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International investment implications of Russia’s war against Ukraine (abridged version)

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Russia’s war against Ukraine has triggered unprecedented policy responses around the globe, raising manifold implications for international investment policy, both immediate and longer term.

- The war has brought about a range of government responses and the adoption of international investment-specific measures, including economic sanctions targeting the Russian government and individuals, and other entities.
- Businesses have taken steps towards divesting their operations in Russia.
- The Russian government has responded by restricting investment and capital flows in and out of Russia.
- The impact on foreign direct investment (FDI) and other capital flows to and from both Ukraine and Russia has been immediate and profound; combined with divestments, these will accelerate the decade-long downward trend of investment in Russia.
- Longer-term implications include: impacts on energy security and the clean energy transition; the protections afforded to investors under investment treaties and potential treaty-based litigation; and the role of foreign investment in the reconstruction of Ukraine.

What are the key issues?

Governments and businesses have taken investment-specific measures in response to Russia's invasion of Ukraine, with economic sanctions targeting the Russian government, investments made by individuals and entities associated with the Russian government, and designated individuals and entities close to the Russian government. These measures are exceptional in respect of their nature and scope, their severity and the swiftness of their application, and include:

- the prohibition of access by the Russian government and companies to capital markets, the prohibition of listing of shares of Russian state-owned enterprises (SOEs) and selling of securities to Russian clients, the removal of selected Russian banks from the SWIFT messaging system
- the freezing of the foreign assets of a number of sanctioned Russians individuals and entities
- the prohibition to provide financial rating services to Russian companies, the prohibition of transactions with the Central Bank of Russia (CBR), the Russian government and specific Russian SOEs and banks, including the trading of Russian sovereign bonds, and the freezing of the CBR's assets held abroad.

A considerable number of companies from a wide array of industries have taken steps towards divesting their operations in Russia for a variety of reasons, including reputational and liability risks, human-rights considerations, volatile market conditions, and practical challenges. These include companies in the consumer goods, energy, food, media, tech, goods & retail, travel, and finance sectors, among others). Divestment announcements came within days of the adoption of the first round of sanctions, which have ranged from holding off new investments (i.e. postponing future planned business while continuing substantive operations), scaling back of operations (i.e. reducing some business activities while maintaining other operations), partial or total suspension of activities (i.e. temporarily reducing operations while keeping hypothetical resumption options open), to the complete withdrawal of operations (i.e. complete halt of operations and exiting the country). These business decisions appear to have reinforced the impact of public-sector policy responses.

Russia has adopted measures in response to slow the currency devaluation, capital outflows and the drop in asset prices. These included stringent capital controls and coercive measures, including nationalisation, against companies and organisations that have adopted decisions against Russian interests. The Russian government has sought to prevent Russian residents from moving capital abroad and losing foreign currency, while adopting measures seeking to prevent foreign investors from divesting from Russia (e.g. the CBR ordered market participants to reject foreign clients' bids to sell Russian securities to prevent divestment from financial assets and capital flight). Repayment of debt obligations to foreign entities has also been made more difficult.

What are the impacts?

Russia's invasion of Ukraine and the subsequent international response have brought a further negative shock and disruption to the world economy, with immediate consequences on foreign direct investment (FDI) and other capital flows. The impact on global FDI flows will however be limited, as Russia's role as a recipient and origin of FDI is marginal, according to OECD FDI statistics. Even before February 2022, its inward and outward FDI stocks accounted for only around 1-1.5% of global FDI stocks, although there is expected to be an immediate impact on FDI inflows in Russia. Investors from selected OECD countries still make up a sizable share of the Russian inward investment. According to the CBR, the Netherlands and the United Kingdom are the second and third largest FDI sources with 9% and 7% respectively, also reflecting the role of these countries as financial centres. From a sectoral perspective, trade, mining and manufacturing are the key FDI recipients in Russia. In 2020, services excluding financial and insurance activities represented 37% of the total inward FDI stock in Russia, followed by mining and

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quarrying (24%), manufacturing (21%) and financial and insurance activities (14%). Among services, wholesale and retail trade is the largest recipient sector of FDI in Russia (16% of total inward FDI stock), followed by professional, scientific and technical activities (9%) and real estate activities (6%).

The impact on global and Emerging Markets (EM) portfolio flows is yet uncertain, even though in the short run increasing global uncertainty and higher global inflation are further weighing on already weak capital flows to emerging markets. Spill-overs on global equity markets and sovereigns have overall remained limited. Eastern European equity markets were hit more substantially, including Hungary, Poland and Serbia, while emerging Asian markets and Western European markets were also affected, but to a lesser extend, reflecting investors' concerns about elevated commodity prices and the weakening economic outlook. Sovereign credit default swap spreads (a measure of the market's view of the risks of default) have also increased significantly in Serbia, Romania, Hungary, Poland and Bulgaria. A number of banks from Austria, Italy and France have the largest absolute exposures to Russia, due to their Russian subsidiaries. The profitability of those banks is likely to decline following disruptions to their business activities in Russia. The aggregate exposures of European and U.S. banks to Russia amount to about 0.8 and 0.4%, respectively, of their total claims. A number of banks from Austria, Italy and France have the largest absolute exposures to Russia, due to their Russian subsidiaries. The profitability of those banks is likely to decline following disruptions to their business activities in Russia. The aggregate exposures of European and U.S. banks to Russia is nonetheless limited, amounting to about 0.8 and 0.4%, respectively, of their total claims. In the longer run, the removal of Russia from all major EM indices will entail a rebalancing of portfolio flows. The impact will nonetheless be limited by the low weight Russia has held recently in these indices

What is the outlook?

It is still too early to predict the long-term consequences of all these actions. However, their impact on the international investment environment is already perceptible. Some of these developments in policy and investment flows, already underway since 2014, have accelerated sharply in recent weeks, notably the increasing financial and economic isolation of the Russian economy. The effects of the war will increase the costs of doing business across borders, at least in the short term, and may lead many companies to reinvest a smaller share of their earnings than they have done in the recent past or put on hold new investments, both mergers and acquisitions (M&As) and greenfield investments.

Potential treaty implications also require attention for policy makers. Potential claims based on investment treaties by businesses or individuals affected by government measures taken in the context of the war may reveal weaknesses in the design and interpretations of many – especially older – investment treaties, pointing to the importance of concerted reform.

Improving energy security is a medium-term venture, but significant gains can be achieved already in 2022. The war has triggered a rapid and fundamental reshaping of European energy policy, with energy security now the continent's primary concern. Accelerating the clean energy transition will require substantial public and private investment. Thanks to their financial and technical capacities and their global operations, MNEs are key players in developing and disseminating clean energy technologies across borders. FDI accounts for 30% of new investments in renewable energy globally. FDI in the energy sector is also rapidly shifting away from fossil fuels and into renewables, reaching over 90% of energy-related FDI in OECD economies in 2021 and over 70% for non-OECD economies. The extent to which FDI contributes to financing clean energy will depend on a number of framework conditions, including the market and regulatory environment as well as specific policies designed to promote low-carbon investments.

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What are the key considerations for policy makers?

- The long-term consequences of Russia's invasion of Ukraine are still being played out – but the impact on the international investment environment is already taking shape.
- How governments frame and conceptualise standards of protection and access to investor-state arbitration in their respective treaty practices may change. Currently, 46 bilateral investment treaties with Russia are currently known to be in force, 22 of which between OECD Members and Russia. Public- and private-sector responses have already affected ongoing treaty proceedings, with investor-state arbitral proceedings brought by Russia-affiliated claimants, including against the European Union and Ukraine.
- Public funds from OECD member countries and international organisations, as well as private investment, will be vital to mobilising efforts to help Ukraine during the conflict. The first official Ukrainian figures on the economic costs of the conflict (28 March 2022) estimated the costs of the Russian invasion to over USD 500 billion.
- Resorting to unsustainable fuel options in the short-term may delay the energy transition. Developing and emerging economies that import considerable quantities of fossil fuels from Russia are at risk of surging inflation and recession and also likely to resort to coal to mitigate the shock. Public and private investment are critical to driving forward the clean energy transition.

Further reading

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