

Role of FDI in Russia's economic diversification

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EBRD



Outline

- EBRD experience in Russia
- Diversification challenges
- Lessons from recent developments in the automotive sector



EBRD in Russia in 2006

- Doubling of business activities to Euro 1.5 billion in 2006
- Portfolio size of Euro 4.8 billion at the end of 2006
- Significant increase in the share of equity (from 11% to 17%)
- 33% of Bank's activities in the corporate sector, 15% trade finance, 13% lending to SMEs, 22% FI projects
- 90% of Bank's activities in the regions
- Increase by 60% of medium-sized projects
- Leadership in rouble syndications



Transition challenges

- **Diversify the economy**
- **Promote competitive markets**
- **Raise corporate standards and practices**
- **Catalyze capital flows for investment**



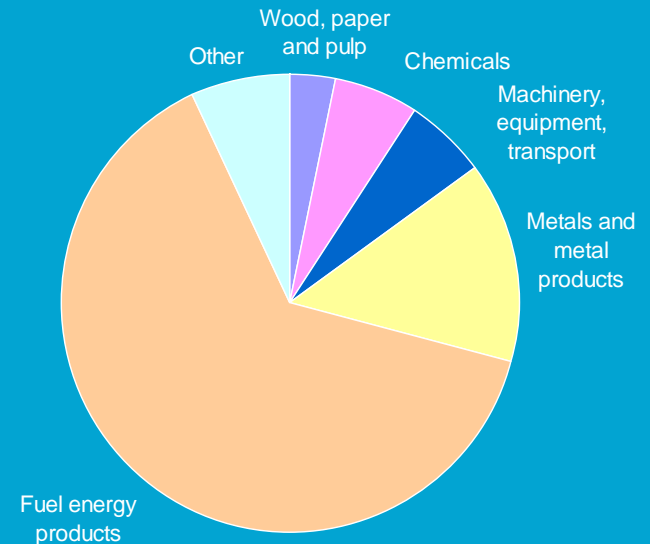
Diversifying the economy: sectors and regions

- Lower barriers to new business
 - bureaucracy, logistics, business services, infrastructure
- Policy reforms
 - market entry/exit, relationship between local and central authorities, regional business environment...
- World market integration

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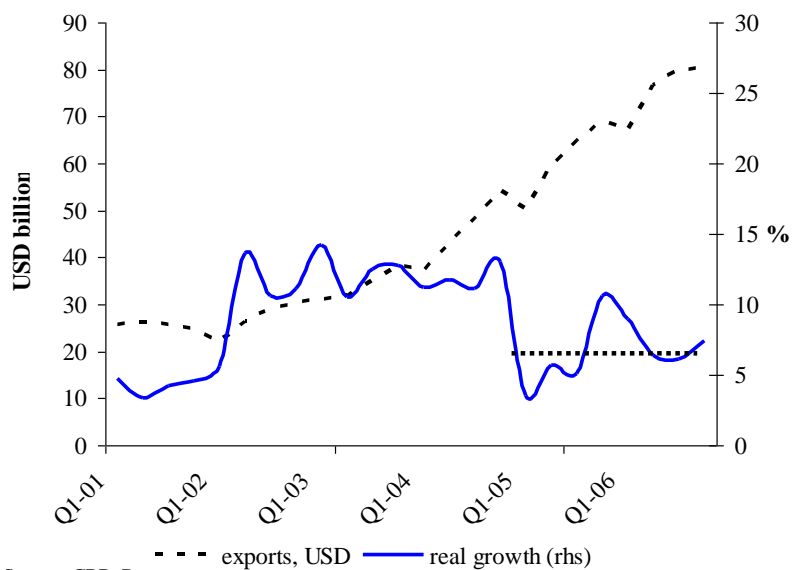
- directly support investments in new sectors
- start-up and growth finance through intermediaries for maximum reach
- invest in logistics, services, policy dialogue

Structure of Russian exports



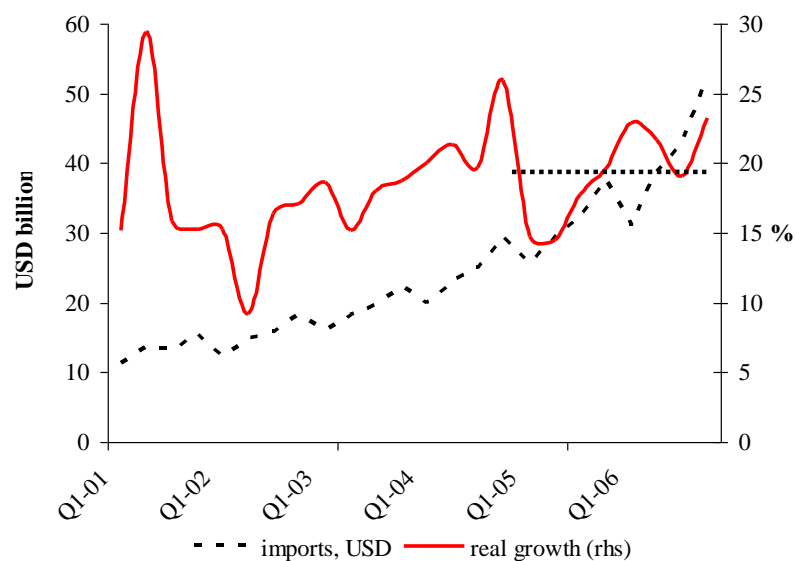
Strong export figures conceal weak volume growth, and the rapidly growing import penetration

Exports



Source: CBR, Rosstat.
 - - - exports, USD — real growth (rhs)

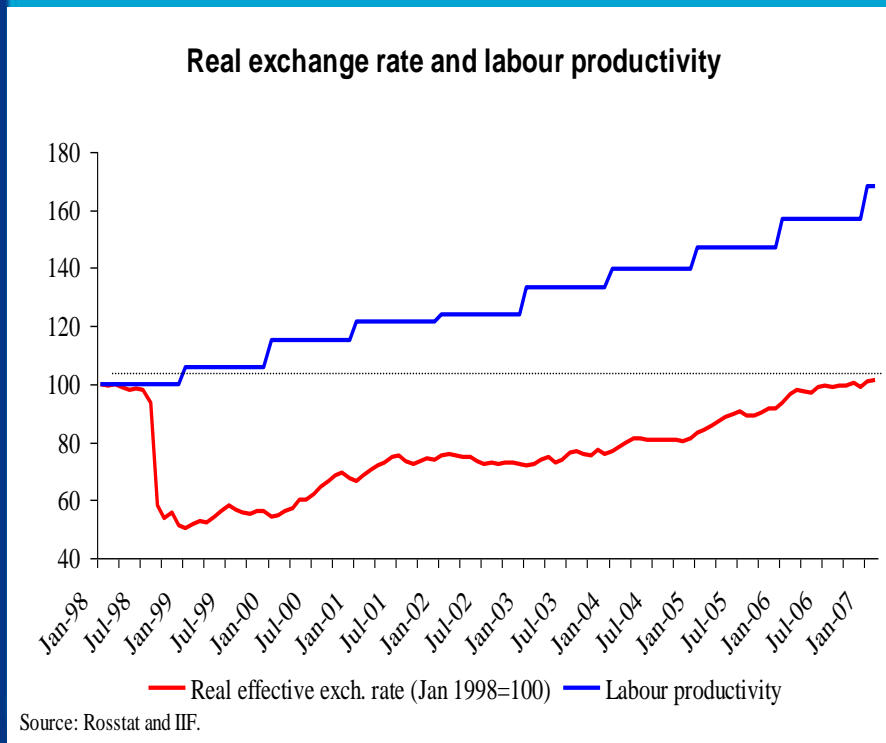
Imports



Source: CBR, Rosstat.
 - - - imports, USD — real growth (rhs)



Real exchange rate appreciation, productivity increases, and demographic challenges



- Shrinking labour supply: working age population peaks at 90 million in 2007, projected at about 75 million in 2025
- Already regionally tight labour markets, and strong wage growth
- Implications of poor health in terms of low productivity, early retirement and high medical expenditures

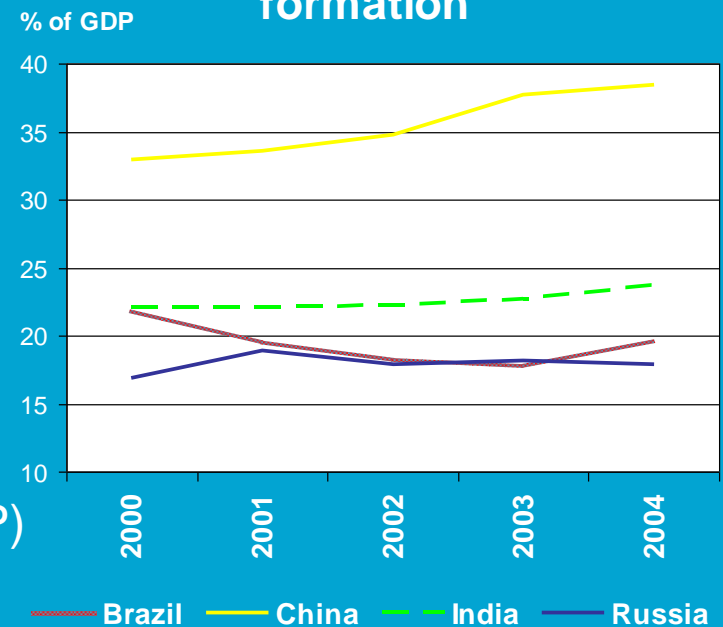
The investment challenge

- Raise level and improve quality of investment
 - draw private capital into infrastructure and energy
 - long-term foreign investment
 - quality financial intermediation

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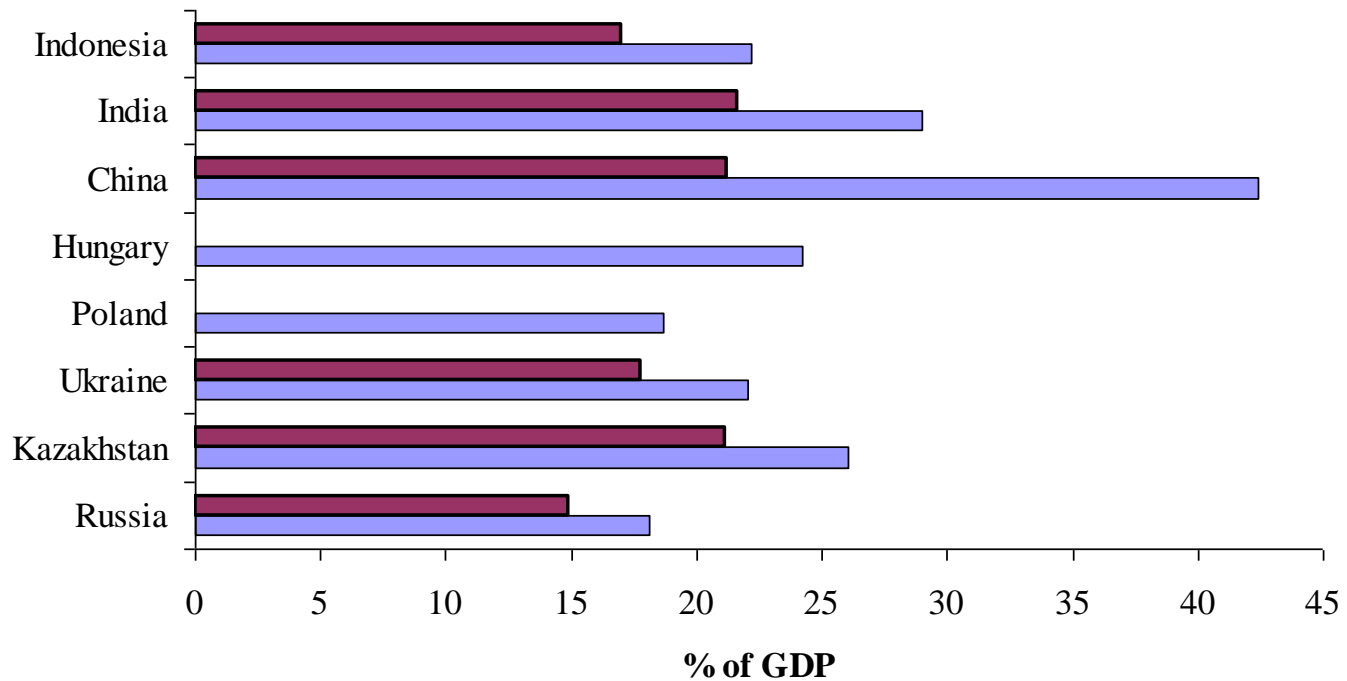
- structures for private funding (e.g., PPP)
- leverage risk taking and mitigating capacity to attract private funding
- policy dialogue on conditions for private funding (commercialisation, privatisation)
- support healthy, diverse financial sector

Gross fixed capital formation



The role of private investments

2005-6 levels of fixed capital formation



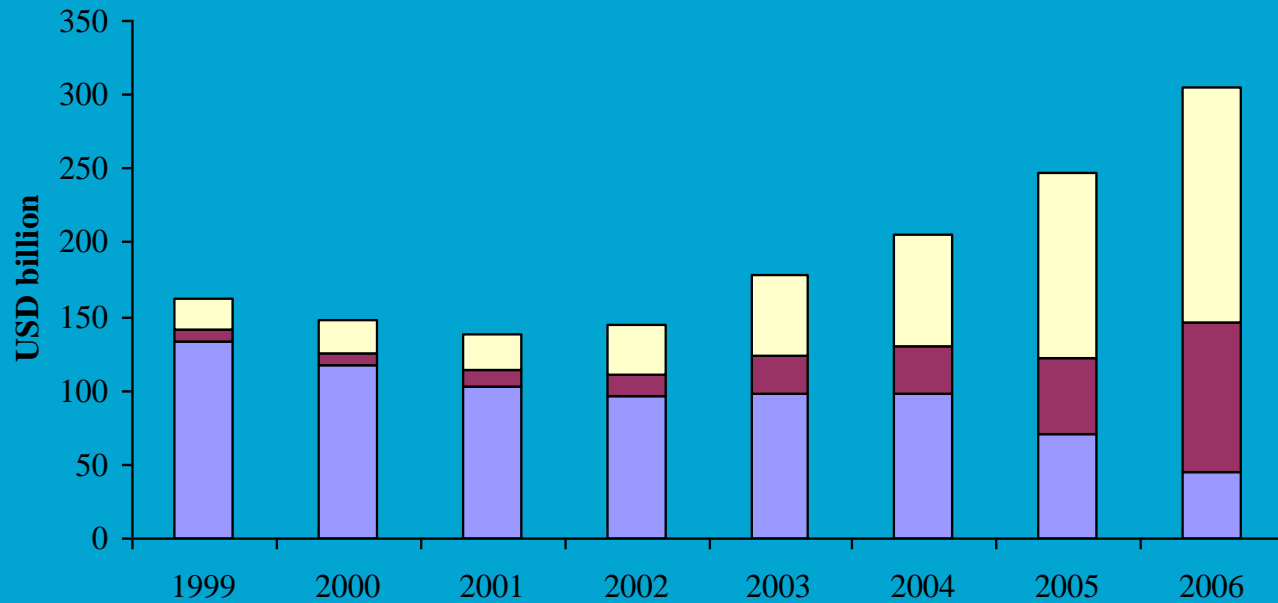
Source: IMF World Economic Outlook.

■ total ■ private



Private sector borrowing from abroad grows rapidly

External Debt of Russia



Source: CBR.

Legend: General Government (purple), Banks (maroon), Non-financial corporations (yellow)



SYNDICATIONS AND ROUBLE FINANCING

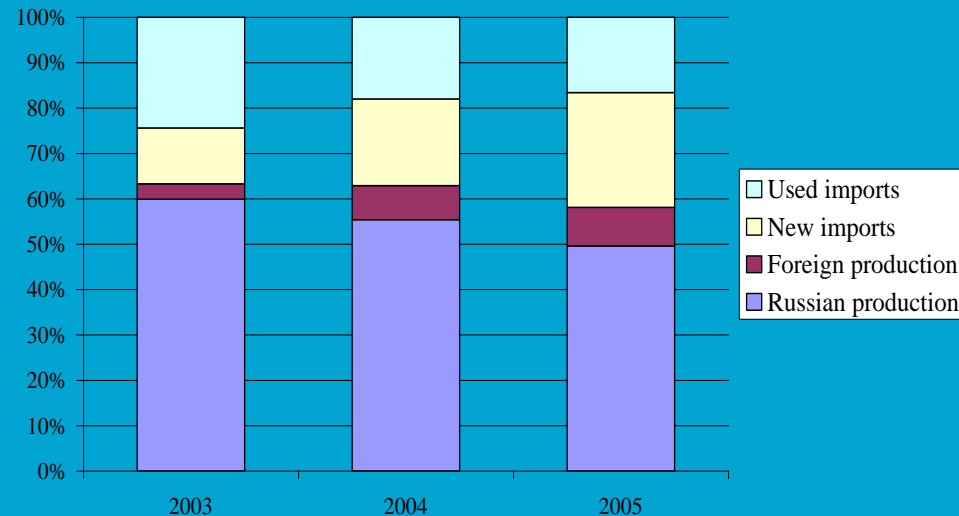
- EBRD established leadership in RUB syndications in 2006: 55 syndications in total of which 18 in Russia. EUR 2.6 bn volume of which EUR 1.6 bn in Russia
- **2007 prognosis**
 - Liquidity will cause continued contraction in spreads
 - Banks will go down the credit curve in search of yield and sectoral diversification away from Oil & Gas and prime FIs
 - RUB syndications will grow as ordinary industrials seek RUB funding, and as banks respond to the need
- **New sources of long dated Rouble liquidity enabled lifting of RUB ceiling Jan 2007**
 - First Euro Rouble bond issued
 - First Cross currency basis swap
 - In addition to domestic bonds and inter-bank lines
- **Ability to provide fixed rate and floating rates loans**
 - Use of Mosprime in interest rate swap market
 - Improved transparency in swap and bond market
- **Changes to the liquidity management guidelines**
 - Increased disbursement projections have led to the need for the management of a larger pool of liquidity assets



Recent developments in the automotive sector

- Half of car sales foreign and half domestic
- Used car sales in rapid decline
- Local assembly now accounts for around one-third of foreign car sales

Market share of passenger cars by ownership and production location



Key structural changes

- Foreign assembly operations the first to enter
- Components now the fastest-growing segment of the automotive market
- Domestic producers have grown moderately but are losing market share
- Only around 50 percent of components currently meet international standards → vertical integration in the local industry fast disappearing under pressure to procure high-quality components



Import Tariffs in 2005

Relatively liberal countries			Relatively restrictive countries		
	Cars	Parts		Cars	Parts
Brazil	35	10-20	India	105	30
Chile	6	6	Malaysia	60-150	12-30
China	34	11-17	Thailand	62-80	10-42
Indonesia	40	15			
Mexico	20-30	14-18			
Russia	25	0-5			
South Africa	31	8-20			



Policy issues

- Liberal trade policy has been effective at supporting the growth of the industry
- A predictable policy framework is key for this industry (5-10 years investment horizon)
- Government policies should now focus on the components industry
 - Regulatory regime could be simplified to encourage entry of smaller component suppliers
 - Perception of corruption and judicial uncertainty at local levels also hinder entry of smaller component suppliers
 - Local infrastructure constraints, especially access to land, shipment logistics and power supply connections, are key bottlenecks
- Global competition in the automotive sector exerts permanent pressure for innovation and consumer-orientation → dismal international experience with state control in the car sector



Thank you for your attention

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