4 Investment Climate and Investment Risk

4.1 CONCEPTUALISING THE INVESTMENT CLIMATE

In section 1.2 the following definition of the investment climate was proposed: investment climate is a multiple category encompassing everything that the foreign investor takes into consideration when evaluating how well conditions in a particular country favour capital investment, including the economy and culture, ideology and politics. Defined in this manner, the investment climate becomes, rather unexpectedly, in a considerable degree a complex matter for conceptualisation.

This results, first of all, from the fact that, thus defined, the category of the investment climate appears to comprise quite a strong investor specific element inasmuch as the investment climate represents business conditions as they are evaluated, in every separate case, by a particular investor through the prism of his specific interests, strategies and advantages. So, unlike meteorology, strictly speaking, the same economic territory, in the terms of the above definition, may comprise as many investment ‘climates’ as is the number of foreign investors. A similar point has been made by Kobrin (1978) who wrote that political instability is clearly a property of the environment, while risk is a property of the firm. Such an approach explains why countries which, according to conventional wisdom, are least appropriate for foreign ventures manage, none the less, to attract foreign capital, as was the case of Soviet Russia in the 1920s and 1930s.

Further, the notion of the investment climate tends to be unmanageably extensive. It may be analyzed at macro and micro levels, in terms of economics, political science or, for instance, sociology.

Thus, at a macro level, it includes the economic and political situation in the country, as well as public sentiments and the national cultural background. Several parameters are usually referred to in this context, including the following.

Politics – the official attitude towards foreign ventures; the tradition of observing international agreements; the participation in the system of international agreements and agencies providing the infrastructure of the world economic regime; the strength of public institutions; the continuity of polit-

A. Kuznetsov, Foreign Investment in Contemporary Russia
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ical rule; the degree of pragmatism (or, conversely, idealisation) of state politics; the efficacy of state apparatus, etc.

*The economy* – the general economic situation (crisis, stagnation, boom); the exchange regime; the rate of inflation; the state of development of the capital market and the banking system; the tariffs and non-tariff barriers; the budget deficit and the balance of payments; the conditions on the labour market. In particular, foreign investors are sensitive to regulations and conditions putting limits on the freedom of the movement of capital and to factors determining the costs of production – the cost and quality of labour, and the development of the transport infrastructure in the first place.

*The social and cultural sphere* – the public attitude towards private property in general and to foreign property in particular; the degree of the cohesion of the society on the essential strategies of economic and social development of the country; party and trade-union mobilisation; the tradition of business ethics; management culture; the educational level of the population; traditions influencing consumption pattern, etc.

At a micro level, the investment climate shows itself in bilateral relations between the foreign investor and various state agencies, the foreign investor and local economic agents: suppliers and buyers, banks, trade-unions, and others. This level is very important. It is there the general estimates of business conditions by investors, based on the analysis of macro level data and other summarised input, takes the form of concrete relations between a foreign venture and a local environment.

The two levels interrelate. It is their combination that constitutes the investment climate since, for example, the effort of the central power to attract foreign capital may be undermined by the absence of motivation on the part of local authorities or paralyzed because of low executive culture. On the other hand, local initiative and involvement, especially in large countries, are essential to the success of the policy of central authorities as they may compensate for the defaults in regulation on a national scale.

To cope with the broad range of factors forming the notion of the investment climate one needs to introduce a model which, at the cost of abstracting from certain aspects of the subject, would permit to focus on its principle features. This book dwells on the problem of how to optimise strategy towards foreign capital (direct investment mainly) under the particular conditions of the transitional economy. This implies concentrating on two of the major broad categories of risks faced by international business in such an economy: political risk and policy risk.

The two types of risk are interdependent. It is not always easy to make a straightforward distinction between them. First, for the foreign investor