German Investment in Russia

Adrienne Shannon

Lehigh University

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Introduction

Since the reunification and the end of communist rule, both Germany and Russia have taken steps to prepare for integration into the global economy. For Germany, this process has been a successful one. For Russia, the transformation to a market economy has a long way to go. Some steps toward this transformation include privatization, a stable legal system, and an economic atmosphere favorable to a wide range of foreign investors. As a close neighbor and trade partner, it is in Germany's political and economic interests to facilitate Russia's transition to a market economy.

In return for Soviet renunciation of control over East Germany in 1990, Chancellor Helmut Kohl and Foreign Minister Hans-Dietrich Genscher made an agreement with President Mikhail Gorbachev and Foreign Minister Eduard Shevardnadze shortly after reunification that Germany would help Russia economically and politically. Germany, as of 1998, has been Russia's largest donor and creditor. Russia has always admired German industry, as reflected in such Russian proverbs as "Wherever you see a machine, there must be a German nearby." (Blaney, p. 282) With mutual interests and a long (and occasionally antagonistic) relationship, it is natural for the two countries to work together in developing the Russian economy.

In this paper I discuss the political and economic reasons for German investment in Russia and Germany's involvement in Russia's integration into the European Union. I give background on both the Russian and German economies in order to demonstrate the contrast in economic development in each of the two countries since reunification. I discuss some of Russia's economic problems to explain why non-German investors have been less eager to invest in Russia than have those in Germany. I also describe different types of German companies who have established subsidiaries in Russia. Finally, I discuss Russia's future and Germany's role in this future over the next several years.

The Russian Economy

The economic situation in Russia in 1998 looks bleak. As Vice President Victor Chernomyrdin said regarding the state of the economy in the "breakthrough" year of 1997, "We were striving for the best, but it turned out as usual." ("Better Luck Next Year," p. 24)
Falling inflation and interest rates are promising signs, but Russia still has to deal with a huge backlog of payments, including wages owed to workers. This situation, however, is an improvement over the stagnation of 1997 and the six percent contraction of the economy in 1996. ("From Marx, Maybe to Market," p. 11) Nevertheless, several major problems stand in the way of Russia's economic transformation.

The first is the uncertainty surrounding Boris Yeltsin's health. Doubts about his physical and mental state will do nothing for economic development, nor will they encourage foreign investment. Yeltsin's health problems and periodic stays in the hospital have the same effects on the economy each time: any economic progression ceases and politicians begin to make decisions with the thought of a Yeltsin successor in mind. Even the stock market is affected — when Yeltsin was ill with a cold in December 1997, it dropped five percent. ("Better Luck Next Year," p. 24) Russia may soon be faced with choosing a successor to Yeltsin or dealing once again with economic stagnation during 1998.

Another problem is the budget: accurate deficit figures are simply unattainable. Since a corrupt tax system makes it difficult for the government to collect taxes from Russian residents, it cannot spend what it needs to. This results in cuts in investment programs and also a withholding of pensions and salaries from Russian citizens. These cuts in turn have resulted in a deficit that looks much lower than what was originally predicted at the start of the fiscal year. For example, a deficit of nine percent of gross domestic product (GDP) was predicted for 1997, but the actual deficit turned out to be much less. ("From Marx, Maybe to Market," p. 11) Normally a positive sign, deficit reductions are the result of unfortunate cuts in necessary programs and expenditures.

A third problem is that of too little investment in the Russian economy. Since the average real rate of return on new capital is only 10-15 percent, most Russian companies, when they even have money to invest, invest in GKO's (treasury bills). In 1996, yields on treasury bills went to 350 percent, while inflation dropped to 22 percent. In 1997, yields dropped to 30 percent, so the chance of making a fortune on GKO's was greatly reduced. ("From Marx, Maybe to Market," p. 11)

Some money not invested in GKO's has been invested abroad. About $65 billion has gone out of the country since 1992, mainly through Russian companies registered in the Bahamas, Belize, the Cayman Islands, Liechtenstein, Luxembourg, and (principally) Cyprus — 16,000 Russian companies were registered in Cyprus alone in 1996. Like Russian companies, citizens fearful of the unstable economy also tend to shy away from direct economic investment, hoarding 22.7 percent of their collective income, with four-fifths in U.S. dollars. ("From Marx, Maybe to Market," p. 11)

**Russia's Confusing Tax Laws**

One reason why companies are investing their money elsewhere (and the reason why investment in Russia by countries other than Germany has been sluggish) is Russia's complicated tax system. Most of the tax burden (31.2 percent of GDP in 1994) falls on the companies, because the government finds it easier to collect taxes from companies than it does from individual citizens. Many companies either leave the country or use one of the many loopholes to evade taxation. One loophole, due to a double-taxation treaty, gives a tax break to companies based in Cyprus. Many loopholes have been closed with the help of the IMF, but unfortunately some have not. Gazprom, Russia's natural gas monopoly, probably owes back taxes amounting to 2-3 percent of GDP according to World Bank estimates. ("From Marx, Maybe to Market," p. 11)

Businesses in Russia face up to 180 different local and federal taxes. Tax regulations are often written by different government agencies, such as the central bank and the finance ministry, that compete with each other for power and control. Furthermore, foreign investors are discouraged by a value added tax, which places a 20 percent tax on any loans a foreign company makes to its Russian subsidiary. (Forbes, p. 25)

In addition to burdensome taxation laws, the tax system is corrupt, and many Russian citizens avoid paying taxes altogether. These people make up part of Russia's "shadow economy,"
or the informal economy in which people deal in cash and neglect to report their income to tax authorities. Recent studies suggest that this “shadow economy” may account for as much as half of GDP, and that many citizens are much better off economically than they appear on paper. (Caryl, p. 38) This informal cash economy results in decreased revenue for the government, which is then forced to borrow money at high interest rates and cut back on the amount of public goods it can provide.

The German Economy

Turning now to Germany, it is important to note that the former East Germany has fared much better in reforming both its economy and its political system than its eastern neighbor. This has enabled Germany as a whole to emerge as a strong country within Europe, one that can invest in and influence changes in Russia. According to a December 1997 monthly report on the economic situation in the Federal Republic of Germany, the German economy exhibited growth throughout 1997. The GDP rose by 2.4 percent compared with the preceding year. Foreign exports grew by 16.7 percent compared with those of 1996. (Bundesministerium für Wirtschaft)

The greater stability of Germany's economy and government can be attributed to several factors. One is the existence of a stable constitution and legal system. In addition, the federal government gives subsidies to companies, which makes investment more appealing to Western firms, while legal stability, comprehensible business laws (including those concerning taxation), and foreign investment security help companies further. (Thomas, p. 505) Problems like comprehensible business laws and taxation problems have not been dealt with to as great an extent in Russia. Furthermore, East Germany moved away from socialism and the Communist Party during the reunification. Russia, on the other hand, must contend with the still-strong Communist Party, which rejects many proposed reforms, making the transition to a market economy considerably more difficult. (Thomas, p. 505)

The structure of Germany's economy is also relatively unique. Of all large corporations in the world, only three percent are German. Instead, Germany has many mid-sized firms, or Mittelstand, which account for much of the output of various German industries, including the chemical, machine tool, and automobile industries. (Claudon, p. 95) In the past few years, as many as 12,000 workers from the former Soviet Union are participating in on-the-job training programs in the German Mittelstand. The Germans hope these workers will in turn purchase German-made products after returning to the former Soviet Union, thereby increasing German exports to the area. Germany also hopes to encourage East European firms to emulate the structure and western-oriented business principles of the Mittelstand. (Claudon, p. 99)

Why Germany Is Investing in Russia

To the Germans, Russia has potential for investment. Despite their lack of economic and political stability, Russia and the countries of the former Soviet Union are rich in natural resources. Furthermore, Russia and Germany have a relationship that dates back centuries; and as Russia's neighbor and trade partner, Germany has an interest in promoting economic growth in the region. The Foreign Investment Promotion Center (FIPC), under the Ministry of Economy of the Russian Federation, lists several reasons to invest in Russia. Naturally, it has an interest in promoting investment in Russia, but its reasons are ones that German investors have begun to take advantage of.

First, Russia is one of the richest countries in the world in natural resources — precious metals, timber, oil, and natural gas are among the most abundant. In addition to oil and gas, many other industries, such as defense, machinery, transport and transportation, telecommunications, and food processing and distribution are also prime targets for investment. (FIPC) High technology, from space research to eye microsurgery, has moved into the private sector and is open to foreign investors. Finally, the FIPC describes the “strong internal demand for all kinds of goods and services and insufficient supply from local sources [which] create a gap that is largely covered by imports.” (FIPC)
Coupled with relatively low labor costs, these qualities make Russia a prime target for German investors and businesses.

Those not involved with the Russian government are advocating investment in Russia as well. One authority cites several reasons why foreign investment in Russia could have lucrative payoffs. ("Sale of the Century.") The first is Russia's oil fields, comprising 10 percent of the world's reserve and 40 percent of the world's gas fields. Second, there are 150 million people living in Russia who are eager for consumer goods. For example, only one big tobacco company exists to serve some of the heaviest smokers in the world. Russia also has a rapidly growing service sector, abundant with opportunity for entrepreneurs.

In 1997, the International Financial Corporation (IFC) began regular publication of an Investment Index for Russia, which is a promising sign for foreign investors who hold the IFC in high regard. According to the IFC, trade in Russian stocks has achieved a level acceptable to Western investors and comparable to stocks in other emerging markets like Brazil and Mexico. (Grishankov, p. 9) Because of its Investment Index, Russia will be able to attract more portfolio investments, and the payoffs will be more profitable than those in other emerging markets, particularly Venezuela and Hungary. (Grishankov, p. 9)

**German Businesses in Russia**

Germany's investment and development in Russia have been steadily growing, making it one of Russia's most important trading partners. Germany is the largest and most diversified of Western investors in Russia. Companies in fields ranging from oil to banking to consumer goods have established branches in Russia over the past few years. Five years ago, the number of German companies in Russia was only 30, but as of 1997 this number has grown to approximately 410. Companies with established offices in Russia include Pfaff, Krups, Lufthansa, Bau Klotz, Mercedes Benz, and Spiegel. (FIPC) Germany's trade with Russia is expected to triple last year's results. Major German construction companies have also been involved in rebuilding facilities and infrastructure in Russia, including pipeline and road construction, administrative buildings and health care facilities, as well as building homes for Russian army officers.

Germany ranks among the top three nations that directly invest in the Russian economy, with the United States and the UK being the others. (FIPC) Perhaps because of its geographical proximity, Germany seems to be the most prominent investor in the Russian economy. Its close economic relationship is supported by a number of bilateral treaties, based on the Russian Soviet Federalist Socialist Republic (RSFSR) Law on Foreign Investment and the Intergovernmental Treaty on Taxation which gives economic protection and most-favored-nation status to foreign investors. Also signed was a Russian-German Treaty on Elimination of Double Taxation on Income and Property in 1996. (FIPC) This treaty helps eliminate some problems related to double taxation of German corporations and makes investing in Russia more appealing to German investors.

German banks are also investing in Russian businesses. One of these banks is Kreditanstalt fur Wiederaufbau, which in a 1996 agreement with the Russian Entrepreneurship Bank promised financial support to small- and medium-sized businesses in Russia. (Makovskaya, p. 10) In the agreement, Kreditanstalt fur Wiederaufbau offered a 10-year, DM 50 million credit line to the Russian Entrepreneurship Bank (REB). Alexander Nichiporuk, chairman of the board of the REB, said it was the first program in which private investments would be guaranteed by both the German and Russian governments. REB, as the primary borrower, will then offer loans to the final borrowers for different investment projects. Loans of up to DM 1 million will be granted for a 3-year period at an annual interest rate of no more than 15 percent. Most of the funds will go to projects in Moscow, St. Petersburg, and the Vladimir and Tyumen regions. The recipients are not required to purchase any materials needed for these projects from Germany, but Kreditanstalt fur Wiederaufbau does require the money to be used for specific projects only and not just to increase a business's current assets. (Makovskaya, p. 10)

Westdeutsche Landesbank (WLB) opened a branch in St. Petersburg in 1995 to attract
new Russian clients. Dieter Falke, who serves on the WLB's board of directors, said the bank hopes to “fill the gap” for companies doing business in and out of Russia. WLB is also willing to assume risks on investment projects with Western firms while helping local medium and big businesses. ("Large German Bank Opens Representative Office," p. 1)

Another German investor in Russia is Schering, a large pharmaceutical company. Schering established a subsidiary in Russia in 1992, and has seen increasing sales and profits since it began its investment program. The company also has future plans to build a pharmaceutical factory in Russia, demonstrating its faith in Russia not just as a marketplace but as a country worthy of long-term investments. (Shpakov, p. 8)

Beyond Business Involvement

In a speech to the Alfred Herrhausen Society in Berlin, Chancellor Helmut Kohl reported that the amount of bilateral trade between the two countries in 1996 was approximately DM 27 billion, a 12 percent increase over the previous year. The German government supports this trade with Russia through DM 1.5 billion in trade guarantees, while an additional DM 1 billion is available for projects of interest to both countries. (Kohl, 1997) In addition, Kohl noted that a German business center, Haus der Deutschen Wirtschaft, was opened in March of 1997 to provide the German business community with a base for their operations in Russia.

In addition to involvement in Russia, Germany promotes economic development in other countries of the former Soviet Union, particularly Ukraine. As the second-largest country of the former Soviet Union, Ukraine’s market holds promise for Germany as well as the rest of Europe. (Blaney, p. 5) Germany has given over DM 3 billion in aid to Ukraine as of July 1996 and supports its desire to join the Council of Europe. (Pogorzhelsky, p. 26)

Other Eastern European countries in which Germany has invested include the Czech Republic, the Slovak Republic, Poland, and Hungary. Investment in these countries takes the form of capital investment guarantees, debt relief, humanitarian aid, and the German capital share in the European Bank for Reconstruction and Development. ("German Support for the Reform Process..." p. 3) This economic aid will help to achieve increased political stability in these newly emerging democracies.

**Political Reasons for German Investment**

Although important, increased trade with the former Soviet Union is not the only reason why Germany is giving aid and investment. Among the members of the European Union, Germany has emerged as the strongest country. Coupled with its geographical proximity to Russia and other East European nations, Germany has a legitimate fear of the impact of instability in the region and how this instability might affect it. (Blaney, p. 285) Instability could mean loss of both export markets and access to raw materials for Germany and, perhaps more importantly, the threat of nuclear proliferation.

Nuclear proliferation is a concern in Russia, as well as in other countries of the former Soviet Union which still hold caches of nuclear weapons. The leakage of nuclear materials in the form of theft has been a problem in the former Soviet Union and has created a threat to other nations. Furthermore, many of the newly independent states may not have accurate and complete records of nuclear material they received after the fall of the Soviet Union. (Moore, p. 15) The potential of this situation to destabilize Europe is one reason why Germany has directed so much attention and aid to Russia and other countries of the former Soviet Union. Meanwhile, some nuclear materials have been illegally shipped from Russia through Germany on their way to other countries. Germany has also supported an environmental cleanup in Russia, since environmental problems in Russia resulting from nuclear waste could affect Europe as a whole. (Blaney, pp. 289-90)

Russian organized crime also poses a threat to foreign companies doing business in Russia, particularly the threat of unwelcome “protection” by the Russian mafia. Because they control many aspects of Russian society, from the food supply to the production of minerals to the politics of reform in Russia, the Russian mafia
has succeeded in becoming an important (albeit corrupt) political influence in Russia. ("The Makings of a Molotov Cocktail," p. 35) Russian organized crime is also active in Germany, a fact which could threaten German national security. This has caused the two countries' intelligence services to cooperate on the matter.

Still another concern for Germany is the two million ethnic Germans living in Russia, Kazakhstan, and Ukraine, as well as refugees from the former Soviet Union seeking asylum in Germany. Although Germany's economic situation provides a greater possibility of employment for these groups, Germany simply cannot afford to support them all. The German government has offered money to those countries harboring ethnic Germans, so that they will be more inclined to stay there. (Blaney, p. 286)

**German Investment in Russia's Future**

Like the Marshall Plan, Kohl has called German investment in and aid to Russia "help towards self-help" — help which will allow Russia to make necessary structural changes in its economy so that it will not need aid in the future. Kohl sees German investment not just as investment in Russia, but as "investment in a common European future." (Kohl, 1997) He also hopes to see Russia become not just an economic partner with Germany, but with all of Europe, as he believes there is a place for Russia in European society and politics.

Germany hopes to facilitate Russia's integration into Europe by encouraging Russian cooperation with the European Union, including the opening of a free-trade zone. In addition, Russia has recently become a member of the International Monetary Fund and the World Bank. In 1996 it joined the Council of Europe to emphasize its commitment to human rights and the rule of law. (Kohl, 1997) At the World Economic Summit in Denver, President Yeltsin opened the conference of the heads of state and government, further emphasizing the commitment of both Europe and the United States to incorporating Russia into the G-7 (to become G-8 upon Russia's membership). However, this will not happen without a firm commitment from Russia to nuclear safety, one of the foremost concerns of Kohl and other leaders of the G-7 nations. Russia has already agreed to establish a nuclear-free zone in Central and Eastern Europe; and in September 1996, Russia and the G-7 signed an agreement for a comprehensive ban on all nuclear testing. (Orlov, p. 4) Kohl sees the formation of a nuclear-free zone as a possibility in the future, but Yeltsin is confident that Russia's steps towards nuclear safety will grant him full-member privileges in the G-8.

Kohl has also spoken of Germany's commitment to overcoming ethnic and religious conflicts caused by the breakup of the Soviet Union. At the NATO summit in January 1994, the "Partnership for Peace" was established to promote solutions to these ethnic and religious problems. (Kohl, 1996) European security requires Russia to make a firm commitment to cooperation with the European Union, and Germany seeks to strengthen its relationship with Russia for this reason as well. Germany also plans to improve the security and defense fields in Russia and in Europe as a whole. For Germany, the issue of national security and a united Europe is a vital one considering its geography and proximity to so many nations. (Kohl, 1996)

**Conclusions**

German-Russian relations have been intertwined for centuries, and now they are closer than ever. Building trust between the two nations is an important step towards Russian involvement in the European Union and its relations with the rest of the world. Communist rule has left its mark, however, and citizens of the former Soviet Union are now trying to survive in a new economic and political environment as they move towards democracy and a free-market economy.

Germany has been at the forefront of efforts to strengthen the European Union, and for Germany a strong European Union includes Russia. As a country known for its pragmatism, Germany sees economic investment as the best way to stabilize Russia's political system, thereby ensuring Germany's own status as neighbor and partner. Progress has been made in Russia, but changing the whole system of thinking from communism to democracy is a difficult process.
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