Russia the Eternal Enigma

Winston Churchill with great prescience stated in 1939

I cannot forecast to you the action of Russia. It is a riddle, wrapped in a mystery, inside an enigma; but perhaps there is a key. That key is Russian national interest.

Might similar thoughts have crossed the mind of Napoleon at Borodino (Бородинское сражение) *124 years earlier?*

I

Making sense of Russia

To paraphrase Churchill - Russia to this today remains mostly an enigma. After a relatively short period – little more than a decade – during which Western experts, advisers, politicians and business people visiting Russia were mostly free to discuss and explore sensitive issues – that window of opportunity is now mostly closed, except to the most trusted few. Russia appears again to have closed in on itself. Western policies towards Russia, it has to be said, have done little to discourage this. A huge missed opportunity. Cold War thinking is now clearly ascendant. Russia's strengths and weaknesses are again under close scrutiny. The immediate economic and political outlook looks decidedly uncertain. In trying to make sense of the situation and draw conclusions the following interconnected questions are explored:

- What are the key facts and figures revealed by the Russia's economic prospects?
- What are the key factors that will impact upon the reserves position of the CBR (Central Bank of Russia) in coming months?
- How will the Russian Government and the CBR respond to these challenges?
- How will the prospective Rouble exchange rate be impacted by these developments?
- What is driving oil prices lower
- How will these different influences impact on Russian behaviour?

II

The main economic indicators

In researching these questions data published by the CBR the Russian Ministry of Finance, the OECD and the World Bank and The Economist amongst others have been assessed. The key economic background facts confirm that the Russian economy is growing significantly more slowly than other major Emerging Market economies. Seasonally adjusted growth for the first two quarters of 2014 was close to zero. China and India recorded annualised rates of growth of 7.8% and 3.1% respectively in Q2 2014. Russian growth for 2014 is projected to settle at an annualised 0.4%. The CBR's most recent forecasts are projecting growth at zero for 2015 with inflation at around the 8% level.[1]

Slowdown reflects a range of concerns. The ongoing geopolitical tensions notably in relation to the Ukraine are a major influence. The various rounds of sanctions and countersanctions

[1] Poll Forecasts of The Economist and the World Bank are similar

have also had a depressive impact. Confidence has also been adversely impacted by moves to restrict the country's access to international capital markets. More generally the softening of world oil and gas prices, a consequence of the weaker global economic outlook, is a major factor. Oil prices have fallen from around $109 a barrel in the first half of 2014 to around the $70 level where they are currently trading. The CBR maintains that that oil at around the $90 level is required to stave off recession. Consensus forecasts point to this settling at or around the $83 level in 2015. This assessment assumes no serious widening of conflict in the Middle East. Who can possibly say? What if the US officially restarts QE? Read on.

III

The Balance of Payments

The immediate impact of these developments has seen a very large rise in capital outflows from Russia in H1 2014, a fall in investment and sharp decline in consumer spending. It has also unsettled currency markets. The Rouble has weakened against all major currencies. In the past three months it has fallen by 30% against the dollar. This has prompted intervention by the CBR and a tightening of monetary policy. Despite these moves market sentiment in respect of the Rouble remains negative. It is currency trading at around the 50 per dollar level in a worsening outlook.

The current account strengthened in the first half of 2014. The half year figure puts the surplus at around $44.2bn – some 4.6% of GDP. This reflects two main factors. First import demand softened in response to rising geopolitical tensions and slower domestic demand. This reduced the non-oil current account deficit to $131.3bn or 13.6% of GDP – a marked improvement on the year earlier levels. Exports of oil and gas products increased. Imports of machinery, equipment and transport vehicles declined. Non energy exports failed to gain from the depreciation of the Rouble an adverse pointer to underlying international competitiveness. But the key consideration is how falling oil prices will impact on the annual current account surplus and the government budget. As things stand falling oil export revenues reflecting weaker international oil prices will wipe out Russia's current account surplus[2] remembering that oil revenues account for around 16% of national output, 70% of total exports and 52% of the Federal budget.[3]

IV

Geopolitical tensions

Russia's capital and financial accounts have been adversely impacted by these events. The most significant impact was a sharp increase in net capital outflows. These totalled $74.5bn in the first half of 2014 compared with $33.5bn in the preceding twelve month period. This marks a greater than doubling of outflows. It is likely that some of these outflows will return to Russia in the form of *round tripping* FDI.[4] This is part of the off-shoring phenomenon of Russia as operators in the business enterprise sector move funds out of Russian to exploit tax and other advantages. Households' net purchases of foreign currency at $12bn (compared with $3.9bn the previous year) were also a significant factor. The downside pressures led to CBR intervention in the first half of 2014 with sales by the central bank reaching $37.7bn.

[2] Remembering that Russia is one the largest producers of oil at 12 mb/d in 2013 along with the US and Saudi Arabia.
[3] See the World Bank Report on Russia September 2014
[4] This is referred to as FDI though in reality it mostly represents returning Russian capital.

V

The peculiarities of Russian demand and supply for FX

Demand for FX in Russia is characterised by demand for dollars (and other major currencies) to meet payments whether for goods and services or interest on debt and/or its repayment and the purchase and/or sale of foreign assets. There is also strong speculative/prudential demand for FX. In normal circumstances the balance between inflows of FX (export revenues and invisibles) and outflows (import payments plus Russian-style FDI and debt servicing/repayment) determines the net reserve position. This currently stands at somewhat above $400bn.

That figure in normal circumstances will vary as the balance between inflow and outflow changes. The rise in geopolitical risk, following events in Ukraine, has disturbed this balance. Net export earnings have fallen somewhat faster than net import liabilities. Export revenues have eased because of the somewhat softer market for Russian oil and non-oil products. Costs of debt servicing have risen for Russian borrowers in dollars and other convertible currencies reflecting the worsening risk outlook for Russia.[5] These events have some downside implications for net FX reserves. But the principal influence at work has three main components: prudential demand for dollars by corporate and bank operators fearing prospective Rouble weakening; corporate capital flight triggered by fears and uncertainties about the domestic economy; and households also taking steps to protect themselves by shifting assets into dollars.

VI

The Reserves Position

If these special factors were not so potentially significant - the gross current reserves position of around $454bn would appear adequate. In order to identify a more realistic position in respect of reserves it would be reasonable to deduct gold, SDRs (Special Drawing Rights) and the FX assets of the SWF (sovereign wealth fund). This reduces the total net reserves available for intervention to around $242bn. Following interventions earlier in 2014 by the CBR this figure could well be closer to $215bn. An important caveat, however, is that the SWF[6] (or National Wellbeing Fund as it is also referred to) will begin investing in the re-building of Russian infrastructure. This will have the effect of freeing up more CBR reserves as the Fund sells dollars and buys Roubles.

It is reported that distributional[7] issues between the different non bank corporate participants in FX markets may arise in future. There are reports that net FX surpluses are much higher in the Metals and Mining, Utilities and Transport sectors when compared with the Oil, Gas and Telecoms sectors. These issues could be significant if instability in markets rises to the point where capital outflow becomes an issue beyond the control of the CBR. Across the economy there are other factors at work. There is some $120bn of external debt maturing in 2015 according to the CBR. Some proportion of this debt is held by parties who may find it difficult to refinance because of sanctions. This may lead to a scramble for dollars which will weaken further the Rouble.

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[5] Russian CDS (Credit Default Swaps) spreads have widened sharply.

[6] The Russian National Wealth Fund is Russia's sovereign wealth fund. It was created after the Stabilisation Fund of the Russian Federation was split into two separate investment funds at the beginning of 2008.

[7] Distributional issues reflect the powers of different economic groups to act first to protect their perceived economic interests at the expense of others because of the ownership and control of FX assets.

VII

The response of the CBR and the State

There will inevitably be considerable selling pressure on the Rouble in coming months. On balance, however, it is unlikely to develop into a significant FX crisis. Some further easing back in the Rouble's REER (Rouble Effective Exchange Rate) can be expected. In trading in early November there was again evidence of CBR intervention in the face of Rouble selling at around the 45 level against the dollar. The CBR is determined to halt this drift. In early November domestic interest rates were raised to 9.5% thus making Rouble deposits yield more than dollars. The CBR has also threatened heavier intervention against dollar speculators. It has also restricted banks' access to Roubles in a bid to limit speculative moves against the local currency.

Though financial sanctions have increased significantly the cost of Russian borrowing there are a number of options still open to the Russian authorities in addressing concerns about dollar shortage over and above the existing swap and/repo facilities. The Sino/Russian agreement on mutual cooperation in the field of international financing needs to be taken into account. Both parties favour the development of alternative financing institutions. There are also a number of options/that are open to the Russian authorities. These would include detaching the domestic Rouble from the international Rouble. This would enable the authorities to exert stronger control over the exchange rate without depressing further domestic demand.[8] It is also important to recognise that the global financial architecture is changing. This may very well soften the impact of any further tightening of dollar related financial sanctions aimed at weakening Russia's capacity to manage its international financing needs

VIII

QE and the law of unintended consequences

There is still no firm evidence on the effect of QE on oil and other commodity prices. But there are some matters of interest. Well before the global financial crisis broke in early 2008 speculative flows in international money markets, driven by the shadow banking industry, saw oil rise from around the $92 level in October 2007 to record highs of $145 in June of that year. As the global financial crisis broke and OECD output fell sharply - oil prices eased back reaching lows of around $47. The Fed began QE[9] early on in the crisis and repeated asset purchases at different stages thereafter. Oil prices again started to uptick reaching 'highs' at around the $109 level in March 2011.

The oil sell-off in June 2014 appears to have coincided with "tapering" by the Fed as QE operations were reduced. Some may see this as evidence that Fed interventions may turn out to be an unintended influence fuelling a further speculative hike in oil prices. If true then further "tapering" by the Fed could very well see oil prices at permanently lower levels with the dollar once again riding high. Good for oil consumers. Not good for oil producers in general. Definitely bleak news for the Kremlin as Russia struggles with still lower oil prices, collapsing growth and a looming budget crisis.

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[8] The creation of a light and a heavy Rouble with the heavy international Rouble attracting much higher interest rates would have the effect of cushioning the domestic economy from interest rate increases.

[9] QE involved the Fed in buying government securities in a bid to push interest rates to low levels. The Fed balance sheet currently shows holdings of around $4tr.

IX

How will Russia's policy settings change?

Back to Churchill we are bound to ask – where will it end? Is Russia heading towards collapse or have they as ever been canny enough to have thought carefully about their options and how best to exercise them. Finally – how is Russia's best national interest served? Given the continuing weakness in the Eurozone and the huge problem of Ukraine on the EU's doorstep - it is highly likely that Russia will continue its policy of *divide and rule* in benighted Ukraine. Any worsening of Russia's domestic economic situation is likely to weaken the resolve the EU to continue to support damaging sanctions against its neighbour. The EU also has exposures to Russia in the form of energy dependence. There is a great deal at stake. A lot for both parties to talk about.

Looking further afield the outcome of the Middle East crisis remains impossible to call. The possibility that the conflict will spread to Saudi Arabia can no longer be ruled out. Were that to happen then oil could begin to move sharply higher taking pressure off the Russian current account, reserves and budget pressures. In short Russia has every incentive to continue to meddle and destabilise both on Europe's borders and elsewhere in the Middle East putting everyone yet again on the back foot. Meantime America may well look on as weaker energy prices lead to lay-offs and shut-downs of its uneconomic shale and fracking activities. Unless of course the Fed decides to provide further support to a weakening US economy and QE once again, magically, puts the dollar lower and oil prices higher. An odd wotrld!

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December 2014