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INDEPENDENT NEWS FROM RUSSIA

Ruble Plunge Shows Russia's Reliance on Western Money

By The Moscow Times

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A woman walks along a street past a board showing currency exchange rates in Moscow, Oct. 16, 2014.

A steep plunge in the ruble, caused by sanctions over the Ukraine crisis and falling oil prices, has underlined Russia's heavy dependence on Western finance to balance its dollar-thirsty economy.

For all President Vladimir Putin's anti-Western bravado and talk of shifting Russia's economic ties to Asia, the last few weeks show the opposite — that the cogs of the economy are oiled by financial flows from the West.

A fall in foreign exchange inflows has prompted some economists to ask whether Putin and his government might be encouraged to wind down the conflict in Ukraine and divert resources and attention to the economy.

"There's enough incentive on them to make a political settlement. ... With Russia the story is about FX," said one economist, who requested anonymity. "That is Russia's Achilles' heel."

The ruble has shed some 20 percent against the dollar this year, including 6.5 percent in the last month alone, and the immediate catalyst for the breakneck descent is the tumbling price of oil, Russia's major export.

Putin's promises to reduce reliance on energy exports have not been fulfilled, and each one-dollar fall in the oil price knocks around $2.5-3 billion off Russia's exports over the course of a year, implying that the $25 decline seen in the last three months could cost Russia $65-75 billion.

If all other things are equal, that would be enough to wipe out the current account surplus that constitutes the basic source of foreign currency earnings.

An even deeper problem is the hit delivered to foreign exchange inflows by a collapse of foreign investment into Russia as a result of the tensions around eastern Ukraine, where forces loyal to Kiev have been fighting pro-Russian separatists whom the West says are backed by Russian troops and weapons.

Balance of payments data for the first nine months of the year shows that investment inflows fell to the tune of $125 billion, and even turned negative due to repayments of existing debts outweighing new inflows.

The resulting chasm in the foreign exchange market suggests that, barring a strong rebound of the oil price, the downward pressure on the ruble will continue until Western sanctions are lifted and investment recovers.

Plugging the Hole

One reason to think that the ruble has yet to price in the full impact of the oil price and investment plunges is the role that the Central Bank has played in plugging the forex hole.

The bank has already spent over $50 billion this year — including more than $10 billion this month — filling the gap and thereby supporting the ruble.

But under plans to float the ruble from the start of next year — recently reasserted by the bank's governor Elvira Nabiullina — the bank aims to withdraw from regular interventions in the market. Its policy projections show its total interventions falling to zero next year.

According to these projections, the crucial factor that will bring payments into balance will be a sharp fall in net capital outflows — to $35 billion next year from a forecast $90 billion this year — implying a strong recovery in foreign investment.

The bank's forecast for this year is looking optimistic, given that net outflows amounted to $85 billion in the fist nine months, and are now soaring again as investors dump the ruble.

And its 2015 forecast is not only a major turnaround from this year, but also well below the $61 billion net outflow seen in 2013. Other forecasters are much less optimistic.

A tightening of Western sanctions against Moscow in September, the latest of several rounds that began over Russia's annexation of the Crimea peninsula and have continued despite a shaky cease-fire, raises doubts that Western investment inflows will recover soon.

"I would imagine that type of investment has virtually ground to halt — and that's a key element," said John Hardy, head of FX Strategy at Saxo Bank. "Capital flows are an enormous factor."

Meanwhile, Russian companies require around $100 billion next year to pay off foreign debts — a major drain on dollars even before the other outflows, typically worth tens of billions of dollars, that Russians make annually are considered.

Not all analysts are pessimistic. "The current account surplus should be stronger and enough to cover capital outflows," predicted Natalia Orlova, economist at Alfa Bank.

She said that most forecasters are underestimating the fall in imports that will result from the already weaker ruble. But she added that her bullish scenario depends on a recovery of oil prices — a view that many other analysts question.

"This huge drop in crude prices is really putting the screws to the ruble," said Saxo's Hardy, who predicted that the ruble would reach 45 against the dollar in six months from 41 today.

"The reality is that the Central Bank is managing a vicious decline," he added. "I don't think it [the ruble] will be floated — given the strains."

Back-Door Intervention?

Any backtracking on the ruble float would be a heavy blow to the Central Bank, which has underlined the importance of sticking to the plan, a central pillar of its monetary strategy.

"If they start to hesitate this will be a big hit on their credibility, so at the moment they don't have another choice," Orlova said.

One possibility is that the Central Bank will use its still sizable $450 billion in foreign exchange reserves to support debt repayments, providing indirect support to the ruble by meeting the demand for dollars.

The Central Bank has already said that it will provide dollars to Russian banks via repo loans up to 28-days. Prime Minister Dmitry Medvedev has ordered the bank to draw up broader measures to refinance foreign currency debts.

The bank's officials have also said repeatedly that they would still step in to support the ruble if financial stability was at risk, emphasizing that a range of "non-standard measures" could be used if needed.

But these vague plans are doing little to reassure markets. Some analysts say more substantial and systematic measures are the only way to restore stability, perhaps ultimately including capital controls that restrict Russians' ability to purchase foreign currency.

Others say the key signal would be Putin reconsidering his policy over Ukraine, which has led to the worst tensions with the West since the end of the Cold War.

A planned meeting with Ukrainian President Petro Poroshenko in Milan on Friday has encouraged hopes of a breakthrough, but Putin has not dropped his anti-Western rhetoric.

"All that kind of stuff [planned by the Central Bank] is important in normal markets, but we're not in normal markets," said Saxo's Hardy. "And we won't see a return to normal markets until we see a very clear detente, a solution for Ukraine, and all sanctions ceasing."