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IMPACT OF RUSSIA-UKRAINE WAR ON INTERNATIONAL INVESTMENT FLOWS AND POLICY PERSPECTIVE

Dr. Sandeep Kumar Garg*

ABSTRACT

The war comes at a time when the global economy is in turmoil. As new coronavirus varieties appeared and governments restricted investment, the recovery from the recession caused by the epidemic has slowed. Fed and other major central banks have raised interest rates as a result of higher price levels. Russia's foreign direct investment (FDI) to and from the Russian Federation is significantly affected by the conflict in Ukraine, which began in February 2022. The specific nature of sanctions and counter-Ukraine is not yet known, thus the extent of the hit will be determined by the sanctions and counter-Ukraine. However, some of them have already had a negative impact on the country's finances, adding to the strain created by the war. As a result of sanctions implemented in 2014, Russia's economic capacity has already been weakened, according to this study's findings. In order to decouple the Russian economy from FDI partners, the Russian government has to pay a heavy price.

Keywords: *Russia, Ukraine, War, Foreign Direct Investment, FDI, Investment, Breakdown.*

Introduction

Two main points made in a recent Financial Times story about Ukrainian FDI. In the first place, fresh foreign direct investment (FDI) into Ukraine dropped sharply once the conflict with Russia began. Even though Ukraine's business climate has improved, political and security concerns continue to impede foreign direct investment (FDI).

The fact that the majority of pre-war FDI originated in Ukraine (and Russia) and was channelled through special purpose corporations is vital to keep in mind. There's still a lot of uncertainty surrounding the armed war with Russia, but if Ukraine wants to attract more FDI, it needs to solve the long-standing issues that prevent it from doing so.[1]

Even before the events of 2014, FDI had already begun to decline in the country. Ukrainian FDI declined by 46.4 percent in 2013 (from $8.4 billion in 2012), due to a decline in demand for Ukrainian goods, deteriorating political conditions, and economic instability. In 2009, FDI declined by 56% as a result of a sharp decline in global investment flows following the global financial crisis.

For Ukraine and its neighbours, however, the tripling of FDI in 2014 was unprecedented. While FDI increased in 2015 by $2.96 billion and by $2.13 billion in the 6 months of 2016, it has not yet returned to the levels of 2013 or 2012. Importantly, this rise is mostly attributable to the influx of foreign money into banks that have been recapitalized, while greenfield investment has remained modest. [2-3]

General Considerations on the Effects of War and Sanctions

There can be no war without violence. Invasion of Ukraine is just the latest example of this. Ukraine is taking the brunt of the impact as the violence continues there. It also has a negative impact on the Russian Federation, and not just in terms of the number of dead soldiers, which was kept a secret during the conflict's early days. The state's budget bears a heavy burden during times of war. Various billions of dollars have been estimated to be spent on each day of conflict (a much more limited intervention in Syria had allegedly cost about 4 billion dollars per day). Even if some of the resources parked outside the Russian Federation are frozen, the stockpiles put up before the war could vanish swiftly (see also below). Third countries are barred from sending soldiers to Ukraine because of Russia's standing as a nuclear superpower. Financial aid, military aid, and sanctions on Russian interests are the

* Associate Professor, Dyal Singh College, University of Delhi, Delhi, India.

only options they have to respond. Sanctions are particularly important in terms of the war's financial ramifications. As a reminder, Russia has veto power in the Security Council, which means that all UN members are not bound by any of these resolutions. Western powers indicated above attempted to create their own systems, which they attempted to coordinate between themselves and persuade other countries of their own free will to join. No third country would be compelled to join them, and Russia is certain to take its own countermeasures in response (e.g., exchange controls on export proceeds). The purpose of this study is to determine the probable impact of sanctions and countersanctions on Russian FDI inflows and outflows. There are no true alternatives to these procedures, despite their severe limits and disadvantages. The most significant drawback of sanctions is that they do not completely break off economic ties; rather, they raise expenses and reduce the ease with which businesses can conduct business. The consequences of the sanctions implemented after Russia's annexation of Crimea in 2014 may be seen in the fact that they have harmed both Russia and the countries who imposed them. The 'free rider' countries have come out on top, which is ironic. In the absence of sanctions against Russia, companies from other countries (such as China or India) take advantage of the absence of Western competitors. It should also be mentioned that Russia's economic independence and diversification have improved substantially since 2014. To get a bite out of the latest round of sanctions, they had to be much harsher.

Reviews of Literature

FDI's direct and indirect effects on host countries can be studied in a variety of ways according to Industrial Organization theory. Direct FDI effects are measured by comparing the performance of FDI and non-FDI enterprises. For example, indirect impacts "explore several facets of the interaction between MNCs and host country populations that are plausibly related to FDI spillovers," as described by Blomström, Globerman and Kokko (1999). [4]

By looking at the variations in labour productivity, capital-labor ratio, pay level, and profitability of companies with and without foreign investment, Blomström (1989) estimates the direct effects. For the same four-digit industry, he finds that "... foreign subsidiaries in general demonstrate higher labour productivity and capital intensity than Mexican manufacturing units of a similar size". Wages at foreign companies appear to be higher as well." Companies in other countries have better-quality employees and capital. Labor salary as a percentage of total value added and profit margins per unit of capital are higher in international enterprises, notwithstanding this. In order to avoid paying some taxes, international corporations hide their income. Blomström describes it this way: His final conclusion acknowledges that his data is flawed and says, "Although our results indicate disparities in performance between foreign and domestic production units in Mexico's manufacturing industry, we are unable to establish that these assumptions are statistically different from zero.". [4]

The UN predicted a drop in FDI this year as the food, fuel, and financial problems brought on by Russia's war in Ukraine dampened investor confidence. However, according to UNCTAD, global FDI is unlikely to be sustained in 2022 after recovering to pre-pandemic levels in 2021, reaching over $1.6 trillion. According to Rebeca Grynspan, the UNCTAD chief, "the global investment environment radically changed with the commencement of the war in Ukraine. When it comes to foreign direct investment, the former Costa Rica vice president predicted that "substantial downward pressure" on global FDI could be applied this year. UNCTAD's World Investment Report 2022 warns that signs of weakening have already emerged. Project announcements for new greenfield projects fell 21% globally in first quarter statistics, while cross-border M&A activity was down 13%, and international project financing deals were down 4%. Projects that develop new physical facilities, which are considered productive in part because they often produce jobs, are commonly referred to as "greenfield investments." Greenfield projects are seen as a predictor of future foreign direct investment (FDI). As a result of rising food and fuel costs and tighter monetary conditions brought on by the Ukraine conflict, UNCTAD reported that the business and investment climate has "shifted substantially" this year. [5]

Growth momentum in 2021 could not be sustained and global FDI flows will "likely go on a downward trend or at best remain flat" in 2022, according to a report from the International Monetary Fund. Antonio Guterres, the UN Secretary-General, predicted that "fragile growth of real productive investment" will continue in 2022.

Most of Switzerland's pension funds, according to a survey by Swissinfo.ch, avoid investing in the arms industry. While 11 pension funds were asked anonymously if they invest in the makers of "controversial weapons, such cluster bombs, anti-personnel mines and weapons of mass destruction," only eight responded that they did not. Three others did not provide any information on the issue.

In 2021, the top 10 economies for FDI inflows will be the United States, China, Hong Kong, Singapore, Canada, Brazil, India, South Africa, Russia, and Mexico, according to the World Investment Report. Global FDI flows jumped 64% to $1.58 trillion last year from a low base in 2020 mainly to surging merger and acquisition activity and significant increase in foreign project finance due to permissive lending and major infrastructure stimulus packages. As a result of increased strength in Asia, a partial recovery in Latin America and the Caribbean, and an increase in Africa, global inflows to emerging economies increased by 30% to $837 billion, the biggest ever recorded amount of money going to those countries' economies. An all-time high of 1,262 projects with a combined value of $656 billion were announced in international project financing arrangements last year. [6]

Objective

- To examine the role that Foreign Direct Investment (FDI) has played in the growth of a country.
- To examine the inflow and outflow of FDI (foreign direct investment) into and out of Ukraine.
- To examine the impact of war on longer-term implications for international investment and investment policy-making.
- Analyze Ukraine's investment difficulties and prospects.

Research Methodology

This study is based on information gathered from different sources, including articles, newspapers, and other published works. The information gathered for this research came from a variety of sources, including the Internet.

Result and Discussion

Ukraine's primary source of foreign direct investment (FDI) has long been Cyprus (Figure 1). Cyprus-registered investors made up 32.7 percent of FDI stock as in January 2014, compared to 24.4 percent now. Cyprus, the British Virgin Islands, and Belize make up 29.6 percent of the FDI stock in the three tax havens (38.8 percent at the beginning of 2014).

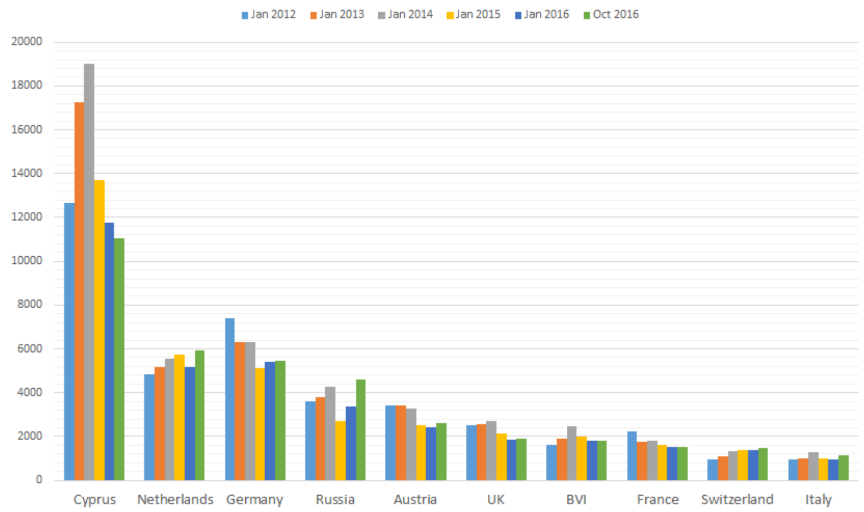


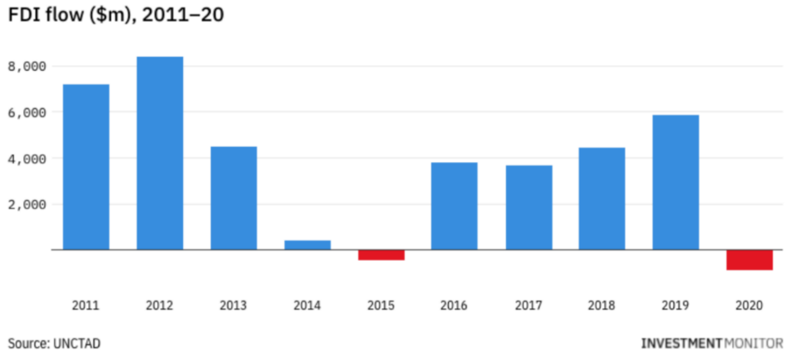
Figure 1: The Source of Ukrainian FDI [4]

Ukrainian and Russian money is frequently invested in Cyprus and other tax havens. Special purpose enterprises (SPEs) are used by investors in certain nations to pay less tax and gain a special legal position, among other advantages. Real Russian investment in Ukraine was at least three times as large as the official figures indicated at the end of 2014 (approximately $9.9 billion compared to $2.7 billion), according to an OECD Investment Policy Review report.

Looking at the origins of FDI stock increase in the years leading up to the crisis reveals much more about where FDI in Ukraine came from (Figure 1).

According to Investment Monitor, Russia's aggression against Ukraine will have an effect on FDI. As of 2020, Ukraine was ranked 10th in central and eastern Europe and 56th worldwide in terms of FDI receipts.

More than half of the investments in software, renewable energy, and logistics have come from the US, the UK, and Germany. When Russia annexed Crimea in 2014, FDI into Ukraine plummeted. It then progressively rose until the COVID-19 conflict. [7]

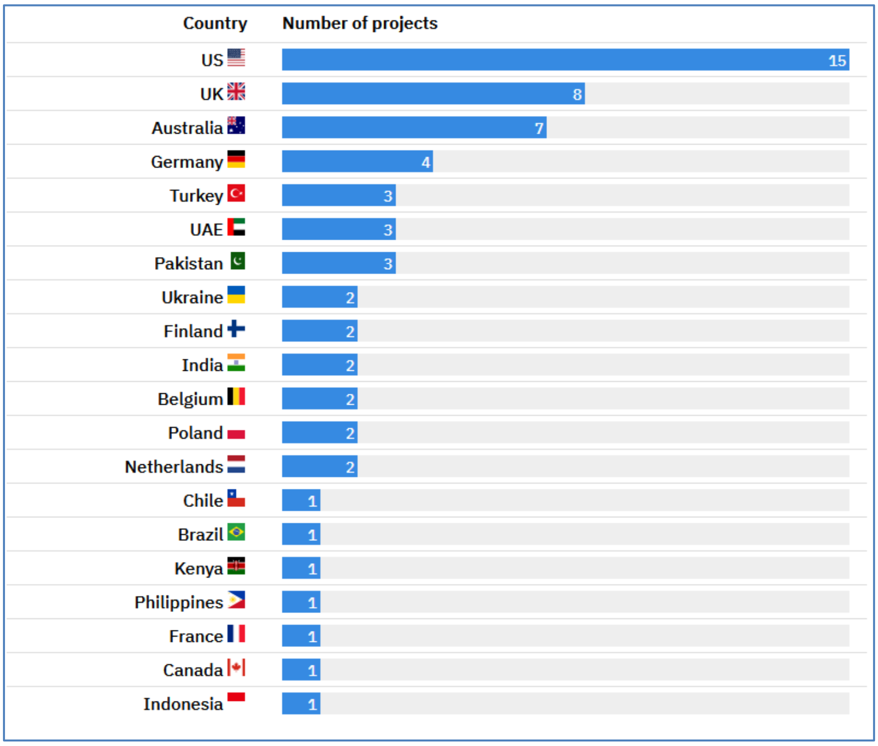


The Russian invasion of Ukraine has a direct effect on foreign investment, as seen in Figure 2.

FDI in the first half of 2021 was estimated at $852 billion after the COVID-19 pandemic had a negative impact on investment. It's been a bumpy ride, however. The western regions of Ukraine have seen the most investment from abroad, with German automakers accounting for the majority of that investment.

Investing in the defence business is an ever-present alternative for investors concerned about global security. According to the FDI Projects Database at GlobalData, 68 new defence projects will be announced or begin construction in 2019 and 2020.

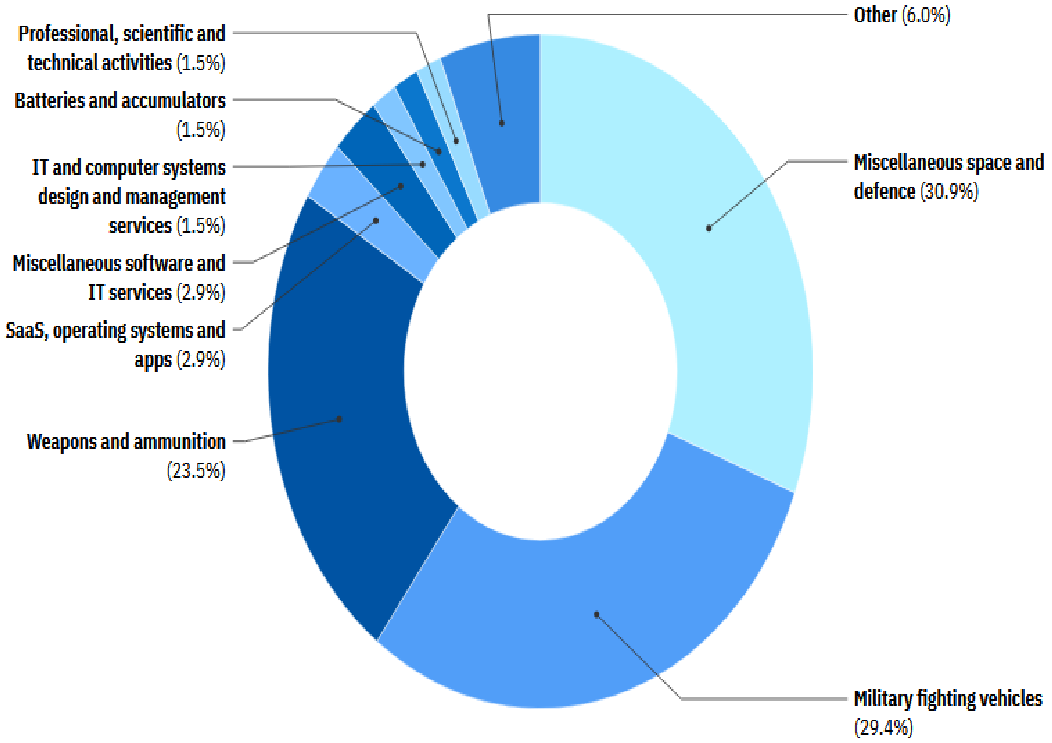
It's no surprise that the United States and the United Kingdom are leading investors in defense-related FDI; they're followed by the United Arab Emirates; Pakistan; Ukraine; Finland; India; Belgium; Poland; and Netherlands.



Source: Global Data's FDI Projects Database [8]

Figure 3: Defense FDI Projects by Destination Country

According to the data, the 'miscellaneous space and defence' sector has received the most foreign investment in the defence industry, followed by military fighting vehicles and weapons and ammunition.



Source: Global Data's FDI Projects Database [8]

Figure 4: FDI Projects in the Defence Sector, Broken Down by Sector

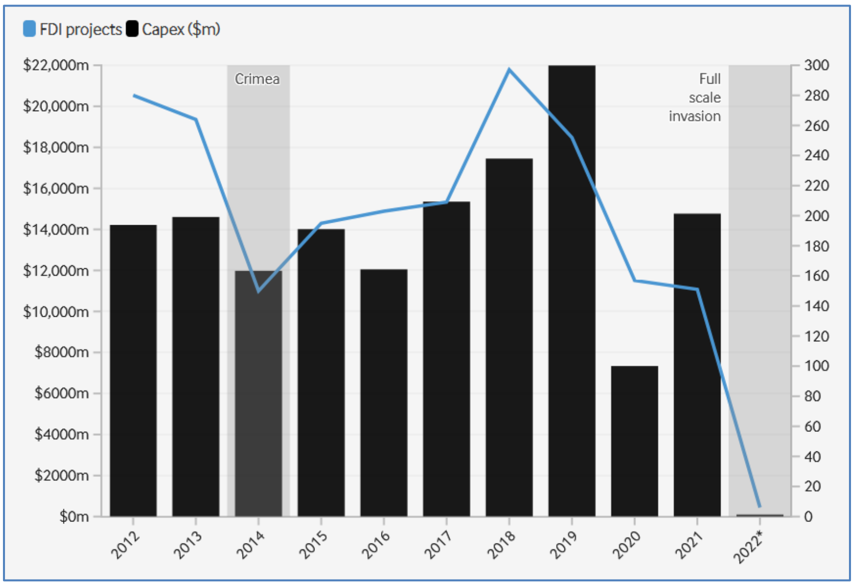
Australia, Belgium, Canada, Finland, Germany, India, Kenya; the Netherlands; Pakistan; Spain; the UAE; the UK; Ukraine; as well as the US. Australia, Chile, Finland, France, Germany, Indonesia, Malaysia, Pakistan, the Philippines, Romania, Sri Lanka, Turkey, the United Arab Emirates, the UK, the US, and Vietnam were among the nations that attracted FDI investments in military fighting vehicles in 2019 and 2020.

Australia, Belgium, Brazil, India, Poland, Turkey, the UAE, and the United States have all announced or established foreign direct investment (FDI) projects in or around the weapons and ammunition industry. US, UK, France, Israel, India, and Italy were all key contributors to new FDI projects in the defence sector.

The Organization for Economic Co-operation and Development (OECD) released a report on May 4 stating that Russia's full-scale invasion of Ukraine has had a "deep and immediate" impact on capital flows in both nations.

Russia's "wanton destruction of property, including commercial and industrial assets and infrastructure," according to the Organization for Economic Co-operation and Development (OECD), will necessitate "enormous" investment in Ukraine. On February 24th, 2022, the OECD Council imposed an immediate suspension on Russia and Belarus' membership in OECD bodies.

On February 24, the invasion began, and since then, FDI into Russia and Ukraine has virtually ceased to exist. Figures from fDi Markets show that in the first three months of 2022, just $98.5 million worth of greenfield FDI was announced in Russia, a decrease of 95.6% from the previous year. During the same time period, greenfield FDI in Ukraine decreased by 34.8% in value.



Source: FDI Markets *Data for 2022 only shows greenfield FDI announced between January and March [9]

Figure 5: A Dramatic Decline in Foreign Investment is Caused by Putin's Conflict

According to fDi Markets, nearly two-thirds of all greenfield FDI announced in Russia during the past decade came from investors from OECD countries.

Discussion

FDI and other capital flows have been negatively affected by Russia's invasion of Ukraine and the international response, which has resulted in a further negative shock and disruption to the global economy. It won't have much of an effect, though, because Russia's role as a recipient or source of FDI is negligible, according to OECD FDI figures. FDI flows into and out of Russia are likely to drop by as much as 1-1.5% by February 2022, even if the impact on Russian FDI inflows is immediate. Many foreign investors, particularly those from the Organization for Economic Cooperation and Development (OECD), nevertheless contribute to the Russian inward investment. Because of their status as global financial hubs, the Netherlands and Britain rank second and third in terms of FDI source countries, respectively receiving 9 percent and 7 percent of incoming capital. Russia's main FDI beneficiaries are in commerce, mining, and manufacturing, in that order. Services, excluding banking and insurance activities, will account for 37% of total inward FDI stock in Russia in 2020, followed by mining and quarrying (24%), manufacturing (21%), and finance and insurance activities (14 percent). Largest beneficiary of FDI in Russia (16 percent of total inward FDI stock) is wholesale and retail commerce, followed by professional, scientific and technical industries (9 percent) and real estate activities (6 percent).

In the short term, increased global uncertainty and rising global inflation are putting additional pressure on already weak capital flows to developing economies, but the long-term impact is yet to be seen. There has been little spillover to global equities markets and sovereigns. Emerging Asian and Western European equities markets were also affected, but to a lesser extent, by investor fears about rising commodity costs and a dimming economic outlook in Eastern Europe, especially Hungary, Poland, and Serbia. There has been a large rise in sovereign credit default swap spreads (a metric reflecting market perceptions of default risks in Serbia, Romania, Hungary, Poland and Bulgaria). Due to their Russian subsidiaries, some banks from Austria, Italy, and France have the highest absolute exposures to Russia. Following Russian economic disruptions, the profitability of such banks is projected to decrease. European and U.S. banks' aggregate exposures to Russia is approximately 0.8 and 0.4 percent of their total claims, respectively. Due to their Russian subsidiaries, several Austrian, Italian, and French banks have the highest absolute exposures to Russia. These banks' profitability will most likely suffer if their operations in Russia are disrupted. Despite this, the combined exposure of European and American banks to Russia is very small, at only 0.8% and 0.4% of their total claims, respectively. Russia's removal from the major EM indices will have a long-term impact on portfolio rebalancing. However, the impact will be limited due to the previous low weighting of Russia in these indices. [10]

Conclusion

In conclusion, the conflict in Ukraine has a negative short-, medium-, and long-term impact for FDI into and out of the Russian Federation. The precise nature of the sanctions and countersanctions, which are now unknown, will determine how much damage is done. The paradox of this conflict is that, despite the planners' best efforts, the Russian Federation is already becoming weaker, and this situation could get worse in the future environment.

While it is still too early to predict the long-term consequences of all these actions, their impact on the international investment. Russia's large-scale war against Ukraine will, beyond its immediate repercussions, entail longer-term implications for international investment and investment policy-making.

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 small 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 increasing geopolitical risks brought on by Russia's invasion of Ukraine will have a negative impact on the world economy in 2022. As a result, the policy trade-offs faced by central banks around the world will be exacerbated. According to our model, such effects are predicted to greatly increase inflation and decrease GDP. These consequences are considerable, but they don't seem to be big enough to stop the world from recovering from the pandemic. The war's course is, however, extremely unpredictable, and unanticipated events in the fight could lead to significant shifts in the geopolitical risk and exacerbate its economic implications.

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