

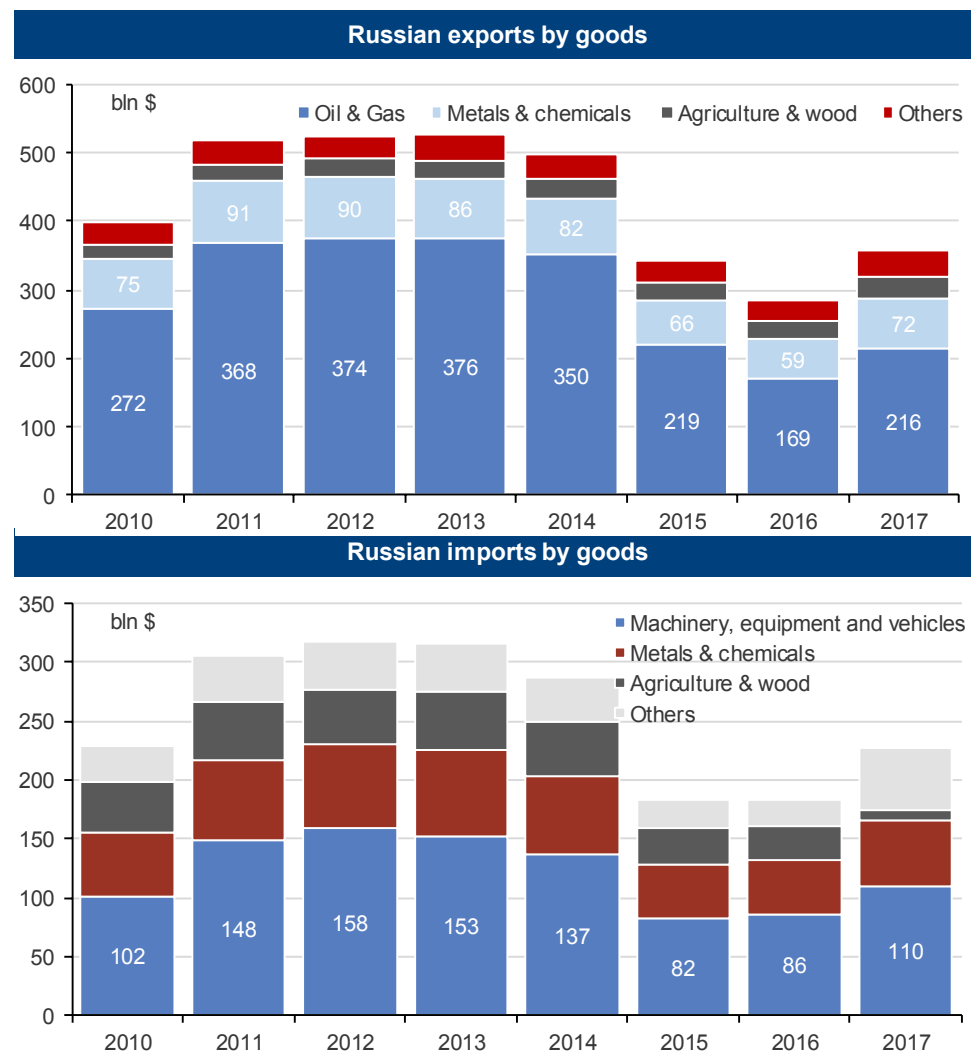
Trade in National Currencies: Challenges and Opportunities

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Russian economy: it is still mostly about commodities

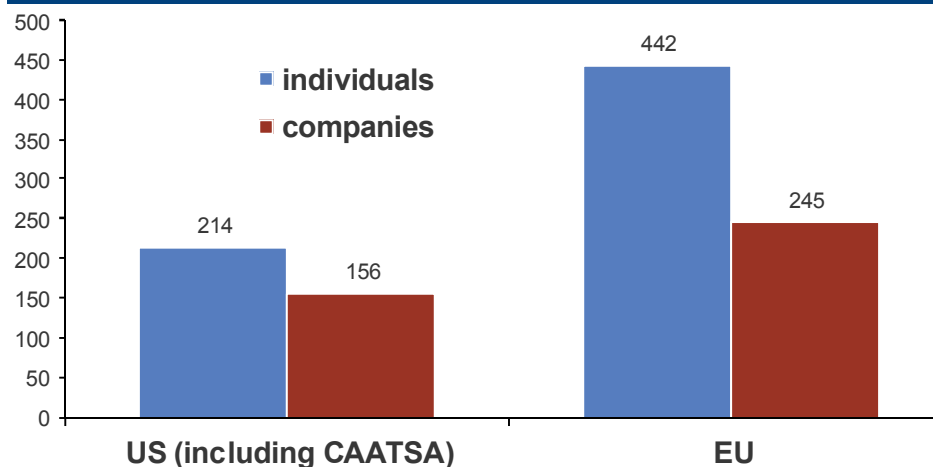
- Russian GDP per capita (\$10.6 thousand/per capita in 2017) is comparable to Turkey (~\$10.5 thousand) and higher than Iran (~\$5.3 thousand) and India (~\$2 thousand).
- Russian exports are strongly dependent on commodity products. **Oil & gas, metals contribute to about ~80% of total Russian exports.** It has consequences for trade in national currencies as commodities are generally priced in USD. Russian imports consists mainly of machinery, vehicles and other consumer goods.
- **High share of commodity exports haven't changed despite** numerous efforts by the Government to diversify the economy and stimulate manufacturing/high tech industries.
- **Russian foreign trade declined significantly in 2015-16** due to lower oil prices and economic recession and started to restore in 2017-18. But it hasn't reached maximum levels of 2013.
- **Russia has a strong positive trade and current account balance.** It means that the country receives more FX than it spends. By definition, it means that Russia's foreign assets continue to grow.



Russian context since 2014: the war of sanctions

- Since 2014, as the situation in Ukraine deteriorated, Western countries gradually implemented sanctions against Russia.
- Current sanctions by the US/EU include sanctions against targeted individuals, financial sanctions against the number of banks and companies and some technological sanctions. **The most important are financial sanctions as they limit the ability of Russian corporates to attract foreign financing from the West.**
- **Russia retaliated with its own counter-sanctions.** It mainly includes the ban on food imports from EU and some other countries. It was implemented in 2014 and is still in place.
- CAATSA law implemented signed in August 2017 broadened the scope of possible sanctions against Russia and included cyber attacks as a possible reason for implementing new ones. **CAATSA gave legal grounds for 'secondary sanctions'**.
- **Sanctions have made significant damage to the Russian economy** and continue to hinder long term economic growth potential. But to the date they haven't influenced Russian public opinion.

Number of people included in Ukraine related financial sanctions (as of Oct'18)

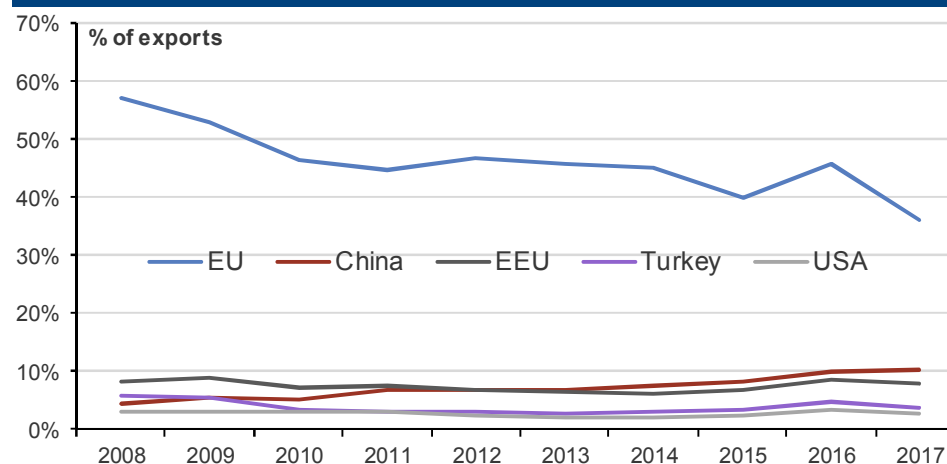


- **In April 2018 the US expanded sanctions including number of businessmen** (Deripaska, Kerimov and others) and number of top Russian state companies (most importantly **Rosoboronexport**, a weapons trading state company).
- After November 2018 there's a risk of new US sanctions coming in with some major state banks may be included in SDN list and the US may forbid the their companies to buy new issues of Russian government debt.
- **Sanctions create strong stimulus to trade in national currencies and not trade in USD as any USD-based transactions possibly may be blocked.**

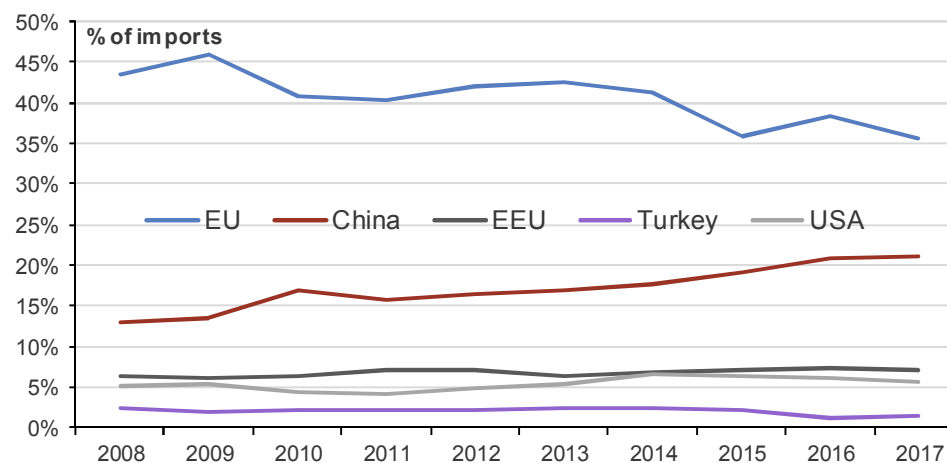
Russian main trading partners: less EU and more China

- **EU is still Russia's main trading partner** contributing to 36% of trade turnover. The share of EU in Russian foreign trade declined gradually in the last 10 years even before 2014.
- **Share of China in Russian foreign trade increased** the most in the last years (from 7.4% of trade turnover in 2008 to 14.6% in 2017). Russia increased oil exports to China becoming the major supplier while China increased exports of consumer and investment goods to Russia. But Russia is not a priority market for China as it takes about 2% of China's foreign trade.
- **Russia is a member or regional trade block Eurasian Economic Union - EEU).** Another members of EEU are Armenia, Belarus, Kazakhstan and Kyrgyzstan. Economic integration with EEU countries allowed to increase trade in national currencies for Russia. But the problem is that other EEU countries are relatively small and foreign trade with is about \$45 bln per year (7.4% of Russia's foreign trade turnover). So potential to increase the trade is limited by the size of EEU economies.

Structure of Russian exports by trading partners

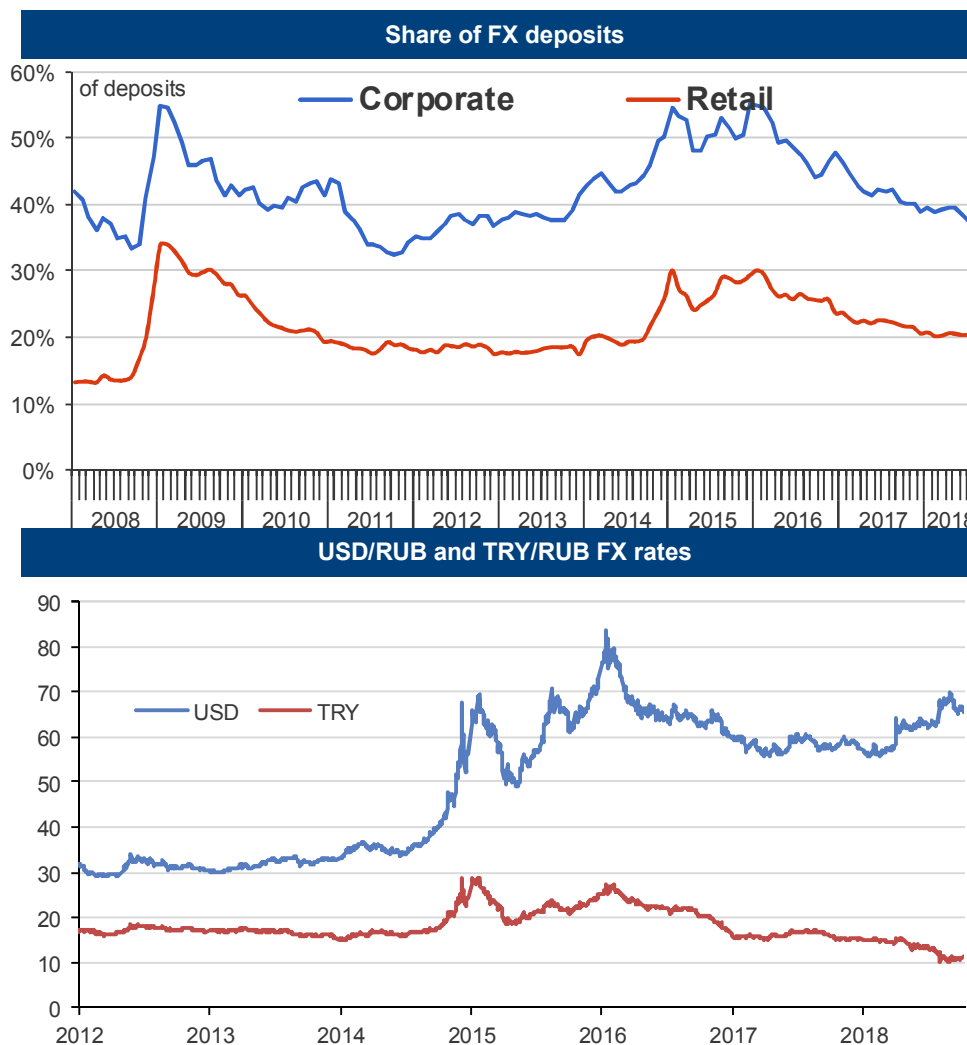


Structure of Russian imports by trading partners



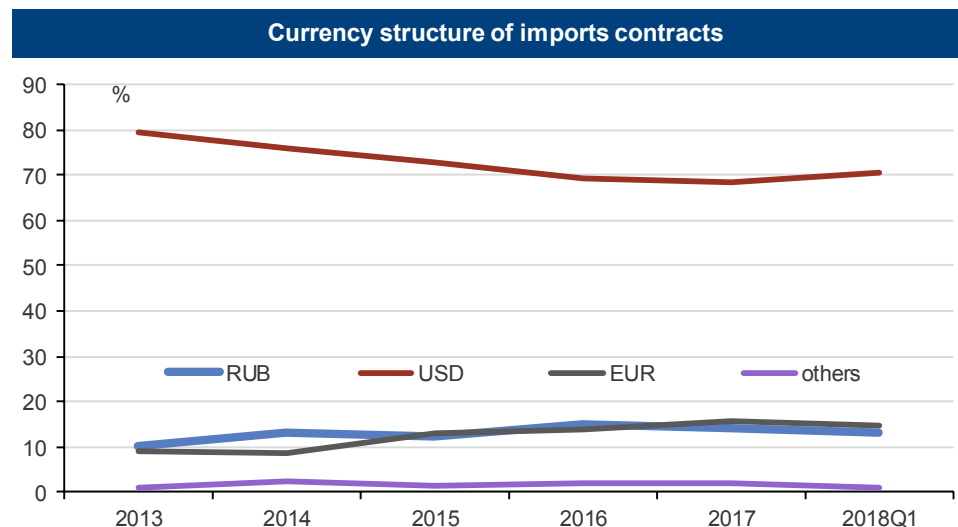
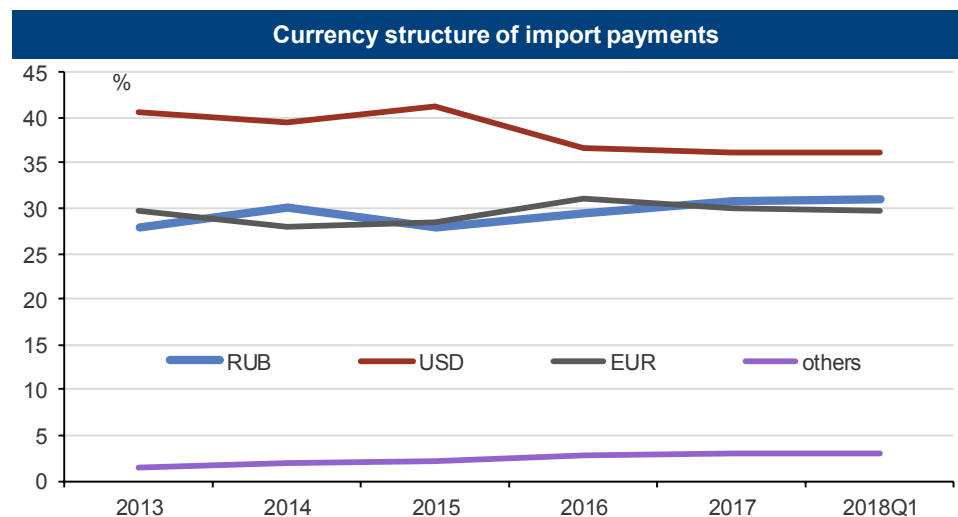
Russia's economic policy: stability is in priority, still volatile RUB

- From November 2014 Russian CBR moved to free floating FX regime and abandoned FX interventions and any targets for FX rate. There were FX interventions implemented by Minfin.
- CBR also made a gradual shift towards fully-fledged **inflation targeting, which was officially introduced from the beginning of 2015.**
- In the last years central bank conducted relatively tight monetary policy aiming to keep real rates positive at 2-3% range.
- **Fiscal policy was also relatively conservative** with limits on growth in government expenditures. Currently there's a fiscal rule in place which limits the levels of the government at low levels (about \$42/barrel this year).
- **Conservative macroeconomic policy allowed the economy to adapt to huge external shocks.** It also helped to decrease sensitivity of households and corporates on FX rate fluctuations and decreased pass-through effect from FX on inflation. RUB is still volatile due to high share of commodity exports and sanctions shock.



Russia's use of trade in national currencies: current status

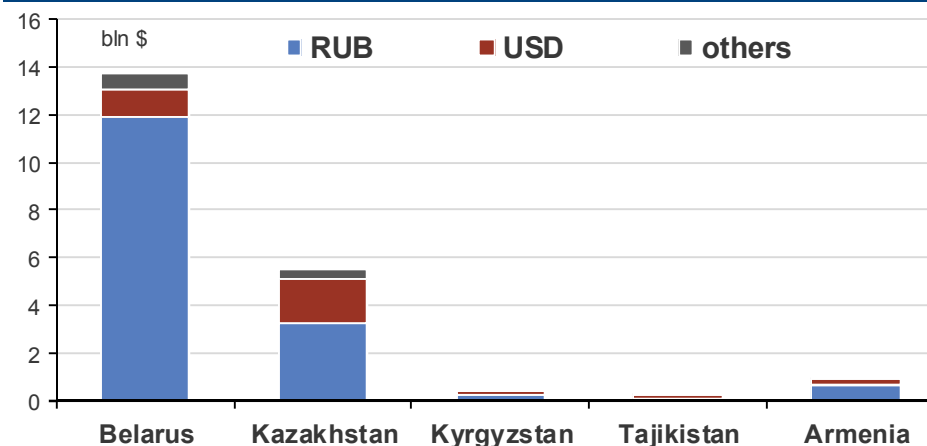
- Since early 2010s Russia officially started to **support international trade in national currencies** and expanding reserve currencies.
- As of 2018Q1 RUB was used in 13% of export payments (9% - EU, 6.4%- China) and in 31% of import transaction (by value). (29.5% - EU, 3.8% - China)
- Specific measures that were implemented to support trade in national currencies:
 1. **Stronger economic integration with neighbor countries** by creation EEU. It also helps that these economies are smaller and less financially developed than Russian economy.
 2. **Special financing instruments and bodies** to facilitate foreign trade in national currencies including export-import agency, development bank, trade financing in RUB etc.
 3. **Direct FX trade in CNY/RUB and BYN/RUB** organized in Moscow Exchange (MOEX). In 2017 total value of CNY/RUB spot market was \$5.8 bln.
 4. **Trade in commodity markets in national currencies.** Since 2017 SPIMEX commodity exchange organized spot and futures trade for URALS crude.



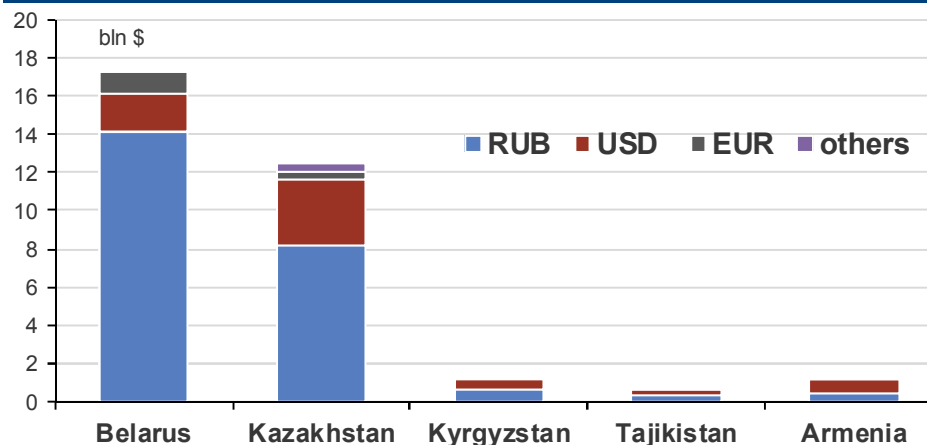
Russia's use of trade in national currencies: success of EEU (relative)

- RUB is heavily used in intra - Eurasia Union foreign trade (~ 80% of payments) due to strong economic links (trade, remittances, investments etc).
- The success of RUB in EEU trade is influenced by dominance of Russian economy in EEU, strong cultural and investment links, unified labor market and subsidies that Russia is ready to provide to support the EEU.
- **But intra-EEU trade excluding Russia is still dominated by USD (50-80% of transactions by value).**
- According to survey of EEU businessmen in 2018, main obstacles for use of national currencies are:
 1. Low liquidity of FX cross-currencies and high costs associated with these transactions.
 2. Lack or total absence of instruments for hedging FX risks.
 3. High costs of trade financing in national currencies.
- **Mutual investments are important facilitators of trade in national currencies.**

Currency structure of payments FROM Russia with EEU countries

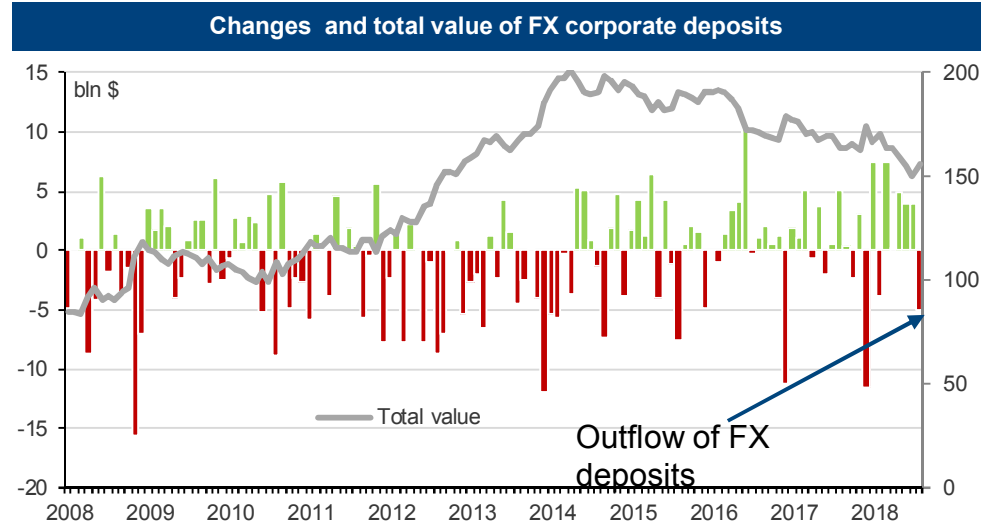
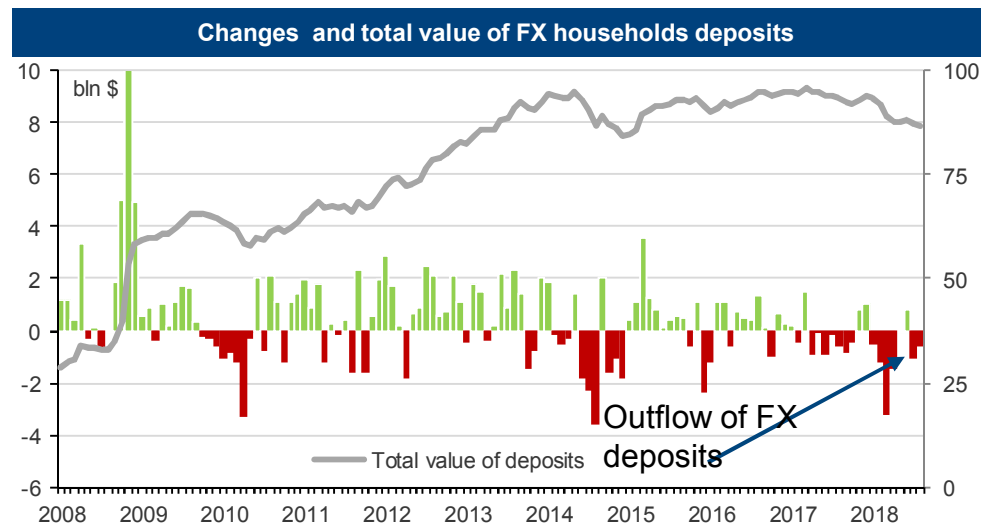


Currency structure of payments TO Russia with EEU countries

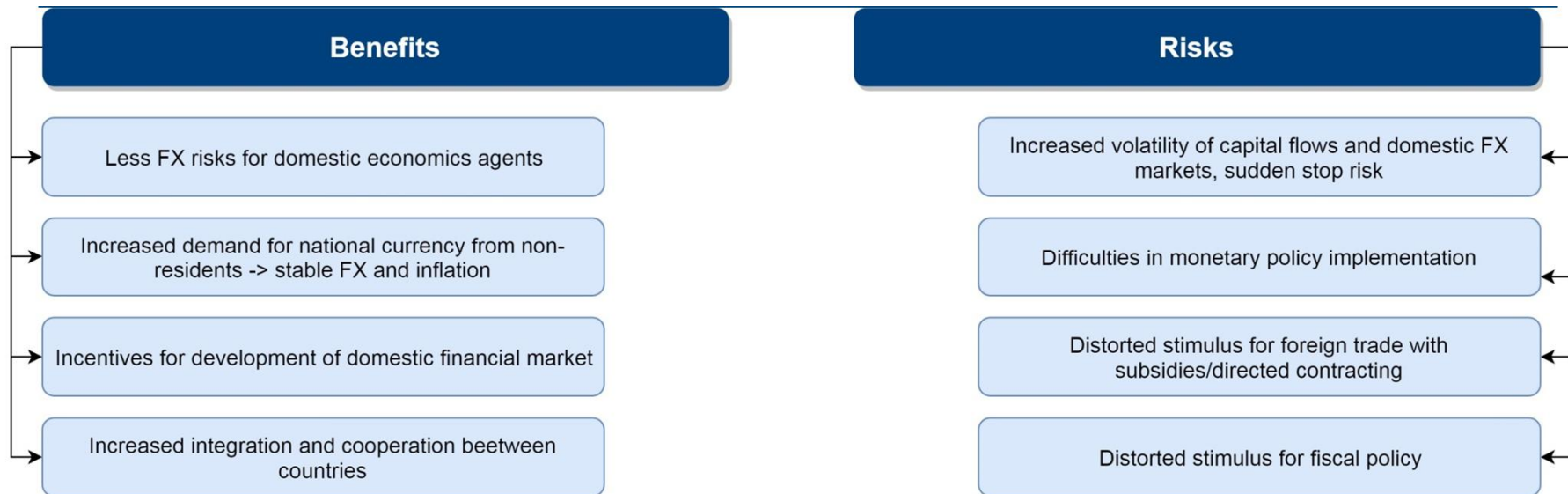


Trade in national currencies: current discussion in Russia

- **Head of VTB bank Andrei Kostin presented a 'plan for de-dollarization'** in August 2018. According to public sources, the plan was approved by President V. Putin and will be implemented in near future.
- Despite to some loud statements made by Kostin, the actual details of the plan are rather modest and include the following:
 1. Decrease of USD use in foreign trade transaction in favor of EUR, CNY, RUB and others.
 2. Transfer of legal addresses of the largest Russian corporations to national jurisdiction (including creation of domestic financial offshores)
 3. Creation of domestic Euroclear analogue for domestic issues of Eurobonds.
- **Kostin's plan for dedollarization even if implemented doesn't mean any radical changes in Russian economic policy.** There no plans to implement ban on use of FX in Russia. But it already has lead to outflow of FX deposits from domestic banks and large capital outflow. State banks were hit the most.



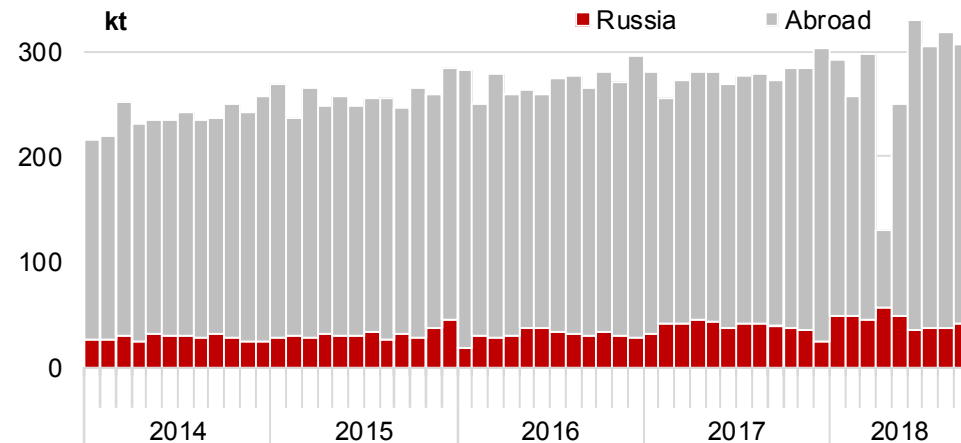
Benefits and risks of increased international currency usage



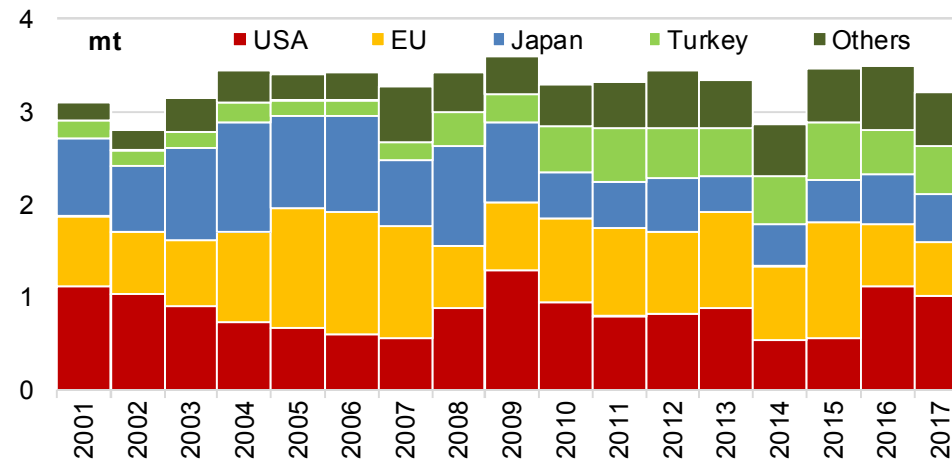
Case #1: RUSAL's story

- **RUSAL, EN+ and other companies of Oleg Deripaska were included to the SDN list in April 2018.** This means that all US people must sell their shares and bonds of targeted companies and terminate all contracts by a certain date.
- The sanctions hit RUSAL hard as about 80% of its production goes for export.
- In April 2018 RUSAL asked their customers to make payments in EUR in order to by pass US sanctions. In May 2018 there fears about RUSAL making payments on the Eurobonds but the company could make the payments.
- **In 2Q18 export shipments of RUSAL fell 22% y-o-y** due but it's mainly April crush. Then production and shipment has recovered but it's mainly effect of front-loading from foreign buyers.
- OFAC extended for the second time the expiration date of certain general licenses related to EN+ Group and RUSAL. So maybe there will be easing on RUSAL.
- **But RUSAL story showed that even largest corporation can become target of US sanctions.**

RUSALs shipments by target destination, Jan 14 – Sep 18

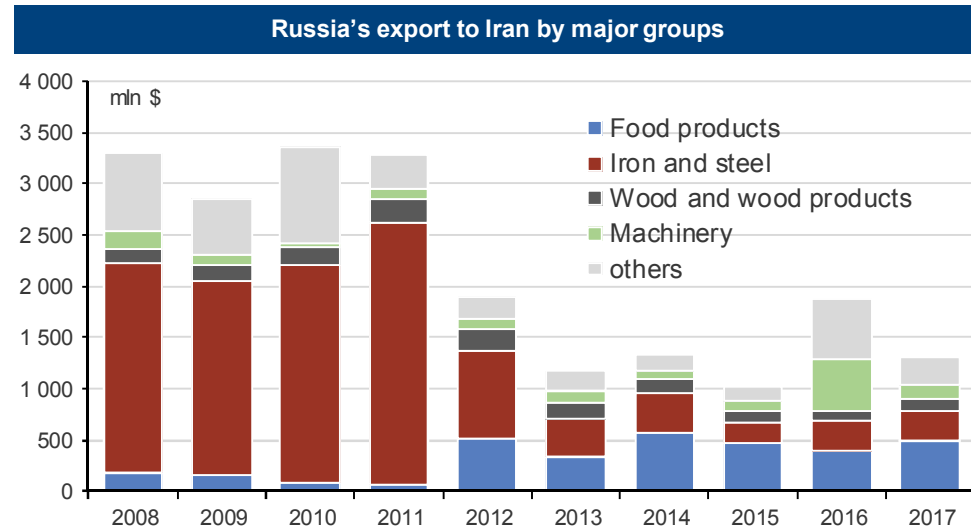


RUSAL's exports by country



Case #2: Russia-Iran 'oil for goods deal'

- Russia and Iran began to discuss the so-called program "oil for goods" a few years ago. The start of the joint program was repeatedly postponed, largely due to difficulties with cash payments. The organization authorized by the Russian government (Promsriereimport state company).
- Under the terms of the program, Tehran sells 5 mln t/year 100'000 barrels/day) to Russia. Half of the receipts must be spent purchase Russian goods and services. Currently payments are made in EUR. For example, the funds are used to finance the electrification of the Hamsar-Inche-Burun railway line by RZD.
- Russia-Iran 'oil for goods' deal can hardly be described as success story as the scope remains limited.
- EU is considering to use the same barter scheme via Russia. According to the scheme Russia will buy and process Iranian crude and then export it to EU. As European companies do not make direct payments to Iran, formally there's no break of the US sanctions. But still there are huge legal risks. So the future of the scheme is uncertain.



Conclusions

1. **USD for a long time is a dominant currency of the world** with little competition from EUR and CNY due to their specific factors. But increased and questionable use of financial sanctions by the US will contribute to declining role of the USD. Major benefits of the USD for foreigners are stable economic environment and the most liquid financial markets in the world with plenty of instruments.
2. **Increased use of financial sanctions by the US has made it clear that there significant risks even for largest corporations like RUSAL.** It's non-economic risk and cannot be hedged away. So every major company in a country hit by sanctions will consider or already has some sort of plan 'B'. It means that there is a large demand for alternative global payments/financial system by passing US. That's why different regional payments solutions have a future. **But in order to make them sustainable they have to be competitive both in terms of pricing and quantitative measures(time, security, reliability etc).** New solutions may be more advanced than existing ones.
3. **Main challenges for Russia as in other EMs are volatile economic environment** with frequent recessions, currency crashes, spikes in inflation etc. So the trust in domestic currency both by citizens and foreigners is relatively low. **Stable macroeconomic environment is absolute necessity to promote the use of national currencies both for trade and savings. So efficient monetary and fiscal policy are required.**
4. In order to facilitate trade in national currencies you have to facilitate mutual investments. Investment project create long term demand for transactions between countries. **So favorable investment climate for foreign investors should be a priority.**
5. In order to develop increased use of national currencies in trade some forms of subsidies are needed. There are strong incentives why people prefer to trade in USD or EUR so it's necessary to create market stimulus in trade in national currencies. But these subsidies should be carefully crafted and not distort the market.
6. **Development of local financial markets is also a key.** Most direct FX trade in national currencies is illiquid or non-existent and lacks necessary hedging instruments. It creates extra costs and uncertainty for economic agents.
7. **Financial markets mutual access, harmonization of regulation and variety of instruments are also necessary.**
8. Russian approach (as in other countries) is aimed firstly **at the use of the own currency.** It's a prisoners dilemma. In order to promote alternative everyone has to cooperate with other for our mutual benefit.