$650 bln of Corporate Debt Interwines Russia and the West

London, March 14, 2014 (Reuters) -- To understand Western unease about the idea of imposing wide-ranging sanctions on Moscow over its intervention in Ukraine, consider an ongoing deal by one of the Kremlin''s corporate gaints.

Russian state oil company Rosneft is working to obtain up to $5 billion from oil major BP, which owns a fifth of Rosneft, in exchange for oil supplies over five years, three banking and trading sources familiar with the details said.

BP is in turn syndicating the money from a consortium of banks including Lloyds, partially owned by the British government, and Germany's top bank Deutsche.

The banks and BP declined to comment on the deal, the latest in a string of similar arrangements between Rosneft and oil firms and traders such as Glencore and Vitol.

Rosneft said it was working on two deals with "long-time reliable partners" and that terms have yet to be agreed.

While Russia is generally perceived as a country with very little state foreign debt, its external corporate debt of more than $650 billion has made its companies, a lot of them controlled by the Kremlin, and the Western financial system closely interconnected.

"Interdependencies are key: Russia depends heavily on oil and gas exports to balance its budget, Europe depends upon Russia energy and has significant financial exposure to Russian companies," said Nic Brown from French bank Natixis.

The usual format of sanctions is to block trade and capital flows, which then cause damage to the economy and undermine support for the government.

Many U.S. and European politicians have pointed out that this strategy has worked well in such countries as Iran and would be equally efficient to put pressure on Moscow to change its course with Ukraine.

"Placing Iran-style sanctions on exports, or even the mechanisms by which exporters get paid for their product, would quickly result in a sharp rise in commodity prices and damage the still fragile global recovery prospects," said Chris Weafer of Macro Advisory consultancy.

Stricter U.S. and European Union sanctions have more than halved Iranian oil exports since 2012 while creating no major cross-border debt problems since most of the financial activity between the West and Iran was already subdued for years.

"Elite sanctions, asset freezes and trade restrictions could make it very difficult for Russian banks and corporates to secure external financing and roll over debt liabilities," said Tim Ash from Standard Bank.

Most Debt State Owned

Russian state foreign debt has fluctuated at about $30 billion to $35 billion since 2008, amounting to just 2 percent of GDP.

During the 2008 global financial crisis, it was the heavy external debt of private Russian companies, of about $400 billion, which almost paralyzed the economy.

Fast forward five years, and the country's total foreign debt rose to $732 billion as of Jan. 1, 2014, from $636 billion a year earlier and $464 billion at the start of 2008, according to the Central Bank, with the bulk of new debt raised by Russian state companies.

According to Nomura, Russia's external debt stands at 34 percent of GDP and only Singapore and China, with $1.2 trillion and $812 billion respectively, have a higher debt among emerging market economies.

The debt of the Kremlin oil and gas majors Rosneft and Gazprom stands at a combined $90 billion and four state banks Sberbank, VTB, VEB and Rosselkhozbank have at least $60 billion in foreign credits.

According to ratings agency S&P, Rosneft alone faces maturities of $15.9 billion and $16.2 billion this year and next.

A Kremlin aide warned last week that Moscow might refuse to pay off loans to U.S. banks as a retaliation measure against sanctions.

Mikhail Yemelianov from pro-Kremlin party A Just Russia went even further: "If [the West] freezer our assets, then our companies could stop paying foreign debts. The Russian corporate debt exceeds $700 billion."

Barclays, which features among top lenders to Russia, last week downgraded Russian sovereign credit to underweight in its global emerging market credit portfolio.

"For the Russian credit complex, we think that the threat of restrictions to export markets is a clear credit negative. Overall, we see Rosneft and Gazprom as most vulnerable given recent developments," it said.

Self-Inflicted Damage

Regulatory filings by the top four U.S. commercial banks — Citigroup, Bank of America Corp, JPMorgan Chase and Wells Fargo — show they have about $24 billion in exposure to Russia.

For most of them it is tiny compared to the much heavier exposure of European banks. Some of the debt is traded on the secondary market so it can be held by institutions ranging from hedge and insurance to mutual and pension funds.

"Europe is in a tough spot since its economy is so interlinked with the Russian economy," said oil consultancy Petromatrix.

Russia gets more than half its budget revenues from energy exports, the world's largest. It supplies Europe with a quarter of its oil and almost a third of its gas. Russia is also the largest exporter of metals and a significant supplier of wheat.

But the country is also the fifth-largest consumer market in the world, falling just behind Germany. Last year, it imported almost $350 billion worth of consumer goods, food, medicines and machinery. About half came from the EU.

"Perhaps the current conflict will also make it clear to all sides how much they depend on each other and that this makes it necessary to compromise," said a Commerzbank representative.

Weafer argues there is no need for additional sanctions to undermine economic growth as that is happening already anyway. The Russian economy is showing its slowest growth since the 2008 crisis. Capital flight was $62.7 billion in 2013 and since 2008 outflows have reached $420 billion.

"The real potential damage to Russia's economic future is self-inflicted. The real fallout from a prolonged conflict in Ukraine, or even of a worsening of the already negative international perception of Moscow's role in the affairs of its neighbor, may be to radically slow the inflow of much needed investment capital while capital outflows accelerate," he said.