Challenges for development financing in BRICS: Perspective from Russia

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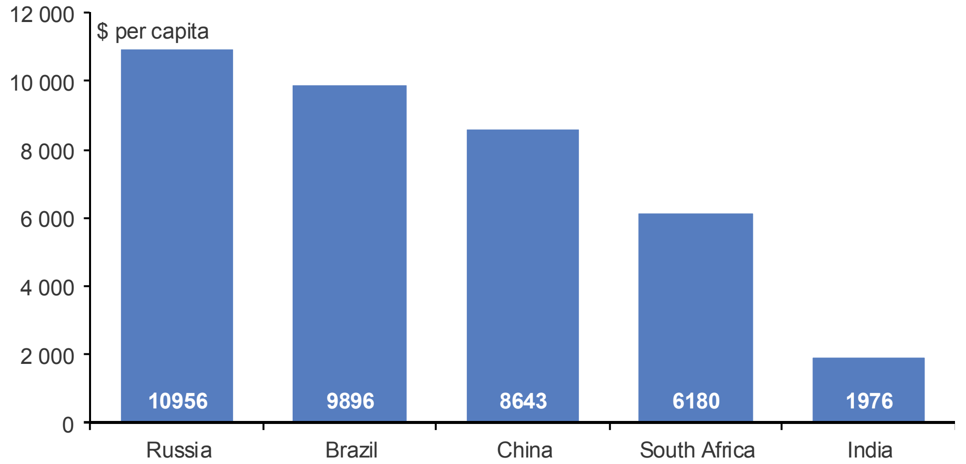
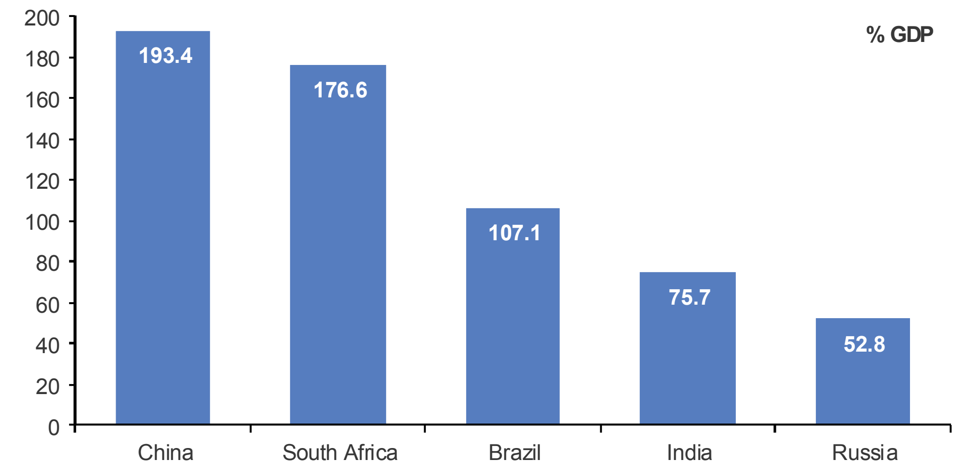
BRICS: there are still lots of differences

- BRICS countries are rather different both on structures of their economies and on current level of economic development.
- Formally Russia has a highest level of GDP per capita (in current $) closely matched by China and Brazil. At the same time Russia has been experiencing long term slowdown in growth rates and struggles to keep growth rates even above 2%.
- Degree of financial development also varies significantly in BRICS. In terms of domestic credit provided by financial sector China and South Africa stand out (>150% of GDP).
- Different structures of the economic and financial sector makes it difficult to establish common policies for financial development in BRICS.
- But it doesn't mean that there's no common ground for cooperation and development.

GDP per capita in BRICS (2017)



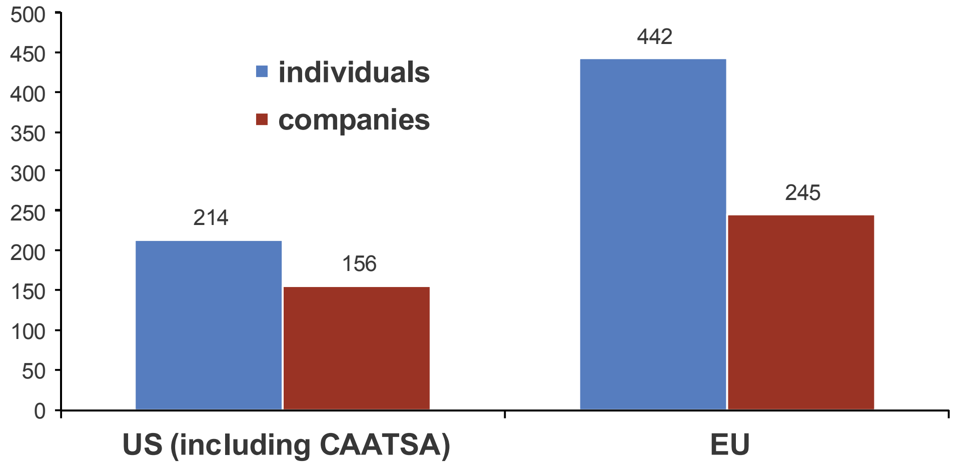
Domestic credit provided by financial sector (2015)



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 counties. 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)



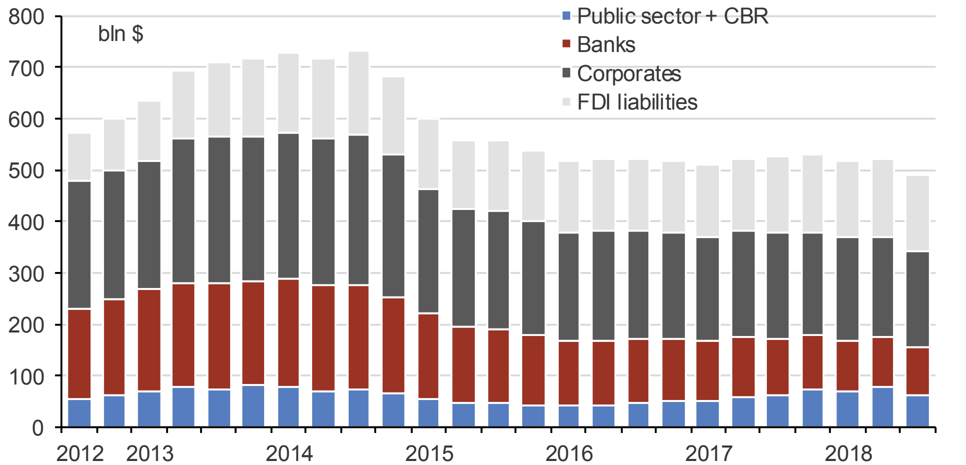
- **In April 2018 the US expanded sanctions including number of businessmen** (Deripaska, Kerimov and others) and number of top Russian state companies (most importantly **Rosoboronexport**, a weapons trading state company).
- After November 2018 there's a risk of new US sanctions coming in with some 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.**

Source: OFAC, European Commission, IEF calculations and estimates

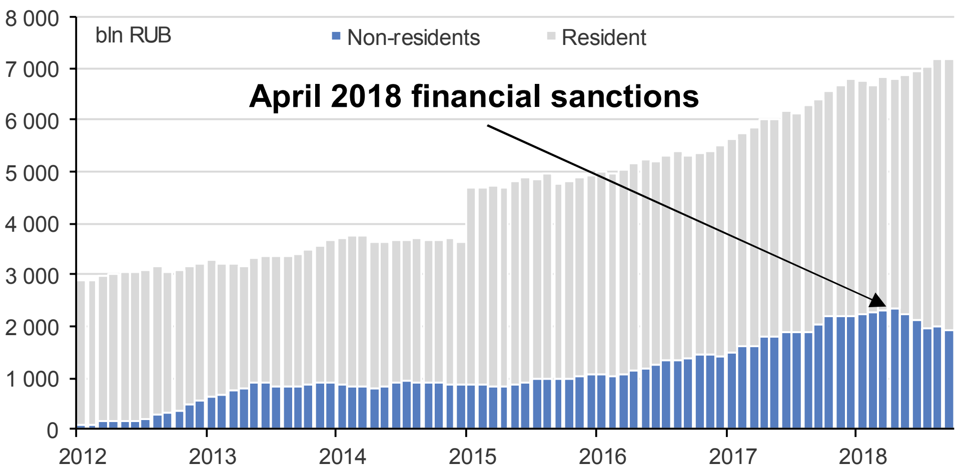
Sanctions limited abilities for Russian corporates & govt for financing

- Financial sanctions have limited opportunities for Russian corporates & Government to access the Western capital markets as investor base diminished.
- It have led to gradual decrease in Russia's external debt from $700+ bln in 2014 to below $500 bln in 2018 as companies paid out their external debt without refinancing. As companies & Govt turned to domestic borrowing it increased domestic rates.
- April 2018 sanctions and possibilities of sanctions against new issues of government bonds became a shock for OFZ markets. In April-October 2018 non –residents sold about $8 bln of OFZ holdings. To a larger extent the sell-off was absorbed by residents (mainly state banks) but increased the cost of borrowing for the Government.

Russia's external debt , 2012-2018



OFZ ownership by resident & non-residents



FDI flows are still heavy concentrated in EU/US for BRICS

BRICS FDI stock matrix in 2017 (bln $)

From/To	Brazil	Russia	India	China	South Africa	BRICS	USA	EU
Brazil	-	0	0	2	0	**2**	46	115
Russia	0	-	1	1	0	**2**	7	342
India	0	3	-	0	0	**3**	19	51
China	6	15	8	-	7	**36**	78	227
South Africa	0	0	1	0	-	**1**	4	90
BRICS	**6**	**17**	**10**	**3**	**8**	**45**	**156**	**825**
United States	126	14	44	189	7	**380**	-	3 244
EU	430	304	113	378	67	**1 291**	3 096	-

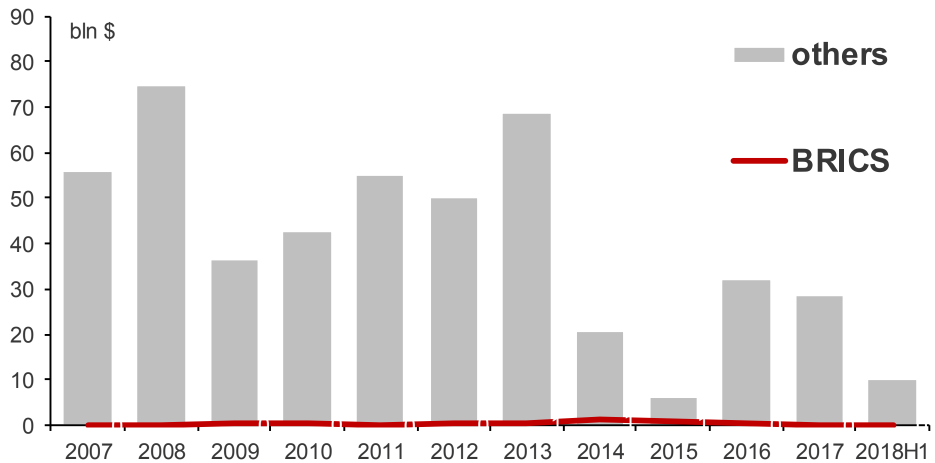
- Most of FDI flows in BRICS come through developed markets, mainly the US and EU. The situation haven't changed much in the last years.
- Current instruments for development financing in BRICS like NDB provide loans to the governments not to the companies. Mostly these politically backed large investment projects.

Source: national statistics

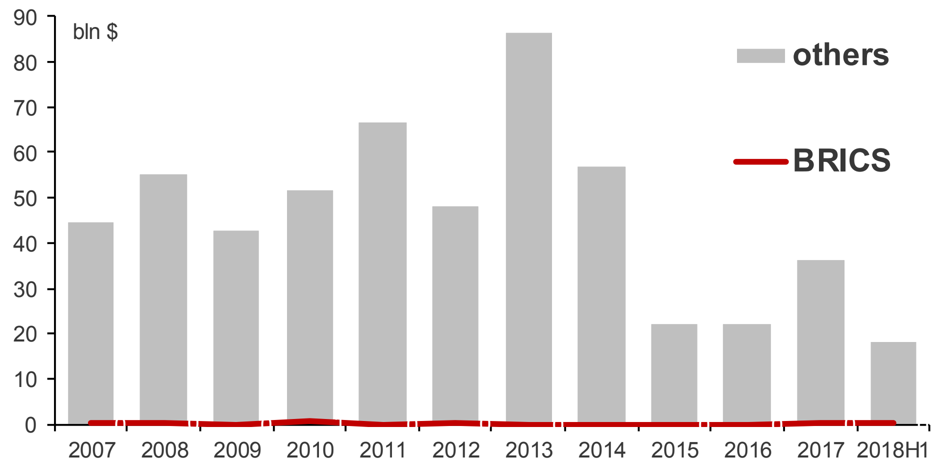
Financial inflows between BRICS countries haven’t increased much in the last years

- There two important pillars of BRICS financial cooperation – Contingency Reserve Arrangement (CAR) and New Development Bank (NDB). These are important mechanisms fostering financial cooperation but are not enough.
- BRICS countries are responsible for just small share of FDI inflows and outflows in Russian economy despite some large scale investment projects, mainly in oil & gas (Yamal LNG financing, Rosneft’s upstream projects with Indian companies, equity stakes of Sinopec and Silk Road Fund in Sibur and others).
- Obviously FDI data is distorted by the way M&A deals financially are structured. A lot of financing arrangements are done through offshore jurisdictions. But still no major breakthrough was archived in the last years.

FDI inflow to Russia



FDI outflows from Russia



Source: Bank of Russia

NDB activity in BRICS: what are the current results?

NDB financed projects in Russia

PROJECT	LOAN AMOUNT	Sov/Non-Sovn	BORROWER	GUARANTOR	LENDING MODALITY	TARGET SECTOR
Sustainable infrastructure in relation to "ZapSibNefteKhim" Project	300	Non-sovereign	SIBUR	SIBUR	Non-sovereign project loan	Sustainable infrastructure
Small Historic Cities (Russia)	220	Sovereign	Govt	Sub-projects in nine participating small historic cities	Sovereign project loan	Urban infrastructure, sustainable development
Volga	320	Sovereign	Govt	Sub-projects in five participating cities in the Volga River Basin	Sovereign project loan	Water supply and sanitation, sustainable development
Ufa Eastern Exit	68,8	Sovereign	Govt	Government of Bashkortostan	Sovereign project loan	Transportation
Judicial Support	460	Sovereign	Govt	Beneficiaries – Supreme Court, Moscow City Court and District Courts, Federal Bailiffs Service	Sovereign project loan	Social infrastructure
EDB/IIB	100	Non-sovereign	EDB/IIB	Nord Hydro-Bely Porog + other subproject(s)	National financial intermediary (NFI): two step loan	Renewable energy (hydro-power) + green energy

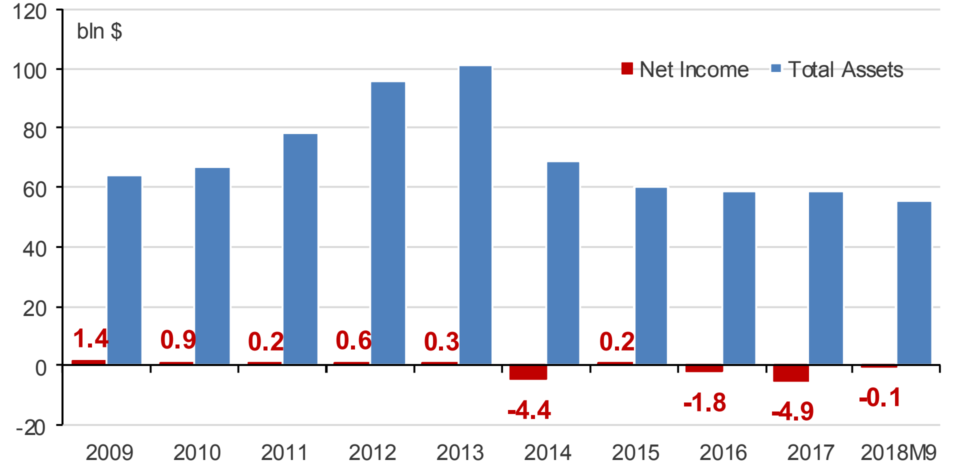
- NDB is a Multilateral Development Bank established by BRICS countries to mobilise resources for infrastructure and sustainable development projects.
- Paid in capital of NDB is $10 bln and subscribed capital is $50 bln. NDB has AA+ long term credit rating.
- Almost 80% of lending of NDB goes to Sovereign or Sovereign-guaranteed projects.

Source: national statistics

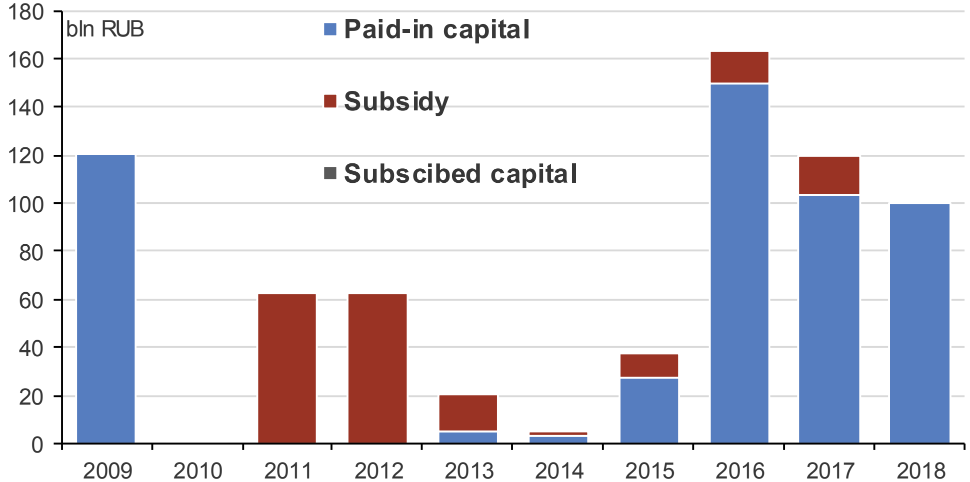
Changes in development financing strategy in Russia: VEB case

- VEB is Russian major national development bank. The VEB group consists of several banks and companies. Total assets are about $55 bln currently. But VEB is still on the way to find a sustainable business strategy.
- In the past VEB became a victim of poor management practices & involvement in politically motivated projects. In the last 5 years total losses of VEB amounted around $10 bln. In last years the Government was forced to inject $2-3 bln of fresh capital per annum in order to keep the bank bank afloat.
- Despite numerous attempts, VEB is mainly a sole creditor in investor projects. It's share of syndicated credits is about 10% of total portfolio.
- New management of VEB (former Deputy PM Igor Shuvalov) announced a new strategy – "factory of project financing". The aim is to consolidate & optimize different government entities doing development financing. It's not clear year how viable and effective new strategy of VEB will be.
- Till 2024 VEB will get about $10 bln of subsidies from the budget to refinance external financing and another $5 bln to increase capital.

VEB's main financial figures



Currency structure of export contracts



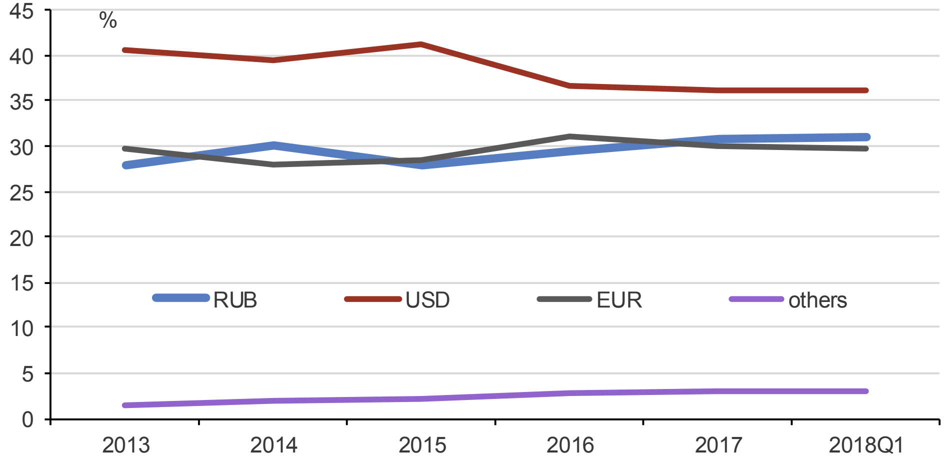
Some Steps to Improve Financial Cooperation in BRICS

1. **BRICS supported alternative payment systems**. 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 bypassing 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).
2. **Increase of trade in local currencies**. 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 to not distort the market.
3. **BRICS rating agency** - unification of requirements and ensuring comparability of credit ratings of issuers, increasing the level of confidence in the ratings at a global level.
4. Unification of the **regulation of the capital markets** of the BRICS countries.
5. **"Bridges" between stock exchanges and depositories** of BRICS member countries to ensure direct access of investors to national markets of BRICS countries.
6. **Common commodity futures exchange** with the aim of establishing regional benchmarks (for example, ESPO crude for oil market).
7. Establishing **financial media targeting BRICS** financial markets.
8. **Liberalization of access to home capital markets** of the BRICS member countries for their issuers.

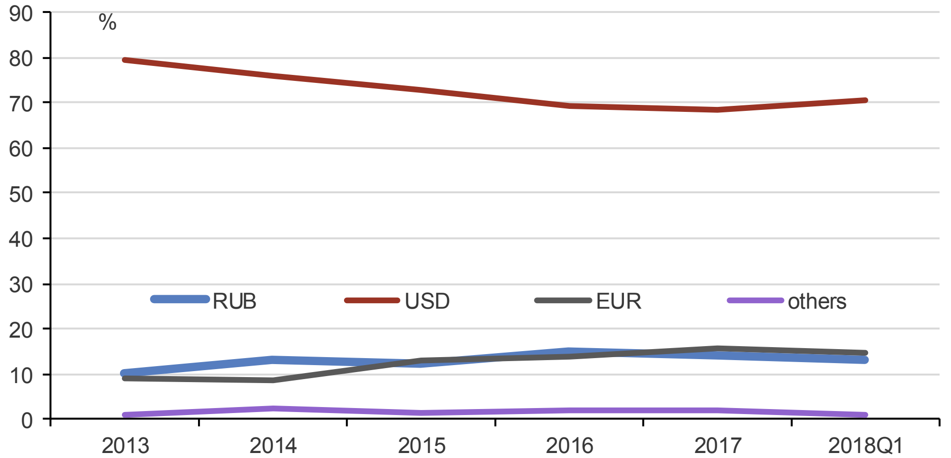
Russia’s use of trade in national currencies: current status

- 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.

Currency structure of import payments

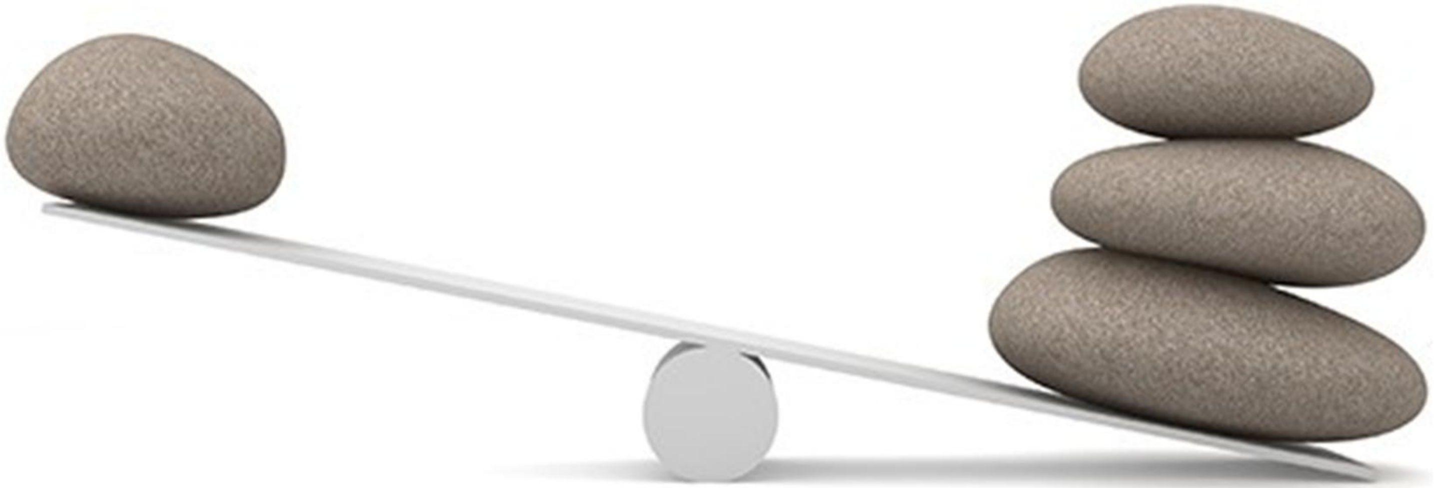


Currency structure of export contracts



Benefits and risks of increased international currency usage

Benefits	Risks
Less FX risks for domestic economics agents	Increased volatility of capital flows and domestic FX markets, sudden stop risk
Increased demand for national currency from non-residents -> stable FX and inflation	Difficulties in monetary policy implementation
Incentives for development of domestic financial market	Distorted stimulus for foreign trade with subsidies/directed contracting
Increased integration and cooperation beetween countries	Distorted stimulus for fiscal policy



Source: IEF analysis