



## Lean against the wind: The moderation effect of foreign investments during the economic recession in Russia



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### ABSTRACT

Using a unique panel database of more than 1000 Russian public companies covering the period from 2004 to 2014, this study uses quantile regression techniques to investigate the moderating effects of foreign partners on company performance during the economic recession. The empirical findings are robust and confirm the positive impact of foreign ownership on limiting the negative effect of the recession on company performance. The strength of the impact depends on the level of firms' financial results. The outcomes have implications for company investment policy. The evidence supports government policy towards encouraging foreign entry liberalization in emerging markets during periods of turbulence.

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*“What we need – surprise – is more research.”*

Paul Krugman (2000, p.57) on the subject of studying FDI influence during the crisis

### 1. Introduction

In the last 10 years, the world economy has been dominated by the deepest economic crisis since the Great Depression. The GDP of most countries around the globe dramatically declined, accompanied by an increase in the unemployment rate and a decrease in trade volumes. Thus, the GDP in industrial countries fell by 4.5%, while average GDP growth in emerging economies dropped from 8.8% in 2007–0.4% in the second half of 2008, with world trade volume shrinking by over 40% in the same period (UNCTAD, 2010). In response, many economists have shown a growing interest in researching different aspects of the global crisis (see, for example, Eaton, Kortum, & Kramarz, 2011), particularly foreign investments as a significant factor in preventing the collapse of global trade. Given the challenges of modernizing financial institutions, this increased research interest has improved our understanding of whether or not foreign capital flows can offset negative recessionary consequences. Nevertheless, most of this research has focused on debating the pattern of macroeconomic responses to the crisis, while firm-level evidence remains limited and elusive. The finance and trade literature has largely

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grown independently of the behaviour of companies with foreign ownership. In a paper on the Asian crisis of 1997–98, Krugman (2000) argued that FDI accompanies financial crises, although “hard statistical evidence of a surge in FDI into Asia was not yet available” (p. 44). We believe this dearth of statistical evidence remains even today. In fact, few studies have attempted to estimate the role of foreign ownership in the economic crisis. Instead of investigating these uncertain empirical observations, most countries continue to pursue policies aimed at encouraging more FDI inflows.

The importance of FDI is especially crucial for developing countries and emerging markets. In 2010, for the first time, developing and transition economies together attracted more than half of global FDI flows (UNCTAD, 2010). For emerging markets, foreign ownership helps to fill gaps in human capital, providing resources in the form of management experience, technological capabilities and skills. One more frequently identified advantage of foreign investment flows is its perceived stability relative to other types of capital flows. The results of Desai et al. (2007) indicate another role of FDI in emerging markets, namely, the growth of affiliates during currency crises when local firms cut their activities and work under strict constraints. In this sense, the dramatic shift in the Russian economy from 2004 to 2014, when it experienced at least three periods of recession, constitutes an ideal context for the examination of microeconomic responses of foreign ownership to large negative economic shocks. Therefore, the investigation of mechanisms smoothing the effect of the crisis is particularly essential.

Relatively few analyses have examined the role of foreign ownership in establishment reactions to the economic crisis, while the results of these existing analyses are not consistent. Desai et al. (2007), evaluating the reaction of multinational and local firms to sharp depreciations, found that US multinationals increase sales, assets and investment significantly more than local firms, both during and following depreciations. At the same time, Alvarez, Bravo-Ortega, & Zahler (2015) found no significant difference in how multinationals and domestic firms reacted to the economic downturn in Chile. Tong and Wei (2011) examined whether the volume and composition of capital flows affected the extent of the credit crunch faced by manufacturing firms. Using data from 3823 firms in 24 emerging countries, the authors found declines in stock prices to be, on average, more severe for firms that were intrinsically more dependent on external finance. Only the composition of capital flows mattered: pre-crisis exposure to non-FDI capital inflows worsened firms' susceptibility to the credit crunch, whereas exposure to FDI alleviated liquidity constraints.

Our analysis draws on the different stages of the business cycle in this unique period and examines 1096 public, considerably heterogeneous, Russian companies between 2004 and 2014, as well as covering the different periods of the economic cycle and focusing on foreign ownership. A related and intriguing hypothesis is that foreign ownership tends to “lean against the wind” and may help companies to overcome the impacts of the recession, thereby outperforming firms that are reliant on domestic capital. The instrumental quantile regression approach to panel data was applied for testing this hypothesis.

We contribute empirical evidence regarding the FDI topic in several respects. First, foreign- and domestic-invested firms were compared in the wake of the recession helps to clarify the conflicting evidence found in previous papers regarding the extent to which financial constraints limit growth. Second, our findings shed more light on the role of close relationships with foreign partners for emerging economies: multinational companies fared, on average, better than did firms with local investments and similar economic characteristics during the recession. Therefore, our findings could provide additional guidance to company managers seeking to increase their competitiveness by implementing a globalization strategy. Finally, the results could be considered as an argument for policymaking decisions regarding government spending on investment promotion, especially to attract foreign firms.

The rest of the paper is presented as follows. Section 2 covers the background of the study, which motivates the subsequent analysis and empirical specifications in the context of a review of the existing literature. Section 3 is devoted to the methodology, while the main findings are presented in Section 4. Section 5 concludes the paper.

## 2. Did foreign ownership matter to companies during the economic downturn?

### 2.1. Definition and identification of the recession

Since our study primarily investigates the recession period, we have found in the literature several definitions for this particular stage of the cycle. In our paper, we follow the broader definition of Burns and Mitchell (1946) and define a recession as *a period in which a broad range of economic indicators falls for a sustained period, roughly at least half a year, immediately following an economic peak to the preceding trough* (p. 57).

Authors offer different measures for estimating the recession period. An increasingly popular way to identify a recession period is by employing *recession indicators*, developed in 2008 by the Organization for Economic Co-operation and Development (OECD) to provide analysts with early signals of turning points in economic activity (for a deeper understanding, see OECD, 1998). The concept of *composite leading indicators* (CLIs) is based on the updated view of the business cycle concept. It concentrates on estimating fluctuations around long-term trends and is thus more appropriate in historical contexts (Klucik and Juriova, 2010). The turning points are measured with the use of various quantitative and qualitative proxies, identified according to deviations (OECD, 2008). The difference as compared to classical metrics is this model's earlier prediction of peaks and troughs, given that it does not require an absolute decline in economic activity to identify a recession. Following Klucik and Juriova (2010), who justify the use of the CLI tool for identification of the recession stages, we adopt the tool in the empirical section of this study as the main instrument for drawing the economic cycle stages.

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