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FOREIGN DIRECT INVESTMENT BETWEEN THE EU AND EAEU

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

AUTHORS

Peter Balas, Peter Havlik, Elina Cielava, Anastasia Stepanova, Nadejda Komendantova, Yury Zaytsev, Alexander Knobel

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The project builds on the intense research going on in many countries, including Member States of both the EU and the EAEU, the United States, China, Japan, Turkey and Ukraine, and on the outcomes of seven international workshops held at IIASA from June 2013 to April 2016, as well as several high-level conferences organized by IIASA in 2017. These multiple evidence-based meetings convened in the framework of the project were attended by renowned scientists, experts, business representatives and high-level policymakers, including representatives from the European Commission (EC) and the Eurasian Economic Commission (EEC) and resulted in a number of reports and publications.

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About the Authors

Peter Balas is a Senior Research Scholar, International Institute for Applied Systems Analysis (IIASA). (Contact: petbalas@hotmail.com)

Peter Havlik is a Staff Economist, The Vienna Institute for International Economic Studies (wiiw) and Guest Research Scholar, International Institute for Applied Systems Analysis (IIASA). (Contact: havlik@wiiw.ac.at)

Elina Cielava is a Senior Expert and External trade Counselor at the Ministry of the Economy of Latvia. (Contact: elina.kampe@gmail.com)

Anastasia Stepanova is the Project Manager and Research Scholar, International Institute for Applied Systems Analysis (IIASA). (Contact: stepanov@iiasa.ac.at)

Nadejda Komendantova is a Research Scholar, Risk and Resilience, International Institute for Applied Systems Analysis (IIASA). (Contact: komendan@iiasa.ac.at)

Yury Zaytsev is a Senior Researcher, Institute of Applied Economic Research, Russian Presidential Academy of National Economy and Public Administration (RANEPA). (Contact: yuriy.zaitsev@gmail.com)

Alexander Knobel is the Director of the International Trade Center, Russian Presidential Academy of National Economy and Public Administration (RANEPA); as well as the Head, International Trade Department, Gaidar Institute for Economic Policy. (Contact: knobel@iep.ru)

Foreign Direct Investment between the EU and EAEU

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Executive 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.

Introduction

This is one of the follow-up research studies of the Eurasian Project undertaken by the International Institute of Applied Systems Analysis (IIASA; Laxenburg, Austria) between 2014 and 2016. The three-year project aimed to explore the possibilities, conditions, and obstacles related to implementing the "Lisbon–to–Vladivostok concept, i.e., the creation of a common economic space between Europe (more specifically, the European Union) and the Eurasian countries (Russia and the other members of the Eurasian Economic Union, the Eastern Partnership countries, and the Central Asian countries).[1] The Project covered many, but not all, aspects of the potential economic-trade relationship between the two regions. Before launching a further deepened and expanded phase of the Eurasian Project, it was decided to prepare, in the course of 2017, three studies arising from our research that focus on subjects of particular interest to the business community in both regions. The purpose was to gain better insights into the potential of restoring and expanding intra-regional economic links and the most practical ways of doing so. The present study deals with investment flows, most specifically flows of Foreign Direct Investment (FDI), between the two regions.

One of the four basic freedoms of international economic relations, including the EU's internal market, is the free flow of capital. FDI is a major catalyst and component of development, restructuring, and modernization; it includes, foreign investment intended to establish lasting and direct links with the undertakings to which capital is made available for furthering future economic activities.[2] When investments take the form of shareholdings (or inter-company credits), it is presupposed that the shares will enable the shareholder to participate in the management of the company or to fully control it.[3] This contrasts with other forms of foreign investment where there is no intention of investors to control and manage the enterprise. Such investments, which are often of a short-term and speculative nature, are commonly referred to as "portfolio investments."[4]

Because of the long-term flow of the capital involved, FDI has positive impacts for the investing country - and even more benefits for the recipient one - providing stability to the economic relations, enhancing overall trade in goods and services, and allowing the flow of human capital linked to the project. However, the very long-term nature of FDI makes it especially sensitive to changes in the political, macro-economic, and economic policy environment. Therefore, in this study, particular attention has been devoted to the political and policy factors influencing FDI flows, the evolution of the macroeconomic situation, and the broader economic environment of FDI-related multilateral and

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[1] International Institute for Applied Systems Analysis (2016, 2017) Reports of Phase I.
URL: http://www.iiasa.ac.at/web/home/research/eurasian/Reports.html

[2] The terms "direct investment" appeared in the Chapter on capital movements and payments of the EC Treaty and now in Articles 63-66 TFEU (in that context, it has been interpreted by the Court of Justice and is largely based on widely accepted definitions of the IMF and the OECD).

[3] European Commission Communication "Towards a comprehensive European international investment policy" COM(2010)343 *final*, 7.7.2010.
FDI methodological particularities according to the OECD Benchmark Definition (BMD4) and the IMF's Balance of Payments Manual (BPM6) are further described in Part I

[4] The Court of Justice of the EU has described the notion of "portfolio investment" as "the acquisition of shares on the capital market solely with the intention of making a financial investment without any intention to influence the management and control of the undertaking" (Judgment of 26 September 2008, Commission/Netherlands, Joined Cases C-282/4 and C-283/04).

international disciplines. As well as assessing official policies, analysis is provided regarding their implementation in practice.

FDI is a very important aspect of the economic relations between the European Union (EU) and the countries of the Eurasian region. The member countries of the Eurasian Economic Union (EAEU), the Eastern Partnership (EaP) countries, and the Central Asian states have, since the early 1990s, become major targets of FDI from the EU member states. The growth rate of FDI has often exceeded the development of all other forms of economic-trade relations, even if its level has lagged behind those achieved by the new Central and East European member states of the EU. In the last decade, reverse investment flows into the EU, especially from Russian companies, have also become more significant. As the present study was limited in scope, depth, and geographical coverage, it involves only those countries in both the EU and Eurasian regions that play a particularly important role in FDI activities.

Although the subject of FDI is huge, our intention has been to explore the actual situation in both regions, the factors influencing FDI flows, and the ideas and proposals for short-term steps to reverse the negative trends of the recent past. The study has thus been designed to address in a first part, the evolution of FDI in the EU and the Eurasian region, based on FDI flows and stocks, analyzing the impacts of the fluctuations over time (Part I); this is followed by a description of political and policy factors and of the multilateral and international regulatory framework affecting FDI (Part II). Part III deals with the official policies and measures related to FDI in both regions (the EU and its member states, as well as the EAEU and other Eurasian countries), supplemented by an assessment of the investment climate by the business community. The energy sector has been chosen as a particular case study, as it is of utmost importance for both regions and their FDI policies (Part IV). Finally, conclusions and short-term recommendations are provided for reversing the recent negative trends of the inter-regional FDI flows and the broader policy climate exposed by the study.

PART I

The Evolution of Foreign Direct Investments in the EU, the Eurasian Countries, and the EU's Central/Eastern-European Member States (2005–2016)

Government investment policies, tax regimes, restrictions and subsidies, as well as profitability and cost factors are important elements of the FDI policies that **affect investor decisions**. However, other aspects, such as the geographical proximity to markets, the quality of physical and legal infrastructure - the economic climate in general - are also essential factors. The motives of foreign investors, i.e., the profit perspectives, may differ substantially, depending on the priority given to the local market versus the generation of export capacities. A large number of considerations play a role even before investors make the decision to tie up substantial long-term resources in another country.

From the **host country's perspective**, the motives for attracting foreign investment are also manifold, ranging from acquiring badly needed foreign exchange to fill the government's coffers to gaining access to new technologies and new markets, as well as marketing and management know-how, so as to become part of global value chains - and possibly, in the longer term - of regional integration structures. From the host countries' perspective, there are also differences between export-oriented FDI projects and those focused on the domestic market. There are sectoral considerations, as well: in general, FDI flows into the manufacturing sector have been beneficial in terms of creating modern, competitive industries, leading to new exports and revenue generation. Thus, investment promotion, which is an important component of industrial policy, has recently become more popular again, particularly in the context of transition and restructuring.

FDI flowing into the service sectors (including finance, insurance, and especially retail trade and real estate) have raised more questions. On the one hand, the more competitive foreign companies often displace domestic service providers, and such investments tend to generate additional import demand rather than creating new export capacities. FDI inflows into these sectors may thus aggravate the balance-of-payments problems and potentially instigate financial bubbles. That is why the less developed European and Eurasian countries have been much more conservative about opening their services markets. However, the lack of advanced services may hinder the development of manufacturing and other important sectors. Thus, a suitable balance should be found among the various considerations.

There is an extensive literature regarding the various aspects of FDI; this study, however, is limited to a more general overview. The first subject we tackle is the development of recent investment flows and stocks in the region. The focus is on countries where FDI plays an important part in international economic relations. The trends are analyzed in a dynamic and cross-country perspective, looking at the various indicators of the FDI performance of individual countries in relation to GDP growth, export revenues, and FDI-related incomes. The investors' motives, such as labor costs and other indicators, are also analyzed: the investment climate is analyzed from a cross-country perspective and the sectoral composition of FDI is examined. More detailed analysis is provided on EU-level policies, on those member states that are the sources of major investment flows, and on the most important host countries in Eurasia, i.e., Russia, Kazakhstan, Ukraine, Azerbaijan, and Belarus. The last chapter deals with the FDI performance of Central and Eastern European countries that have become members of the EU (EU-CEE), in some cases including the South-Eastern European countries that have received associated status (overall referred to as "CEESE"): we do this to show the reasons why their FDI performance is much more impressive than that of the Eurasian region. The main source of data is the wiiw FDI Database which is based on the official statistics provided by the respective Central Banks.[5] However, for the next chapter on the EU's investment trends Eurostat data were also used.

1.1. The EU's FDI activities in the last decade, particularly in the Eurasian region

The point of departure for this study is an overview of the investment activities of the EU globally in the recent period. Beyond the overall trends, particular attention is devoted to the flow of investments to and from the countries of the Eurasian region.

As EU performance is presented on the basis of Eurostat data, there could be substantial differences from the data contained in the following chapters, which are based on national balance-of-payments (BOP) figures. The data are also not directly compatible for other reasons (see details in Annex I); however, the overall trends are similar.

Globally the EU is both the largest source and destination of FDI, measured by both investment stocks and flows. However, in recent years there have been important changes in the trends regarding third countries, both in FDI inflows and the outflows.[6] There was a big fall in outward investment in 2014, mainly due to large-scale disinvestments in the traditional EU partners, like the USA and Switzerland. As a result, FDI outflows fell to an unprecedented low level of less than €60 billion in 2014. A similar sharp decline also occurred in FDI inflows into the EU, which fell below €100 billion from the €400–500 billion level in previous years (see Annex II, Table 1). However, by 2015 this dip - probably first caused by uncertainties around the euro and by economic and political difficulties in a number of member states - stopped. Looking at the geographic pattern of the weaker inflows (Annex II, Table 2), the figures show a decline from the majority of other regions, mainly from the USA (from €352.8 billion in 2013 to €-24.8 billion in 2014), but also from Brazil (from €10.0 billion in 2013 to €-2.0 billion in 2014) and Singapore (from €11.7 billion in 2013 to €-4.5 billion in 2014).

Overall, by 2015 the amount of both the inward and outward FDI flows of the EU recovered, reaching levels similar to those recorded in 2013 - around €470 billion and €540 billion, respectively. The EU investment in the USA and Switzerland increased most in 2015, accounting for 70% of all EU FDI outflows. A significant rise in FDI was also seen toward South Africa, Singapore, Turkey, and Japan. The FDI inflows into the EU also recovered, particularly from the USA (reaching €252 billion), and also from Switzerland, Canada, the Gulf States, and Singapore.

As a consequence, over the whole period, **EU FDI stocks, both outward and inward, continued to grow** (see Annex II, Table 1). In the past decade, the global EU investment stocks have increased quite considerably: the total investment in third countries grew from €2.4 trillion in 2005 to €6.9 trillion by

[5] See Annex I for methodology and Annex V for detailed statistics. wiiw FDI Database, based on official statistics published by the respective central banks, is available online (https://data.wiiw.ac.at/foreign-direct-investment.html).

[6] Note that the 2013–2015 figures are based on new methodological standards—Balance of Payments Manual, 6th edition (BPM6), and Benchmark Definition of FDI, 4th edition (BD4) . Therefore, the statistics from 2013 onwards are not directly comparable with those for previous years.

2016. The inward investment stock showed a similar trend, reaching €5.7 trillion in 2016 against €1.8 trillion in 2005. These figures also show that **the EU has, all along, remained a net investor**, with outward stocks consistently exceeding inward ones.

1.1.1. Geographic distribution of the EU's FDI activities, with special focus on the Eurasian region

At the end of 2015, North America had the largest share (40.8%) of **EU outward FDI stock** (see Annex II, Tables 3 and 4), with the USA accounting for 37.1% (€2.56 trillion). European countries outside the EU accounted for 19.6% of total outward stocks, with Switzerland being the second most important investment destination, accounting for 11.9%. Among the top 10 countries of outward FDI were Bermuda (reflecting its role as an important EU offshore financial center), Brazil, Canada, and Asian emerging economies, like Singapore and Hong Kong, with a combined share of 11.5%.

In **the Eurasian region the Russian Federation was by far the top FDI destination, accounting for 2.4% of the total EU outward stocks,** and the second destination among European countries. No other Eurasian country has had a comparable role among the EU's investment targets, having shares well below 1%.

Regarding **the inward investment stocks in the EU** in 2015 (see Annex II, Tables 3 and 4) the USA had the highest share (41.4%), mainly invested in the financial services sector and manufacturing. Again, Switzerland was the second with 10.8%, of which more than half was invested in financial services. Several offshore financial centers, like Bermuda, Jersey, the Cayman Islands, and Gibraltar also had shares of between 2.8–8.6% each.

Of the countries of the **Eurasian region only the Russian Federation was a major investor**, but even so it accounted for only 1.1% of the total inward stock in the EU. Other Eurasian countries had only a minuscule role as investors.

Finally, regarding **the EU FDI stocks by economic activities** (Annex II, Table 5), services had the largest shares of both outward (58.6%) and inward (87.3%) FDI stocks. Within these figures 65.4% of outward stocks and 83.9% of inward stocks were linked to financial and insurance activities. Manufacturing was the second-largest sector, with 26.9% of outward stocks and 9.5% of inward stocks.

The details of the FDI activities of EU member states playing a major role in the Eurasian region are as follows:

By 2016 **Austria's** accumulated global outward FDI stock amounted to €190 billion (€21,740 per capita), concentrated mainly in the banking and insurance sectors. Russia was not among the top 10 destinations for Austrian investors: even in the peak year of 2008, just 5.4% of Austrian FDI went to Russia (see Annex II, Figure 1).

Germany is one of the largest investors worldwide, targeting in particular the manufacturing industry. The total German FDI stock abroad reached €1,267 billion (€15.360 per capita) by the end of 2016 (Annex II, Figure 1). Of this, 1.3% went to Russia (even in the peak year, 2013, only around 2% of German FDI stocks were destined for Russia).

France has also been one of the major global investors with nearly €1,200 billion invested abroad as of the end of 2016 (€17,900 per capita). The structure of partner destinations is similar to that of

Germany: thus, Russia also accounts in this case for 1.3% (the same as in 2013). Nearly €10 billion in French FDI went to Kazakhstan, 0.8% of the total.

Italy has been less active in global FDI flows: just €450 billion in outward FDI stocks as of the end of 2016 (€7,400 per capita). Italy has been relatively more engaged in Russia, representing 2% of its FDI stocks: see Annex II, Figure 1). Moreover, Italy is the only EU country to have increased its FDI stock in Russia after 2013.

Last but not least**, the Netherlands** has been the largest investor globally among the EU countries, with more than €1,300 billion in accumulated FDI stocks as of the end of 2016 (€77,800 per capita), even without taking special purpose enterprises (SPEs) into account.[7] However, Russia accounted for just 0.3% of Dutch FDI stocks, including SPEs, with 0.7%.

The detailed geographical composition of FDI stocks of these EU member states is contained in Annex II, Figure 1.

1.2. The role of FDI in the major Eurasian countries

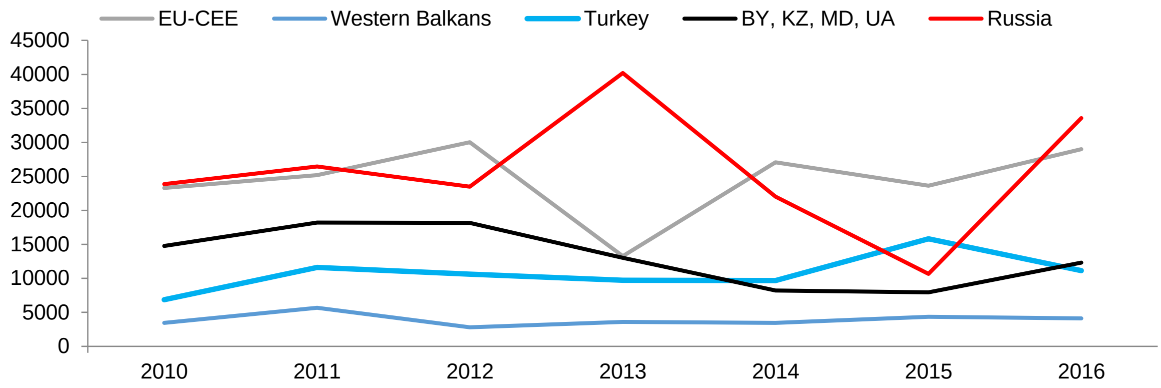
The chapter above has already described the main trends in EU investment flows and stocks in the Eurasian region. Below, a more detailed analysis of FDI stocks and flows is given in a dynamic and cross-country perspective, focusing on the key EAEU members (Belarus, Kazakhstan, and Russia) and on the countries with which Association Agreements containing a Free Trade Area (AA/DCFTA) have been concluded, i.e., Georgia, Moldova, and Ukraine. The FDI performance of individual countries is assessed in relation to GDP growth, export revenues, and FDI-related incomes. The investors' motives, such as labor costs and other indicators, are also discussed, with the investment climate being evaluated in a cross-country perspective. Finally, some preliminary conclusions and policy recommendations are provided about the factors behind the different FDI performance of the EAEU and DCFTA countries and, for a broader regional comparison, that of the CESEE states. The main source of data in this and the next part of the study is the wiiw FDI Database, based on official statistics provided by the respective Central Banks.[8]

To provide a clearer picture of the FDI performance of the Eurasian countries, the following graph compares the inflow of foreign investment in a broader perspective, looking also at the groups of European countries that are not among the "old" EU member states:

[7] Netherlands is one of the few countries which report both datasets to Eurostat. Including SPEs, the total Dutch FDI stocks abroad reach around €4,800 billion; the difference is mainly FDI SPEs registered in OPEC, Switzerland, Luxembourg, and United Kingdom. Dutch SPEs are also being used by Russia and Kazakhstan.

[8] See Annex I for methodology and Annex V for detailed statistics. wiiw FDI Database, based on official statistics published by the respective central banks, is available online (https://data.wiiw.ac.at/foreign-direct-investment.html).

Figure 1. FDI inflows in the main regions, € million



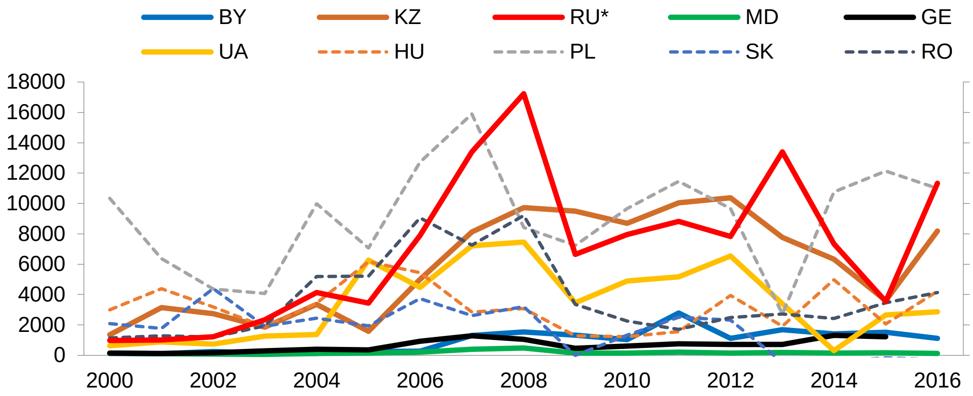
Source: adapted from wiiw FDI Report 2017; wiiw FDI Database.

The comparative FDI flows are highly volatile, and there is no straightforward explanation for such fluctuations.[9] Moreover, as already demonstrated, the data may differ in the various sources and have been frequently revised even several years into the past.[10] In 2015, for example, Russia and Kazakhstan received unusually low inflows due to the combined effects of sanctions, the collapse of oil prices, and subsequent domestic currency devaluations. In 2016 the FDI inflows into Russia rose sharply, due to the considerable size of a single transaction (see below for details); inflows to Kazakhstan also recovered (Figure 2a). FDI inflows into Ukraine also increased in 2016, primarily due to the banks' recapitalization and the privatization of some companies with the participation of institutional investors such as the EBRD. FDI inflows to Georgia were high during the whole 2014–2016 period (about €1.5 billion per year), presumably thanks to improved implementation of the DCFTA commitments. A similar trend, albeit at a much smaller scale, was observed in Moldova.

[9] UNCTAD, 2017.

[10] Another source of FDI data is UNCTAD: the World Investment Report published annually by UNCTAD. Data on greenfield projects are available from fDiMarkets (www.fdimarkets.com, a division of Financial Times Ltd). The EDB Centre for Integration Studies uses a similar methodology in monitoring and analysis of FDI (EDB, 2016).

Figure 2a. FDI inflows in selected countries, € million

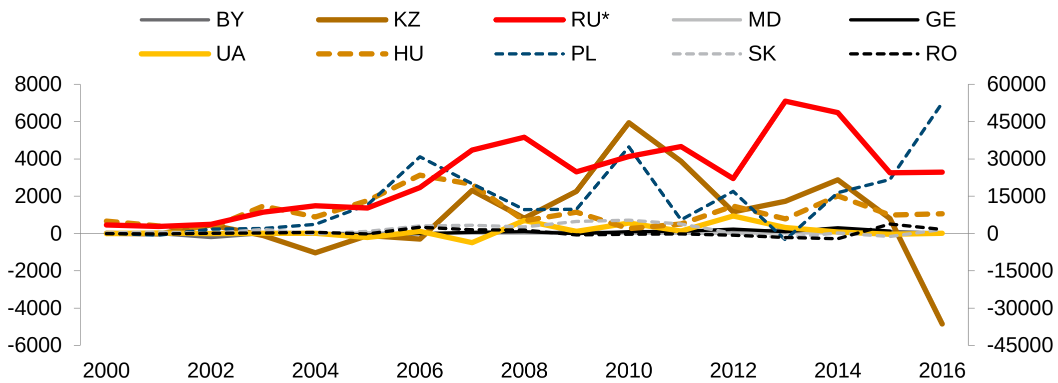


*Russia: right scale.

Source: wiiw FDI Database. Georgia: UNCTAD, World Investment Report, wiiw calculations

A similar volatility could be observed in FDI outflows, especially in the case of Kazakhstan, Russia, and Poland (Figure 2b).[11] In the first two countries, the reasons for the drop are probably linked to the worsening economic situation caused by the fall in energy prices. In the case of Russia, the political factors linked to the Ukrainian crisis, as mentioned, also contributed to reduced outflows.

Figure 2b. FDI outflows in selected countries, € million



*Russia: right scale.

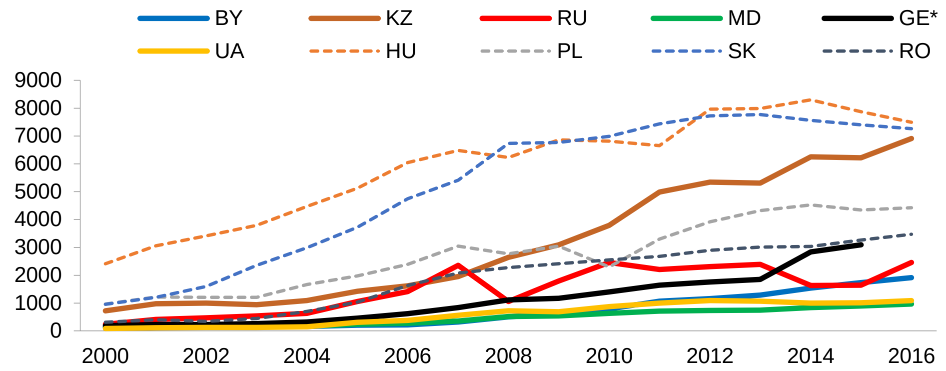
Source: wiiw FDI Database. Georgia: UNCTAD, World Investment Report, wiiw calculations.

A better tool for cross-country FDI comparison is the use of data on per capita stocks/flows (or as a percentage of GDP), as it eliminates the effects of the countries' sizes. Figure 3 shows that apart from

[11] In addition, methodological issues affect the volatility (and comparability) of FDI data: in particular, assets/liabilities accounting and directional principle, as well as changes in balance of payments methodology (BMP5 until 2012 and BMP6 since 2013), provide widely different results (e.g., for Cyprus and Austria). For Austria see: https://www.oenb.at/isaweb/report.do?report=9.3.04.

Kazakhstan, all EAEU and DCFTA countries accumulated on aggregate, much less FDI than their EU-CEE peers, not to mention the West European EU states. As discussed later, there are structural features behind these considerable differences.

Figure 3. FDI inward stocks per capita, in €



* Georgia: Excluding Abkhazia and South Ossetia.

Source: wiiw FDI Database. Georgia: UNCTAD, World investment report, wiiw calculations.

After the broader international comparison, we turn to an overview of the main characteristics of FDI developments in the key EAEU and DCFTA countries, also looking at the performance of the EU-CEE peers.

1.2.1. FDI in Eurasian Economic Union (EAEU)

The Russian Federation

Russian FDI, both inward and outward, which dominates the whole EAEU region in absolute terms, peaked in 2013 and fell significantly in the following two years, and it did not fully recover after the upturn which began in 2016 (Figure 4, data for 2017 not yet available). Inflows suffered a first major blow in 2014 and then declined further in 2015 to a level unprecedented over the previous 10—or even 20—years, if measured as a percentage of GDP.

In 2015 the high FDI outflows seen in 2013–2014 fell almost to their 2010–2012 values and stayed there in 2016. Net FDI was negative in 2015, as outflows surpassed inflows in the previous three years: low FDI thus contributed to, and was a sign of, the massive capital flight from Russia. However, in 2016, inflows surpassed outflows by more than €9 billion, mainly due to a single major investment (a 19.5% stake in the giant oil company Rosneft was sold for €10.2 billion to a Singapore investment vehicle, a joint venture between Qatar and the Swiss oil trading firm Glencore), while loan instruments remained negative.[12] The rapid contraction of FDI during 2014–2015 is connected to the decline in Russia's economic performance, Western sanctions on Russian companies and banks which restricted their international transactions, and the tighter EU rules governing capital transactions. In addition, the

[12] Singapore appeared among the top ten investors in Russia in 2016, with FDI stocks amounting to nearly €14 billion as at the end of 2016.

ruble lost close to 40% of its value after the oil price collapse in 2014, making Russian companies cheaper in euro terms.

FDI stocks were also drastically reduced during this period - by more than €150 billion between the end of 2012 and the end of 2015 (to €240 billion). Some of the disinvestment can also be attributed to the official “de-offshorization” campaign, launched in 2014 and implemented from the beginning of 2015, which aimed to bring about the return of the Russian flight capital. Some of the capital outflow can be attributed to debt service payments. The massive reduction in investment - domestic as well as foreign - does not augur at all well for Russia’s modernization and diversification prospects.

The Western sanctions also banned cooperation with Russian oil firms, affecting the activities of such companies as Exxon Mobil and BP. Rosneft was thus forced to terminate its exploration project with Exxon. On the other hand, BP, as a co-owner of Rosneft, benefited from rising output, despite low oil prices in 2015. Meanwhile, the third-largest US oil producer, ConocoPhillips, withdrew fully from Russia.

In 2015 FDI inflows were exclusively in the form of reinvestments of foreign investors’ earnings; the inflow of equity and loan instruments turned negative. The 2016 increase in net inflows, apart from the Rosneft deal, were also attributable to the growth in reinvested earnings, amounting to some €15 billion. The list of mergers and acquisitions in the oil and gas sector was also complemented by the acquisition of assets by Indian companies: a joint venture between Vankor India and ONGC Videsh Ltd and Vankorneft.[13] A positive dynamics of FDI inflows has now begun, and is confirmed by data for the first quarter of 2017: growth in incoming FDI (USD 4.7 billion) has reached 51% and 99%, respectively, compared with the corresponding periods of 2015 and 2016. The most recent increased inflows are connected with such transactions as the sale of a 10% stake in the Russian petrochemical holding Sibur to the Chinese Silk Road Fund,[14] the launch of the construction of a Mercedes-Benz passenger car factory in the Yesipovo industrial park by the German company Daimler, etc.[15] The latter project is the largest one launched by a Western company in Russia since the introduction of sanctions. The recent dynamics of incoming FDI could encourage foreign investors to continue with existing projects[16] and to launch new ones in Russia.[17] Moreover, the import substitution strategy may partly contribute to an increase in the inflows, although these projects primarily support the development of local producers through the provision of new skills and technologies, rather than improving their international competitiveness.

[13] Rosneft successfully closed the deal to sell 11% of Vankorneft to ONGC Videsh Limited. NK PJSC "Rosneft" (in Russian). 28.10.2016. URL: https://www.rosneft.ru/press/releases/item/184363/

[14] The deal to sell a 10% stake in Sibur to the Chinese Silk Road Fund is closed. January 25, 2017, Vedomosti (in Russian). URL: https://www.vedomosti.ru/business/news/2017/01/25/674825-sdelka

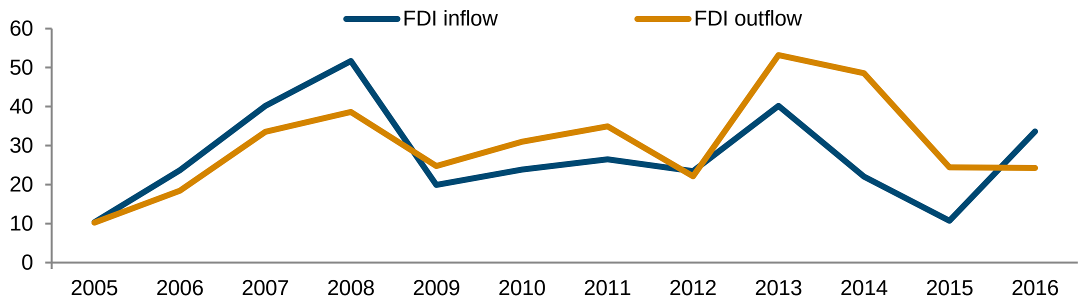
[15] Daimler began to build a plant in Moscow suburbs, Vedomosti (in Russian). URL: http://www.vedomosti.ru/auto/galleries/2017/06/20/695254-daimler-nachal-zavod

[16] BP President in Russia David Campbell said that the company, which owns 19.75% of Rosneft, will continue to invest in Russia, despite the sanctions. March 30, 2017, Vedomosti. (in Russian) URL: https://www.vedomosti.ru/business/news/2017/03/30/683385-bp-rossiyu-sanktsii

[17] The American Hines can buy the last Stockmann facility in Russia. (in Russian) URL: https://www.vedomosti.ru/realty/articles/2017/02/21/678503-hines-stockmann-rossii

The greenfield FDI also shows a sustained level, with amounts of €10 billion in each year from 2014 to 2016.18 There is no contradiction here: not only can greenfield commitments not be realized, but also - and this is the main point - the directional data on FDI inflows and outflows represent a net amount of new and withdrawn investment flows. (In 2015, gross Russian FDI liabilities increased by about €32 billion, and a similar amount was also withdrawn from the country.) Thus, financing for new projects can flow into the country, even as other previously invested foreign assets leave.

Figure 4. Russia: FDI inflows and outflows, € billion



Source: wiiw FDI Database.

Traditionally, about half of Russian inward FDI comes from tax havens and offshore centers, while two-thirds of outward FDI go to the same destinations (Annex III, Figure 1). Some EU member states, such as Cyprus, Luxembourg, and the Netherlands, as well as the offshore centers in the Caribbean are home to Russian companies and holdings, probably chosen for security and tax optimization reasons. In 2014 FDI inflows from Luxembourg, like most of the other countries involved in the embargo against Russia, declined. However, Cyprus remained a main FDI source and destination. Its share has traditionally been high: about one-third of both inflow and outflow stocks have been related to Cyprus, and the share of other tax havens has been of similar size in the longer run.[19] Russian deposit holders burned their fingers with the Cyprus banks in 2013, but this did not take away their appetite to continue to use the island for registering companies and parking flight capital. In fact, the tax-haven conditions in Cyprus were hardly affected by the euro crisis. As part of the money was converted into bank shares, Russians became shareholders in Cypriot banks; if they owned 10% or more of the shares, they could gain direct-investor status.

A large part of the FDI stocks in Russia is thus originally Russian capital that is kept abroad and returns to Russia as foreign investment. This round-tripping capital is essentially different from the "genuine" FDI: it overstates the importance of foreign capital in Russia and is certainly not instrumental to the modernization and restructuring of the economy.[20] But tax optimization and even outright criminality

[18] See wiiw FDI Report 2017

[19] Cyprus' extraordinary role as a special off-shore investment vehicle is visible also in the statistics published by Eurostat: inward FDI stocks per capita in Cyprus (from outside the EU) amounted to nearly €50,000 in 2015; outward FDI stock per capita invested from Cyprus (outside the EU) to more than €170,000 in 2015. The favourable tax regime explains interest of Russian business in Cyprus (EY, 2017).

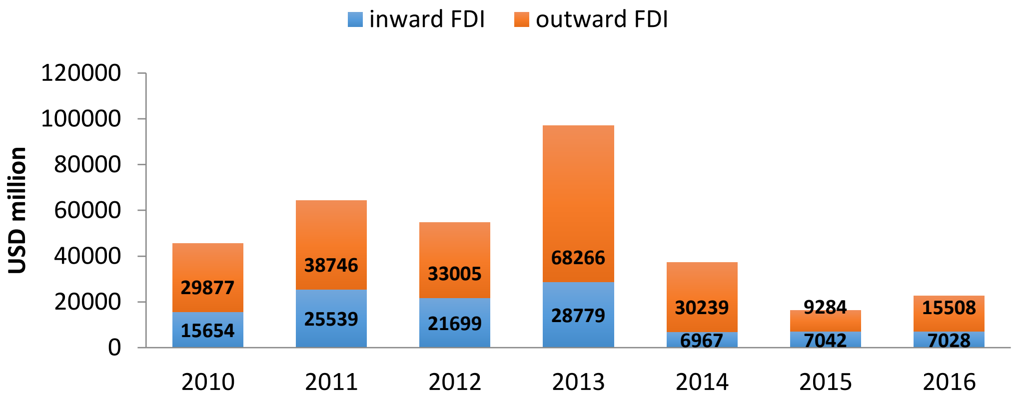
[20] A similar pattern can be observed in other (post-Soviet) EAEU and DCFTA countries, in contrast to EU CEE (see below).

are not the only reasons for Russian capital to look overseas: capital owners, who have good reasons not to trust the protection of property rights in Russia, not to mention the fuzzy business environment, feel that their money or their company headquarters are safer abroad

In 2014 the value of Russian FDI directed to offshore jurisdictions decreased more than twofold compared to the previous year, when it amounted to USD30.2 billion. In the following years, this indicator showed a marked decline: to USD9.3 billion in 2015 and USD15.5 billion in 2016. Despite this, Russia in 2016 became one of the top five sources of offshore investment. The offshore country of Cyprus has been a key recipient of Russian investment since the pre-crisis period: it received about 30% of the total volume of Russian FDI in the 2007–2016 period while the share of the British Virgin Islands and the Netherlands accounted for 18.1% and 8.2%, respectively.

With regard to incoming FDI from offshore countries, business reacted positively to the authorities' call for de-offshorization of the economy, as evidenced by the statistics of the Central Bank of Russia over the past two years. The flow of funds has increased significantly from offshore companies registered in the Bahamas and Bermuda. The growth of incoming FDI in 2016 was 37.3% and 26.4%, respectively, compared to 2014.

Figure 5. Russia: offshore FDI flows (USD million)



Note: Offshore statistics covers countries such as the Bahamas, Bermuda, the British Virgin Islands, Cyprus, the Netherlands and Luxembourg.

Source: CBR database.

At the same time, the balance of FDI flows with the countries traditionally considered as transit stations for Russian capital, such as Cyprus and Luxembourg, was positive. This trend confirms the withdrawal of Russian business from offshores, and is also linked to the rise in the cost of offshore services as well as to the introduction in 2015 of mandatory reporting on controlled foreign companies.21 With all these turbulent movements in FDI flows and the loss in value of some assets, Russian inward FDI stock fell from the peak of €389 billion in 2012 to €240 billion in 2015, rising again to €360 billion in 2016.

[21] Reporting on the controlled foreign companies was introduced by the federal law "On Amending Part One and Two of the Tax Code of the Russian Federation (Regarding Taxation of the Profit of Foreign Companies Controlled and the Income of Foreign Organizations)" from 24 November 2014 No. 376-FZ.

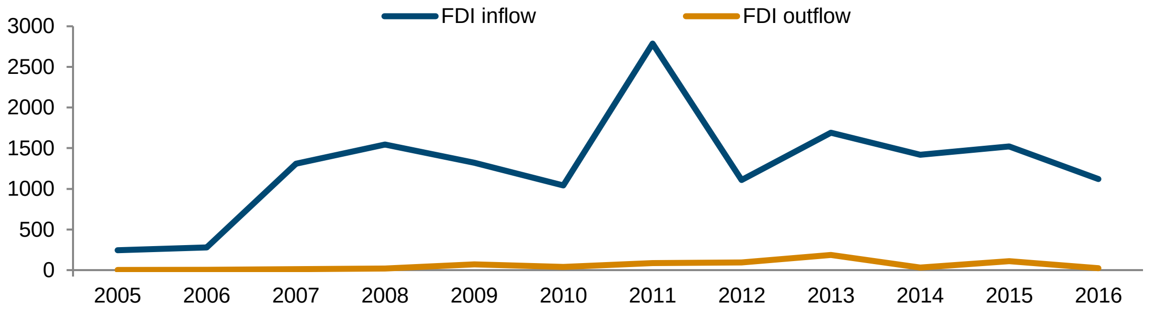
The inward stock in Russia diminished more than the outward stock in 2014, but the former recovered slightly in 2015, while the latter again shrank.

About 40% of outward stocks were held in Cyprus in 2013; that proportion declined sharply in 2014, but remained flat in 2015 (at 36%) while increasing to 42% in 2016. Two further destinations for Russian investors are also important: Netherlands and Austria (16% and 6.5% of the 2016 outward stocks, respectively) (Annex III, Figure 3). Despite the decline in Russian FDI and its geographic shifts in recent years, the focus remains on tax havens and offshore centers; the share of round-tripping capital has increased as Russian FDI has been shrinking. Government measures could not improve business conditions to generate sufficient trust among Russian capital holders to curtail capital flight. Genuine FDI, which is not round-tripping Russian capital, has been ravaged.

Belarus

Belarus was a late starter and a sluggish reformer, and did not really welcome foreign investors or privatization in general (Dobrinsky et al., 2016). A new privatization program began only in 2008 and it granted foreign investors some incentives. Before that, FDI was marginal: inflows to Belarus peaked in 2011 and have stayed relatively modest ever since. In contrast to Russia, there have been virtually no outflows of FDI from the country (Figure 6). However, based just on country size, Belarus has received more FDI than either Moldova or Ukraine, but less than its EU-CEE peers. The inflow of about €120 per capita (year 2016) was three times higher than that of Moldova and double that of Ukraine (see Annex V, Table 1). In 2016 FDI inflows declined, but were still higher on a per capita basis than in Moldova and Ukraine. Because of the relatively short history of FDI in the country, the stocks reached lower levels than in countries with a longer tradition of welcoming foreign investment. The FDI stock per capita in Belarus (€1,900 in 2016) was less than 40% of the Polish and Lithuanian levels, while the difference measured in terms of FDI stock per GDP is marginal. The poorer DCFTA peers, Moldova and Ukraine, had a somewhat similar FDI penetration ratio (FDI stocks as a percentage of GDP – see Annex V, Table 1).

Figure 6. Belarus: FDI inflows and outflows, € million



Source: wiiw FDI Database.

FDI in Belarus is mainly of Russian origin (Russian investment amounted to 57–58% of the stocks in both 2009 and 2015 (the earliest and latest years for which detailed data are available; see Annex III, Figure 4). In addition, FDI from Cyprus - another 16% of FDI inward stocks in 2015 - is in all likelihood also of Russian origin, making the direct and indirect FDI dependence on Russia much greater. The concentration of flows is even higher in outward FDI: 80% of the €521 million outward FDI stock is located in Russia. The Russian connection constitutes the most important difference between Belarus and its peers. Kazakhstan, Ukraine, and Moldova, not to mention the new CEE EU members, do not have the same kind of dependence on Russian FDI flows and stocks as Belarus does.

The majority of Belarus industry is still state-owned. A peculiarity of the FDI practice is how similar its policies are to those pursued by some of the former socialist countries during the 1980s: i.e., state-owned companies forming joint ventures (JVs) with foreign investors. As of 1 January 2015, there were 7,099 registered companies with foreign capital in the country, of which 4,052 were JVs, 3,018 were foreign enterprises, and 29 were "other."[22] The total contribution of foreign investors to the statutory capital of enterprises with foreign capital was USD2,648 million (USD1,268 million in joint ventures, USD1,377 million in foreign enterprises, and USD3.2 million in others). Thus, about half of registered foreign capital was in JVs. This mode of FDI was favored by the transition economies in the first years of economic and political transformation, when the legal framework had only just been established and most of the economy was still under state ownership. It should be noted that JV is a somewhat vague concept and is not a specific corporate form. It is supported by the authorities in Belarus and China, where one of the participants in the JV is the local government or a state-owned enterprise (SOE). A recent example of a joint venture entry to Belarus has been in car production: Chevrolet (Opel) cars will be assembled in Belarus by General Motors and Unison which was itself established as a joint Belarusian–British project.[23]

In 2016 the government announced public sales and tenders for shares in 60 state-owned companies. The list published by the State Property Committee includes 56 open joint stock companies and four enterprises as asset complexes, but the process stalled due to the economic recession and institutional bottlenecks. Special economic zones, industrial parks (e.g., the Chinese-Belarus industrial park "Great Stone") and other incentives are yet to bear fruit. The potential for FDI in Belarus is doubtlessly high, but it is uncertain when it can be realized.

Kazakhstan

The resource-rich Kazakh economy has attracted a great deal of FDI. In relative terms, Kazakhstan recorded the highest FDI inflows and accumulated the biggest FDI stocks of all EAEU and DCFTA countries. Inward FDI stock per capita (€6,900 in 2016) was even higher than the average for the EU CEE (see Annex V, Table 1). FDI in Kazakhstan was highly concentrated in both geographic and sectoral terms: about half of FDI stocks originated in the Netherlands (Royal Dutch Shell, etc.), another 18% in the USA (Exxon Mobile, Chevron) and 10% in France (Total). As the investing companies also indicate, the main share of FDI inflows went into the energy sector. The share of China (2.7% of FDI stock) is still low, yet rapidly increasing (Figure 7).24 Some 75% of accumulated FDI stocks in Kazakhstan in 2016 were concentrated in mining and quarrying; only 5% of the FDI went into manufacturing. In 2016 a

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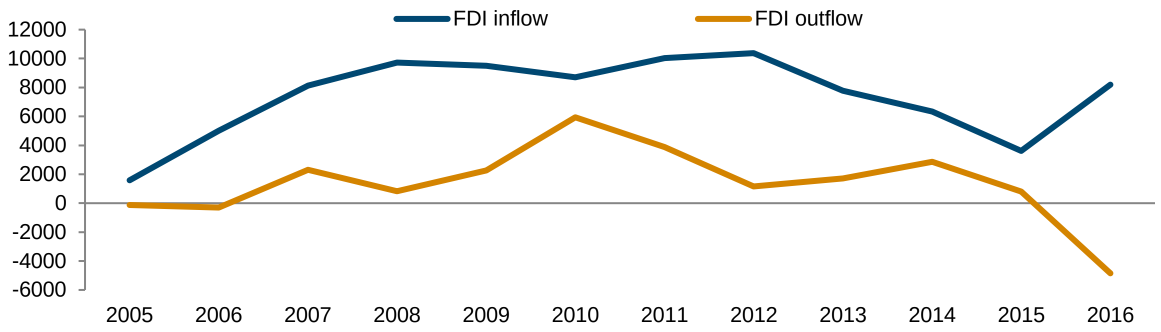
[22] http://www.economy.gov.by/en/investors/lgoty-preferencii/FIGURES

[23] http://www.belarus.by/en/business/business-news/general-motors-to-assemble-chevrolet-or-opel-cars-in-belarus_i_0000010654.html

[24] An interesting feature of Kazakh FDI—in contrast to other post-Soviet countries—is that the role of Cyprus in FDI flows is rather low (just 0.3% of FDI stocks). Instead, the Netherlands is also used for tax optimization purposes by multinational companies.

huge negative outflow occurred which was partly related to a reclassification of FDI activities in the mining industry.

Figure 7. Kazakhstan: FDI inflows and outflows, € million



Source: wiiw FDI Database.

1.2.2. FDI in DCFTA countries (Georgia, Moldova, Ukraine)

The DCFTA countries (especially Moldova and Ukraine) were lagging behind with respect to attracting FDI, largely due to various “frozen” conflicts, the poor investment climate, and serious institutional bottlenecks, as also reflected by their ranking in the Global Competitiveness Database. It is generally expected that the implementation of the DCFTAs (signed in 2014 and in force since 2016) with the EU will lead to a more predictable and familiar (to EU investors) regulatory environment. The approximation of EU norms and standards is expected to facilitate the inflows of foreign investment, the major benefits of which are the modernization and restructuring of domestic industries, job creation, technology spill-overs, investment in human capital, better managerial practices, logistics improvements, etc. Importantly, this will also help integrate the domestic companies into global value chains, which might be difficult for domestic firms to accomplish on their own (see Adarov and Havlik, 2016).

Similar to the earlier experiences of EU–CEE states, the inflows of FDI, both greenfield and via mergers and acquisitions, are expected to be the main vehicles of industrial modernization and restructuring in these countries. Owing to the commercial acumen of foreign firms, investments normally target the most promising areas for cooperation and result in positive spill-overs for both upstream and downstream industries in the recipient economies. As evidenced in the EU-CEE countries, integration with the EU has indeed resulted in a boost to FDI inflows, even prior to membership (when the prospect of membership was becoming apparent: see Avery et al., 2009; Hunya and Richter, 2011; Grinberg et al., 2008; Liebscher et al, 2007).

It should be stressed that the benefits of FDI inflows depend heavily on the progress made in improving the regulatory environment. DCFTA countries that have already moved forward with real reforms will thus see fewer additional gains due to the fact that there is a smaller gap to cover. The case in point is Georgia, which already made significant progress in creating a favorable business environment in the 2000s, thus attracting much FDI - accelerating to 15–20% of GDP in 2006–2007. During the whole 1995–2016 period, FDI amounted to over USD16 billion, mainly from Azerbaijan and Turkey, and principally targeting the transport and communications sectors.[25] By 2016 FDI stocks reached more than 110% of GDP (the highest share not only among the DCFTA peers but also in comparison with the CESEE countries, though in per capita terms FDI stocks are still lagging somewhat behind; see Annex V, Table 1). In 2016 FDI inflows to Georgia amounted to another €1.5 billion according to preliminary data.

A distinct feature of FDI in the DCFTA countries (similar to Russia) has been the skewed geographic origin of investors. In Ukraine, for example, more than 30% of FDI stocks came from Cyprus; the share of FDI from Western Europe (EU15) was just 36% of total stocks in 2016. In Georgia, apart from Azerbaijan and Turkey, much of the FDI comes from the United Arab Emirates and the Virgin Islands (Annex V, Table 1). In Moldova, the biggest investing country is Russia (30% of FDI stocks); Cyprus accounts for another 10% (Annex V, Table 2). The extremely high shares of Cyprus in the case of Ukraine and Moldova indicate that this kind of FDI most likely represents a simple recycling of domestic flight capital and possibly also serves tax evasion. Progress in the DCFTAs' implementation and institutional reforms in general should result in a diminution of the share of FDI originating from offshore sources.[26]

To date, Moldova has been relatively less successful in attracting FDI, despite introducing Special Economic Zones to improve the business environment and attract investors into selected areas (Annex V, Table 1 and 2). The acceleration of FDI inflows in 2007–2008 came to an abrupt end because of the global economic crisis (see more in Giucci and Radeke, 2012; Lupusur et al., 2017). In per capita terms, FDI stocks in Moldova are the lowest compared to the CESEE peers (less than €1,000 in 2016), and they have shown no signs of acceleration even after the signing of the DCFTA. The single main investor has been Russia, making Moldova the second most dependent country (after Belarus) on Russian investment (between 2009 and 2015, the share of FDI from Russia in Moldova even increased (Annex V, Table 2).

In Ukraine, too, the FDI flows have been highly volatile (Figure 8). After a drop in 2014 resulting from the political crisis, FDI inflows had somewhat recovered by 2015–2016, but they still remain rather low compared both to the country's regional peers, as well as in terms of the country's potential and needs. Unfortunately, the investment climate in Ukraine is still quite poor: it suffers not only from widespread corruption and other institutional bottlenecks, but also from the economic and security effects of the situation regarding Crimea and the continued conflict in the Donbas. The share of Cyprus in Ukrainian FDI stocks also remains exceptionally high. The single largest institutional investor in Ukraine was the EBRD with nearly €12 billion committed as at the end of 2016 and with investments in more than 380 projects.[27] Russian FDI projects in Ukraine (telecoms, banking, etc.) are facing serious obstacles due to the conflict and the mutual sanctions. Strangely enough, Russian FDI stocks in Ukraine increased in 2016, reaching 10% of the total, largely at the expense of Cyprus and the Netherlands.

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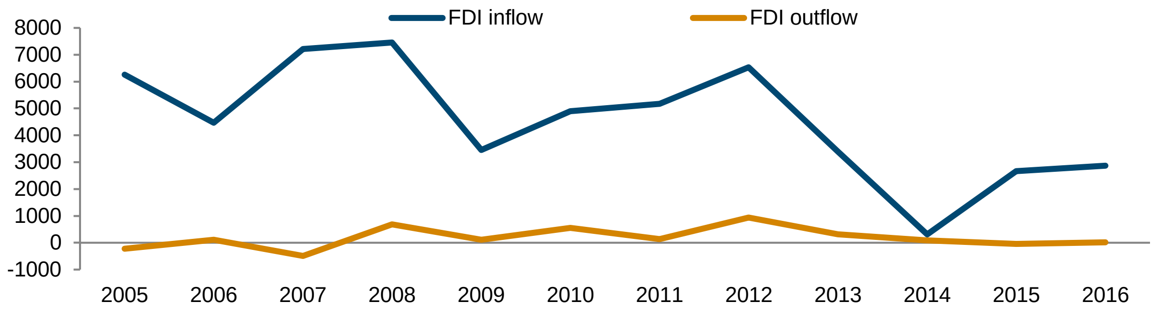
[25] Source: Ministry of Economy and Sustainable Development of Georgia. http://www.economy.ge/en/economic-review/foreign-direct-investments and National Statistics Office of Georgia.

[26] For a comparison, 85% of FDI stocks in Hungary and Poland originate from the EU15; in Romania it is 80%; in Slovakia 70% (another 16% come from the Czech Republic and Korea); in Serbia 64%, etc. – see wiiw FDI Report 2017 and Table 2 below.

[27] See http://www.ebrd.com/ukraine.html.

Figure 8. Ukraine: FDI inflows and outflows, € million



Source: wiiw FDI Database.

FDI stocks per capita have been much lower in the DCFTA countries than in the regional peer economies, and in recent years there has not yet been a noticeable increase in the inflows, with the exception of Georgia. In Ukraine, the reported increase in FDI inflows during 2015 and 2016 related to the recapitalization of banks, frequently with EBRD participation. The implementation of AA/DCFTA has so far not led to any marked increase in FDI in any of the DCFTA countries.[28]

1.3. The FDI performance of selected Central Eastern and South-Eastern European (CEESE) countries

This section provides more detailed information about investment activities in the both the EU–CEE and the broader CESEE region. Special attention is devoted to the results of attracting FDI from the "old" EU member states, (especially from Austria, France, Germany, Italy, and the Netherlands), as these are the key countries providing FDI to the EAEU and DCFTA countries. Direct comparison with the data in section 1.1 above is difficult, as the FDI data provided by the Eurostat are not always fully comparable with the BOP-based data used here. Nevertheless, come common trends and features can be observed. (There is also the issue of the treatment of Special Purpose Enterprises - SPEs - see Annex I on methodology for details).

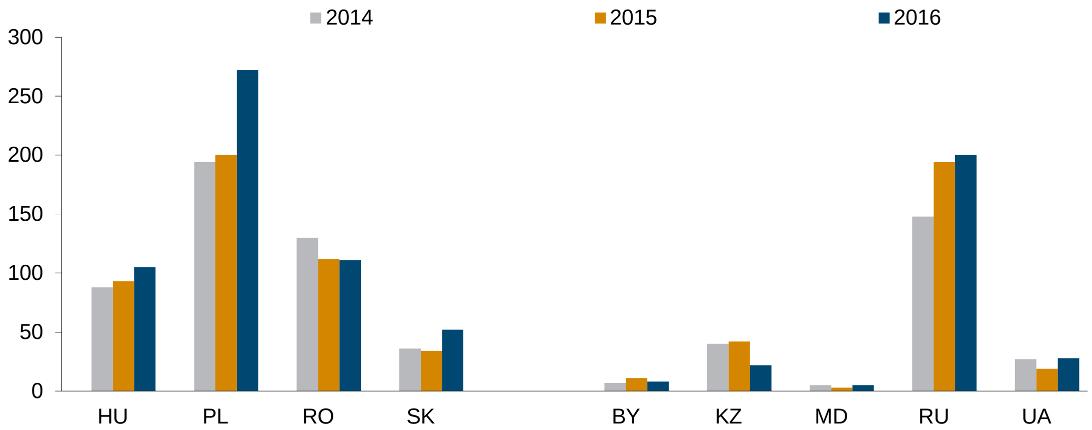
It was thought to be both useful and instructive to look at the performance of the CEESE countries in attracting FDI and the role that this inflow has played in their transformation and economic development. At the start of the fundamental political changes in the early 90s these countries were at levels of economic development comparable to those of the Eurasian countries. Since then, some of them have joined the EU and others have gained associate status. FDI from the Western countries, and in particular from the EU, has played a major role in the results achieved: Map 1 in Annex VI demonstrates the results in attracting FDI in various parts of the European continent.

Thus, apart from Ireland, the Netherlands, Cyprus and other tax havens which are outliers, only Georgia, Kazakhstan, and Montenegro have attracted more FDI than their respective (rather low) GDP. The CEESE countries are in the upper half of the list. Beyond the present situation of FDI stocks, the intentions of foreign investors to set up new projects are another useful indicator for the future. In this

[28] See Adarov and Havlik (2016) for outstanding implementation challenges; Jarábik, B. et al. (2017) for a recent assessment of implementation progress in all three DCFTA countries.

respect, greenfield investments are especially important, in contrast to the portfolio investments realized in existing projects.

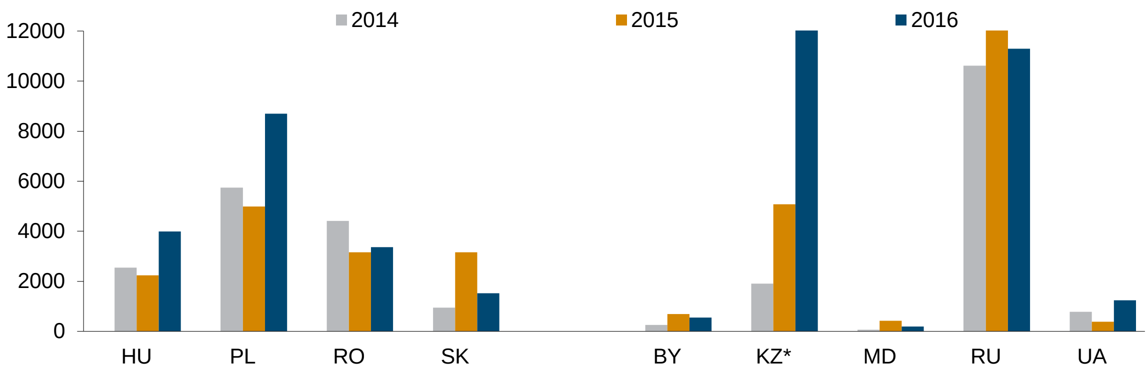
Figure 9a. Number of greenfield FDI projects announced in selected countries, 2014–2016



* KZ 2016: €35,122 million

Source: www.fdimarkets.com (adapted from wiiw FDI Report 2017).

Figure 9b. Investment capital pledged in greenfield projects by country 2014–2016, € million



* KZ 2016: €35,122 million

Source: www.fdimarkets.com (adapted from wiiw FDI Report 2017).

The message of the graphs is evident: the four largest and most successful new EU members in particular were able to attract most greenfield investment, in spite of being much smaller than Russia or the energy-rich Kazakhstan. On the other hand, for the less advanced and smaller countries like Bulgaria, even EU membership has not brought in too many new projects.

To give a more detailed background and explanation to the different FDI results, in Table 1 of Annex V an overview is provided of the key FDI characteristics for selected CEESE countries as of 2016. For international comparison, relative indicators (e.g., FDI per capita or FDI as a percentage of GDP) are used. Thus, both the EAEU and DCFTA countries have attracted much less FDI than the CESEE group[29] (with the exception of Kazakhstan).

The experiences of the EU's Central-Eastern European members clearly indicate that the FDI inflows have significantly contributed to the modernization and economic restructuring of these economies. In particular, FDI has been beneficial in the manufacturing industry, business services such as IT, software development, and logistics. Such investment has been especially welcome as it has helped to establish competitive export-oriented industries (the German–CEE automotive cluster being a case in point).[30] On the other hand, FDI in the non-tradable sectors (retail and wholesale trade, real estate) has been more problematic because it risks widening the trade and current account deficits. Developments of this kind have been observed in several Western Balkan countries such as Albania, Bosnia-Herzegovina, Kosovo, and Montenegro (see Gabrisch et al., 2016). Foreign investment has been actively promoted and supported by state-sponsored investment promotion agencies such as CzechInvest in the Czech Republic, Sario in Slovakia, PAIIZ in Poland, etc.

Hungary has been a pioneer among the Central and East European countries regarding reforms, trade liberalization, and attracting foreign investors. The first joint ventures with foreign investors were established during the 1980s, about 40 years ago. Although Hungary's accumulated FDI stocks remain high (€7,500 per capita as at the end of 2016), other EU CEE have either caught up (Slovakia) or even surpassed the earlier Hungarian pole position (Czech Republic and Estonia; see Annex VII, Figure 1).

Poland was the second of the EU CEE countries to open up to foreign investors in the early 1990s. FDI was actively promoted during the first stages of transition but the country subsequently become less welcoming to foreign capital, especially when the governments led or dominated by the Kaczynski brothers were in power.[31] On the other hand, Romania and Slovakia - both relative newcomers with respect to reforms and FDI openness - have rapidly caught up and become attractive destinations for foreign investors. In terms of FDI stocks per capita, Slovakia is now on a par with Hungary and Romania (a larger country), and is catching up with Poland. As far as the geographic distribution of foreign investors is concerned, the Netherlands and Germany are in the lead, with other West European countries (Austria, France, and Italy) also playing important roles (Annex VII, Figure 1).

The comparison with the EAEU and DCFTA countries is also interesting in another respect: in none of the EU-CEE countries is Cyprus prominently represented, and the practice of round-tripping of domestic investors is much less prominent than in either Russia or Ukraine. In these countries tax optimization is carried out partly via the Netherlands. The primary reason for the Dutch holding company regime is its tax efficiency (mostly zero tax rate), the flexibility of Dutch corporate and tax law, and the relatively low costs of incorporation and annual maintenance.[32]

[29] For a comparison, FDI stock per capita on average for the European Union amounted to €12,800 in 2016 according to Eurostat, twice as much as average for EU-CEE. Per capita FDI stock (from extra-EU) in Cyprus reached nearly €50,000 in 2015, in Austria €14,300, in Germany €2,400.

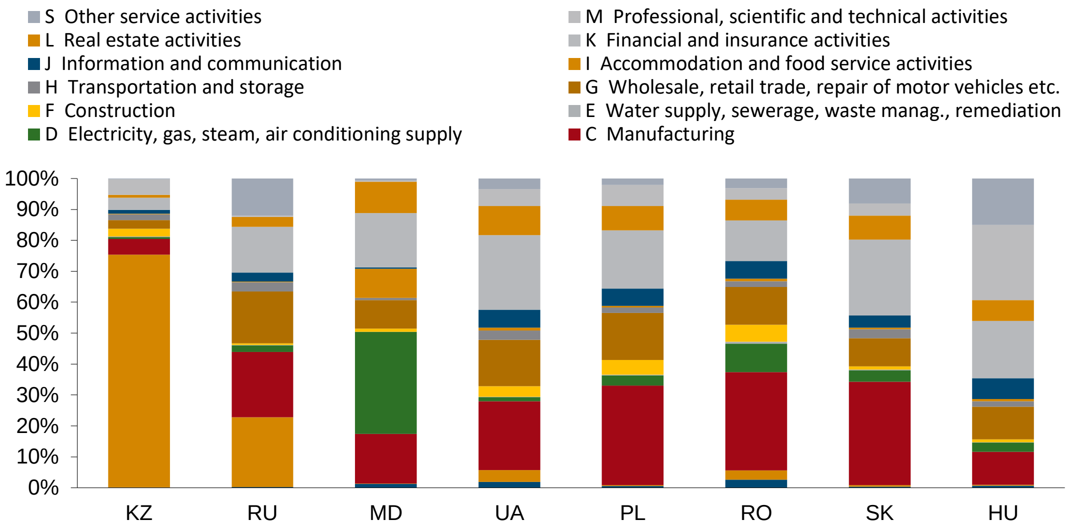
[30] See IMF Multi-Country Report, no. 13/263, August 2013; Stöllinger and Stehrer (2015), Szanyi (2017).

[31] Both Hungary and Poland started to openly question some elements of the FDI-led development model, in particular, by curtailing the activity of foreign multinationals and using the ideology of economic patriotism: for a recent overview see Szanyi (2017).

[32] See www.tax-consultants-international.com/read/_dutch_holding_Company. For similar reasons The Netherlands is playing an important FDI role in Kazakhstan.

Last but not least, it is not just the volume of the registered FDI per se; its sectoral structure, investors' motives (e.g., domestic market penetration vs exports) and other FDI structural and "quality" characteristics also matter greatly. There are important differences in the sectoral composition of FDI in the EAEU, the DCFTA, and the EU-CEE countries. In the latter group the bulk of FDI has been concentrated in manufacturing, trade, and financial services, with each of these three broad sectors accounting for about 20–30% of total FDI stocks. In this respect, the DCFTA countries have not been greatly different from Hungary, Poland, Romania, Slovakia, or Serbia. As far as the EAEU countries are concerned, most FDI has been concentrated in the energy and mining sectors (especially in Kazakhstan and Russia; see Figure 10). In contrast, the manufacturing industry has been the main target of foreign investors in Poland, Romania, and Slovakia (surprisingly, less so in Hungary where holdings account for a high share of FDI stocks).[33] In Moldova, Ukraine, and Romania, there are some (small) investments in agriculture. The energy sector is an important FDI target in Moldova and Romania; mining is important in Kazakhstan and Russia (there are no comparable data for Belarus and Georgia).

Figure 10. FDI inward stock by economic activities in selected countries, 2016/2015 (in % of total FDI stocks)



Source: wiiw FDI Database.

Table 2 (in Annex V) provides detailed cross-country data on FDI stock distribution according to partner countries for the selected EAEU, DCFTA, and EU CEE countries by major investing countries. As mentioned, in the EAEU and DCFTA countries it is mainly Cyprus, the Netherlands, and Russia who are the top investors, whereas in the EU-CEE it is mainly Austria and Germany (as well as the Netherlands). The share of FDI stocks from Western Europe (EU15) in the EU-CEE is double that of both EAEU and DCFTA countries (apart from Kazakhstan, where the Netherlands is dominant).

How can the huge differences in FDI structural characteristics across individual countries be explained? A number of factors play a role: geography, size of the country, resource endowment, costs and skills of labor, government FDI policies, and the investment climate in general. Figure 11 depicts the

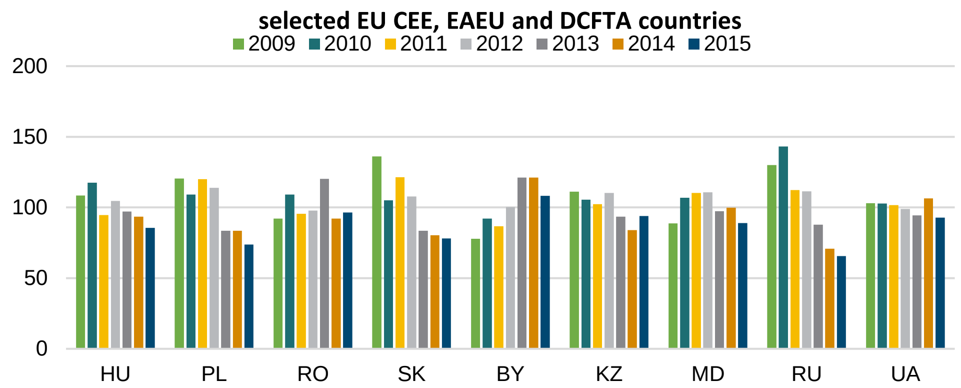
[33]See wiiw FDI Report 2017 for peculiarities of FDI accounting in Hungary ("special purpose entities").

estimated deviation of FDI stocks in each economy from its potential level over the 2009–2015 period. In this graph, various characteristics of the countries (macroeconomic variables, distance from the market, trade costs, etc.) are taken into account. The average FDI potential level for each economy over the seven-year period is 100; years of under-performance and years of over-performance are included. The deviation from the part explained (the FDI potential) is a small share of actual FDI changes, just 6.1%. If a country's performance improves, it changes from below to above 100 - for example, in Belarus in 2012–2014 and in Moldova during 2010–2012. Thus, the investment environment in these countries has improved. A declining slope, from above 100 falling to a level below it, means that the performance of the economy has deteriorated over time (see, for example, Hungary, Slovakia and, most notably, Russia).[34]

It is clear that the investment climate matters a lot. A number of indicators have been used to evaluate the countries' business and investment environment. Some of the most frequently used indicators are the Doing Business surveys conducted by the World Bank, rankings published by the World Economic Forum, and others. How are the EAEU and DCFTA countries positioning themselves in this respect?

According to the latest World Bank Doing Business survey for 2018 (published on 31 October 2017 and registering big shifts in ranking scores), the EAEU and DCFTA countries covered in this paper received the following ranking (out of the 190 countries surveyed):[35] Georgia (9), Poland (27), Russian Federation (35), Kazakhstan (36), Belarus (38), Slovakia (39), Moldova (44), Romania (45), Armenia (47), Hungary (48), Azerbaijan (57), Ukraine (76) and Kyrgyzstan (77). The Russian Federation, Kazakhstan, Belarus, and Georgia were among the top 10 countries that had recently managed to improve their ranking (these average rankings are based on the evaluation of 10 factors relevant to doing business such as access to finance, trading across borders, protecting minority investors, etc.).

Figure 11. Deviations from the average FDI potential (100), 2009–2015



Source: Estimations by M. Goshi (wiiw) using World Development Indicators (WDI), CEPII, UN Comtrade, CEFTA FDI Database.

[34] See wiiw FDI Report 2017 for more details regarding the estimation methodology and other results.

[35] See http://www.doingbusiness.org/reports/global-reports/doing-business-2018; http://www.doingbusiness.org/reports/global-reports/doing-business-2017.

Alternatively, the World Economic Forum provided in its latest Global Competitiveness Index (published in September 2016)[36] the following rankings (from 138 countries): Poland (36), Russia (43), Kazakhstan (53), Georgia (59), Romania (62), Slovakia (65), Hungary (69), Armenia (79), Ukraine (65), Moldova (100) and Kyrgyzstan (111). Only Poland, Russia, Armenia, Ukraine and Georgia improved their rankings; other countries from our sample fell back in their ranking compared to the previous assessment.

Needless to say, all these rankings have been criticized, and have some drawbacks. Still, they provide - together with other assessment and economic analyses - a useful shorthand overview of the various countries' international investment standing. Obviously, other macroeconomic indicators and political risk analyses (in addition to industry and even enterprise-specific conditions and market analysis) are indispensable for making informed investment decisions. The remaining (geopolitical and other) risks are hard to evaluate and will always be present.

[36]See https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1.

PART II

External Factors Affecting FDI Policies

2.1. The impacts of political measures, sanctions, and economic policy directions on FDI flows

Prevailing political conditions and policy choices can be essential for many areas of international economic relations, but this is especially true for foreign investments. Its most important form, FDI, represents long-term commitment, implemented in another country, subject to the recipient country's supervision and control. In this study, as has been the case during the whole Eurasian Project, the **political aspects are treated as externalities**: there is no attempt to propose solutions or make judgements; the facts and their economic impacts are just described in an objective manner.

The Eurasian Project was launched at a rather unfortunate moment in late 2013, when the tensions between the EU, Russia, and Ukraine were becoming increasingly visible. By the time the first meeting took place in March 2014, President Yanukovich had already fled Ukraine and the takeover of Crimea had just been completed. The ever-more difficult and frosty EU-Russia relations defined the whole period of the Project, and it was impossible to ignore the impacts of these on inter- and intra-regional economic relations. However, on the positive side, in spite of the challenging conditions, substantive discussions took place at six Eurasian Project workshops, where the participants were able to express their views on a professional basis, avoiding political conflicts. Actually, after the suspension of most aspects of the Western countries' relations with Russia, IIASA and its Eurasian Project offered one of the few remaining forums in which European and Russian officials, experts, and researchers could meet and exchange views.

The debates at the IIASA workshops became more intensive with the introduction of sanctions by the EU due to Russian military actions in Crimea and in the Donbass, soon followed by Russia's own imposition of sanctions on the EU. Even if the political and legal aspects of these sanctions were not discussed at the IIASA meetings, their direct and indirect impacts on investment flows and on the broader business environment came up repeatedly. This was all the more unavoidable, given that some of the sanctions directly affected FDI flows, including in the strategically important energy sector. Actually, some of the sanctions expressly targeted this sector, Russian energy companies, and the participation of European companies in certain energy projects, as described in detail in Part IV.

By 2015 the political relations became even more tense. **Russia took a very negative view of the entry into force of the EU–Ukraine AA/DCFTA, considering that it directly affected its political and economic interests.** The trilateral EU–Russia–Ukraine trade negotiations started with the intention of finding mutually agreeable solutions to Russia's complaints, and have been already going on for over a year. The detailed talks took place at the senior official level, but were closely supervised - and every time conducted - by ministers, showing the importance of the subject. However, in spite of the intensive work, the EU and Ukraine on the one hand, and Russia on the other, remained far apart. In the EU/Ukrainian view the existence of an FTA is fully compatible with the parallel maintenance of another FTA, specifically with the CIS FTA linking Ukraine and Russia. However, Russia complained about the expected negative effects of the EU–Ukraine DCFTA, which would reduce the big competitive advantage of Russian products at the Ukrainian market. There were also different views about the regulatory aspects, with Russia insisting that Ukraine should continue to apply Russian/EAEU technical, health, and veterinary standards, even on a long-term basis.

When in June 2015 Russia put forward its new proposal, **it became clear that reaching an agreement was not possible:** the Russian document required the acceptance of such conditions as the price for keeping the CIS relations with Ukraine in force, which would have made the application of the already signed and approved EU–Ukraine DCFTA impossible. As such demands were politically, legally, and economically unacceptable for both partners, the failure of the trilateral process became unavoidable. Thus, by the time the talks came to an end in December, **Russia announced that as of 1 January 2016 it would suspend its CIS FTA relations with Ukraine**. Additionally, restrictions on the transit of EU and Ukraine products via Russia to Kazakhstan and other Central Asian countries were introduced, causing further damage to regional economic relations. These steps eventually led to a WTO dispute case between Ukraine and Russia, which is still going on.[37] The politically motivated restrictions and bans have caused serious economic losses to all sides, and have also further weakened the FDI links. The resolution of this situation would require a fundamental improvement in political relations, but at this stage there is no sign of such a change.

While the political restrictions and sanctions played a major role in the shrinking of all areas of EU–Russia (as well as Ukraine–Russia) economic relations, **their impacts have been intensified and supplemented by the new directions of Russia's economic policy.** The country has, in past years, started to follow increasingly protectionist and inward-looking policies based on a program of import substitution and elimination of foreign competition.[38] These policies aimed first of all to reduce imports in general, by substituting Russian products and services for them. If substitution was impossible, using imports from other EAEU countries was promoted, or if eventually imports from third countries were considered unavoidable, steps were taken to squeeze out the products of countries considered unfriendly and replace them with imports from politically friendly (or at least neutral) countries. Thus, due to economic, but also political reasons China has recently taken over the role of being the largest source of Russia's imports from the EU. The restrictive measures have also targeted foreign investors and investments from the "unfriendly" countries, primarily of EU member states.[39] It should be noted that some investors might welcome the squeezing out of competing imports, but in the longer term such policies tend to lead to decreasing international competitiveness on the part of the country concerned.

These measures, directly influencing the economic relationship, were also the subject of detailed discussions at the IIASA workshops, with various aspects of FDI flows also having come up repeatedly. There were lively debates about the requirements applied by Russia to investments in the production of goods. The EU view was that several of these government-mandated measures represented a breach of the WTO obligations contained in the TRIMs Agreement: they covered broader areas and sectors than the temporary exemptions allowed under Russia's WTO accession protocol. There were debates about certain elements of Russia's GATS commitments e.g., in the area of transport and

[37] Dispute Settlement Case No DS512. No panel report available yet.

[38] European Parliament (2017), Russia's and the EU's sanctions: economic and trade effects, compliance, and the way forward.

[39] European Parliament (2017), Russia's and the EU's sanctions: economic and trade effects, compliance and the way forward.

different interpretations of the coverage of GATT Article V related to the freedom of transit. The operations of companies owned or controlled by the state, especially in monopoly positions, also came up. The treatment of public procurement in foreign-owned companies was a further controversial area. All these problems are discussed in detail in the chapters that follow, but it is important to point out even at this stage that the combination of political and economic restrictions had major negative effects on EU–Russia FDI flows.

2.2. Multilateral/international disciplines on FDI

The multilateral framework regulating foreign direct investments is quite fragmented and patchy, even though several international organizations and bodies deal with various aspects of FDI. In the 1990s attempts were made within the OECD to negotiate a comprehensive Multilateral Investment Agreement, but these efforts failed. Subsequently, in 2001 the issue of investments was tentatively placed on the agenda of the WTO's Doha Round but due to the strong resistance of developing countries the subject was eventually dropped from the negotiations. As a consequence, neither the WTO nor the OECD or other international bodies regulate FDI activities in a comprehensive manner. Only some of its aspects are subject to international rules.

2.2.1. Framework of the World Trade Organization (WTO)

The two major WTO agreements[40] addressing FDI-related issues are the Agreement on Trade-Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS), both of which entered into force in 1995 as part of the outcomes of the Uruguay Round negotiations.

The Agreement on Trade-Related Investment Measures (TRIMs)

The TRIMs Agreement aims at eliminating the trade-distorting effects of investment measures taken by WTO members. The origins of this agreement are in the multiplying international disputes in 1980s (particularly, the "FIRA dispute," initiated by the USA against Canada, based on the Foreign Investment Review Act of Canada, which imposed local content requirements). Thus, at the launch of the Uruguay Round it was decided that investment measures affecting trade should be placed under WTO rules. The negotiations related to what has become the "TRIMs Agreement" were not smooth and undisputed. The WTO members split into two big camps: the developed countries vs. the developing countries (DCs). The two central issues separating the groups were: i) whether the disciplines imposed on TRIMs should be limited just to the clarifications of the existing articles of the General Agreement on Tariffs and Trade (GATT) or whether they should be substantially expanded to cover all such government or administrative measures affecting FDI that cause trade distortions. The second issue was whether such measures should be completely prohibited or evaluated on a case-by-case basis, depending on their actual economic effects.

The developed countries, especially the USA, insisted that all requirements linked to FDI should be considered as TRIMs, i.e. that any interference by governments into the trade relations in case of FDI should fall under GATT rules. Thus, the USA put forward an extensive list of trade-distorting TRIMs, including requirements on local content, export performance, balance-of-trade issues, local equity, as

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[40] Some indirect effects on the foreign direct investment could be also found in such WTO Agreements as the Agreement on Subsidies and Countervailing Measures (ASCM), the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs) as well as the Government Procurement Agreement (GPA).

well as restrictions on domestic sales, access to foreign exchange and remittances, and different investment incentives. The developing countries argued, however, that TRIMs are more related to national development and investment policies, which are not covered by GATT. In the end, the compromises on the TRIMs Agreement were closer to the DCs' views: both the scope of coverage and the list of prohibited measures are quite limited. Article 1 of the Agreement states that the agreement applies only to investment measures affecting trade in goods, and excludes most requirements and restrictions on foreign investors.

In general, the Agreement did not introduce any new obligations, but rather just confirmed the existing GATT prohibitions of measures restricting imports. These are the local content and the balance-of-trade requirements.

The General Agreement on Trade in Services (GATS)

Due to the limited scope of the TRIMs Agreement, the GATS is often considered as the real investment agreement of the WTO, at least as far as trade in services is concerned. GATS includes investment provisions, as it covers a services supply mode - the commercial presence of a service supplier in another country. In GATS terminology, this is called establishment, or mode 3. Foreign direct investments in the services sector, within the scope of mode 3, are subject to the GATS' cross-cutting most-favored nation (MFN) requirement, and WTO members are required to comply with their respective schedules of GATS commitments. The schedules must specify the level of market access, including the extent of foreign equity participation and any limitations on national treatment.[41] The GATS covers substantial aspects of the entry, establishment, and treatment of foreign investors who provide services in the host country by commercial presence; however, it does not contain provisions on some measures affecting foreign investments, for example, nationalization or expropriation. This kind of protection can be provided by bilateral investment treaties (BITs), which are not part of the WTO framework, but cover investments in all sectors, not just in services.

In spite of its limitations, the GATS is considered as one of the major achievements of the Uruguay Round and its existence can be partially explained by its separation from the TRIMs Agreement. Most developing countries focused on the goods sector, considering their competitive advantage to be in the production and exports of goods, while the services of interest to them, like tourism, had already largely been liberalized. However, the outcomes of the Round had to be accepted in their totality, or not at all; thus, while the TRIMs Agreement was linked to the negotiations on goods, much desired by the developing countries, the GATS was negotiated in a separate process mainly with the active participation of the developed countries. This ultimately resulted in a meaningful outcome in the GATS, including the proper coverage of investment in services and substantial market access commitments. The EU, due to its major interests in the sector, was one of the most active participants, fully using its substantial experience on advanced integration in the regional liberalization of trade in services.[42]

[41] Members have to provide the existing national treatment limitations in their schedules of GATS commitments; otherwise the same level of the treatment is extended to foreign services and service suppliers.

[42] Only the USA at that time also had some experience in services liberalization and had concluded a number of treaties of specific services, like aviation, shipping and communications plus free trade agreements with Israel and Canada, and therefore was another most active participant on the developed country side.

The Government Procurement Agreement (GPA)

A substantial part of economic activities worldwide, including in both the EU and Eurasian countries, is represented by government procurement, i.e., the purchase by central and regional government bodies and state-owned/controlled companies of goods and services from private companies. The GPA, which regulates these activities, is among the few plurilateral agreements that are part of the WTO system: its members are predominantly developed countries plus a limited number of emerging and developing economies. Most of the latter, even if founding members of the GATT, have, over the decades, considered it against their interests to join the GPA. On the other hand, for the recently acceding WTO members, including emerging economies, it has become a standard part of the accession commitments to start negotiations to join the GPA within a limited timeframe (in general, four years after the WTO accession).

The GPA's coverage from the EU side is quite extensive; its Annex 1 contains a list of "central government entities" whose procurement activities are covered (both those of the EU and of the Member States); Annex 2 provides the list of the "sub-central government entities" and Annex 3 "all other covered entities." In light of this extensive opening of its markets, it is no surprise that the EU expects comparable reciprocal commitments from the countries, including those from the Eurasian region, that have obligations to become GPA parties.

FDI-related disputes in the WTO

The WTO's Dispute Settlement Body (DSB) is the forum authorized to deal with all legal disputes among members, including those related to the aspects of FDI activities. Thus, when it comes to trade in goods, in the past decades, the obligations of the TRIMS Agreement and, for services, those of the GATS, have been the subjects of numerous WTO disputes. These have often ultimately ended up before the WTO's highest legal forum, the Appellate Body.

In EU–Eurasia relations the major differences in viewpoints with Russia have been apparent since the early years of this decade because of Russia's use of TRIMs measures that overreach its specific WTO accession terms (see below for more detail). The automotive industry which is considered as a major strategic sector by Russia, has also been the focus of differences. The EU in 2012, the year of Russia's WTO accession, launched a WTO case due to the so-called "recycling fee" selectively imposed by Russia on imported motor vehicles, contrary to GATT and the TRIMs provisions.[43] Since then several further WTO cases have been launched by the EU against Russia, some of them with implications for FDI. As will be spelt out later, Russia has also initiated a few WTO disputes against the EU.

Following the suspension by Russia from 1 January 2016 of its CIS relations with Ukraine, the latter also initiated a WTO case, claiming breaches by Russia of its commitments related, among other things, to the transit of goods and transport services.[44] Subsequently, in May 2017 Russia requested consultations with Ukraine regarding the latter's restrictions in respect of trade in services and transit.[45]

Some of the dispute procedures have already been completed; others are ongoing, not having reached the stage of issuing a panel report or of ruling by the WTO's Appellate Body. However, foreign investors

[43] Dispute Settlement Case No DS462. No panel report available yet.

[44] Dispute Settlement Case No DS512. No panel report available yet.

[45] Dispute Settlement Case No DS525. No panel established yet.

are well advised to follow the developments and outcomes of these disputes and draw the necessary conclusions about the possible similar impacts on their own investment activities. (The details are provided below, in the context of Russia's WTO relations.)

2.2.2. The treatment of FDI under preferential arrangements

The WTO provisions regulate only the most general features of the preferential agreements, i.e., the Free Trade Agreements (FTAs) and Customs Unions (CUs). These rules require the parties to respect, in both the goods and services areas, broad requirements regarding the extent of trade and sectoral coverage, as well as the time limits for achieving full liberalization. The GATT, the first element of what has become the WTO framework, sets stricter requirements for the FTAs and CUs than the GATS. This is because preferential arrangements are among the few permitted exceptions to the general obligation of all WTO members to treat other members in a non-discriminatory fashion, i.e., the Most-Favored Nation (MFN) and National Treatment in case of goods, and MFN only in case of services. (The latter aspect, including establishment, i.e., investments, is subject to negotiations under the GATS). However, the parties to such arrangements are free to agree all other aspects among themselves, including more stringent (i.e., WTO+) rules applicable to all areas covered, including FDI.

The developed countries, especially the EU, have recently been signing only preferential agreements providing for stricter controls on the treatment of foreign investments and investors than those foreseen under the TRIMs and GATS agreements. The goal is to limit the scope of government measures to regulate investment from, or directed to, preferential partner(s) and thereby ensure that there is a level playing field for domestic and foreign investors. Thus, measures that are not prohibited under the TRIMs Agreement, such as local equity requirements, technology transfer, and licensing requirements, restrictions on the entry and local employment of persons linked to investment projects, foreign exchange remittance limitations, and export performance requirements are often banned in trade between preferential partners. As will later be spelt out later in detail, these measures are the source of difficult discussions, sometimes leading to formal WTO dispute procedures between the EU other members—in the Eurasian region, Russia.

2.2.3. Framework of the Organization for Economic Co-operation and Development (OECD)

The OECD's legal instruments on international investment include two major arrangements: the OECD Codes of Liberalization,[46] to which countries accede when they become members, and the 1976 Declaration on International Investment and Multinational Enterprises, to which non-member countries can also subscribe.

The two Codes of Liberalization contain binding rules on the non-discriminatory, progressive liberalization of capital movements and transactions, mostly in the services sector. The Declaration contains the policy commitments necessary to improve the investment climate and make a positive contribution to overall economic and social policies with respect to the operations of multinational enterprises. It consists of four elements: 1) The Guidelines for Multinational Enterprises, containing a set of voluntary rules of conduct for multinational enterprises; 2) The National Treatment principle,

[46] In the investment sector those are two: the Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations.

applied to foreign-controlled enterprises; 3) Conflicting Requirements to avoid or minimize the imposition of such requirements on multinational enterprises; and 4) International investment incentives and limitations to be subject to transparency.

Apart from these binding commitments there are other OECD activities affecting the global investment climate. In particular, the fight against tax evasion is also directly relevant to investment flows. Thus, in November 2016 the Multilateral Convention on Tax Treaty Related Measures was adopted to prevent base-erosion and profit-shifting (BEPS)[47] as a result of extensive work since 2013. The Convention contains a wide set of collaborative tools to close the gaps in international tax rules by modifying the application of the bilateral tax treaties. As this is quite a recent understanding, signed only in July 2017, its global impacts still cannot be judged. Nonetheless, it was signed by 70 countries, including almost all EU member states, plus Armenia, Georgia, and the Russian Federation,[48] so there are hopes for meaningful impacts in the Eurasian region, too.

There are some other OECD programs related to countries which are not yet members of the Organization. The EU, which is the main supporter of the OECD activities related to the Eurasian region, makes a voluntary contribution to financing the "OECD Eurasia Competitiveness Programme." This aims to promote economic transformation in the Eastern countries and help them to prepare, first, for joining specific OECD programs or commitments, and eventually for becoming members of the Organization.

2.2.4. Other international forums for investment disputes

The disputes resolution between investors and states has emerged as a high-profile issue since the 2000s, as governments have been facing multiplying arbitration claims from foreign investors. These are often related to fundamental public sectors and policies, like health, social services, the protection of the environment, and public security. This increased activity has come from the growing awareness of investors of the legal possibilities open to them, as well as the emergence of third-party financing of claims (companies and institutions with legal expertise providing the funds in exchange for a share of any proceeds from the case), promoting an international arbitration industry. Such investor claims, if successful, have often created expensive financial consequences - the compensation claimed can amount to hundreds of millions, if not billions, of US dollars.

Thus, it is not surprising that even in many developed countries - including EU member states - political attitudes have significantly shifted with respect to investor–state arbitration. These countries and also international institutions are now striving to establish more transparent and fair dispute-resolution systems, securing the rights of states to make regulations in the public interest. The recent developments in the EU are described in Part III.

Finally, regarding preferential agreements - these still overwhelmingly remain unchanged and contain the traditional investor-to-state dispute settlement mechanisms. However, the EU has started to

[47]Base erosion and profit shifting (BEPS) are tax avoidance strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations.

[48]All signatories of the Convention still have to undergo the internal ratification, acceptance, or approval procedures to allow the Convention to enter into force in each jurisdiction.

negotiate comprehensive integration-level agreements with a new type of investment dispute-resolution. This type of mechanisms is expected to gradually gain ground in due course.

The activities of UNCITRAL and ICSID's

Two important bodies worth mentioning with regard to the global investment framework are the United Nations Commission on International Trade Law (UNCITRAL) and the World Bank's International Centre for Settlement of Investment Disputes (ICSID). Both institutions' core functions include the operation of investor-to-state arbitration bodies, but they also carry out other activities with impacts on the global investment climate.

UNCITRAL's duties include cases linked to trade law. Thus, its work is organized into several commissions, including ones specialized in small- and medium-size enterprises, e-commerce, insolvency law related to dispute settlement, and investor-to-state dispute settlement reform. As regards the last element, a recent achievement has been the Transparency Registry, providing information and documents on treaty-based investor-state arbitration, effective from 1 April 2014 (based on the UNCITRAL Rules on Transparency in Treaty-based Investor-State Arbitration). This is an important turning point in the transparency of ISDS cases, as the practice had previously been to conduct such disputes behind closed doors, with almost no public information.

The **ICSID** is the leading ISDS arbitration body, having administered approximately 70% of all ISDS cases.[49] Its Convention on the Settlement of Investment Disputes has been signed by 161 countries and ratified by 153 countries, making it a leader also in the procedural changes of ISDS. It has contributed to the development of the ISDS system by adopting provisions on the transparency of the arbitral process and as advisor to other arbitration proceedings. As regards membership, almost all EU member states have ratified the Convention (except Poland, which is not a signatory). On the Eurasian side, the Convention was signed by all EAEU countries; however, the Russian Federation and Kyrgyzstan have still not ratified it.[50] Ukraine and Azerbaijan have also ratified the ICSID Convention.

2.2.5. Bilateral Investment Treaties (BITs)

Bilateral Investment Treaties are among the international agreements with the longest history, given that the need to protect the interests of investors in other countries arose quite early on. BITs can be either free-standing agreements or parts of broader treaties that also cover other aspects of the bilateral relations. Not surprisingly, as developed countries, including Western European countries, are the main sources of international investment flows, they initiated the first signing of BITs. The 28 member states of the EU have now over 1,100 BITs in force, mostly with non-EU partners.

It should be noted that as a result of several EU enlargement rounds, there are still around 200 bilateral investment treaties between the EU member states themselves. Most of these intra-EU BITs were agreed in the 1990s, before the EU enlargements of 2004, 2007, and 2013, between the then members of the EU and those who would become the "new" member states. After the conclusion of the accession process the new EU members also became subject to the same rules for cross-border investments in the internal market as the "old" ones. Thus, the intra-EU BITs have become redundant;

[49]According to ICSID 2016 Annual Report.

[50] The Russian Federation signed the Convention in 1992, Kyrgyzstan in 1995.

however, due to legal and procedural complexities these agreements still have not been terminated by the majority of the member states.

The BITs play an especially important role in promoting the investment flows between the EU and the Eurasian countries due to the lack of other legal instruments protecting foreign investments. Thus, in spite of FDI becoming a EU competence, even today it is possible for member states to sign new BITs, based on advance information being provided to, and agreed by, the European Commission, in accordance with the process described in Part III

The ICSID, as mentioned above, plays a leading role in the ISDS activity, which is most frequently linked to alleged breaches of BITs. As the report cited,[51] altogether 23 such cases were identified, the majority of which (12) were based on ICSID arbitration rules, according to the UNCTAD Investment Dispute Settlement database. Seven cases were handled under UNCITRAL's arbitral rules and in only four ISDS cases have other arbitral rules been used. As regards the sectoral coverage, the sectors affected are mining and quarrying (5 cases), manufacturing (5 cases), construction (4 cases), and financial services (3 cases).

With the recently changed attitudes in the EU toward ISDS, the importance of BITs can be expected to decrease over time. The current trend is to sign comprehensive EU-level investment agreements with the most important partners, taking the protection of investors to EU level, subject to the new mechanism for the settlement of disputes.

[51]Disputes among the EU countries and Russia, Kazakhstan, Ukraine, and Armenia

PART III

FDI Policies and Practices of the EU, its Member States and the Eurasian Countries

As mentioned above, the situation of the EU and that of the Eurasian countries are fundamentally different in terms of their international commitments related to FDI. The 12 member states of the European Economic Community participated actively in the Uruguay Round negotiations regarding the TRIMs and the GATS agreements and were founding members of the WTO. The new members joining the EU since then have taken on, without reservations, all aspects of the TRIMs Agreement and have also undertaken comparable, meaningful commitments under GATS. This was underpinned by two facts: services constitute an increasingly important part of the EU's Internal Market and the European Commission also carefully monitors the free flow of services. There can be no discrimination against established foreign-owned enterprises compared to national ones. Furthermore, foreign investment has become part of the EU's common trade policy, and the European Commission now negotiates new investment-related international agreements, including preferential arrangements, with third countries.

In contrast, in the Eurasian region, the regulation of FDI remains in the hands of national governments, and the EAEU has no competence in this respect. Each country has different regulations: countries that joined the WTO in the last decade act in line with their respective multilateral commitments, while countries like Belarus basically regulate foreign investment as they wish.

In the following chapters the regulation of FDI is looked at and assessed in the EU and some of its selected member states, as well as in the Eurasian countries.

3.1. The EU and its member states

The EU's approach to foreign investment policy should be divided into two stages: before and after the Treaty of Lisbon, which entered into force on 1 December 2009. Before this date investment policy was a shared competence between the EU and the member states. The EU competence has extended only to negotiating market access for investors. The member states were in charge of investment protection, what was mainly ensured by concluding BITs[52] to secure the investors' rights. However, the promotion of in- and outflows of FDI was, and remains, member states' competence.

After the Treaty of Lisbon, FDI became part of the common commercial policy.[53] Considering the importance and sensitivity of the subject, transition to the new situation was gradual. To ensure a smooth shifting of powers and provide legal security to both EU and foreign investors, a new regulation establishing transitional arrangements for investment agreements between the member states and

[52] Investment policy was and still is often complemented by other investment promotion efforts by member states and sub-national levels of government. These efforts include a variety of instruments, ranging from investment incentives to assistance and support schemes within the remits of the common EU commercial policy and EU law.

[53] The Lisbon Treaty included "foreign direct investment" in the "common commercial policy" of the EC Treaty, currently named the Treaty on the Functioning of the European Union (TFEU). The most directly related provisions of these changes are contained in Articles 206 and 207 TFEU.

third countries was adopted.[54] Based on this regulation, the European Commission (EC) now negotiates investment agreements or the relevant provisions with third countries. The EC also reviews all BITs signed by the member states, giving authorization for their maintenance, or entry into force, until they are replaced by comprehensive EU-level investment agreements. An important recent example is the ongoing negotiating process of a stand-alone bilateral investment agreement between the EU and China. However, authorization can be given to member states to negotiate new BITs, but only in exceptional cases.[55] The impacts of the new situation are also shown by the statistics: the number of BITs concluded by the member states has significantly dropped, with only 11 new BITs being signed with third countries in the past five years.[56]

An additional piece of legislation to address the new competence issues was adopted in 2014: the Regulation establishing a framework for managing financial responsibility.[57] Its aim is to provide legal and financial certainty for investors by ensuring that the awards resulting from arbitration processes are paid promptly, regardless of the financial responsibility of the member state affected or the EU.

However, in spite of the gradual approach there have been recurring debates between the European Commission and the member states about how far the EU's exclusive competence extends regarding investment policy. This dispute was finally resolved by the recent ruling of the Court of Justice of the European Union (ECJ), dated 16 May 2017, which clarified that the EU's exclusive competence covers all aspects of foreign investments, except for portfolio investments and dispute settlement between investors and states (ISDS). According to this ruling the first aspect falls under the competence of the member states; for ISDS a new type of international arbitration mechanism is being elaborated for use in the EU-level investment agreements. This new mechanism called "Investment Court System" is intended to eliminate the shortcomings of the arbitration process by introducing fairer and more transparent rules and procedures (like a two-level judicial structure and appellate mechanism), as well as by using more cost-effective and faster dispute resolution (like clear procedural deadlines, fees for judges etc.),

Another recent initiative affecting EU investment policies came from President Juncker's 2017 State of the Union speech. On 13 September 2017 the Commission published a draft Regulation to establish a framework for screening FDI from third countries coming into the EU.[58] The objective was to set up a mechanism involving the member states and the Commission in screening the details, nature, and objectives of such investments. The background of this new initiative is the EU's view about the lack of a level playing field, with numerous foreign countries and companies enjoying the benefits of the

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[54] Regulation (EU) No 1219/2012 of the European Parliament and of the Council of 12 December 2012

[55] As such cases define the situations in which the EU is not intending to open formal EU investment negotiations with the particular third country in the near future (as far as this is consistent with the Union's principles and objectives for external action) or some kind of amendments are needed to the bilateral investment agreement that has been concluded.

[56] UNCTAD data.

According to *the European Commission Communication on Towards a comprehensive European international investment policy COM(2010)343 final* member states together accounted for almost half of the investment agreements in force around the world in 2010, reaching almost 1,200 signed BITs.

[57] Regulation (EU) No 912/2014 of the European Parliament and of the Council of 23 July 2014

[58] Proposal for a Regulation of the European Parliament and of the Council establishing a framework for screening of foreign direct investments into the European Union COM(2017)487 final

EU's liberal investment regime, while maintaining strong restrictions against FDI in their domestic markets. Most concerns are linked to China, but some Russian investments in the EU have also raised questions. The Regulation would allow specific circumstances to be taken into account and ensure a higher degree of consistency among member states: at present an FDI review mechanism exists only in 12 of them.[59] An EU-level framework would allow more strategic analysis and evaluation of FDI from third countries. Under the new mechanism, the Commission will have an obligation to screen investment projects and programs from the point of view of EU interest (including in such strategic areas as research, space, transport, energy, and telecommunications). The proposal still needs to be adopted by the Council and the European Parliament, but the Commission will implement two immediate interim measures: i) setting up a coordination group on inward FDI and ii) starting an in-depth analysis of FDI flows into the EU.

The attitude of the new government of France should be highlighted in this regard. France had adopted a law in 2005, listing sensitive sectors where prior approval was required before foreign acquisition of a controlling equity stake. In 2014 the list was expanded, adding the energy, water, health, transportation, and telecommunications sectors. In 2008 the French government also established a strategic investment fund to prevent the foreign takeover of strategically important enterprises by increasing the national share in such companies. As shown by the EC initiative, France is not the only member state to have increasing concerns about lack of reciprocity: there is thus a good chance that this mechanism will be implemented.

Finally, concerning the EU's investment relations with the Eurasian countries, the BITs that have been signed remain completely valid. BITs are in force between the majority of the important countries on both sides, especially among those with major interests in international investment flows. Most EU member states have signed BITs with Ukraine (26)[60] and the Russian Federation (25),[61] followed by Belarus (24), Kazakhstan (23), Armenia (17), and Kyrgyzstan (12).[62] Georgia, Moldova, and Ukraine signed AA/DCFTAs with the EU in 2016 which include provisions on FDI as well. The implementation of these agreements is expected to improve the business climate and stimulate FDI.[63]

The EU's international/multilateral and preferential commitments

3.1.1. WTO Framework

The TRIMS Agreement

The Agreement applies to trade in goods, which has fallen under EU competence for decades. During the Uruguay Round, the European Commission negotiated on behalf of the then 12 member states, undertaking all commitments: the EU, as one of the major GATT members interested in a strong TRIMs Agreement, did not request any special conditions or exemptions for itself. The member states that acceded later to the EU also undertook all commitments without reservations. As the European

[59] Austria, Denmark, Germany, Finland, France, Latvia, Lithuania, Italy, Poland, Portugal, Spain, the United Kingdom

[60] One of which has still not entered into force.

[61] Five of which have still not entered into force.

[62] One of which has not yet entered into force.

[63] See Adarov, A. and Havlik, P., (2016), "Benefits and Costs of DCFTA. Evaluation of the Impact on Georgia, Moldova and Ukraine". Joint Working Paper, Bertelsmann Stiftung and wiiw, December.

Commission carefully monitors to ensure that member states do not discriminate between their own and other countries' companies in the internal market, foreign investments in practice enjoy WTO+ treatment.

The GATS

In contrast, with respect to GATS the EU's situation is more complicated. At the time of the Uruguay Round, services did not yet fall under common competence, and that situation changed only at the end of the negotiations. Additionally, each EU member state is an individual member of the WTO/GATT, irrespective of the common trade policy. Even after services became part of the common competence, the implementation of the changes was quite slow. Responsibility for the regulation of third countries' provision of services is thus different among the various groups of EU member states. The situation was further complicated by each EU enlargement round: with WTO membership being a precondition for EU accession, each new member state brought its own distinct WTO commitments. After each enlargement the EU had to submit a notification to the WTO concerning the modification of its GATS commitments due to the obligations of the new member state(s).[64]

As a result, the EU's WTO services schedule is a mix of various elements. The certified EU services schedule covers only the 12 member states that were part of the EEC in 1994 and signed the original GATS agreement. The special protocols for the financial and telecommunication services were signed later, when three states that were earlier EFTA members had already acceded to the EU. Thus, for those sectors the GATS obligations are the EU15's services commitments. All member states that acceded later have their own, different GATS schedules under their own names. This complex situation is not expected to change in the foreseeable future in the WTO context; only the new FTAs provide a chance of greater homogeneity.

This complexity makes it practically impossible to describe the EU's services commitments in general. This is therefore done separately with respect to those specific member states of particular interest for this study: Germany, France, and Italy are founding members of the WTO and thus have a common GATS schedule. Austria is covered by the EU15's additional sectoral commitments, but Austria has a separate schedule concerning service sectors. The situation of Cyprus is similar, as it joined the EU in 2004.

Germany's most restricted sectors under mode 3 are, according to the World Bank Services Trade Restrictions Index (STRI) Database, **professional services** (limitations providing services through specific legal forms as well as limitations of ownership or control) and **transportation** (limitations operate enterprises in this sector in many cases are limited to EU nationals only).

Austria's services sector limitations under mode 3 are similar to those of Germany. The most restricted sectors are also **professional services** (limitations on ownership and control by foreign nationals are applicable) as well as **transport services** (limitations on ownership and control).[65]

With regard to **France**, the most restricted services sectors under mode 3 are **transport services** (international maritime shipping and rail freight sectors are closed to foreign acquisition and in other

[64] In accordance with GATS Article XXI, the EU was required to enter into negotiations with any other WTO member that indicated it was affected by the modification of existing commitments and reach an agreement on compensation measures.

[65] The World Bank Services Trade Restrictions Database.

transport sectors, ownership or control of enterprises are limited to EU nationals only), **professional services** (limitations on ownership and control, establishment of branches and partnerships) and **telecommunication services** (voting shares threshold for non-EU natural or juridical persons in the fixed-line telecommunications sector).

Italy's most restricted services sectors under mode 3 are **transport services** (limitations on ownership and control as well as economic needs test in certain areas may be applicable), **professional services** (limitations on legal forms providing services), **financial services** (specific activities in insurance sector, like takeovers, establishment of a company, are subject to approval and authorization), as well as **retail services** (economic needs test might be applicable).

As for **Cyprus**, no information is available in the World Bank's Services Trade Restrictions Database. However, it is possible to draw some conclusions from its GATS commitments, where financial services (which are of particular importance for Cyprus) are the ones mostly covered by its concessions. As already described in Part I, a significant part of the FDI flows of the Eurasian countries are realized via off-shore tax havens, and in the case of Russia Cyprus has an especially important role. Therefore, the financial services have the broadest coverage in the Cyprus GATS schedule. There are horizontal commitments applicable for all sectors regarding non-resident partnerships, a foreign participation limitation threshold, applicability of an economic needs test, and limitations for establishing branches. Specific limitations in the Cyprus GATS schedule mostly concern **financial services sector** (limitations on registration, ownership, control and establishment of branches; authorization and licensing in some sub-sectors needed, as well as economic needs test might be applicable; investments in some sector companies are subject to prior approval) and to some extent also **professional services** (providing of services is subject to authorization). A detailed overview of these EU member states' particular services sectors limitations is contained in Annex VIII, Table 1.

Disputes in the WTO about investment-related measures involving the EU or its member states

While the EU is a either a complainant or defendant in a large number of WTO dispute settlement (DS) cases, only a small part of these are related to FDI. There are some DS complaints against the EU, which are claimed to affect the conditions for foreign investments**.** These are generally not cases about measures clearly prohibited by the **TRIMs Agreement**, i.e., direct import restrictions on goods, but rather disputes linked to foreign investments affecting different sectors, including services; on that basis they could be claims about the indirect impacts on trade in goods. On the other hand, the EU has brought several (9) complaints against other WTO members,[66] the most important of which in the Eurasian region is the one involving Russia[67] (described below in detail).

With respect to **the GATS,** and more specifically its mode 3 (establishment) commitments, the EU has brought complaints (4) against other WTO members,[68] although none of those are countries of the Eurasian region. Turning to defensive WTO cases, due to the complex nature of the Agreement itself and to the different situations within the various member states, some cases have been brought

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[66] WTO Dispute Settlement gateway.
URL: https://www.wto.org/english/tratop_e/dispu_e/find_dispu_cases_e.htm

[67] Dispute Settlement Case No DS462. No panel report available yet.

[68] WTO Dispute Settlement gateway.
URL: https://www.wto.org/english/tratop_e/dispu_e/find_dispu_cases_e.htm

against the EU or its member states (4 cases).[69] Regarding alleged breaches of the EU's commitments related to mode 3, there are even examples linked to a Eurasian country, Russia. As described in Part IV, a few years ago Russia launched two cases against the EU's energy policies, and some of its claims relate to the treatment of Russian investors.[70]

3.1.2. FDI in the EU's preferential agreements

The EU has a large number of preferential agreements for goods, first of all FTAs, but also a few Customs Union agreements. In the last decades, however, it has started to conclude comprehensive preferential agreements that also cover services and investments. Apart from the new agreements (the most recent of which is the CETA signed with Canada), a growing number of the earlier, first-generation, goods-only FTAs have now also been upgraded to cover, at least partially, all 4 freedoms.

Concerning **TRIMS-type measures**, especially with developed country partners, the EU strives to go well beyond the limited WTO disciplines and to also cover such investment measures as the forced transfer of technologies, export obligations, and other restrictive requirements. The goal is to ensure that foreign investors and investments can operate under conditions similar to those applicable to domestic ones.

In the **area of services** there is a similar trend. While, under the GATS, the members' commitments are typically binding only to the existing level of liberalization - and not even fully - the EU in its new preferential agreements strives to achieve substantial new market access, including in sensitive sectors, where mode 3 (establishment) was earlier largely closed to foreign investors. The new agreements also provide an opportunity to gradually move toward a higher level of consistency among the different service commitments of the EU member states. Even after a relatively short time these new agreements thus also bring about more activity in the sphere of investments.

Apart from the specific market access commitments, the new agreements' **cross-cutting provisions** also ensure much improved conditions for investors. There are specific, enhanced rules regulating and limiting the interventions of states/governments in setting the conditions of investments, including through state-owned or state-controlled enterprises. The rules applicable for government procurement also go beyond the national market access commitments undertaken in the context of the WTO's Government Procurement Agreement (GPA), allowing more possibilities for foreign-owned firms. As in the Eurasian region most of the existing FTAs do not cover services and as, apart from Ukraine, no other country is as yet a member of the GPA, government procurement in services is one of the most challenging areas for EU investors in most Eurasian markets.

In the **EU-Eurasia context only the 3 DCFTAs** signed with Ukraine, Georgia, and Moldova are comprehensive agreements, covering disciplines directly linked to FDI. These provisions are described here based on the example of the most ambitious agreement, the one signed with Ukraine. As FDI flows in general require a rather close, long-lasting relationship, **numerous provisions of the EU-Ukraine AA/DCFTA affect investment activities.** These include such broad, systemic commitments as

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[69] WTO Dispute Settlement gateway.
URL: https://www.wto.org/english/tratop_e/dispu_e/find_dispu_cases_e.htm

[70] Dispute Settlement Case No DS476. The panel report is expected soon.
Dispute Settlement Case No DS494. The panel has been established, but does not have members.

the effectiveness of democratic institutions, the rule of law, and the whole political–economic transformation process. An effective system of justice is especially important for investment activities. The treatment and mobility of workers linked to foreign investments also need to be improved and facilitated. Last but not least, there are detailed provisions about the fight against corruption.

The specific **economic commitments are included under Part IV, dealing with trade-related matters.** As a general rule**, the DCFTA is in all important areas asymmetric**, ensuring that the EU opens its markets faster and to a greater extent than Ukraine, reflecting the different levels of development and competitiveness. Concerning **trade in goods**, apart from the obligation to eliminate all duties on imports, this also applies - in Ukraine's case - to exports. There is a general ban (except for a limited number of products set out in the Agreement) on the maintenance of prohibitions and restrictions on imports and exports. Detailed provisions regulate the close cooperation on customs administration, the conditions of trade defense measures, and Ukraine's obligations to gradually harmonize its non-tariff regulations, standards, health, and sanitary measures with those of the EU. All these commitments are intended to ensure a business- and investor-friendly environment. In this manner a level playing field, the stability and improvement of the conditions for business, as well as the prohibition of treating goods differently based on the nationality of the producers, can be achieved.

There are detailed provisions about **trade in services, including establishment** (mode 3). The Agreement specifies the commitments of both sides in the important sectors regarding market access and the protection/treatment of companies and of people linked to the provision of services. The general obligations related to establishment must be respected in all service sectors, except for a limited number of areas, such as e.g., audio-visual services, maritime and air transport, for which specific conditions or other international agreements are applicable. The detailed commitments and the pace of liberalization are contained in the Annexes drawn up for both sides. **Here, similarly to goods, asymmetry applies**; the differences in the level of commitments for services, including establishment, are even larger than for goods. There are specific provisions for the most important strategic sectors, such as financial services, telecommunication, and transport, reflecting the sectoral specificities. Last but not least, the **DCFTA stipulates the right to regulate to ensure legitimacy of policy objectives**, and to apply any related restrictions, licensing requirements in a transparent manner, in line with the commitments under the Agreement.

The **provisions regarding movement of capital are especially important for investment flows**. The Agreement requires that from its entry into force both parties ensure the free movement of capital related to direct investments made in accordance with the provisions of the DCFTA. This obligation also applies to the liquidation or repatriation of the invested capital and of the profits. Ukraine has undertaken to ensure that full harmonization with the level of liberalization of the EU is to be achieved in the financial sector as a pre-condition for gaining access to the EU's internal market. There is also a commitment not to make any requirement stricter than was the case before the entry into force of the Agreement. If due to exceptional circumstances temporary safeguard measures to the free movement of capital are introduced, their duration must not exceed six months.

The DCFTA also contains **a number of general obligations that are important for foreign investors**. These include commitments to **gradually open up to each other the public procurement markets**, ensuring transparent, non-discriminatory conditions for competition. The Agreement specifies the thresholds above which these obligations apply and as a way of gradual liberalization, the thresholds are reviewed every two years.

A long chapter details the obligations for **the protection of intellectual property**, considered especially important by the EU for an improved investment environment. Through commitment to the protection of intellectual property and the transfer of technologies linked to investments, the parties go well beyond the limited disciplines contained in the TRIMs Agreement. Detailed provisions and institutional arrangements ensure the gradual harmonization of the protection of intellectual property in Ukraine with that of the EU.

Among the **obligations linked to competition the anti-trust area is particularly relevant for FDI**. The agreement contains **detailed regulations for the operation of public enterprises, in particular, those entrusted with special or exclusive rights**. The right to maintain such enterprises is recognized, but there is an obligation that the competition authorities of both sides regularly cooperate and exchange information about the operations of such entities and promptly deal with the concerns raised. Within five years from the entry into force of the Agreement, it must be ensured that the state monopolies purchase goods on equal terms from all companies of both sides. There are also similar **detailed rules for the provision of state aid**, where the general obligation is the avoidance of distorting the terms of competition. However, there are certain, well-defined exceptions when state aid can be provided selectively so as to achieve important public policy goals. In this area, too, full compliance with the EU's regulatory regime is to be achieved within five years.

Finally, there are detailed provisions for the settlement of disputes arising from complaints from either side, by relying on a bilateral dispute settlement mechanism.

3.1.3. OECD framework

The EU's position under the OECD is rather complex. Due to the particular nature of the OECD with its own accession processes, not all EU member states are yet members of the Organization. The accession process of several of them is still under way; for others, it has not even started. The six EU member states that are not yet OECD members have nonetheless undertaken to respect some of its instruments related to taxation. More importantly, due to the much more stringent rules applicable to FDI in the EU internal market, as well as under the international agreements signed with third countries, all 28 member states are de facto under binding rules concerning foreign investments. Those member states that are not yet members of the OECD, participate in the activities of the EU delegation as observers.

26 EU Member States have signed the recently adopted OECD Multinational Convention on Tax Treaty Related Measures to prevent the practice of base erosion and profit shifting (BEPS). After the member states' internal adoption procedures and its implementation, this Convention is expected to bring significant changes in the investment flows, especially for the members' financial services.

3.1.4. Other international mechanisms relied on for investment-related disputes

The EU has been and remains a strong supporter of UNCITRAL and the ICSID, the major international forums where the interests of EU investors can be defended in international disputes not linked to WTO commitments. This is quite natural, as the EU is the largest investing entity in third countries or in receiving incoming investments. On the other hand, as these two organizations have been the ones predominantly used for the increasingly controversial ISDS procedures, at mentioned above, the EU and the member states are actively engaged in a process of finding alternative solutions. These efforts are focused first of all on the preferential relations, as the broader acceptance of the modified ISDS mechanism is heavily disputed, mainly by the USA. The latter is strongly opposed to any change and wishes to maintain the possibility of ISDS benefits especially to its huge multinational companies.

3.2. Russia, the EAEU, and other major Eurasian countries

When the Uruguay Round concluded, none of the Eurasian countries were members of the WTO and could not participate in the formulation of the FDI-related multilateral rules. Instead, during their subsequent WTO accession processes, they had to commit to bringing their domestic policies into line with existing multilateral rules. No Eurasian country has achieved membership of the OECD to date (although cooperation and technical assistance programs have been set up for the region). Among the Eurasian countries, the integration processes are also at a much earlier stage than in the EU. FDI is not yet covered by any of the existing preferential arrangements. For those reasons, **apart from the WTO commitments, the Eurasian countries have very few international rules for their national policies and measures related to FDI**. This gives the governments great freedom to shape their FDI policies, but this freedom is also a major reason for the shortcomings of their investment environment and their limited success in attracting foreign investments.

In many Eurasian countries, there are two types of problems with the treatment of foreign investments/investors: **first, the implementation of the formal international obligations, and second, the practical situation, the actual business environment**, for foreign-owned companies. The latter practices include the actions (or lack of actions) of the state and regional bodies, of the judiciary, frequently linked to corruption. According to the reports of EU companies, these negative experiences have recently been especially encountered in Russia, since the breakdown of political relations with the West, across all areas of the economic relationship.

3.2.1. WTO framework

The EAEU countries have recently almost all become members of the WTO, except for Belarus. However, there has been progress in this regard, too, since Belarus resumed its WTO accession negotiations in 2016. Of the major Eurasian countries covered by this study, Ukraine has been a member of the WTO since May 2008, the Russian Federation since August 2012, Kazakhstan since November 2015, while Azerbaijan has observer status and is not making any apparent efforts to take the process forward.[71] However, even WTO membership does not automatically mean that on the day of its accession a new member's trade and investment regime is already in full compliance with WTO rules, and some Eurasian countries have negotiated certain transitional exemptions.

The TRIMS Agreement

Several Eurasian countries, first of all Russia, have from the time of opening up their economies to foreign investments in the early 1990s, **set extensive conditions and requirements for foreign investors.** These terms have often gone beyond the limited and relatively weak TRIMS rules, requiring

[71] In July 2017 the Azerbaijan representative stated the country's intention to accelerate its accession process, but WTO Members pointed out that this would require a focus on the bilateral market access talks, in which the country has shown no interest.

the inclusion of special commitments in their accession protocols. None of the Eurasian countries were members of the WTO when the TRIMs Agreement was negotiated, but later experiences have shown that their views are much closer to those of the developing countries and that they are interested in the most limited TRIMs disciplines possible. Thus, during their WTO accession the TRIMs area was one of the most difficult and controversial subjects, **especially for Russia,72 and to a lesser extent, for Kazakhstan. Eventually both countries were provided temporary exemptions to apply prohibited TRIMs**. The details are described for each country concerned.

The GATS

As in the TRIMs area, the Eurasian countries had to undertake commitments in the services sector only after the Uruguay Round, as part of their WTO accession process. Due to the sensitive nature of services, this was a much-discussed area, with **most Eurasian countries maintaining substantial limitations**. Even if each country has achieved some degree of openness by eliminating certain limitations, in the economically most important establishment area (mode 3) numerous excluded sectors remain. This is not by chance: the most sensitive commitments are normally those affecting the most closed service sectors. Therefore, when discussing the selected countries' GATS commitments, the attention is focused on those service sectors that, according to the World Bank Services Trade Restrictiveness Index (STRI),[73] are subject to most limitations for FDI.

3.2.2. FDI in the Eurasian countries' preferential agreements

There **are two substantial preferential agreements in force in the region**. The first and broadest one is the network of agreements among the members of the **Commonwealth of Independent States (CIS)**, set up after the collapse of the Soviet Union. Its goal was to maintain the close links among the economies of many (but not all) ex-Soviet countries, by providing a framework for the continued free trade in goods. The other, more recent integration is the **EAEU, a customs union**, at present comprising six members. However, neither of these preferential arrangements goes beyond trade in goods; investments are regulated at the national level.

When it comes to preferential agreements with third countries, the developments are even more limited. There are only a **few FTAs of the EAEU or concluded by its members with partners outside the region**, such as the ones with New Zealand or Vietnam, but none of these cover services and FDI. The only meaningful arrangements extending to investment activities are the DCFTAs of the EaP countries with the EU, described above.

3.2.3. OECD framework

As none of the Eurasian countries are yet members of the OECD, or its related bodies, they have no international obligations under its investment-related instruments. The accession process of several countries started in the previous decade and cooperation programs have been also set up (largely financed by the EU) aiming to speed up the reform and transformation process, similarly to the Central and Eastern European countries which have meanwhile become EU members. **These cooperation**

[72] WTO (2016), Trade Policy Review: Russian Federation.

[73] World Bank Services Trade Restrictions Database, http://iresearch.worldbank.org/servicetrade/

programs continue with several Eurasian countries, like Ukraine, Kazakhstan, and Azerbaijan, and OECD reports are prepared from time to time about the progress achieved.

In 2017 Ukraine and Kazakhstan[74] were invited to become adherents to the OECD Declaration on International Investment and Multinational Enterprises. Being committed to the Declaration, both countries undertook to provide national treatment to foreign investors, as well as to promote responsible business practices. In accordance with the Guidelines they have committed to establish a National Contact Point to promote such business principles, to handle inquiries in the national context, and provide a mediation and conciliation platform for resolving problematic issues that may arise. As a result of all these commitments, a more transparent and trustworthy investment climate is expected to develop in both countries.

The first and most advanced of these processes, the **Russian accession process, has been de facto suspended since early 2014 because of the Ukrainian crisis**, even though it was originally planned that Russia would achieve membership in that year. No formal decision was taken, but the Western members of the OECD opposed to Russia's political–military actions halted the progress of the accession-related work. This situation could change only if a qualitative improvement in political relations were to take place. The Russian Federation was also involved in other OECD activities apart from the accession process, some of which still continue. Thus, last year Russia also signed the OECD Multilateral Convention on Tax Treaty Related Measures to prevent base erosion and profit shifting (BEPS). Once the Convention enters into force, its proper implementation could bring substantial changes in Russian investment flows, especially regarding tax havens.

3.2.4. Other international mechanisms used by the Eurasian countries for the settlement of investment-related disputes

As most Eurasian countries are members of UNCITRAL and ICSID, the dispute-settlement processes of these can be triggered in cases where there is no breach of, for example, WTO rules. The countries covered by the study have quite extensive experience in investment disputes not only as respondents, but also as claimants. These are **predominantly investor-to-state disputes (ISDS),** the majority initiated by Western, including EU, countries. According to the UNCTAD database, the Russian Federation has been involved in 40 ISDS cases (in 24 cases as a respondent and in 16 cases as a claimant), Kazakhstan's figures are 18 and 5 cases, respectively, Ukraine's 22 and 11, and Armenia has been involved in 2 as a respondent.[75] The respondent status in general signals that according to the foreign investors there are substantial problems in the FDI-related regulatory framework or the authorities' practices. However, the relatively large number of DS cases launched in particular by Russia and Ukraine show that they also have complaints as investors. Regarding the sectoral coverage of those cases in which Eurasian countries are respondents, the large majority are in the mining and quarrying sector, but there are also disputes related to such sectors as financial services, real estate businesses, and manufacturing and construction services.

[74] OECD (2017), Investment Policy Reviews: Kazakhstan.
[75] UNCTAD Investment Dispute Settlement database.

UNCITRAL and ICSID are the most frequently used bodies for administering these disputes, but due to its geographical proximity the Arbitration Institute of the Stockholm Chamber of Commerce (SCC) also plays a role.

3.2.5. FDI-related policies and measures relied on by the selected major Eurasian countries

The Russian Federation

As described earlier, **Russia's respect for its WTO obligations** is one of the most debated areas of its economic relations with the EU and other Western partners. During its long accession process, Russia eventually undertook an unprecedented number of detailed WTO commitments, but under the present circumstances, even this is not a guarantee of the actual implementation of the obligations.

The TRIMs Agreement

Since the early 1990s the Russian Federation (RF) has imposed extensive requirements and preconditions on foreign investment. **Negotiating its investment-related commitments has thus been one of the most difficult areas of the WTO accession process**. Under the compromise negotiated, the RF received exemptions from the rules of the TRIMs Agreement for a transitional period ending on 1 July 2018 for two programs operated as part of the country's automotive assembly investment regime.[76] The condition was that by this deadline the RF should bring its investment regulations into compliance with the TRIMs Agreement - and, of course, that it would not extend such policies to other sectors.

However, a few months after the WTO members approved the RF's accession and even before the country became an actual WTO member, a new regulation was introduced in the automotive sector.[77] This provided for differentiation in the treatment of cars produced in Russia and imported vehicles, discriminating against the latter. Considering that the majority of the cars imported into Russia came from the EU, the quite unusual step of initiating a WTO dispute case against a brand-new WTO member was taken. After detailed consultations, the matter finally did not get to the panel process, as the Russian side undertook to modify its regulation to stop this discriminatory treatment.

Unfortunately, the problems with the RF's FDI regulations have continued ever since. Although the WTO exemption, mentioned above, is limited to the two specific areas**, actual FDI policies diverge greatly from the country's WTO commitments.**[78] According to EU companies' recurring complaints, there are a host of TRIMs-inconsistent measures in other machinery sectors (non-exempted automotive branches, agricultural machinery, heavy transport equipment, etc.), linking government permissions and/or support for foreign companies to the acceptance of burdensome local content, export performance, and/or balance-of-trade requirements. These practices have become even more frequent since the introduction of the political sanctions, with Russia following a policy of maximum

[76] Both programs concern the duty-free entry of auto parts used in the production of vehicles that contain a certain level of Russian content (the first introduced in 2005 and the second, in 2010).
WTO (2016), Trade Policy Review: Russian Federation.

[77] WTO (2016), Trade Policy Review: Russian Federation.

[78] WTO (2016), Trade Policy Review: Russian Federation.

import substitution.[79] TRIMs-type measures are thus a recurring subject of the technical-level contacts between the EU and the RF. As even the most recent discussions in November 2017 did not bring the positions any closer, further WTO disputes cannot be excluded. It also remains to be seen how the specific commitments undertaken by the RF and falling due in mid-2018, will be implemented.

Another recurring problem is the **preference given to Russian, principally state-owned or state-controlled companies** over firms owned by foreign investors, when it comes to the terms of their operations and the granting of government orders or state subsidies. All this has led to much criticism in the WTO, as seen during **Russia's first Trade Policy Review in December 2016,** whose conclusions stated that modernizing the RF economy, as well as the fostering its global competitiveness, will be determined by the success of "political and economic reforms which face challenges from vested interests, governance issues, and the complexity of the economic environment."[80]

The GATS

As regards the RF's GATS commitments, according to the World Bank's Services Trade Restrictions Database, the most restricted sectors under mode 3, with one of the highest scores for Eurasian countries, are financial services (banking and insurance), telecommunications (fixed-line, as well as mobile telecommunications) and air transport services.[81]

Despite the limited commitments in the **financial services** sector[82] undertaken under the GATS (especially in non-insurance financial services), the Russian banking and insurance sector remains quite restrictive. Firstly, there is a rather long phase-out period of 9 years (expiring in 2021) for the establishment of branches of foreign **insurance** companies (except for insurance of state procurement and mandatory insurance other than mandatory insurance of the civil liability of car owners). Additionally, for non-resident branches the RF may apply some conditions upon establishment (like licensing, minimum value of total assets, guarantee deposit, practical experience of employees, etc.) without a deadline. There is a limitation on mode 3 for insurers that are subsidiaries of a foreign investor, in which the foreign participation in the charter capital (voting shares) exceeds 51% for a period of 5 years ending in 2018. The RF is also unbound with respect to issuance of licenses to provide life insurance services, mandatory personal insurance of passengers, and mandatory insurance of civil liability for car owners, and similar restriction are applicable for reinsurance and retrocession. Additionally, there is an overall limit of 25% share of foreign capital in the charter capital of all insurance companies; prior permission is required before shares in the charter capital is shifted to foreign investors and their subsidiaries, and also for the increase in the capital of an insurance company from foreign investors' funds. As a **new issue, concerns are being raised over the state-owned reinsurance company** established in 2016, with a government requirement that insurance companies conduct 10% of their reinsurance business with this company.[83] It should be stressed that no reference to such a requirement has been included in Russia's WTO accession protocol.

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[79] European Parliament (2017), Russia's and the EU's sanctions: economic and trade effects, compliance and the way forward.

[80] WTO (2016), Trade Policy Review: Russian Federation.

[81] The World Bank Services Trade Restrictions Database.

[82] WTO (2012), Trade in Services. Schedules of Specific Commitments and Exemptions. Russian Federation. (GATS/SC/149), (GATS/EL/149)

[83] Federal Law No. 363-FZ adopted on 3 July 2016

As regards **banking services**, the limitations are even stricter: as foreign capital participation in the banking system must not exceed 50%, prior authorization from the Central Bank is needed for all foreign investments. The RF's GATS commitments also allow temporary limits to be imposed on foreign investment in the banking and insurance sectors, if the total foreign investment in these sectors exceeds a specified charter capital ratio; this ratio is calculated annually and if it is exceeded, the Central Bank can take action to temporarily limit further foreign investment in the sectors. The RF undertook to review the need for such temporary discretionary measures in the banking and insurance subsectors until August 2017. Due to the financial crisis, the RF first introduced specific measures to preserve the banking sector's stability; however, as reported by the WTO, in December 2014 the government's capital support program was completed and most of the restrictive measures were lifted.[84]

As for the **telecommunications sector**,[85] the RF undertook to open its market by eliminating foreign participation equity limitations in specific operators after four years: as this deadline ended in 2017, overall sector openness should improve. In the GATS commitments, it was indicated that incorporation and a maximum foreign equity cap of 49% was applicable to charter capital, but according to information from the WTO, this requirement has been lifted.[86]

Regarding **air transport** services,[87] the RF undertook only limited GATS commitments. A foreign equity limit and a further limit on foreign participation in charter capital were also included.

With regard to air transport, the issue of **Siberian overflight charges** should be mentioned: these are especially burdensome for the EU carriers whose Asian routes cross Russian airspace. During the RF's WTO accession negotiations in 2011, at the request of the EU, a specific commitment was made to phase out of these charges by 1 January 2014. From then on, charges were required to be cost-related, transparent, and paid to the responsible authorities. Furthermore, as of 1 January 2012, all new EU carrier flights to Asian destinations should no longer be charged. However, **the RF consistently refuses to respect this commitment**, using the income to subsidize Aeroflot and other Russian carriers. This issue is raised consistently by the EU, but without any result to date.

Further WTO-related issues affecting FDI

The RF has undertaken to start negotiations about **accession to the WTO's Government Procurement Agreement (GPA)** by submitting a first offer within four years from the time of its WTO accession. The application to initiate the GPA negotiations was received from the RF in August 2016 and the discussions of the initial offer took place at the October 2017 meeting of the Committee on Government Procurement. On this occasion, many comments were made by the members, including the EU, but in the present atmosphere a timetable for completion of these negotiations is very uncertain. Until this happens, the foreign-owned companies remain at a major disadvantage compared to Russian ones: the procurement by the government, or state/government-owned

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[84] WTO (2016), Trade Policy Review: Russian Federation.

[85] WTO (2012), Trade in Services. Schedules of Specific Commitments and Exemptions. Russian Federation. (GATS/SC/149), (GATS/EL/149)

[86] WTO (2016), Trade Policy Review: Russian Federation.

[87] WTO (2012), Trade in Services. Schedules of Specific Commitments and Exemptions. Russian Federation. (GATS/SC/149), (GATS/EL/149)

companies of goods and services is quite a big part of the country's economic activity. This is thus also an important factor for the investment climate in the country.

In general, the **multilateral rules applicable to state-owned and state-controlled enterprises - in GATT terminology, state trading enterprises, (STEs)** - is a very important issue of the WTO accession for most Eurasian countries. In Russia, the STEs are especially influential in many economic sectors. The relevant GATT Art. XVII requires that STEs act in a non-discriminatory manner and, even if in monopoly position, exclusively on the basis of commercial considerations. STEs are also required not to raise import or export restrictions to trade by their operations. To avoid any misinterpretation, the EU insisted that Russia in its WTO accession protocol should formally notify the companies falling into the STE category. In spite of the clear provisions, the Russian side has a different interpretation of its obligations, especially concerning national treatment, which is another source of recurrent debate.

In the recent years, in addition to the WTO disputes described above, **further cases have also been initiated by the EU against Russia about matters affecting the investment environment**. To date 4 DS cases have been launched, including on Russian trade defense practices, import restrictions in the meat sector, and tariffs applied to paper products.[88] Of the four cases, two have been closed: one is at the appeal stage and one is still in progress. These outcomes show the EU's claims about Russia's repeated lack respect for its WTO obligations have been largely justified.

As mentioned, Russia has also initiated some cases with FDI links, two against the EU's energy policies and a new one in early 2018 against the EU's new trade defense regime. None of these cases have so far reached the decision system of the WTO DS system.[89]

With the political-economic relationship between the EU and Russia in its current state, it is certainly not ideal that WTO disputes are most frequently the occasion for meetings between their officials. **With no other Eurasian country has the EU such a controversial relationship**; there are no WTO disputes involving others. If Russia were to create the conditions for the gradual restoration of a closer economic relationship with the EU, there would be a much better chance of resolving debates bilaterally, instead of through a WTO legal process.

Other international disputes concerning foreign investments/investors

There is a major, long-standing dispute of investors from the EU and other Western countries with the Russian Federation. This is linked **to the nationalization/expropriation of the Yukos company at the start of the previous decade.** These foreign investors had substantial shares in the previously privately owned company, but at the time of Yukos' nationalization and the taking over of its assets by the government-owned Rosneft, their ownership rights had not been respected. This led to lengthy legal disputes ending with the decisions of the adjudicating body that the RF owes some USD 50 billion compensation to the foreign investors.[90] The RF disputes these decisions and is not ready for compliance. There are also some further cases linked to Yukos' nationalization which are still pending,

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[88] WTO Dispute Settlement gateway.

[89] WTO Dispute Settlement gateway.

[90] Hulley Enterprises v. Russia (2005), Veteran Petroleum v. Russia (2005), RosInvest v. Russia (2005), Yukos Universal v. Russia (2005), Quasar de Valores SICAV and others v. Russia (2007)
UNCTAD, Investment Dispute Settlement Navigator.

among others due to the termination of the Energy Charter Treaty's provisional application by the RF.[91] This well-known, heavily politicized matter is one of the major reasons for the negative assessment of the Russian investment climate.

The actual business-investment environment in Russia for foreign companies

Beyond the shortcomings of the RF's implementation of its formal international commitments, there has recently been a broader and deeper issue: the practical business-investment environment facing foreign companies. With the breakdown of the political relations between the RF and the West and the introduction of mutual sanctions, a marked increase in such problems has been reported. These are present in all areas of the economy, but especially marked in the goods sector: there is now a general, declared policy of import substitution, efforts for maximum localization of production within the country, and discrimination against foreign companies in favor of domestic/EAEU ones.[92] The actions or non-actions of the central and regional authorities and the shortcomings of the judicial system mean that foreign-owned companies are under constant pressure to bring production operations to Russia, even when this is not in their economic interest.[93] The already established companies, especially the small- and medium-sized ones, face frequent discrimination and a lack of readiness by the government bodies or the judiciary to effectively deal with their problems. All these factors are probably the biggest reasons for the outflow of investment from the RF in the recent years.

The Russian government started to take action in 2014 to prevent off-shoring, in reaction to the Western sanctions imposed on some of the biggest companies, top businesspeople, and officials, restricting their foreign fund-raising and travel to Western countries. The tighter regulation of offshore businesses as of 1 January 2015 stipulated that subsidiaries of Russian companies abroad must declare their revenues and pay a 20% tax on their earnings retained in countries with which Russia does not have a double taxation agreement (see Box 1).[94] Initially this regulation applied only to majority Russian-owned companies but since the beginning of 2016, 25% ownership is the threshold. As a result, major businesspeople are reported as having moved their businesses back to Russia. Under this legislation, known as the "capital amnesty bill," businesses and citizens who declared their foreign assets to the Russian tax authorities in 2015 could use this possibility without facing criminal investigations into the sources of the declared assets.

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[91] Yukos Capital v. Russia (2013), Luxtona v. Russia (2014)
UNCTAD, Investment Dispute Settlement Navigator.

[92] European Parliament (2017), Russia's and the EU's sanctions: economic and trade effects, compliance and the way forward.4

[93] OECD (2015), Improving the business climate in Russia (ECO/WKP(2015)10).

[94] Russia has signed double taxation treaties with nearly 80 countries, including EU, USA, China, and Japan – see https://legalknowledgeportal.com/2013/06/14/double-taxation-treaties-in-russia/.

BOX 1. THE RUSSIAN LAW ON FOREIGN CONTROLLED COMPANIES

The law on controlled foreign companies #376 FZ was adopted on 24 November 2014. The new legislation obliges all potential taxpayers to notify the tax authorities of the Russian Federation about any participation in the capital of the controlled foreign companies (CEC), with a mandatory annual declaration and confirmation of revenues and profits received by such companies. The required threshold of participation for the recognition of legal entities or individuals as controlling persons in the CEC has been set at 50% in 2017. The law covers the following areas:

1. By including undistributed profits of companies in the taxable base of controlling residents of the Russian Federation the law implements a taxation mechanism for the profits of controlled foreign companies (mostly offshore) in Russia. In addition, it imposes responsibility for non-compliance with the obligations specified in the law (Chapter 3.4 of the Tax Code of the Russian Federation).

2. The law makes significant changes to the Tax Code of the Russian Federation on taxation of incomes of foreign companies (Chapter 25 of the Tax Code of the Russian Federation).

It introduces changes in the procedure for recognizing organizations as tax residents of the Russian Federation.

3. The law introduces certain restrictions on the operation of international treaties on avoidance of double taxation, guided by the rule of "actual recipient of income" (Article 7, 312 of the Tax Code).

Source: Compiled by authors.

There are no data about the specific effects of these measures, but according to Russian official statistics, the FDI inflows, after reaching their lowest point of in 2014–2015, started to increase again in 2016. It is not clear to what extent is this due to genuine new FDI and to repatriated Russian capital. It should be noted that, as spelt out in Part I, the Eurostat data about the EU investments show a continued downward trend. What is certain, however, is that the share of off-shore sources even today remains large, which is probably a reflection of the still difficult investment environment in the country.

Kazakhstan

Kazakhstan started its WTO accession process in the early 90s but the process only started to speed up from the middle of the previous decade. Thus, by 2010, when the decision about the formation of the Russian-led Customs Union was taken, many bilateral market access negotiations with the WTO Members, (including with the EU) were already at an advanced stage. During these talks Kazakhstan in many areas, including those of interest to foreign investors, undertook to provide more liberal conditions than Russia. Thus, once the accession negotiations restarted from 2011, under the new conditions, Kazakhstan undertook to maintain the already negotiated lower market access barriers for a transition period, before fully adjusting to the common trade regime of the Customs Union.

The TRIMs Agreement

Kazakhstan, similarly to Russia, has for a long time maintained special requirements for foreign investors in the automotive sector although on a much more limited scale. This subject has therefore not posed big difficulties for the country's WTO accession negotiations. Kazakhstan's commitments include an exemption for the maintenance of TRIMs-inconsistent measures for a small number of products during a transitional period ending in 2018 in the case of the automotive sector, and in 2021 for the oil and gas sector. It should be noted that Kazakhstan's track record on compliance with its FDI-related WTO exceptions is much better than that of the RF, and it has not attempted to introduce prohibited TRIMS.

The GATS

During its WTO accession negotiations, Kazakhstan asked for phase-out periods for a limited number of measures. Thus, by 2020 it will no longer apply an economic needs test (ENT) to foreign specialists hired as intra-corporate transferees, and by 2021 the local content requirements will be eliminated for subcontracts concluded in a tender process. On the other hand, cross-cutting quantitative restrictions on the movement of people, including even key personnel, are applied on a permanent basis.

According to the World Bank's STRI data, the most restricted of Kazakhstan's services sectors with respect to establishment (mode 3) are fixed-line telecommunications, financial services (banking and insurance), transportation (air transport), and professional services (auditing).[95] At its WTO accession Kazakhstan undertook specific commitment in 10 service sectors and 116 subsectors in its Schedule.

Regarding **telecommunications**[96] the foreign equity limit will be eliminated by 2018.[97] The previous restriction on the foreign equity limit (except for JSC "Kazakhtelecom") has already been lifted, ahead of the deadline in the country's GATS schedule. Since the beginning of 2016, this limitation has been replaced by a screening and approval mechanism.[98]

In **financial services**[99] foreign insurance companies and banks will be allowed to establish branches by 2020.[100] Thus in November 2015 Kazakhstan adopted Law N. 422-V foreseeing that from 16 December 2020 non-resident banks, insurance, reinsurance, and brokerage companies will be allowed to establish branches. Kazakhstan retained the right to apply some conditions for non-resident branches upon establishment (such as minimum amounts of total assets, deposit amounts, or practice/experience of employees). Despite the country's positive intention to lift the restriction on the establishment of branches, some limitations could thus also be applied to investors in the financial sector in the future.

As regards **air transport**,[101] Kazakhstan has retained a 49% foreign equity limit in its GATS schedule. As of 1 January 2016 this restriction has been lifted, but the government now intends to reinstitute it, in view of the increasing economic difficulties,.[102] Thus, in the sector, the limitations on commercial presence will probably also remain in the future, as the country's WTO commitments do not prohibit this.

[95] The World Bank Services Trade Restrictions Database.

[96] WTO (2016), Trade in Services. Schedules of Specific Commitments and Exemptions. The Republic of Kazakhstan. (GATS/SC/154), (GATS/EL/154)

[97] Already lifted and replaced by the screening and approval mechanism according to amendments of the Law of National Security No 527-IV, 6 January 2012.

[98] Law N. 527-IV, Article 23 (6 January 2012).

[99] WTO (2016), Trade in Services. Schedules of Specific Commitments and Exemptions. The Republic of Kazakhstan. (GATS/SC/154), (GATS/EL/154)

[100] GATS Schedule of specific commitments on services.

[101] WTO (2016), Trade in Services. Schedules of Specific Commitments and Exemptions. The Republic of Kazakhstan. (GATS/SC/154), (GATS/EL/154)

[102] According to the OECD Investment Review of Kazakhstan 2017.

Finally, in the **auditing services** limitations on commercial presence, as well as requirements on qualifications and membership in professional bodies, can be maintained.

The conditions for foreign investors will improve in case of Kazakhstan, too, once the country joins the GPA, as government procurement plays a major role in the economy of the country. According to its WTO accession commitments, Kazakhstan should start the process in 2019 (within 4 years of its accession).

Other WTO commitments affecting FDI

With respect to **State-owned/controlled enterprises**, Kazakhstan committed not just to ensuring that their purchases and sales would be made exclusively on the basis of commercial considerations, but also to providing opportunities to other WTO members to participate in such transactions. In this manner, Kazakhstan ensured a much more FDI-friendly environment than Russia, which has been also demonstrated by its more impressive results in attracting foreign investment.

The country also made a commitment to eliminate, within a limited period, all WTO-inconsistent administrative measures, restrictions, bans, domestic supply, and licensing requirements restricting imports of all products. The more liberal Kazakh economic-trade policies compared to those of other Eurasian countries have been **recognized and appreciated by the EU**. This led in 2015 to the conclusion of an **enhanced Partnership and Cooperation Agreement** in parallel with the completion of the country's WTO accession process.

The combined effects of WTO membership and the new agreement have been a great help in maintaining foreign investors' interest, as clearly shown by the recent data about Kazakhstan's FDI results which greatly exceed those of its Eurasian peers.

Finally, it is important to note that **Kazakhstan - in common with other EAEU members - has not had the same kind of political tensions with the Western countries and Ukraine as Russia**, did not apply sanctions against any of these partners, and does not aspire to a geopolitical role. Because of the unusual situation whereby **various members of the same customs union now apply different tariffs and non-tariff measures to trade with the same countries, the free flow of products was de facto suspended** between Kazakhstan (and other EAEU members), and Russia, with the latter reintroducing customs controls on its internal borders and thereby hampering the free flow of goods within the EAEU. These additional trade barriers also act as disincentives to FDI flows in the region.

Kazakhstan and the OECD

Kazakhstan's long-standing cooperation with the OECD has particularly intensified **since 2015, when a Kazakhstan Country Program was signed**. As Kazakhstan has no political problems with the OECD members, it is currently considered as the most important partner in the region. It participates in the work on a broad range of subjects and is member of over 30 OECD committees, even chairing some of them. In 2017 it was the first Eurasian country to host the OECD's Eurasia program.

Ukraine

During its WTO accession process Ukraine was in a unique situation compared to other Eurasian countries. The final stages of its WTO accession process coincided with the intensive negotiations of the AA/DCFTA with the EU. In this manner, the two processes supported each other, with the DCFTA talks helping to speed up the formerly rather slow and difficult WTO accession negotiations. After all, under the preferential agreement Ukraine undertook commitments going far beyond those discussed in Geneva, thereby diminishing the sensitivity of the concessions to be offered in the WTO context. However, the other WTO members were also well aware of the preferential talks with the EU and wanted to get the possible maximum benefits on a multilateral basis, in order to reduce the gap between their own and the EU's much better market access possibilities.

During the WTO accession negotiations, foreground issues were similar to those of other aspiring members from the Eurasian region. On the other hand, the fact that Ukraine is a net importer of energy, meant that in some respects different WTO commitments had been focused upon in Geneva than those of the energy-rich Eurasian countries.

The TRIMs Agreement

Ukraine did not ask for any exemptions during its WTO accession negotiations for measures falling under the TRIMs Agreement; thus, its policies in this area are fully in line with the multilateral rules.

The GATS

For Ukraine, the most restricted sectors in mode 3 are financial services (banking and insurance), telecommunications (fixed-line and mobile communications), retail, transportation (rail and air transport) and professional services (auditing, accounting, and legal services).[103] Ukraine has made substantial commitments under the GATS in all sectors, and the majority are full commitments, without any limitations on market access or national treatment.

In **financial services**[104] Ukraine has allowed the establishment of foreign insurance branches after a 5-year period, although some pre-establishment conditions are applicable. As regards the banking sector, for mode 3 mostly full commitments have been made. However, as the sector was severely affected by the financial crisis, some special measures were introduced in recent years. According to the WTO's Trade Policy Review of Ukraine in March 2016, "out of the 127 banks licensed as of 1 December 2015, 7 were under temporary administration by the Deposit Guarantee Fund, and over 60 were subject to liquidation, including three large banks (Bank Nadra, Delta Bank, and Bank Finance and Credit)."[105] The difficult economic situation led to the introduction of such measures as raising the minimum regulatory capital requirement.

With regard to **telecommunications**[106] Ukraine has committed to provide open and non-discriminatory access to its market covering all subsectors, but for local, long-distance, and international telecommunication services via fixed-line or mobile networks, retained the right to license. On 2 March 2015 Law No. 222-VIII was adopted providing for the elimination of licensing for all telecommunication services as of 1 January 2018, meaning a decrease in the sector's restrictiveness index.

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[103] The World Bank Services Trade Restrictions Database.

[104] WTO (2008), Trade in Services. Schedules of Specific Commitments and Exemptions. Ukraine. (GATS/SC/144), (GATS/EL/144)

[105] WTO Trade Policy Review of Ukraine 2016.

[106] WTO (2008), Trade in Services. Schedules of Specific Commitments and Exemptions. Ukraine. (GATS/SC/144), (GATS/EL/144)

The **retail sector** is fully liberalized under the GATS for mode 3; however, according to the World Bank's Services Trade Restrictions database, the licensing criteria applied to foreign retailers are more burdensome.

As the **transport sector** plays a crucial role in the Ukrainian economy, it is - not surprisingly - indicated as one of the most restricted areas. Nevertheless, in air transport services, mode 3 is almost fully covered under the GATS,[107] with the exception of computer reservation systems. Some limited requirements are also applied, like the certification of air operators. For rail transport Ukraine has scheduled an MFN exemption with respect to passenger and freight transport, but full commitments have been undertaken for the maintenance and repair of railway equipment and for supporting services for railway transportation.

Land transport both by trucks and trains, as well as through pipelines, is especially important, considering that Ukraine is a major hub of transit traffic. Thus**, Ukraine had no problem committing to quite a liberal approach to transport services for all goods.** It also allowed, from the start, foreign investment in the Ukrainian transport companies. Truck transport was and remains one of Ukraine's major strategic interests but as, under WTO accessions, only new members undertake commitments, possible concessions with the EU were left for the DCFTA relationship.

With regard to such **professional services**[108] as auditing, accounting, and legal services, again almost full commitments were undertaken for mode 3, except for the notary services, which only Ukrainian citizens can provide. However, according the World Bank Services Trade Restrictions database, the provision of such services to state-owned firms is subject to special regulation.

Ukraine's other FDI-related WTO commitments

Concerning **government procurement**, Ukraine, following up on its WTO accession commitment, applied for GPA accession in February 2011, less than three years after joining the WTO. It submitted the first offer in March 2014 and after a rather quick negotiating process the WTO Committee on Government Procurement in November 2015 invited the country to join the GPA. Following the legal formalities, Ukraine became a party to the GPA in May 2016: the first country from the Eurasian region to do so. Soon afterwards, a GPA implementation office was established to help Ukrainian suppliers benefit from GPA membership, and to assist foreign companies in the domestic government procurement market. Thus, in this respect Ukraine is setting a good example for the other countries of the region.

The **use of export duties** was a more sensitive subject during the accession talks. Unlike the energy-rich Eurasian countries, Ukraine's internationally most competitive sector is agriculture. As the country can produce especially plant products at prices well below the world market levels, Ukraine has for a long time applied export duties, e.g. on cereals and oilseeds. The goal has been – apart from ensuring revenues for the budget – to keep the domestic prices low, both for social policy reasons, but also to make the downstream products more competitive. Thus, for mostly agricultural products temporary exemptions have been negotiated, during which the export duties had to be gradually reduced to zero.

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[107] WTO (2008), Trade in Services. Schedules of Specific Commitments and Exemptions. Ukraine. (GATS/SC/144), (GATS/EL/144)

[108] WTO (2008), Trade in Services. Schedules of Specific Commitments and Exemptions. Ukraine. (GATS/SC/144), (GATS/EL/144)

While Ukraine has shown good compliance with this commitment, recently an **export ban on wood logs has been introduced.** As this is a discriminatory measure, not applied for the local sales of wood, the issue is a subject of debates both in the WTO and in the DCFTA context. Such steps are not helpful for the much needed FDI inflows into the country.

Finally, concerning **state-owned/controlled companies,** which played an important role in the Ukrainian economy, too, the country undertook to ensure that their activities would be in line with the STE disciplines of the GATT. While this is an important commitment, especially in the recent period there were some cases when its practical implementation has been put into question. With the gradual advancing of the privatization process there is an expectation that the situation should improve over time.

Ukraine and the OECD

Ukraine is one of the Eurasian countries which, like Russia and Kazakhstan, has long-standing relations and also a cooperation program with the OECD. The Ukrainian Governments in office since the political changes of 2014 have embarked on **an ambitious reform program to improve the business environment and to turn the country into an attractive investment destination**. In order to support this process, cooperation programs have been set up with the OECD, providing for the preparation of regular reviews, in close cooperation with the Ukrainian authorities. There is ongoing work in various areas, such as improving both the quality of the overall economic governance, as well as the investment climate. Unfortunately, the pace of implementation after a good start in 2014-15 recently has been rather disappointing. Openness, transparency, non-discrimination, fight against corruption and policy convergence with international investment standards, including those promoted in the OECD decisions and declarations, are all important elements of these efforts. Only in this manner is there a chance to increase the recently diminished FDI inflows.

The FDI-related aspects of Ukraine's preferential agreements

The EU-Ukraine AA/DCFTA has been already described above. The only other preferential agreements in the region dealing with FDI are the similar DCFTAs in force between the EU and the other two EaP countries, Georgia and Moldova (although their coverage is not as comprehensive as the one of Ukraine).

3.3. The actual investment environment and practical experiences of EU companies in the Eurasian countries

In order to get a broader overview of the EU investors' perceptions of the conditions for FDI in the Eurasian countries, a survey has been prepared with a list of relevant questions. In the August-November 2017 period the questionnaires were sent to stakeholders from different EU Member States with substantial interest in FDI in the Eurasian region. The goal has been to understand how the EU business circles, companies, as well as official bodies perceive the relevant factors of the investment environment in five important Eurasian countries. The list included the Russian Federation, Kazakhstan, Azerbaijan, Belarus, and Ukraine. The survey had two parts: the first focused on the four risks considered as the most important ones (economic factors, institutional environment, business environment, political/policy, social and cultural environment). Additionally, considering the multitude of factors influencing investment conditions, a second group of questions was also prepared about such issues as the quality of the banking services, the risks stemming from indebtedness, insufficiently high profitability, and cash flows, cost overruns, etc.

In reaction to the questionnaires sent to investors, as well as official representatives - altogether more than 50 stakeholders - 14 completed documents were sent back. Additionally, questionnaires were completed by the members of the "Lisbon-to-Vladivostok" Working Group comprising German companies, and reactions were also provided through telephone interviews. The detailed results are contained in Annex IX, the summary of the reactions is as follows:

Replies were received from Germany, Austria, Belgium, France, and Latvia.[109] The respondents represented the following economic sectors: financial services (23%), production of consumer goods (17%), energy production and distribution (15%), agriculture (12%), automotive sector (10%), industrial equipment and machinery (8%), construction and real estate (7%), telecommunications (5%) and transport sector (3%).

The representativeness of the survey was somewhat limited due to the available time and resources, which might explain the small number of responses. It can be assumed that the main responders were companies with high stakes and strong exposure in the target countries. For this reason, **the results of the survey are probably in some respects substantially different from the analyses done by more recognized and objective bodies,** like international organizations, large business associations, government institutions. For example, the environment for foreign investors, particularly in Russia, Azerbaijan, and Belarus is shown to be more positive and welcoming than assessed by the latter sources, as described in point 3.2. That being said, including these results in the study to provide a more varied picture was considered useful in terms of getting the assessment of the various factors by stakeholders with practical experiences.

The results concerning the 4 main factors:

Economic factors

The evaluation of economic factors in FDI showed quite polarized views on the part of respondents. The best marks were given to Kazakhstan and to Azerbaijan, followed by Russia. Altogether, Kazakhstan received the highest "very good" and "good" assessments (53%). On the other hand, 86% of the respondents considered the economic environment in Ukraine to be poor (probably as a result of the combined economic and political conditions of the country). This was followed by rather lackluster results for Belarus, where 83% considered the economic environment to be "neutral, probably showing the country's lack of experience in creating helpful conditions for foreign investors" (Annex IX, Figure 1 and Table 1).

[109] Prior the survey a questionnaire was developed based on the review of existing scientific literature about different factors influencing FDI in transition economies. The questionnaire template developed is available in the Annex. The questionnaire was distributed by using three options: 1) as an online questionnaire by using the tool of Monkey Survey; 2) as a printed version during the workshop at IIASA on the 30 October 2017 with the representatives from the Schneider group; 3) as a printed version sent by post. Altogether 26 completed questionnaires were received, of which 3 questionnaires were disqualified, as answers to several questions were missing. As a very specialized group of stakeholders were approached, it is assumed that there are enough completed questionnaires to obtain robust results.

Institutional environment

The institutional environment - in contrast to the economic one - was evaluated mainly as poor for FDI in Azerbaijan (77%), while again Kazakhstan had most of the "very good" assessments (19%). The views were most polarized around the two largest economies, Russia and Ukraine: a significant share of respondents evaluated the institutional environment in Russia as good (53%), and 34% as "poor". In the case of Ukraine, the "good" share was 34%, while the "bad" or "very bad" share was 66%. Belarus and, to a lesser extent, Kazakhstan were mainly evaluated as neutral (84% and 81% respectively) (Annex IX, Figure 2 and Table 2).

Business environment

The business environment for FDI was evaluated as the best in Russia and Kazakhstan with "very good" or "good" assessments of a total 67% for Russia (18–49%), and 30% (17–13%) for Kazakhstan. They were followed by Azerbaijan and Belarus with mostly "good" and "neutral" qualifications. Ukraine's business environment was evaluated as the worst, with "poor" (50%) and even "very bad" (14%) (Annex IX, Figure 3, and Table 3).

The significance of political, policy, social, and cultural factors

This was the most mixed, but also the most interesting area of the survey, showing the attitudes toward FDI of the central and local government institutions, the judiciary, and the population at large. The respondents were asked to evaluate the importance of differences in the political, policy, social, and cultural factors in percentage terms compared to the environment in the EU countries, namely, how the different attitudes impacted FDI, creating barriers to foreign investments. **Political and policy factors were perceived as the most significant obstacles to FDI in all five countries** with figures between 62 and 89, while the importance of social and cultural factors was considered much less significant (Annex IX, Figure 4, and Table 4).

Concerns over the financial, governance, project management, and public opinion risks

This part of the survey dealt with the relative importance of the perceived risks in each of the selected countries. The respondents could indicate several risk factors; thus, the totals often exceeded 100%. The figures show that in most cases the highest risks are attributed to the financial and governance aspects. In case of Russia, these were 50 and 40%, respectively, (Annex IX, Figure 5 and Table 5); for Kazakhstan, a similar 50 and 45% (Annex IX, Figure 6, and Table 6); for Azerbaijan, and especially Ukraine, these factors were assessed as even more significant, with 77 and 67% (Annex IX, Figure 7 and Table 7) for the former and 90 and 95% for Ukraine (Annex IX, Figure 9 and Table 9).

Looking at the other two types of risks, i.e., those related to project management and public opinion, the picture is different. For these indicators, the EAEU member countries and Azerbaijan have the highest figures, with expected problems of project management in the range of 63–83%, but the (negative) public opinion about FDI is even higher, between 83 and 100% - indicating a rather hostile general attitude towards foreign investment. On the other hand, for these indicators Ukraine has the lowest figures, certainly due to its closer relationship with the EU: its risks, considered as hostile to FDI, are assessed only at 19% for project management and 44% for public opinion.

The role of other risk factors

Beyond the four types of major risks, further factors in the survey gave a more detailed picture of the respondents' perceptions. The replies show that **there are considerable concerns in each country** about profitability perspectives, level of indebtedness, quality of banks and financial services, cost overruns, and other typical business risks (Annex IX, Figure 10).

The final and most important part of the survey dealt with **the investors' views about the future, including the expected occurrence of the various types of risks. Political risks are perceived as the ones most likely to happen both in Russia and Ukraine**, with 100% for both. These risks are also considered as likely in Kazakhstan and Belarus with 77% each, while the lowest probability of 69% is indicated for Azerbaijan (Annex IX, Figure 11 and Table 10).

For **regulatory risks Kazakhstan is in the lead** with 92%, followed by Ukraine (85%) and Russia (77%). The lowest figures are given to Belarus and Azerbaijan with 54% each. The operational risks are considered as the highest in Kazakhstan and Ukraine with 85% each, followed by Russia at 62%, while again Belarus and Azerbaijan are at the bottom of the list with 54% each. Finally, when it comes to revenue risks, Kazakhstan and Ukraine are in the lead with 85% each, Russia is in the middle with 69%, while Belarus and Azerbaijan are at the bottom of the ranking with 62%.

All these figures are interesting not just in themselves, but also in terms of the perceived comparative probabilities. It is certainly food for thought that the investors take for granted that political problems for FDI will arise in Russia and Ukraine, while the probability of the other risks are considered lower and more evenly distributed among the five countries.

Recommendations: Proposed future steps

The most important parts of the survey were the respondents' recommendations for practical steps to be taken by the governments to improve the investment climate. The answers focused on specific and concrete policy tools, such as **the preparation of roadmaps for the planned changes and the general need to apply clear and transparent standards**. The respondents also mentioned the need to standardize tariffs, a higher degree of regional consistency in policy approaches, including the preparation of clear concepts and plans to decrease uncertainty for foreign investors. Several recommendations stressed the need to improve the work of the institutions dealing with the FDI environment, even the desirability of more common cultural approaches across the five countries (probably due to the mainly high level of public hostility to foreign investments). There were also more general political recommendations, such as the need to create stability by dealing with conflicts not only inside the region, but also outside it.

Finally, on the specific question regarding how to improve cooperation and integration with the European Union, the most frequent answer was that **each country of the region should "conclude broad trade and investments agreements" with the EU**, leading to the "reduction of non-tariff barriers."

PART IV

Foreign Direct Investment in the Energy Sector

Energy is a strategically important resource, with extensive infrastructure needed for its supply. It is essential for every aspect of modern life, from public services to economic activities and for population use**. It is also a fundamental element of international economic relations, be it trade in goods, services, or foreign investment**. Without a reliable and efficient supply of energy, sustainable development is also impossible.

The energy sector, which is highly capital-intensive from exploration to extraction, processing and distribution, provides millions of jobs globally. The number of jobs dependent on the sector are, due to the multiplier effect, even higher. The impacts of the energy industry are greater than the sum of its parts, as energy is also needed for the production of energy itself, as well as for the operations of the related services. At the same time, the **historically high volatility of energy prices, the restrictions and cartel-type actions influencing supplies, have, from time to time, induced huge shocks in importing countries**. In the recent period new production technologies, and the rapid increase in the role of renewable sources have, to a certain extent, decreased this volatility at a regional level and in the global market.

Energy is also a basic factor of the EU–Eurasia economic relations. For the EAEU countries, especially Russia and Kazakhstan, energy is the key source of exports, foreign exchange, and budget revenues. It is also important for other energy-rich Eurasian countries, from Azerbaijan to Uzbekistan. On the other hand, for the EU, which is heavily dependent on imports of fossil fuels, the supply cuts and market uncertainties of the recent period, coupled with the political tensions with Russia and the disputes about the energy transit through Ukraine, have **led to a rethinking of the inter-regional energy relations**. These experiences have led to new programs aimed at lessening the dependence on supplies from the Eurasian countries, diversifying the sources geographically and by increasing the share and composition of renewable energies, typically coming from domestic sources. The decision in a number of European countries to phase out nuclear energy and reduce reliance on coal-fired power plants, as well as the gradual electrification of the transport sector and the absence of other, environmentally friendly technologies to provide the base load at affordable prices, have tended to increase the demand for natural gas. The recent political events undercutting trust, in particular, between the EU and Russia, has also had negative effects for both sides in the energy sector; it would thus be in the common interest to create conditions to restore the earlier level of cooperation.

4.1. Trade and investment flows in the energy sector in the Eurasian region

Globally, total investment in the energy sector in 2016 was above USD 1.7 trillion, which is equivalent to 2.2% of the global GDP. Spending on electricity networks increased by 6% and energy efficiency increased by 9%, while investment in oil- and gas-based power generation has decreased. Thus, in 2016 new investments in the electricity sector for the first time exceeded those in the oil and gas sectors. Still, the latter with a share of 38% attracts close to two-fifth of global energy investments (IEA, 2016).[110]

In the **Eurasian region,** the energy sector represents a significant share of GDP, especially in the large energy-producing countries, like Russia, Kazakhstan, and Azerbaijan. Of the five countries analyzed in this chapter, these three are major energy exporters, while Belarus and Ukraine are net importers (see Annex X, Figure1). Russia and Kazakhstan mainly export crude oil, processed oil products. and gas, Azerbaijan to a larger extent crude oil. According to the International Energy Agency, Russia exports 5.2 million barrels per day of crude oil and 2.4 million barrels of petroleum products. In 2016 more than 30% of the crude oil imported into the OECD countries was supplied by Russia. The share of gas in Russian exports is much smaller (see Annex X, Figure 2).

The value of crude oil and processed oil products imported by Belarus (€4.5 billion in 2016) and Ukraine (€4 billion in 2015) were similar. However, while in the case of Belarus the value of gas imported was half of that of oil (€2.6 billion), in Ukraine the sums were almost equal: gas €4.7 billion, compared to oil's €4 billion. Ukraine is also the only country which is a large importer of coal (€2 billion).

Concerning the **relationship between the intra- and inter-regional trade in energy products**, according to data of the Central Bank of Russia the value of Russian crude oil exports to the EU is much higher than that destined to the Eurasian region, i.e., the CIS countries. There was also a slight decline in the Russian oil exports to the CIS countries, while exports to Europe continued to grow (see Annex X, Figure 3). The same tendency can be observed regarding the Russian exports of natural gas: the value of sales to the EU much exceeds those directed to the CIS countries. In the last few years, exports to the CIS countries declined in parallel with a significant growth in deliveries to the EU (see Annex X, Figure 4).

Russia is also a large exporter of coal: in 2016 its value was higher (€9.3 billion) than that of gas (€4 billion). In 2015 more than 45% of the Russian coal exports were destined for Asia, while in Europe the major markets were Germany (10%), Netherlands (8%), Turkey (7%), and the United Kingdom (5%) (UN COMTRADE).

The Russian economy is to a great extent driven by energy exports. In 2016 incomes from the oil and gas sector had a 36% share in the Russian federal budget revenues.[111] Such dependence on fossil fuels makes Russia's economic growth vulnerable to fluctuations in energy prices, as well as to political risks. As all these factors have increased the Russian budget deficit, and the Russian Government was compelled to raise the mineral extraction tax and the export tax, leading to higher costs for the oil and gas companies.

Europe is an increasingly important importer of Russian oil, and especially of natural gas. In 2015 almost 90% of Russian natural gas exports were destined for Europe, with Germany, Turkey, and Italy being the major consumers. The remaining 10% was delivered to Asia as liquefied natural gas. In contrast, the value gas exports from Russia to Ukraine, earlier the third largest market, declined by

[110] IEA (2016). World Energy Investment 2016. International Energy Agency.
URL: https://www.iea.org/newsroom/news/2016/september/world-energy-investment-2016.html

[111] http://www.roskazna.ru/ispolnenie-byudzhetov/konsolidirovannyj-byudzhet/

more 30% due to the break-down in political relations, and leading to disputes on payment terms and prices. In the case of crude oil, Asia's share is higher, with China representing 18% of Russian exports.

For the European Union, Russia is one of the most important sources of energy, covering a significant share of European needs. In 2016 the share of the Russian natural gas was 38% of EU imports. Of crude oil and oil products, its share was 29%. Russian energy exports have different weights in the various EU countries. Seven EU member states buy more than 75% of their total imports of natural gas from Russia: mainly Central and Eastern European countries, including Bulgaria, Czech Republic, Estonia, Latvia, Austria, Poland, Romania, Slovenia, Slovakia, and Finland. Germany, Greece and Hungary are also covering the majority of their needs from Russia. Due to its huge demand, Germany is overall one of the main Russian markets for natural gas (European Commission, 2017). Kazakhstan also covers a significant part (7%) of energy demand, as the third most important supplier after Norway.

The size of the **electricity trade is much smaller**, as the countries of the Eurasian region export raw energy products rather than electricity. Even though Russia is one of the top producers of electricity in the world with more the 230 GW installed generation capacity, most of the output covers domestic needs; the share of electricity exports is minor.

Finally, looking at the **importance of the energy sector in foreign investments**, in 2016 in Russia two sectors, manufacturing and mining and quarrying, attracted the biggest share of FDI in equity terms, investment of earnings, and debt instruments. In contrast, FDI directed into the education, health, and water sectors were almost non-existent (see Annex X, Table 1).

Despite the important role played in the Russian economy, the value of FDI in the electricity and gas sectors is relatively small. In 2016, out of 439 billion in total FDI inward stocks only €9.7 billion went to these areas. However, FDI into the mining and quarrying sectors, which also include the energy extractive industries, were almost ten times higher than investment in electricity and gas, amounting to €98 billion at the end of 2016.

The **situation of Kazakhstan is similar to that of Russia**, with the mining and quarrying sectors attracting the majority of FDI, and the shares of manufacturing and electricity being relatively small (see Annex X, Table 2). Ukraine's situation is quite different because of its lower fossil fuel resources. Here, the financial and insurance activities attract the biggest share of FDI, while the mining and quarrying sector plays only a minor role (see Annex X, Table 3).

The specific effects of the political tensions and sanctions on the energy sector

Part II has already dealt with the overall impacts on the economy and on FDI of the politically motivated measures and sanctions against Russia introduced by Western countries, including the EU, due to the Ukrainian crisis. **Energy, as a strategically important sector for the Russian economy and exports, has been heavily affected by these measures, especially given that a number of sanctions specifically targeted this sector**.

Prohibitions and bans directed at Russian (mostly state-owned or state-controlled) energy companies take the form of cutting off financing and freezing of assets. High-level representatives of the energy sector are among the people most affected by sanctions.

The economically most important measures are banning **the transfer of advanced technologies for the exploration and extraction of crude oil and the scaling back of Western companies' participation in certain projects**. These have had direct impacts on FDI flows in this area. More broadly, several new

EU policies have also aimed to gradually reduce reliance on Russian energy, diverting imports to alternative sources. The diversification of the types of energy used (supporting the production of renewable energy, heavier taxing of fossil fuels) have also contributed to the fall in energy imports from Russia and thus incomes for the country. Diversification of the routes of supply from Russia to the various EU member states, in particular initiatives to avoid supplies via Ukraine and/or the EU countries closest to Russia, have led, however, to internal debates. The EU countries involved strongly argue for, as part of the common EU energy policy, the scaling back or even abandonment of transport projects that adversely affect their political/economic interests (best shown by the debates around the "Nordstream 2" gas pipeline).

While all these measures have had undeniably considerable costs for numerous EU member states and also for Ukraine, the negative impacts on Russia, and more specifically on its energy sector, are more pronounced.

4.2. Multilateral/international disciplines in the energy sector

The **WTO has no specific provisions related to energy.** Energy products are considered as goods, all forms of energy (including electricity) have tariffs numbers, and the WTO members can apply tariffs on these products within the limits of their GATT/WTO commitments. The general rules applicable to trade in goods also cover energy, and if acceding countries wish to have temporary exemptions, those provisions must be included in their WTO Accession Protocols.

Based on this logic, the **TRIMs Agreement** is also applicable without any specific provisions to the energy sector. However, considering the strategic importance of energy, especially for the energy-producing and -exporting countries, foreign investments in this sector are especially frequently linked to various conditions and restrictions. As energy products are normally in high demand, these requirements - differently from other sectors - are typically not import restrictions or export obligations, but rather local content requirements linked to the equipment used, the technology to be transferred, or the downstream local processing requirements. Only a minority of these measures need exemptions from the TRIMs disciplines, as the majority are not subject to WTO rules and prohibitions.

In case of **energy-related services** the situation is more complex. One of the most disputed aspects is the **transport of energy products** which, as a service activity, also falls under the GATS. Again, due to the strategic importance of energy, the various means of transport are subject to different interpretations and often to disputes. There are in general no debates when energy products are transported by train, truck, or on water: in such cases the general rules for the transport of goods apply. However, some forms of energy are partially or exclusively supplied over networks: electricity via grids, oil and gas by pipelines. In such cases FDI-related problems also arise, as the construction of networks is quite capital-intensive and there are wide differences in terms of the extent to which foreign investors are allowed to participate. The ownership rights linked to networks, the conditions of their use, capacity restraints, transit rights, etc., can lead to big disputes. While the EU has strong interests in ensuring neutral and transparent conditions, some Eurasian countries question if any WTO disciplines at all are applicable to these forms of transport.

Other investment-intensive services linked to energy products, like exploration, distribution, technical services for equipment used, etc., are often also subject to restrictions, as there are only low levels of commitment in most Eurasian countries' WTO schedules. The relative weakness or even lack of WTO disciplines for the energy sector and the major discrepancies in its openness to FDI, cause frequent tensions and, increasingly, a wish by the more liberal Western countries, including the EU, to achieve a level playing field by insisting on reciprocity. These concerns have led to the elaboration of energy-specific agreements on the European continent.

4.3. Specific plurilateral agreements for the energy sector

While the GATT's Uruguay Round negotiations were still under way in the early 1990s, the collapse of the Soviet Union occurred, resulting in major reductions in East–West tensions. These fundamental changes led to new initiatives, also in the energy sector, aimed at elaborating specific international agreements.

The Energy Charter Treaty

The roots of the Energy Charter Treaty (ECT) are in the early 1990s, when the **opportunity arose to develop close cooperation in the energy sector between the Western and the Eastern parts of Europe.** Decreasing potential energy dependence and diversifying supply sources had been the intention of West European countries for some time, but the new situation and uncertainties arising in Russia and several other energy-rich countries gave a new boost to these efforts. The energy-importing Western countries were interested in supply security, while the energy-producing Eurasian states needed major resources to reconstruct their economies.

Based on the shared interests, in December 1991 the European Energy Charter (EEC) declaration was signed; this laid down the principles to be pursued in the sector by the signatories and the guidelines for the negotiation of a legally binding international treaty. Based on the declaration and after several years of negotiations, the ECT and the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) were signed in December 1994**. The new legal instruments eventually entered into force in April 1998,** after completion of the ratification process.

The ECT became the first binding multilateral treaty to cover most activities in the energy sector. The document has eight parts, of which the most important ones are Part II (Commerce, dealing with the energy trade and transit, trade related investment measures etc.), Part III (Investment Promotion and Protection, which, among other things, prescribes such obligations as the fair and equitable treatment of all investments, the entry of natural persons and key personnel, non-discrimination, protection against expropriation etc.), Part IV (Miscellaneous Provisions, dealing with such issues as sovereignty over energy resources, environmental aspects, transparency, state-owned enterprises etc.) and Part V (Dispute Settlement, providing for investor-to-state and state-to-state dispute settlement processes).

In the following years, **a few adaptations were proposed in addition to the original provisions**. For instance, to ensure consistency of the ECT with the new WTO rules agreed under the TRIMs Agreement, the Amendment concerning Trade-Related Provisions was adopted in April 1998. Another proposed amendment concerned investment provisions: as the ECT, as signed in 1994, mainly covered investment protection only in the post-establishment phase, it was proposed to adopt the Supplementary Investment Treaty to also cover the market access possibilities for new investments. Due to the reluctance of several energy-producing countries, however, **the discussions on these commitments were first postponed, and later abandoned.**

The **most controversial proposed amendment dealt with the transit of energy** under Article 7(1)[112] of the ECT. The original text was considered unclear; thus, in order to clarify these provisions in 2000 a Transit Protocol was proposed. The proposal included such issues as access to energy transport facilities, the cost-effectiveness of transit tariffs, the definition of available capacities, and the so-called "transit theft" issue. As **the draft Protocol led to big disputes between the EU and Russia**, no agreement could be reached. Finally, the negotiations stopped and the issues in question have become increasingly politicized. In 2001 the Russian Parliament adopted a declaration that the ratification of the Treaty was closely linked to acceptable transit provisions. **This eventually led to Russia's decision not to become a Contracting Party to the ECT.**

These developments resulted in divergent coverages for the various countries' ECT obligations. The document was signed by 52 states and the EU; however, it was ratified only by 48 states[113] and the EU. In the European and Eurasian regions, the ECT was signed and ratified by all EU member states, except Italy. As regards the Eurasian side, Armenia, Azerbaijan, Belarus, Kazakhstan, Kyrgyzstan, Russia, and Ukraine were among the initial signatories in December 1994, but they took different approaches during the subsequent ratification processes.

Russia signed the ECT in December 1994 and provisionally applied it until 18 October 2009. However**, in August 2009 the Russian Federation officially informed the Depository that it did not intend to become a Contracting Party** to it and the PEEREA. Thus, Russia terminated the ECT's provisional application. This decision was taken for two main reasons: first, the energy transit issue mentioned above, but even more so, **the many disputes with Russia stemming from the ECT**. This means in particular that ISDS cases began from 2005 onward due to the expropriation of the Yukos company by the Russian state. As mentioned, all these cases ended with judgments in favor of the investors, with Russia altogether being made to pay some USD 50 billion in compensation. A few other cases are still pending (Yukos Capital v. Russia in 2013; Luxtona v. Russia in 2014). These unresolved legal obligations cause continuous political, legal, and economic problems between Russia and the investors, and to the Western governments behind them.

Of the other Eurasian countries **Armenia** ratified the ECT and the PEEREA in December 1997 (which entered into force in April 1998) and the 1998 Amendment to the trade-related provisions of the ECT. **Azerbaijan** ratified both the ECT and the PEEREA at the same time but accepted only the provisional application of the 1998 Amendment. **Belarus** has accepted only the provisional application of the ECT and 1998 Amendment. **Kazakhstan** ratified both the ECT and the PEEREA in October 1995 (entry into force August 1996), but has accepted only the provisional application of the 1998 Amendment. **Kyrgyzstan** ratified the ECT and the PEEREA in April 1997 but has accepted only the provisional application of the 1998 Amendment. **Ukraine** ratified the ECT and the PEEREA in February 1998 (entry into force, January 1999) and also ratified the 1998 Amendment. To sum up, while the signing of the

[112]Article 7(1) states: "Each Contracting Party shall take the necessary measures to facilitate the Transit of Energy Materials and Products consistent with the principle of freedom of transit and without distinction as to the origin, destination or ownership of such Energy Materials and Products or discrimination as to pricing on the basis of such distinctions, and without imposing any unreasonable delays, restrictions or charges."

[113] Australia, Norway and Russia has not ratified the ECT as well as Belarus has not ratified the ECT, but applies it provisionally.

ECT was a major step toward creating stable conditions for foreign investors in the Eurasian region, its implementation and the actual practical impacts show a much more nuanced picture.

The Energy Community (Treaty)

The Energy Community is an international organization established between the EU and a number of European countries **to create an integrated pan-European energy market**. The organization was founded by the Treaty signed in October 2005 which entered into force in July 2006. It currently has nine members: the EU on one side, and eight contracting parties: Albania, Bosnia and Herzegovina, Kosovo, FYROM (the former Yugoslav Republic of Macedonia), Moldova, Montenegro, Serbia, and Ukraine. This Treaty is thus one of the very few international agreements to which only the EU is a member, and not its member states. Georgia, Armenia, Norway, and Turkey have observer status, although Georgia is in the process of becoming a member of the ECT.

As the Energy Community is an EU-driven project, the Treaty foresees that **the contracting parties implement the key elements of the EU's energy-related legislation**, develop appropriate regulatory frameworks and liberalize their energy markets. The Treaty contains common rules for the internal market in electricity and gas, several Directives on environmental protection (like rules on industrial emissions), and on antitrust and state aid rules. Furthermore, the contracting parties have committed to the establishment of implementation plans for the Directives on the promotion of energy derived from renewable sources. In parallel with the development of the EU's energy-related regulatory regime, the Treaty and the policy areas it covers are also continuously evolving. In 2007 the Energy Community regulations were extended to the EU directives on the security of electricity and gas supplies. Since 2010 it has also covered the main EU legislation on energy efficiency (like the Directives on the energy performance of buildings, energy labelling, and energy efficiency). Concerning the oil sector, the parties have agreed to implement the 2009 EU Directive on the minimum stocks of crude oil and petroleum products by 2023.

Although, **the overall political commitment by the parties to extend the Energy Community's coverage to increasingly broader aspects of the European energy policy is a positive fact, the organization is often criticized for the shortcomings of implementation**. Bridging the existing gap between the political commitments and the actual implementation of the Energy Community rules remains a major challenge.

4.4. The OECD's energy-related activities and instruments

As the OECD has several energy-related activities, the relevant bodies and committees (Council, Executive Committee, and other committees) regularly discuss various aspects of the sector. As mentioned, **two specialized bodies were also established to deal specifically with energy issues:** the International Energy Agency (IEA) and the Nuclear Energy Agency (NEA). Both agencies provide substantial inputs to governments' energy-related decisions and carry out analyses in linked policy areas.

The International Energy Agency

The IEA is an autonomous inter-governmental organization established in 1974 under the framework of the OECD, in reaction to the oil crisis of 1973. Its initial focus was a mechanism **to deal with the physical disruptions in the oil supply,** and also to gather information and statistical data about the international oil market and other energy sectors. The current extended mandate of the IEA focuses on three energy policy aspects: energy security, economic development, and environmental protection.

Only OECD member states can become members of the IEA. However, even OECD membership does not automatically mean membership of the IEA, as applicant countries also need to commit to several preconditions: **continuously maintain reserves of crude oil and/or processed oil products**, that are equivalent to 90 days of the prior year's average net oil imports; draw up a demand restraint program to reduce national oil consumption in a crisis situation by up to 10%; and adopt appropriate legislation in these areas.

The IEA, apart from activities regarding member countries, has also developed special cooperation programs with such non-member countries as Russia, which have a major influence on the global energy market.

The Nuclear Energy Agency

The NEA is an inter-governmental agency, also established in the framework of the OECD. It was founded in 1958 as the European Nuclear Energy Agency (ENEA). The USA at that time participated only as an associate member. However, as the membership expanded to other regions, after Japan's accession in 1972, it was renamed as the NEA.

It has currently 33 members from Europe, North America, and the Asia-Pacific region, accounting for approximately 85% of the world's installed nuclear capacity. As stated in its Strategic Plan,[114] the **aim of the NEA is to assist the member countries in maintaining and developing cooperation for safe, environmentally sound and economically rational nuclear energy for peaceful purposes**. In the broader OECD framework, it provides inputs to governments' decisions on nuclear energy policy and to the Organization's analyses in such areas as energy and sustainable development.

4.5. Energy-specific policies related to FDI in the EU and its member states

Energy is also a strategic sector for the EU - as the world's second largest economy, it consumes one-fifth of the world's energy. However, as it has only limited own sources, it depends on other countries for its energy supply. **The EU imports just over half of its energy needs and is the largest energy importer in the world**. The importance of the energy sector is nothing new for the EU countries - the EU's concerns regarding energy supply have been a core matter since its formation, starting as the Coal and Steel Treaty (1952) and the Euratom Treaty (1957).

The sharing of competences in the energy area between the EU and the member states was provided for only by the Lisbon Treaty in 2009. **Thus, the Member States' governments still have strong competences in energy matters;** they remain in charge of providing national supply security by choosing their own energy mix and having control over their own primary energy sources. As a result, there is a limited scope for European initiatives in terms of security of supply, apart from the completion of the internal market and the development of infrastructures and interconnections.

4.5.1. EU-level policies and measures

Historically, energy networks in the EU member states have been developed and operated by national monopolies, usually in full or partial state ownership. Therefore**, EU-level policies focused initially on**

[114] The Strategic Plan of the Nuclear Energy Agency: 2017-2022

the liberalization and development of the internal market. In 1996 (for electricity) and 1998 (for gas) two EU Directives entered into force, aiming at liberalization measures - the so-called "First Energy Package." The provisions of the Directives included such issues as the minimum unbundling requirements, minimum eligibility thresholds, and network access conditions. However, these Directives lacked guidance regarding cross-border trade and integration of the national energy markets. Reacting to these shortcomings, in 2003 the "Second Energy Package" was adopted. Under its Directives **the EU member states were required to establish independent national regulatory authorities for the supervision and regulation of the electricity and gas markets, fully liberalize their markets by specific dates,** and follow stricter provisions regarding network access conditions and the unbundling of companies. Within this framework, the Regulation on cross-border trade of electricity was also adopted.

The European Commission in its Communication of 2007, three years after the expiry of the deadline for implementing "Second Energy Package," was, however, compelled to point out that **at the wholesale level the gas and electricity markets still remained essentially national** and "generally maintained the high level of concentration of the pre-liberalization period."[115] Thus, the Commission initiated infringement proceedings against 21 EU member states, and issued "The EU Strategic Energy Review" which broadened the objectives of EU energy policy from pure market liberalization and competition to such issues as environmental sustainability and security of supply.[116] **In 2009 the "Third Energy Package" was adopted aiming at the further liberalization of the internal electricity and gas markets**.[117]

As a further development, in February 2015 the **Commission published a Communication on the Energy Union** which highlighted five strategic EU energy policy areas for the future: energy security, solidarity and trust; a fully integrated European energy market; energy efficiency contributing to moderation of demand; decarbonizing the economy; and research, innovation, and competitiveness.[118] During recent years, in line with this package, several legislative proposals have been put forward aimed at achieving the goals of the Energy Union.

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[115] Communication from the Commission to the European Council and the European Parliament. An Energy Policy for Europe. COM(2007)1final (10.1.2007.)

[116] The EU Strategic Energy Review. Driving Investment in Clean and Secure Energy. (January 2007)

[117] The last Regulation was adopted additionally in 2010 as a result of the gas crisis in early 2009 when the Russian Federation cut off supplies to Europe through Ukrainian pipelines.

[118] Energy Union Package. Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Investment Bank. A Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy. COM(2015) 80 final (25.2.2015.)

4.5.2. Policies and measures in selected EU member states

Based on the EU-level initiatives, the present state of the major member states' energy policies is as follows:

In **Germany**, the federal government in 2010 adopted a comprehensive new strategy, the Energy Concept, which set out the principles of a long-term, integrated energy policy by 2050 with renewable energy as the cornerstone of future supply (the Renewable Energy Act 2017 was also adopted). Another important energy policy target very much welcomed by the public was the acceleration of the phase-out of Germany's nuclear power stations by 2022. These two main policy targets dominating the sector are specific legislation supporting renewable energy and the grid expansion, promoting energy efficiency and funding of the reforms. However, given the size and energy intensity of Germany's economy, as well as its location in the center of Europe, a balance between sustainability, affordability, and competitiveness of the sector must be maintained.

Austria in 2010 also adopted the Energy Strategy which has security of supply, energy efficiency, and renewable energy sources as its main components. Two of the main aims of Austrian energy policy are to reduce the country's dependence on energy imports and to strengthen its security of supply. So far, import dependence has been slightly reduced due to an increase in the supply of bioenergy. As regards the security of supply, Austria has focused for a long time on oil and more recently, on natural gas. The IEA in its review of Austrian energy policy suggested exploring the country's shale gas resources.[119] However, such activities would require an extensive obligatory environmental impact assessment process, which is very sensitive issue.

With regard to **France**, during the last decade the government's efforts toward sustainable energy supplies and the green growth of the economy should be highlighted.[120] These goals were also demonstrated by France's hosting of the UN's 21st climate change conference in 2015, at which the Paris Agreement on the emission reduction commitments to deal with climate change was negotiated. In recent years, France has been developing an ambitious and integrated energy and climate policy framework for the energy transition by 2030 and has adopted significant new policies, including carbon budget/pricing instruments, tax incentives, and considerable public funding of its implementation (estimated to reach €47.5 billion over the 2014–2025 period).[121]

Italy's energy policy goals foresee exceeding the EU-2020 environmental and decarbonization objectives and taking a lead role in implementing the EU Roadmap-2050, which is mirrored in the National Energy Strategy adopted in 2013. As an FDI-related energy policy improvement, the speeding up of the lengthy authorization processes for new energy infrastructure can be highlighted. A national priority in the Strategy is improved energy efficiency, to be promoted by a variety of regulatory measures and economic instruments (like tax incentives, innovated trading mechanism, the white certificates scheme etc.) With regard to renewable energy, Italy has experienced impressive growth in

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[119] International Energy Agency. Energy Policies of IEA countries. Austria. 2014.

[120] In August 2015, France adopted a long-term framework for the energy transition up to 2030 and 2050 called "The Energy Transition for Green Growth Act".

[121] According to the International Energy Agency review of energy policies of IEA countries. France. 2016.

the last decade,[122] by successfully integrating variable renewable generation while also maintaining a stable power system. However, changes to the support scheme will change the remuneration structure of existing installations. Thus, the IEA review of Italy's energy policy referred to the uncertainty undermining investor confidence and increasing the cost of capital for future investments.[123]

4.5.3. The EU's international/multilateral and preferential commitments

WTO framework

The EU activities regarding the energy sector are to a large extent **focused on government procurement,** as in the energy sector an especially large part of the transactions are concluded between states and private companies, Thus, considering that Government Procurement Agreement (GPA) coverage on the EU side is quite extensive, the early GPA accession of the Russian Federation (in the process) and Kazakhstan (to be started in 2018) is considered especially important in this sector.

The other matters of EU interest in the Eurasian countries are **dual pricing and similar market distortions.** Even if the existing WTO rules on energy are incomplete and are covered by different WTO instruments,[124] it is possible to take legal action against measures that are in breach of the multilateral disciplines. At present, the EU is not bringing any WTO cases against the Eurasian countries in the energy sector.

On the other hand**, in April 2014 the Russian Federation initiated two WTO disputes against the EU, based on the latter's "Third Energy Package.**"[125] Russia requested dispute settlement consultations with the EU regarding Directives, Regulations, implementing legislation, and decisions of the "Third Energy Package," claiming breaches of the GATS, GATT, the Agreement on Subsidies and Countervailing Measures, and the TRIMs Agreement. Due to the complexity of the dispute, the report of the panel has not yet been issued, but it is expected soon.

Energy-related provisions in the EU's preferential agreements

As spelt out in Part III, investment-related aspects are important elements of the EU's preferential arrangements, and the same can be said about the energy sector. In the absence of an effective multilateral framework covering the elements of this important sector, the **EU is able to defend its basic interests linked to energy only by preferential agreements**. Due to the size of the EU, these agreements also strongly influence the international energy markets and the conditions under which other importing countries can obtain energy supplies.

The FTAs have three basic objectives linked to the energy sector: the reduction of technical barriers to trade, the elimination of export duties on energy resources, and the opening up of new business

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[122] According to the International Energy Agency's Italy's review of energy policy (2016), the share of renewables in total final consumption reached 13.5% at the end of 2013, up from 10% in 2010, and trends suggest that Italy is on track to exceed its 2020 target of 17%.

[123] International Energy Agency. Energy Policies of IEA countries. Italy. 2016.

[124] They range from the MFN, NT principles, rules on monopolies and SOEs (in the GATT and the GATS), prohibition of quantitative restrictions (the GATT) to subsidies (Agreement on Subsidies and Countervailing Measures), government procurement issues (Government Procurement Agreement), dumping (Anti-dumping Agreement), technical obstacles to trade (Agreement on Technical Barriers to Trade), TRIMs (TRIMs Agreement) and provisions related to biofuels (Agreement on Agriculture).

[125] DS476 Energy Package (panel composed on 7 March 2016). The panel report expected soon.

opportunities for the provision of energy-related services. The specific provisions change from case to case, depending on both the EU's and the partner country's interests, as well as the gaps between their respective regulatory regimes. The so-called "new- generation" FTAs having most impact on the EU energy sector are the agreements with Canada (CETA) and the one discussed with Japan (the talks about the potentially most important the EU–USA FTA (TTIP) are at present suspended). Beyond these major agreements, all those recently signed or negotiated have similar energy-related provisions.

The EU-Ukraine AA/DCFTA

Each of the AA/DCFTAs concluded by the EU with the three Eastern Partnership countries contain provisions linked to energy and to foreign investments. The most detailed of these documents is the one signed with Ukraine, which deals with the energy sector not just in the DCFTA-related part but also under other headings of the Agreement. The trade part contains a dedicated chapter on energy, focusing on the trade-related aspects of the gas, crude oil, and electricity sectors. As a general approach, **the provisions go beyond the WTO disciplines and also incorporate elements of the Energy Community Treaty** described earlier. Numerous provisions relate to the broader conditions of FDI in the sector: the basic rule is market-based pricing for energy products; however, the maintenance of regulated prices for gas and electricity is allowed based on broader economic policy considerations, under transparent and objective conditions. When it comes to exports of energy products, there is a prohibition on dual pricing, as this would lead to sales to the other party at prices higher than those applied in the domestic market.

Concerning the **transport of energy products**, the Agreement requires that for the fixed infrastructure (pipelines, electricity networks) the terms of use (tariffs for transport, capacity-allocation procedures, and all other conditions) be set in an objective, transparent, and non-discriminatory manner. For this purpose, specific cooperation and consultation procedures are foreseen. The conditions **for the transit of energy products** have to respect the GATT provisions regarding the freedom of transit, ensuring that such conditions either do not act as barriers to trade or allow the unauthorized removal of transited energy.

The specific provisions about **the relationship to the Energy Community Treaty** foresee that any action taken in the energy sector must be consistent with the relevant EU legislation and the Treaty itself. In case of conflicts with the provisions of the DCFTA, the Treaty or the EU implementing legislation are to be followed by Ukraine.

Concerning **investments in the energy sector**, in particular, the exploration and extraction of fossil energy, the parties are free to establish the terms of access and to designate the specific geographical regions that are opened up for such activities. However, once such activities are allowed, the terms, the licensing procedures, and the financial obligations and taxes to be paid must be applied without discrimination to the companies of both parties.

The Agreement also contains specific provisions concerning **cooperation in the energy sector**. The goal is to ensure the gradual harmonization of the sectoral regulations with those of the EU, including the institutions and administrative procedures. The provisions of the Energy Charter Treaty are among the guiding principles of the cooperation. The areas foreseen include the implementation of energy strategies and policies, the setting up of mechanisms to deal with crisis situations, the modernization of the common energy infrastructure, measures aimed at the long-term stability of trade in energy products, and improvement of investment conditions in the sector. Cooperation is also foreseen in the environmental area, including energy-saving technologies, the development of renewable energy resources, and common international action to ensure effective decisions and measures against climate change. The Agreement also contains **specific provisions for the nuclear energy sector**, including the EU's assistance in dealing with the consequences of the Chernobyl disaster.

4.6. The major Eurasian countries' FDI-related policies

4.6.1. The Eurasian countries' international/multilateral and preferential commitments

WTO framework

With energy playing an exceptionally big role in several Eurasian countries' economies and their trade relations, the sectoral commitments were among the most important, but also most difficult, elements of their WTO accession negotiations. From the EU side, as described in the previous chapter, both for economic and supply security reasons there was a strong intention to use the WTO accessions of the energy-rich Eurasian countries to negotiate such commitments, as these, at least partially, fill the gaps in the existing multilateral rules. These include limiting: i) the use of export restrictions and export duties; ii) the possibility of charging unreasonably low energy prices for domestic producers compared to the much higher export prices (and thus causing a trade-distorting subsidy); iii) the practice of charging different levels of export duties at different points on the borders; and iv) the questioning of the freedom of transit for some energy delivery methods and the restrictions applied to access to the transport networks of these products.

The **Eurasian countries had exactly the opposite interests**; they wished to undertake the fewest possible specific obligations in order to maintain the freedom to shape their energy-related policies in a manner that maximized the economic and also political benefits from their energy resources. They thus resisted the EU's and other Western countries' intentions to fill the gaps in the multilateral framework as much as possible. Finding a compromise for the energy-related commitments often delayed the Eurasian countries' WTO accession, and these commitments were generally among the last chapters of their protocols to be agreed. There were some differences in the details of the commitments finally undertaken, but due both to the size of the Russian economy and the exceptionally important role played by energy in it, the accession process of Russia was the most difficult and controversial of all. The details of each Eurasian country's specific obligations are described below.

Other international organizations and agreements relevant in the energy sector

The Eurasian countries are not members of the OECD, or of its specialized energy agencies, the IEA and the NEA. Under point 4.4. above, the limited cooperation with some of the Eurasian countries has already been described.

The same applies to the energy-specific international agreements, the Energy Charter Treaty, and the Energy Community Treaty. Being basically EU-initiated agreements, these were also analyzed in point 4.3. from the point of view of their Eurasian members.

4.6.2. The Eurasian countries' policies and measures related to FDI in the energy sector

As a general working method, for each country, their respective, often quite different, international obligations and commitments are described first; this is followed by a summary of their formal policies and regulations that impact on FDI in the energy sector. The views of the actual measures taken—the practical implementation of the policies—are collected from a broad range of sources, including well-known international organizations and bodies, business associations, major economic partners, etc. There could also be different, conflicting assessments.

The Russian Federation

WTO commitments

During Russia's long WTO accession process, all the controversial issues described above came to the surface. While most of the policies and restrictions applied by Russia also had at least an indirect impact on foreign investments in the energy sector, we focus on those which are more directly linked to the conditions of FDI:

A. Russia has traditionally placed many conditions on allowing foreign investment in most areas, but this has been even more the case in the strategically important energy sector. It was thus not surprising **that some special exemptions were asked for energy products, specifically for gas and crude oil**. However, unlike the large number of temporary exemptions negotiated for other sectors, **for energy goods a different approach was negotiated: the possibility of permanently applying a dual pricing regime, with certain bound ceilings.**

The use of **export duties and administrative restrictions on energy products** is possible under WTO rules, but subject to certain conditions. Although the EU would have preferred a complete prohibition, Russia made it clear that if it had to completely stop dual pricing, it would rather not join the WTO. Thus, a compromise had to be found, under which **Russia bound into its WTO agreement the maximum export duties applicable for both natural gas and liquefied natural gas (LNG), while setting a formula for export duties on crude oil**, linked to the changes in world market prices. While many countries apply lower, regulated prices for private and/or public sector consumers, in Russia's case the dual pricing regime is more general and also benefits Russian industrial producers, including those of energy-intensive products. Their exports led to market disturbances, so the EU decided to reserve the right to apply special protective measures in the case of distortions caused by unduly low-priced Russian manufactured products. This means taking the higher export prices into account for trade defense calculations. Russia disputes this method and very recently started a WTO dispute procedure against the EU.

B. There are **also some other WTO rules affecting trade in energy products, over which the EU - and other WTO members - have concerns**:

- In the energy sector the **multilateral rules applicable to state-owned and/or controlled enterprises (STEs) are especially important.** Their activities and influence are even more decisive in this strategically important area than anywhere else, from exploration, extraction and processing to internal and external trade, transport, and transit. Thus, the EU insisted that Russia in its WTO accession protocol should formally notify the companies of the defining player, the Gazprom group, as STEs, falling under Article XVII of the GATT. The EU's expectation was that the accession commitments would guide Gazprom's activities with respect to both aspects of non-discrimination, i.e., the MFN and the national treatment obligations. The experiences of the EU energy companies, especially recently, led them to the view that these obligations would be respected.

- There are also **disputes about the Russian practice of applying different export duties at different border exit points.** In the EU's view Russia, by applying this kind of government intervention, ensures that it is able to sell, e.g., gas to China, at lower prices than those charged to EU customers. Russia defends this practice by referring to different costs and geographical conditions, but in the EU's view, these conditions cannot justify such government measures. The issue remains unresolved and is the topic of recurring debates.
- **The transit of energy products via Russia is another hotly disputed subject**. Russia questions the applicability of GATT Art. V. about the freedom of transit in the case of products transiting via networks, like oil or gas pipelines, or electrical grids. For this reason, the EU is not able to directly import cheaper gas from the Central Asian countries: Russia insists on first buying the gas at lower prices from the exporters and then reselling it at a substantial profit to European customers. This is much facilitated by almost complete Russian government control via state-owned/controlled companies, like Gazprom and Rosneft, over the Russian pipeline networks. This practice is questioned by the EU and is again the subject of debates.
- The problems have been further deepened due to **recent broader political decisions.** As mentioned, Russia prohibited the transit via its territory of all EU and Ukrainian products, including energy, toward such Central Asian destinations as Kazakhstan. Subsequently Ukraine banned the transit and/or transport of energy products to the Crimea and the Donbas region. These measures are now subject to still ongoing, mutual WTO dispute-settlement procedures between both countries.

C. In terms of the **GATS, the situation is also quite complex.** First, due to the strategic importance of the energy sector, Russia has been very cautious about making commitments related to energy during its GATS accession negotiations. Nevertheless, some were made, and there are disputes as to whether these are being respected, while in other cases the general policies applied might raise questions about their GATS compatibility. The problematic issues are as follows:

- **Transport, and the actual transit of energy products, do not only fall under GATT rules, as these are service activities,** subject to the GATS general MFN obligation. Transport services not linked to transit are also subject to the same GATS MFN obligation. Beside the disputes mentioned under point B, there are also questions about the fulfilment, in practice, of this commitment.
- Russia has undertaken only very few direct **FDI-related commitments in the energy sector**, as it wished to give preference to the domestic companies even when these were in partnership with foreign investors. Concerning core energy-related activities, only some auxiliary services were undertaken under its GATS accession commitments. Under the current situation of mutual sanctions, some of which specifically apply to the energy sector, only a fundamental change in the political–economic relations with the EU can bring a major upswing of FDI inflows to the Russian energy sector.

Russia and the OECD

As mentioned, Russia has a long-standing relationship with the OECD. In 1996 it officially applied for membership and in 2007 the formal accession process was begun. The OECD even currently regularly conducts a review of Russian policies in several areas, including investment, science, and technology. However, due to the political tensions the accession process was de facto suspended in 2014.

Thus, Russia's status did not change in the two agencies dealing with energy matters, the IEA and the NEA; it retains observer status. Russia is especially interested in the area of nuclear energy due to the importance of this sector in its energy mix: in the last decade, nuclear energy contributed 16% to the total Russian electricity production. Russia currently has 31 nuclear reactors installed and four more units are under construction. That is why Russia is actively participating in a number of the NEA's activities, and as an observer in several Committees.

Other international commitments

Russia took over all obligations of the Soviet Union under the existing bilateral investment treaties and also concluded further BITs with most EU countries; altogether 25 of these documents are now in force. Due to the limited effects of other international agreements, these treaties are also the strongest protection for investments in the energy sector. The BITs contain the standard investment protection and promotion clauses, like national treatment, provisions for fair and equitable treatment, most-favored nation status, protection against expropriations, and the principle of *pacta sunt servanda* (agreements are to be kept). However, there have been recurring disputes with the EU and several of its member states about the actual implementation of these commitments.

Energy-related provisions in the Russian Federation's preferential agreements

Russia is a party to the Eurasian Economic Union, the Common Economic Space, and the Treaty on a Free Trade Area between members of the CIS states. Russia has a number of preferential arrangements, such as the Agreement on Rules of Origin of Goods Originating from Developing and Least Developed Countries, Protocol on Common System of Tariff Preferences of the Customs Union or Decision No 130 of the Customs Union Commission. While several of these agreements also cover trade in energy products, none deals directly with FDI.

The Russian Federation's FDI-related policies in the energy sector

The energy policy of Russia is regulated by the **Energy Strategy**,[126] adopted by the Russian government in 2000 for the 20-year period to 2020.The strategy is based on the Energy Policy Concept of Russia in the New Economic Condition,[127] the document, the Major Directions of Energy Strategy of Russia for the period up to 2010,[128] and the Major provisions of the Energy Strategy of Russia for the period up to 2010.[129] In 2000 the new version of the "Major provisions of Energy Strategy of Russia for the period up to 2020" was approved.[130]

One of the main principles of the strategy is to increase the relevance and predictability of the state regulations to **stimulate private initiatives in implementing the energy policy, including through investments**. Currently a few years before the end of the 20-year program, it is already clear that **the level of large-scale investments in the renewal of the energy sector is not sufficient.** There are various

[126] Approved by Decree N°1715-r of the Government of the Russian Federation dated 13 November 2009

[127] Approved by Resolution N° 26 of September 10, 1992 of the Government of the Russian Federation

[128] Approved by Edict N° 472 of May 7, 1995

[129] Adopted by Resolution N°1006 of October 13, 1995 of the Government of the Russian Federation

[130] Approved by Resolution N° 39 of November 23, 2000 of the Government of the Russian Federation

reasons for this, including the fiscal policy related to the export revenues of energy companies. This also affects the private sector by allowing only low profitability when energy companies serve the domestic market. All objective assessments agree that in the past period **the role of the state-owned/-controlled companies has increased and thus the possibilities for private companies have diminished.** Furthermore—as often stressed by Russia's foreign partners—according to several analyses, the regulated prices in the domestic market are still too low and do not cover costs and reasonable profits. While this can be explained by social considerations in the case of private consumers, such prices also act as subsidies for the downstream industries, principally in the production of energy-intensive semi-finished products (steel, chemicals, etc.).

The Energy Strategy also contains the mechanisms for achieving its basic goals: the creation of a favorable economic environment for investments in the energy complex, including coordinated tariffs, taxes, customs, anti-monopoly regulations, and institutional reforms. Furthermore, the **strategy stresses the need to stimulate business activity by incentives for investment and innovation**, by improving the management of the state sector, and introducing technical regulations, national standards and norms for the energy sector's development. The strategy also foresees the rationalization of the tax burden for energy companies and improvement of the business environment by establishing clear rules for the relationship between the state and private investors, and by providing guarantees for investors' rights. **The implementation of these plans would also be much welcomed by the foreign business community**. The low level of FDI inflows in recent years was to a large extent caused by the uncertain, fast-changing economic and investment conditions, as many foreign investors started considering that they were not being fairly treated in the energy sector.

The strategy also has other priorities: energy efficiency, i.e., a decrease in the energy intensity in energy production and supply, sustainable energy development, and technological improvement. The following long-term directions are set for the energy sector: transition to innovative and energy-efficient development; changes in the structure and scale of energy production; and the development of a competitive market environment and integration into the world energy system. The reduction in energy intensity should be reached mainly thanks to the growth of industrial sectors that consume less energy and are specialized in high-technology and science-intensive production, thus leading to the structural transformation of the Russian economy. Again, these are areas of much interest for the European business. Should the broader environment change, there is much scope for FDI in the area of modern, efficient technologies.

One of the main objectives of the strategy is to increase the quality of fossil fuel products exported to the world market. The goals are to improve energy safety, energy effectiveness, budget effectiveness, and ecological security. Another priority is the development of the energy market infrastructure which includes the strengthening of market mechanisms and institutions needed for a more liberal trade regime of energy products, and the further development of the energy transport infrastructure (Ministry of Industry and Energy of the Russian Federation, 2010). These objectives were set in light of the low level of investment in the energy complex: during the last 5 years, investments reached only 60% of the level identified by the Energy Strategy. A related problem is equipment aging, and thus the need for replacement and renewal. These factors mirror the concerns of the EU side: the continued barriers to foreign companies, lack of access to the energy transport networks, and the monopolistic position of the state-owned/controlled companies.

In 2006 the strategy was further developed and the document "On the refinement of the Energy Strategy of Russia for the period to 2020 and its prolongation up to 2030."[131] The new document confirms all the goals and priorities set by the strategy that are valid until 2020. Additionally, it sets new guidelines for the sector in the light of the increased role of innovation in the Russian economy.[132] Special attention is devoted to the development of the energy sector in such regions as Eastern Siberia, the Far East and the North-West regions of Russia, the Yamal Peninsula, and the continental shelf of the Russian Federation.

To sum up, there are numerous possibilities, in principle, that reflect the views of the EU, the member states and the business community. **Creating the necessary political conditions for restoring closer cooperation between the EU and Russia would bring huge benefits for both sides.** What is not clear, however, is when or whether the necessary changes in Russia's economic and trade policies will occur to allow these ambitious development goals to be realized. There is no reference to the new conditions created since the elaboration of the first strategy in 2000, i.e., to Russia's WTO membership, to its continued interest in being more closely involved in, and eventually joining, the OECD and its related agencies. For a real upswing in the foreign investors' interest, a restoration of trust is needed; this was lost due to various restrictive government measures and the takeover of energy assets owned by Western investors. Therefore, leaving aside the positive technical aspects of the Strategy, economic policy changes are also necessary and should be elaborated.

Kazakhstan

WTO commitments

Kazakhstan, like Russia a major energy-exporting and -producing country, also **had price regulations for both the domestic and exports of energy products.** As a Customs Union partner during Russia's WTO accession, Kazakhstan requested a similar permanent solution for energy products, i.e., gas and crude oil, as the treatment agreed by Russia. Thus, the bound price levels are the same as those of Russia, and there were other similarities in the issues of both accession processes. However, the commitments undertaken by Kazakhstan also ensured a more FDI-friendly environment in the energy sector:

- Kazakhstan **did not give up its right to apply price controls in certain cases**. It has committed, however, that such controls would not be used in any sector to provide protection for domestic products in the goods sector or to undercut commitments undertaken with respect to services.
- With respect to **state owned/controlled enterprises**, Kazakhstan's commitment to operating its STEs fully in line with GATT Article XVII, ensuring that their purchases and sales would be made exclusively on the basis of commercial considerations, also applies to the state-owned/controlled companies operating in the energy sector.

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[131] Adopted by the Decree of the Ministry of Industry and Energy dated 21.12.2006, N° 413

[132] Specified in the Conception of Long-Term Socio-Economic Development of the Russian Federation up to 2020 approved by Decree N° 1662-r of the Government of the Russian Federation dated 17 November 2008

- **Access to the government-controlled pipeline system was** also among the most debated issues in Kazakhstan's case. The country eventually agreed to ensure foreign investors active in the country WTO-bound access to these pipelines on a non-discriminatory basis. This means that when transporting oil or gas, there would be no difference between the terms or tariffs offered to foreign and domestic producers based on the origin and destination of the energy products.
- For this reason, **the issue of transit of energy products was not a controversial one** during the accession negotiations. On the contrary, strangely enough, **Kazakhstan has become the biggest loser due to the transit restrictions introduced by Russia as part of its sanctions against the EU and Ukraine.** The Russian transit bans for the supply of all products from Western countries and Ukraine through its territory to Kazakhstan, has led to major supply problems and price rises in the country. Kazakhstan also faces limits on the exports of energy products through Russia to the EU, and has had to find alternative, more expensive, and more complicated supply routes for many of its exports to Europe.

Kazakhstan and the OECD

Kazakhstan's intensive **cooperation with the OECD also covers energy-related subjects**, and assistance programs are under way (largely financed by the EU) dealing with such subjects as the improvement of energy efficiency, the environmentally friendly development of the energy sector, etc. The OECD regularly prepares detailed studies about the various subjects of the Country Program, describing the progress made and providing recommendations for further development. All this work contributes to improving the country's international image and encourages foreign investors to expand their activities in Kazakhstan's energy sector.

Kazakhstan's FDI-related policies in the energy sector

The fuel and energy complex plays a key role in the economic and social well-being of the country; the exploitation of its raw material potential is the main source of Kazakhstan's economic growth. The **Strategic Plan for the Development of the Republic of Kazakhstan until 2020** sets the target of the country getting on to the list of the 50 most competitive economies in the world in terms of socioeconomic development. In the **Strategy for Development of the Republic of Kazakhstan until 2030**, the oil and gas industries are designated as the main drivers of growth. The strategy outlines such long-term targets as the transformation of Kazakhstan into one of the safest, most stable, and ecologically sustainable countries, with a dynamically developing economy.[133]

In December 2012, President Nursultan Nazarbayev also announced the **Kazakhstan 2050 Strategy**, which calls for widespread economic, social, and political reforms to position Kazakhstan among the top 30 global economies by 2050[134] (details in Annex XI). While these plans are very ambitious, based on the country's resources and its more open economic-trade policies, it has a better chance of substantial progress than some of the other Eurasian countries do. Quite apart from the lack of major political tensions between Kazakhstan and the West, the country's readiness to provide more opportunities for FDI, including in the strategically important energy sector, allows its own resources to be combined with the capital, technology, and export markets offered by foreign investors.

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[133] In the Strategy for development of the Republic of Kazakhstan until the year 2030. http://www.akorda.kz/en/official_documents/strategies_and_programs

[134] Kazakhstan 2050 Strategy leads to government restructuring. Carnegie Endowment for International Peace

The unified electricity system of Kazakhstan is represented by 76 power stations, and the National Electric Grid (NEC) is the backbone of the system. The electricity distribution is carried out by 20 regional energy companies and about 150 small transmission companies. About 179 energy-supply organizations are registered in Kazakhstan, 40 of which are subject to the provisions of the Law "On natural monopolies and regulated markets".[135] This shows that the extent of centralization and direct Government control is much more limited than in the case of e.g., Russia. However, the electricity infrastructure is in a rather poor state; replacing and upgrading it needs further, large-scale investments. The country's own resources have been much reduced by the lower energy prices; as far as continued favorable conditions for foreign investors is concerned, **there is scope for the further inflow of capital**.

The strategic priorities for the development of the fuel and energy sector are: energy security; development of the resource base and improvement of the environment. Thus, the major goals are to increase the efficiency of energy resources use to promote economic growth and the quality of life of the population, as well as to strengthen foreign economic relations.

Currently, the country implements the basic concepts of a **green economy. The Action Plan for the Development of Alternative and Renewable Energy for 2013–2020** was adopted in January 2013. A key initiative in the area of renewable energy is the **Program of Wind Power Development to 2030** which defines this source as one of the priority directions. In December 2014, the government approved the **Concept of Gas Sector Development until 2030**. Under the **Green Economy Concept**, there are plans to optimize hydrocarbon exploration, while also observing ecological standards. The concept sets the target of 50% of Kazakhstan's energy consumption coming from alternative and renewable sources by 2050. It can be achieved by a parallel 25% reduction in energy intensity by 2020 (compared to the 2008 level). Further goals are to solve the drinking water supply restrictions by 2020 and the those on agricultural water supply by 2040.[136]

The goals of **Strategy-2050** can be achieved with the help of the industrial and technological modernization of the fuel and energy complex, and the further development of transport and infrastructure. The development of the fossil fuels sector includes the consistent liberalization of oil refining and the market of petroleum products, plus the intensification of geological exploration activities by attracting investments. Further improvements of the regulatory and tax instruments are necessary to stimulate the technological development of the energy sector and the further development of the domestic energy and fuel markets. Other goals are to increase the energy exports and to develop the international cooperation, including through the future common energy market of the EAEU. **The policy approach followed by Kazakhstan allows balanced reliance on good relations with both the EAEU and EU partners, enhancing the domestic financial resources through FDI.**

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[135] Concepts of development of the fuel and energy complex of the Republic of Kazakhstan until 2030 June 28, 2014 No. 724.

[136] IEA Agency. Eastern Europe, Caucasus and Central Asia report. Energy Policies Beyond. IEA Countries. Kazakhstan. 2012

Ukraine

WTO commitments

Ukraine has been, and remains, a net importer of energy, with limited resources (except for coal). In the country's WTO accession negotiations, this has meant that fighting for special conditions in the gas and oil sector, has not been as important as it had been for energy-rich states such as Russia or Kazakhstan. This is probably why in sectors and activities related to energy, the accession process was easier and less specific commitments needed to be made.

With respect to the **TRIMs Agreement, Ukraine did not ask for any temporary exemptions for energy products either**. A more sensitive issue was the application of export duties and restrictions on various products and raw materials, but for the reasons mentioned, energy products were not among these.

In common with other Eurasian countries, a much-discussed issue was the activities of **the state-owned/controlled enterprises which played an especially important role in the energy sector.** Close to 60% of the energy is produced by these companies, making them of great interest to foreign investors. Thus, Ukraine also undertook to fully respect the relevant GATT provisions for STEs operating in the energy sector.

As part of its **accession commitments negotiated with the GPA**, Ukraine has drawn up schedules containing the specific procurement activities and entities in the energy sector falling under the disciplines of the Agreement.

For Ukraine, which is **one of the major transit routes for EU–Eurasia trade, and in particular for the transit of oil and gas** by pipelines, respect for the relevant GATT rules has not posed the kind of problems that it did for Russia. On the contrary, it was interested in increasing the transit traffic of energy products to better utilize its transport capacities. Thus, in its WTO commitments it undertook to respect all multilateral rules on transit by all means of transport. Subsequently, following the suspension of the CIS relations by Russia as of 1 January 2016, one of the first things to occur was the stopping of the transit of Ukrainian products via Russia to Central Asia. This issue led to various Ukrainian counter-measures (including a transit blockade for Russian railway traffic). Ukraine and Russia have brought WTO DS cases against each other, which are still ongoing.

Ukraine and the OECD

The **OECD programs set up to support Ukraine also cover the energy sector**, with special emphasis on improving the efficiency of energy use across the board for private, public, and industrial use. Government measures and the improved work of central and regional authorities are important elements of these efforts, along with the further raising of the low energy prices which have been a major drain on the budget. Such measures also increase the attractiveness of the Ukrainian energy sector for investments, including foreign investments. The better utilization of the country's ample biomass resources is another essential element of this program - at present only 7% of the total consumption comes from renewable sources, way below potential. A successful transition would also help to cut the country's import bill, and also have positive effects on the environment.

Other international commitments of Ukraine

Ukraine's **relations with the two energy-specific European international agreements, the Energy Charter Treaty and the Energy Community Treaty**, have already been introduced under the previous chapter. One might add that while Ukraine has undertaken all the relevant commitments, **the implementation is - similarly to various elements of the general investment environment - still rather patchy**. This is also an important factor in the low-level FDI inflows experienced in recent years.

Apart from the country's most comprehensive preferential agreement, the DCFTA, with the EU, the other **economically important agreement is the one linking Ukraine with other CIS countries**. However, it does not cover FDI in the energy sector. Even more significantly, since the suspension by Russia, the largest Eurasian economy, of CIS relations with Ukraine, the document's economic importance has greatly decreased. Still, the CIS Agreement remains a valuable basis for the continued economic links with the other CIS countries, including EAEU members, that are not following the Russian line.

Ukraine's FDI-related policies in the energy sector

Since the start of this decade the **energy policy of Ukraine has focused on decreasing fossil fuel imports** and, in parallel, on diversifying its energy supply sources. These goals were guided as much by economic, as by supply security considerations. The reorientation of the policies already started during the previous leadership, as reflected in the Program of Economic Reforms for 2010–2014.[137] This document called for the first major increase in the regulated, extremely low consumer prices by 50% for district heating systems and private consumers in 2010. **In 2012 the Updated Energy Strategy of Ukraine for the period till 2030** was released, foreseeing such reforms as increased competition in the energy markets, as well as deregulation and the diversification of energy sources. However, the **implementation of the real reforms was not begun, and it was only the new leadership of the country since 2014** that has taken more decisive steps to change the direction of the national energy policies.

The **recurring disputes with Russia about the quantities and prices of fossil fuels (especially gas) sold to Ukraine** in the previous years have led to major conflicts, additional costs, and repeated cuts in supply (influencing not just Ukraine, but also the EU member states dependent on transit via this route).

[137] IEA, Ukraine Energy Policy Review 2006, OECD/IEA, Paris, available at: www.iea.org/publications/freepublications/publication/ukraine2006-1.pdf

However, since 2014, with the breakdown of relations between the two countries, the reforms have taken on a new urgency. Although there is still trade in energy products between both countries, there are more and more problems and disputes. The EU tries to play an intermediary role between Russia and Ukraine, but the results are patchy and the interruption of supplies is a recurring fact, with both sides accusing each other. Thus, **Ukraine increasingly tries to import fossil fuels from the EU and other sources,** even if the costs are higher (reverse gas flows, coal from South Africa, etc.). For the sake of objectivity, it should be added that **there are also problems created by the Ukrainian side in supplying the Crimea and the Eastern Donbas with energy**, even if these are partly attributed to non-governmental actions.

As a result of the recent efforts Ukraine has made **major progress in both cutting its energy consumption and imports** and in exploring new sources of supply. The main tools include increasing domestic conventional and unconventional gas production, the development of biomass potential, improving the country's energy efficiency, and the further raising of energy tariffs.[138] Ukraine has also created improved conditions to attract investors into the modernization of the coal, electricity, gas, and heat-generation sectors, and transmission networks. This is all the more necessary because the earlier regulatory framework was designed to ensure the domination of the state entities; thus, the implementing mechanisms also had to be adjusted to the present directions of energy policy.

Azerbaijan

Azerbaijan's international commitments in the energy sector

Azerbaijan is **the country in the Eurasian region with the fewest international commitments**. Based on the rich oil and gas resources, and the firm political control asserted by the top leadership, it has not been considered necessary to undertake burdensome international obligations that would limit Azerbaijan's freedom of action. Thus, while it maintains rather good and close political relations with Russia, the country did not join the EAEU or any international organizations dominated by the Western countries. On the other hand, **as a general policy, it has been quite open to FDI in the energy sector**.

Azerbaijan has a **long-standing, but very slow-moving WTO accession process**. It started 20 years ago, in 1997, but during this time there have only been 14 formal meetings, the last one being in July 2017. The Azerbaijani delegation did submit the basic documents necessary for an applicant country, but the meetings are rather formalistic. The WTO Secretariat from time to time updates the report about the overall economic situation and new legislation, but cannot record much progress in the core negotiations. **The major obstacle is the reluctance of the country to enter into serious bilateral market access talks with WTO members**; this was also the complaint most often raised at the last meeting. Apparently, Azerbaijan even in these more difficult times, with much reduced oil prices, does not see enough benefits from exposing its weak industry, agricultural, and service sectors to foreign competition. Thus, there is no expectation that any of the energy-related instruments of the WTO, be it the TRIMs Agreement, or the GATS, would be applicable to Azerbaijan in the foreseeable future.

Concerning the **OECD, Azerbaijan is again not a Eurasian country with very close links to the Organization**. The **OECD has a cooperation framework with the country**; it participates in a number

[138] See Astrov, V. and Podkaminer, L., (2017), "Energy Tariff Reform in Ukraine". Wiiw Research Report 416, February.

of committees and, from time to time, OECD reports are prepared about specific areas and sectoral policies, including energy. The technical assistance offered in some special areas is used, but according to the OECD studies' more sensitive recommendations (combating corruption, need for more professional government services, more liberal economic-trade policies, etc.) are apparently not followed. There are also some contacts with the two energy agencies linked to the OECD.

Guided by its strong interests in the energy sector, Azerbaijan is a member of the Energy Charter Treaty, but it has no relations with the Energy Community Treaty.

The **only preferential framework of which Azerbaijan is a member is the CIS**. On this basis, it conducts free trade in most goods with the other members. However, it does not seem to be interested in any change of the status quo of the current CIS setup.

Azerbaijan has BITs with a number of EU member states, but these apply only to the protection of the existing (already admitted) foreign investments. There are no commitments concerning market access or the opening of the country to new investments. Thus, the investment policies, including in the energy sector, are basically set autonomously by the country.

Azerbaijan's FDI-related policies in the energy sector

The energy sector in Azerbaijan is even more important than in other energy-rich Eurasian countries, with gas and oil providing 90% of exports. Thus, the fall in energy prices brought about a major slowdown in economic growth, from around 3% in the first half of the decade to just 1% in 2015. The energy sector has been the major target of FDI for years, which has been helped by the relatively liberal investment regime: **FDI is allowed in all areas, except those prohibited by law** (ownership of land is one of the few exceptions). There are no restrictions on acquiring, managing, and selling foreign-owned companies and beyond the numerous BITs, the country has a recent new law protecting foreign investments in all sectors. While the energy area is expected to remain the main focus of FDI in the future, the government is trying to diversify the sectoral composition with various support measures, designating also transportation, tourism, agriculture and information-communication technologies as its preferred targets for foreign investment.

For the energy sector the basic legislation was drafted in 1990. It was supplemented by sectoral laws for the different energy products, which were adopted by the first half of this decade. The institutional and legal framework of the sector contains the following state programs*:* 2003, National Program on Sustainable Social and Economic Development for Ecology; 2004, State Program on the Use of Alternative and Renewable Energy Sources; 2005, State program for the development of the fuel-energy complex (2005–2015).[139]

The purpose of this last program is to reduce the losses of energy, to prevent its theft and inefficient use, focusing primarily on electricity and gas. The program aims to raise energy product prices to the level of the real costs of productions, thereby stimulating the effective use of resources.[140] The State Strategy on the Use of Alternative and Renewable Energy Sources for the period 2012–2020 proposes **a legal framework to achieve the following goals by 2020:** reduction in greenhouse gas (GHG)

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[139] Development of energy policy and strategy of Azerbaijan. Presentation report (on Russian). Speaker Abulfaz Kerimov. 2015

[140] http://portal-energo.ru/articles/details/id/859

emissions by at least 20% below the 1990 levels; production of 20% of the electricity from renewables and increase in energy efficiency of 20%.

The main priorities of the energy policy are as follows: **energy security; energy efficiency of the economy; environmental safety of energy, and financial energy efficiency**. These goals are to be achieved by the reduction of the unit production costs and more efficient use of energy through: i) rationalization of consumption; ii) energy-saving technologies and equipment in all sectors; iii) more use of the local energy resources, including renewable energy.

To achieve these important, but costly objectives, **since 2014, following the fall in world energy prices, additional steps were taken to improve FDI conditions in the sector**. The new investment regulations for the period 2016–2020 include such measures as a reduction in administrative formalities in licensing requirements for foreign investments: the prerogatives and competitive advantages of the state-owned energy companies are also to be reduced. **Equally important are fiscal measures**: exemption from import tariffs on equipment needed for new investments during the first 7 years; also for 7 years, 50% reduction in all taxes linked to new investments and to foreign investors' incomes. A new free trade zone has been set up to attract processing industries, and other support measures are also foreseen. As a result, FDI inflows have started to grow again, along with GDP, which reached a growth rate of 2.5% in 2016.

To sum up, the Azerbaijani government wishes to overcome the challenges of lower energy prices through longer-term structural measures aimed at better conditions for FDI in priority sectors, principally the energy area. This sector also remains the basis of the country's future economic development, but with a changed mix of enterprises, giving a bigger role to foreign-owned companies.

Belarus

WTO accession

The country's WTO accession process started in 1993, but especially in the early period its progress was rather slow and there were long gaps between meetings. The major reason was the extremely **cautious approach by the top leadership toward any changes in the basic economic setup inherited from the Soviet period**. As a result, Belarus is still the only EAEU member without WTO membership.

In parallel with the worsening economic situation, a **decision was recently taken to speed up the WTO accession process**. Belarus has shown renewed activity during the past two years, submitting updated documents on all aspects of its economic situation and legislative framework. Now there are meetings every 6–8 months, with the last one taking place in September 2017. **The acceleration of the talks is supported by both the country's major economic partner, Russia, the Western countries, mainly the EU**. It is hoped that WTO membership will support the political and economic reforms needed to transform the country. Thus, the process is on several tracks: comprehensive meetings about the major systemic issues, like overall economic-trade policies, plurilateral meetings with agricultural exporters about the particular aspects of this sector (like agricultural subsidies), and bilateral talks about the market access commitments.

The basic question is whether the top leadership of Belarus is ready to agree to such in-depth systemic changes in the economic policies and structures of the country, in addition to the opening of markets to meet the WTO members' expectations. Belarus - supported by Russia - also **wishes to gain acceptance of its membership of the EAEU customs union, by aligning its commitments with those**

of Russia. In some critical areas, like the treatment of energy products, this will be probably possible, but it remains to be seen what compromise can be found for the broad range of issues not falling under EAEU competence, where the arguments about the customs union are weaker. Belarus originally hoped to complete the accession process during 2017, but this will clearly not happen before 2018 at the earliest.

Among other issues, the **energy sector remains a key aspect of the accession talks**. While the alignment of the border measures with those of Russia will probably not be challenged, there are **big questions about such systemic issues as the role of the state and of STEs in the sector and the beginning of meaningful reforms and privatization.** FDI has been practically absent in the energy sector so far, and it remains to be seen how this situation might change by the end of the accession process.

Belarus and the OECD

Belarus, like other Eurasian countries, is **covered by the OECD's Eurasian program**. This involves observer status, or even membership of some committees, occasional assessments by the Organization of the country's overall economic situation and specific sectors. There are also technical assistance programs related to various policies, including those linked to energy. Cooperation has become more intensive in the last few years. Belarus was the subject of a regional energy sector assessment prepared in 2015, while in 2016 a dedicated pilot study was prepared about its clean energy program. The closer cooperation, including with the two energy agencies linked to the OECD, is expected to continue in parallel with the country's accelerated WTO accession process.

Belarus' other international commitments

Belarus, although a net energy importer, has strong interests in the energy sector. It **thus remained a member of the Energy Charter Treaty,** even after the departure of its main ally, Russia. It has, however, no relations with the Energy Community Treaty.

In terms of preferential relationships, Belarus is a member of the EAEU and the CIS. As described earlier, there is limited coverage of energy-related subjects by these agreements and a lack of FDI-related ones.

Belarus' FDI-related policies in the energy sector

The main priority of Belarus' energy policy is to guarantee the reliable supply of energy. The country has very limited resources of its own; its economy is to a large extent based on importing oil and gas from Russia at low prices and transforming those into semi-finished products for exports. The imported energy is used to operate quite an energy-intensive manufacturing sector and to cover all other needs. Thus, the **strategy's goals include the reduction of energy import dependence and the improvement of the efficiency and financial stability of the energy sector**. According to the plans, the share of natural gas in the domestic energy supply has to be reduced to 50% by 2035 from the current 60%. The other priorities include diversification of the sources of energy, the development of renewable energy sources, and energy efficiency measures. The first goal is based on the planned increase in the use of nuclear energy, with a new nuclear power station becoming operational by 2020. The share of renewable sources should reach 9% by 2035.[141]

In 2016 the government issued the new **"Concept of Energy Security,"** which is currently the main basis of the energy policy of Belarus. The document confirms the earlier targets to decrease reliance on imported natural gas, while expanding trade and regional cooperation in other kinds of energy sources. It also includes the goals of diversifying the geographical sources of supply and increasing the volume of energy transit (this, of course, to a large extent depends on the development of energy relations between the EU and Russia). The document also stresses the need to introduce new technologies and reduce energy intensity. A further pillar of energy security is to increase the energy reserves through modernization and expansion of the oil storage system.

In 2016 the government also approved **the "Comprehensive Development Plan for the Electricity Sector up to 2025 and beyond."** This is based mainly on the integration of the planned nuclear power station into the energy system by implementing the necessary changes in the regulatory and technical framework. As mentioned, the new regulatory framework includes laws are intended to support the development of the renewable energy sources,[142] and the introduction of energy efficiency measures.[143]

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[141] OECD / IEA (2016). Partner country series: Clean Energy Technology Assessment Methodology Pilot Study. Belarus.

[142] Law of the Republic of Belarus on Renewable Energy Sources (2010), Strategy of Energy Potential Development of the Republic of Belarus (2010) and Programme of the Development of Domestic, Renewable and Non-Conventional Energy Sources for 2011-2015

[143] Directive of the President of the Republic of Belarus: "Saving and Thrift are the Main Factors of Economic Security of the State" (2007) and Strategy of Energy Potential Development of the Republic of Belarus (2010)

PART V

Conclusions and Short-Term Recommendations for FDI Policies

Investment flows between the EU and Russia and other Eurasian countries used to be among the most important areas of East–West economic relations. In recent years, however, along with the fall in the trade of goods and services, there has been a steep decline in mutual FDI flows. In the energy-producing Eurasian countries this has been caused partly by their weakened economic situation resulting from the collapse of oil prices in 2014 and the associated drop in export incomes. However, in the largest country of the region, Russia, other special factors, starting with the geopolitical tensions around Ukraine, have also played a very significant role. The introduction of mutual sanctions between the USA, EU, and Russia in 2014 has been a deterrent to foreign investment which, in spite of an uptick in 2016, is still much lower than the levels being achieved at the start of the decade.

Additionally, Russia's increasingly inward-looking economic-trade policies, focused on protecting the domestic market, have also greatly contributed to European investors losing interest. Foreign investments, while mutually beneficial for both the investor and the recipient countries, are long-term commitments, and thus extremely sensitive to political, regulatory, and economic policy factors. Unless there is a major change in these conditions, no long-term increase in the EU–Russia investment flows can be expected. Qualitative changes are necessary in the institutional and regulatory framework to avoid, as a minimum, the continued outflow of existing FDI, the drop in stocks, and the creation of conditions for inflows to gradually grow. The downward trends, although less dramatic, have also been apparent in Ukraine, Kazakhstan, and other Eurasian countries. In Ukraine the negative effects of the political-military tensions have been coupled with an uneven implementation of reforms and of systemic transformation measures, a not sufficiently investor-friendly environment, etc.

How disappointing the FDI results of the Eurasian countries are is even clearer in comparison with the performance of the new Central-Eastern European members of the EU. In spite of starting in the early 1990s from a situation broadly similar to that of the Eurasian countries, these have attained several times more FDI both in absolute and per capita terms. The positive effects of foreign investment on modernization and restructuring are clearly visible, for example, in their export structures.

For FDI there are no comprehensive international disciplines: the rules of the WTO and the OECD instruments cover this area only to a limited extent. 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 the EAEU members there are no such agreements in force, only the Deep and Comprehensive FTAs (DCFTAs) concluded between the EU and the Eastern Partnership (EaP) countries, like Ukraine, cover FDI. While in the EU member states the strong rules of the internal market also protect foreign-owned companies (equal treatment), in the EAEU countries. foreign investment terms are mainly regulated by national investment policies. These conditions, for the political and economic policy reasons mentioned, are currently rather negative in most EAEU member states. This is also shown by the analyses and rankings of international organizations, and by the conclusions of several respected research institutes. In Russia's case the fulfilment of the existing but limited WTO commitments is a source of recurring tensions with the EU, and has led to several dispute procedures. The outcomes of the completed WTO cases have justified the EU's concerns. Only a qualitative change in the underlying political, regulatory, and other economic policy factors would bring about a positive turn of events. The shortcomings of the FDI investment climate in many Eurasian countries are the main deterrent to foreign investors, even if some of the established companies might support the restrictions applied to competing imports. This has been confirmed by the views of companies which are active in the region, and can be seen from replies to the targeted questionnaires.

Energy supplies are the most significant part of the EU–Eurasia economic relationship. The supply of energy is strategically important for both the exporting and importing countries, and this is the sector where the investment flows are the highest, not just from West to East, but 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 the energy sector. The sector is, beyond the generally applicable international FDI disciplines, subject to several specific arrangements, including the European Charter Treaty (ECT), the Energy Community Treaty, and some instruments of the OECD. However, the impacts of these rules have been much blurred in recent times. While most Eurasian countries are parties to the ECT, Russia a few years ago renounced it, and has never joined the Energy Community Treaty (which covers the EaP countries). With the lack of preferential arrangements between the EU and the EAEU states, there are no ways of counteracting the negative trends of FDI. With the energy sector being such a strategic area, foreign investments are hampered also by the politically motivated restrictions not just in the intra-regional context, but also the Eurasian region itself.

To sum up, the present state of affairs is a lose–lose situation in the area of FDI. No country can escape its negative impacts, and there is little hope of a quick improvement. This study focuses on the economic aspects; the political problems are treated as externalities to be resolved by the competent actors. However, poor political relations also directly affect the economic environment in the countries concerned, the confidence of investors and – ultimately - the economic situation and prospects in Eurasia. It would be in the interests of all countries of the broader region to reverse these negative trends and to start restoring the conditions for mutually beneficial investment flows.

Recommendations

Based on the detailed examination of the various factors influencing FDI flows, it is evident that political, regulatory, and economic policy factors are particularly important for the type of long-term commitment inherent in FDI. However, considering the current political tensions, most experts do not expect fundamental changes in East–West relations in the near future. Thus, only some short-term measures with limited effect can be recommended:

- Strict adherence to the already accepted international commitments and regulations concerning the protection of the existing foreign investments and respecting those for new investors. 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. This would at least allow further worsening of an already difficult situation to be avoided.
- Streamlining and simplifying the administrative procedures and technical barriers linked to the admission and protection of foreign investors and investments. The actual FDI policies and practical measures in most Eurasian countries diverge greatly from their multilateral and international commitments. Thus, foreign investors often complain about unreasonable

administrative barriers, corruption, burdensome technical regulations and other regulatory obstacles when entering, or functioning, in these markets. Such practices include different administrative requirements, certification obligations, and excessively restrictive standards, lacking reasonable scientific grounds, and also contradictory and frequently changing foreign investment regulations, notification requirements, inconsistent tax and customs administration practices, etc.

There are a number of specific areas where action is needed. First, some countries, including Russia, should simplify the procedures associated with enforcing contracts. Second, countries must substantially improve the way they deal with construction permits (Ukraine and Azerbaijan), borrowing (Azerbaijan, Belarus, Kazakhstan), paying taxes (Belarus), trading across borders (Kazakhstan, Ukraine, and Russia), resolving insolvency (Ukraine) and obtaining electricity (Ukraine). Third, the government of Kazakhstan should reconsider its migration policy and restrictions on the employment of key foreign personnel. To employ foreign workers, the employers must obtain permits to use a quota limited to 60,000 people. There are also more general proposals for most, it not all Eurasian countries. It is recommended to get rid of the overlapping control functions and procedures of the various supervisory bodies, initiated both by legislation and enforcement practices. It is also proposed that the public authorities responsible for the practical application of new legal acts provide official explanations and clarifications about such acts, and also about those in an advanced preparatory stage. The best international practices should be applied in order to achieve real progress in these areas.

- **Avoiding the frequent overreach and corrupt practices on the part of state authorities**. Corruption at different levels, contradictory foreign investment regulations, prohibitions or limitations of foreign investment in a discriminatory manner are recurring complaints by investors. This is underpinned by an alarming recent trend in strengthened import substitution and localization policies (primarily implemented by state owned/controlled enterprises and especially characterizing government procurement activities. To create a reasonable role for FDI, the predominant role and monopolistic behavior of many SOEs or domestic oligarchs should thus be curbed by appropriate regulatory and anti-monopoly measures.
- Linked to the above, **ensuring a gradual opening of government procurement to foreign-owned companies**. The lack of transparency and the application of different discriminatory measures in government procurement have been highlighted by foreign companies as one of the major problems encountered. Russia's and Kazakhstan's accessions to the GPA is eagerly awaited by these companies to improve the present situation.
- **Providing more transparency regarding investments and investors**; the majority of East–West FDI transactions are conducted via tax havens and shell companies which hide the real owners/beneficiaries. This leads, at a minimum, to loss of government revenues in both the investing and recipient countries, to a general lack of transparency, and often to criminal practices. It would thus be useful to intensify both the internal enforcement and international cooperation (in particular with the OECD and the EU). Internally, this pattern can only change with marked improvements in the regulatory environment and investment climate. FDI inflows should be promoted by proactive government policies (and in large countries, such as Kazakhstan, Russia, or Ukraine, also at the regional level) that focus mainly on attracting FDI into the manufacturing and business services, thereby supporting modernization and economic restructuring. At the

international level, adherence to the bodies and tools globally addressing these issues would be of the highest importance (like the OECD Multilateral Convention on Tax Treaty Related Measures to prevent base erosion and profit shifting (BEPS).

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ANNEX I: Methodological Issues

Nowadays there is a single methodological framework which is largely used by the EU countries and the Eurasian economies to define and account for FDI in national accounts. Thus, the Central Banks of EU and Eurasian countries have introduced the requirements, provided by the IMF Balance of Payment and International Investment Position Manual (BPM6).[144] It complies with general economic concepts set out by the System of National Accounts, 2008 (SNA, 2008)[145] and with the OECD Benchmark Definition of Foreign Direct Investment (BMD4).[146]

According to the IMF and OECD definitions, foreign direct investment (FDI) reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise). The lasting interest is associated with a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter. The degree of influence is measured by direct investor's ownership of 10% or more of a company's capital.

The BPM6 stipulates the assets/liabilities presentation, as well as the directional principle for FDI data presentation. The assets/liabilities presentation of FDI is used for balance of payments and for the international investment position (IIP). The directional principle, which is organized according to the direction of the FDI relationship (inward, FDI in the reporting economy, and outward, FDI abroad), is the principle used in the Coordinated Direct Investment Survey (CDIS),[147] which enforces national FDI statistics submission. For current research purposes of the present study the directional principle under BPM6 is used for FDI analysis.

The directional principle is a core rule for FDI analysis according to OECD. This rule is attributed to outward direct investments of the reporting country abroad and inward direct investments of non-residents in the reporting country. The main international institutions publishing data on FDI (Eurostat, OECD, UNCTAD) follow the directional principle as well. This principle is applied also in the wiiw FDI database which is used in the present study.[148]

OECD methodological particularities

Most of the EU countries comply with OECD standards on FDI statistics, reflected in the Benchmark Definition of Foreign Direct Investment (BMD4), which sets the world standard for FDI statistics. It is fully compatible with the BPM6. Underlying concepts and definitions that apply to cross-border investments are fully in line with those set by the BPM6. These standards introduce new reporting techniques for financial measures of direct investment taking into account the impact of globalization and changing financing models of multinational enterprises (MNE). It devotes, for the first time, a chapter to the economic activities of MNEs and a chapter on the uses of FDI statistics.

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[144] IMF Balance of Payment and International Investment Position Manual (BMP6).
URL: http://www.imf.org/external/pubs/ft/bop/2007/pdf/bpm6.pdf

[145] System of National Accounts by the Commission of the European Communities, International Monetary Fund, Organisation for Economic Co-operation and Development, United Nations, and World Bank.

[146] Benchmark Definition of Foreign Direct Investment.
URL: http://www.oecd.org/daf/inv/investmentstatisticsandanalysis/40193734.pdf

[147] Coordinated Direct Investment Survey (CDIS).
URL: https://www.imf.org/external/pubs/ft/bop/2015/pdf/15-10.pdf .

[148] https://data.wiiw.ac.at/foreign-direct-investment.html.

The main advantage of the OECD FDI statistics is the disaggregation of FDI data on special purpose entities (SPEs) and resident operating companies, introduced by the BMD4. This allows identification of the FDI associated mainly with the physical presence of the resident operating companies and excluding SPEs. The idea is that the SPEs (i.e. entities owned by foreigners without economic activity, most of whose assets consist of foreign equity holdings) may often distort FDI statistics. First, transactions by SPEs inflate the FDI flows into and out of the country where they are located. Second, SPEs can distort the geographic distribution of FDI statistics for countries because it can appear that they are receiving investment from countries whose investors are just passing capital through SPEs.[149]

However, in case of the current analysis only some EU-member states publish FDI flow and stock data excluding SPEs. The Eurasian countries do not disaggregate the FDI data separating SPEs. However, using the EU countries' national FDI data deterged from funds associated with SPEs illustrates that most of the mutual FDI flows from Russia on the one side and France, Germany, and Italy on the other are associated with the physical presence of the resident operating companies. The same tendency was observed for Ukraine, Azerbaijan, and Kazakhstan with Germany and France as investment partners. The differences between FDI data according to assets/liabilities and directional principle, respectively, is particularly high for Russia.

Exchange rate issues

Given that the national FDI statistics of the Central Banks of Eurasian countries is provided in US dollars, for consistency reasons with the EU data it should be converted into EUR. According to the IMF, the market price should be used as the basis for the valuation of FDI flows and stocks, although this means different approaches for both types of data. For flows, market price refers to the actual price agreed upon by the partners on the date of the transaction and should not reflect changes induced by fluctuations in exchange rates. For this reason, the period EUR/USD average exchange rate is used. For stocks, the IMF recommends using the market price at the time of the compilation of the stocks. Thus, the end of period EUR/USD exchange rate is used.

Services

FDI flows are often associated with services. Transactions in services can often take place between the companies in a direct investment relationship. Many of them do not necessarily involve cash payments and merely give rise to entries in intercompany accounts. If the production does not involve physical presence, such as in some cases of banking, insurance, or other financial services, the operations should be recognized as being in the territory by virtue of the registration or legal domicile of those operations in that territory.[150]

The national authorities may report updated/revised data, which could miss non-transaction changes arising from, for example, exchange rate and price changes. This refers primarily to stock data on FDI. The FDI data of the EU national central banks published in EUR generally correlates the data of Eurasian countries, published in USD with an exchange rate correction. The data observation starts with 2002

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[149] The OECD gives an extensive explanation of the meaning of the SPEs. Examples of SPEs include brass plate companies, financing subsidiaries, conduits, holding companies, shelf companies, and shell companies. URL: https://www.oecd.org/daf/inv/How-MNEs-channel-investments.pdf

[150] Services. IMF Balance of Payment and International Investment Position Manual (BPM6). URL: https://www.imf.org/external/pubs/ft/bop/2014/pdf/BPM6_12F.pdf

when the EUR was introduced. This would help to decrease the errors associated with exchange rate calculations.

The interpretation of FDI flow data by the standard location factors has become increasingly difficult due to the widespread use of special investment vehicles and other reporting peculiarities (see below examples of Russia and Hungary). Especially for the EU-CEE, it seems unrealistic to explain fluctuations in FDI inflows by changes in economic or regulatory conditions, which in fact are rather slow. Capital relations between subsidiaries and parent companies have become more complex: capital reserves, losses, and profits are shifted around within multinational conglomerates in various forms of FDI and income. Further methodological problems arise if FDI includes capital transactions other than real investments.

Balance of Payments and International Investment Position Manual Edition 6 (BPM6)

Unless otherwise stated, FDI data used in this report are based on BPM6 definition:
https://www.imf.org/external/pubs/ft/bop/2007/bopman6.htm

BPM6 updates the fifth edition of the Balance of Payments Manual (BPM5). Also the corresponding OECD Benchmark Definition of Foreign Direct Investment, 4th edition 2008 replaces the 3rd edition. In BPM6, direct investment is presented on an **assets and liability** (A/L) basis, instead of on the directional principle (DP) used in BPM5. This increases both the net acquisition of financial assets and the net incurrence of liabilities. Netting out assets and liabilities results in the same amount as netting inflows and outflows in the (new) directional principle (FDI net is the same). The **directional principle** under BPM6 is used for FDI analysis and is provided in the **wiiw FDI Database** used for this report.

In the **standard components**, direct investment is classified according to the relationship between the investor and the entity receiving the investment as equity, reinvested earnings and debt instruments. The wiiw FDI Database and this report provide these data for the countries covered.

BPM6 prescribes market prices for the valuation of international accounts. However, market prices are not readily available for many assets/liabilities including for unlisted and other equity. For EU Member States the application of the 'Own Funds at Book Value' derived from the **balance sheet of the direct investment** enterprise is recommended by Eurostat in case a market price (listing on a stock exchange) is not available. The wiiw FDI Database complies with Eurostat standards.

Changes in FDI stocks (positions) other than those due to transactions (flows), occur due to exchange rate movements, as well as other price changes resulting from holding gains or losses and other changes e.g. reclassifications from portfolio investment to direct investment.

Directional principle – the main presentation form to support FDI analysis

based on https://www.oenb.at/en/Statistics/Reporting/New-Balance-of-Payments-Manual-in-2014.html

The **directional principle**, in which outward direct investments of the reporting country abroad and inward direct investments of non-residents in the reporting country are recorded on a net basis, serves for more detailed analyses by the main international institutions publishing data on FDI (Eurostat, OECD, UNCTAD). In the new "extended" directional principle, debt instruments (loans) between fellow enterprises are treated according to the location of the headquarters (residents vs. non-residents). Net basis means gross investment minus disinvestment; as a consequence, both FDI inflows and outflows can take a **negative** sign.

The main difference between the two presentational styles (A/L and DP) stems from the treatment of **"reverse investments,"**, i.e., receivables of a foreign subsidiary vis-à-vis the parent (in the reporting country). According to the assets/liabilities concept, these receivables are added to the payables of the reporting country (FDI outflow), whereas according to the directional principle, they are subtracted from active direct investments (reducing the FDI inflow). In case reverse investments are higher than the assets/liabilities, negative FDI flow and stock figures may appear.

All data available in the wiiw FDI Database **exclude** Special Purpose Entities (SPEs).

ANNEX II: The European Union FDI Statistics Data

Table 1. European Union FDI flows and stocks (2005 – 2015)

Year	Region	Partner label	IN_FLOWS mill. euro	IN_STOCKS mill. euro	OUT_FLOWS mill. euro	OUT_STOCKS mill. euro
2005	EU (27 countries)	Extra EU-27	129 714	1 835 136	239 880	2 426 226
2006	EU (27 countries)	Extra EU-27	231 184	2 022 675	317 685	2 746 002
2007	EU (27 countries)	Extra EU-27	432 106	2 415 408	564 225	3 201 173
2008	EU (27 countries)	Extra EU-27	182 128	2 495 960	381 229	3 321 998
2009	EU (27 countries)	Extra EU-27	274 434	2 738 383	331 872	3 751 071
2010	EU (27 countries)	Extra EU-27	222 635	3 144 668	302 774	4 236 979
2011	EU (27 countries)	Extra EU-27	424 696	3 719 450	473 113	4 901 237
2012	EU (27 countries)	Extra EU-27	309 559	3 905 009	316 619	5 129 992
2013	EU (28 countries)	Extra EU-28	506 799	4 130 346	546 778	5 456 192
2014	EU (28 countries)	Extra EU-28	98 750	4 758 479	58 287	6 000 194
2015	EU (28 countries)	Extra EU-28	466 517	5 744 913	537 162	6 891 625

Source: Eurostat (bop_fdi_main (<-2012); bop_fdi6_geo (2013->)) Break in series in 2008 and 2013.
Data until 2012 calculated according to BPM5, data from 2013 calculated according to BPM6.

Table 2. European Union FDI flows by destinations (2013-2015)

	Outward FDI flows				Inward FDI flows			
	Value (billion EUR)			Share (%)	Value (billion EUR)			Share (%)
	2013	2014	2015	2015	2013	2014	2015	2015
Europe (non-EU, including EFTA), of which	58.1	-39.7	46.4	95.1	-2.8	42.7	109.5	139.8
Norway	8.3	6.6	7.0	14.4	1.0	3.4	1.7	2.2
Switzerland	20.1	-33.0	48.8	100.0	18.3	26.9	78.3	100.0
Russia	6.4	1.6	2.1	4.3	7.3	10.4	4.5	5.7
Turkey	2.6	4.0	10.7	21.8	2.8	1.3	-0.8	-1.0
Ukraine	0.0	-1.9	0.0	0.1	0.6	0.4	-2.7	-3.4
Africa, of which	17.6	11.6	30.9	63.3	2.9	1.1	-0.6	-0.7
Egypt	3.4	1.6	-2.6	-5.4	0.4	0.1	-0.3	-0.4
South Africa	1.2	3.5	24.5	50.2	-0.6	0.9	0.8	1.0
North America, of which	288.6	-63.5	304.8	624.2	369.0	-12.4	276.7	353.2
Canada	14.2	19.8	-18.7	-38.3	16.2	12.4	24.2	30.9
United States	274.4	-83.3	323.5	662.6	352.8	-24.8	252.4	322.3
Central America, of which	66.3	35.0	74.0	151.6	57.0	23.9	62.3	79.5
Mexico	21.5	24.6	18.3	37.5	2.6	5.3	2.7	3.4
South America, of which	52.8	48.3	43.2	88.4	10.5	-0.8	-2.6	-3.3
Argentina	6.0	1.9	5.0	10.3	0.2	0.4	-0.1	-0.1
Brazil	45.0	32.8	28.9	59.3	10.0	-2.0	-2.1	-2.7
Asia, of which	49.6	55.9	37.3	76.4	54.2	29.5	29.2	37.3
Arabian Gulf Countries	2.5	7.7	-4.5	-9.2	6.0	-2.7	9.7	12.4
China (excl. Hong Kong)	20.9	8.8	6.0	12.3	6.6	7.9	6.3	8.0
Hong Kong	15.8	4.7	2.0	4.1	7.8	2.6	-15.7	-20.1
India	4.7	4.8	6.2	12.7	0.0	1.7	1.1	1.4
Japan	8.2	-0.6	10.9	22.3	9.7	10.6	6.1	7.8
Singapore	2.7	8.5	27.8	57.0	11.7	-4.5	14.2	18.1
South Korea	0.8	5.5	-4.5	-9.3	1.3	4.5	2.2	2.8
Oceania and southern polar regions, of which	12.5	10.3	-6.3	-12.8	5.8	4.3	-2.4	-3.0
Australia	11.9	9.3	-8.5	-17.4	4.6	3.1	-1.1	-1.4
Offshore financial centres	85.9	7.2	64.2	131.4	42.5	17.5	83.0	105.9

Source: Eurostat

Note: 2013–2015, based on international standards BPM6 and BD4. The sum of data by continent does not always equal the extra-EU total because of non-allocated flows.

Table 3. European Union FDI outward stocks (end 2015)

	Billion EUR	(%)
Other Europe (non-EU-28)	1,350.6	19.6
Northern Africa	80.9	1.2
Central and South Africa	212.8	3.1
Near and Middle East	98.7	1.4
Asian countries	795.0	11.5
Oceania and Southern Polar regions	141.4	2.1
North America	2,809.2	40.8
Central America	805.2	11.7
South America	490.2	7.1

Source: Eurostat (online data code: bop_fdi6_pos).

Note: The sum of the value of outward stocks by continent does not equal the extra-EU total because of non-allocated stocks.

Table 4. Top 10 countries as extra EU-28 partners for FDI stocks (end 2013–2015)

	Outward				**Inward**			
	Value (billion EUR)			Share (%)	Value (billion EUR)			Share (%)
	2013	2014	2015	2015	2013	2014	2015	2015
United States	1,835.6	2,059,4	2,559.8	37.1	1,676.0	1,784.9	2,380.9	41.4
Switzerland	676.8	691.8	821.8	11.9	491.5	501.6	619.3	10.8
Bermuda	276.2	304.5	362.6	5.3	310.8	426.8	495.0	8.6
Brazil	276.8	331.6	329.9	4.8	101.1	116.6	127.6	2.2
Canada	227.5	273.5	248.8	3.6	131.4	199.4	219.2	3.8
China	126.0	143.2	167.9	2.4	36.0	23.5	34.9	0.6
Russia	192.1	162.7	162.2	2.4	52.6	56.4	61.0	1.1
Mexico	111.8	135.1	161.6	2.3	25.3	31.1	36.5	0.6
Singapore	98.5	116.4	153.2	2.2	36.8	52.7	57.0	1.0
Hong Kong	112.6	127.6	119.2	1.7	57.5	89.8	79.0	1.4

Source: Eurostat (online data codes: bop_fdi_main and bop_fdi6_pos).

Based on international standards BPM6 and BD4.

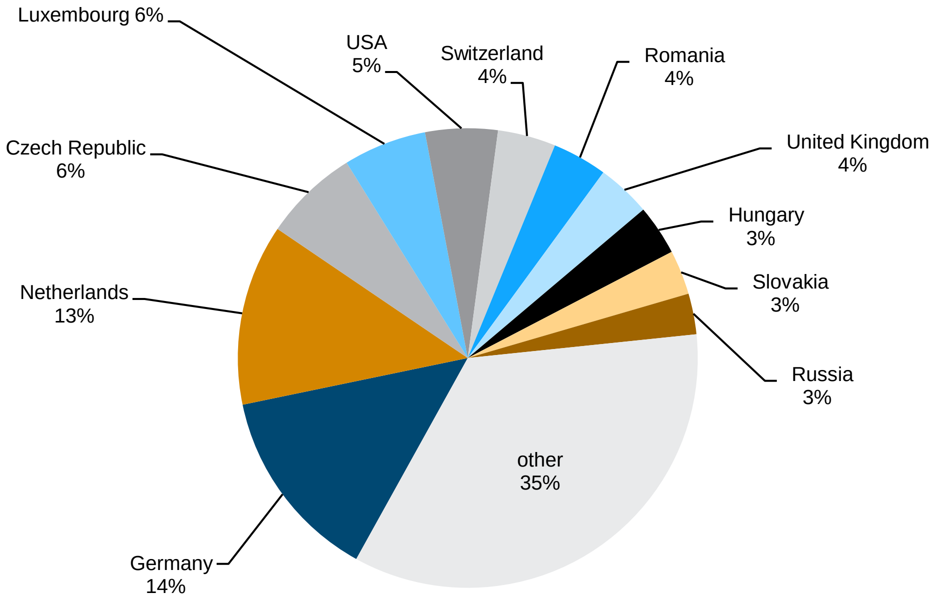
Table 5. European Union FDI stocks by economic activity (end 2014)

	Outward	Inward
Total	6,000.2	4,758.5
Agriculture, hunting, and fishing	4.2	2.5
Mining and quarrying	635.1	44.0
Manufacturing	1,615.6	451.7
Food products, beverages, and tobacco products	276.6	107.1
Textiles and wood activities	45.4	12.0
Petroleum, chemical, pharmaceutical products	595.9	176.6
Metal and machinery products	415.0	73.4
Vehicles and other transport equipment	130.7	46.0
Electricity, gas, steam, and air conditioning	71.3	14.7
Water supply; sewerage, waste management	4.3	2.3
Construction	50.7	15.2
Services	3,519.1	4,155.6
Trade; repairs of motor vehicles and motorcyles	245.3	184.8
Transportation and storage	66.9	30.0
Accommodation and food service activities	40.1	11.6
Information and communication	283.3	83.3
Financial and insurance activities	2,301.6	3,490.0
Real estate activities	42.7	66.5
Professional, scientific, and technical activities	413.9	212.2
Other services (NACE Rev. 2 Sections N to U)	125.2	77.2
Other, including activities not allocated	99.9	72.4

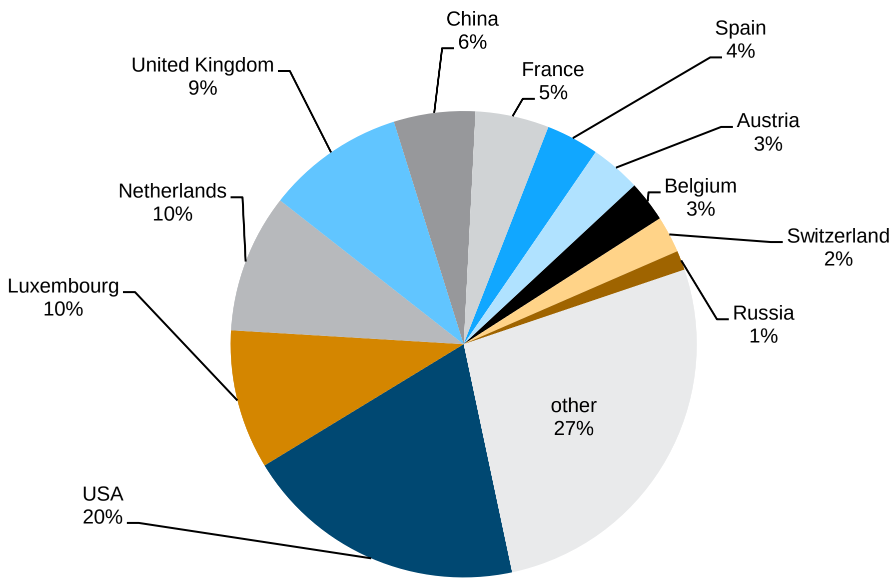
Source: Eurostat (online data code: bop_fdi6_pos)

Figure 1. EU Member States' FDI outward stock by partners, Top 10 destinations, as of end-2016)

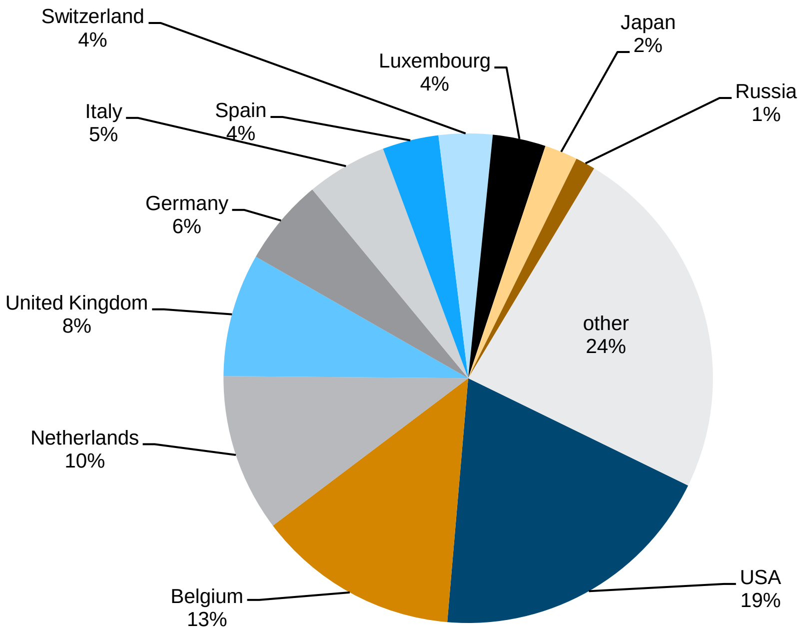
Austria (EUR 190 billion)



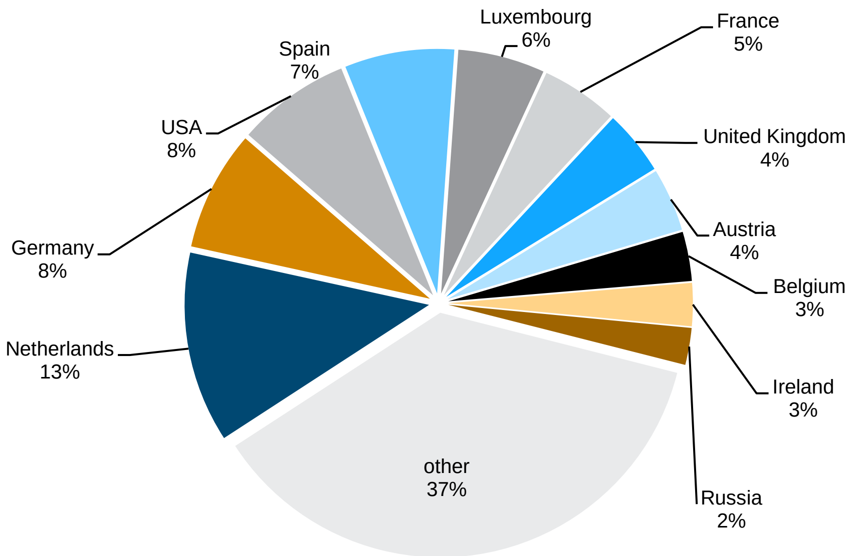
Germany (EUR 1267 billion)



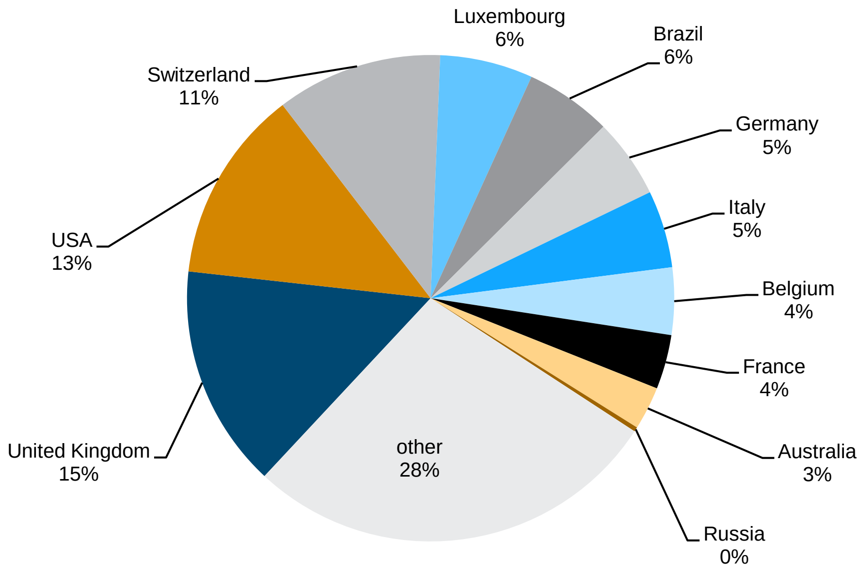
France (EUR 1195 billion)



Italy (EUR 448 billion)



Netherlands (EUR 1322 billion)

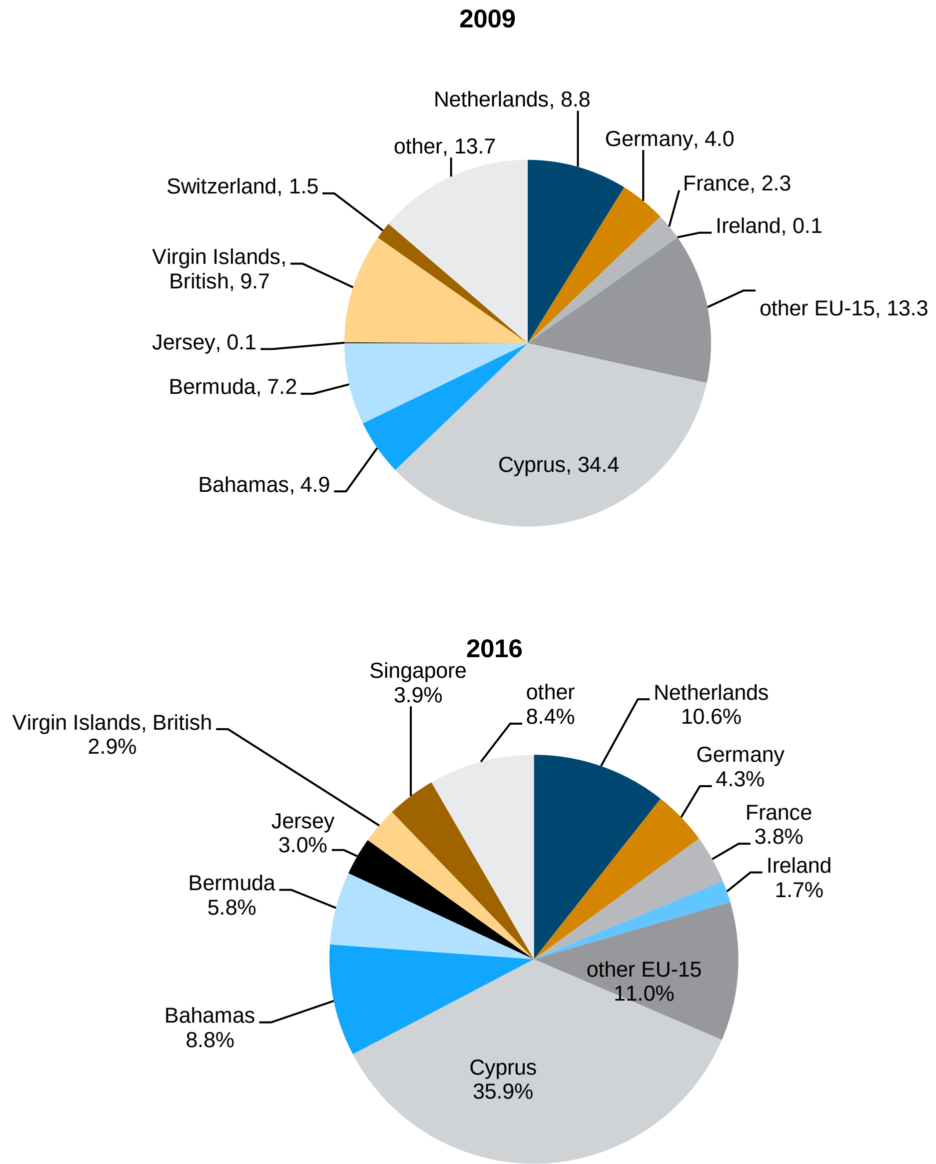


Remarks: China excluding Hong Kong; data for Netherlands excluding SPEs.

Source: Eurostat, National Bank of Austria, wiiw calculations.

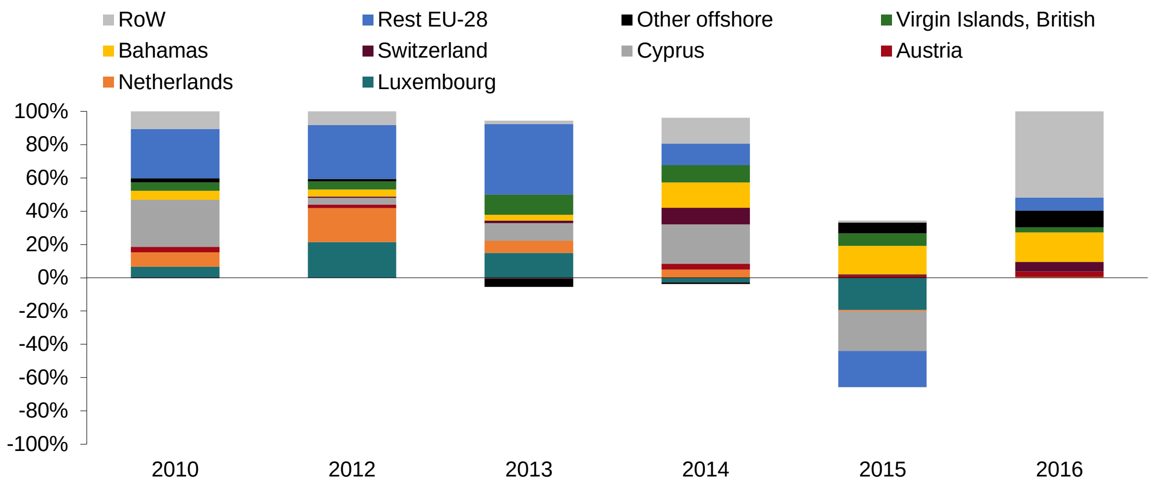
Annex III: FDI in Eurasian Economic Union (EAEU)

Figure 1. Russian FDI inward stock by key partners (%), Top 10 (ranking 2016)



Source: wiiw FDI Database.

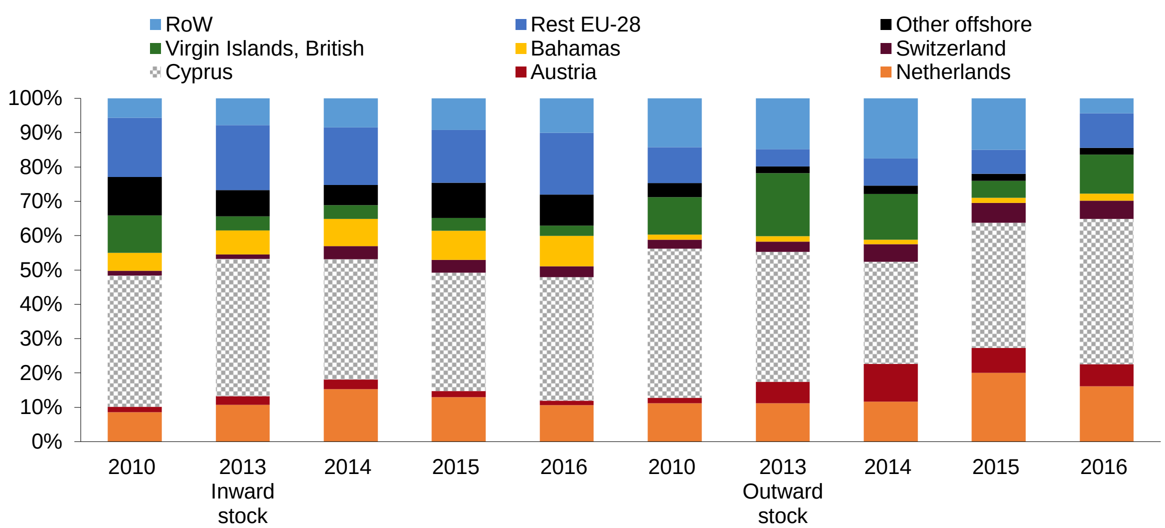
Figure 2. Russia: FDI Inflows by countries, in % of total inflows



*) 2016: RoW - mainly inflows from Singapore (related to the above mentioned Rosneft deal) which accounted for 50% of the inflow. Inflows from Cyprus were negative.

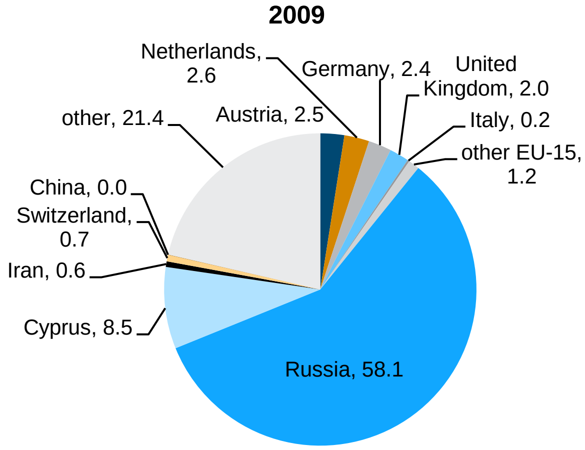
Source: wiiw FDI database.

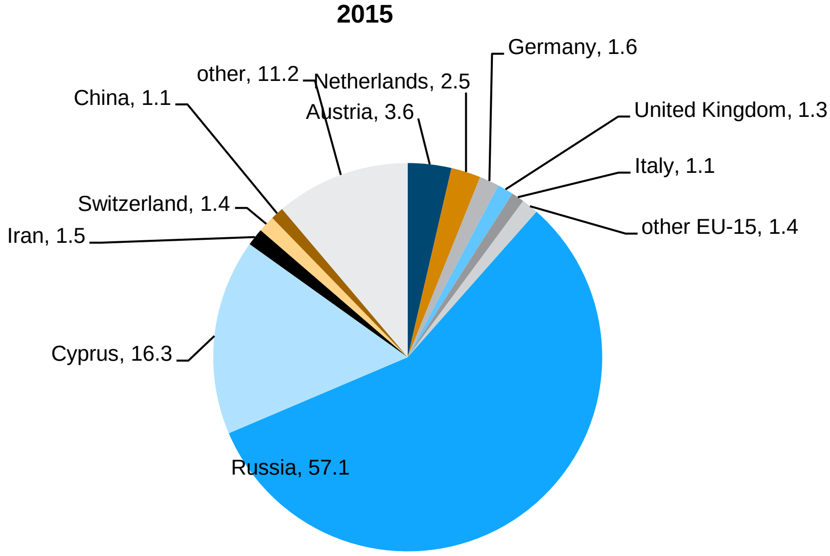
Figure 3. Russia: FDI inward and outward stock, in % of total



Source: wiiw FDI Database.

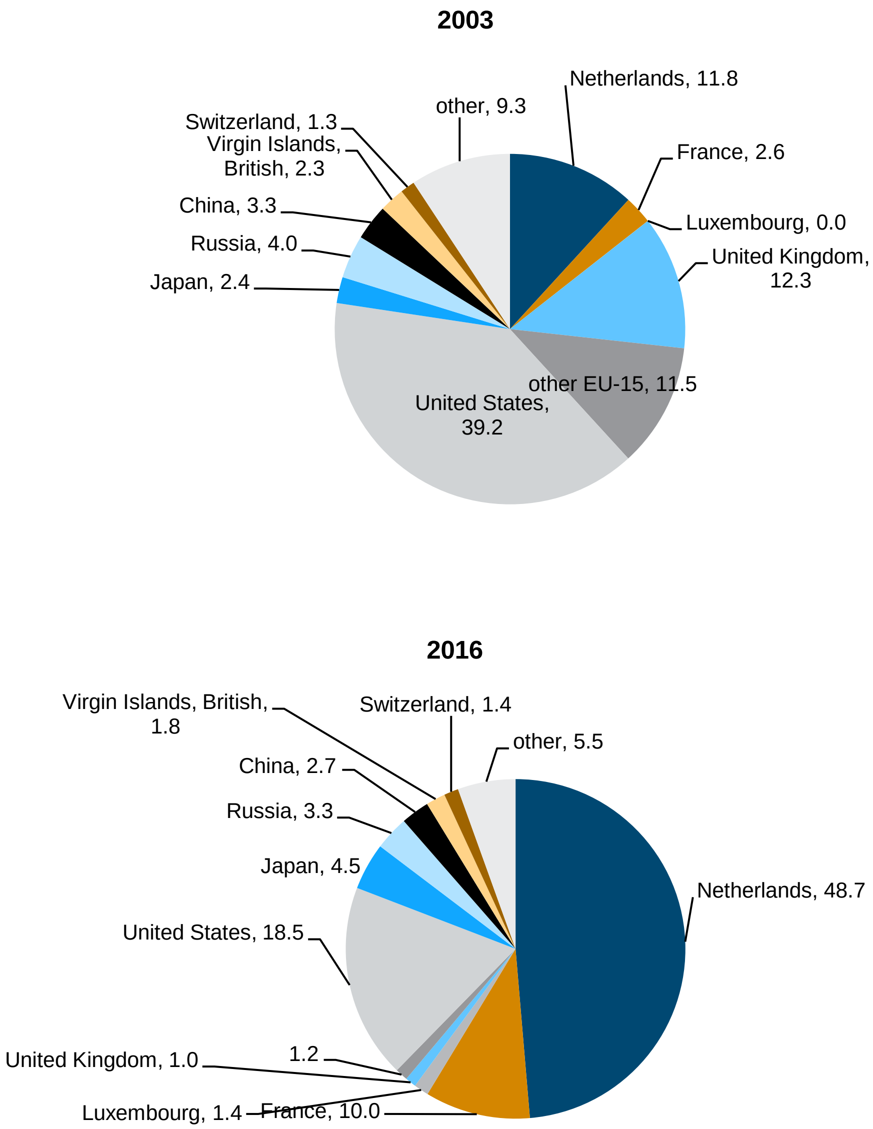
Figure 4. Belarus' FDI inward stock by key partners (%), Top 10 (ranking 2015)





Source: wiiw FDI Database.

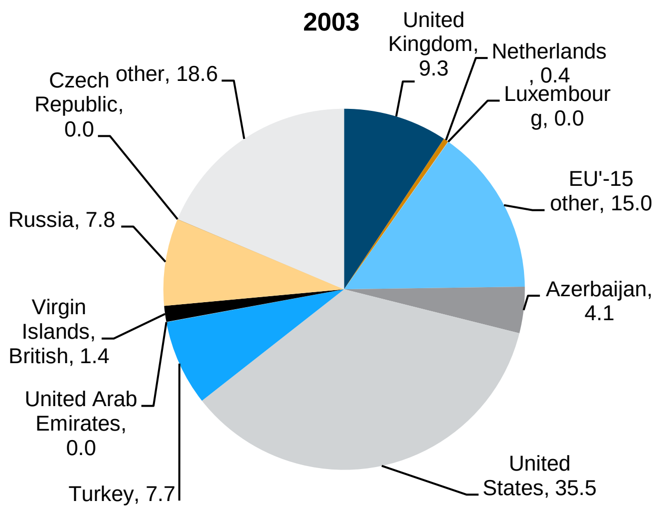
Figure 5. Kazakhstan FDI inward stock by key partners (%), Top 10 (ranking 2016)

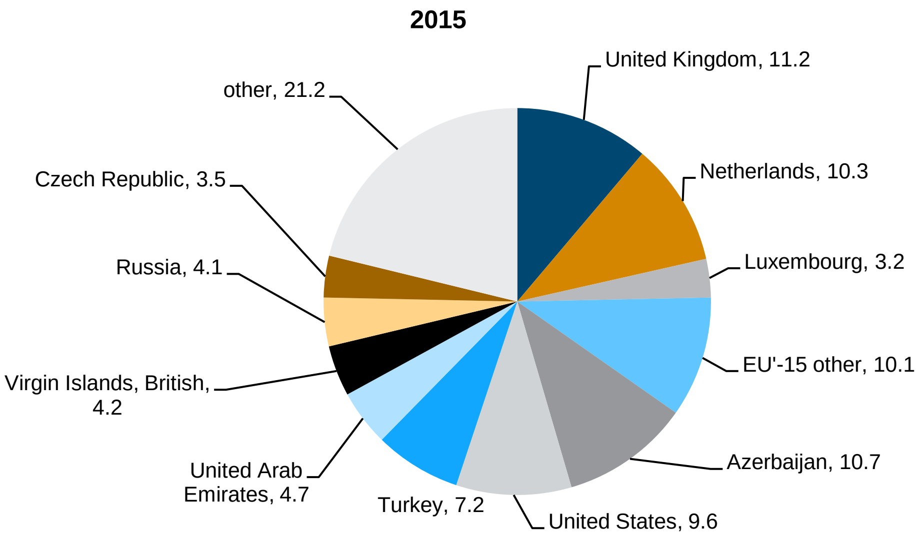


Source: wiiw FDI Database.

ANNEX IV: FDI in DCFTA Countries (Georgia, Moldova, Ukraine)

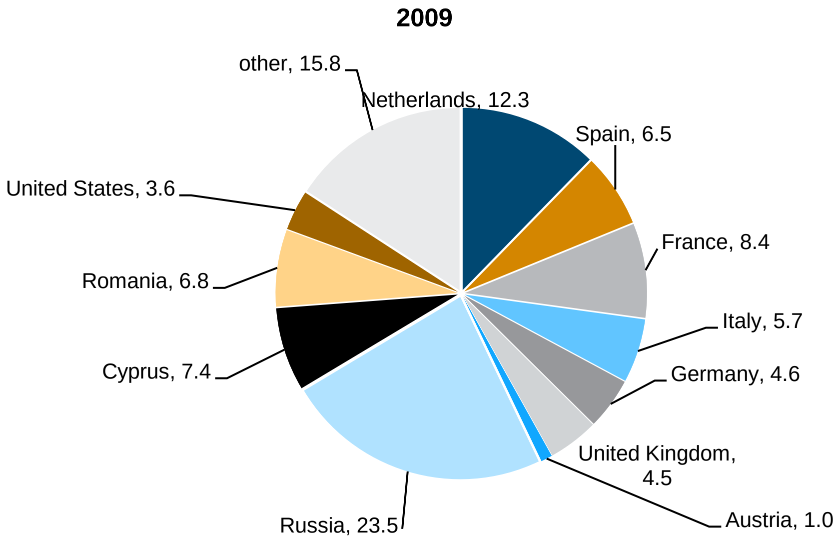
Figure 1. Georgia FDI inward stock by key partners (%), Top 10 (ranking 2015)

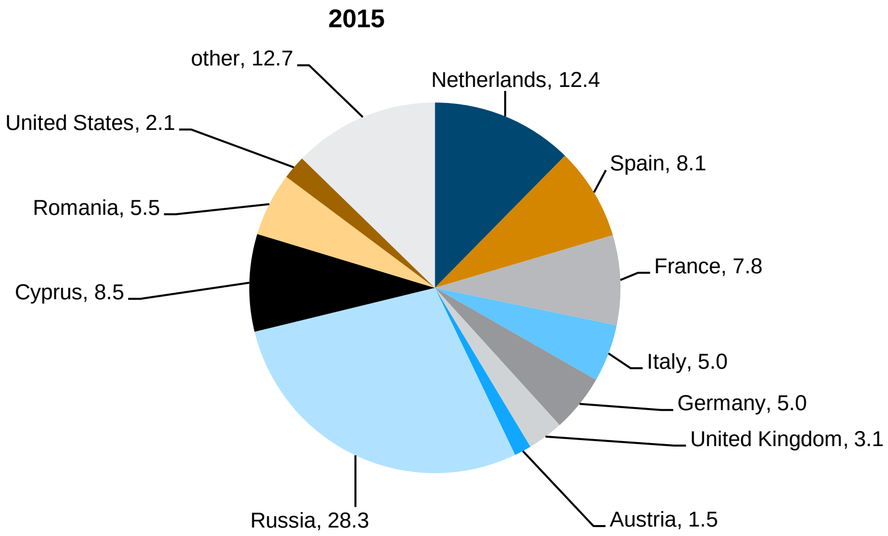




Source: wiiw FDI Database and GeoStat (estimated from cumulated FDI inflows).

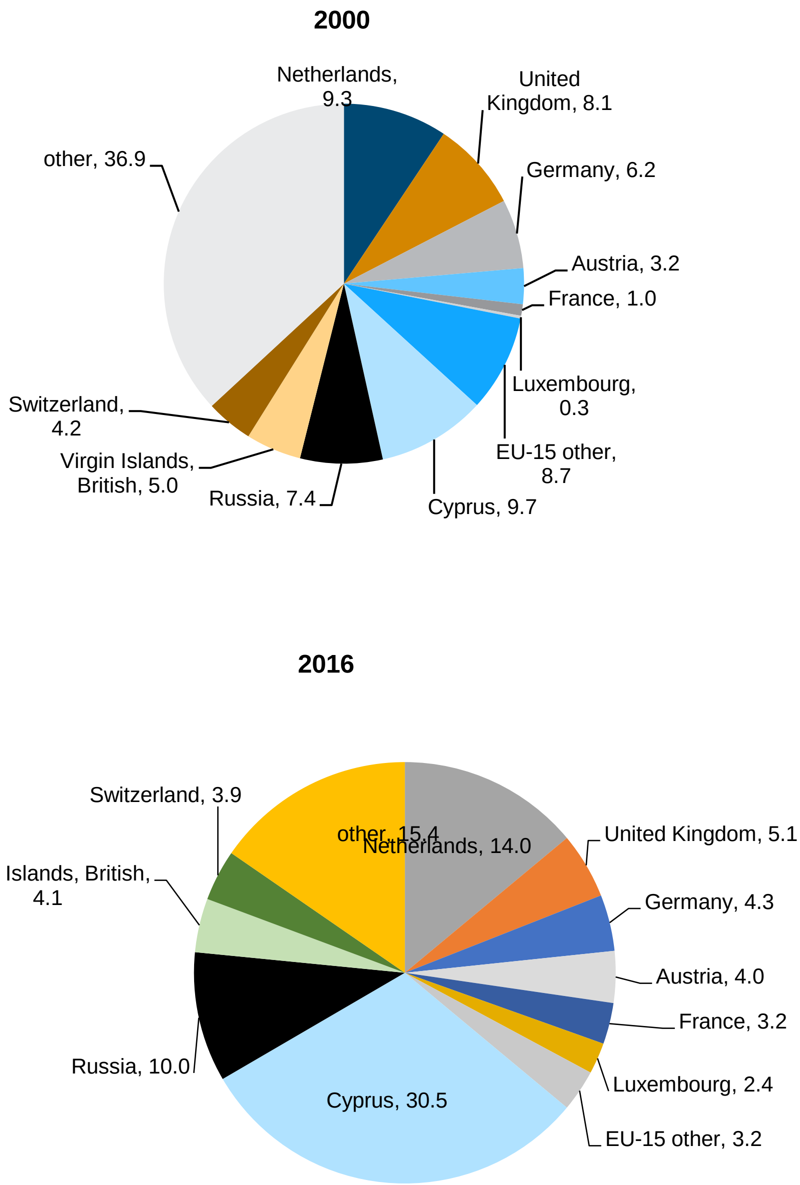
Figure 2. Moldova FDI inward stock by key partners (%), Top 10 (ranking 2015)





Source: wiiw FDI Database.

Figure 3. Ukraine FDI inward stock by key partners (%), Top 10 (ranking 2016)



Source: wiiw FDI Database.

ANNEX V: FDI Overview in Selected EU, EAEU, DCFTA Countries

Table 1. Overview of Foreign Direct Investment (FDI) in 2016

	Inflow	Inflow	FDI net		Inward	Inflow	Inward
	EUR mn	growth	EUR mn	Inflow	stock	as % of	stock as
	2016	p.a. in %		per capita, EUR		GFCF	% of GDP
Bulgaria	702	-72.3	530	98	5,632	7.8	84.5
Croatia	1,577	547.5	1,959	378	6,304	17.6	57.6
Czech Republic	6,104	1355.8	5,214	578	10,333	14.2	62.7
Estonia	787	573.1	354	598	13,817	17.1	87.1
Hungary 1)	4,226	105.4	3,171	431	7,490	21.1	65.3
Latvia	114	-81.0	-47	58	6,923	2.5	54.0
Lithuania	-188	. 2)	-65	-66	4,586	-2.6	33.8
Poland	11,000	-9.4	4,000	286	4,424	14.4	40.1
Romania	4,134	19.4	3,917	210	3,458	10.8	40.2
Slovakia	-267	51.4	-491	-49	7,263	-1.6	48.8
Slovenia	831	-43.3	742	403	5,850	11.3	30.4
EU-CEE	**29,020**	**22.7**	**19,283**	**280**	**5,643**	**12.3**	**49.5**
Albania	983	10.4	958	342	1,980	33.7	52.8
Bosnia and Herzegovina	258	5.8	247	68	1,703	9.7	43.4
Kosovo	216	-30.1	176	182	1,953	14.0	57.5
Macedonia	358	65.4	354	172	2,309	17.2	48.6
Montenegro	205	-67.6	372	327	7,039	22.0	116.6
Serbia	2,078	-1.8	1,861	294	4,079	34.2	84.4
Turkey	11,115	-29.7	8,264	140	1,583	4.8	16.3
Western Balkans + Turkey	**15,212**	**-24.8**	**12,233**	**157**	**1,842**	**6.2**	**21.1**
Belarus	1,122	-26.2	1,097	118	1,911	10.9	42.4
Kazakhstan	8,196	126.5	13,046	460	6,907	30.0	101.6
Georgia	1,500	10.0		405	4050		115.1
Moldova	129	-21.3	121	36	964	9.5	56.2
Russia	33,568	314.0	9,232	229	2,447	13.9	31.1
Ukraine	2,871	7.5	2,857	67	1,087	22.5	55.0
CIS-4 + Ukraine	**47,000**	**150.0**	**26,508**	**220**	**2,500**	**15.7**	**39.1**
Total region	**92,000**	**45.9**	**58,000**	**220**	**3,159**	**11.6**	**38.2**

Remarks:
Data refer to BPM6 directional principle, unless otherwise stated.
Moldova: BPM5. Georgia: estimates from GeoStat.
Data exclude special purpose entities (SPEs).
FDI net: inflow minus outflow.
GFCF: Gross fixed capital formation.
1) Inflow and outflow excluding capital in transit and restructuring of asset portfolios. 2) No growth rate given, due to change from positive to negative value.

Sources: wiiw databases incorporating national and Eurostat statistics; adapted from wiiw FDI Report 2017.

Table 2. Inward FDI stock in selected EAEU, DCFTA and EU CEE by major investing home countries, 2015, shares in %

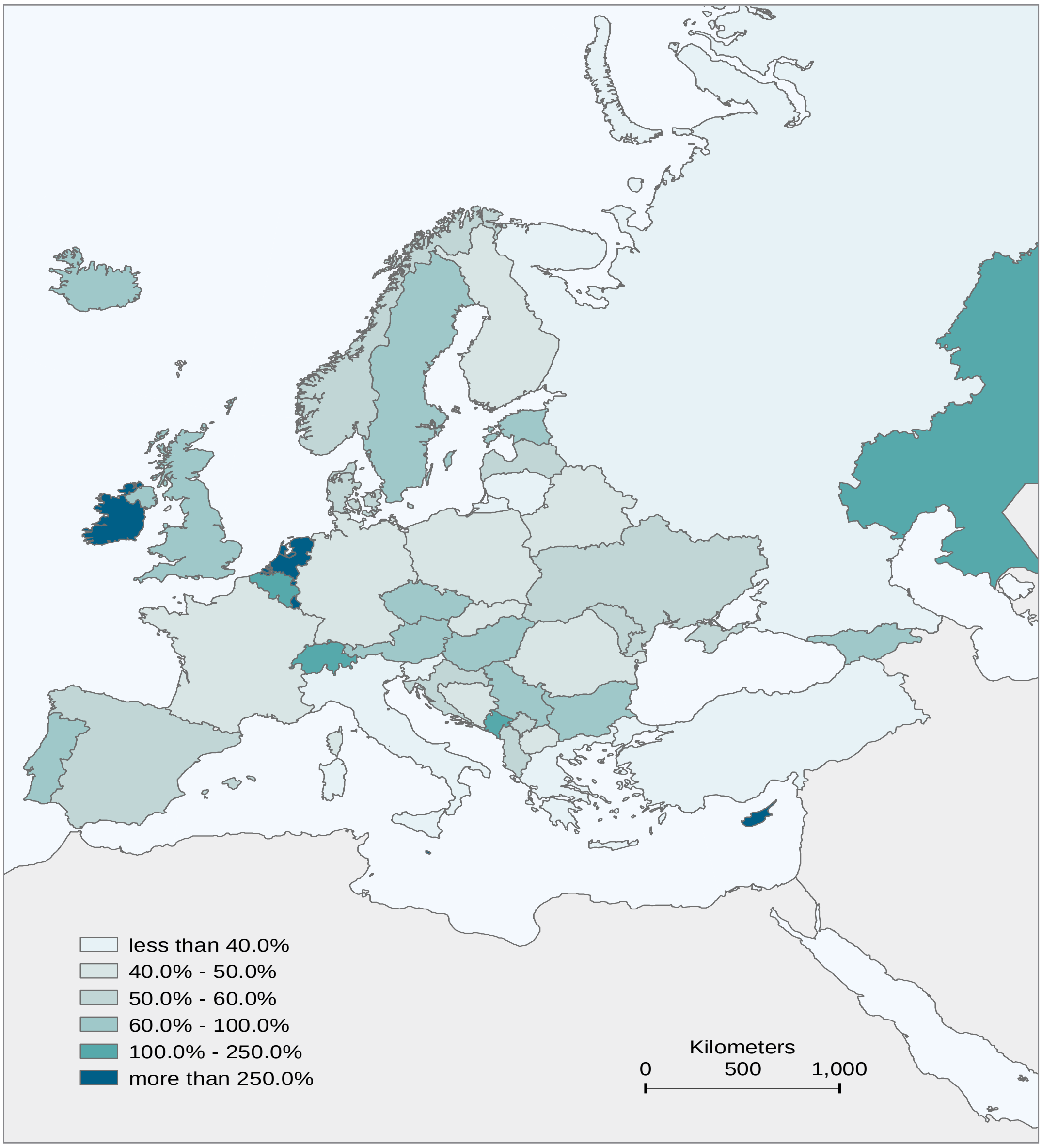
FDI recipients	BY	KZ	MD	RU	UA	HU	PL	RO	SK
Investors:									
Austria	3.6	0.8	1.5	1.8	4.8	16.7	3.8	14.2	15.7
Belgium	0.0	0.3	0.4	0.4	0.3	2.0	3.0	2.2	5.4
Spain	.	.	.	.	.	0.9	6.2	2.2	1.4
Cyprus	16.3	0.2	8.5	33.6	32.3	1.6	3.5	6.9	2.9
France	0.0	10.1	7.8	3.9	3.4	1.1	10.7	6.7	2.2
Germany	1.6	0.3	5.0	5.3	4.6	22.4	16.4	12.5	6.3
Hungary	0.0	0.0	0.6	0.2	1.4	.	0.3	1.5	5.4
Italy	1.1	0.1	5.0	0.4	1.0	1.2	5.1	5.2	6.6
Luxembourg	0.3	0.5	0.0	3.1	1.1	-2.0	11.5	4.1	8.8
Netherlands	2.5	50.1	12.4	12.6	15.4	28.1	18.2	25.0	19.5
Russia	57.1	2.7	28.3	.	7.4	-0.1	0.2	0.1	-0.4
Sweden	0.3	0.5	0.1	0.9	0.8	0.4	2.3	0.6	0.6
Switzerland	1.4	1.4	0.9	3.3	3.9	0.4	2.5	3.5	1.7
United Kingdom	1.3	-0.1	3.1	2.4	4.7	5.1	5.5	2.1	1.1
United States	0.8	17.5	2.1	0.5	1.7	-1.4	2.9	2.5	0.7
Other countries	13.1	15.0	20.8	31.2	16.2	21.2	4.5	6.6	20.0
									.
EU-15	11.5	62.7	44.3	36.8	37.4	84.8	87.1	79.5	70.3
EU-28	31.3	63.4	61.0	71.0	75.5				
Total	100.0	100.0	100.0	100.0	100.0				

FDI from other countries: in Moldova mostly from Romania; in Slovakia mostly from Czech Republic.

Source: wiiw FDI Database.

ANNEX VI: FDI Inward Stocks in Europe

Map 1. FDI inward stocks in Europe, in % of GDP, 2016

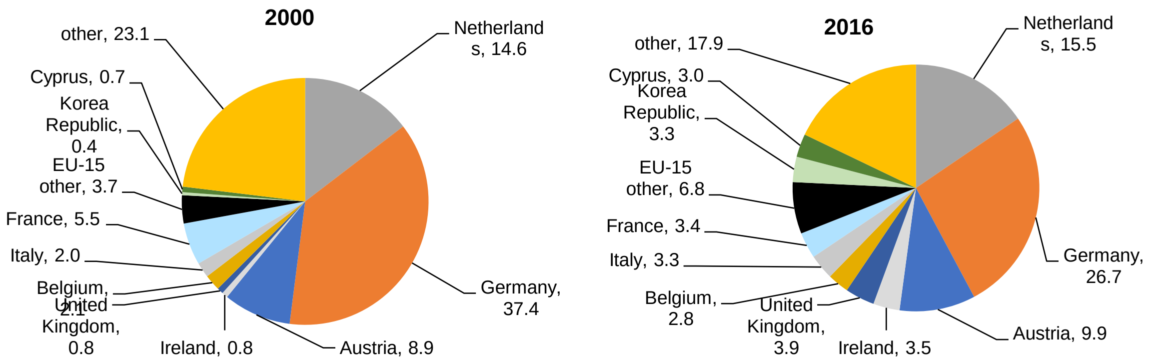


Source: wiiw Handbook of Statistics 2017 incorporating national statistics and Eurostat.

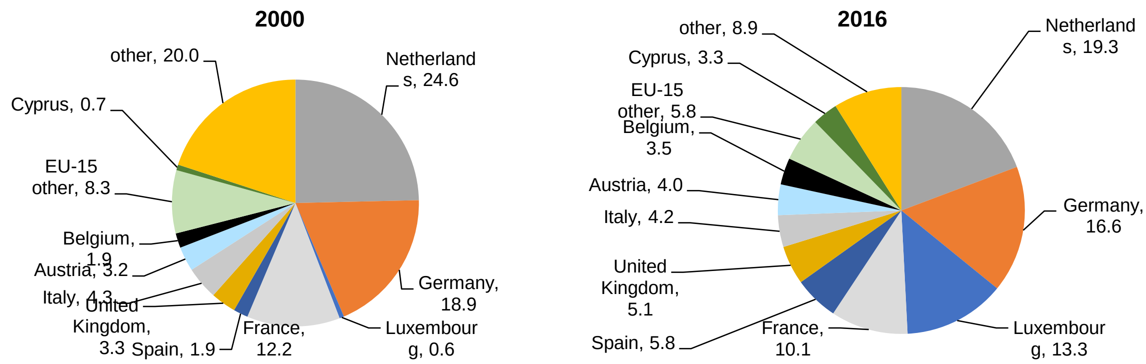
ANNEX VII: FDI in Selected EU CEE Peer Economies

Figure 1. Selected EU-CEE: FDI inward stock by key partners (%), Top 10 (ranking 2016)

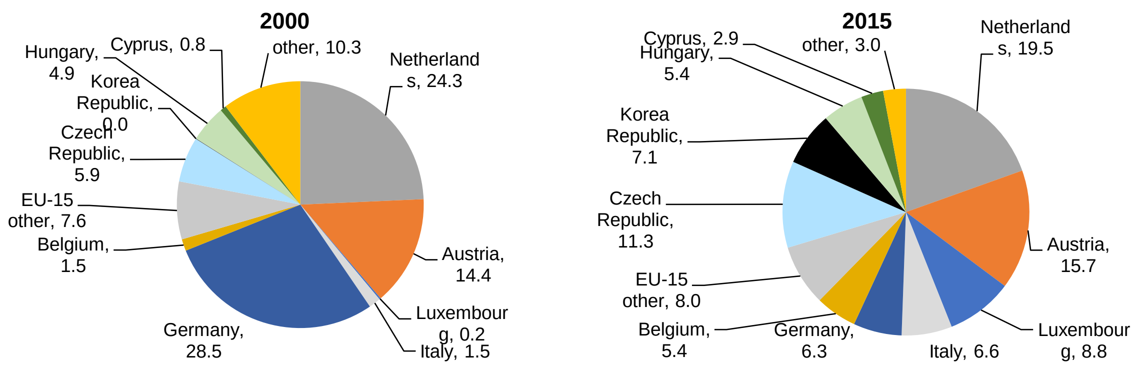
Hungary



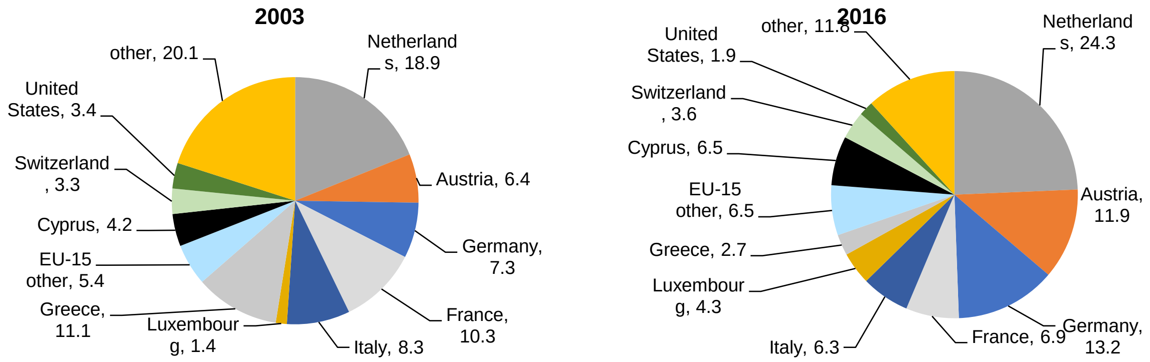
Poland



Slovakia



Romania



Source: wiiw FDI Database based on Direct Investment statistics of respective National Banks

ANNEX VIII: EU Member States' WTO GATS Commitments

Table 1. Selected EU countries' WTO GATS commitments in particular services sectors

EU country	Services sector	Sub-sector/s	Restrictions under mode 3*
Germany	professional services	accounting and auditing services	providing of services through specific legal forms (such as "GmbH&CoKG","EWIV") are not allowed
			foreign companies/professionals in these areas may hold up to 49% of ownership or control.
			qualifications of professionals are subject to specific qualification and experience requirements
		legal services	legal advice, domestic law services and legal representation in courts is not allowed by foreign companies/representatives
			providing legal advice is not allowed by foreign law firms which are not owned or controlled by locally licensed professionals
	transport services	air transport services	to provide domestic and international passenger air transport services a license to operate an enterprise is granted only to companies majority-controlled by nationals of the EEA countries
		maritime transport services	the right to the national flag is reserved to ships owned by German or EU nationals, respectively by companies controlled by EU-nationals and located in the EU
			maritime auxiliary services are quite open, except for Bremen where there is a monopoly with regard to cargo handling and maritime agency services
		road transport services	domestic road freight sector is open only to companies of the EU countries
Austria	professional services	accounting and auditing services	foreign professionals are not permitted to form a partnership with local firms
			limitations on ownership and control by foreign nationals: only foreign professionals from GATS member countries may hold up to 25% ownership, while at least 51% must be held by locally qualified and resident professionals
			managing directors must be residents of Austria
		legal services	establishment of branches is allowed only to licensed lawyers from EEA countries and foreign lawyers are not permitted to hire local lawyers as employees
	transport services	air transport services	domestic and international passenger air transport sector companies must be established as subsidiaries and the effective control must be held by Austrians
		road transport services	domestic road freight sector is open only to companies from the EU; however, under certain circumstances exemptions to firms from non-EU countries are possible
		rail transport services	in domestic rail freight transport services entry is allowed upon meeting the licensing and investment requirements

France	transport services	maritime transport services	international maritime shipping is closed for foreign acquisition, the establishment of a registered company for the purpose of operating a fleet under the national flag, is not allowed
		rail transport services	domestic rail transport sector is closed for foreign acquisition
		air transport services	companies must be entirely or majority owned/controlled by EU nationals
		road transport services	domestic road freight transport sector is open only to firms of EU Member States
	professional services	accounting and auditing services	ownership or control by non-locally-licensed professionals is limited to 25%
			for the auditing services restrictions on the clientele are also imposed: there are special requirements for auditing state-owned enterprises
		legal services	non-EU firms are not permitted to establish branch offices in France under their own names
			non-EU lawyers and firms are not permitted to form partnerships with, or hire, French lawyers
			depending on the form of establishment, majority ownership or control may be required to be held by the professionals who are active in the firm
	telecommunication services	fixed-line telecommunications services	non-EU natural or juridical persons may not hold over 20% of the voting shares of firms that operate radio-based infrastructure for the provision of telecom services
Italy	transport services	air transport services	for domestic and international air transport services, at least two-thirds of the share capital must be owned by Italian citizens
			licenses are subject to a nationality requirement, as well as control of enterprises must be held by EU citizens
		maritime transport services	for international maritime shipping, at least a 50% share must be owned by Italian citizens, the Italian public sector or Italian private companies (exemptions may be allowed if company has its primary establishment in Italy)
			for maritime auxiliary services an economic needs test is applicable to cargo handling
		road transport services	domestic road freight services sector is open only to EU firms (under certain circumstances, exemptions to firms from non-EU countries are possible)
		rail transport services	providing domestic rail freight transport services is allowed for international freight transport if the foreign company is registered in the EU
	professional services	accounting and auditing services	access is restricted to natural persons (however, the establishment of professional associations of natural persons is permitted)
		legal services	for legal advice on domestic law and legal representation in courts commercial presence for providing these services may take any legal form allowed under the national law of an EU member State

	financial services	insurance services	for automobile insurance, the takeover of an Italian company by a company originating from a non-EU country approval is needed
			for life insurance and reinsurance services approval is required to establish a new company or acquire an existing firm
			for automobile and life insurance sectors the supervisory authority of the insurance industry may deny authorization if the home country of the company has not enacted reciprocal legislation to permit Italian insurance companies to operate in that country
Cyprus	financial services	insurance and reinsurance services	insurance and reinsurance services are restricted to insurance companies registered in Cyprus and authorized by the responsible national authority
			investment by non-residents in insurance companies requires the prior approval of the Central Bank
			the share of foreign participation in the capital of local insurance companies is determined on a case by case basis, depending on an economic needs test
		banking services	for banking services, a license is required from the Central Bank and for the granting of the license an economic needs test may be applied
			branches of foreign banks must be registered in Cyprus under the Companies Law and licensed under the Banking Law
		broking services	in securities broking services, a brokerage firm may only be registered as a member of the Cyprus Stock Exchange and registered in accordance with the Companies Law of Cyprus
			firms acting as brokers must employ individuals as brokers only provided that they are appropriately licensed
			banks and insurance companies may not undertake brokerage business (however their subsidiary brokerage firms may do so)
	professional services	accounting, auditing and taxation services	access is restricted to natural persons who have obtained authorization from the Minister of Finance (authorization is subject to an economic needs test); However, professional associations/partnerships among natural persons are permitted.

* Commitments under WTO GATS Schedules of commitments.

ANNEX IX: Survey Results

Figure 1. Evaluations of influence of economic factors on FDI (in % of all responses)

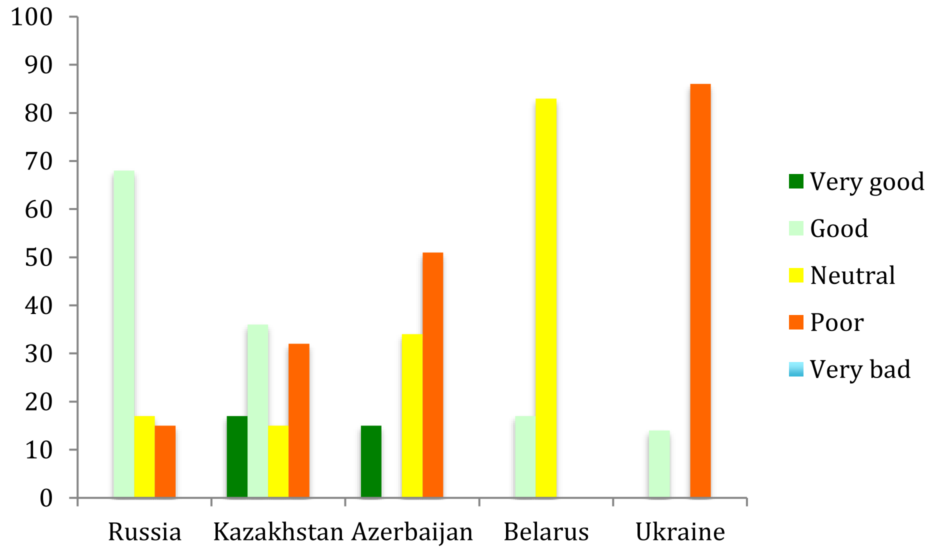


Table 1. Evaluations of influence of economic factors on FDI (in % of all responses)

	Russia	Kazakhstan	Azerbaijan	Belarus	Ukraine
Very good	0	17	15	0	0
Good	68	36	0	17	14
Neutral	17	15	34	83	0
Poor	15	32	51	0	86
Very bad	0		0	0	0

Figure 2. Evaluations of influence of institutional environment on FDI (in % of all responses)

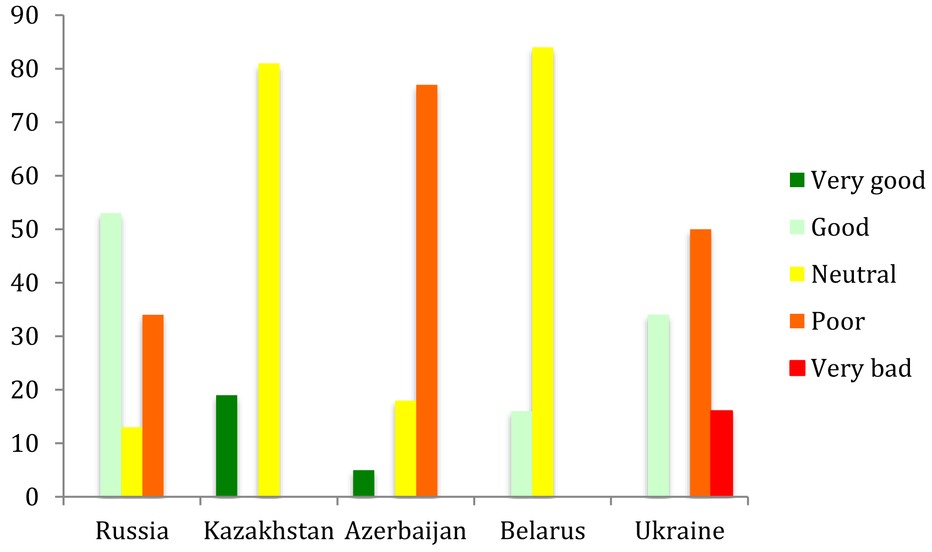


Table 2. Evaluations of influence of institutional environment on FDI (in % of all responses)

	Russia	Kazakhstan	Azerbaijan	Belarus	Ukraine
Very good	0	19	5	0	0
Good	53	0	0	16	34
Neutral	13	81	18	84	0
Poor	34	0	77	0	50
Very bad	0	0	0	0	16

Figure 3. Evaluations of business environment for FDI (in % of all responses)

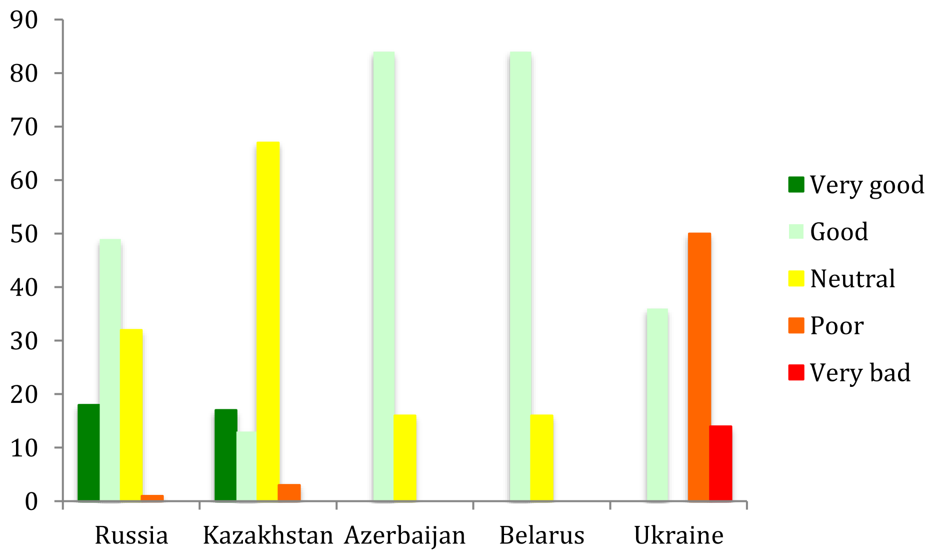


Table 3. Evaluations of business environment for FDI (in % of all responses)

	Russia	Kazakhstan	Azerbaijan	Belarus	Ukraine
Very good	18	17	0	0	0
Good	49	13	84	84	36
Neutral	32	67	16	16	0
Poor	1	3	0	0	50
Very bad	0	0	0	0	14

Figure 4. Importance of differences in political, policy, social and cultural factors in five countries (comparatively to EU) as a barrier for FDI (in % of all responses)

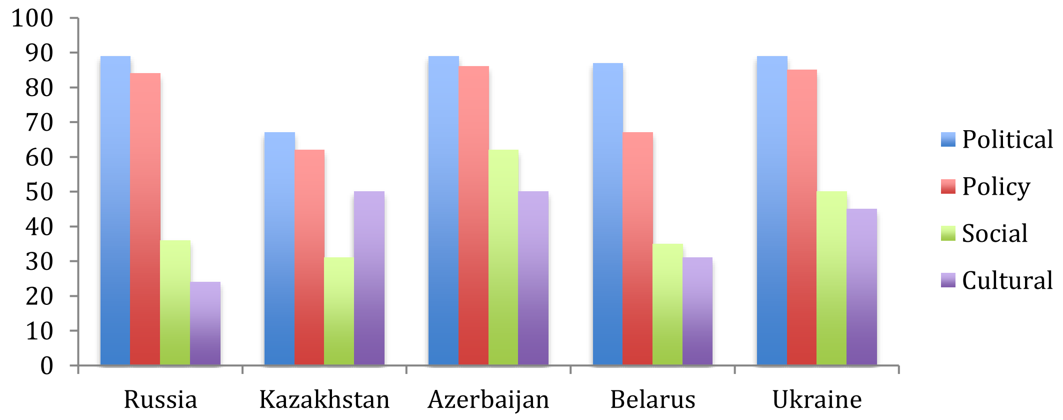


Table 4. Importance of differences in political, policy, social and cultural factors in five countries (comparatively to EU) as a barrier for FDI (in % of all responses)

	Russia	Kazakhstan	Azerbaijan	Belarus	Ukraine
Political	89	67	89	87	89
Policy	84	62	86	67	85
Social	36	31	62	35	50
Cultural	24	50	50	31	45

Figure 5. Perceptions of significant of the risk in Russia (in % of all responses)

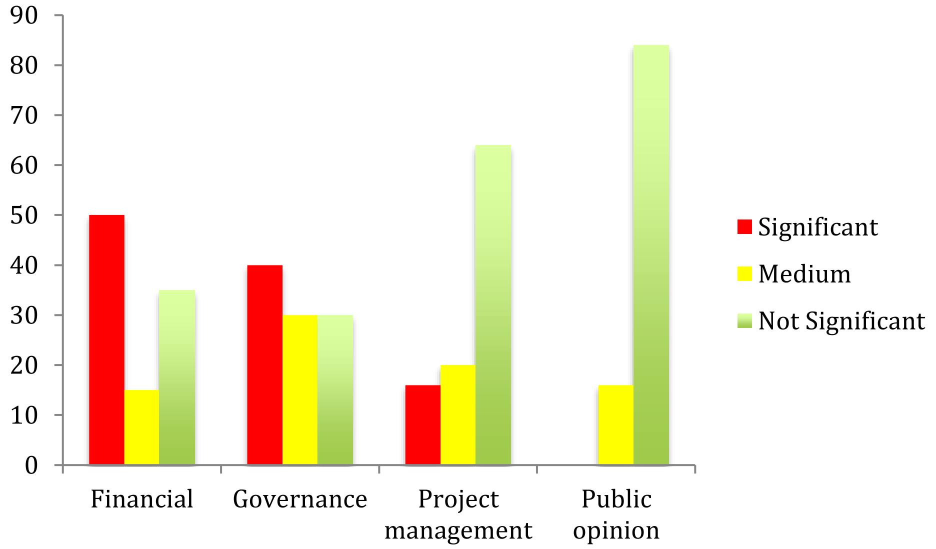


Table 5. Perceptions of significant of the risk in Russia (in % of all responses)

	Significant	Medium	Not Significant
Financial	50	15	35
Governance	40	30	30
Project management	16	20	64
Public opinion	0	16	84

Figure 6. Perceptions of significant of the risk in Kazakhstan (in % of all responses)

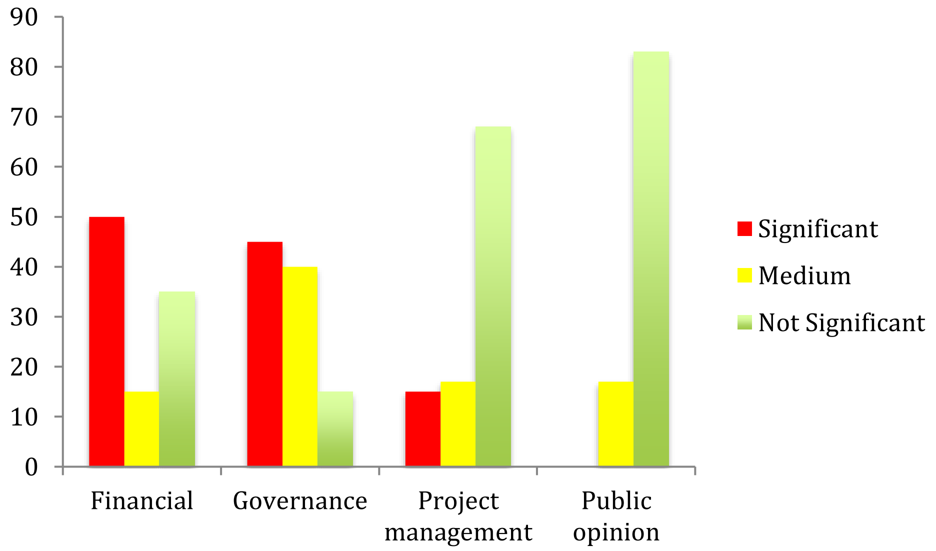


Table 6. Perceptions of significant of the risk in Kazakhstan (in % of all responses)

	Significant	Medium	Not Significant
Financial	50	15	35
Governance	45	40	15
Project management	15	17	68
Public opinion	0	17	83

Figure 7. Perceptions of significant of the risk in Azerbaijan (in % of all responses)

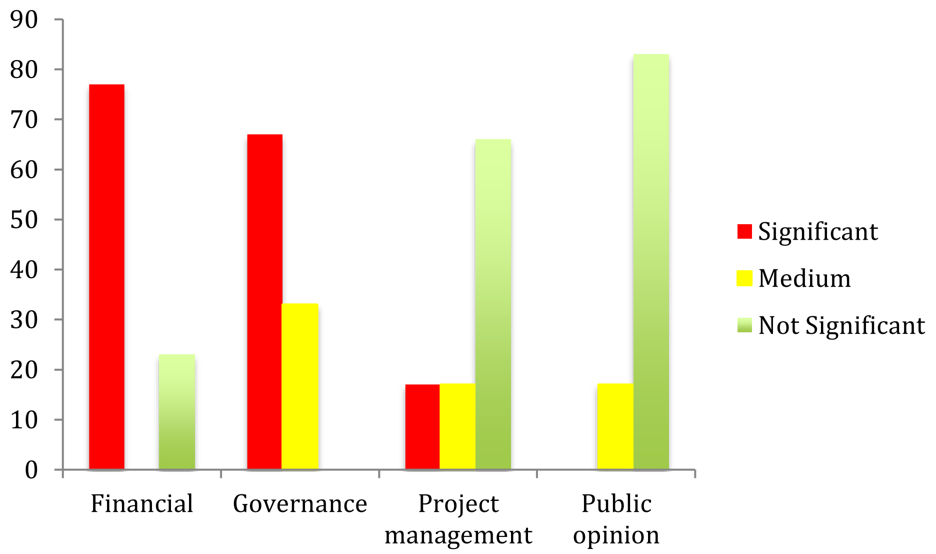


Table 7. Perceptions of significant of the risk in Azerbaijan (in % of all responses)

	Significant	Medium	Not Significant
Financial	77	0	23
Governance	67	33	0
Project management	17	17	66
Public opinion	0	17	83

Figure 8. Perceptions of significant of the risk in Belarus (in % of all responses)

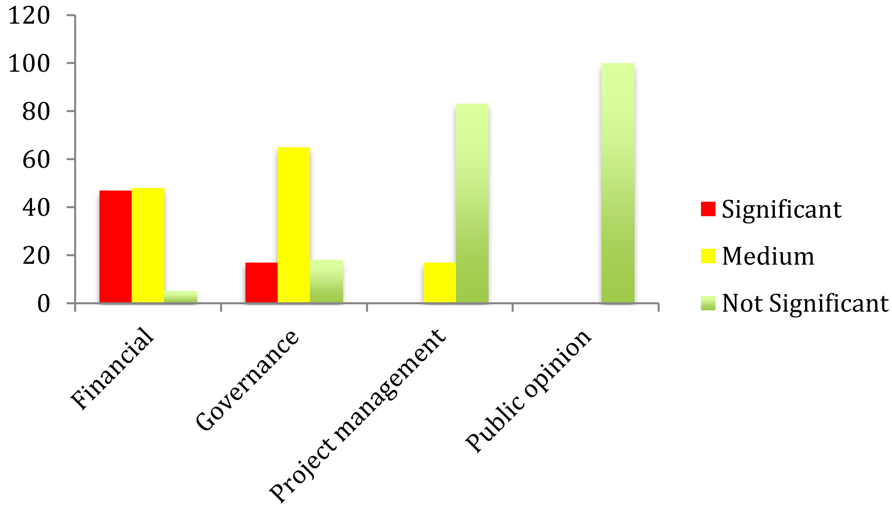


Table 8. Perceptions of significant of the risk in Belarus (in % of all responses)

	Significant	Medium	Not Significant
Financial	47	48	5
Governance	17	65	18
Project management	0	17	83
Public opinion	0	0	100

Figure 9. Perceptions of significant of the risk in Ukraine (in % of all responses)

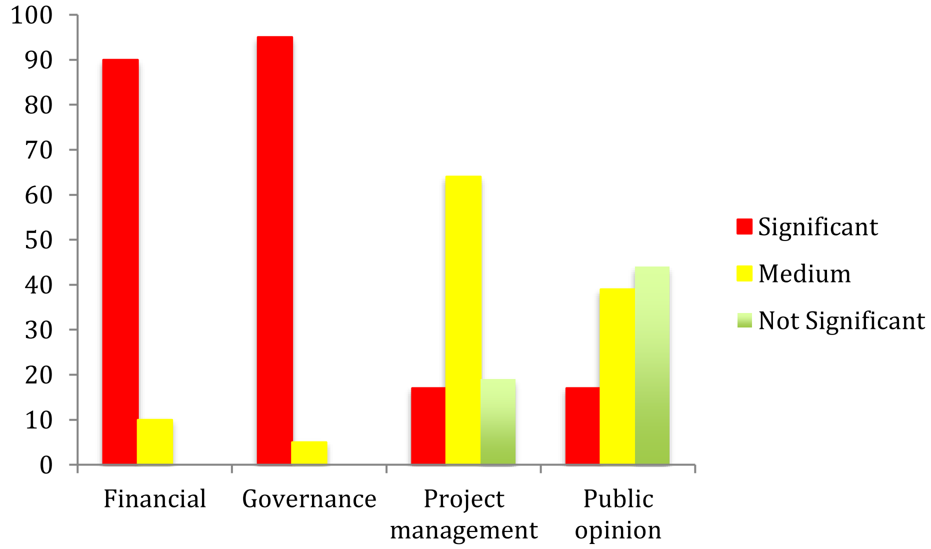


Table 9. Perceptions of significant of the risk in Ukraine (in % of all responses)

	Significant	Medium	Not Significant
Financial	90	10	0
Governance	95	5	0
Project management	17	64	19
Public opinion	17	39	44

Figure 10. Evaluation of risks regarding their impact on FDI (in % of all responses)

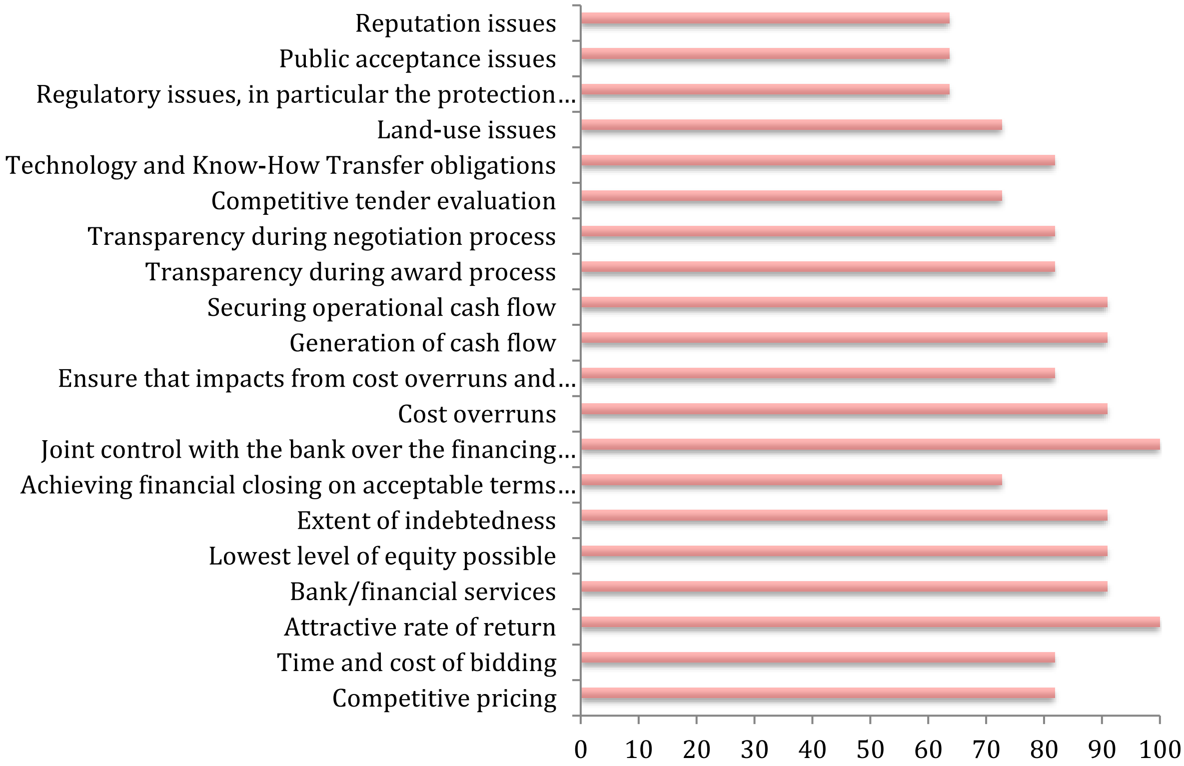


Figure 11. Perceived likelihood to happen for political, revenue, operational, and regulatory risks (in % of all responses)

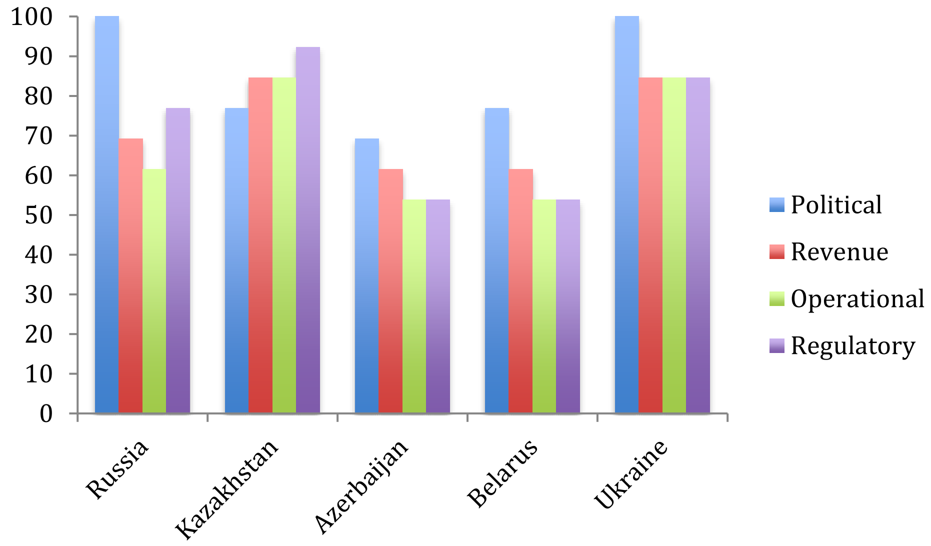
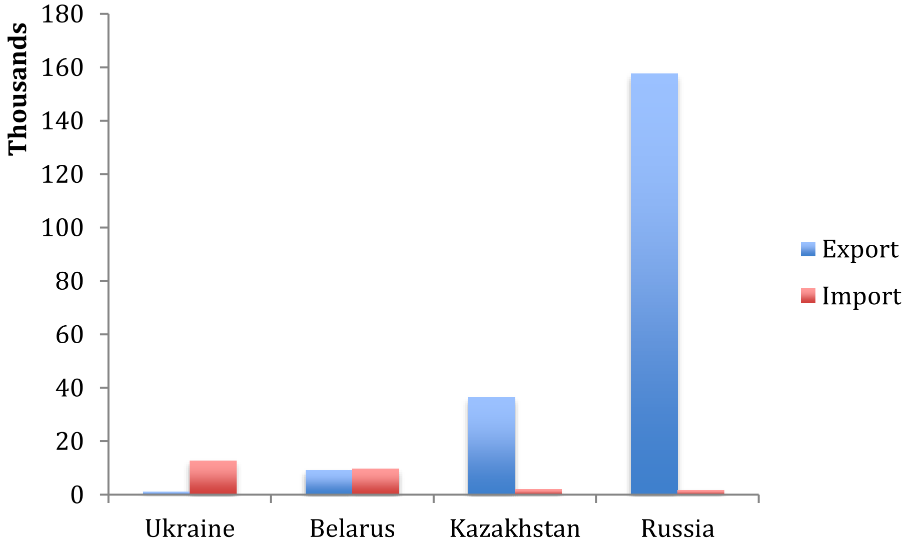


Table 10. Perceived likelihood to happen for political, revenue, operational, and regulatory risks (in % of all responses)

	Kazakhstan	Azerbaijan	Belarus	Ukraine	Russia
Political	77	69	77	100	100
Revenue	85	62	62	85	69
Operational	85	54	54	85	62
Regulatory	92	54	54	85	77

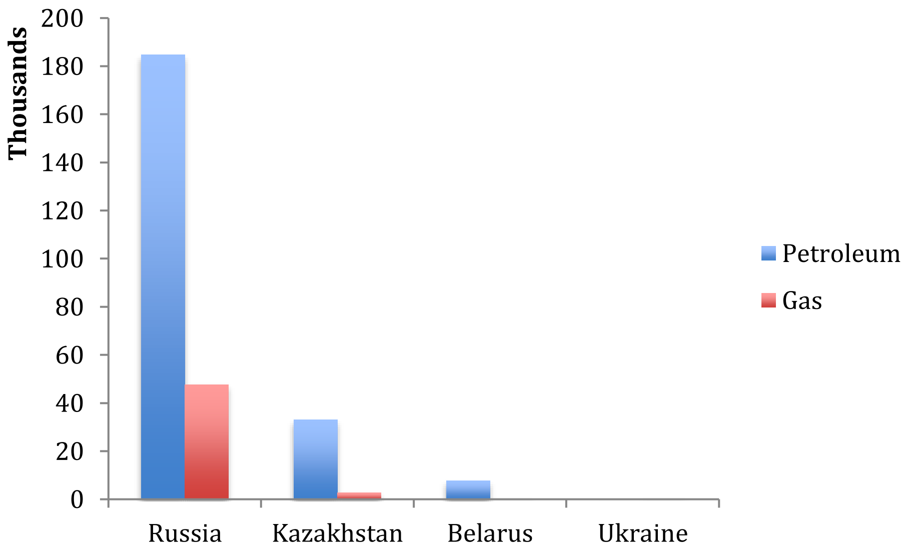
ANNEX X: Energy Sector Statistics Data

Figure 1. Volumes of export and import of energy products in Belarus, Kazakhstan, Russia and Ukraine in 2016 (EUR billion)



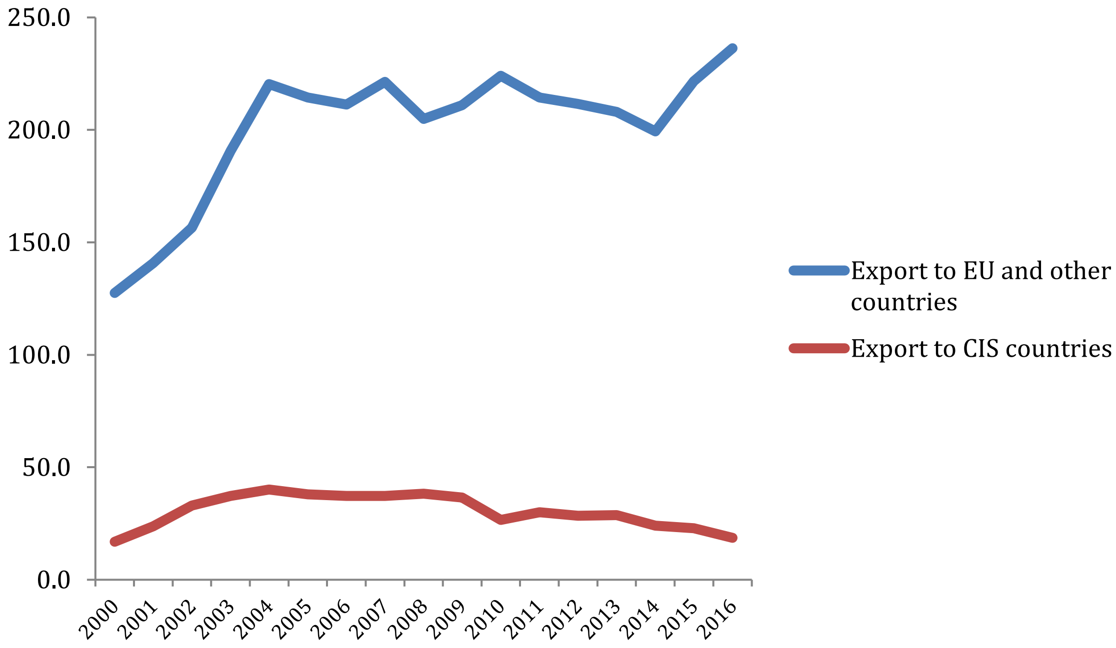
Source: UN COMTRADE

Figure 2. Volumes of export of petroleum, petroleum products as well as of natural and manufactured gas in Belarus, Kazakhstan, Russia and Ukraine in 2016 (EUR billion)



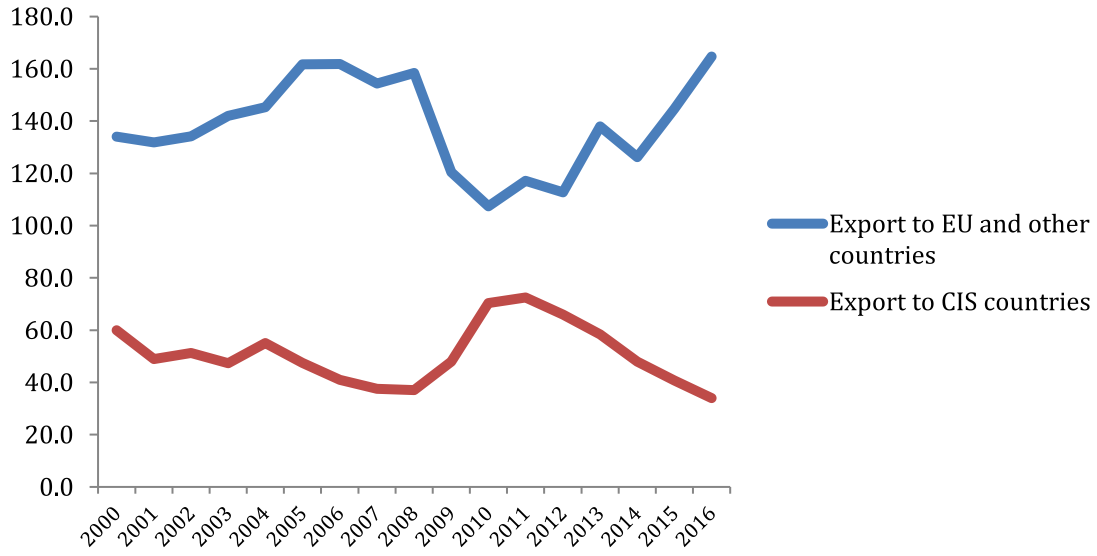
Source: UN COMTRADE

Figure 3. Russian crude oil exports to EU and CIS countries (million tons)



Source: Central Bank of the Russian Federation

Figure 4. Russian natural gas exports to EU and CIS countries (million tons)



Source: Central Bank of the Russian Federation

Table 1. Volumes of FDI stocks in Russia in 2016 (EUR million)

Industry/Product	2014	2015	2016
Total by activities	305,825.2	317,937.7	438,917.5
Agriculture. forestry and fishing	1,187.6	1,231.8	1,175.5
Mining and quarrying	55,447.5	66,485.0	98,642.8
Manufacturing	63,760.1	65,648.9	92,508.5
Electricity, gas, steam, air conditioning supply	7,284.3	6,594.8	9,659.5
Water supply, sewerage, waste management, remediation	50.5	47.8	43.2
Construction	8,827.3	8,362.1	2,390.9
Wholesale, retail trade, repair of motor vehicles etc.	51,630.0	59,256.0	73,425.1
Transportation and storage	4,545.6	4,844.6	13,374.3
Accommodation and food service activities	500.5	529.2	611.6
Information and communication	17,017.9	12,354.7	12,946.0
Financial and insurance activities	51,298.3	46,921.2	64,737.3
Real estate activities	10,885.9	10,467.4	14,168.3
Professional, scientific and technical activities	1,156.0	1,088.4	1,663.0
Public administration, defense, compulsory social security	0.1	0.1	2.9
Education	2.7	2.4	1.5
Human health and social work activities	469.1	412.5	481.1
Arts, entertainment and recreation	502.8	340.7	495.7
Other service activities	21,902.3	23,153.0	41,681.8
Other not elsewhere classified activities (A-U)	9,356.7	10,196.9	10,908.6

Source: wiiw FDI Database.

Table 2. Volumes of FDI in Kazakhstan in 2016 (EUR million)

Industry/Product	2014	2015	2016
Total by activities	106,175.1	109,557.5	123,948.8
Agriculture, forestry and fishing	126.6	79.1	167.5
Mining and quarrying	19,998.8	17,468.4	93,200.5
Manufacturing	10,699.1	6,728.0	6,228.9
Electricity, gas, steam, air conditioning supply	1,319.1	741.2	888.7
Water supply, sewerage, waste management, remediation	32.0	72.3	188.1
Construction	2,680.9	2,290.0	3,032.0
Wholesale, retail trade, repair of motor vehicles etc.	4,367.6	3,232.0	3,574.0
Transportation and storage	1,159.9	1,830.4	2,210.4
Accommodation and food service activities	277.6	299.6	324.6
Information and communication	1,753.3	1,190.5	1,521.1
Financial and insurance activities	4,357.5	4,211.2	4,896.8
Real estate activities	809.1	792.4	1,140.5
Professional, scientific and technical activities	58,484.6	70,458.4	6,325.3
Administrative and support service activities	40.7	21.1	43.2
Education	39.8	40.0	52.2
Other service activities	28.6	103.0	154.9

Source: wiiw FDI Database.

Table 3. Volumes of FDI in Ukraine in 2016 (EUR million)

Industry/Product	2014	2015	2016
Total by activities	40,192.4	40,305.0	42,895.0
Agriculture, forestry and fishing	827.7	785.8	878.6
Mining and quarrying	2,788.0	2,028.5	1,652.4
Manufacturing	9,016.6	9,136.2	9,538.9
Electricity, gas, steam, air conditioning supply	697.3	623.3	625.7
Water supply, sewerage, waste management, remediation	74.4	56.7	69.8
Construction	1,480.3	1,392.5	1,392.1
Wholesale, retail trade, repair of motor vehicles etc.	6,510.9	6,121.5	5,997.8
Transportation and storage	1,379.0	1,297.8	1,401.5
Accommodation and food service activities	372.9	362.9	380.7
Information and communication	1,680.5	2,359.5	2,489.4
Financial and insurance activities	7,744.6	8,287.8	10,045.6
Real estate activities	3,773.2	4,087.5	4,180.3
Professional, scientific and technical activities	2,398.7	2,255.9	2,425.2
Administrative and support service activities	1,209.8	1,285.2	1,593.3
Public administration, defense, compulsory social security	0.1	.	.
Education	12.5	17.8	23.1
Human health and social work activities	66.2	63.2	62.6
Arts, entertainment and recreation	139.0	123.7	116.8
Other service activities	20.7	.	.
Other not else were classified activities	.	19.3	21.1

Source: wiiw FDI Database.

ANNEX XI: Kazakhstan's National Energy Policy Details

List 1. Ministries and committees regulating the energy sector in Kazakhstan

1) The Ministry of Energy;
2) The Committee for Regulation of Natural Monopolies and Protection of Competition (CRNMPC) at the Ministry of National Economy;
3) The Committee on Statistics at the Ministry of National Economy;
4) The National Fund and the Sovereign Wealth Fund.

List 2. Legal framework regulating the energy industry of Kazakhstan

1) the Law of the Republic of Kazakhstan dated January 13, 2012 "On Energy Saving and Energy Efficiency Improvement";
2) the Law of the Republic of Kazakhstan of June 24, 2010 "On Subsoil and Subsoil Use";
3) the Law of the Republic of Kazakhstan dated November 9, 2004 "On technical regulation";
4) the Law of the Republic of Kazakhstan dated June 22, 2012 "About the main pipeline";
5) the Law of the Republic of Kazakhstan dated July 20, 2011 "On state regulation of production and turnover of certain types of petroleum products";
6) the Law of the Republic of Kazakhstan dated January 9, 2012 "On gas and gas supply;
7) the Law of the Republic of Kazakhstan of 14 April 1997 "On Atomic Energy Use";
8) the Law of the Republic of Kazakhstan dated April 23, 1998 " About radiation safety of the population ";
9) the Law of the Republic of Kazakhstan dated July 16, 2001 "On architectural, town-planning and construction activity in the Republic of Kazakhstan";
10) the Law of the Republic of Kazakhstan dated November 9, 2004 "On technical regulation";
11) the Law of the Republic of Kazakhstan dated July 21, 2007 "On Export Control";
12) the Law of the Republic of Kazakhstan dated July 9, 2004 "On Electric Power Industry";
13) the Law of the Republic of Kazakhstan dated July 9, 1998 "On Natural Monopolies and Regulated Markets";
14) the Law of the Republic of Kazakhstan dated July 4, 2009 "On Support for the Use of Renewable Energy Sources";
15) the Law of the Republic of Kazakhstan of December 25, 2008 "On Competition";
16) the Law of the Republic of Kazakhstan of January 9, 2012 "On State Support of Industrial Innovative Activities";
17) the Law of the Republic of Kazakhstan dated July 7, 2006 "On Concessions".

Source: http://kz.energo.gov.kz

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