



Challenges and Opportunities of Economic Integration within a Wider European and Eurasian Space



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FOREIGN DIRECT INVESTMENT BETWEEN THE EU AND EAEU

Executive Summary

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Summary

Investment flows between the EU and Russia, as well as other Eurasian countries used to be among the most important areas of the East-West economic relations. However, in the recent years, along with the fall in trade of goods and services, there was a steep decline in FDI flows, particularly in case of **Russia**. Partially this has been due to the weakened economic situation stemming from the drop of incomes from energy exports, but the political tensions around Ukraine also played a very significant role. The introduction of mutual sanctions between the EU and Russia since 2014 has had a deterrent effect on foreign investments, which, in spite of an uptick in 2016, are a fraction of the levels achieved at the start of the decade. Additionally Russia's increasingly protectionist and inward-looking economic-trade policies also much contributed to the loss of interest of European investors... Foreign investments, while mutually beneficial for both the investor and the recipient countries, as long-term commitments are extremely sensitive to both political and economic policy impacts. Thus, unless there is a major change in these conditions, no major increase in the EU-Russia investment flows can be expected, on the contrary, the outflow of even existing FDI, the drop in foreign investment stocks might continue. The downward trends, although less dramatic, have been apparent also in case of Ukraine, Kazakhstan and other Eurasian countries. The fall in FDI performance is in some cases, like **Kazakhstan**, linked to the worsening economic situation due to the fall in energy export incomes. In **Ukraine**, the negative effects of the political-military tensions have been coupled with the uneven pace of reforms and economic transformation, the still not sufficiently investor-friendly environment. The rather disappointing FDI performance of the Eurasian countries is even clearer if compared with the results of the new Central-Eastern European members of the EU. These countries, in spite of starting in the early 90s from a situation similar to that of the Eurasian countries, have both in absolute and per capita terms attained several times higher levels of FDI than the latter group.

For FDI there are no comprehensive international disciplines, the WTO rules and the OECD instruments only partially and to a limited extent cover this area of economic relations. Only the more recent Free Trade Agreements (FTAs) and other preferential arrangements of the EU provide for **clear rules and improved market access for foreign investors**. Between the EU and Russia and other EAEU members there are no such agreements in force, only the Deep and Comprehensive FTAs (DCFTAs) concluded between the EU and such Eastern Partnership (EaP) countries as Ukraine, cover FDI. While in the EU Member States, the strong rules of the Internal Market protect also foreign-owned companies, in case of the EAEU countries mostly their national investment policies regulate the terms of foreign investments. These conditions, due to both the political and economic policy reasons mentioned, are at present rather negative, as shown also by analyses of international organizations. In Russia's case even their existing, limited WTO commitments are not respected, which is a source of recurring tensions and debates with the EU. A positive turn would be possible only in case of progress of a qualitative change in the underlying political and economic policy factors. The shortcomings of the FDI conditions in many Eurasian countries, including also other EAEU and EaP countries are a deterrent for foreign investors. This

has been confirmed by the views of companies, which are active in the region, as seen from replies to targeted questionnaires.

Energy supplies represent the most significant parts of the EU-Eurasia economic relationship. The supply of energy is strategically important for both the exporting and importing countries and this is the only sector where there are also substantial investment flows from East to West. However, FDI in this area, especially between the EU and Russia, has been particularly affected by the political and economic tensions, with several sanctions targeting energy production. For the energy sector, beyond the generally applicable multilateral FDI disciplines, there are several specific international arrangements in force, including the **European Charter Treaty (ECT)**, the **Energy Community Treaty**, as well as some **instruments of the OECD**. These provide for clearer and more meaningful rules than the general international provisions on FDI. However, in the recent period their impacts have been much blunted. While most Eurasian countries are parties to the ECT, Russia has a few years ago renounced it, and never joined the Energy Community Treaty, which covers most EaP countries. As there are no preferential arrangements between either the EU and the EAEU states, there are no means to counteract the negative trends on FDI flows. Being a strategic area, foreign investments in the energy sector are hampered by the often politically motivated restrictions not just in the intra-regional context, but also within the Eurasian region.

Based on the detailed examination of the various factors influencing FDI flows, the final part of the study contains a summary, as well as recommendations. Especially the latter are important both for Governments, as well as for the business communities in all countries. It is generally recognized that in case of FDI the political and economic policy circumstances are especially important and in this respect unfortunately no fundamental changes can be expected in the foreseeable future. Thus, **only some short-term measures of limited effects can be realistically recommended**. These include, first, the avoidance of the further worsening of an already difficult situation. The Governments are proposed to adhere to the already accepted international commitments and disciplines concerning the **protection of the existing foreign investments** and to respect those for new investors. Thus, the treatment of established investments, as well as the access conditions for new ventures should be in line with each country's specific international obligations. A further recommendation is to **streamline and simplify the administrative procedures** linked to the admission and protection of investors and investments, to avoid the frequent over-reach and corrupt practices by the state authorities. The predominant role and monopolistic behavior of many state-owned or state-controlled companies should be checked, a **gradual opening of government procurement** for foreign-owned companies ensured. It would be also important to provide **more transparency** around investments and investors: a major part of East-West FDI transactions is conducted via various tax havens and shell companies, hiding the real owners/beneficiaries. As this leads, as a minimum, to loss of Government revenues in both the investing and recipient countries, and often to criminal practices, it would be important to intensify both internal enforcement, as well as international cooperation in this area.

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