Emerging Markets Weekly

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Overview

Russia has suffered a currency crisis, and the full ramifications for financial stability, the economic outlook, and politics are unlikely to be clear for some time. The collapse in the rouble over recent days followed belated attempts by Russia's central bank (CBR) to support the currency through tighter monetary policy. Hikes in its key interest rate, by 100bps to 10.5% on 11 December, and a further desperate 650bps in the early hours of 16 December, simply poured fuel on the flames, and so the currency briefly plunged to RUB80/$, down more than 50%YTD, following the second hike. The sheer magnitude of the depreciation amid thin markets, coupled with overdue intensified market intervention, has for now seen the downward momentum peter out. But, not least given uncertainty about the oil price, as well as the economic and financial consequences of the rouble's sharp move, the future path of the exchange rate is unclear. Should significant depreciation pressures re-emerge, a range of policies, including capital controls, might yet be considered.

The rouble crisis

- Over recent days, the Russian Central Bank (CBR) desperately took measures to try to arrest the plunge in the rouble. But with the action initially too little too late, and subsequently of a magnitude likely to impact very negatively economic activity, the hikes simply added to downwards pressure on the currency. After the CBR raised the key rate by 100bps to 10.5% on 11 December, the rouble's slide continued. And following a further massive (650bps) hike to 17% in the early hours of 16 December, the rouble went into free-fall, at one point hitting RUB80/$.
- Despite a subsequent bounce back in thin markets, and assisted by $2bn of CBR forex interventions, the rouble closed 16 December close to RUB68/$, down more than 5% on the day, taking the decline over the year to date to about 50%, the worst performance of all currencies (inferior even to the Ukrainian hryvna). The rouble remained volatile on 17 December. However, further intervention, including by the Finance Ministry, has for now seen the downward momentum peter out, with the currency oscillating in the morning around RUB70/$.
- The CBR's rate hikes were accompanied by measures to support dollar liquidity, while at the same time seeking to preserve its foreign reserves. In particular, the CBR increased the funds available under its 28 days forex repo operations from $1.5bn to $5bn and also announced new weekly 12 month repo auctions to provide Russian banks with needed hard currency liquidity.
- The rouble crisis reflected several fundamental factors including: 1) plummeting oil prices, with the price of Brent crude down about 45% since mid-June to below $60bbl early on 17 December; 2) international sanctions limiting the corporate sector's ability to borrow on international financial markets and so raising uncertainty about its ability to meet large-scale foreign currency debt obligations; and 3) a recognition of the marked deterioration in Russia's economic outlook, reflected in new CBR "risk scenario" forecasts assuming an oil price of $60bbl, suggesting a drop in GDP of 4.6% in 2015 and a further 1.0% in 2016, implying deep recession for the coming 2-2½ years.

Our take

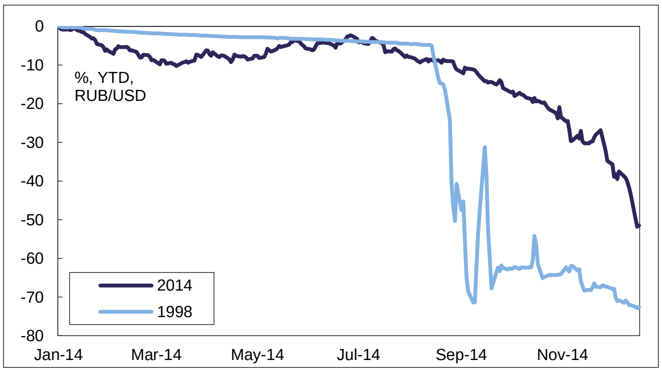
- The panic rate hike might be interpreted as an attempt to shake out speculative "shorts" against the rouble. But with the measure initially not reinforced by large-scale interventions to reverse the trend, and bound to have had a major negative impact on economic activity, it was self-defeating, merely strengthening the fundamental case for a weaker rouble. Given the ongoing drop in the oil price; the likely damage to balance sheets from un-hedged currency exposures; and the further hit to confidence, boost to inflation, and other damaging consequences of recent events, the longer rates remain at current elevated levels, the more that the CBR's "risk scenario" will look conservative. And – particularly if the oil price keeps falling – that might well maintain downward pressure on the rouble.
- The CBR will continue to support corporate foreign debt redemption, with $30bn due in December and around $130bn due in the coming year, using $100-200bn from its foreign reserves ($400bn in total). As a result, at this stage, we do not anticipate major defaults over the near term. Indeed, despite the lower oil price, not least since imports will be very weak as domestic demand shrinks the trade and current account surpluses will be maintained (on the assumption of a $60bbl oil price, the CBR forecasts a trade surplus of $129bn and current account surplus of $39bn in 2015) providing some support to the balance of payments. Nevertheless, full ramifications for financial stability, the economic outlook and politics will remain uncertain for some time.

What's next?

- Given the dire fundamentals, we see a significant risk that the rouble will come under renewed pressure to depreciate. Due to the ineffectiveness of the rate hikes, the authorities might well resort to even more aggressive intervention, perhaps committing around $50bn of reserves to support the currency over coming weeks. By the same token, however, that would likely add to speculation that capital controls might eventually have to be used as a last resort. Yet the effectiveness of such controls would also be highly debatable – in practice, such measures would inevitably encourage capital flight by whatever means possible (legal or not). So – certainly at least for as long as the oil price continues to decline and sanctions persist in current form – we see no obvious end to the crisis. And a more proactive and clearly communicated strategy for tackling the crisis, in place of the failed reactive panic measures of recent weeks, would also seem necessary to stabilise market conditions. That might also imply personnel changes in senior relevant positions in the Russian authorities. All eyes should be on Putin’s annual press conference tomorrow.

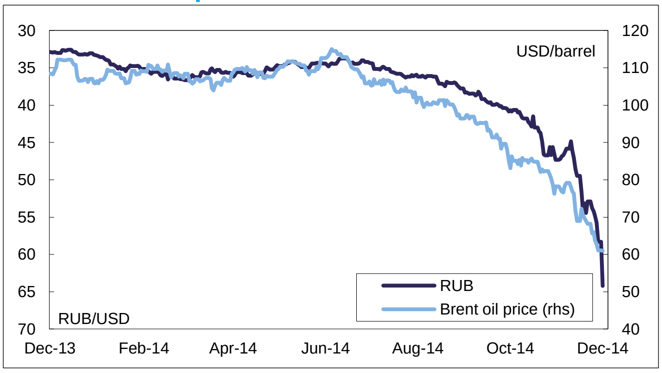
- While weighing on risk appetite, direct financial market contagion from the rouble crisis has so far been relatively limited, certainly compared to the last such crisis in 1998. Indeed, of all major emerging market currencies, only the Turkish lira and Brazilian real – whose fundamentals also give some cause for concern – have seen adjustments in excess of 4% against the dollar over the past five days, with other EM European currencies down only about 1-2% on a similar basis. Nevertheless, given the significant financial losses that will accrue to domestic entities as well as exposed foreign investors, the eventual costs of the rouble debacle might be expected eventually to prove significant. Indeed, we certainly would expect some problems associated with foreign debt redemption by Russian private sector entities (particularly those which are not politically well-connected). And the eventual imposition of capital controls might well provide a further shock to wider markets.
- The direct economic effects elsewhere, while unlikely to be huge, will also be felt. With Russian GDP likely to contract by 4% or more next year, the hit to demand for exports from, e.g. Germany where exports to Russia amount to more than 1% of GDP, are likely to be non-negligible. So, the rouble crisis is likely to represent yet another blow to already downbeat economic sentiment in the euro area.

Rouble crisis: 1998 and 2014



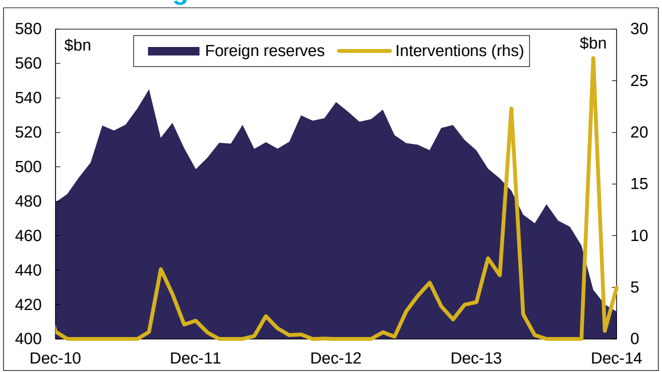
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Rouble and oil price



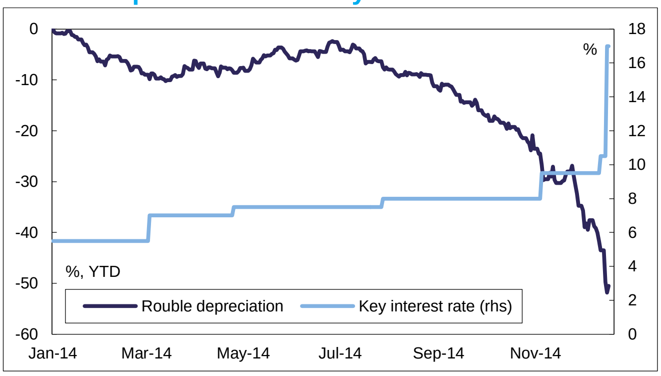
Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Russian foreign reserves and CBR interventions*



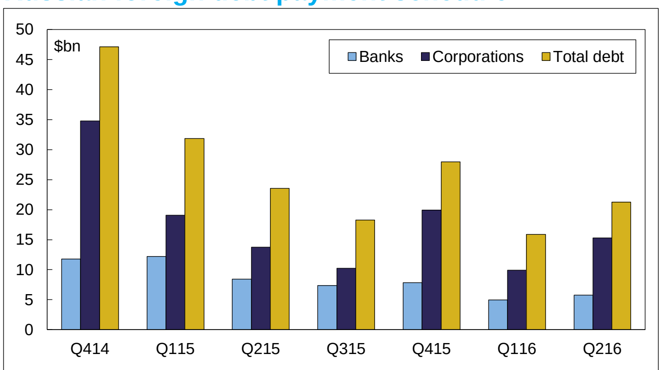
**Finance Ministry resources used for interventions are excluded. Source: Bloomberg and Daiwa Capital Markets Europe Ltd.*

Rouble depreciation and key interest rate



Source: Datastream and Daiwa Capital Markets Europe Ltd.

Russian foreign debt payment schedule



Source: Russian Central Bank and Daiwa Capital Markets Europe Ltd.

Exchange rates and recent changes

Currency	/US$	%W/W*	%YTD
Russian rouble	**71.85**	-28.4	-56.5
Turkish lira	**2.37**	-5.1	-15.1
Polish zloty	**3.36**	-0.1	-9.8
Hungarian forint	**249.2**	-0.8	-12.8
Mexican peso	**14.80**	-2.7	-12.7
South African rand	**11.66**	-2.2	-12.0

**Change from close previous Tuesday as at noon GMT. Source: Bloomberg*

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