RUSSIA'S GOLD INDUSTRY

Executive summary

- At the turn of the century Russia possessed a gold industry that had promise but was unproductive by world standards. Since then, it has grown to become the world's third largest by production with the potential to grow further still.

- The growth of the industry reflects a more general push by the Russian state to make natural resources the basis for economic growth. Russia's Strategy for the Development of the Mineral Resource Base of Russia until 2035 ('the Strategy'), which was published in 2018, calls for a doubling down on resource extraction to ensure Russia remains a major commodities producer and exporter.

- Like other resource industries, a dominant role is played by one firm, Polyus, which has been given access to the country's most important untapped deposit, Sukhoi Log, and is the beneficiary of considerable state support. In return, it is relied upon to make a major contribution to stretching production targets. It is likely that its role, and those of Russia's second-tier producers, will become more important following the war in Ukraine.

- However, Russia's gold resources are located in its most remote and inhospitable regions. This has historically ensured an important role for small producers, especially with respect to exploration and production at alluvial sites, which represent a reasonable proportion of overall production.

- Foreign companies have played an important but ultimately limited role in Russia's gold industry since the Soviet period. The country's largest reserves are given federal significance and only made available only to Russian companies. The Russian business environment, the climatic and geological challenges, and the long-term investment requirement also deter foreign investors. However, Russia has come to rely on foreign equipment and all producers are now facing the prospect of diminished productivity as suppliers pull out of the market. This is the major risk to the industry in the short term.

- While Russia is a top gold producer, it is also a major buyer of its own gold. Russia has increased its gold reserves at a faster rate than any other country since 2006, and the Central Bank of Russia (CBR) has first refusal on all gold produced. Moreover, until recently firms had to sell their gold through Russian banks, which acted as intermediaries between the producers CBR and export markets.

- Russia's role as a major resource producer will remain central to its response to Western pressure and its interaction with the rest of the world. The strategic and monetary value of its gold reserves have increased since its foreign reserves were frozen, so what is happening in this industry, as much as any other, is now of considerable international interest.

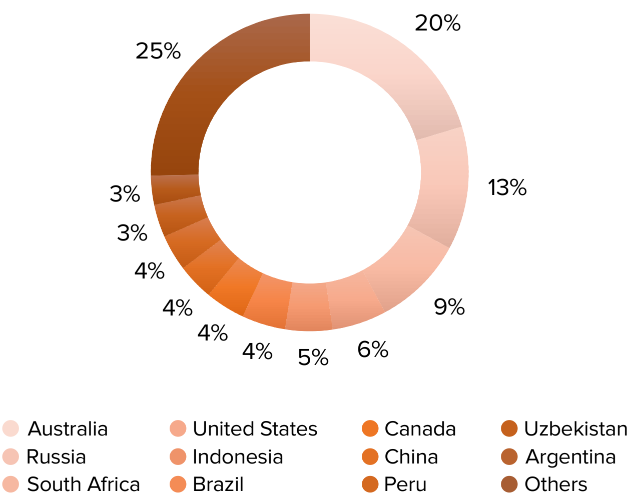
Australia and Russia also have by far the largest reserves in the ground (Table 2 and Figure 2) while Russia has yet to exploit some of its most significant deposits, such as Sukhoi Log, the largest in the world. Considering that new large-scale deposits of this kind are now found less frequently, the role played by Russia as a major gold producer will remain of long-term significance to the world market.

Table 2. Countries with the largest gold reserves underground (tonnes, rounded)

Country	Reserves
Australia	11,000
Russia	6,800
South Africa	5,000
United States	3,000
Indonesia	2,600
Brazil	2,400
Canada	2,200
China	2,000
Peru	2,000
Uzbekistan	1,800
Argentina	1,600
Others	13,700

Source: United States Geological Survey

Figure 2. Countries with the largest gold reserves underground (rounded), 2021



Source: United States Geological Survey

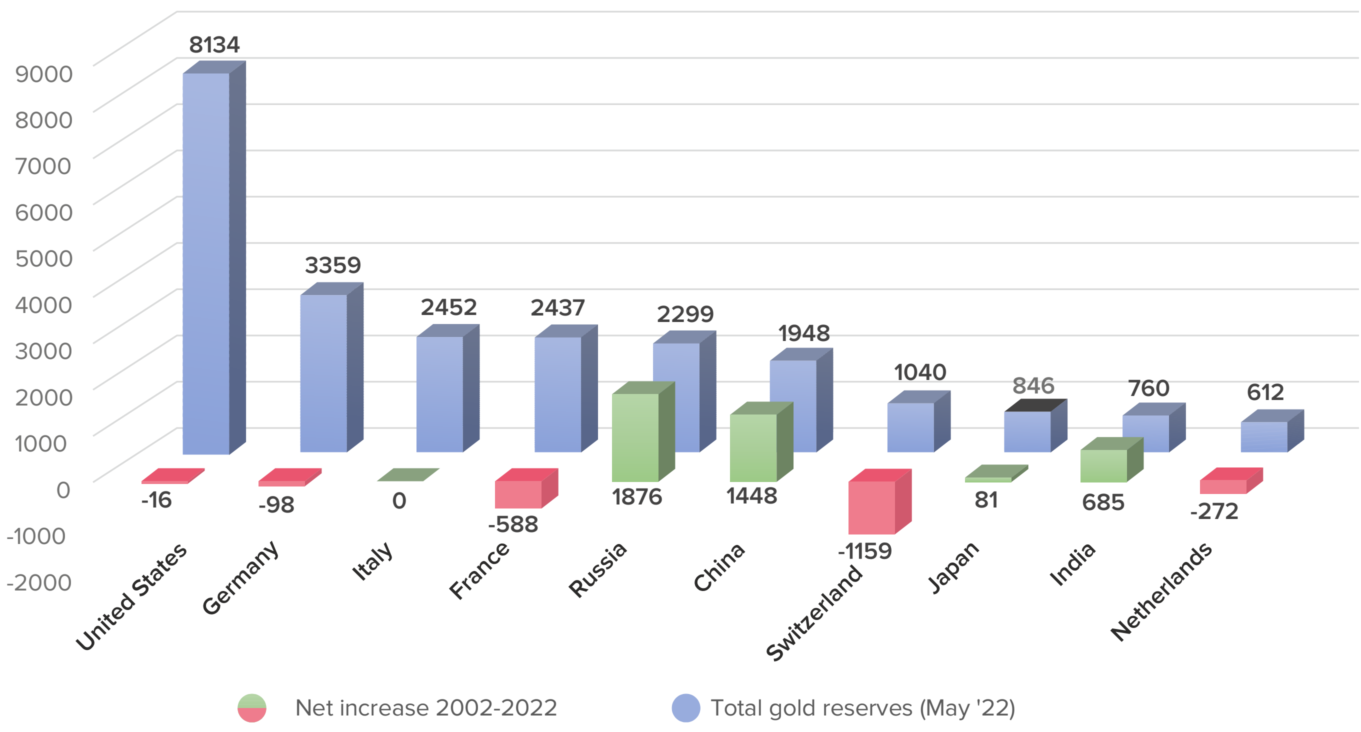
Gold within Russia's foreign reserves

In addition to being a major producer with significant reserves underground, Russia is also a source of demand for gold because the state is a particularly important buyer. Over the last two decades, it has added more tonnes of gold to national reserves than any other country. Indeed, until the war in Ukraine, it looked possible that Russia would become the third largest gold reserve holder, over-taking France and Italy, whose reserves have declined and remained unchanged respectively over the twenty-year period shown in Figure 4. In Russia, the scale of domestic buying distinguishes it from other major gold-producing countries, including those of China and Australia, which are geared towards manufacturing and export.

Table 3. Change in reserves in countries with the largest gold reserves, 2002-22 (tonnes)

	Net increase 2002-2022	Total gold reserves (May '22)	Gold as % of total reserves
United States	-16	8134	68,2
Germany	-98	3359	67,7
Italy	0	2452	65
France	-588	2437	60,3
Russia	1876	2299	22,4
China	1448	1948	3,6
Switzerland	-1159	1040	5,9
Japan	81	846	3,9
India	685	760	7,8
Netherlands	-272	612	57,7

Figure 3. Net increase in gold reserves in countries with the largest gold reserves, 2002-22



At a time when Russia's *siloviki* ('power people') are making the headlines, it is useful to recall that Putin has continually supported an 'economic bloc' of senior officials, including Anton Siluanov and Elvira Nabiullina, who have delivered relative fiscal stability through a series of economic crises. Indeed, while the rate of Russia's sovereign gold purchases has been world-leading, they represent only part of a wider policy of reserve accumulation that began in 2006 when the Russian state settled its external debts, which had been a major priority for Putin's economic team, and became a net saver. In that year, Russia also achieved currency convertibility and, as capital inflows increased, the government began to accumulate foreign reserves, partly as a way to cool inflation, some of which were placed into the country's sovereign stabilisation fund. Later, foreign currency purchases were made according to the CBR's so-called 'fiscal rule', created to protect the economy from oil price volatility. As Figure 2 shows, prior to the war in Ukraine, Russia's gold represented a fifth of its overall reserves, in a diverse asset portfolio. As Nabiullina stated to the State Duma on the launch of the CBR's Annual Report last year, "it is crucial for our economy to have diversified reserves."

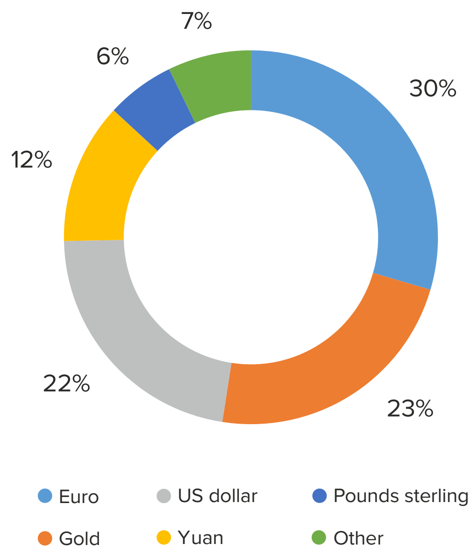
Since the imposition of Western sanctions in 2014, Russia has more explicitly framed its reserve accumulation as a calibrated hedge against 'external threats' and 'sanctions risks'. In practice this has meant de-dollarisation. According to Nabiullina, the CBR reduced the portion of US dollars fourfold between 2013 and 2021, raised its share of gold to over 20 per cent from 8 per cent, and its share of yuan from zero to 17 per cent. However, by this February its reserves still remained diverse overall, and its hedging against the dollar in favour of gold and the yuan was not meant to

Table 4. Russia's international reserves before February 2022 (June 30, 2021). Foreign exchange and gold assets by asset class

Assets	USD, bn	Share of Assets %
Government securities of foreign issuers (i.e. with an explicit government guarantee)	218.3	38.9
Deposits and account balances with foreign counterparties	138.8	24.7
Gold	128.5	22.9
Non-government securities of foreign issues	45.8	8.2
International organisations securities	23.5	4.2
Net position with the IMF	1	0.2
Reverse repo operations with foreign counterparties	3.6	0.6
Claims on foreign counterparties on foreign currency supply	1.4	0.2
Claims in foreign currency on Russian counterparties and issuers (i.e. claims on Russian credit institutions, Eurobonds of the government and other Russian issuers)	0.2	0
Total	**561.1**	**99.9**

Source: Central Bank of Russia

Figure 4. Proportion of world production from countries producing at least 100 tonnes, 2021



Source: United States Geological Survey

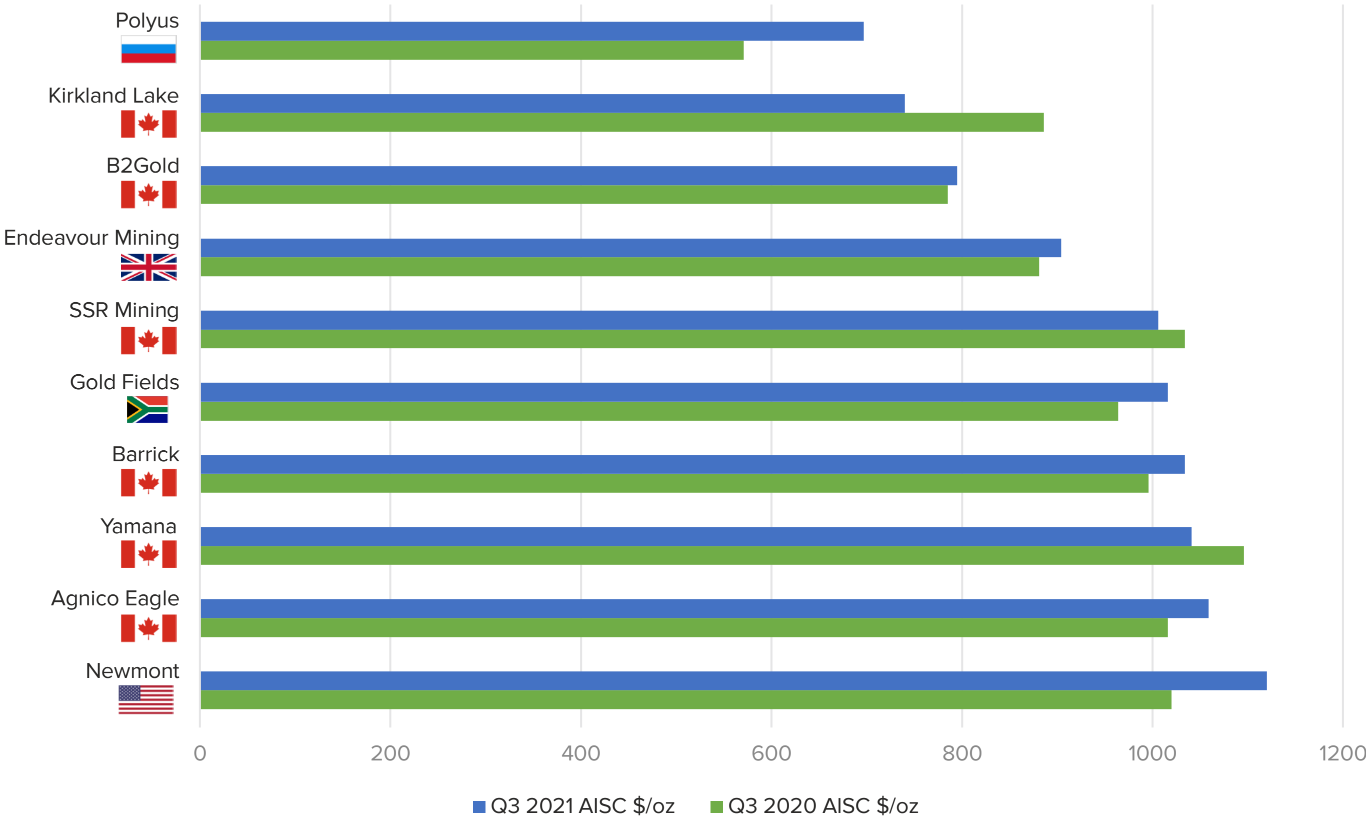
prepare the country for the wide-ranging isolation from Western economies it faces today. The situation has now clearly changed. As discussed in the final section, the CBR is now actively increasing its gold and yuan holdings even more in the face of Western pressure on its foreign reserves.

Russia's determination to build its gold reserves has shaped the development and structure of the domestic gold market, and its interaction with overseas markets. Until 2020, the state had first refusal on all gold produced in the country, and bought gold from domestic producers (albeit at world prices so as not to deter investment).[3] Even if the state declined to buy an offer of gold, producers were still obliged to provide purchase agreements to both the Ministry of Economy and Ministry of Economic Development which, theoretically, allowed the state to see where all Russian gold production was sold. Furthermore, Russian mining law includes the concept of a 'deposit of federal significance' which, in the case of gold, refers to a vein (lode) reserve of 50 tonnes. This limits the availability of such deposits to foreign owners and producers.

The state's influence over the industry was also underlined by the fact that, until 2020, a limited number of preferred banks were licenced to trade gold, acting

[3] In gold purchases, the state is represented by the Central Bank of Russia (CBR) and Gokhran (the State Fund of Precious Metals and Stones responsible for their storage, release and use). The CBR has stated that this gold is located "exclusively in the vaults of the Bank of Russia within the country".

Figure 12. The World's Lowest Cost Gold Producers.



Source. Based on calculations by Kitco.

take complete control of the project. In hindsight, Polyus's control over Sukhoi Log, and its stake in the industry, looks predetermined. More than that, the main players in the process – Rostec, VTB and eventually Sberbank, which became a major financier to the development, are all state entities.

The fact that Sukhoi Log was, in essence, allocated to Polyus, represents a general example, not an isolated case. USM has received comparable support from Sberbank, Gazprombank and VEB, Russia's development financing institution, to support the construction of the supporting infrastructure for Udokan, and the site has been designated a 'Territory of Accelerated Development' (TOR), entitling the company to a range of benefits and tax breaks. As discussed, the metals industries are not led by formal state champions but the state has worked informally with Polyus, USM and others, to advance their relative position through preferred access to strategically significant resources and opportunities. In return, these businesses reach the scale necessary to realise the state's strategic production ambitions. As the chart below shows, Polyus has been able to leverage these advantages to become the world's lowest cost gold miner, based on an All-In Sustaining Costs measure.

The role of SMEs

Examining the largest companies can, while important, detract attention from a larger industry which, unusually for Russia's metals and mining sectors, does not lack participation among small and medium sized producers. Around 500 companies operate in the sector overall, revealing an industry with sufficient opportunity to support a high number of companies producing small amounts of gold. As Table 10 shows, only 12 companies consistently produce over four tonnes of gold a year but the industry evidently sustains a far larger number of companies producing less than two tonnes per annum.

Indeed, beyond production targets, the Strategy sets very few specific objectives for the gold industry as a whole. The role to be played by Sukhoi Log, or foreign investors, are not explicitly mentioned, for example. Surprisingly, one area of focus is on smaller producers, first by underlining their importance as explorers, and second to call for improving access to subsoil rights through the declarative principle and the establishment of a simplified procedure for the extraction of alluvial gold by individual entrepreneurs. These provisions are intriguing because of their underwhelming scale in

Polyus, *Sukhoi Log*

comparison to the value of Russia's largest producers and their world-scale projects.

However, SMEs have historically punched above their weight in this industry, especially at remote alluvial sites. While entrepreneurial individuals and teams of prospectors do not represent the bulk of production, alluvial sites have accounted for nearly a third of total production in some years, a higher level than in other major producing countries. Alluvial deposits are of less interest to large companies, less homogenous, and production is often seasonal. In regions where alluvial mining is important, such as Magadan, smaller enterprises can play a role in contributing to regional economic development, at least according to Russian policymakers.

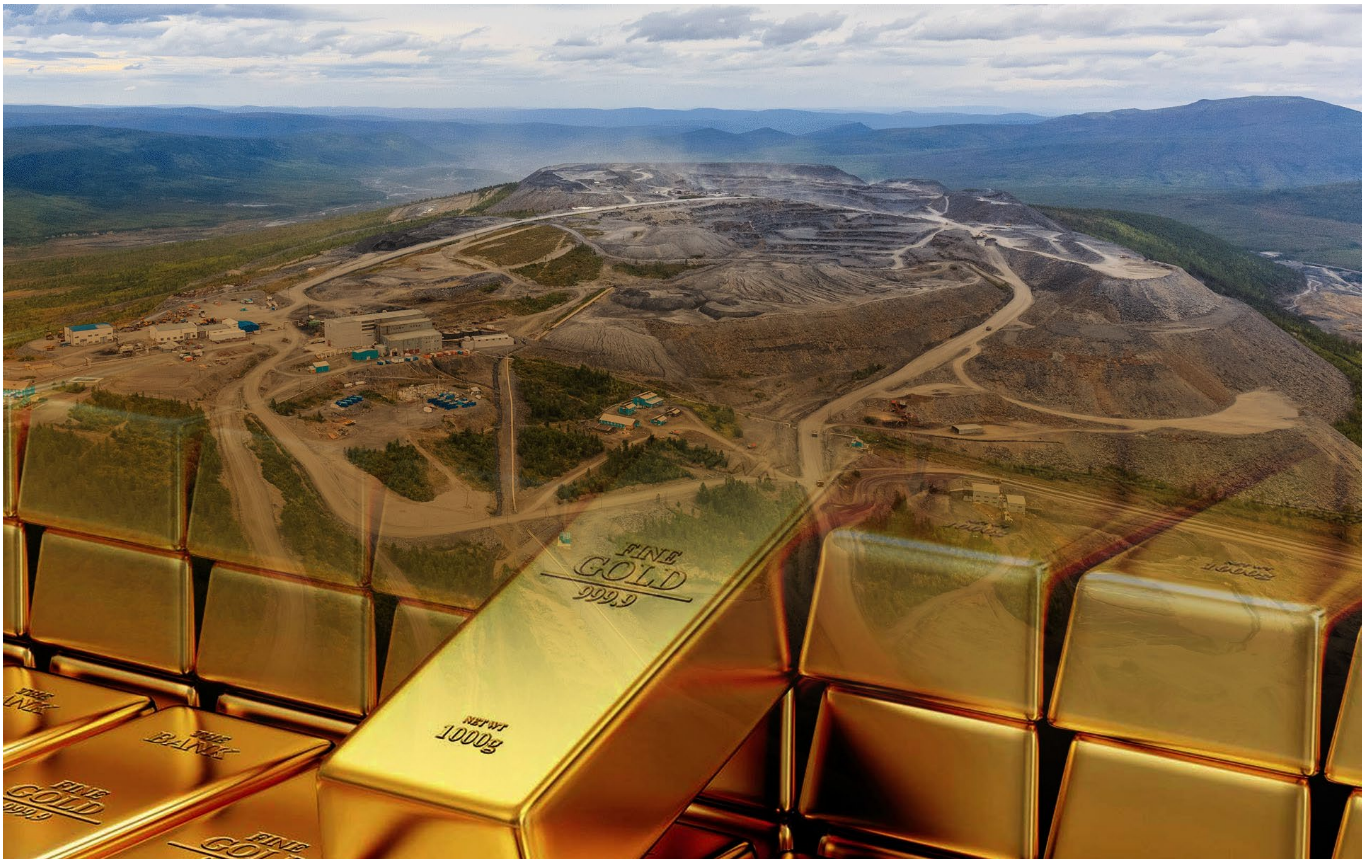
There is some evidence that new resources are available for supporting SMEs in the sector. According to one report, the liberalisation of the declarative principle has increased the volume of investments in the RFE four times to 8.6bn roubles between 2019 and 2020, and almost twice again to 14.9bn between 2020 and 2021. Since February 2022, the government plans to extend this liberalisation to the Siberian Federal District. Other initiatives to support SMEs have cropped up across the region, such as a recent pilot scheme to attract 'junior' mining companies to Chukhotka Autonomous Okrug, with support from the regional government.

In general, the government has a lamentable record of support to SMEs and historically only the largest producers have been able to independently fund their development, while companies producing one tonne of gold every year have found it very difficult to access finance. Therefore, alluvial deposits will continue to attract prospectors – they are less capital intensive than primary deposits and can indicate larger local deposits – and, due to their relevance to the country's overall production, continue to have some value to the state. But it remains to be seen whether the SMEs doing the work will receive support to grow.

The role of foreign investors

If the situation for SMEs, in terms of their overall contribution, looks stable, the situation for foreign investors has never looked worse. In 2018, an EY Russia report stated that the industry was among Russia's most transparent and, despite country risk it had become highly integrated with international capital flows. We would counter that, in fact, the list of foreign investors has been rather unimpressive in comparison to the dominant stakes held by Polyus and Polymetal. As early as 2004, large businesses from other industries, including Nornickel, bought in to the industry through acquisitions, and Polyus was able to purchase the

Figure 14. Map of Russia showing the top the regions in which the top ten miners operate



1. Russia is a top tier gold producer

In just over 20 years, Russia has become one of the world's top three gold producers and it remains ambitious. For Moscow, gold production has both economic and strategic imperatives.

Russia's gold deposits are located in some of the world's most inhospitable and remote regions, while alluvial mining remains unusually significant. The most important mines tend to be controlled by few large companies which draw on significant state support and funding to ensure their development. Russia's numerous smaller producers have a valuable role exploring and developing less significant, more remote and alluvial deposits.

2. Russia is a major buyer of its own gold

Since 2006, Russia has also added gold to its national reserves at a faster rate than any other economy. The CBR was the country's primary buyer until the pandemic, and it has resumed this role since February 2022, although producers are also developing as exporters in their own right.

It is not yet known how much gold the CBR is buying but the it is refilling and rebalancing the state's national reserves in favour of gold following the freezing of its dollar and euro holdings. Its purchases also offer a guaranteed price (albeit slightly lower than the world price) to the producers during the crisis.

3. The hierarchy of Russian producers looks resilient

Only three gold magnates have divested their majority stakes as a result of sanctions this year. They responded logically, by transferring their shares to allies or family members.

Russia's most important producer, Polyus, has assumed an apparently unassailable position as de facto national champion. The company has received significant top-level support from the Kremlin and the state banks, particularly VTB, which also appears to have a special role in the industry.

At the same time, there is reasonable level of competition for control among second tier producers, underlining the opportunities in the industry. The figures emerging from the current industry-wide ownership reshuffle, and their relationships with the


Polyus, Olimpiada

state banks, will be interesting to watch, but unlikely to change the overall industrial profile of the sector.

With over 500 companies active in production, most of them SMEs, the industry is relatively open and competitive, which differentiates it from other metals and mining sectors.

4. Foreign ownership in the gold industry has been limited but foreign suppliers have become critical

Only one Western company, Kinross, has succeeded in entering the Russian industry at scale. Others, such as Polymetal and Petropavlovsk, have listings oversees but are controlled by Russians. Foreign miners have been deterred by the fact that the best deposits tend to end up in Russian hands, as well as the challenge and cost of developing them in a high-risk business environment.

However, the gold industry grew with a high level of dependence on foreign equipment and supplies. Replacing this poses an unprecedented challenge to the whole industry. How the industry responds to equipment shortages is less obvious. The state is unlikely to be able to resolve the shortfall by intensifying import substitution or the parallel import scheme (in principle the two policies contradict each other anyway). More practical ideas, such as intensified industrial cooperation with, say, China or Turkey, are way off.

The most interesting and effective responses are likely to be at firm level. Russian companies (including banks), whether large or small, tend to be at their most innovative when circumventing obstacles (if not developing their products). This applies to the securing new export markets too.

5. The plan so far: stockpiling gold but not pegging to it

The Russian state's appetite for stockpiling gold has been high for over fifteen years and the war in Ukraine has only intensified its demand, which Russia's gold producers have a crucial role in supplying. The idea that Russia plans to peg the rouble to gold, however, seems more a theoretical than likely. This would limit its ability to conduct counter-cyclical monetary policy which has been the hallmark of CBR policy for years, and Nabiullina has formerly dismissed the idea. Nevertheless, having a large pile of gold will always provide the state with further options.

Either way, Russia's priorities are practical. Its role as a major commodities exporter is likely to endure, as it has previous crises, but the state needs to find new intermediaries if it is going to trade its sovereign gold, and the onus is now on the gold producers to find new suppliers and export markets.