



The 2014 Ruble Devaluation: A Perfect Storm

It is commonly believed that the steep decline of the Russian ruble this autumn resulted from the US and EU economic sanctions against Russia. This is not the whole story, though. The present-day situation on the Russian currency market is a “perfect storm” with sanctions being just one of many factors that came about at the same time. Each of these circumstances has its own logic and could potentially affect the Russian economy, but none of them alone could have caused such a storm. However, all of them combined did. Moreover, these factors are not going anywhere, likely making the Russian ruble unstable for the foreseeable future.

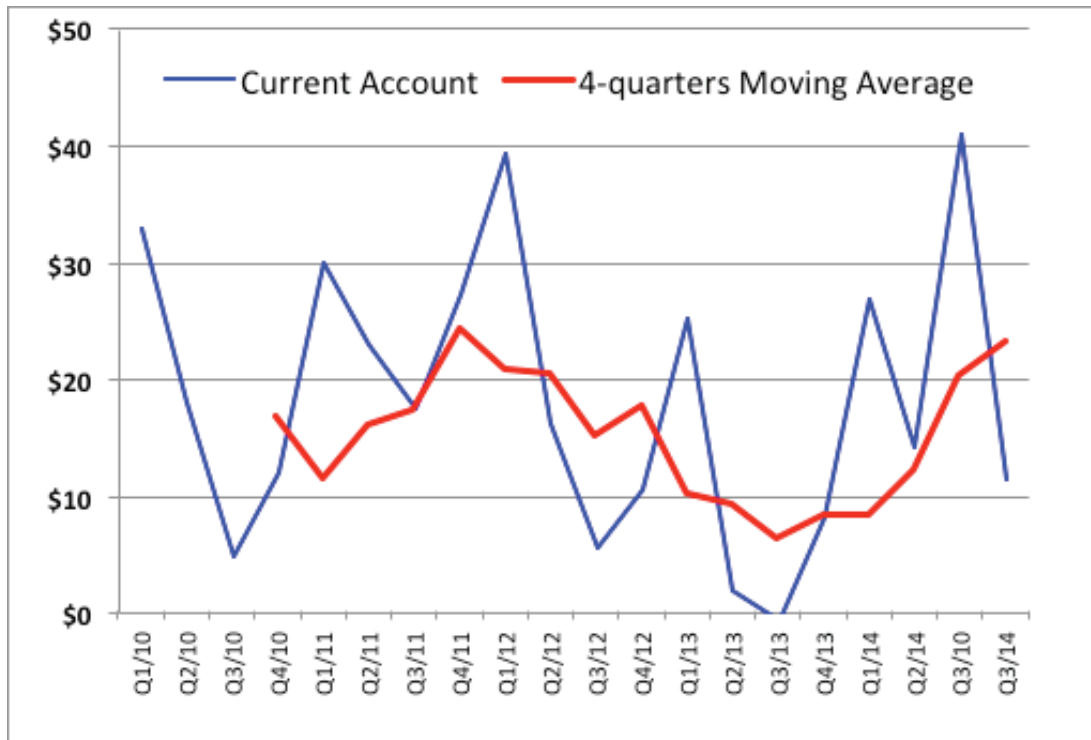
Oil

The first and most important factor affecting the ruble was the erosion of the oil safety cushion that became apparent as early as 2013. Oil prices have been rapidly falling since the middle of this year –

they were down by a quarter in four months. The value of the ruble is strongly linked to oil prices, which has been demonstrated several times over the last thirty years. Oil and refineries comprise half of Russia’s exports (two thirds gas included). While oil prices started declining in August, the trend caught up with export revenues only in October and there was much less currency on the market than usual. In contrast, the demand for currency has not declined yet (due to the seasonal factor – importers were paying for New Year deliveries).

From the balance of payments perspective, the 20 percent decline in oil revenues amounts to \$5 billion in monthly losses. In addition, the corporate sector needs currency to repay its external debt (\$8-9 billion a month in October-November and over \$30 billion in December). It therefore becomes clear that all objective conditions for the ruble’s decline were already in place by October.

Figure 1. Russian Current Account 2010-2014 (quarterly, \$bn)



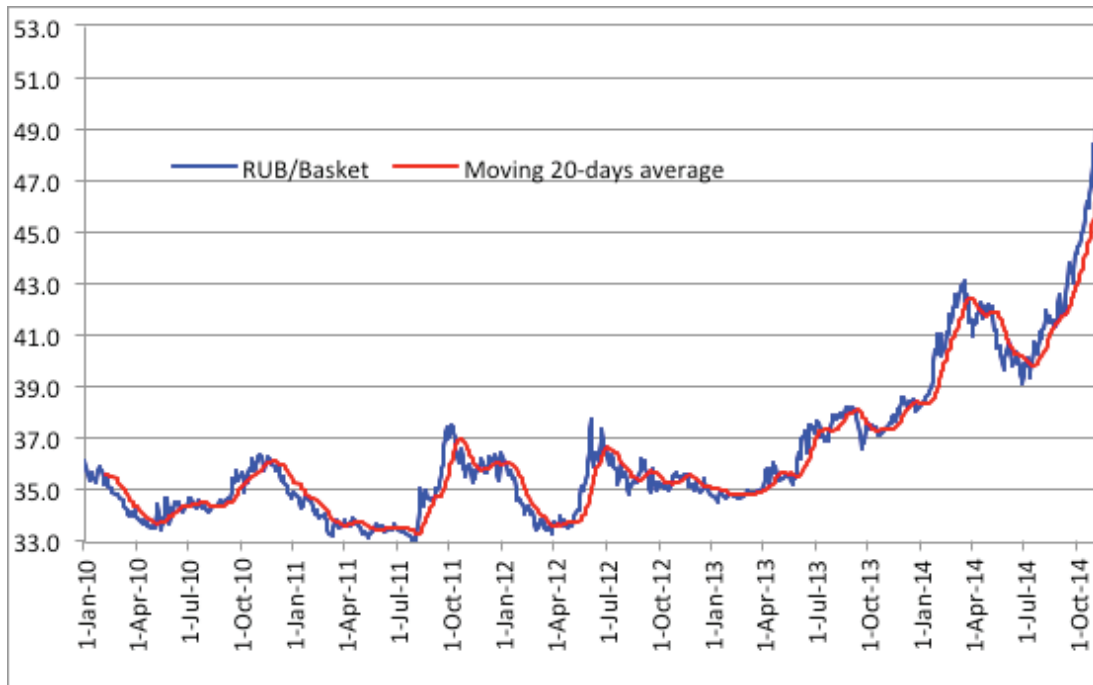
Source: Central Bank of Russia

Remember 2011?

Russia has always had current account surpluses. Not only deficits, but surpluses below 1 percent of GDP, were extremely rare and always led to the weakening of the ruble. In the second quarter of 2013, the surplus practically dissipated (Figure 1), and the ruble started its rapid decline, which was noted by many observers. But in reality, the ruble started to weaken two years earlier in August 2011, and even more at the end of September 2011 with Putin's announcement regarding his return to the presidency. Figure 2 clearly depicts this turning point in Russian currency dynamics. From that point

on, the ruble was doomed to decline at the rate of 10 – 15 percent a year. Such a devaluation would have allowed to contain (or reduce) the demand for imported goods and services and maintain the stability of the balance of payments. Sustained international investments or currency interventions by the Bank of Russia (as a short-term instrument) could have become an alternative to (or inhibitor of) the devaluation. But events took a different course, and a host of other factors have come into play since this spring.

Figure 2. Russian Ruble per Bi-Currency Basket (55%\$ + 45%€), 2010-2014



Source: Central Bank of Russia

Capital Flight

Russia's annexation of Crimea triggered massive capital flight and increased the demand for foreign currency. As a result, instead of the influx of international capital, the balance of payments was saddled with the Russian capital outflow. As the political events continued to unfold, Russia became an active player in the conflict in eastern Ukraine. The downing of MH-17 was followed by Western economic sanctions that precluded Russia's state-owned banks and companies from accessing capital markets. Although a limited number of companies were targeted by the sanctions, the Russian corporate sector cannot raise loans or sell their equity on

foreign markets at this time.¹ Nevertheless, companies have to repay their debts, which sharply inflates the demand for currency. Russia's major borrowers (banks and raw material companies) have sufficiently large liquidity reserves and want to avoid defaults. However, many of them are afraid that political relations with the West are not about to improve in the nearest future; hence, it is better to stock up on foreign currency now than buy it at a higher price six months later.

Non-economic Factors

Economic factors alone do not tell the whole story — there is also a significant psychological dimen-

sion, which is extremely hard to quantify. Nevertheless, it sometimes plays a greater role than any economic forces. This dimension has to do with the largely uncertain economic prospects under the conditions of political confrontation with the West. A substantial part of society and the business community can no longer anticipate what awaits the country in a month, six months, or a year. Some decided to weather the storm with the help of foreign currency.

One vivid example of the psychological dimension is what happened in reaction to the Central Bank's moves this past October. The Central Bank published a draft *Guidelines for Monetary Policy* in early September. It stated that as part of its transition to an inflation-targeting regime, the CBR intends to abandon currency interventions that support the ruble. In fact, the CBR did not mean that it would completely cease to intervene; it simply stated that it would only enter the market in the case of financial instability. However, this statement was not explained, and market players prepared to embrace new realities.

These realities set in rather quickly – in October. Russian bankers tend to be faster decision makers than government officials are. As soon as oil prices dipped below the \$100 mark, they realized that it was time to stock up on currency. It would have been quite a rational decision under normal circumstances; the problem was that banks have few liquid ruble assets of their own. Households and businesses were not particularly concerned about the dollar rate at that time and did not rush to get rid of their rubles. In this situation, the banks' only option was to take loans from the Central Bank. And the CBR gave loans with no limitations. Besides, the CBR decided to reinforce protection of the ruble rate – the notorious rule of “\$350 million in interven-

tions shifts the trading band by five kopecks” gave bankers an excellent chance to make a profit.

The CBR had been lending banks rubles at an 8 percent annual rate for all of October. Naturally, all this money was used to purchase currency. After all, besides providing loans, the Bank of Russia had also been selling currency, gradually lowering the ruble exchange rate. As a result, within one month, the bi-currency basket became 15 percent more expensive, which gave banks 400 percent annualized profit. (Incidentally, the CBR acted in the same fashion during the crisis of 2008–2009. At that time, it had spent \$200 billion, and the run on the ruble ended two days after the Central Bank stopped providing liquidity to banks.) In short, misconstrued signals from the Central Bank contributed to the ruble's precipitous fall.

The New Normal

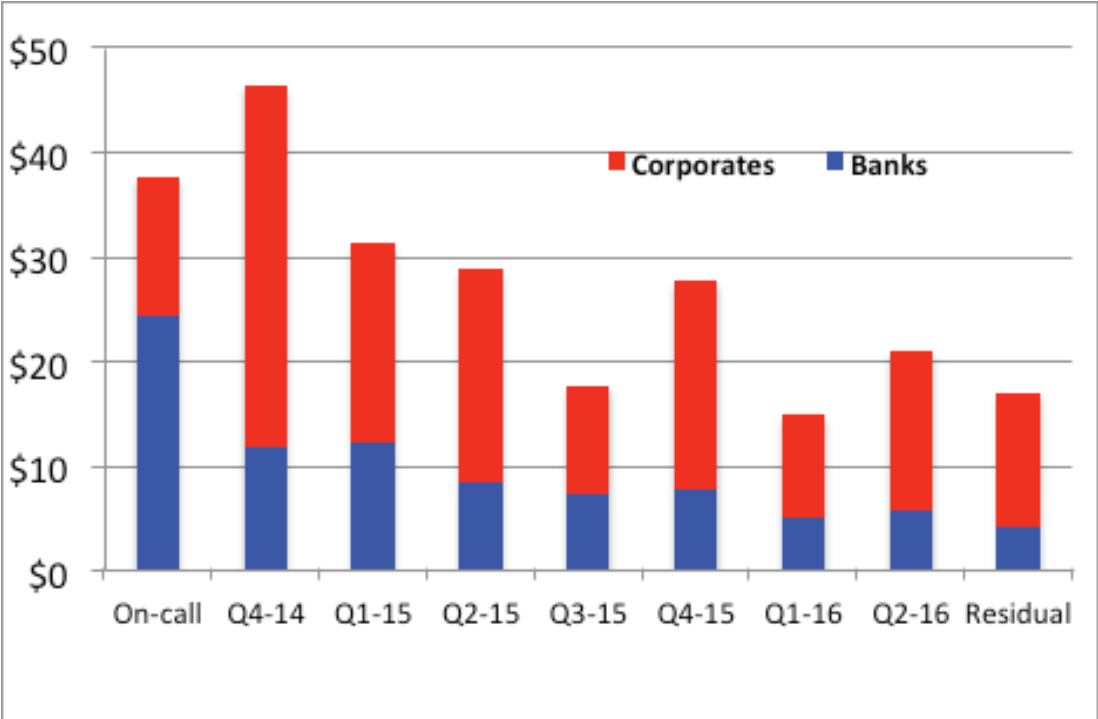
On November 10, the CBR made radical changes to its policy. It abolished the operational band and adopted a free-floating exchange rate. It also announced that it would abandon its interventions to support the national currency. At the same time, the CBR stressed that it would be ready to implement currency interventions if the financial situation in the country became unstable. The CBR also stopped extending new loans to banks. The combination of these steps led to the stabilization of the ruble exchange rate.

Today, no one can confidently predict future ruble dynamics. It appears, however, that Russia's current economic fundamentals are rather sound and do not portend the ruble's serious weakening in the coming year. On the one hand, if the ruble does not appreciate soon, the recent devaluation must significantly lower the demand for imported goods

and services. If this happens, the current account might increase substantially – up to \$100–120 billion annually (6-7% of GDP). This amount is more than sufficient to offset the loss of export proceeds that

will result from the decline in oil prices. Given the price of \$80 a barrel, Russian exports stand to lose \$65–70 billion a year.

Figure 3. Scheduled Repayment of Russian Corporate Foreign Debt (\$bln/qtr.)



Residual – divided by 5 years

Source: Central Bank of Russia

On the other hand, according to the CBR, by the end of 2015 (in five quarters), Russian banks and companies have to repay foreign debt amounting to \$150 billion (8.5% GDP) (Figure 3). That would seem to put huge pressure on the balance of payments, though the real pressure might be less significant. A large part of this debt is owed to affiliated parties

(as a rule, business owners), and it may be repaid or restructured without any impact on the balance of payments. For instance, in the third quarter of 2014, the external corporate debt decreased by \$40 billion, even though the current account was just \$11 billion, and the CBR did not spend a single dollar on currency interventions.

In this situation, the expectations of Russian households and businesses become the key factor that will determine the dynamics of the ruble. It is obvious that the further escalation of the political situation in the next few months will weaken the ruble and vice versa.

In the long run (beyond 2015), the fate of the ruble will depend on Russia's economic outlook. Declining imports and increasing capital flight reduce investment. If technological sanctions in the oil and gas sector are not eliminated, Russia may face stagnation of output beginning in mid-2015 and its decline beginning in mid-2016. Decline in hydrocarbons production will further slow economic growth and weaken the balance of payments due to lower export volumes. If the CBR sticks to its free-floating ruble policy, the weakness of the balance of payments will be offset by the consistent weakening of the ruble.

In summary:

- Falling oil prices, capital flight, and psychological dimensions played just as large a role in the ruble devaluation as sanctions.
- Fundamentally, the ruble began to weaken in 2011.
- The new normal in the short-run is unpredictable ruble dynamics.

Endnotes

- 1 Since April 2014, Alfa and Otkrytie banks, as well as Gazprom, have managed to raise foreign debt.

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