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Ruble to trend weaker through 2010

The government's forecast looks sounder than most analyst predictions

Since the managed devaluation (completed in February 2009) that resolved Russia's most recent currency crisis, the ruble has been allowed to float more freely than during the pre-crisis period. The increasing exchange rate volatility seen in Q3/09 has torpedoed any consensus among analysts about the ruble's likely direction during the coming year.

Key judgments

- We expect the ruble to weaken against the dual USD/EUR basket over the next 12 months.
- The decisive drivers are the capital account deficit – which, even on a sanguine oil price view, will exceed the current account surplus – and the decreasing scope for sterilising the liquidity generated by the huge fiscal stimulus.
- If this ruble weakness intensifies, the authorities might abandon their tentative hands-off approach to the exchange rate. But given money velocity trends and the net foreign asset positions of banks and households, we do not expect anything more than modest depreciation – in the range of 10-15 per cent.
- The official government forecast for the ruble averaging 33.9 to the US$ in 2010 looks about right. This makes the present 12-month NDF price look rich.

CORE CASE

Shift to a 'dirty float' – but where will the ruble go?

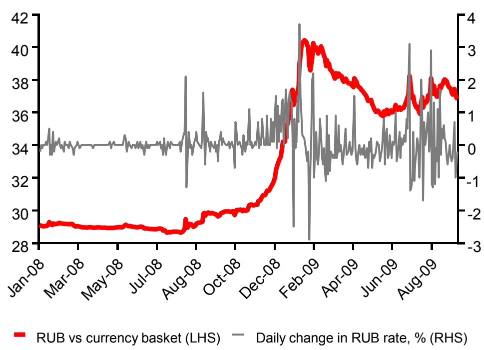
In the years before the 2008 crash, Russian macroeconomic policy presented a sharp contrast between sound (counter-cyclical) fiscal policy and unsound (inflationary) monetary and exchange rate policy. As a result, the Russian government now has scope to apply fiscal stimulus to hasten the end of the deep recession which began in Q4/08 (a topic we examined in detail in a recent note).

However, the sustainability of the recovery will depend largely on improvements in financial policy across the board: monetary and exchange rate strategy, financial market development and structural reform in the banking and non-bank financial services sectors.

The exchange rate lies at the heart of the strategic policy choices involved here. A number of policy declarations and actions during the crisis point to an improved understanding at the top political level that combining a managed exchange rate with an open capital account – as Russia did in the pre-crisis period – undermines sustainable growth. While still intervening to cushion pressure on the currency in either direction, the Central Bank (CBR) clearly now has the political authority to allow the ruble exchange rate to move more freely than was the case in the pre-crisis period. This reflects official satisfaction with last winter's depreciation (traumatic though the experience was at the time) and the absence since then of entrenched one-way speculative pressures on the ruble.

This change shows up in the increasing volatility of the ruble exchange rate (see Chart 1 below).

Chart 1: Ruble vs USD/EUR currency basket, 2008 - present



Sources: Bloomberg, TS.

The most recent experience in Q3/09 is particularly significant. This period has seen some quite sharp movements (frequent 1.5-2 per cent daily volatility against the dual USD/EUR basket) despite the fact that, in contrast to earlier bouts of volatility during this crisis, there have been no oil price or capital flight shocks. A notable result of this heightened exchange rate volatility has been repeated devaluation rumours (in July-August 2009). Such scares are readily explicable in the light of the past years' experience of a managed exchange rate ("dirty peg"), with market participants jumping to the conclusion that any such sharp moves in the exchange rate (the ruble lost 5.7 per cent against the dual basket during the period 1-13 July) must be part of some new government plan.

The reality, on the contrary, is that the authorities are starting to wean themselves off pegging the exchange rate. But this policy departure remains tentative. Nor will there be any "big bang" shift to a classic inflation-targeting regime based on a freely floating exchange rate.

The key question for now is how the ruble exchange rate is likely to behave in the next 6-12 months, given that the currency is being left more to its own devices. A reflection of this new reality – which might best be regarded as a shift from a "dirty peg" to a "dirty float" – is the lack of consensus on the direction of the ruble exchange rate: local investment banks' end-2009 forecasts for the ruble to the US$ range from a 5 per cent appreciation relative to the present level of Rb30.0:US$1 to a 10 per cent depreciation. Forecasters' traditional focus on the ruble/US$ rate – despite the CBR's policy of tracking the dual USD/EUR basket – extends to the government itself, with the Ministry of Economic Development avoiding discussion of USD/EUR scenarios in its exchange rate projections. A neutral – or agnostic – view on the USD/EUR rate is also implied by the CBR's progressive shifting of the dual basket weightings towards parity (they now stand at 55:45 in favour of the dollar).

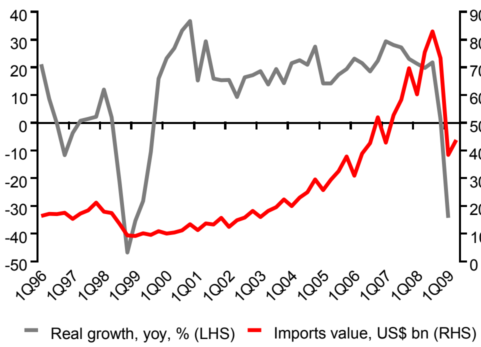
This note analyses the drivers acting on the half-unchained ruble – the key ones in our view are the above-mentioned fiscal stimulus and the capital account of the balance of payments – as the basis for our prediction of the currency's likely direction in the remainder of 2009 and in 2010. Getting this call right is of obvious importance for all investors exposed to Russian assets. But it is important for another reason: the behaviour of the ruble exchange rate in the coming period will feed back into the political motivation determining the choice of monetary policy strategy. Despite improved political tolerance for ruble volatility, large absolute exchange rate movements in either direction (though the actual direction, in our view, will be down) may cause the government to balk at completing the step-up to the improved monetary policy framework required for more sustainable growth. We will return to this subject – a fundamental long-term driver of returns on Russian assets – in a forthcoming research report.

Weak ruble driver No. 1: Balance of payments – capital account

The most straightforward view of the ruble exchange rate is that it follows the price of oil – which, along with gas (whose price is linked to oil), accounts for more than 60 per cent of Russia's exports. Since the period November 2008 – early February 2009, during which the ruble was devalued by 30 per cent, the oil price has risen 75 per cent to trade stably in the range of US$70/bbl, while the ruble has gained 8 per cent against the dual basket (11 per cent at its year-to-date high in May). This might prompt expectations of further ruble gains assuming the oil price holds its ground. In our view, any such expectations are based on a misunderstanding of Russia's balance of payments.

Although very large oil price movements (such as the 75 per cent fall posted in Q4/08) will drive the ruble up or down, more moderate price changes (up to around 20 per cent) will have little impact on the exchange rate. This is because the increasing value of exports caused by a rising oil price is quickly offset by rising imports. The previous episode of devaluation and import contraction in 1998 was followed by a prompt revival in imports as soon as the ruble stabilised (see Chart 2 below). If anything, the boost to import substitution from the devaluation seen during the winter of 2008-09 will be even weaker than it was after the 1998 devaluation.

Chart 2: Import dynamics, 1Q/96-2Q09



Sources: Rosstat, CBR.

The prospective revival of imports is reflected in the Ministry of Economic Development's July 2009 external trade projections: there is a modest difference of only 16 per cent in the trade balance between the base case and more optimistic scenarios for the oil price (see Table 1 below).

Table 1: Forecast trade balance under various oil price assumptions (US$ billion)

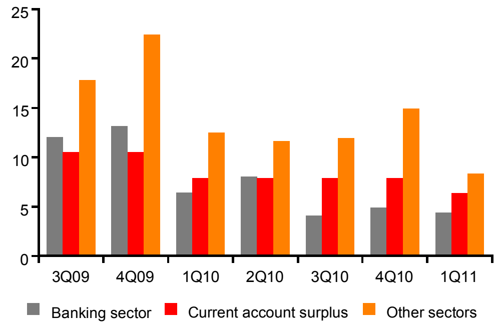
	2010	2011	2012	2010	2011	2012	Difference between scenarios		
	$55/bbl	$56/bbl	$57/bbl	$60/bbl	$70/bbl	$77/bbl	2010	2011	2012
Exports	275.6	281.8	289.1	294.3	338.1	374.6	18.7	56.3	85.5
Imports	194.8	205.1	219.3	200.5	216.1	236.5	5.7	11.0	17.2
Trade balance	80.8	76.7	69.8	93.8	122.0	138.1	13.0	45.3	68.3

Source: Ministry of Economic Development, July 2009.

The difference that these alternative oil price scenarios would make to the current account outturn would be even more modest. One reason for this is the flipside of another consideration which has made some observers bullish on the ruble's prospects in the coming months: namely, that Russian companies with foreign debt are now enjoying improved refinancing prospects compared with the funding desert in which they found themselves from the onset of the global crash until spring 2009. But the refinancing on offer in both syndicated loan and debt capital markets is coming at a higher price than the original borrowing. For example, important refinancing for MTS in May 2009 – the first foreign refinancing for a major Russian company with ruble revenues as opposed to being a commodity exporter – came in at LIBOR + 6.5 per cent, 1.64 percentage points higher than the interest rate on the original loan. Thus, improved refinancing conditions spell higher foreign debt interest payments – both because of the increased cost of borrowing and the higher level of the total stock of debt. And a larger total of foreign debt service means – other things being equal – a smaller current account surplus.

The most important point of all, however, is that the capital account will remain in deficit, despite the welcome availability of some (as opposed to zero) refinancing for the US$43.5 billion and US$73.5 billion of non-sovereign foreign debt falling due, respectively, in the last four months of 2009 and in 2010. The modest reversal in net private capital flows in Q2/09 (which saw a US$7.2 billion inflow after the US$34.8 billion outflow in Q1/09) has turned sharply negative again in Q3/09, with net outflows of US$16.1 billion in July and US$8.4 billion in August. As things stand, Russian corporates are enjoying better refinancing conditions than the banks, reflecting lenders' concerns about bank solvency amid continued uncertainty about peak NPL levels.

Chart 3: Official balance of payments forecasts, Q3/09-Q1/11 (US$ billion)



Sources: CBR, Ministry of Economic Development.
Note: Quarterly current account inflows shown here are one-quarter of the annual amount estimated by the Ministry of Economic Development.

To sum up, the existing official balance of payments forecasts shown in Chart 3 above imply that capital outflows will exceed the current account surplus until at least the end of 2010. This would remain the case even if the debts of the non-financial sector were rolled over because, as just noted, the result would be to increase debt service outflows and so reduce the current account surplus. With no offsetting factor in sight for the next year (neither net FDI increases nor speculative portfolio inflows are plausible as early as 2010), the result will be steady downward pressure on the ruble.

Weak ruble driver No. 2: Liquidity and sterilisation

In addition to the external environment pointing to a depreciating trend for the ruble exchange rate, the most powerful and immediate driver for ruble weakness through 2010 will be the combination of the domestic liquidity created by the fiscal stimulus and the decreasing capacity of the CBR to sterilise that liquidity.

In the years before the 2008 crash, the CBR's monetary policy was emasculated by the combination of a managed exchange rate and free capital flows. To prevent balance of payments surpluses producing politically intolerable ruble appreciation, the CBR made massive ruble interventions in the domestic FX market, while having to rely on the budget surplus (which, of course, it could not control) as the only effective sterilisation tool.

At first glance, the CBR's task now seems easier than was the case before the crisis, as it no longer has to contend with huge capital inflows (while, on the other hand, the threat of runaway capital flight brought on by the crisis has satisfactorily receded since Q1/09). In the first phase of the crisis, the CBR offset capital flight by providing liquidity to the domestic financial system in the form of:

- REPO auctions (the cheapest funding);
- Various types of Lombard loans;

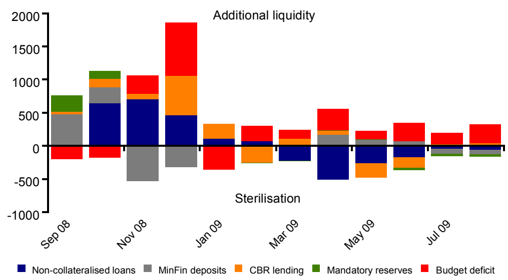
- Reductions in banks' mandatory reserves;
- Non-collateralised loans (the most important tool).

The Finance Ministry also chipped in during the first phase of the crisis by placing idle Federal Treasury funds on deposit in eligible banks that bid for such (typically three-month) funding.

On closer inspection, the old headache has been replaced by a new one – arising from the swing from budget surplus to large deficit. This deficit – Rb3.2 trillion (about US$100 billion) in 2009 – is being financed by drawing down the Reserve Fund. The CBR, which had previously invested the Fund's resources on the government's behalf in EU and US sovereign bonds, is now converting that money into rubles off-market – that is, via money creation. This means that there will be no resulting upward pressure on the ruble exchange rate. In fact, the exchange rate pressure will be downward, since the converted funds will be spent domestically. Unless sterilised, this spending will boost the money supply.

In H1/09, such sterilisation was possible because, for the usual reasons of bureaucratic inefficiency, the 2009 fiscal stimulus has been slow to get going, resulting in a budget deficit for this period of only Rb720 billion. That sum was easily sterilised by the CBR – mainly by withdrawing around Rb1.5 trillion worth of non-collateralised lending (see Chart 4 below, which shows all sterilisation factors except the CBR's dollar interventions in the FX market; as can be seen from the broadly stable level of official foreign exchange reserves, these have not been material).

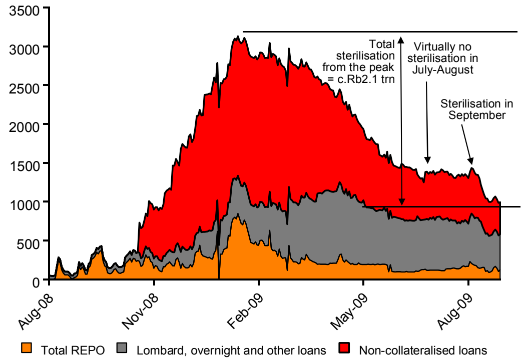
Chart 4: Sources of liquidity and sterilisation, September 2008 - August 2009 (Rb billion)



Sources: CBR, Ministry of Finance.

That non-collateralised lending contributed most to raising the level of the CBR's emergency funding of the domestic financial system to its peak of Rb3.1 trillion on 26 January 2009. But as Chart 5 below shows, the sterilisation effort during H1/09 was resumed in September 2009 (and, at time of writing, the ruble is going up as a result); but remaining sterilisation capacity in the face of continuing Reserve Fund monetisation is now very limited.

Chart 5: Funds provided by the CBR, August 2008 - September 2009 (Rb billion)



Source: CBR.

The combined outstanding sum of non-collateralised loans and Finance Ministry deposits is around Rb675 billion (Rb415 billion and Rb260 billion, respectively). These are the only practicable and material sterilisation tools. The 200 bps increase in mandatory reserves since January has contributed only Rb95 billion of sterilisation. Another potential instrument is the CBR's own short-term bills (OBRs) with an apparent (though unofficial) quarterly issuance target of Rb100 billion. But the offered yields are usually too low (negative in real terms) to attract interest: at the latest OBR auction, on 15 September, the CBR placed less than Rb3 billion of the Rb100 billion offered at an annualised yield of 8.2 per cent. Whatever the exact mix of reasons for this – concerns about the CBR's P&L and reluctance to weaken the recovery by crowding out domestic borrowers – the result remains the same: unsterilised money creation.

The effective remaining sterilisation capacity of around Rb700 billion (stretching into 2010, when most of the outstanding non-collateralised loans fall due) will leave not only about Rb1.6 trillion of unsterilised liquidity in 2009 but also virtually the entire projected 2010 budget deficit of Rb3 trillion unsterilised. For the purpose of funding that 2010 deficit, the dwindling Reserve Fund will pass the baton to Russian sovereign bond issues. But the effect on the exchange rate of new Eurobond issues will be no different from that, already noted, of the monetisation of the Reserve Fund: the proceeds of foreign borrowing will be converted into rubles off-market and spent. This, in turn, spells monetary expansion and further downward pressure on the ruble during 2010.

CONCLUSION

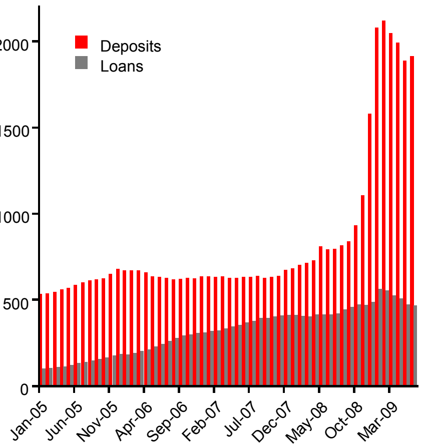
The main risk to any analysis of the likely direction of the ruble exchange rate based on fundamental drivers is that these very drivers will somehow be overridden by government policy. We have already noted the wrong-headed speculation among market participants in July-August that the government was planning a further devaluation. One of the supposed motivations for this devaluation plan was fiscal expediency: devaluation would increase the ruble proceeds from natural resource export duties and, from 2010 onwards, new Eurobond issues. In reality, far from any inclination towards adventurist initiatives on the exchange rate, the authorities' approach is reactive: they would return to a hands-on exchange rate policy only if the ruble's movements were sufficiently large to pose a threat to the paramount goals of stability and growth.

If the ruble were trending sharply stronger, traditional competitiveness concerns might produce a return to the bad old policies of the pre-crash period. That test will very likely materialise before the end of President Medvedev's term in 2012, and the response to that future challenge constitutes an important medium-term investment theme. As mentioned above, we will be returning to this subject in a forthcoming research note. On a 12-month view, based on the drivers analysed in the previous section, we see the ruble trending weaker. This raises the question of whether the depreciation trend will be sufficiently strong to elicit an active government policy response. We think not.

The eternal wild card here is, of course, the oil price. It will be clear from our balance of payments analysis that we see the capital account continuing to exert downward pressure on the ruble even if the oil price remains strong. That said, our call would be underpinned by a softer oil price – driven more by weaker than hoped-for recovery in developed countries. Short of another oil price collapse like that in Q4/08, the expected weakening of the ruble will not quicken into a repeat of last winter's big devaluation.

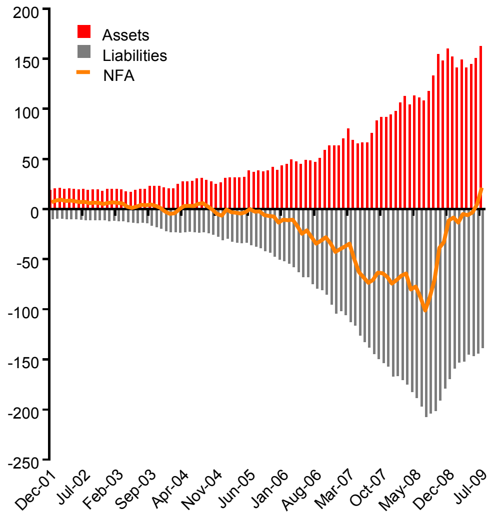
Turning from external to domestic drivers, we see no grounds for supposing that renewed ruble deprecation will trigger renewed capital flight, which, in turn, would force the authorities to react against the threat of a panic-driven devaluation overshoot. For one thing, neither the public nor the banks now have anything to lose from a weakening ruble, since both at present enjoy a positive net foreign assets position (see Charts 6 and 7 below).

Chart 6: Retail FX loans and FX deposits, January 2005 - May 2009 (equivalent Rb billion)



Source: CBR.

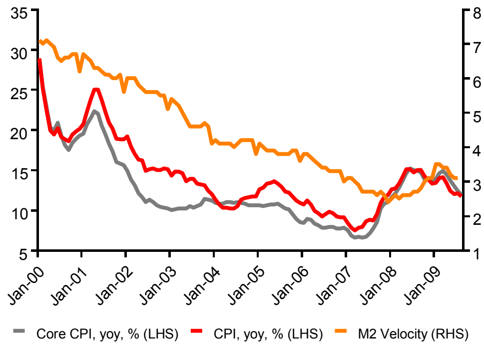
Chart 7: Net foreign assets of banking sector, December 2001 - June 2009 (US$ billion)



Source: CBR.

More fundamentally, the core driver of the expected depreciation trend – namely, the monetary expansion caused by unsterilised liquidity injections – will itself be absorbed by the continuing post-crisis recovery in monetary demand (or decrease in the velocity of money, which amounts to the same thing). Chart 8 below shows that the scope here, though modest compared with the previous crisis of 10 years ago, is real.

Chart 8: CPI, core CPI and Ruble M2 velocity, 2000 - present



Source: CBR.

Recovering demand for ruble money will complement global deflationary pressures in blunting the impact of the ruble depreciation drivers that we have identified. At the same time – even given this prospect of inflation falling faster than the authorities have until now been expecting – the resulting fundamental support for the ruble will be offset by the CBR's continuing to combat the recession by reducing its policy rate in line with the declining CPI.

In short, the prospect here is a neutral one: no sharp government policy initiatives in response to ruble depreciation (precisely because that depreciation will be mild), and the policy settings in place leaving the natural (i.e., downwards) direction of the ruble undisturbed. The bottom line is that the Ministry of Economic Development's forecast of an average 2010 ruble/US$ rate of Rb33.9:US$1 – that is, 12.5 per cent lower than the present spot rate – looks sensible. That implies an end-2010 rate nearer 35. Comparing that forecast with the present NDF curve – which slopes smoothly to a 12-month spot price of Rb33.05:US$ – makes current Rb:US$ NDF prices look rich.

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