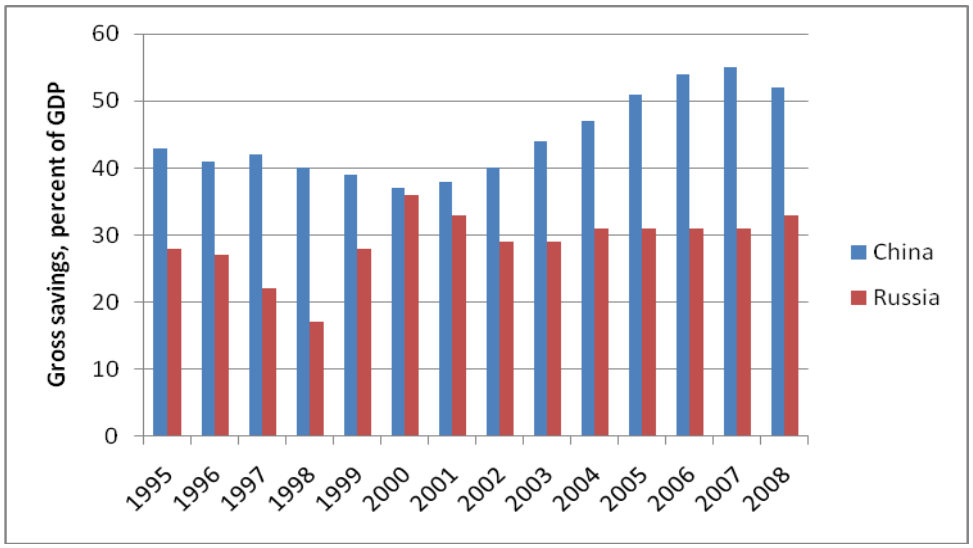
Through trade and FDI China has become highly integrated into the world economy. WTO membership has developed this integration even further. Most of foreign trade is conducted by foreign based companies through their manufacturing facilities in the country, exporting their goods to the western countries (over 40 percent of China's exports go to

[159] OECD Economic Survey Russia 2009, p.36

Europe and the US)[160] and importing inputs from the Asian countries. In fact the foreign companies' share of exports is 55 percent, while only 13 percent when it comes to serving the local market.[161]

As mentioned above, China has a very high rate of capital accumulation triggered by high savings rate in the society. This was a major growth factor for the Chinese economy as capital per worker increased significantly boosting productivity. In fact, as reported by OECD, "capital per employed person has grown at around 7.5 percent annually and has accounted for over half of the growth in income per head since 1988".[162]

Figure 12: Gross savings as a percent of GDP, China and Russia



Source: WDI Online database

Other sources of the Chinese economic growth have been the improving quality of education and the reallocation of labour from agriculture.[163]The movement of workers from agriculture where productivity was quite low into the service sector has yielded a significant contribution to the economic growth. The flow of workers from agriculture into the manufacturing sector was mostly to replace the laid off workers of large state-owned enterprises. The total share of growth in income per head attributed to the sector shift of the

[160] The World Bank in China, quarterly update, February 2008, p.7

[161] OECD Economic Survey Russia 2009, p.30

[162] OECD Economic Survey China, 2005 p.32

[163] OECD Economic Survey China (2005) p.32

workforce is estimated to be around one-fifth of the growth.[164] The increased quality of the labour force due to the implementation of education reforms has boosted productivity as well. It is estimated by the above mentioned OECD report that "the annual increase in productivity due to the accumulation of human capital was about 1 percent over the past two decades". [165]

After the Asian crisis, the exchange rate policy of the country has been directed at pegging the rate of Renminbi against the US dollar. That meant the authorities had to intervene when necessary into the market to support the exchange rate. This policy has been quite successful with a daily volatility of Renminbi averaging at 8 basis points against the US dollar between January 1994 and March 2005. Sometimes, however, the intervention came at a high price of depleting large amount of foreign currency reserves. In July 2005 China revalued its currency against the US dollar by 2.5 per cent and Renminbi was allowed to fluctuate daily up to 0.3 percent.[166]

Inflation has been kept at a quite low rate as follows from the figure 9 averaging at two percent throughout the first decade of the twenty-first century, however rising in recent years, mostly due to rising food prices which comprise a large share of consumer goods basket in China. At the same time, its volatility has been quite high compared to most OECD countries.

The onset of the global economic downturn has been tackled by the Chinese economy much better than by the Russian. The Chinese financial sector has been insulated from the adverse effect of the financial crisis as the Chinese banks had relatively modest exposure to sub-prime assets and the authorities impose capital controls. In addition, large fiscal surpluses ensured that authorities had enough resources to implement sufficient stimulus measures. Nevertheless, the impact on the real economy has been more profound due to its high integration with the world economy. The Chinese exports were particularly hard hit as the global demand was slowing down first in the developed countries and then in the emerging markets. In the first two months of 2009 they were down 21 percent y-o-y on average.[167] According to the World Bank estimates exports of goods and services will be down by 12.4 percent in 2009 y-o-y bouncing back up to 9.9 percent in 2010.[168] Market-based investment

[164] OECD Economic Survey China (2005) p.32

[165] OECD Economic Survey China (2005) p.32

[166] OECD Economic Survey China, 2005 p.58-61

[167] China quarterly update March 2009, p.2 The World Bank

[168] China quarterly update November 2009, p.11 The World Bank

has slowed down as well giving a spare production capacity especially in manufacturing. Imports went down in the first quarter of 2009, but rose again since March following an increase in demand for raw materials.[169]Following the above mentioned conditions, real GDP growth remained still positive in 2008, yet falling throughout the year. It was 6.8 percent y-o-y in the fourth quarter of 2008, however, it has recovered later in 2009 on the back of expansionary fiscal and monetary policies of the government and is projected to be at 8.4 percent in 2009.[170]

The reaction of the government to the crisis was indeed swift and overwhelming. It announced a 10 point stimulus plan according to which the authorities were to spend 4 trillion RMB mainly on infrastructure projects. Large liquidity was injected into the banking system through lower required reserve ratios in commercial banks. Credit quotas that constrained lending were also lifted. As a result, new lending in the first quarter of 2009 averaged 5 percent of GDP.[171] In total the important measures of the authorities to support the economy helped safeguard macroeconomic stability despite the worst global slowdown in decades.

Summary

Russia has been successful in creating a stable macroeconomic environment that lasted a decade between 1998 and 2008. It experienced an impressive economic growth, accumulated large financial reserves, saw the decline in inflation and unemployment, and considerably reduced its public debt. However, this decade was preceded by a period of strong economic recession and worsening in most macroeconomic indicators. Now, with a new crisis, Russia's economy once again finds itself in a recession. Macroeconomic stability turned out to be very fragile in the economy supported by mainly transitory growth factors. China has enjoyed a much longer period of continued growth with better macroeconomic fundamentals than Russia for most of the time, even compared to the best times for the Russian economy. China has had less volatile exchange rate, lower inflation, larger foreign currency reserves. Through a string of market reforms it has created a much more diversified economy than Russia, an economy whose macroeconomic stability depends much less on the export of natural resources and their prices.

[169] China quarterly update June 2009, p.4 World Bank

[170] China quarterly update November 2009, p.11 World Bank

[171] China quarterly update June 2009, p.2 World Bank

4.2.3 Legal system

In democratic countries legal system is independent of political influence and through the system of check and balances can influence the decisions of the other branches of power. In Russia the legal system is often influenced by the authorities and in addition is known to be corrupt. Hence it is highly unreliable and inefficient, acting as deterrent to foreign investors.

Property rights of domestic and foreign investors are guaranteed by law, and nationalization is prohibited with an exception in sectors deemed of national interest. This exception is an issue for foreign investors as it gives a right to the Russian authorities to expropriate their property even though compensation is supposed to be paid in full.

The intellectual property rights (IPR) protection in Russia is notoriously weak with media piracy and counterfeiting of patented and copyright protected goods being widespread. According to a survey of fifty major foreign investors in Russia, conducted by The Coalition for Intellectual Property Rights, the violations of IPR cost businesses around one billion USD annually. Hundreds of millions of dollars are lost by the authorities in the form of taxes, duties and investment.[172] The Office of the U.S. Trade Representative estimates that pirated products make up 80 percent of the Russian market for DVDs and 66 percent of music compact discs.

One of the problems is the fact that the notion of IPR is something new to Russia as this issue did not exist in the Soviet Union where all property belonged to the state. Hence the concept of intellectual property is something new to most Russians. Russia has adopted a number of laws and regulations as well as institutions like a patent and trademark agency that are supposed to protect intellectual property rights. Yet, the actually knowledge about IPR protection remains quite inadequate both among lawmakers and those who are supposed to enforce the laws. In addition coupled with endemic corruption and absence of political will, enforcement of IPR laws becomes very difficult.

Notwithstanding serious problems with safeguarding property rights in the country, the Russian authorities have made sincere efforts to crack down on these types of violations. As a part of the accession process to the WTO, Russia has amended laws that are in line with WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights. Actions against copyright violations have become far more frequent and efficient. However, there have yet to

[172] Intellectual Property Rights: A Key to Russia's Economic Revival, CIPR (2000) http://www.cipr.org/activities/articles/RBWipr.pdf

be handed out severe punishments for IPR violations as most convictions end with fines or suspended prison sentences.[173]

China is no less known for its IPR violations. Copyrights, patents, brand-names, trademarks are routinely stolen. In fact, according to respondents in A.T.Kearney survey one of the primary concerns over China's investment environment is the rule of law in the country with abuses of intellectual property being widespread.[174]

However, China has had to comply with the tough conditions of the WTO accession including those that concern the IPR. As a result, the efficiency of public effort in combating the violations has increased. On March 2007 the Property Rights Law was promulgated that for the first time establishes a notion of private property rights that are to be treated equally with state property rights. This is a welcomed development, but the successful enforcement of this law is yet to become a fact.[175]

According to Business Monitor International, Russia scores 21.6 out of 100 on the *rule of law* indicator in BMI's legal framework ratings. This is much lower than for most other east European counties, with the global average being 49.3[176]The Economic Freedom Index ranks both countries far below the global average regarding the rule of law and property rights in both countries.[177]The Global Competitiveness Report 2009-2010 reports pretty much the same. Regarding the efficiency of legal framework in settling disputes and challenge the legality of government actions China scores much higher than Russia, taking 43rd place in the rating with Russia being only 109. When it comes to the judicial independence from political influences of government or firms China is again taking a higher rating (62 against 116).The same goes for a number of other criteria like intellectual property protection, property rights and even the ability of law to protect the interests of minority shareholders. The World Bank's Governance Indicators paint pretty much the same picture. China's score -0.33 on rule of law (measured on a scale between -2.5 to +2.5 is -0.33 while Russia's is even lower at -0.91.

[173] Sherman Katz & Matthew Ocheltree "Intellectual property rights as a key obstacle to Russia's WTO accession (2006), p.9

[174] A.T.Kearney FDI confidence index 2007

[175] OECD Investment Policy Review China, 2008, p. 23-27

[176] Business Monitor International Russia Forecast Report Q2 2008

[177] http://www.heritage.org/Index/Explore.aspx

Summary

Both countries have a poor record of judicial independence and the rule of law. Property rights are violated on a wide scale which distorts foreign investment. Improvements in this area have been made in both China and Russia. However, the former has already been accepted in WTO on stringent requirements that oblige China to treat the issue of intellectual property rights seriously. Russia despite some positive developments in the area of IPR protection is lagging behind China when it comes to serious commitments to deal with the issue. The violations of IPR and generally weak legal system problems are exacerbated by wide spread corruption, general lack of knowledge about property rights and the absence of political will to enforce the property rights regulations. Hence, one can conclude that China has a certain advantage before Russia with regards to the functioning of the legal system.

4.2.4 Bureaucracy and corruption

Both Russia and China are notoriously known for their extensive, cumbersome and ineffective bureaucracy. It is no less well known that in addition to the problem of excessive red tape, bureaucracy in both countries is crippled by corruption, which has affected both countries in the most profound ways.

OECD economic survey 2006 of Russia points out a number of studies which show that both foreign and domestic investors alike consider inefficient bureaucracy and corruption to be the major obstacles to investment in Russia.[178]There is no lack of published information about the impediments to business caused by the Chinese red tape either.

According to the National Service of State statistics of Russia the number of officials employed in public administration grew by 33 percent between 1994 and 2005 and comprised about 1.5 million people in 2005.[179] Given the decrease of population in this period, the number of state employees per citizen in Russia has been increasing dramatically recently. Another feature of the Russian bureaucracy is that the number of federal employees is almost half of all state employees while in other countries it is usually far less than those working for the local and regional governments. However, the problem of the Russian bureaucracy is not its numbers.

[178] OECD Economic Survey Russia 2006, p.116, 140

[179] OECD Economic Survey Russia 2006, p.119

The problem is rather its inefficiency, contempt of the ordinary people's needs and the extent of unproductive rigid regulations. Civil servants are very unpopular in Russia among the general public for the lack of understanding, unresponsiveness and indifference to people as well as the inefficiency of their work. The level of government satisfaction with the performance of civil servants is quite low as well.[180] Not surprisingly we find that Russia is ranked very low for the quality of public institutions in the World Economic Forum's 2009 Global Competitiveness Report, ending up at 114th place, whereas China received the 48th position.[181] This is not to say that the Chinese bureaucracy has no flaws. There are over 46 million government employees in China and the extent of red tape, non-transparency in decision making and unresponsiveness is quite significant. Yet, the bureaucracy in China appears to be more productive than in Russia. It is best summarized by David Li's words in his paper on contemporary East Asia: "In China, the government functions as a "helping hand" for economic development, promoting economic growth, while in Russia, the government is like a "grabbing hand," suffocating economic development."[182]

The inefficiency of public institutions in both countries is aggravated by the widespread corruption among the state bureaucrats. According to an online article by Bloomberg on June 6th 2008[183]officials take about 240 billion USD in bribes a year with businesses making payoffs of 33 billion USD a year while Russians spend around 3 billion USD on bribes every day. According to the Global Corruption Report 2003, published by Transparency International, a Berlin-based anti-corruption organization, Russian citizens were spending about 2.8 billion USD on bribes in 2002, showing that situation is not changing to the better, and in fact is only getting worse.[184] The fact that the situation with regards to corruption is deteriorating is also confirmed by the OECD Economic Survey 2006 on Russia that points to a number of sources that show that corruption is on the rise in the country.[185]

In an article "Corruption Threatens China's Future" by Minxin Pei, a senior associate at Carnegie Endowment for International Peace, it is estimated that the direct costs of corruption

[180] OECD Economic Survey Russia 2006, p.121

[181] World Competitiveness Report 2009, p.116, 268

[182] David Li (1998) Changing Incentives of the Chinese Bureaucracy

[183] http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aiWcse_TEMu4

[184] Global Corruption Report 2003, p.165

[185] OECD Economic Survey Russia 2006

could have been as much as 3 percent of GDP in 2003 or around 86 billion USD. That exceeds the government's spending on education in 2006.[186] In that same article the author points to the fact that along with the development of the market economy the frequency and amount of bribes as well as other forms of corruption like kickbacks, collection of illegal fees, misappropriation of state funds have risen suggesting that the corruption is an even more serious problem than it was before. Corruption is mostly concentrated in the state run areas of economy, like infrastructure projects and sales of land; the financial sector is hit by corruption hard as well.

Numerous reports by a number of international agencies confirm the poor reputation of these countries when it comes to the rule of law and honest practices of civil servants.

Transparency International in its latest Corruption Perceptions Index 2008 ranks Russia among the world's most corrupted countries, at 147 out of 180 studied. In the same Index China ranks much higher than Russia and takes 72nd place.[187] The Corruption Perceptions Index ranks countries in terms of the degree to which corruption is perceived to exist among public officials and politicians. Examining the Corruption Perceptions Index reports going up to five years back I found that Russia has not really made much progress during that time in terms of corruption levels, ranking constantly among the most corrupted countries (143 out of 179 in 2007, 121 out of 163 in 2006, 126 out of 158 in 2005, 90 out of 145 in 2004, 71out of 102 in 2003). When it comes to China, the country cannot be proud of much progress in its corruption rankings either, yet, remaining constantly ahead of Russia in the corresponding years (72 out of 179 in 2007, 70 out of 163 in 2006, 78 out of 158 in 2005, 71 out of 145 in 2004, 59 out of 102 in 2003).

TI's Bribe Payers Index 2008, which is another survey of Transparency International, used to evaluate the supply side of corruption - the propensity of firms from the most industrialized countries to bribe abroad, seem to confirm the above mentioned findings of corrupt nature of business and government practices in China and Russia. According to the Index 2008, companies based in Russia and China are perceived to frequently engage in bribery to win business in countries across the world.[188] They end up at the bottom of the Index, far behind most of other industrialized countries. Again, having checked country

[186] "Corruption Threatens China's Future" Minxin Pei, October 2007

[187] Corruption Perceptions Index 2008, www.transparency.org

[188] Bribe Payers Index 2008, www.transparency.org

rankings in the previous Bribe Payers Index 2006, I found, not surprisingly, China and Russia at the bottom of the list.

The World Competitiveness Report 2009-2010 indicated corruption as the most problematic factor for doing business in Russia. For China corruption was indicated as a medium problematic factor with other factors being considered more troubling for foreign investors.[189]

When it comes to the courses of corruption in both countries, the picture appears to be quite complex. Both countries have inherited the practices of irregular activities as they were very common during the central planning economies to make the inefficient and slow bureaucracy to perform its functions. Yet, the present day corruption is also the consequence of the role the new institutions have played in creating corruption opportunities when the old system of check and balances was destroyed. Jens Christopher Andvig argues that a number of inherited cultural codes of conduct like historically established corruption rates, that were passed over in the transition from one economic system to another were also of great importance. Both Russia and China are known to have had highly corrupt public administrations going back several centuries before the establishment of a socialist system.[190]

Having said that, even though both countries have experienced and are experiencing unprecedented corruption during their transitions to the market economy, there are differences and similarities in the corruption level as well as the effect the corruption has had on both countries. As Harley Balzer, an Associate Professor at Georgetown University remarked at a 17 October 2005 Kennan Institute seminar "that while corruption rankings indicate that it is an enormous problem in both countries, corruption seems, at least thus far, to be doing less damage in China." The difference, he argued, is "in the nature and quality of the corruption. Russia's natural resource economy leads to rent-seeking, unproductive corruption, while corruption in China occurs in conjunction with real investment in industry and infrastructure."[191] Robert Amsterdam in his blog under the headline "Comparative Corruption of Russia and China" also notes that China and Russia experience very different types of corruption in the government. According to him, there are "few countries that that can

[189] World Competetiviness Report 2009, p.268, 116

[190] Jens Christopher Andvig, Corruption in China and Russia compared: different legacies of central planning, 2005

[191] http://www.wilsoncenter.org/index.cfm?fuseaction=events.event_summary&event_id=140427

compare with the extremely high levels of government that institutionalized corruption has reached within the Russian government, as opposed to China, were there is a more prolific brand of corruption entrepreneurs at lower levels of government".[192]

Having described the nature of corruption and the effect it has on the economies of both countries, one needs to say, that the authorities do take measures to counteract this problem.

It appears that the Russian authorities take this problem very seriously. Dmitry Medvedev, the Russian President, has taken a tough stance against corruption and has promised to combat what he calls a "culture of legal nihilism". An Anti-corruption Counsel was established which is headed by the President himself and the National Plan on Counteracting Corruption was approved in July 2008. Since then a number of bills and laws have been amended strengthening the legislative platform to fight corruption. Some other measures were also taken, like making known to public financial statements of highly ranked government officials as well as introducing greater transparency to the public administration service as well as reducing a number of cumbersome regulations.[193]

In China the Chinese authorities also fight corruption realizing that it is becoming a serious impediment to economic growth and foreign investment. The frequent cases of high profile corruption investigations and subsequent conviction of top government officials are becoming very common. The Chinese authorities also adopt a lot of laws and directives against corruption, but the effectiveness of some is open to doubt. China has entered international agreements to fight corruption, ethics education is being introduced in schools etc.

Summary

Both China and Russia have extensive and ineffective bureaucracies that slow down the process of economic reforms and impede economic development causing additional costs to businesses. Yet, the quality of public institutions, although low by OECD standards appears to be higher in China than in Russia. The fact that the system of civil servants and public officials is highly corrupt magnifies the problem of bureaucracy. Again, both countries have a huge challenge of combating corruption, but in Russia corruption is by far a more serious impediment to foreign investment as reported by various international surveys and analysts.

[192] http://www.robertamsterdam.com/2008/10/comparative_corruption_of_russ.htm

[193] OECD Economic Survey: Russian Federation 2009, p. 142

Thus I can conclude that with regards to bureaucracy and corruption, China is positioned much better than Russia and FDI is less affected by these problems in China.

4.2.5 Government intervention

The degree of state involvement in the Russian economy is very extensive. It is expressed through the direct public ownership as well as government involvement in the private business sector. It is further enhanced through regulations and administrative burden on business, aggravated by existing explicit barriers to trade and FDI.

OECD's Product Market Regulation (PMR) index that measures the degree of state regulatory environment and the extent to which it allows free competition in the economy indicates that the overall level of state regulations is very high in Russia, much higher than in any OECD country, even though there are significant variations regarding individual components of the index.[194]

One of such components is the measure of state control. It is indicated as highly pervasive, higher than in any OECD country. Since the beginning of Putin's presidency, government has put an emphasis on strengthening the role of the public sector in the economy. Creation of large state-controlled enterprises that occupy the dominant position in so-called "strategic sectors" has been at the cornerstone of this strategy.[195] This is reflected in the increase of majority stakes of federal government in total holdings from 25 percent in 2005 to 61 percent in 2008. Even though only 9 percent of all firms were state-owned in 2007, these enterprises tend to be much larger than private firms. For example, the share of market capitalization of the Russian equity market controlled by the state was 40 percent in 2007. Especially high state presence was in banking industry, manufacturing and gas and oil sector. The participation of private capital, including foreign, in minority stakes is tightly controlled and limited in such companies.

Yet, the state control is not limited only to the state ownership of enterprises. In Russia the distinction between the public and private sector is not very clear sometimes, with government often having close ties with private enterprises. Another form of interfering in the private sector is through the so-called golden shares that allow government members to veto

[194] Unless specified otherwise, information on Russia in this section is based on OECD Economic Survey Russia 2009, chapter 5, p.125-165

[195] OECD Investment Policy Review:Russian Federation (2008), p. 28-36

strategic decisions of private corporations in which government owns no conventional stock. Golden shares were created as a part of privatization program in sectors deemed strategic by the government.

The presence of such big state-controlled enterprises as well as direct government intervention in the affairs of private firms distorts free and honest competition in the market, which leads to losses in efficiency and productivity, as it draws resources from the most productive private companies. In fact, the number of companies producing a given percentage of Russian GDP has fallen since 2005, indicating the increasing consolidation in the market, mostly through state conglomerates that acquire non-core assets across market segments.

Another interesting fact is that the authorities in Russia were responsible for 53 percent of all violations of antitrust law in 2007.[196] The situation when the government is a market player, regulator and policymaker leads to unfair government practices that are bias against private firms, providing state-owned companies with state support. This increases ownership advantages of state-owned corporations, reducing the value of those of foreign companies, undoubtedly deterring foreign investors. No surprise, Russia ranks very low when it comes to t*ransparency of government policymaking* in the World Competitiveness Report 2009-2010, much lower than China.

Competition in China is safeguarded through the Anti-Monopoly Law which came into force on August 1st 2008. An important component of the Law is that it is applied equally to both domestic and foreign-owned enterprises.[197]Yet, it remains to be seen whether this law will truly not discriminate against private sector enterprises and especially foreign-owned. State-owned enterprises in China being ineffective and unproductive as they are, still receive support of the government, which is quite discriminatory against private sector firms. For example, state-owned banks continue to lend to unprofitable SOEs at favourable terms accumulating bad loans. However, as indicated by the World Competitiveness Report 2009-2010 the effectiveness of anti-monopoly policy in China is significantly better than in Russia.[198]

[196] OECD Economic Survey Russia (2009), p.142

[197] OECD Investment Policy Review China 2008, p.27

[198] World Competitiveness Report 2009-2010

Another component of PMR assesses regulatory and administrative environment through the measure of its transparency and business-friendliness. Russia ranks quite well in comparison with the average of OECD countries when it comes to the transparency of its regulations. However, the administrative burden on companies starting a new business is quite high compared to most OECD countries, acting as a barrier to entry. This is also confirmed by World Bank's Doing Business Report 2010 where Russia ranks 106 out of 182 countries when it comes to *the ease of starting a business*. Yet, it is still much higher than China which ranks 151 on the same indicator.[199] According to 2009 Index of Economic Freedom constructed by the Heritage Foundation and Wall Street Journal that measures economic freedom across countries, the overall freedom to conduct business in Russia is constrained by complex regulatory environment as for example obtaining a business licence takes more than the world average of 18 procedures and 225 days. Russia scores slightly higher on the *business freedom* component of the Index than China, which lacks regulatory transparency.[200] Quite different is the conclusion of the Global Competitiveness Report 2009-2010 which ranks Russia much lower than China in terms of burden of government regulation.[201]

Labour regulations in both Russia and China are quite rigid and the non-salary cost of employing a worker is high. Both countries score low compared to the world average when it comes to labour freedom component of Index of Economic Freedom. The situation in China became especially difficult for employers after a new employment law became effective on January 1st 2008. Doing Business Report 2010 indicates that labour regulations are more rigid in China than Russia, both lower than OECD average. The former ranks 140 while the latter 109th in the world when it comes to *the ease of employing workers* indicator. Hiring workers is easier in China, but the redundancy costs are much higher in China than in Russia. This finding is confirmed by the World Competitiveness Report 2009-2010 which says that firing costs are much lower in Russia. This has also been reflected in the growing unemployment in the country during the crisis time, whereas during the economic crisis of 1998 the labour regulations were much tighter and employers preferred to delay payments of wages instead of laying off people.

[199] Doing business report 2010

[200] http://www.heritage.org/Index/About.aspx

[201] World Competitiveness Report 2009-2010

The extensive environmental degradation in both Russia and China that puts high costs on the society has forced policymakers in both countries to develop a set of laws and regulations that protect the environment. However, the regulatory and legal frameworks remain largely ineffective in both countries as the authorities often do not have the ability or willingness to enforce its provisions. The breaches in regulations by the companies that are strong engines of growth in the region are often unnoticed by the authorities. In many instances, the sheer number of regulatory provisions makes it difficult for the enforcing authorities to implement them. For instance, the environmental legislation in Russia comprises of more than 30 federal laws and about 200 regulations. Standard and technical norms are described in another 800 documents.[202]

The regulation that affects country's openness to trade is extremely important for resource-seeking FDI as often the inputs are imported and final products exported from the host country. Tariff regime and other non-tariff barriers are especially critical here as it determines the cost of products crossing the state borders. High tariffs encourage market-seeking FDI through tariff-jumping as exporting final products from the home base becomes too expensive.

Exports and imports have been very important for the Chinese economic development and the reduction of trade barriers has been at the cornerstone of China's economic rise. It all started with the creation of special economic zones with lower trade barriers, progressing to further relaxation of import and export controls according to the conditions of China's accession to WTO. Russian experience with special economic zones has been less successful breeding rent-seeking and corruption instead of fostering innovation and foreign investment. WTO accession has been postponed indefinitely mainly for political and economic reasons.

Not surprisingly, China's average tariff rate was lower than Russia's and amounted to 4.3 percent in 2006 while Russia had 9.6 percent in 2005 according to the Index of Economic Freedom by the Heritage Foundation.[203] The same report ranked China higher with regards to trade freedom than Russia. World Competitiveness Report 2009-2010 confirms this ranking as China receives 69th place with regards to prevalence of trade barriers (meaning it is positioned more favourably than Russia), while Russia ranks far behind at 125th place.

[202] Environmental Policy and Regulation in Russia, OECD 2006; OECD Investment Policy Review China 2008, p.260-275

[203] http://www.heritage.org/Index/About.aspx

According to the World Doing Business Report 2010 China's advantage of *ease in trading across borders* is supported by its high rank of 44 while Russia has 162. This indicator measures the cost and time of import and export operation in both countries.[204]

The tax system in Russia is relatively new and many concepts and rules that are considered standard in the developed countries' tax systems still have not been adopted in Russia. During the 1990s tax collection was inefficient with tax avoidance being a common practice both because of weak enforcement capabilities of the authorities and complex tax regulations. In 2001 the Russian tax system was simplified and the tax burden on companies and individuals was eased. Combined with increased state capabilities to enforce the law, including the provisions of tax regulations, the state tax revenues increased sharply.

Until January 1st 2009 the corporate tax rate was 24 percent, but amid the economic crisis, the tax burden on corporations was decreased to 20 percent. For individuals there is a flat tax rate of 13 percent. Value-added tax is currently 18 percent, but there has been a lot of discussion lately regarding decreasing the VAT rate. The most important tax rate in Russia in terms of the tax revenue it provides, is the mineral resources tax which is levied on the volume of extracted oil and gas.

Despite the improvements in tax collection procedures, a report by Ernst and Young mentions that 63 percent of respondents consider the current tax regime to have a negative impact on the investment climate, suggesting there is a considerable room in improvement.[205]

Tax collection has been very important for the Russian authorities to fill the state pockets. However, the authorities are also known to have used the tax avoidance allegations as a political instrument. The already mentioned Yukos case is probably the best illustration of these very unfortunate practices.

Until recently there was a different tax rate for foreign and domestic enterprises in China. Foreign investors had to pay 15 percent of their income in corporate income tax, while the domestic enterprises had a 33 percent corporate income tax on average. On March 16th 2007 a new Enterprise Income Tax Law was adopted, which set a single corporate income tax rate of 25 percent for all enterprises regardless of their nationality.[206] This measure is supposed to

[204] Doing Business Report 2010.

[205] Quoted in Business Monitor International's "The Russia Business Forecast Report Q3 2008", p. 49

[206] OECD Investment Policy Review China 2008, p.19

bring more clarity and transparency into the Chinese tax regime. The authorities also hope that this will reduce the extent of round tripping FDI, as one of the major incentives for the returning domestic capital has been removed. It is important to notice, that there are still tax incentives offered for projects in the least developed parts of the country.

According to the 2009 Tax Misery and Reform Index published by the Forbes, China is placed among the countries that impose the harshest taxes, first and foremost due to high marginal personal income tax and employer social security tax. Russia ranks quite low with a far more friendly tax regime.[207] This is also confirmed by the 2009 Index of Economic Freedom where Russia scores higher than China when it comes to tax freedom component of the Index.[208] The World Competitiveness Report 2009-2010 also ranks Russia higher when it comes to the *total tax rate* criteria (meaning Russia has lower total tax rate) than China. However, China is ranked higher regarding the *extent and effect of taxation,* the fact that probably reflects more transparent tax rules that are more fairly applied.

In addition to the overall burden of state control and regulations that affect both domestic private firms and foreign enterprises alike, there are explicit barriers to foreign capital in Russia. The friendliness of the Russian political regime towards foreign capital has gradually declined over the years, something that has been reflected in the legal framework for FDI in the country.

The latest Law on Strategic Sectors that entered into force in May 2008 was a long awaited measure by the foreign investors. It defines sectors that are deemed "strategic" by the Russian government and where participation of the foreign investors is a subject to government review. The law is welcomed by the international community as it brings transparency to the approval practices which had been applied on a very unclear basis prior to the adoption of the Law. However, the list of the so-called "strategic" sectors has included 42 areas of economy which goes far beyond the OECD recommendations for FDI restrictions that should be focused entirely on the areas of national security and public order. The timeframe for notification of decisions is also longer than the best international practices would suggest.[209] The provisions of the Law demonstrate yet again the government's drive for establishing greater control of the economy which has become apparent in the recent years.

[207] www.forbes.com

[208] http://www.heritage.org/Index/Explore.aspx

[209] OECD Investment Policy Reviews Russian Federation 2008, p. 23-36

This is an unwelcomed development seen through the eyes of the international investment community, which has experienced the reduction of investment opportunities in Russia.

However, it is important to mention that these opportunities remain significant which has been reflected in a great amount of FDI in recent years. Especially the restructuring and privatization of the electricity sector has yielded great promises for foreign companies, which became majority owners of parts of the Russian electricity generation industry.

China has been open to foreign investors since the beginning of its transformation in the late 1970s gradually adopting FDI legislation and removing barriers to foreign investors. All foreign investments are subject to the restrictions laid out in the Catalogue for the Guidance of Foreign Investment Industries. The Catalogue divides FDI into prohibited, restricted, permitted and encouraged categories. Adopted first in 1997, it has been revised a few times reflecting the objectives of the Chinese government regarding foreign investments. In the beginning of the transformation period the Chinese authorities regarded FDI as a way of increasing exports in order to increase the influx of foreign currency. As the economy evolved and the foreign exchange reserves soared to become the largest in the world, the Chinese economy depends now much less on exports than before. The Chinese government today seeks to increase high-technology FDI to target the domestic market instead. The latest revision of the Catalogue took place on December 1st 2007 expanding the encouraged category of sectors open to FDI to include the sectors that are in great need of new technology. OECD reviewing the list of prohibited and restricted sectors argues that blocking FDI in areas that are polluting or deemed traditional is not the best way to deal with the perceived dangers. Much more effective way to, say, preserve traditional industries like tea and Chinese medicine is to increase training and pollution can be better contained by environmental laws and their effective implementation.

Summary

The degree of state intervention in the market economies of Russia and China is quite extensive. Both countries suffer from the inadequacies of state regulation that inhibits the development of business and deters foreign investments. China has particularly complex regulation with regards to opening a business, while Russia suffers from a general pervasive state ownership in the economy. Labour regulations also favour Russia as a destination of FDI. At the same time, China has improved its economic trade openness and fair treatment of foreign investors following the accession to WTO, while Russia has retained higher tariffs rates. Tax regime in Russia imposes less burden on foreign investors than that of China,

however, the less transparent rules and tax regulations make it even less favourable to investors than the one in China. Russia is also known to limit the participation of foreign investors in many sectors of the economy which are considered strategic.

4.2.6 Infrastructure

Infrastructure was important priority for the government in the Soviet Union, which was investing heavily into the development of electric lines, railways, airports, hydro-electric power systems etc. However, following the fall of the USSR and the downturn in the Russian economy, no funds were allocated to maintenance of the infrastructure stock. As a consequence of this, Russia has today a huge stock of old Soviet build infrastructure which urgently needs replacement and further development.

The network of roads is especially in great need of renovation. The quality of roads is notoriously poor as every Russian knows all too well. The transport network is much better developed around the major cities of Moscow and Saint-Petersburg, yet with quite significant shortcomings as severe traffic jams and delays in rail traffic are quite common. Outside the major cities and especially beyond the area of European Russia the network of roads is poorly maintained or does not exist at all. According to a report by Renaissance Capital "less than 40 percent of federal roads, and about a quarter of regional roads, meet Russian regulatory requirements".[210]The domestic air network is not reliable as delays and cancellations of flights are common occurrence. The safety of air traffic, which is very poor, is another concern. After the breakup of the national carrier Aeroflot, a lot of small companies were created which complicated the problem of maintenance control.

At the outset of its economic transition China had very similar infrastructure problems to those Russia experiences today or even more serious as China was mostly a rural country at that time. Despite major deficiencies in infrastructure the Chinese economy managed to grow at a high pace. Yet, insufficient infrastructure was becoming a major problem to economic development. Opposite to the situation in Russia, the development of infrastructure stock in China has been implemented at a rapid pace with quite remarkable results. The Chinese government has spent billions of dollars on expressways, ports, railways and other infrastructure.

[210] Quoted in article "Russia missed out on chance to improve its roads" in Los Angeles Times by Megan K. Stack on July 15th 2009 http://articles.latimes.com/2009/jul/15/world/fg-russia-roads15

As a result China has far outpaced Russia in modernizing its roads, airports, power plants and other infrastructure. For example, from 1990 to 2008 the length of roads in Russia increased from 885.000 km to 940.000 km, whereas the length of paved roads increased from 656.000km to 754.000 km (including 30.000 km of express ways).[211] For comparison, China in 1988 had only 147 km of express ways. Today it has 41000 km of express ways, which is second to only the US. China has 1.930.000 km of roads today of which 1.575.000 km is paved roads.[212] The difference is staggering especially when we take into account the size of the countries and the trend of rapid development of road network in China and almost non-existing development of one in Russia.

But the difference does not stop at roadways. According to an online article by Vladislav Inozemtzev in the Russian newspaper Vedomosti on 17th of July 2009 in Russia "from 1989 to 2008, the volume of overseas transport fell by 4.8 percent, and the number of airline passengers- by 2.1 times; housing stock put into operation fell by 34 percent, and connecting to the power grid became a nationwide problem". At the same time, the same source points out that in China "in only the last five years, 3.1 billion square meters of housing were built, 480.000 km of automotive and 19.000 km of rail routes; 16 large new airports have been put into operation, the first high-speed trains have been launched, six Chinese ports entered the list of the top 12 sea gateways of the world (moreover, the least busy of them handles more cargo than all of Russia's ports combined), and connecting to the electrical grid now takes 19 days."[213]

The above mentioned information is supported by the World Competitiveness Report 2009-2010 which ranks China 46 with regards to the level of development of its infrastructure. Russia occupies 71st position and is behind China with regards to every single type of physical infrastructure, from quality of roads to quality of electricity supply.[214]

Realizing the importance of sufficient infrastructure for economic growth and attraction of foreign investment given the poor state of Russian roads, railways, airports, the Russian

[211] The Federal Service of State Statistics (www.gks.ru) and the World FactBook

[212] Dr. Yongding Yu (2005) "China's Rise, Twin Surplus and the Change of China's Development Strategy", Institute of World Economics and Politics, Chinese Academy of Social Sciences; World FactBook, ww.cia.gov

[213] http://www.vedomosti.ru/newspaper/article.shtml?2009/07/14/204837 translated in http://www.theotherrussia.org/2009/07/17/russia-lagging-behind-in-infrastructure-modernization-%E2%80%93-inozemtsev/

[214] Global Competitiveness Report 2009-2010

government takes steps to remedy the situation. Additional source of public financing have been established like the Investment Fund, the Development Bank and the Russian Venture Company which are to be supported by private investors whose participation in investment projects in infrastructure is envisaged as well.[215]

For now, however, the participation of the private sector in infrastructure projects remains very limited. While China mostly relies on public financing in this area too, the Chinese authorities are actively seeking private investors to participate in infrastructure development offering them variety of incentives. For example, there are provisions in the Enterprise Income Tax Law that open for tax deductions for income from major public infrastructure investment projects supported by the state.[216]

Without more active participation of private capital it is unclear how Russia will manage to develop its infrastructure to the satisfactory levels, especially now, when the ongoing economic crisis and falling oil prices have significantly diminished the financial abilities of the Russian government. Even in better times the Russian state used to invest around 5 percent of GDP on infrastructure while China allocated 9 percent.[217]With required hundreds of billions of dollars in capital infusions in infrastructure over the next ten years, according to government own estimates, Russia faces a major challenge of upgrading its infrastructure facilities to the optimal levels.[218]

Financial infrastructure in both countries is quite weak by international standards and inadequate to support the growing economies. According to the World Competitiveness Report 2009-2010 China and Russia end up at the 81st and 119th place respectively with regards to financial market sophistication. China comes out better than Russia especially with regards to venture capital availability.[219]

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[215] OECD Investment Policy Review Russia 2008, p.20

[216] OECD Investment Policy Review China 2008, p.22

[217] Mr. Shigeo Katsu, the World Bank Europe and Central Asia Regional Vice President, in his speech during his official visit to the VIth International Investment Forum in Sochi in September 2007 http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/RUSSIANFEDERATIONEXTN/0,,contentMDK:21481768~menuPK:305622~pagePK:2865066~piPK:2865079~theSitePK:305600,00.html

[218] Business Monitor International, Russia Business Forecast Report Q2 2009, p.49

[219] World Competitiviness Report 2009-2010

China has a quite high savings rate and banking system dominates the financial sector, while stock market remains thinly traded and corporate bond market almost does not exist. In fact, "the private sector holds almost twice as much money in bank deposits relative to GDP as the average of four major OECD economies, while holding less than one-fifth the amount of shares and one-tenth the amount of insurance and pension fund saving", as reported by OECD Economic Survey China 2005. Commercial banks account for three-quarters of total assets among the financial institutions.[220]Most of the banks are state-owned and the share of foreign-owned banks in China's banking sector was around 2 percent in 2003 (Russia had 8.1 percent).[221]Many banks in China have lent large portions of the household deposits to money losing state-owned enterprises which no longer are able to service their debt.[222] The amount of bad loans accumulated on the balance sheets of state-owned banks can be as high as 35 percent or about 40 percent of GDP in 2000.[223]

During the Soviet era the healthcare system was centralized, integrated and quite effective. It achieved great success in combating infectious diseases, yet neglecting non-communicable diseases as well as general provision of primary care.[224] Following the years of underinvestment in healthcare during the 1990s, Russia today is in the midst of the health crisis that has not been noticeably remedied during the years of economic growth. Life expectancy at birth is 66 years, less than that of the European Union's average by 14years and China by 8years and it has been falling since the breakup of the Soviet Union.[225]The leading causes of premature death are non-communicable diseases and traffic accidents. Combined with low birth rates it creates a negative demographic trend of decreasing population, and even more importantly working age population.

Health problems in Russia are not just the result of deficiencies in healthcare infrastructure. They are a result of a number of other factors like environmental degradation, traffic-related safety, excessive alcohol and tobacco consumption. Hence, spending money on healthcare only will not resolve Russia's health problems and the problem of high mortality

[220] OECD Economic Survey China 2005, p.139

[221] OECD Economic Survey China 2005, p.151

[222] Nicholas R. Lardy (1998), China's unfinished economic revolution

[223] Chen-uan Tung (2002), Current Problems and Reforms of Chinese Financial System, p.2

[224] OECD Economic Survey Russia 2006, p.191

[225] The World Bank (2008). Russian Economic Report 16, June 2008, p.20; The World Factbook

and low life expectancy should be addressed through a number of measures directed at a broad range of issues.

Notwithstanding the complexity of reasons for general health deterioration, the state of Russian healthcare system has been in decline for a long while. One of the most important reasons for the decline has been the lack of financing and investment in healthcare infrastructure. During the 1990s the real public health expenditures decreased by one-third to come back to the pre-transition levels only in 2006. Currently Russia spends 5.3 percent of its GDP on healthcare, which includes both private and public capital. When it comes only to the public expenditures, they have fluctuated between 2.7 percent and 3.6 percent of GDP since 2001.[226] This is low compared to the EU which spends between 6 and 8 percent of GDP, but comparable to China which spends even less, with 1.9 percent in 2003. However, in total China spent 5.6 percent of its GDP on healthcare with private expenditures making up the biggest share of spending.[227]

It is not just the amount of spending on healthcare that is a problem, but also the allocation and administration procedures leave a lot of room for improvement. According to an IMF study, some countries that spend 30-40 percent less than Russia, still achieve the same results with regards to public health.[228]

As mentioned above government expenditures on healthcare are quite low in China and have actually decreased during the 1980s and 1990s. More people have to pay themselves for medical services, with situation being the worst in the rural areas. Those who cannot afford to pay for medical care simply do not get it.[229]

World Competitiveness Report 2009-2010 shows quite different impact of different diseases on business. For example with regards to malaria, Russia is ranked much higher than

[226] The World Bank (2008). Russian Economic Report 16, June 2008, p.20

[227] "Tough choices: investing in health for development. Experiences from national follow-up to the Commission on Macroeconomics and Health". World Health Organization 2006

[228] Referred to in the World Bank (2008). Russian Economic Report 16, June 2008, p.21

[229] Exploring market opportunities in China. International Business Report 2004; The World Health Report 2008 – Primary Care: Now More Than Ever, p.84

China. When it comes to such diseases as tuberculosis and AIDS, both countries rank close to each other.[230]

When it comes to educational infrastructure, Russia has a long standing trend of high enrolment in higher education as mentioned in the previous sections of the paper. Yet, according to the World Competitiveness Report 2009-2010 the quality of overall educational system including primary education is somewhat higher in China than in Russia, but the difference is not large. Russia scores much higher on internet access at schools, but China is better when it comes to the availability of research and training services.

Summary

Physical infrastructure in Russia after years of neglect is currently in a far worse condition than the one in China. Financial infrastructure is inadequate to support growing economies, yet venture capital is far more available in China than Russia. Due to high savings rate China is able to channel a lot of capital to its most productive use, while Russia's banking system is notoriously weak. Healthcare and education infrastructure are also generally at a higher level of development in China than in Russia, even though both are seriously underfunded.

4.3 Summary of the analysis

This section offers a summary of the analysis of FDI determinants conducted above. Different factors impact FDI differently in both countries affecting the volume and sector distribution of FDI in China and Russia. We can see that Russia is far better endowned with natural resources and that explains the fact that almost one third of all FDI stock in the country is accumulated in the resource-extracting industry, notably in oil and gas. One can speculate that even more FDI could have been located in this sector, but the restrictive investment environment discourages foreign investors. This comes at the time when the existing oil fields have matured and foreign technology and expertise is urgetly needed to explore the new ones. Hence, Russia has a clear advantage compared to China when it comes to the abundance of commercially exploitable resources, but this advantage could have been even more pronounced given a more liberal attitude of the authorities towards foreign capital in this sector.

[230] World Competetiviness Report 2009-2010

Another factor that gives an advantage to Russia is the enrolment of population into the tertiary education providing the country with a pool of well educated labour force. However, the quality and sheer number of people enroled in the primary education gives China an advantage with regards to the manufacturing sector that does not require highly educated workers. The productivity and cost of labour also provides an advantage to China which is extremely important to FDI targeting manufacturing and services sectors. The size of the labour force is also much greater in China with its large population than in Russia which is struggling with the decrease in the numbers of working age population.

One often hears about the great market potential of both countries. Yet, comparing the two in terms of their actual market size as well as market potential, China has a huge advantage. It is the second largest economy in the world measured by purchasing power parity adjusted GDP, whereas Russia is lagging behind.

Both countries appear to be quite stable politically and socially, yet the political and social stability are directly dependent on the macroeconomic stability in both countries. In the absence of free and truly democratic regimes, the authorities' legitimacy and popularity is derived from their economic achievements. Macroeconomic stability has been sustained longer in China whose economy even despite the crisis continued to grow, whereas Russia managed to keep its economy stable during only a decade largely due to favourable transitory factors. When those factors were gone, so was the macroeconomic stability in the country. Political stability has also been affected by the actions of the authorities towards FDI and the pressure applied on foreign investors by the government. Hence, China has a clear advantage regarding macroeconomic stability and certain advantage in political and sociable stability.

The legal environment in both countries is not supportive of FDI and business in general. However, it appears China has achieved more progress in improving the predictability and reliability of its legal regime regarding issues like for example intellectual property rights. The Chinese authorities seem to be genuinely concerned with the market reforms and take the weakness of their legal system more seriously than their counterparts in Russia.

The issue of corruption is high on the agenda in both countries, but it appears more widespread and hence more troubling in Russia than in China. The structure and effectiveness of public administrations in both countries carry a great room for improvement, but the quality of public service still appears higher in China than Russia.

What appears to be highly detrimental to foreign capital in Russia is the pervasive and widespread influence the Russian state exerts on the economy. Much of this influence is politically motivated and can be hard to predict. Whereas the Chinese authorities' grip on the economy has been declining over the years, we witness the opposite process in Russia. And it is a well-known fact that the greatest achievements in the Chinese economy happened where the government reduced its intervention and let the market forces take over. This is bad news for FDI in Russia that has seen a gradual reduction in investment opportunities in the country due to government's policies.

Infrastructure is simply much better developed in China than Russia, especially when we take into the account the progress of its improvement. It is by no means perfect, but significantly outperforms Russia in all of its aspects. The financial system is far better positioned in China as well. The high savings rate provided China with sufficient capital that resulted in massive growth of the economy. People in Russia are less inclined to trust their savings to the banks and the importance of the financial system in the country is hence far more insignificant than it is in China.

Hence I can conclude that China has a very clear and significant advantage over Russia in attracting FDI due to to the market size and market potential of its economy, the productivity and cost of its labour, the macroeconomic stability, existing infrastructure and the smaller extent of the public intervention in its economy. The advantage is less pronounced but still important when it comes to the functioning of its legal system, political and sociable stability and the spread of corruption. Russia appears to be better off in terms of its abundant natural resources and highly educated workforce. In total the advantages that China possesses far outweigh any disadvantages and hence offer an explanation to why China attracts more FDI than Russia. In this context it is important to mention the limitation of this conclusion that has already been mentioned before. There can be lots of other explanations that appear more or less crediable than the one I came to depending on the set of possible FDI determinants that are chosen for analysis. The legitimacy and relevance of the chosen data sources are open to critical review too. The overreliance on the results of public opinion surveys in comparison of FDI determinants is a major weakness of the thesis as well. Much information about Russia has been collected directly from the official source which may have flaws and shortcomings compared to the standards adopted by the international organisations.

5. Conclusion

Two of the world's most prominent and rapidly developing emerging economies, China and Russia share many similarities in their past and present and yet are so different in many respects. Among those similarities is their strive to attract more foreign direct investment that can bolster further development of their economies and integration with the rest of the world. Despite impressive economic achievements of both countries in recent years, China has managed to outperform Russia consistently in attracting FDI. This paper investigated the possible reasons for this phenomenon by analyzing a set of factors that can determine FDI flows in both countries.

According to the findings of the analysis China has indeed managed to create a far more friendly business and investment oriented environment than Russia. China was particularly successful compared to Russia in establishing stable macroeconomic environment, building up a stock of modern infrastructure and reducing the damaging impact of state intervention in the market economy. Moreover, one of the largest markets in the world as well as its great potential to be even large constitutes an additional incentive to invest in China. Russia's strong economic development ended abruptly with the onset of the global economic downturn as the set of favourable conditions that supported the Russian economy suddenly changed.

The findings of the paper may offer an explanation to the relative attractiveness of China as FDI destination compared to Russia. However, FDI determinants are not static and evolve constantly. As they change so does the position of the country as a FDI target. It is impossible to predict the amount and sector direction of the future FDI flows to both countries. However, the experience gained by China and Russia in attracting FDI will assist the authorities to continue to develop policies aimed at creating positive business environment that will benefit not only the foreign capital, but all market participants. One thing certain: both China and Russia are important FDI destinations and will continue to appeal to foreign investors in the nearest future.

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