

# RUSSIAN BANKING SECTOR: KEY POINTS OF INTERNATIONAL EXPANSION

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**Abstract:** *Banking industry is traditionally seen as strictly regulated and driven to avoid political context. While Russian economy in general lacks both well developed regulatory framework and political independence of business entities, we would like to analyze the current state of affairs in an industry for which these attributes have become a hallmark. As Russian non-resource-based industries in general and the banking sector in particular are becoming more and more active players worldwide, the question arises, how exactly do Russian banks internationalize. We analyze four cases of international expansion by Russian banks in order to determine the main destinations for expansion, the entry modes used and whether they resemble resource-based companies in their internationalization. The results show that banks, even while being significantly state owned, are most likely guided by economic motives (as opposed to political ones), are leaning towards safer expansion destinations and are in several ways suffering from home market immaturity.*

**Key words:** *emerging markets, outward FDI, banking sector, Russia.*

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## Introduction

First of all, as Russian economy is not only an emerging one (as opposed to developed) but an economy in transition, it is clear that historical context still plays a major role in the activities of Russian economic agents and, if correctly interpreted, may offer precious insights into their behaviour. However, in order to remain objective we will limit ourselves to those facts that can be interpreted unambiguously.

Outward foreign direct investments (OFDI) from Russia followed the growth trend of developed economies since the second half of the 20<sup>th</sup> century but with sub-par growth tempo, ending with Soviet firms having about 320 affiliates in foreign countries by 1983 (Liuhto & Vahtra, 2007). These companies were often registered as joint ventures and

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were mostly situated in the Council for Mutual Economic Assistance (CMEA) countries; there were about 115 affiliates in OECD and 30 in developing countries; in 1990, the Soviet FDI stock abroad amounted to less than \$1 bn. *There is a strong possibility of organic international expansion having been constrained by environmental limitations.*

The crash of the Soviet Union brought about disruptions in previous economic activities of the largest national enterprises. During the initial transition period which took about 10 years around 1990, they were mostly involved in restructurization and consolidation of assets inside the country. Several studies documented the process of transformation of these former state-owned enterprises (Filatotchev et al., 2007b; King et al., 1995).

The 'catching up' process that started in the end of the 1990s was mostly done by Gazprom and Lukoil (resource giants) with them accounting for around 90% of Russian assets abroad (The Russians Are Coming, 2006); other companies joined later, in early 2000s. While Russia's performance was then and is now more alike to the countries at the higher stages of development (according to the Investment Development Path (IDP) theory (Dunning, 1981; 1986), Russia's FDI inflow should exceed outflow. However, the opposite was observed: \$38.7 bn. inflow vs. 46.1 bn. outflow in 2009 according to UnctadStat), and several explanations of this fact have been developed by scholars.

One of them was based on the idea of oligarchical structure of Russian economy: a larger part of population that forms Russia's overall profile is actually separated from most assets and capital which are controlled by oligarchy being able to behave like a 'state inside a state' on a higher stage of development (Kalotay, 2006).

Another position maintains that it is the hostility of the home country business environment, on the one hand, and the home government incentives, on the other hand, that force and encourage Russian companies to go abroad (Panibratov & Kalotay, 2009).

However, with the main share of OFDI having taken the form of cross-border mergers and acquisitions and greenfield investments present but in much smaller quantities, we might conclude that this state of things reflects the preference of Russian investors to go for quick returns and the lack of cumulative experience, which in turn indicates that until recently *Russian OFDI were more of a quantitative phenomenon than a qualitative one*, being a result of opening the 'Kingston valves' of Russian economy; whether it still holds true will be discussed below.

As for the banking sector, it also has some distinctive features that have historical roots. In the USSR, banks were established by the state for particular reasons in small quantities, thus enabling them to accumulate huge financial resources since this 'particular reason' could authorize a single bank to keep private deposits of about 250 m people or service international accounts of the entire soviet economy. This has resulted in a very high concentration level of current banking sector with several market leaders remaining from the soviet era and the latter having established ties (business, ownership, informal) with virtually every large Russian company set up before 1990s. Whether these ties have 'swayed' banks to behave like their partners or use the same expansion destinations, or had no effect whatsoever is another interesting question,

which, along with the main destinations and entry modes used by Russian banks, will be addressed in this paper.

The previous research on the issues mentioned above is virtually non-existent in Russian context, while the research dedicated to emerging economies in general sometimes led to controversial results, a good example of which could be the notions of banks following their customers or “paving the way” for them. Also, internationalization of Russian NRB (non resource based) industries has recently gained momentum and the fact that NRB companies account for 1/3 of Russian cross-border M&A purchases<sup>1</sup> makes us think they might need to be studied separately from RB (resource based) companies. In turn, Russian banking sector is ranked 3<sup>rd</sup> after machinery and telecommunications in terms of foreign M&A purchases (UNCTAD Cross-border M&A database) with nearly 10% of foreign M&A accounted to them. Quantitative reasons aside, Russian banking sector is different from other NRB sectors in its high concentration and state control, which draws attention to Russian banks’ foreign activities and their peculiarities and raises suspicions about the similarity of banking to RB industries. This leads to a theoretical problem of allocating the banking sector to one of the industry groups, which is also addressed in this paper.

In our study we will analyze the cases of internationalization of four major Russian banks and based on this analysis make generalized conclusions on the internationalization process of the Russian banking sector, specifically on the main destinations, entry modes and the differences between banks and other Russian MNEs which are mostly large natural resource companies.

## **Theoretical background**

While the theory of firm internationalization has been built to explain the motivations and strategies of firms from developed countries (mostly from Europe and the U.S.) expanding to developing markets, there have been attempts to test the applicability of the established concepts to explain the internationalization of companies from less developed markets.

The mainstream research in the field has focused on the amount of OFDI. Moreover, FDI outflows from emerging economies have been often taken as a proxy of activities of EMNEs (Filippov, 2008). Such approach could be challenged since the particular business motives and corporate strategies are neglected if studying Russian MNEs primarily from the perspective of their OFDI. Nevertheless, an increase of market-driven OFDI was expected already in 2005, as well as an increase of NRB companies’ share in total amount of outward investment (Vahtra & Liuhto, 2005).

Motives of EMNEs internationalization are considered to be the same as those of companies from developed economies with market, labour, resource and technology seeking prevailing over the rest (Rasiah, Gammeltoft & Jiang, 2010). In the case of

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<sup>1</sup> We use M&A data as an indicator of foreign activity as there is no sectoral breakdown in Russian OFDI data

Russia, resource and market seeking motives are most often stated as the main ones, but with little respect to industry specifics (Filippov, 2010).

In relation to Russia, a significant number of works contribute to studying general features of MNEs internationalization: they provide insights on possible adaptation of major FDI theories to current Russian environment, such as implementing an extra home economy factor into Dunning's OLI paradigm, or try to give an explanation for the inconsistencies between theory-based expectations and reality. Unfortunately, they suffer from spreading findings from RB industries onto Russian economy in general and overlooking the evidence from NRB industries, which, as this paper intends to prove, is no longer acceptable. While the differentiation between RB and NRB industries and addressing one of them at a time can be traced back to the 1970-s (Kobrin, 1979), in studies dedicated to Russian MNEs a general approach is mainly used.

A lot of research in the area of RB industries is dedicated to relations with governmental bodies, as these industries obviously suffer from great political pressure. These relations become especially complicated when the host country is an emerging economy where legal framework can be very dynamic and RB industries are deemed extremely important by government (Makhija, 1993; Meyer, 2001). Newer studies admit the existence of economic motives behind Russian MNEs' activities and their diversity (Filippov, 2010; Panibratov, 2009) but still address the process of internationalization of Russian companies as a mostly political phenomenon. Also, it has been noted that governmental policies regarding domestic companies going abroad in the past two decades have been becoming more and more encouraging all over emerging countries (Rasiah, Gammeltoft & Jiang, 2010)

Besides the importance of relations with host governments it has been noted that non-governmental organizations play an increasing role in affecting foreign expansion of RB companies as their activities are usually labour-intensive and having large environmental impact (Rugman & Verbeke, 1998; Ramamurti, 2004).

RB industries are the main subject or at least one of them in the majority of studies dedicated to Russian MNEs' activities, even if it isn't explicitly mentioned. This makes studies of Russian NRB industries' internationalization really scarce; furthermore, there are no studies concentrating on Russian banks' internationalization.

In general, banking is considered one of the most home-country oriented sectors due to legal restrictions and the nature of financial services (Rugman & Brain, 2004). In conjunction with the study by Dunning and Feng introducing the idea of institutional factors influencing the internationalization process of companies more than resources, capabilities and market factors (Dunning & Feng, 2008), this might provide insights into Russian banks' foreign affairs.

Determinants of foreign banks' presence and performance were studied by Dopico and Wilcox. Their research explored the correlation between the host economy factors (such as international trade, restrictions on foreign ownership, investment destinations, insurance and other activities) and their attractiveness for foreign banks and their performance (Dopico & Wilcox, 2002).

International activities of banks from developed economies were studied by Qian and Delios in their article tying internationalization theory with experience of Japanese banks. It appears that in their foreign expansion Japanese banks rely mostly on their major clients' actions and having experience in given host market only strengthens this reliance (Qian & Delios, 2008). However, there are works suggesting exactly the opposite, that Japanese banks follow their customers no longer (although they did so before) but actually pave the way for non-financial companies (von der Ruhr & Ryan, 2005).

The proposition of banks from emerging and developed economies competing in the same field was explored by Andreas Petrou. His research showed that while the motives of international expansion indeed are the same, the expansion destinations are significantly different and therefore the competition areas of banks from emerging and developed economies don't overlap (Petrou, 2007).

Roolaht and Varblane studied the inward-outward dynamics in the internationalization process of Swedish banks, their conclusions about different outcomes of high and low levels of international experience seem to be applicable to Russian banks as well. According to their research, a situation when a relatively highly-experienced company is being purchased by an agent with similar or lower experience in international activities might lead to authority conflicts. Establishing subsidiaries as a main entry mode by Russian banks might be seen as a way of avoiding the latter (Roolaht, Valblane, 2009).

A serious research in order to model the determinants of US banks' expansion, which appear to be the level of banking services, the number of subsidiaries, entry barriers, trade intensity and taxation, has been done by Miller and Parkhe (1998). While similar research is not likely to be done about Russian companies due to data discrepancy, the hypotheses about determinants of banks' expansion might give insights into non-US banks' behaviour.

To summarize what has been said about existing literature, there are some works adapting classic FDI theories to emerging economies in general and to Russia in particular. Also, there is a significant number of works dedicated to internationalization of Russian economy as a whole, or some particular industries, mostly RB. As a matter of fact, there has been an effect of 'overshadowing' NRB industries: international activities of companies representing the latter have been traditionally not paid enough attention to and seen as negligible, while ideas gained by generalization of RB industries observations were spread onto the whole Russian economy. While the international activities of banks have drawn researchers' attention, there is a very limited number of works dedicated to Russian banking sector specifically. This, due to the rising importance of the phenomenon, is an issue that we believe needs to be addressed.

## **Research questions and methodology**

There are arguments for the banks acting in a similar way to RB companies due to several reasons, namely: state control over banking industry (either direct through ownership or indirect through informal ties or political pressure), strict legislation and connection

to resource companies via ownership or business connections. The last point might require clarification: in a central-planned economy all business enterprises function not as business entities but as departments of a 'megaenterprise' – the state; it means that some ties between companies (including foreign ones after the dissolution of the USSR) could be inherited from the soviet times.

Hence, this paper is going to answer the following research questions:

1. What are the main destinations for foreign expansion of Russian banks and what determines the choice of them?
2. What foreign entry modes are commonly used by Russian banks and why?
3. Is the internationalization process of Russian banking industry similar to that of RB industries or not?

Our research is conducted in two main stages:

- preliminary study of Russian banking sector internationalization;
- case analysis.

In the first stage we examine data on Russian companies' foreign activities (geographical spread and major deals from companies' own data, Rosstat and the Central Bank of Russia) to recognize the basic patterns. Also, we select the banks for future study using Zephyr database on M&As and other deals by Bureau van Dijk. During the first stage we have chosen the deals where a Russian bank acts as a purchaser of a foreign credit institution and cleared the list of the deals which there was no quantitative data on. Also, we did not include the purchases made by Vneshekonombank and the Central Bank of Russia, as these are actually government agencies de facto (which is reflected in their founding documents, mission, etc.) and not state owned banks. The results show that Sberbank, VTB, Alfa-Bank and Gazprombank account for almost 90% of cross-border M&A deal value by Russian banks in the past ten years. This, as a proof of external activities' concentration, combined with the fact that the Russian banking sector is very concentrated internally with five major banks (the four mentioned above plus Russian Standard) having control of 47.9% of all sector's assets and 52.2% of capital allows us to believe that conclusions derived from the case studies of Sberbank, VTB, Alfa-Bank and Gazprombank are applicable to the whole sector in terms of internationalization.

In the second stage we move on to the case study, where we investigate the international activities of the chosen banks to answer the research questions.

### **A closer look at banking**

On one hand most internationalizing Russian banks are state-owned and even more: closely affiliated with RB companies, on the other hand they use completely different strategy of organic growth without obvious signs of political push in most cases. Moreover, if RB companies often have their deals backed by the government, banks do not always have that privilege. Moreover, banks cannot use export as an entry mode.



Still, they manage to operate working chains of subsidiaries on foreign retail markets, which indicates that their presence on foreign markets is not merely a support for business activities of their parent companies.

## Sberbank

Sberbank has the largest countrywide branch network with 18 regional head offices and more than 19,100 retail outlets with about 245,600 employees. Worldwide Sberbank operates subsidiaries in Kazakhstan and Ukraine and plans to expand into Belarus, China and India. Sberbank is engaged in international activities through direct settlement agreements, correspondent accounts with over 220 foreign credit institutions, trade finance operations and membership in a number of international financial organizations. As of April 16, 2010, the Central Bank of Russia owned 60.3% of Sberbank's ordinary shares and 57.6% of its total share capital, being Sberbank's controlling shareholder. The remaining shares are held by more than 263,000 institutional and private investors. Non-resident ownership of about 32% suggests Sberbank's shares are a compelling investment.

In its foreign market entry activities the bank focuses on establishing representative offices or subsidiary branches. Key aspects of Sberbank's internationalization are summarized in Table 1.

TABLE 1. Summary of Sberbank's foreign activities

<b>Main destinations for expansion</b>	CIS, Eastern Europe, China, India
<b>Notable assets abroad</b>	TeksakaBank (Kazakhstan), Bank NRB (Ukraine), Belpromstroibank (Belarus) Subsidiaries in China, India
<b>Preferred entry modes</b>	Establishing subsidiaries, brownfield investments
<b>Expansion approach</b>	Expanding subsidiary network via greenfield/brownfield investments, only major deals supported by government
<b>Ownership</b>	State-owned

## Vneshtorgbank (VTB)

The VTB Group has developed over the past two decades into a universal financial and banking institution with a leading position in Russia and a constantly expanding presence in the CIS, Western Europe, Africa and Asia. VTB holds the second place in Russia in terms of assets, capital, funding base, corporate and retail lending, with authorized capital of around \$3.6 bn. As of October 01, 2009 VTB's assets reached around \$93 bn. According to 2008 results, the VTB was placed the 70<sup>th</sup> among the world's largest banks.

VTB has two subsidiary banks in Russia, a number of financial companies (VTB Leasing, VTB Insurance, VTB Capital, etc.), subsidiary banks in the CIS countries, as well as several banks in Western Europe. VTB is a shareholder of the East-West United Bank (Luxembourg), the Ost-West Handelsbank (Frankfurt-am-Main) and the Donau-

Bank (Vienna). VTB was the first Russian bank to obtain a license to carry out banking activities in India and China and to open its branches in these two countries; VTB also services bank cards of UnionPay, a Chinese national processing company. Key aspects of VTB's internationalization are summarized in Table 2.

TABLE 2. Summary of VTB's foreign activities

<b>Main destinations for expansion</b>	CIS, Western Europe
<b>Notable assets abroad</b>	VTB-founded Russian Commercial Bank (Switzerland, Cyprus) Subsidiaries in China, India Shares in Donau-Bank (Austria), East-West United Bank (Luxembourg), Ost-West Handelsbank (Germany)
<b>Preferred entry modes</b>	Establishing subsidiaries
<b>Expansion approach</b>	Organic growth through expanding subsidiary network, government involvement at critical points
<b>Ownership</b>	State-owned

### Alfa-Bank

Alfa-Bank is the part of Alfa Group – the Russian largest privately owned financial-industrial conglomerate, with interests in oil and gas, commercial and investment banking, asset management, insurance, retail trade, telecommunications, media and others. Alfa-Bank has more than 200 branches in Russia, the CIS, the Netherlands, the UK and the United States.

The bank usually invests in projects where it can have the majority stake or an equal control. Foreign investors provide the bank with not only capital, but also the expertise which is needed to successfully develop and realize the bank's investment projects. Key aspects of Alfa-Bank's internationalization are summarized in Table 3.

TABLE 3. Summary of Alfa-Bank's foreign activities

<b>Main destinations for expansion</b>	CIS, Western Europe
<b>Notable assets abroad</b>	Amsterdam Trade Bank N.V. (Netherlands) Subsidiaries in CIS, US
<b>Preferred entry modes</b>	Establishing subsidiaries, purchase of major shares
<b>Expansion approach</b>	Careful expansion via greenfield/brownfield investments into CIS or developed markets without state support, hence the affinity to maximizing control
<b>Ownership</b>	Private

### Gazprombank

Gazprombank has operated in the banking market since 1990. Founded by the world's largest gas producer and exporter Gazprom, Gazprombank has become one of the



leaders in the banking sector, while key performance indicators place it among the top three banks of Russia. Gazprombank invests and lends to companies in major sectors of the economy – oil and petrochemical industry, metallurgy, machinery, nuclear industry, electric power industry, real estate construction, transport, telecommunications and trade. Gazprombank actively develops areas closely related to the investment business. Besides strategic investments in oil-and-gas, petrochemical industries, and media-business, in Russia Gazprombank occupies leading positions in transactions in the capital markets (bonds underwriting, arranging financing for clients), corporate finance advisory and project finance.

At present, Gazprombank operates 43 subsidiary banks in Russia, owns branches in Armenia, Belarus and Switzerland, representative offices in China and Mongolia, and other assets in Western Europe. The total number of offices delivering banking and depository services under the single brand name of Gazprombank exceeds 500. Key aspects of Gazprombank’s internationalization are summarized in Table 4.

TABLE 4. Summary of Gazprombank’s foreign activities

<b>Main destinations for expansion</b>	CIS, Europe
<b>Notable assets abroad</b>	IDF Anlagegesellschaft (Liechtenstein), Arosgas Holding AG (Austria) Shares in European gas-related companies
<b>Preferred entry modes</b>	Brownfield/greenfield investment
<b>Expansion approach</b>	Clearly biased towards parent company interests in gas industry and portfolio investments
<b>Ownership</b>	State-owned

When analyzing foreign activities of major Russian banks it becomes clear that Vneshtorgbank’s, Sberbank’s and Alfa-bank’s foreign activities are very similar in their key characteristics: main destinations, preferred entry modes and expansion approach, while Gazprombank’s activities stand out. The former is reflected in the choice of the CIS countries as the main expansion destination with some attempts to enter Western European countries and sometimes China and India, as well as greenfield/brownfield investments being the main instrument in building foreign subsidiary networks. The latter can be explained by the fact that Gazprombank was clearly following its parent company’s lead, often serving as an investment agent, hence the interest in gas industry enterprises and investment funds; second, its deals had more political traces surrounding them than the deals of other banks, and third, its activities clearly lacked the signs of establishing a large subsidiary network and retail orientation present in other banks’ activities. This might be explained by ‘too close’ relation to Gazprom and this allows us to treat Gazprombank as an agent of Gazprom, excluding it from the banking sector study.

## Findings & Discussion

The pattern formed by the studied banks' (except Gazprombank) activities leads us to the following conclusions. First of all, the choice of destinations for expansion might be a result of business motives or caused by environmental constraints. Affinity to the CIS, EU and BRIC countries' markets is likely to be caused by traditionally close ties, some brand awareness and other Russian companies' activities on the CIS markets and high demand for financial services in developed or rapidly developing economies; in this respect banks behave like a typical NRB company. Environmental constraints mentioned above include direct legal regulations encouraging banks to invest in developed economies and inner legislative and political instability prompting to look for safer expansion destinations. If it is the business motives that direct the expansion of Russian banks, then the saturation of current favourite markets or raising attractiveness of others will make the banks look for other destinations and might not have severe negative effects on their expansion; but if it is the environmental constraints that prevail, then Russian banks might face a problem when they are in need for new markets.

Second, the choice of establishing subsidiary networks as an entry mode is arguably a forced one. The nature of financial services combined with Russian economic environment makes export or other 'low-involvement' options like licensing impossible, whereas the same unstable environment encourages banks to look for total control over their foreign operations. While the example of VTB shows that attempts to establish wholly-owned subsidiaries on developed markets can be successful, it is unlikely that without improvement of local business conditions allowing for lesser control Russian banks could go on with the same enthusiasm.

Third, the careful overall expansion approach is again the result of domestic business environment. In order to switch to more aggressive behaviour and try to expand into less developed markets or give up striving for total control over operations there have to be serious improvements in Russian economic environment, while more effective entry into developed markets requires the same to attract clients. As we see, all key characteristics of Russian banks' expansion are more or less dependent on domestic economic conditions.

Initially, banks clearly stand out among the NRB companies; on one hand, most largest banks are state-owned and sometimes even affiliated with resource giants with the liquidity surplus being even more apparent than in the latter; on the other hand, unlike the latter, they do not have the export option when entering foreign market and have to physically establish their presence. Besides, in most countries banking is considered a very sensitive area requiring strict regulation thus limiting the usefulness of the governmental support. In addition, strict regulation in this case has a side-effect: common measures of international activity, such as transnationality index become useless, as the value of foreign assets, for example, indicates not the financial position of the company but the restrictions in place. As with the other service industries, the number of personnel abroad, the number of deals with foreign agents and the indirect

ways of assessing company performance also show a distorted picture thus making performance evaluation and comparison a tricky task by itself.

In comparison to companies from other industries, banks have proven to be rather conservative investors. Expansion to well-known CIS countries in the form of establishing subsidiaries was the most popular choice of internationalization path for most cases followed by expansion to stable Western European and the US markets and, in some cases China and India. This might be considered a wise move, as Russian banks definitely need their domestic clients. Despite initial position being more alike to RB companies, in their expansion Russian banks are behaving like a typical NRB company with the exception of entry mode choice, which is forced by the nature of financial services.

Another interesting feature of Russian banks' internationalization was their affinity to building subsidiary networks and general orientation on retail customers instead of simply following large Russian companies and servicing their needs. This, along with very limited compared to other industries political accompaniment, suggests that Russian banks' foreign expansion is actually an economic phenomenon and not a political one. One could say that it is not the government who uses banks it owns to achieve its goals but vice versa (when it is appropriate).

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