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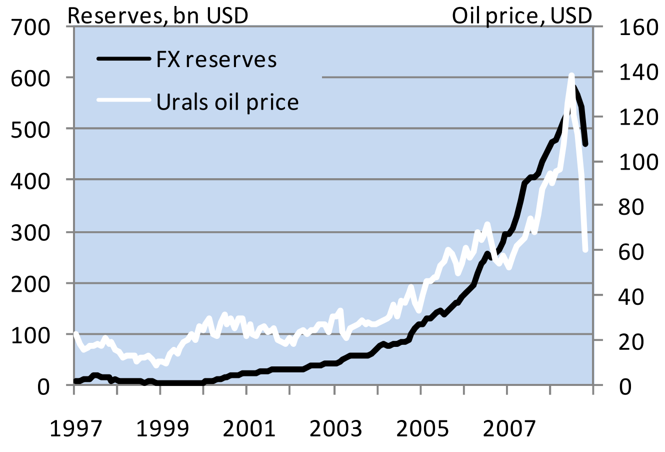
Mika Erkkilä: CBR introduces flexible RUB policy

The escalation of the global financial crisis this autumn marks a turn in the Russian economy and policy-making. When the crisis was confined to the financial sector, Russia continued its policy of an essentially stable and fixed rouble exchange rate. Now the crisis has spread to the real economy. Forecasts for economic growth are being revised downward. For example, the IMF's updated World Economic Outlook forecasts for global and Russian growth in 2009 are 2.2 % and 3.5%, respectively.

Rules of the game have changed

Russia for many years pursued an essentially fixed exchange rate policy. Against the background of increasing oil prices and appreciation pressure on the rouble, the central bank accumulated sizeable foreign exchange reserves. At their peak in August, FX reserves were almost USD 600 bn or about35% of GDP. The stabilisation and subsequent gradual strengthening of the rouble since the start of the 2000s was instrumental in the de-dollarization of the economy. The downside to all this was strongly negative real interest rates in an environment of rapid economic growth, when tighter policies would have been warranted to control inflation. Partly due to the appreciating rouble, borrowing from abroad hugely increased.

FX reserves and oil price



Sources: CBR, Bloomberg

External conditions have now changed dramatically. Currently at less than USD 40 a barrel, the price of Urals-grade oil has receded more than 60% from its average level in the first half of 2008 and even more from its peak of more than USD 140 in early-July. Foreign borrowing has essentially come to a halt. As a consequence, the capital inflows have been reversed and the central bank has become a buyer of roubles in order to stave off depreciation pressures. FX reserves have shrunk by nearly USD 150 bn since their peak amid the central bank's effort to prevent the rouble from weakening versus the binary currency basket (0.55% USD and 0.45% EUR).

The central bank has over the past weeks signalled a departure from its fixed rouble policy. The permitted fluctuation margin versus the basket has been widened by 30 kopeks on each of four occasions. The lower and upper margins now seem to be 28.1 and 31.6 roubles, respectively. The reason was presumably to introduce more volatility and two-way risk into an exchange rate, which was earlier perceived to provide an essentially a one-way bet. If successful, the new policy should remove some of the depreciation pressure off the rouble and slow the decline in FX reserves. The moves signal a pro-active stance and that the central bank has chosen to act from a position of strength, rather than waiting for the situation to deteriorate further and perhaps being forced into making a large one-off and potentially destabilising change later.

RUB basket

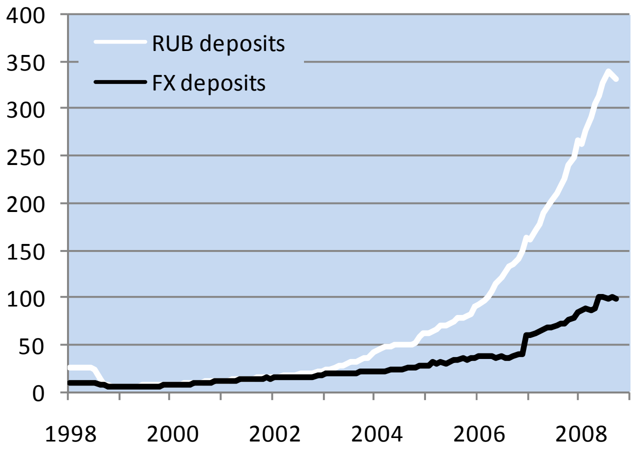
Source: CBR

Deposits sensitive to RUB exchange rate

While the move towards a more flexible exchange rate is in principle welcome, there is one major risk involved. Given the rouble collapse in August 1998, which wiped out the savings of the emerging middle class and led to a bankruptcy wave in the banking sector, the rouble exchange rate is probably the single most important price in Russia which is monitored carefully. The downside of the new policy is that it could lead to an accelerated switch from roubles into FX denominated assets. So far the rouble has reacted to fluctuation-band widening by weakening versus the basket to the new ceiling.

By the end of September, total rouble deposits in the banking system were USD 332 bn,of which households held USD 197 bn. Rouble deposits have increased much faster than currency deposits over the past years, on the back of a trendwise strengthening of the rouble. M2 money supply, which comprises only rouble deposits, fell an unusually large 6% m/m in October, indicating a switch from roubles into foreign currency. The withdrawal of rouble deposits coincides with the weakening of the rouble against the dollar and the basket.

Rouble and FX deposits, bn USD



Source: CBR

While the central bank's FX reserves are enough to theoretically cover a conversion of all rouble deposits into foreign currency, this reduces the room for manoeuvre to cover foreign debt. There is USD 147 bn worth of foreign debt falling due between now and 2009Q4, including over USD 43 bn due in 2008Q4. So far, the central bank is committed to refinancing USD 50 bn of this. In addition, a falling current account surplus on the back of the lower oil price is already tightening the liquidity situation.

More rate hikes?

The central bank hiked its key steering rates following the widening of the rouble's fluctuation band. The refinance rate was raised twice by 200 bps to 13% and the repo rate twice by 200 bps to 10 % since 11 November. According to Finance Minister Alexei Kudrin, the purpose was to put pressure on the banks to increase their deposit rates. But with inflation still around 14% and hence negative real interest rates, additional hikes may be necessary to make it attractive to hold roubles. However, from the central bank's perspective, the dilemma is that the appropriate interest rate level for defending the rouble may be too high for a real economy that is slowing down.

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