International investment implications of Russia's war against Ukraine

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Foreword

Russia's war against Ukraine has triggered unprecedented policy responses around the globe. These policy measures, as well as decisions by multinational companies, raise manifold implications for international investment policy and capital and investment flows. This report provides an overview of the implications, both immediate and longer-term, in what remains a quickly evolving environment.

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Executive summary

The Russian Federation's war against Ukraine is primarily a human tragedy. It also has manifold implications for global policy-making. This note seeks to inform the international investment policy community hosted at the OECD about: the main implications for investment policy; measures, impacts and trends that have been observed in this area; and parameters that will allow them to anticipate future and longer-term impacts.

Section 1 sets out the international investment-specific reactions of various governments and businesses in response to the invasion, as well as measures that the Russian government has taken. It notes that:

- Russia's large-scale aggression against Ukraine has caused outrage and thrown much of the world into turmoil. The overwhelming majority of governments quickly condemned the invasion and many have adopted – in some cases unprecedented – 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.
- A considerable number of companies from a wide array of industries have taken steps towards divesting their operations in Russia for various reasons, including reputational and liability risks, human rights considerations, volatile market conditions, and practical challenges to doing business as a result of the sanctions.
- Russia adopted a number of measures in response to sanctions and a fast depreciating currency, including stringent capital controls to slow the currency devaluation, limit capital outflows and arrest the further drop in asset prices. The authorities also announced they could implement certain coercive measures, including nationalisation, against companies and organisations that have individually adopted economic measures or decisions against Russian interests.

Section 2 lays out positions before and developments since the invasion for FDI and other capital flows as well as international financial spill-overs. The section describes that:

- The Russian invasion of Ukraine and the international response constitutes a further negative shock to the world economy which has a profound and immediate impact on FDI and other capital flows to Ukraine and Russia, as well as knock-on effects for global capital flows through business linkages and displacement effects.
- Russian inward and outward FDI plays a marginal role on a global scale. Impacts on global FDI flows are thus expected to remain limited.
- The impact on Russian inward and outward FDI is significant, however. Preliminary data show a 22% decline in the number of M&A deals concluded in Russia during the first quarter of 2022 compared to the same period in 2021, and a similar drop in announcements of greenfield FDI projects. Combined with increasing divestments by multinationals, declining new investments will accelerate the decade-long downward trend of FDI in Russia. Outward FDI flows from Russia to advanced economies will likely also decline significantly, but advanced economies will be affected to different degrees.

- The impact of sanctions on the Russian economy has been acute and particularly felt on its currency, equity market and sovereign credit conditions. The value of the RUB initially collapsed, along with that of Russian banks, while Russian sovereign credit default swaps surged. A 15% GDP contraction is expected for 2022.
- The freezing of the Central Bank of Russia's (CBR) foreign assets is unprecedented and is limiting the CBR's capacity to use its reserves to defend the RUB. Russia also faced several rating downgrades and its sovereign bonds are now rated to "near default" status.
- Spill-overs on global equity and bond markets have overall remained limited, affecting Eastern European markets more severely, and to a lesser extent emerging Asian markets and Western European markets.

Section 3 provides a look at the longer-term implications for international investment and investment policy making associated with the war against Ukraine, including the effect of the aggression on energy dependence and the clean energy transition, implications of investment treaties and liability considerations, and the role of foreign investment for Ukraine's recovery. The Section sets out that:

- Possible longer-term consequences of the war include increased energy and commodity prices, potential fragmentation of payment systems and financial markets, higher risk premia and currency depreciations in emerging market economies, higher costs of doing business across borders, and potential declines in reinvested earnings of multinationals.
- Many OECD economies are heavily reliant on fossil fuel imports from Russia, which account for 40% of Europe's natural gas imports. Europe's already high energy prices have skyrocketed since the invasion, and are expected to result in 30% higher energy bills for EU households.
- Improving energy security is essential, with the possibility of significant gains already in 2022, as set out in the IEA's 10 Point Plan. Resorting to unsustainable fuel options such as coal in the short-term may delay the energy transition, particularly in fuel import-dependent developing countries. Accelerating the clean energy transition in the medium-term will require substantial public and private investment, including FDI which currently accounts for 30% of global new investments in renewable energy.
- Russia's war in Ukraine could bring about investment treaty claims by Ukrainian investors with business interests in Russia. Russian retaliation for business decisions to divest (including planned nationalisation measures) may also lead to questions of treaty liability. Whether or not measures taken in the current context could lead to treaty-based litigation and how these claims are decided is difficult to predict in light of the uncertainty that characterises the interpretation of treaty provisions.
- According to some estimates, the war is affecting territories that produce 60% of Ukrainian GDP, and the economic costs of the conflict are as high as EUR 565 billion and growing.

Many aspects covered in this note are still evolving quickly and information may soon become outdated. Many secondary effects are still difficult to predict and quantify and thus not the focus of this note. Information and analysis are up to date as of 28 April 2022.

1 Investment-related actions in response to Russia's war against Ukraine

The Russian Federation's large-scale aggression against Ukraine 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 entities close to the government. Separately, businesses have taken steps towards divesting their operations in Russia. The Russian government has, in reaction to these measures, taken a number of actions impacting investment and capital flows in and out of Russia.

Russia's large-scale aggression against Ukraine has caused outrage and thrown the world into turmoil. The majority of governments around the world quickly condemned the invasion. The OECD reacted swiftly, with a condemnation of the aggression by the Council on 24 February 2022 (OECD, 2022[1]) and a series of measures agreed on 25 February 2022 (OECD, 2022[2]) and on 8 March 2022 (OECD, 2022[3]). The invasion was also condemned in the UN General Assembly (United Nations, 2022[4]) and at the ILO (ILO, 2022[5]), among others. A significant number of governments, including all G7 Members and many economies with which Russia had until recently had the most active economic relationships, including Ukraine itself, have adopted comprehensive sanctions and taken other measures in response to the unprovoked invasion of its sovereign neighbour.

Many multinational enterprises with investment or trade relationships in Russia as well as some international financial institutions (e.g. AIIB (2022[6]) with engagement in the country have also suspended or unwound operations in Russia for various reasons, including reputational and liability risks.[1]

The Russian government has taken a series of measures to stabilise the economy, and individuals and entities subject to sanctions for their involvement, support or association with the aggression have sought to evade the measures.

Government responses to Russia's large scale aggression

Since Russia's annexation of Crimea in 2014, many western economies had imposed some economic sanctions on Russia and entities or individuals associated with its government. Further sanctions were adopted more recently in response to Russia's recognition of the two self-proclaimed "people's republics" in Ukraine's Donetsk and Luhansk oblasts and the undisguised advance of Russian military into rebel-held territories on 21 February 2022. These measures were very significantly expanded in the wake of the large-scale aggression deep into government-controlled territories in Ukraine on 24 February 2022 and have reached a much broader scope and magnitude than before. These measures are still progressively strengthened, and the number of countries that have adopted economic and financial sanctions is also growing. Many of these measures have considerable implications for cross-border capital flows and transactions to and from Russia.[2]

These measures are on many levels unprecedented in respect of their nature and scope, their severity and the swiftness of their application. Sanctions in effect in early April 2022 relate to investments in the territory of Russia and to investments originating in or associated with investors close to the Russian authorities. These have included, *inter alia*: the prohibition of access by the Russian government and companies to capital markets, the prohibition of listing of shares of Russian SOEs and selling of securities to Russian clients, the prohibition of sale or transfer of banknotes to Russia, caps on deposits by Russian residents, 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 not least the freezing of the CBR's assets held abroad.[3] Most of these sanctions were extended to Belarus.[4]

Several governments have adopted sanctions affecting investments made by individuals and entities associated with Russia to exert economic pressure on identified actors (e.g. Russian state-owned enterprises (SOEs) and other individuals or entities whose activities are linked to the Russian war effort). Measures freezing and / or confiscating assets owned or controlled by targeted individuals restrict the capacity of those individuals to dispose of and benefit freely from their assets.

Nationals and entities based in jurisdictions that have issued these sanctions are also barred from providing funds or any economic resources to listed persons or entities owned or controlled by them. Australia, the European Union, Japan, New Zealand, Switzerland, among others have adopted individual sanctions, which are updated on an ongoing basis. Others, like France, the United Kingdom, and the United States have set up specific task forces to explore and identify assets belonging to listed persons so as to enhance the effectiveness of their sanctions, and a multilateral taskforce, so called "REPO", was put in place by the EU, the G7 and Australia to increase multilateral cooperation and share information.

Several economies have progressively introduced specific regimes to prohibit transactions with designated Russian economic actors. The European Union for example has adopted a full prohibition on transactions with certain Russian State-owned enterprises associated with the military sector. A number of countries have also announced their decisions to restrict and/or further assess future relations with

Russian economic actors in strategic sectors within their economies. In that regard, a number of measures prohibiting the broadcasting activities of certain press organs within their respective territories were taken by a number of governments, and decisions made to halt licensing processes in critical sectors such as the energy sector.

Certain economies have also announced that they would pay careful consideration to foreign acquisitions by investors controlled by or subject to influence by Russia or Belarus when implementing their investment screening mechanisms (and perhaps even more so in sectors that are currently particularly vulnerable to security risks, including the defence sector, the energy sector and dual-use items technologies). Canada published a Policy Statement in that regard and the European Commission has called on all EU Member States to pay particular attention to these threats.

A number of countries have also adopted measures that directly target investments made in the territory of Russia. Measures in this area vary in their scope as some economies have restricted investments by their nationals either within specific sectors (e.g. the energy or military sectors) or in the Russian market entirely.

Ukraine adopted a number of foreign exchange controls to prevent capital flight and a collapse of its currency. The National Bank of Ukraine (NBU) initially fixed the exchange rate of the Ukrainian hryvnia (UAH) against foreign currencies at the 24 February 2022 level, imposed a moratorium on cross border foreign currency payments and early repayments of loans from non-residents. It prohibited foreign exchange cash withdrawals and capped UAH cash withdrawals to UAH 100,000 per day in Ukraine and UAH 100,000 per month abroad. It also prohibited settlements of credit/guarantees/counter-guarantees opened after 24 February 2022, and remittances abroad using P2P transfers and quasi cash transactions (e.g. replenishment of e-wallets or cashing of travellers' checks) were limited to UAH 100,000 per month. On the other hand, cashless payments abroad with payment cards continued to be authorised.

These stringent exchange controls have been progressively relaxed in recent weeks. The foreign cash withdrawal prohibition was adjusted to a UAH 30,000 cap per day on 1 March 2022 and to a UAH 100,000 cap on 21 March 2022 in Ukraine or abroad from foreign currency accounts with Ukrainian banks. The NBU later allowed banks to buy UAH cash from foreign financial institutions for cashless foreign exchange up to EUR 1 million per day; allowed customers in areas under threat of occupation to withdraw UAH and foreign exchange cash from accounts without restrictions and to purchase foreign exchange cash and investment metals with physical delivery; and allowed the purchase of foreign currency on a forward basis under forward contracts concluded through 23 February 2022. It also allowed the buying of foreign currency to transfer funds for health insurance payments abroad and green card, and limited selling of FX cash to the public.

Further, the NBU also adopted measures against Russian banks by prohibiting transactions in RUB and means of payment from Russia and transactions with Russian or Belarusian counterparts. It revoked the licences and liquidated Ukrainian subsidiaries of Sberbank and VEB, two large Russian banks, and denounced reported activities by Russia to limit the circulation of cash and cashless UAH, as well as attempts to put into circulation RUB in Ukrainian areas under occupation by Russia.

Finally, the NBU co-operates with the National Bank of Poland (NBP) by signing an agreement allowing Ukrainian refugees in Poland to exchange UAH for PLN at more favourable exchange rates and a separate agreement for an foreign exchange swap line of USD 1 billion to replenish the NBU's international reserves.

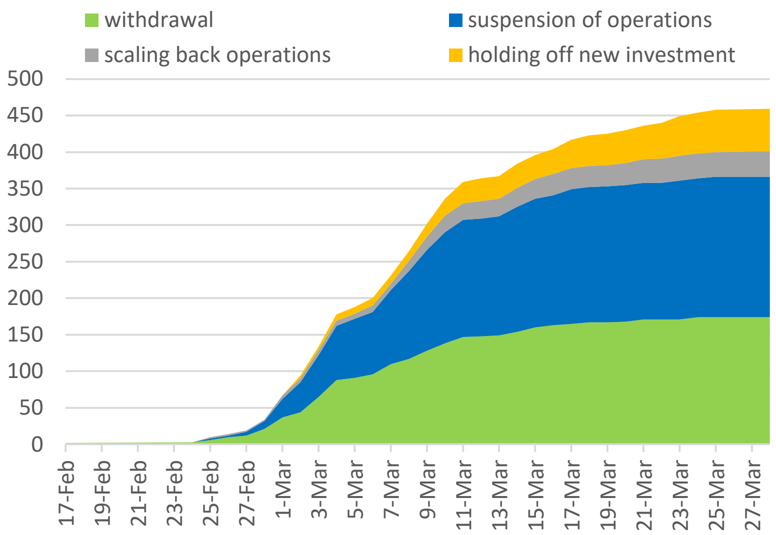
Separately, the Ukrainian government reintroduced a comprehensive set of economic and financial sanctions targeting designated individuals and entities close to the Russian government via a Cabinet Order **amending the Ukrainian** Law on Sanctions. It also **adopted a** law **allowing the nationalisation of property directly or indirectly owned by Russia or Russian nationals for the**

purposes of protecting Ukraine's national interests and national security, and ensuring its economic independence.

Private sector responses to the Russian large scale aggression and to the sanctions adopted by certain economies

A considerable number of companies have taken steps towards divesting their operations in Russia. These include companies from a wide array of industries (consumer goods, energy, food, media, tech, goods & retail, travel, and finance, among others). Divestment announcements came within days of the adoption of the first round of sanctions. A continuous stream of subsequent divestment announcements followed suit (Figure 1). Divestment announcements have ranged from holding off new investments and development (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.

Figure 1. Number of multinational enterprises that have announced changes to their operations in Russia



Source: Yale School of Management (2022[7]).
Note: Latest data available - 28 March.

Beyond mounting reputational pressure and human rights considerations, divestments may be also driven by increasingly volatile market conditions and the practical challenges that foreign companies would face when operating in Russia in light of the direct and indirect impact of sanctions. Financial sanctions on Russian banks, difficulties in making international payments and reduced access to foreign capital are likely to put a strain on balance sheets of both Russian-owned companies and affiliates of foreign companies. Foreign companies may find it challenging to support their affiliates through intracompany loans and injections of equity capital – which are an important component of FDI flows – now that the country's financial system is almost decoupled from advanced economies.[5] Transport logistics between Russia and major advanced economies have also become more challenging since air freight was heavily reduced and European ports closed to Russian ships.

The private sector response may have been constrained by limitations imposed by their respective business models (e.g. franchises) or by the scale of their operations in Russia. As of 27 April 2022, 185 MNEs are reported to have declared not to be willing to reduce or exit operations in Russia. Further, divestment prospects and how these will be effectively and fully rolled out will depend in part on the duration of the large-scale aggression against Ukraine, and on the Russian government's policy responses, as the latter announced that it would consider retaliatory measures including nationalisations and other measures temporarily preventing foreign investors from selling their Russian assets.

Measures taken by Russia

Russia swiftly adopted a number of measures in response to sanctions and a fast depreciating currency, including stringent capital controls to slow the currency devaluation, capital outflows and the further drop in asset prices. These were recently gradually relaxed as the RUB recovered.

On the one hand, the Russian government sought to prevent Russian residents from moving capital abroad and losing foreign currency. The CBR and Russian government introduced a surrender requirement of initially 80% of export proceeds within three business days (later relaxed to 60 working days), a 30% commission on foreign currency purchases by individuals on currency exchanges[6], and a 30% limit on advance payments for certain foreign trade contracts (later relaxed). It banned foreign exchange loans to non-residents and bank, foreign exchange electronic transfers by Russian residents outside of Russia and loans and credit in RUB, as well as acquisition and sale of ownership title to securities and immovable property abroad without approval. It introduced a cap of USD 10 000 on foreign currency cash withdrawals by individuals and of USD 5000 for companies to be used solely for expenses on foreign business trips. It banned issuance and circulation of foreign depository receipts for shares of Russian issuers and limited the sale of receipts converted into shares by residents. Russia also adopted a decree requiring "unfriendly" countries to pay for Russian gas in RUB,[7] which is akin to an increase of the surrender requirement on exporters to 100% for exports to such countries. The CBR ultimately approved different exchange rates for different market participants, introducing a spread between buying and selling of foreign currency.[8]

On the other hand, measures were adopted seeking to prevent foreign investors from divesting from Russia. The CBR ordered market participants to reject foreign clients' bids to sell Russian securities to prevent divestment from financial assets and capital flight. The Moscow Exchange was closed for over a month to avoid dramatic asset sell-off. It reopened on 21 March 2022 for government bonds and 24 March for equities and the CBR announced that it would conduct trading in federal loan bonds to avoid a crash in their price in the amounts necessary to limit risks to financial stability, prohibited short selling, and limited stock trading to 33 shares.

Russia also made repayments of debt obligations to foreigners more difficult, with the CBR initially banning coupon payments to foreign owners of Russian government bonds known as OFZs. Russia then introduced a special temporary debt service procedure to service external debt with RUB under credit contracts with residents of specific foreign states exceeding RUB 10 billion per calendar month. In such cases, RUB would be credited to accounts generally restricted to the payment of taxes or the purchase of federal government bonds placed by the Russian Ministry of Finance. Obligations in foreign currency to foreign creditors that are not part of the official country list can only be carried out in roubles.

The Russian authorities have decided to classify all the countries that have imposed sanctions against Russia as "unfriendly" States. Nationals of "unfriendly" States and nationals from other States having important economic links with those countries, may face a set of specific measures regarding their activities or potential activities in Russian territory. Foreign natural persons and legal entities with links to "unfriendly" States must request the Government Commission on Monitoring Foreign Investment's permission before concluding or performing certain transactions with Russian residents. Under a government resolution, patent holders associated with “unfriendly” States may also have their patents registered in Russia confiscated by the authorities without any compensation.

The Russian authorities have also announced that they could implement certain coercive measures, including nationalisation, against companies and organisations that have individually adopted economic measures or decisions against Russian interests. This is particularly the case for foreign companies that have suspended their activities or left the Russian territory. The government in early March drafted legislation that targets companies from “unfriendly” jurisdictions that have, since 24 February, (i) suspended operations after without obvious commercial reasons, (ii) notified more than one-third of their employees of redundancy or (iii) terminated key agreements with Russian entities. A law was also adopted to allow Russian airline companies to register aircraft leased from foreign firms and continue to operate them domestically. In parallel to these economic measures, Russia adopted a law to facilitate foreign investment by companies from “unfriendly” jurisdictions to invest in certain Russian special administrative regions by simplifying their registration processes.

2 Local and global developments in FDI and capital flows

Russia's large-scale aggression against Ukraine and the ensuing international response have together produced a considerable negative shock to the world economy. 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 are likely to accelerate the decade-long downward trend of investment in Russia. The impact of sanctions on the Russian currency, equity market and sovereign credit and debt conditions has also been acute. On the other hand, due to small exposures to Russia, impacts on global FDI and global equity and debt markets have overall remained limited.

The Russian invasion of Ukraine and the international response have brought a further negative shock and disruption to the world economy which have a profound and immediate impact on FDI and other capital flows. These impacts are primarily noted in Ukraine and Russia, but have knock-on effects for global capital flows through business linkages and displacement effects.[9]

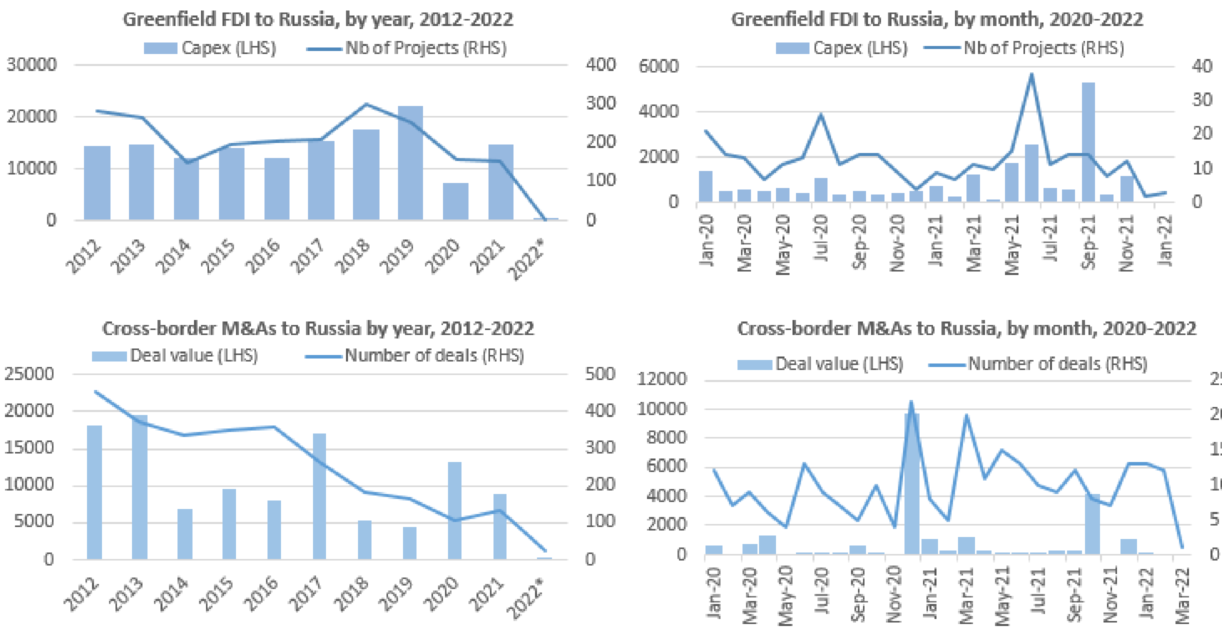
Impact on FDI flows

On a global scale, Russia plays only a marginal role as a recipient and origin of FDI 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. The large-scale aggression is expected to have an immediate impact on FDI inflows in Russia. Preliminary data on cross-border M&As from *Refinitiv* show a 22% decline in the number of M&A deals concluded in Russia during the first quarter of 2022 compared to the same period in 2021. Data on greenfield FDI provided by *fDi Markets* suggest that the number of greenfield FDI projects announced between November 2021 and January 2022 were 23% lower than during the same period a year earlier, and the drop by value was even higher, at over minus 28%.

In addition to a drop in new investments, Russia has and will likely experience significant divestments of foreign multinationals operating in Russia. While divestments are a frequent and natural feature of global supply chains as they allow firms to adapt their operations to changing business realities such as severe liquidity constraints and rising debt levels, the current volume of divestments is likely unprecedented for an economy the size of Russia's. Supply disruptions, demand contractions, a pessimistic outlook of economic actors and the posture that the Russian authorities have most recently taken vis-à-vis foreign-owned enterprises will likely accelerate divestments.

Less new investment and significant divestment of existing positions in Russia will accelerate the decade-long downward trend of FDI in Russia. FDI flows in and from Russia peaked in 2013, but the annexation of Crimea by Russia in 2014 led to a sharp drop in FDI flows to Russia, both greenfield FDI projects and M&A. The number of M&A deals dropped from 453 in 2012 to 108 in 2020. Greenfield investment experienced a slight upward trend between 2015 and 2018 but the number of projects halved between 2018 (300 projects) and 2021, when only 150 projects were announced. Lower levels of reinvestment of earnings – partly due to COVID-19 disruptions – further compounded the downward FDI trends of previous years. In 2020, Russian FDI inflows stood at USD 10 billion and outflows at USD 7 billion, their lowest level since 2005.

Figure 2. Greenfield FDI and cross-border Mergers and Acquisitions to Russia (USD millions)



*Data for 2022 include only greenfield FDI projects announced in January 2022, and M&As announced until March 2022.

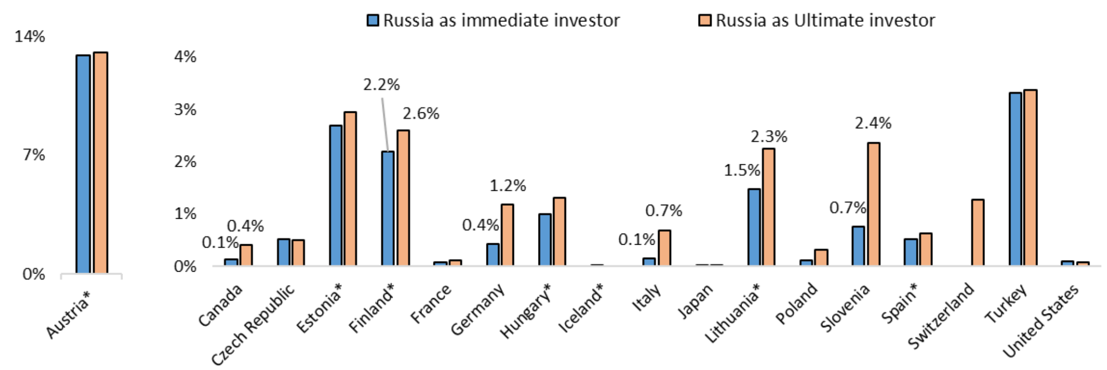
Source: Refinitiv database and Financial Times' fDi Markets database.

Investors from OECD economies still make up a sizable share of the Russian inward investment despite sanctions imposed in the wake of the 2014 annexation of Crimea. According to the CBR, Cyprus is the largest source of foreign investment, accounting for 32% of total inward stock in 2020, followed by Bermuda (11%).[10] This most likely reflects Russian offshore investment, some of which can be round-tripping of domestic investments. The Netherlands and the United Kingdom are the next largest sources with 9% and 7%, respectively, also reflecting the role of these countries as financial centres. Among other OECD countries, France, Germany and Switzerland represented each between 3% and 4% of Russia's total FDI inward stock in 2020.

OECD FDI statistics on ultimate investor nuance the picture of Russia's main partners among OECD economies.[11] OECD statistics show that in 2020, the Netherlands accounted for the majority of total OECD FDI stocks in Russia (41%), followed by Switzerland (13%), France (10%), Germany (8%) and the United Kingdom (7%). Special Purpose Entities (SPEs) hosted in the Netherlands account for almost half of the Netherlands' FDI stock in Russia, indicating that a large share of Netherlands' investments in Russia likely originates elsewhere.

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 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%).

Figure 3. Share of Russia in total inward FDI stock of selected OECD countries

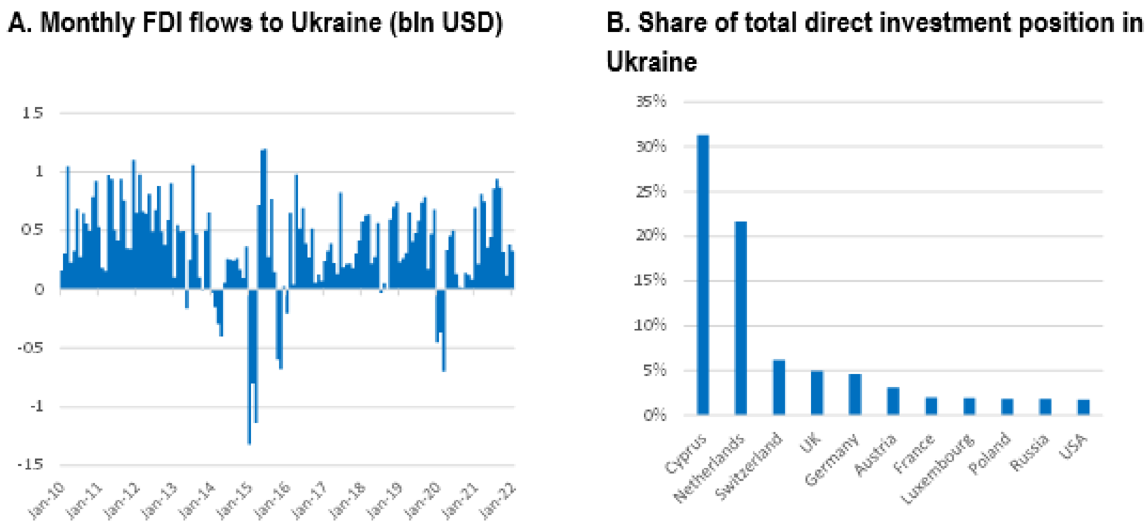


Note: 18 OECD countries currently their inward FDI positons according to ultimate investor in addition to immediate investor to the OECD. This chart represent the share of Russia as immediate and as ultimate investor in total inward FDI position of each country. Countries for which the position of Russia as ultimate investor is more than 0.4 percentage points higher than as immediate investor are highlighted. Data for Austria, Estonia, Finland, Lithuania and Spain exclude resident SPEs. Switzerland's inward FDI from Russia on an immediate basis is not available due to confidentiality restrictions.
Source: OECD FDI statistics database https://www.oecd.org/investment/statistics.htm.

Outward FDI flows from Russia to advanced economies will likely decline significantly in light of international sanctions and economic crisis. Advanced economies will be affected to different degrees. In statistics provided by the CBR, Cyprus appears as the largest recipient of FDI from Russia with almost 50% of Russia's total outward FDI stock in 2020. The second and third largest investment destinations for Russian investment were Austria and the Netherlands, with 8% and 7% of outward FDI stock, respectively. OECD inward FDI statistics by ultimate investors vis-à-vis Russia again provide more nuanced information. According to these data, Russia is a more significant ultimate investor in Canada, Finland, Italy, Lithuania and Slovenia, suggesting that investors from Russia channel funds to these countries via other countries, most likely Cyprus and the Netherlands.

FDI inflows to Ukraine have been volatile since 2014. Ukraine faced important outflows at the beginning of 2014, in 2015 and during the early stages of the COVID-19 shock (Figure 4.A). In terms of exposure, the countries with the largest FDI positions in Ukraine are Cyprus and the Netherlands (typically transit countries) with 31% and 22% respectively, followed by Switzerland, the UK, Germany and Austria (Figure 4.B). A major FDI drop is to be expected since the start of the war.

Figure 4. FDI Inflows to Ukraine



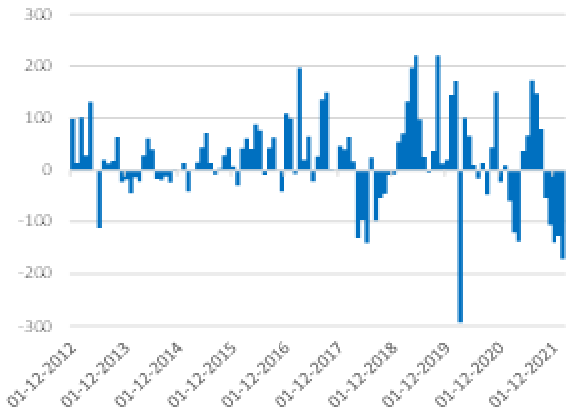
Source: OECD Monthly Capital Flow Dataset (Latest data February 2022) and NBU.

Impact on financial markets and capital flows[12]

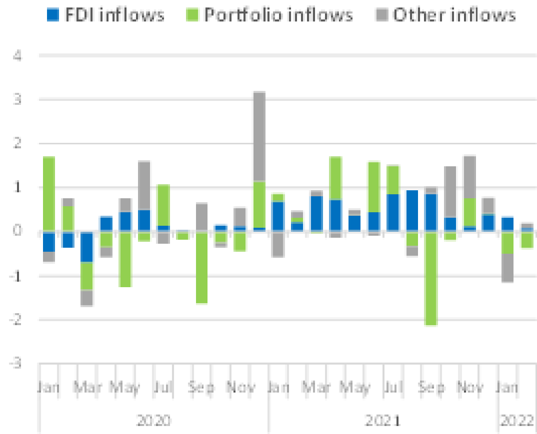
The impact of sanctions on the Russian economy has been acute and particularly felt on its currency, its equity market and sovereign credit conditions. The value of the RUB rapidly collapsed, reaching at worst RUB 150 against the USD (vs. 75 at the beginning of 2022). The market value of Russian banks, which are unable to perform international transactions and are facing both large withdrawal by retail depositors and growing non-performing loans, plummeted, and so as Russian corporate equity more generally, and Russian sovereign credit default swaps (CDS) surged. The International Institute for Finance expects a 15% GDP contraction for 2022. Capital has been flowing out of Russian sovereign bonds already since October 2021 (Figure 5.A) and portfolio and banking inflows to Ukraine have declined since January (Figure 5.B). A substantial impact on flows to both countries should be expected in the data from March 2022 onwards when such data become available. Nonetheless, the tight restrictions introduced by Russia have allowed an apparent stabilisation of domestic financial conditions, most notably a rebound of the RUB to pre-war levels.[13]

Figure 5. Capital flows into Russia and Ukraine

A. Net inflows into Russian sovereign bonds (OFZ) (bln RUB)



B. Capital Inflows to Ukraine (bln USD)

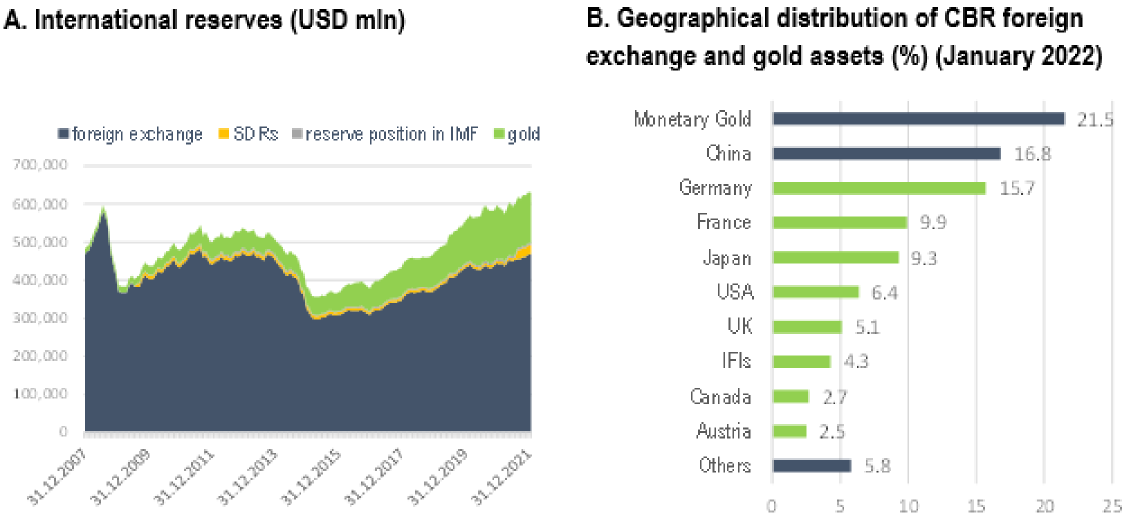


Source: CBR and OECD Monthly Capital Flow Dataset
Note: last data point: February 2022.

The freezing of the CBR foreign assets is limiting the CBR's capacity to use its reserves to defend the RUB. While Central Bank assets had already been frozen in the context of previous sanctions' regimes (e.g. Iran, Afghanistan, or Venezuela), the latest measures targeting the CBR are unprecedented in respect of the number of countries applying the sanctions and the size of the reserves frozen (green bars in Figure 6.B), more than half of the USD 643 billion CBR's international reserves (Figure 6.A). Despite a substantial increase and diversification of the CBR's reserve portfolio since 2014 away from USD and towards yuan and gold, USD- and EUR-denominated reserves combined still represented 45% of the total (10.9% and 33.9% of the reserves respectively) according to the latest data available (January 2022 – Figure 6.B).

Despite such freezing, the CBR was able to use around USD 40 billion of reserves since the start of the war. End of March, the CBR resumed the weekly publication of its international reserves: as of 1 April 2022, the reserves amounted to USD 606.5 billion, down from the USD 643 billion peak.

Figure 6. Russia's International reserves



Source: CBR.

The risk of a Russian default on its foreign debt[14], although limited in absolute size[15], is high due to both sanctions and Russian policies. The instruction of the Russian government to repay foreign exchange debt obligations in RUB, even when contracts have no pre-existing clauses for RUB repayment, raises questions as to whether this situation should be considered a default. Regarding sovereign debt, the freezing of the CBR foreign assets did in theory not allow the possibility of using such assets to repay upcoming coupons. The U.S. Treasury later allowed debt payments from Russia[16] under a temporary license expiring on 25 May 2022 as well as the unfreezing of some of the CBR foreign exchange assets for coupon payment purposes and the first Eurobond coupon was processed on 17 March 2022. On 5 April, the U.S. however clarified that it will not allow further USD debt payments from Russia's accounts at US banks. Russia also faced several rating downgrades and its sovereign bonds are now rated to "near default status".[17]

International financial spill-overs

Spill-overs on global equity markets and sovereigns have overall remained limited. Eastern European equity markets have been hit more substantially, including Hungary, Poland and Serbia, and to a lesser extent emerging Asian markets and Western European markets, reflecting investors' concerns about elevated commodity prices and the subsequent weakening economic outlook. Sovereign Credit Default Swap spreads have also increased significantly in Serbia, Romania, Hungary, Poland and Bulgaria.

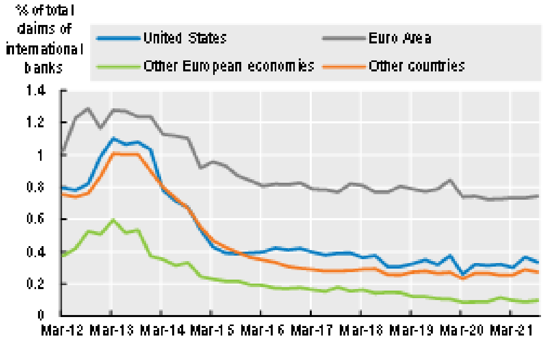
Russia plays only a marginal role in global inward and outward FDI (1-1.5% of global FDI stocks). While this will limit the direct impact on global FDI flows, the additional uncertainty that the war adds on global economic condition may still weight in the short run on global FDI flows that sunk by 38% in 2020 due the COVID-19 pandemic and weight on the recent signs of recovery[18].

The impact on global and Emerging Markets (EM) portfolio flows is yet uncertain. The removal of Russia from all major EM indices will entail a rebalancing of portfolio flows,[19] as Russia's previous weight in these indices will be redistributed among the other countries. The impact will nonetheless be limited by the low weight Russia has held in these indices. Indeed, that weight was already greatly reduced in 2014, falling for instance in the GBI-EM index from 10% at end-March 2014 to 4.7% at end-March 2015, and was further reduced afterwards.

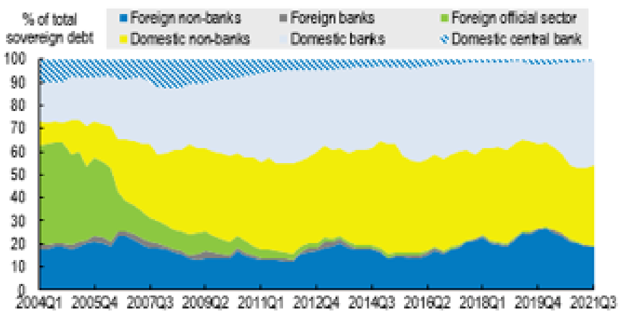
Spill-overs have also affected international banks, particularly European banks with substantial exposures to Russia. A number of banks from Austria, Italy and France have the largest absolute exposures to Russia, due to their Russian subsidiaries. These profitability of those banks is likely to decline following disruptions to their business activities in Russia. Nonetheless the impact is limited by substantial retrenching of international banks' exposure on residents of Russia after the first wave of sanctions in 2014. The aggregate exposures of European and U.S. banks to Russia amount to about 0.8 and 0.4%, respectively, of their total claims (Figure 7.A).

Figure 7. International financial exposures to Russia

A. Exposure of international banks to Russia (% of total claims)



B. Holders of Russian sovereign debt (% total sovereign debt)



Source: BIS and IMF Sovereign Debt Investor Base for Emerging Markets.

3 Outlook: Longer-term implications for international investment and policy making

Russia’s large-scale aggression against Ukraine will, beyond its immediate repercussions, entail longer-term implications for international investment and investment policy-making. These concern amongst others the impact of Russia’s invasion 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, which according to some estimates, has to date sustained losses amounting to EUR 565 billion as a result of the war.

While it is still too early to predict the long-term consequences of all these actions, 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.

The wide-ranging sanctions imposed on Russia together with the breadth of divestments by MNEs could encourage other countries to rebalance or even decouple their global economic and financial linkages, so as to limit the impact of hypothetical sanctions they could face in the future. Such a shift may involve a move towards reduced reliance on the USD for trade transactions, gradual diversification of certain central banks’ reserves away from USD assets, and an increased use or development of alternative payment systems. In parallel, companies and investors may diversify their supply chains and pre-emptively reduce their exposure to countries that they deem may be subject to sanctions in the future. These shifts, even if limited, narrow, and gradual, would lead to a more fragmented global financial system.

Other aspects relevant for investment policymaking such as energy dependence, potential treaty implications and post-war reconstruction also require attention. To unwind dependencies on Russia's fossil fuels, especially in Europe, requires renewed and much accelerated efforts to support the clean energy transition. 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. Rebuilding Ukraine, its cities, infrastructure and industry will require international investment on a large scale. Conducive policies are required to mobilise, encourage and facilitate this investment.

From energy dependence to clean energy transition

Many OECD economies, especially in Europe, are heavily reliant on fossil fuel energy imports from Russia. Russia is the world's largest natural gas exporter, supplying 19% of the world's gas consumption in 2021 (OECD, 2022[8]), the world's second largest oil exporter, supplying 14% of the world's oil (IEA, 2022[9]), and third largest coal exporter. According to OECD data (OECD, 2022[10]), Russia has until recently supplied over 40% of European natural gas imports, a similar proportion of coal imports, and around one quarter of oil imports.

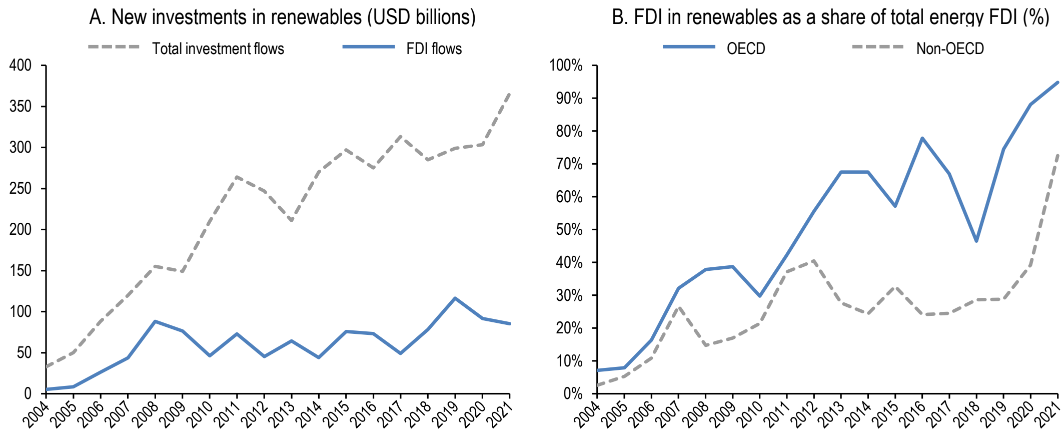
The invasion of Ukraine has propelled Europe's already high energy prices even higher. Europe has been facing increased energy prices for several months, but now uncertainty over supply is exacerbating the problem. Since January 2022 oil prices increased by 20%, European natural gas prices are up 30% and coal prices more than doubled. Natural gas is a key source of heating for many EU households and skyrocketing energy prices are expected to result in 30% higher energy bills for 2022, affecting low-income households the hardest.

Resorting to unsustainable fuel options in the short-term may delay the energy transition. In the short term, all options for addressing the shortfall in Russian oil and gas are on the table, including extending the use of coal-fired power generation. In the days after Russia's large-scale aggression of Ukraine, Poland asked Australia for coal supplies that could substitute for Russian imports. Italy's prime minister has suggested reviving coal-fired power plants to meet the nation's energy demands. Germany signalled that it might extend the lifespan of coal-fired power plants that were due to close by 2030. 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.

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. The IEA has set out a 10 Point Plan (IEA, 2022[11])on how to reduce the EU's reliance on gas imports from Russia by between one-third and one-half over the next year. The EU has proposed a short- to medium-term plan to reduce dependence on Russian gas by two thirds within a year, and eliminate dependence well before 2030. Short-term measures focus on diversifying the gas supply, ensuring Europe's gas stores are filled up ahead of next winter, and protecting vulnerable consumers and businesses against soaring energy prices. The structural measures are all about the energy transition: hastening the renewable build-out, electrifying heating through the rollout of heat pumps, increasing short-term targets on green hydrogen, and addressing energy efficiency of buildings.

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 (Figure 8.A). 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 (Figure 8.B). 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.

Figure 8. FDI in renewable energy



Source: OECD based on BloombergNEF (2022[12]) and Financial Times (2022[13]).

Implications of investment treaties and liability considerations

As at March 2022, 46 bilateral investment treaties concluded with Russia were known to be in force (22 of which were concluded and are in force between OECD Members and Russia).[20] Belarus is a party to 31 bilateral investment treaties currently known to be in force, 17 of which have been concluded with OECD countries.[21]

OECD governments concluded treaties with Russia and Belarus predominantly in the 1990s. The degree of protection afforded to investors under treaties concluded with Russia varies considerably, depending amongst others on whether treaties were concluded pre- or post-1991. By way of example, treaties concluded with Russia may differ significantly in respect of what categories of disputes fall within the scope of arbitral jurisdiction, and with respect to what legal entities qualify as investors and enjoy substantive treaty protections.

Some of these treaties include 'emergency' or 'exception' clauses (broad and general in some treaties, specific to particular treaty obligations and standards of protection in others). Depending on their designs, these may allow countries to take measures in response to security-related matters carved out from treaty scope and thereby shelter themselves from potential treaty liability either at a jurisdictional level or as a defence on the merits.

Under current arbitral interpretations, treaty shopping may also offer beneficial owners protections afforded under treaties concluded between other countries (e.g., non-OECD countries) and Russia. In that regard, the challenges in applying sanctions to Russian oligarchs due to widespread use of shell companies and opaque structures has led to a re-evaluation of the tolerance and facilitation of such structures, and renewed attention to the need for transparency of beneficial ownership. This re-evaluation may also affect investment treaty policies or interpretations permitting or encouraging the use of such structures.[22]

Russia's large-scale aggression against Ukraine has affected businesses and may raise treaty liability considerations. Russia's large-scale aggression against Ukraine could bring about investment treaty claims by Ukrainian investors with business interests in Russia[23] (e.g. in relation to investments made by Ukrainian investors within the territory of Russia). Separately, the economic and financial measures adopted by governments and private sector reactions in response to the war against Ukraine have also affected businesses. Moreover, Russian retaliation against businesses' decisions to withdraw or otherwise modify their business activities have and will continue to impact businesses that are still operating within the territory of Russia or that have suspended or withdrawn their operations in the country. Such measures may also give rise to questions of treaty liability, for instance in relation to a Russian draft federal legislation, which, if adopted in its current form, could allow the nationalization without compensation of assets from persons from or connected with "unfriendly" jurisdictions.

Whether or not measures taken in the current context could lead to treaty-based litigation and how these claims are decided is difficult to predict in light of the uncertainty that characterises the interpretation of treaty provisions. This is especially so in regard to infrequently invoked clauses. Russia's large-scale aggression may further shape how governments frame and conceptualise standards of protection and access to investor-state arbitration in their respective treaty practices.

Public and private sector responses to Russia's aggression have already affected ongoing treaty proceedings. Investor-state arbitral proceedings brought by Russia-affiliated claimants, including against the European Union and Ukraine, appear to have been suspended at the respondents' respective requests.

Russia's aggression against Ukraine may also raise other international investment law and public international law considerations. Poland has announced its withdrawal of consent to be bound by its bilateral investment treaty concluded with Russia, which the latter has not ratified.

The role of foreign investment for Ukraine's recovery

Russia's continued large-scale aggression imposes an unbearable human cost on Ukraine. The fighting also continues to destroy the country's houses, infrastructure, and industries. The first official Ukrainian figures on the economic costs of the conflict, released on 28 March 2022, estimated the costs of the Russian invasion to over USD 500 billion. According to EBRD, around 60% of Ukraine's GDP was generated in territories directly affected by fighting. A significant proportion of Ukraine's energy reserves are concentrated in the Donbass region.

The international community at the OECD is mobilising efforts to help Ukraine during the conflict and prepares assistance for the recovery phase.[24] It will help set policies to enable a swift and successful recovery – returning to the Organisation's roots of rebuilding Europe after World War II. Other constituents have also offered help. For example, the European Council agreed to establish a Ukraine Solidarity Trust Fund and invited its international partners to participate. European authorities also committed to continuing to provide technical assistance to Ukraine in order to implement necessary reforms.

Public funds from OECD member countries and international organisations will be vital, but so too will be private investment. Given the wanton destruction of property, including commercial and industrial assets and infrastructure, the investment needs of Ukraine for its eventual reconstruction will be enormous. Given their superior access to capital and larger financing capabilities foreign multinationals may play an important role in rebuilding the needed infrastructure and industry.

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Notes

[1] For more details see OECD (2022), Responsible business conduct policy implications of the Russian invasion of Ukraine", (forthcoming).

[2] These sanctions target primarily Russia, but some economies have also taken measures against Belarus and the territories of Donetsk and Luhansk oblasts of Ukraine that are not currently controlled by Ukraine's government.

[3] These include measures taken by the United States (including here, here and here and in this joint statement), the European Union, the United Kingdom, Japan, Australia, Canada, Korea, Switzerland, and Singapore.

[4] Notably by the European Union, the United States, Australia and Japan.

[5] Intracompany loans and injections of equity capital is an important component of FDI flows as they allow foreign investors to support their financially struggling foreign affiliates. Analyses of past crises show that foreign investors provided such support to their affiliates. Financial linkages between investors and their foreign affiliates play an important role in the affiliates' resilience to economic crises.

[6] The rate of 30% was set on 2 March 2022, was then reduced to 12% on 4 March 2022 and removed on 10 March 2022 in the context of the introduction of a cap on foreign exchange withdrawals.

[7] The decree sets out a mechanism for buyers to transfer foreign currency to a special account at a bank (Gazprombank), which would then be converted to RUB to be transferred to the seller (Gazprom). The CBR created new accounts type "K" to perform these operations.

[8] Such requirements were relaxed on 11 April 2022, with the CBR cancelling the requirement for banks to limit the difference in the buying and selling rate of foreign currency, with the exception of importing legal entities to pay for import contracts, for which the exchange rate spread should be no more than 2 RUB from the exchange rate.

[9] This section only considers the immediate impact of the war on FDI. The geo-economic developments associated with the invasion and global growth prospects will have further and potentially large effects on FDI that are not covered here.

[10] Bilateral FDI positions by immediate partner country published by the CBR follow the IMF Coordinated Direct Investment Survey (CDIS) requirements.

[11] The presentation by ultimate investing economy allows countries to look through the complex ownership structure to see the country of the direct investor who ultimately controls the investment and, thus, bears the risks and reaps the rewards of the investment. The presentation by UIC can shed light on another important issue: round-tripping. Round-tripping is when funds that have been channelled abroad by resident investors are returned to the domestic economy in the form of direct investment. Russia does not (yet) publish inward FDI positions by UIE but 18 OECD countries currently report this information to the OECD in addition to their inward FDI position by immediate investor, as per the OECD Benchmark Definition 4th edition (BD4) recommendations.

[12] With respect to the spill-overs on global financial markets, readers can refer for further information to OECD (2022), *Assessment of Global Financial Markets*. For a broader assessment on the economic and social impacts of the war, including on GDP and inflation, see Interim Report of the OECD Economic Outlook, March 2022.

[13] Very low liquidity and transaction volumes in the foreign exchange market as a result of the restrictions limit however the reliability of the exchange rate as indicator of actual financial conditions.

[14] Sanctions also impact Western clearing systems settlement of payments with Russian holders of foreign currency Russian government bonds.

[15] The share of foreign exchange denominated sovereign debt has declined significantly in Russia from 63% in 2004 to 19% at end of 2021. Russian sovereign debt was mostly held by domestic creditors (about 80% at end of third quarter 2021, see Figure 7.B).

[16] The license does however not authorise debit to an account on the books of a U.S. financial institution of the Central Bank, the National Wealth Fund, or the Ministry of Finance of the Russian Federation.

[17] Since the start of the war, S&P downgraded Russia's long-term issuer rating from "BB+" to "CC", Moody's from "Baa3" to "Ca", and Fitch from "BBB" to "C".

[18] See OECD's FDI in Figures, April 2021.

[19] As of end-2019, the size of benchmark-driven investments in EM local currency sovereign bonds is estimated between USD 300 billion, about 40% of the foreign investor base (Arslanalp et al. (2020), "*The Rise of Benchmark-Driven Investors in EM Bond Markets: Taking Stock*", IMF Working Papers 20/192). Passive funds made up around 45% of EME equity funds and 17% of EM bond funds in 2019.

[20] These are treaties concluded with (treaties not in force are indicated in *italics*): Albania (1995), *Algeria (2006)*, Argentina (1998), Austria (1990), *Azerbaijan (2014)*, *Bahrain (2014)*, Belgium/Luxembourg (1989), Bulgaria (1993), *Cambodia (2015)*, Canada (1989), China (2006), *Croatia (1996)*, Cuba (1993), *Cyprus (1997)*, Czech Republic (1994), Denmark (1993), Egypt (1997), Ethiopia (1999), Finland (1989), France (1989), Germany (1989), Greece (1993), Hungary (1995), *India (1994)*, Indonesia (2007), *Iran (2015)*, Italy (1996), Japan (1998), Kazakhstan (1998), Korea (1990), Kuwait (1994), Lebanon (1997), Libya (2008), Lithuania (1999), Moldova (1998), Mongolia (1995); Montenegro (1995), *Morocco (2016)*, Netherlands (1989), Norway (1995), *Poland (1992)*, *Portugal (1994)*, *Romania (1993)*, Qatar (2007), Serbia (1995), Singapore (2010), *Slovakia (1993), Slovenia (2000),* South Africa (1998), Spain (1990), Sweden (1995), Switzerland (1990), Turkey (1997), Turkmenistan (2009), Ukraine (1998), United Arab Emirates (2010), United Kingdom (1989), *United States (1992)*, Venezuela (2008), Yemen (2002).

[21] These are treaties concluded with (treaties not in force are indicated in *italics*): Austria (2001), Azerbaijan (2010), *Belgium/Luxembourg (2002)*, Bosnia and Herzegovina (2004), Bulgaria (1996), China (1993), Croatia (2001), Czech Republic (1996), Denmark (2004), Egypt (1997), *Estonia (2009)*, Finland (2006), *France (1993)*, Georgia (2017), Germany (1993), India (2018), Israel (2000), *Italy (1995)*, Jordan (2002), Korea (1997), Latvia (1998), Lithuania (1999), Mexico (2008), Moldova (1999), Netherlands (1995), North Macedonia (2001), Poland (1992), Romania (1995), Serbia (1996), Singapore (2000), Slovakia (2005), *Slovenia (2006)*, Sweden (1994), Switzerland (1993), *Turkey (2018)*, Ukraine (1995), United Kingdom (1994), *United States (1994)*.

[22] See Angel Gurria, The growing pains of investment treaties (2014).

[23] Ukraine-Russia BIT (1998).

[24] OECD (2022), *Large Scale Aggression by Russia against Ukraine: Development Co-operation Implications*, (forthcoming).