WHAT HAPPENED TO RUSSIAN ROUBLE IN 2014?

MAIN SCENARIOS FOR ITS NEAR FUTURE

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We are going to examine the following topics:

I. Key factors that caused the devaluation of Rouble in 2014

II. The efficiency of anti-crisis measures taken by Russian financial authorities

III. Widespread myths, misconceptions and disputable concepts regarding Forex and money market (FX&MM), Rouble and US Dollar

IV. Main scenarios for Rouble in 2015-2016 based on the analysis of the national balance of payments

KEY FACTORS THAT CAUSED THE DEVALUATION OF ROUBLE IN 2014 (in order of significance)

- The tension with the West over the Ukraine and sectoral sanctions against Russian banks and corporations burdened with heavy debts nominated in foreign currencies.
- The plunge of oil prices.
- Constant capital outflow fuelled by poor domestic investment climate and structural slowdown of Russian economy.
- Russian Central Bank (CBR) switched from smoothing Rouble volatility against dual-currency basket to Rouble free float approach within inflation targeting policy.
- The general appreciation of US Dollar against most other major currencies as investors expect the Federal Reserve to start monetary policy tightening in the middle of 2015.

What caused more damage to Rouble in 2014 – oil prices plunge or sectoral sanctions and tension with the West?

INDICATOR/ PERIOD	11.07.2008 - 06.02.2009	10.01.2014 - 30.06.2014	01.07.2014 - 29.12.2014	01.10.2014 - 29.12.2014
USD/RUB change, %	55,50%	2,89%	71,62%	47,30%
BASKET/RUB change (55% USD, 45% EUR), %	38,89%	2,99%	61,42%	44,45%
Oil Brent price change,%	-68%	4,8%	-48,5%	-38,9%
Average oil Brent price, USD	77,56	108,91	90,87	77,69
FX interventions by CBR, USD bln*	208,1	40,67	41,61	41,61
Capital outflow, USD bln (estimate)	-167,3	-70,9	-80,6	-72,9

* Source: http://www.cbr.ru/statistics/

It's difficult to give a well-defined answer as far economic agents, including CBR, act more on the ground of their expectations of future macroeconomic parameters rather than of the present.

Rouble posted the largest losses against US Dollar among most oil dependent currencies in 2014.

SOME OIL DEPENDENT CURRENCIES	CHANGE AG. USD 2014/2013, %	MAXIMAL LOSS AG. USD DURING 2014, %
RUSSIAN ROUBLE	-41,4%	-51,4%
NORWEGIAN KRONA	-18,8%	-18,9%
KAZAKHSTANI TENGE	-15,6%	-17%
MEXICAN PESO	-11,6%	-11,8%
CANADIAN DOLLAR	-8,6%	-9%
NIGERIAN NAIRA	-12,6%	-14,5%
KUWAITI DINAR	-3,6%	
ANGOLAN KWANZA	-5,3%	
ALGERIAN DINAR	-11,1%	
SAUDI ARABIAN RIYAL	OFFICIAL EXCHANGE RATE'S TIGHTLY PEGGED.	
UAE DIRHAM	OFFICIAL EXCHANGE RATE'S TIGHTLY PEGGED.	
IRAQI DINAR	OFFICIAL EXCHANGE RATE'S FIXED. THERE'S BLACK EXCHANGE MARKET	
VENEZUELAN BOLIVAR	OFFICIAL EXCHANGE RATE'S FIXED. THERE'S BLACK EXCHANGE MARKET	
IRANIAN RIAL	OFFICIAL EXCHANGE RATE'S FIXED. THERE'S BLACK EXCHANGE MARKET	

Free floating currencies

Rouble's daily and weekly volatility is impressing as much as the scale of its devaluation.

PARAMETER (%%) \ PERIOD	2013	IH2014	IIIQ2014	IVQ2014
USDRUB SPOT (Close Day/Day) average volatility	0,37	0,48	0,52	2,10
USDRUB SPOT (Day range/Open) average volatility	0,69	0,88	0,90	3,92
USDRUB SPOT (Close Week/Week) average volatility	0,90	1,19	1,36	4,29
USDRUB SPOT (Week range/Open) average volatility	1,17	2,25	2,35	9,50
OIL BRENT SPOT (Close Day/Day) average volatility	0,82	0,62	0,78	1,58
OIL BRENT SPOT (Day range/Open) average volatility	1,61	1,20	1,46	3,26
OIL BRENT SPOT (Close Week/Week) average volatility	1,89	1,27	1,79	3,80
OIL BRENT SPOT (Week range/Open) average volatility	3,85	2,70	3,04	7,35

Main reasons for such astonishing volatility are:

- ✓ Soared oil prices volatility;
- ✓ Much lower liquidity of domestic exchange market as
  - A) CBR abandoned regular currency interventions;
  - B) due to the economic crisis national importers and oil&gas exporters earn less to exchange currencies;
  - C) authorities restricted proprietory trading with Rouble for state controlled banks which received financial support from the state;
  - D) banks risk managers cut limits on Rouble nominated instruments (especially derivatives) available to traders.

So we observe a classical vicious circle:

HIGHER VOLATILITY→HIGHER RISK→SMALLER LIMITS→ LESS LIQUIDITY→HIGHER VOLATILITY

US DOLLAR APPRECIATED AGAINST MOST MAJOR CURRENCIES IN 2014

CURRENCY \ PERIOD	2014/2013
EURO	-12%
BRITISH POUND	-5,9%
POLISH ZLOTY	-14,8%
SWISS FRANC	-10,2%
CANADIAN DOLLAR	-8,6%
AUSTRALIAN DOLLAR	-8,4%
JAPANESE YEN	-12%
KOREAN WON	-4%
CHINESE RENMINBI	-2,4%
INDIAN RUPEE	-2%
RUSSIAN ROUBLE	-41,4%
TURKISH LIRA	-8,1%
BRAZILIAN REAL	-11,1%
MEXICAN PESO	-11,6%
SOUTH AFRICA RAND	-9,7%

CAPITAL OUTFLOW DENTS ROUBLE CONSTANTLY SINCE 2008

CAPITAL OUTFLOW FROM RUSSIA (without government debt), USD bln*	2007	2008	2009	2010	2011	2012	2013	2014
	88	-134	-58	-31	-81	-54	-61	-152

* Source: http://www.cbr.ru/statistics/

THE EFFICIENCY OF ANTI-CRISIS MEASURES TAKEN BY RUSSIAN FINANCIAL AUTHORITIES

In general financial authorities – CBR and Finance Ministry (MINFIN) – have been satisfactory in tackling major macroeconomic shocks (oil prices plunge and sectoral sanctions), and national economy, banking system and financial sector have escaped a collapse so far.

But there were some questionable acts:

- The purchase of 5,7 bln USD by MINFIN in the first half of 2014 strengthened Rouble devaluation mood on the market. CBR was conducting FX interventions at that period, it should have stopped regular FX interventions earlier.

- Attempts to abandon any FX interventions embracing ***free floating*** approach to Rouble exchange rate at the height of the macroeconomic shock was a mistake.

  In our view the ***dirty free floating*** approach that CBR chose in the end is the only feasible solution till Russian economy remains so dependent on the oil&gas sector.

- **Rosneft** listed bonds at 625 bln Roubles on the 15^TH^ December. (and more 400 bln in January of 2015 within the same scheme). The deal wasn't market and transparent, with very few comments from financial authorities and Rosneft representatives. Next day CBR raised its key Rouble interest rate by 6,5% to 17%. Rosneft deal fuelled fears among investors of intentional Rouble devaluation by the government.

- The government have promised sufficient and well-timed support to the biggest national banks and corporations, most of which are state controlled or dominate their industries. There's a high risk that such an approach will only conserve monopolistic nature and low diversification of Russia's economy. The government shouldn't try to rescue any big company (especially with large foreign debt) as «it's too big to fail».

WIDESPREAD MYTHS, MISCONCEPTIONS AND DISPUTABLE CONCEPTS REGARDING FX&MM, ROUBLE AND US DOLLAR

1) *CBR should peg Rouble exchange rate at a certain level and defend it conducting unlimited FX interventions, it has enough foreign currency reserves and its decisiveness would persuade all economic agents that Rouble is a safe heaven and there's no chance making speculative profit by selling Rouble.*

   Historical precedents disprove such the approach providing that capital flows aren't controlled (see GBP, CHF cases). Sooner or later central bank will have to succumb to market pressure and loose the exchange rate or introduce capital flow control.

During the current crisis in Russia it isn't an option at all as sovereign currency reserves have decreased to approximately 327 bln USD (at the end of 2014, excluding monetary gold, SDR, reserves in the IMF) and Russia have to repay up to 200 bln USD of external debt in 2015-2016 alone (even though some corporate debts are likely to be refinanced). Unfortunately we have no idea when sectoral sanctions against Russia will be lifted.

2) *CBR should avoid any interference in exchange market allowing Rouble to float freely, Rouble would find the equilibrium on its own.*

This approach is reasonable for diversified economies without huge external debt. During macroeconomic shocks it takes much more time to find the equilibrium for the national currency left without support, which causes greater losses as excess volatility (see Rouble track in 4Q2014) damages day-to-day economic activity and investments and reinforces a vicious circle «currency collapse → inflation shock by imports → further devaluation».

3) *Capital flows should be limited and controlled in order to prevent speculative inflows/outflows, Rouble should be only partly convertible, Rouble exchange rate is to be pegged.*

This approach can’t be regarded as wrong a priori.

But authorities have to be aware of all its potential negative consequences and side effects for economy as a whole in case of restoring capital flow control (panic claims for currency nominated liabilities by local banks clients, demands to local banks and corporations to pay foreign loans ahead of schedule because of breaking loan covenants, foreign capital and investors flee, growing corruption among state regulators involved in fight with the black exchange market, macroeconomic costs of hand control approach to economy in the long term).

4) *CBR should keep Rouble interest rates low in order to support economy at the height of economic crisis.*

CBR has to raise its key interest rate in response to accelerating inflation and rising market Rouble interest rates (caused by devaluation shock and run from local currency) to slow down the former. The higher key interest rate also makes more attractive Rouble nominated assets (deposits) to all economic agents and increases funding costs of speculation against Rouble.

CBR always tends to cut interest rates as soon as Rouble's stabilized and inflation rate is about to slow down.

5) *US Dollar is a weak and vulnerable currency. The USA will default on their debt sooner or later. It's extremely risky to hold national reserves in US Dollar nominated assets.*

There's no sound alternative to US Dollar as a global reserve currency in the coming years. Foreign central banks and sovereign funds simply have no other liquid assets but US Treasures to hold and invest their billions of reserves in. US Dollar is used in about 85% of all FX deals in the world and 40-45% of payments via the SWIFT.

The US federal debt is really huge, but it's completely nominated in national currency and manageable bearing in mind America's growing population and dynamism of American economy. In terms of GDP growth rate the USA are more viable than Eurozone and Japan. China still control capital flows and Renminbi is only partly convertible. Foreigners hold about a third of the US federal debt, so the USA have no reason to default on their debt. At worst it's easier for America to print more money and pay to creditors than default.

6) *If exclude US Dollar from international trade and capital deals in favour of other currencies it will reduce FX risks and transaction costs.*

Avoiding US Dollar in international transactions and settlements reduces only risks of accounts and payments being blocked by American authorities in case of geopolitical conflict with the USA.

But it won’t reduce transaction costs – quite the contrary, as other currencies (except EUR) are much less liquid, reliable and have no such developed payment infrastructure over the world.

The replacement of US Dollar by national currencies in international transactions shouldn’t advance diversification of national economy and foreign trade but follow them.

MAIN SCENARIOS FOR ROUBLE IN 2015-2016 BASED ON THE ANALYSIS OF THE NATIONAL BALANCE OF PAYMENTS

ASSUMPTIONS / RESULTS	BASIC SCENARIO	OPTIMISTIC	PESSIMISTIC
MAIN ASSUMPTIONS	KEY SECTORAL SANCTIONS INTACT; AVERAGE OIL PRICE: 2015-50$, 2016-60$	KEY SECTORAL SANCTIONS LIFTED SINCE 2016; AVERAGE OIL PRICE: 2015-55$, 2016-65$	KEY SECTORAL SANCTIONS TOUGHENED; AVERAGE OIL PRICE: 2015-40$, 2016-45$
USDRUB SPOT TARGET RANGE	2015: 60,0-80,0 2016: 55,0-75,0	2015: 55,0-75,0 2016: 45,0-65,0	2015,2016: 100,0+

MAIN CONCLUSIONS

- ✓Extreme volatility of Rouble Spot Rate due to sectoral sanctions and weak oil is going to persist as CBR will refrain from significant regular FX interventions in order to preserve currency reserves.

- ✓Sovereign currency reserves are very likely to decrease further, especially in 2015 (from 20 to 40 bln USD within the Basic scenario, not including swap and repo deals).

- ✓The pessimistic scenario is the least probable at the moment. In case it happens there's a high risk that the government will have to restore capital outflows control and compulsory sale of export currency proceeds.

THANK YOU FOR YOUR ATTENTION!

QUESTIONS, PLEASE.

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