RESPONSIVE AND EQUITABLE ECONOMIC GOVERNANCE FOR AFRICA AND THE GLOBAL ECONOMY

BRICS INSIGHTS PAPER 4

NATIONAL AND MULTILATERAL DFIs IN RUSSIA AND THE IMPACT OF THE BRICS NEW DEVELOPMENT BANK

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Introduction

An important condition for economic growth and job creation is investment financing for assets that expand modern economies' productive capacity. These assets include infrastructure, productive capabilities and equipment, new housing and commercial buildings, education, and research and development facilities.

As a prerequisite to channelling long-term financing at a reasonable cost, the economy needs to generate and attract savings. The government can support this through instituting sound fiscal policies and efficient tax systems and creating a business-friendly environment that attracts investment, including from abroad. One of the main challenges in this regard is finding private financing for long-term investment projects.

This paper discusses the existing development finance activities undertaken by development institutions in the Russian Federation. It then looks at ways to improve these practices and the possible role of the BRICS New Development Bank (NDB).

The system of development institutions in Russia

Development institutions are special-purpose governmental (or quasi-governmental) corporations designed to eliminate market failures that constrain economic and social development.[*]

Table 1: Investments by key development institutions in Russia, 2007–2013, billion RUB[†]

	2007	2008	2009	2010	2011	2012	2013
VEB	56.4	98.8	122.8	145.6	185.6	164.9	283.3
Rusnano	-	0.2	32.0	32.0	36.3	33.5	16.4
Skolkovo Foundation	-	-	-	-	2.8	2.9	1.5
Russian Agricultural Bank	213.4	255.4	444.9	328.8	409.0	385.4	427.7
Investment Fund	1.8	41.7	55.1	35.7	58.0	41.6	2.0
EABR	4.0	16.4	24.5	31.8	35.5	56.4	57.6
EBRD	82.6	68.0	104.3	94.2	122.4	103.4	82.1

Sources: EABR (Eurasian Development Bank), *Annual Reports 2007–2013*, http://www.eabr.org/r/investors/yearreport/archivereports/; EBRD (European Bank for Reconstruction and Development), *Annual Reports 2007–2013*, http://www.ebrd.com/news/publications.html; Rusnano, *Annual Reports 2007–2013*, http://www.rusnano.com/about/highlights/annual-report; Russian Agricultural Bank, *Annual Reports 2007–2013*, http://www.rshb.ru/investors/year_report/; Skolkovo Foundation, *Annual Report 2011*, *sk.ru/news/m/skmedia/1340/download.aspx;* VEB (Vnesheconombank), *Annual Reports 2007–2013*, http://www.veb.ru/ifi/rep/annual/; author's calculations

Russia's system of development institutions is extensive (see Table 1) and covers various economic sectors, including the following priorities identified in 2005: housing, healthcare, education and agricultural development. It also addresses several key challenges in the Russian economy, including the current shortage of long-term investment by commercial financial institutions; the need for infrastructure development (physical, financial, technological); and the unfavourable position of Russian exporters due to late entry, a lack of flexibility, inability to adapt to consumer needs, and weak post-sale services.

At present, there is no common strategy and long-term vision for Russia's development institutions, although each of them has its own mission and strategy. As a result, there are diverse industries in each

[*] Khromov M, Solntsev O & R Volkov, 'Development institutions: analysis and evaluation of world evidence', *Problems of Forecasting*, 2, 2009

[†] Currency code for the Russian rouble

institution's loan portfolio without any showing particular results. The Vnesheconombank (VEB) is the country's main development institution and focuses on various areas. Its long-term mission is to diversify the Russian economy, boost its competitive edge and encourage investment. The only criteria for projects to be financed by VEB are that the payoff period is five years and that the project value exceeds RUB 2 billion (about $33 million). According to its financial policy, VEB participates only in those projects that cannot be financed by private investors. There are no priority industries and as a result it finances projects in many areas, sometimes duplicating the work of other development institutions. For instance, by financing projects in the agricultural sector, VEB partly duplicates the role of the Russian Agricultural Bank and Rosagroleasing.

In the field of advanced technology, VEB competes with Rusnano. Rusnano implements state policy for the development of the nano industry in Russia, acting as a co-investor in nanotechnology projects that have substantial economic or social potential. Rusnano's investments to date exceed RUB 100 billion (about $1.7 billion) and are expected to rise.

In the energy sphere, the work of VEB is partly duplicated by the non-profit Skolkovo Foundation, established in 2010. Its goal is to create a sustainable ecosystem of entrepreneurship and innovation, engender a start-up culture and encourage venture capitalism. The Skolkovo Foundation works primarily in five areas identified as key potential sources of economic growth: energy efficiency, nuclear technology, space technology and telecommunications, biology and medical technology, and information technology.

At present, Russia is a major borrower from multilateral development institutions, including the World Bank and regional banks such as the European Bank for Reconstruction and Development (EBRD) and the newly established Eurasian Development Bank (EABR). It is the largest borrower from the EBRD and EABR. Loans to Russia from the EBRD amount to 21.4% of its total credit portfolio. These loans address the country's need for long-term investment and its infrastructure challenges.

While the existing development institutions already attract private investors to projects, to date the role of these investors has been limited. For example, most of the projects in which VEB takes part are financed by the bank itself (50–90%) and most of its liabilities consist of government and central bank deposits. The projects of the other institutions are mainly financed through capital and subsidies from the Russian government. For example, as of the beginning of 2014, the government has provided the Russian Agricultural Bank with 18 capital injections. In 2013, subsidies from the federal government alone amounted to RUB 76 billion (about $1.3 billion). These examples suggest that there is scope to increase the share of private investment in development finance in Russia. In advanced economies, for example, development institutions are normally financed by issuing securities.

Potential impact of the NDB

The NDB could act as an investor in and consultant on the Russian government's planned projects, along with existing development institutions. Most of Russia's development institutions are designed to execute tasks that are not related to the activities of the NDB. The mission of the NDB is to promote infrastructure projects in member countries, which only partly echoes the functions of VEB and other development institutions in Russia. Therefore, it could easily fit into Russia's system of development institutions.

The Russian government is planning to increase investment share as a percentage of gross domestic product to 27% by 2018. Achieving this goal requires a marked increase in both private and public investment, including from development institutions. Public investment will be focused primarily on the expansion of transport infrastructure, as transport is among the industries and sectors that Russia wants to promote within the BRICS co-operation mechanisms.

Another area of potential co-operation for Russia and the NDB is the development of public–private partnerships (PPPs). Russia is concluding consultations on the design of PPP legislation and plans to widen the scope of these mechanisms, building on the success of the Pulkovo airport project.

Russia also recognises the need to take additional policy action to ensure the efficiency of investments and strengthen its position as a natural resource fund manager. The aim is to improve the legal framework regulating public investment reporting and auditing. Issues in this area are now addressed through new legislation on project selection for public investment that was passed in November 2013, and through obligatory public audits. This could be further developed in co-operation with the newly established development bank.

The BRICS Development Council has recently published a list of industries and projects in which each of the BRICS countries is interested, and Russia has included infrastructure projects, among others. One of BRICS's recent public infrastructure projects is especially promising. In May 2014, Russia and China signed a 30-year contract for pipeline gas. The contract stipulates that 38 billion m^3 of Russian gas will be supplied annually to China through the Power of Siberia gas pipeline. The government planned to start constructing the Power of Siberia in August 2014. The NDB could act as an investor and make this project multilateral.

To boost investments among BRICS countries there is also a need to create a more appropriate legal structure for direct foreign investments. For example, while there is currently a bilateral agreement on avoiding double taxation between Russia and other BRICS members, it is not all-inclusive in terms of attaining income. The NDB could act as an advisor and co-ordinating facility in this field.

Furthermore, the NDB could not only promote intra-BRICS investment but also enhance the role of BRICS countries in the international financial architecture and foster their transition to developed economies. Each of the BRICS countries is characterised by significant domestic (social and regional) inequality, and the NDB could play a major role in addressing the problem of 'the middle-income trap' in these countries.

Conclusion

The Russian system of development institutions is extensive and covers many sectors of the economy, including infrastructure, agriculture and nanotechnology. These institutions are designed to address the key challenges facing the Russian economy. However, the system lacks structure and a strategic vision, meaning that some institutions duplicate the roles of others. The institutions are also largely dependent on government resources and attract little private investment.

Given the benefits provided by development institutions, there is scope to improve their efficiency. First, the Russian government has to develop a long-term strategy for the whole system, ensuring that the various development institutions do not duplicate each other's efforts and providing them with clear objectives. Second, there is a need to attract private investors and, thereby, avoid financing projects through public sources alone.

Going forward, it is important to separate the activities of Russia's development institutions. It will also be necessary to set up clear development objectives beyond the generic goals of increasing assets and loan portfolios. Each institution should focus on its own market niche.

Multilateral development institutions in Russia cannot be managed directly by the government. However, it could co-finance projects within its core priority areas alongside national development institutions, while also financing projects that do not fall within the priority areas of national development institutions.

The introduction of a development effectiveness framework similar to those already set up in some of the existing multilateral development banks (eg, the Asian Development Bank, the African Development Bank, the Inter-American Development Bank and the World Bank) should also be considered to increase the efficiency of Russia's development institutions. These frameworks enable the banks to assess development progress in a particular region as a whole, as well as contributions to regional or global development. These progress assessments are based on project-level data presented in the banks' project completion reports. The introduction of a similar system for Russia's development institutions may be beneficial as the relevant institutions' management could better assess their progress in the development sphere. The goal of development institutions is not to make a profit and, therefore, the current use of traditional financial indicators is not accurately reflecting their impact.

The mission of the NDB does not duplicate those of Russia's existing development institutions, and thus it could easily fit into the country's current system. In particular, it could act as an investor in and consultant on planned projects.

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