Russia in troubled times

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Russia: Economic turmoil and policy options

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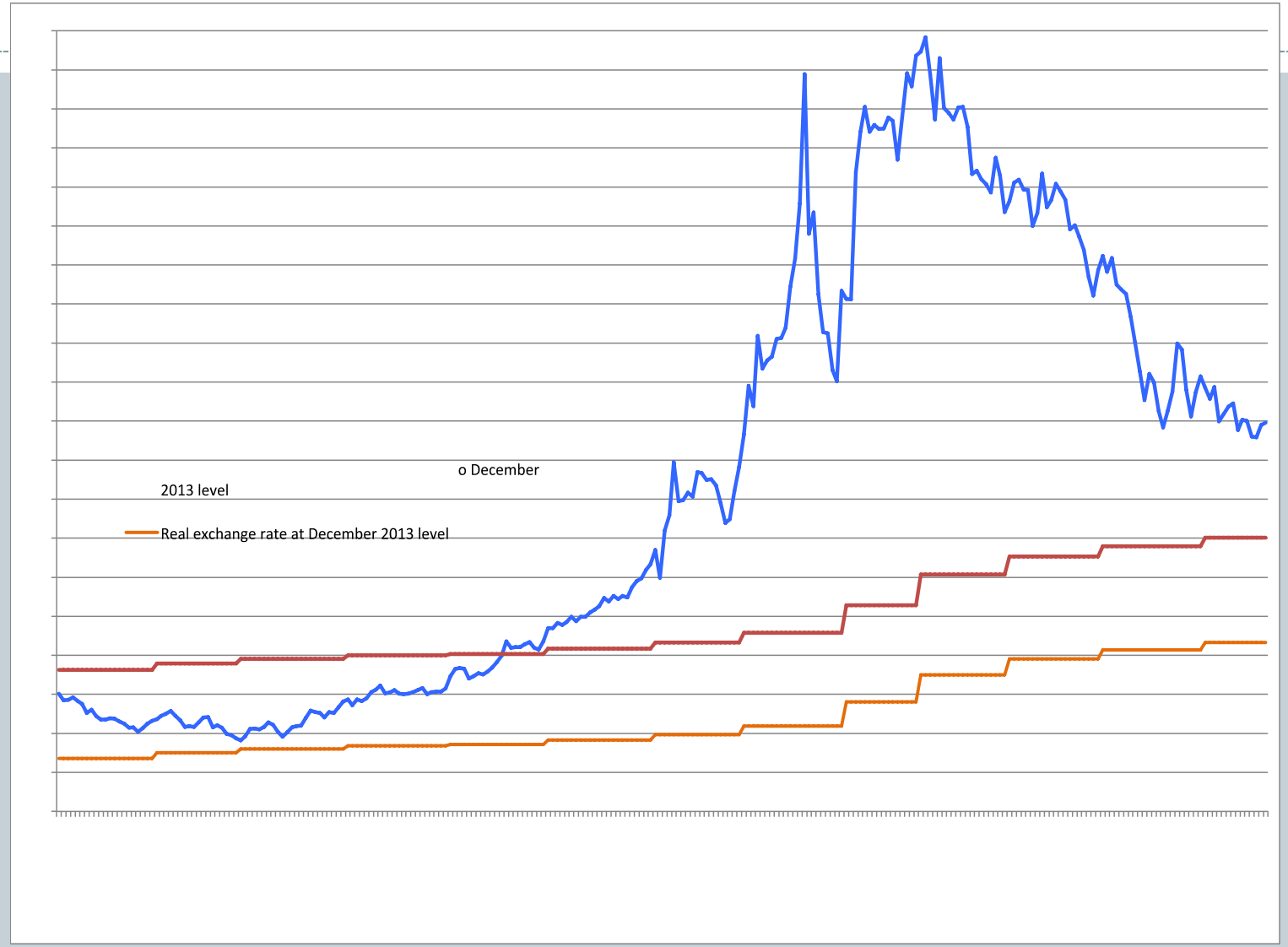
I. Surviving speculation

- Russia has been a strong speculation against the Ruble. This speculation could take place only because of the specific context created by Western sanctions following the Ukrainian crisis.
  - **1. So-called "political" sanctions targeting individuals known or supposed to be close to Vladimir Putin. They are more gesture than substance in such sanctions.**
  - **2. Industrial sanction, remembering what the old COCOM was against war and oil industries. These sanctions seem to have hurt much more the EU economy than the Russian one.**
  - **3. The extension of the SSI statute targeting war and oil industries but also part of the Russian banking system, and making them harder to find new funding, at least in USD. These sanctions were enhanced by what is claimed to be "*BNP-Parisbas*" jurisprudence.**

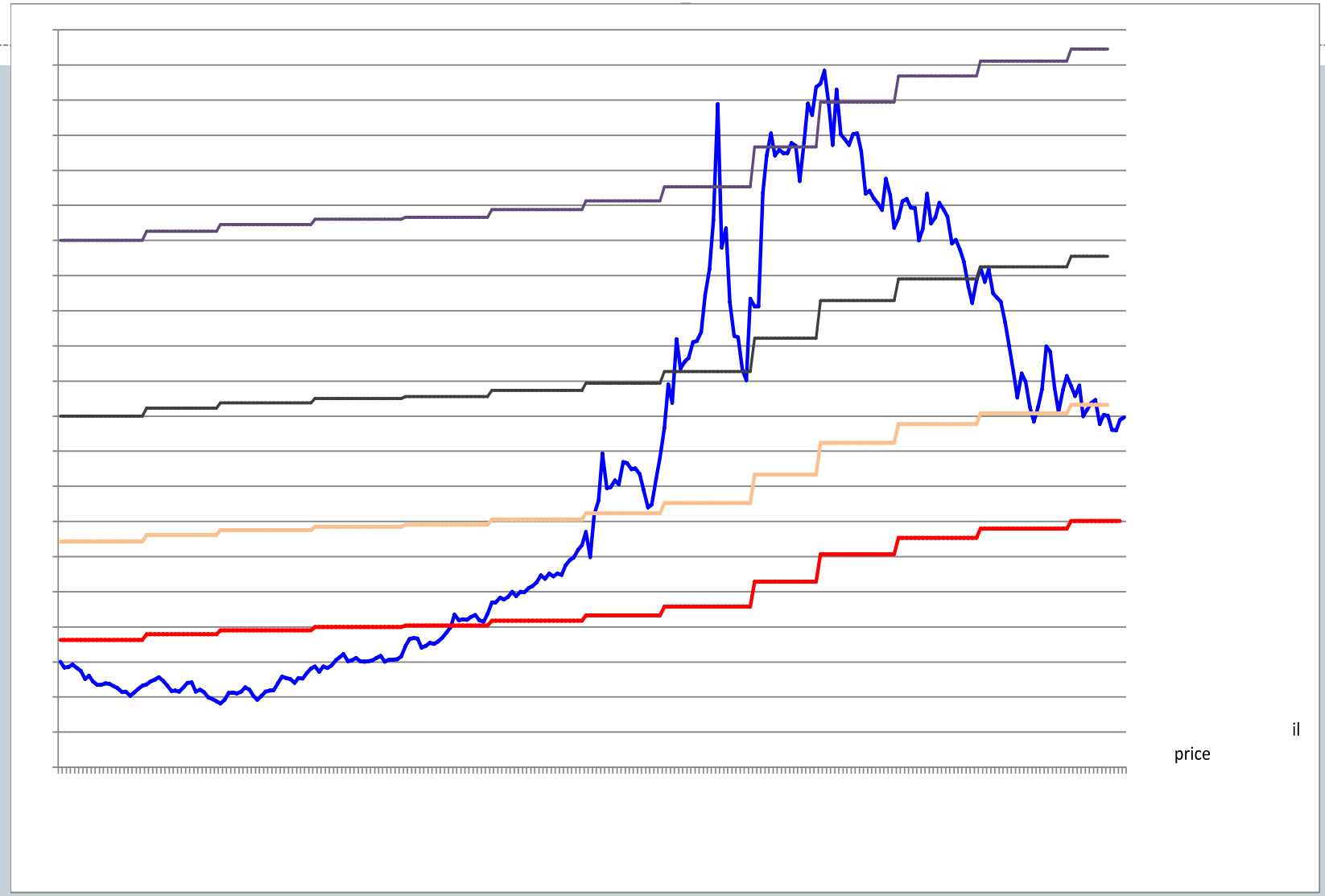
Redeeming (interest and principle) of Russian private debt by quarter, billion USD

	T3-2014	T4-2014	T1-2015	T2-2015	T3 2015	T4 2015	T1 2016	T2 2016
Interests	7,438	7,121	6,65	5,911	5,678	5,42	5,475	4,828
Principle	59,165	47,105	31,833	23,545	18,256	27,983	15,893	21,276
TOTAL	66,603	54,226	38,483	29,456	23,934	33,403	21,368	26,104

Exchange rate of the Ruble against the USD

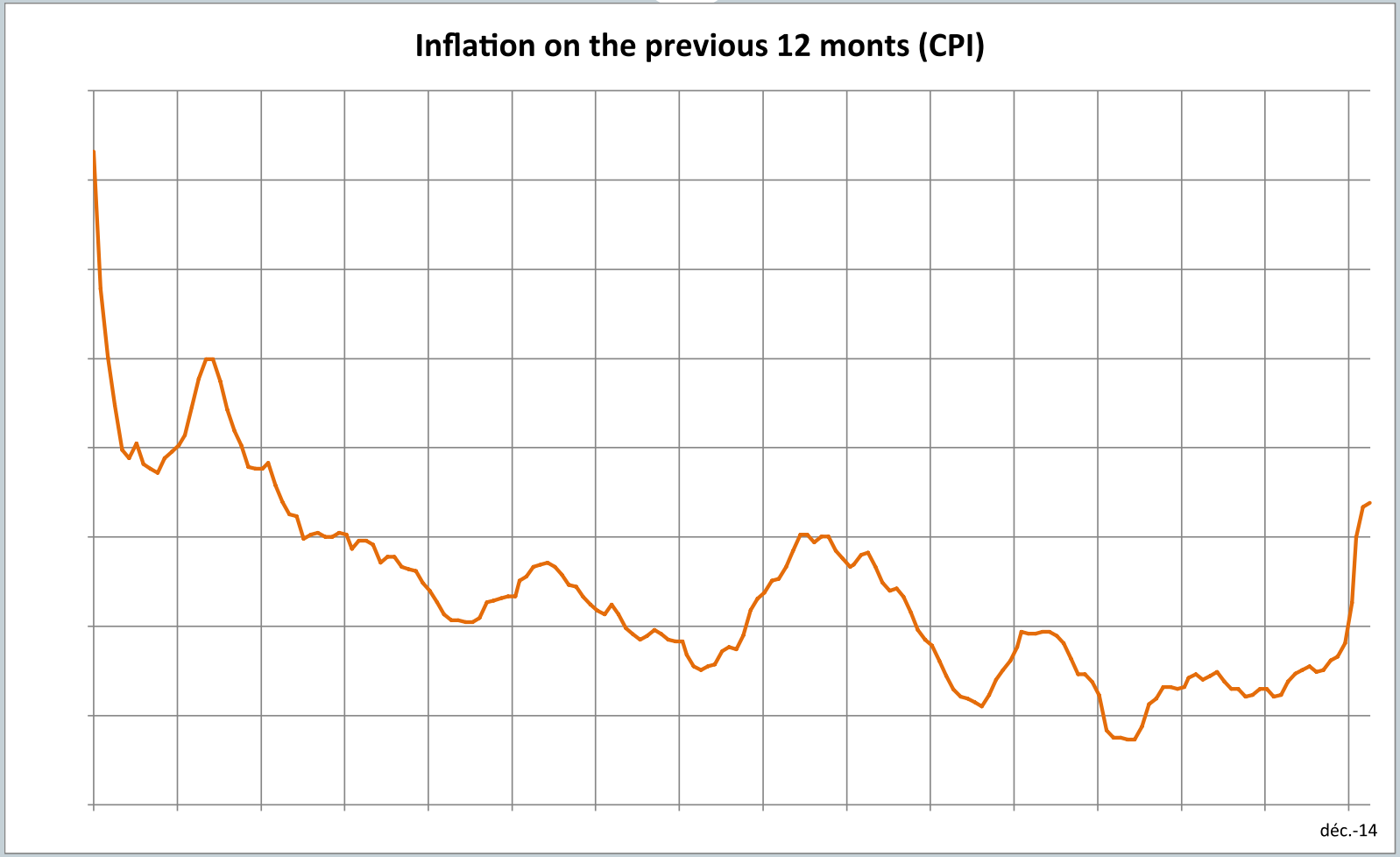


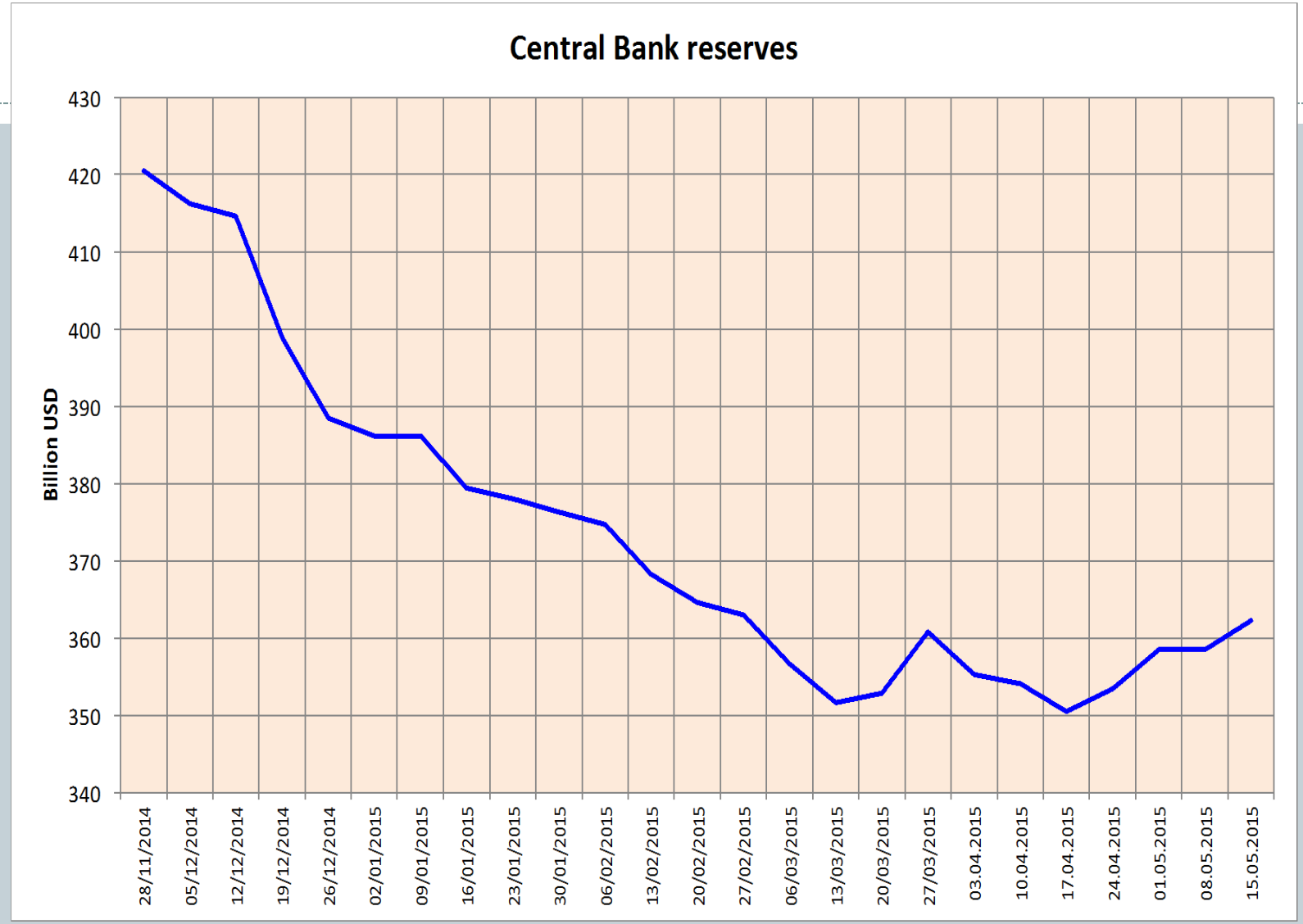
Exchange rate of the Ruble and oil prices



Observations

- 1. The Ruble vs. USD real exchange rate is to stay quite under its April 2014 level for a while.
- 2. The 50 RR/1 USD threshold chosen by the CBR is more or less compatible with a 65 USD/barrel oil price.
- 3. This is showing a strong policy preference for industrial production at the government and CBR level.

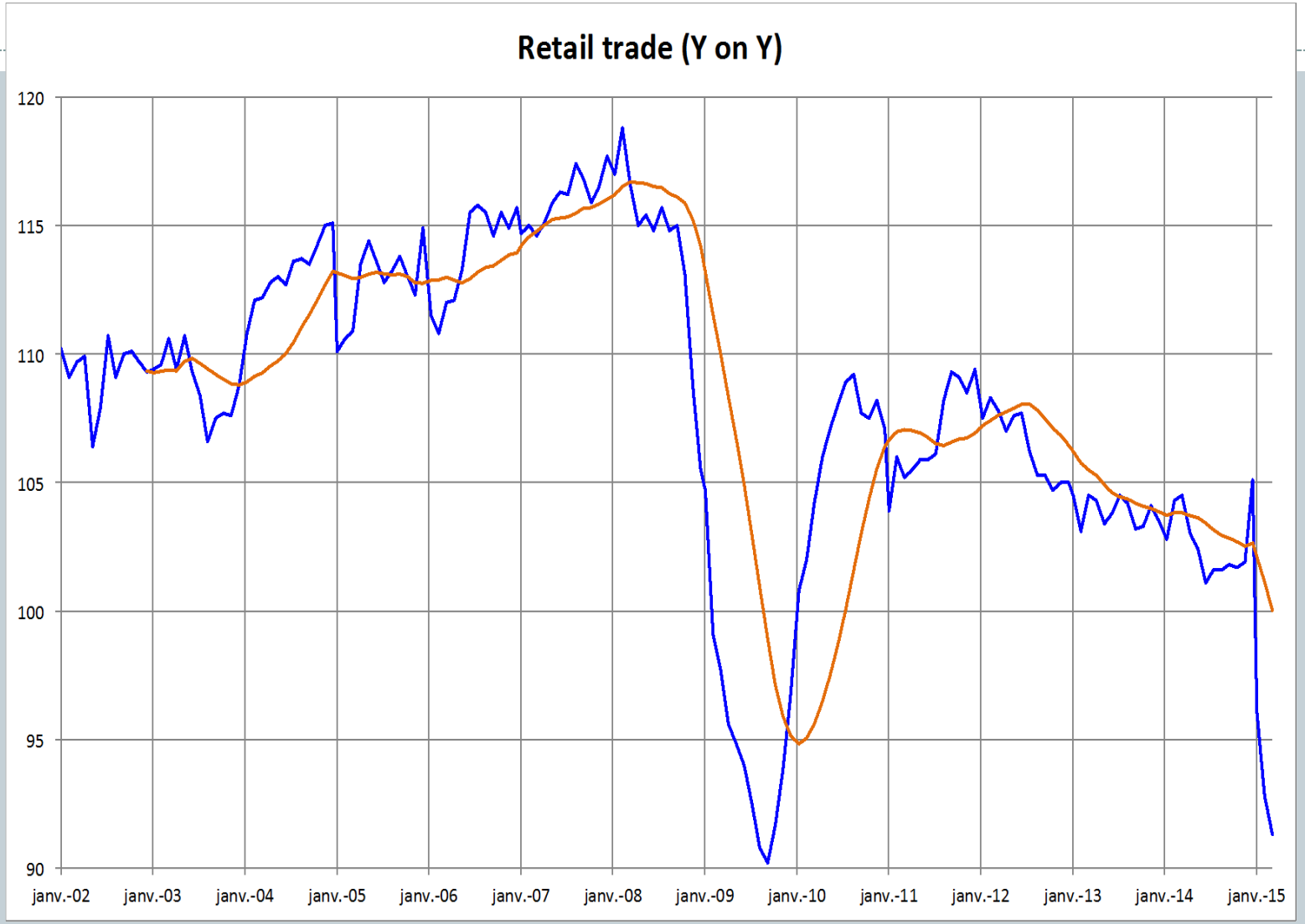

Inflation on the previous 12 monts (CPI)
déc.-14

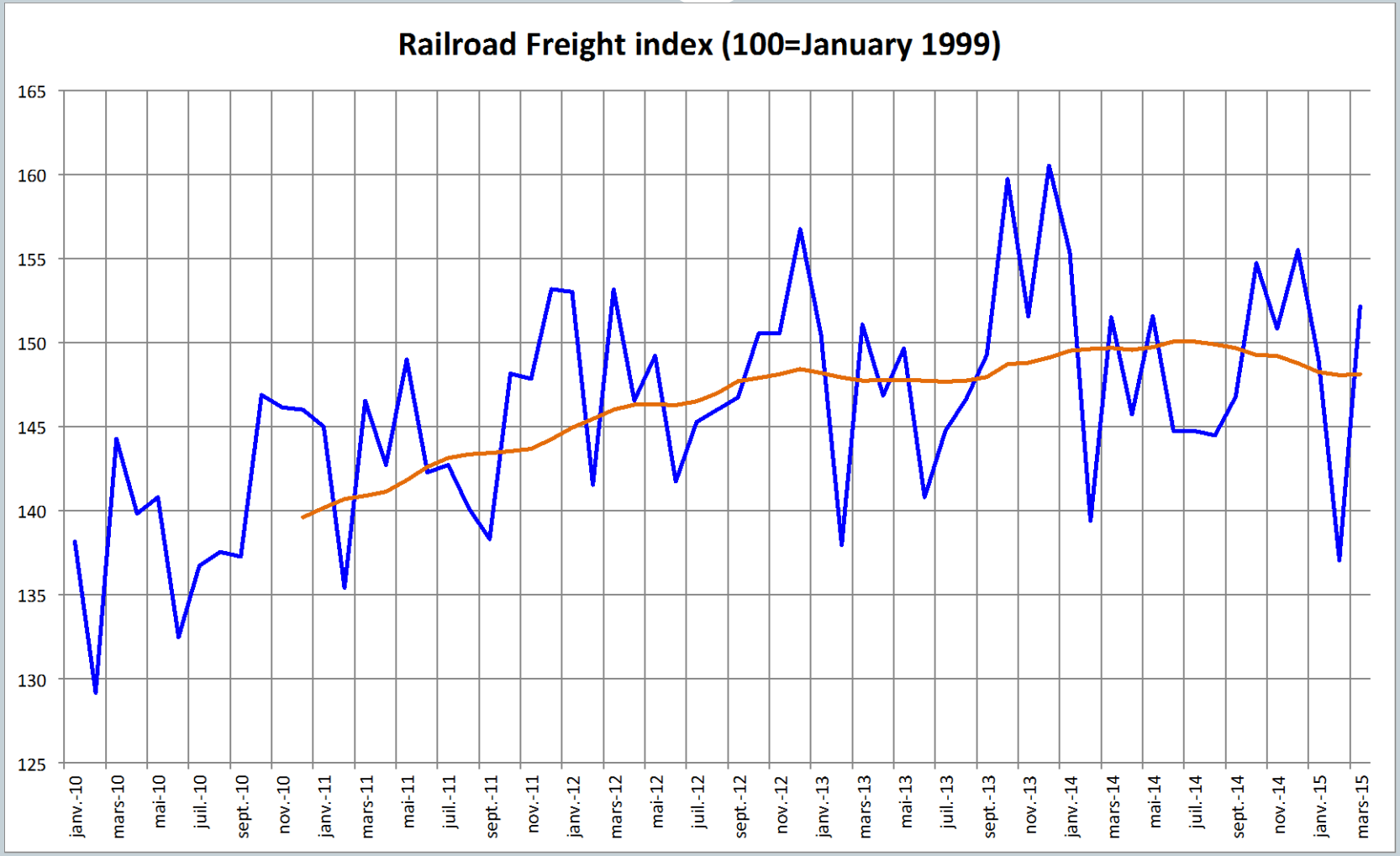

Central Bank reserves
Billion USD
430
420
410
400
390
380
370
360
350
340
28/11/2014
05/12/2014
12/12/2014
19/12/2014
26/12/2014
02/01/2015
09/01/2015
16/01/2015
23/01/2015
30/01/2015
06/02/2015
13/02/2015
20/02/2015
27/02/2015
06/03/2015
13/03/2015
20/03/2015
27/03/2015
03.04.2015
10.04.2015
17.04.2015
24.04.2015
01.05.2015
08.05.2015
15.05.2015

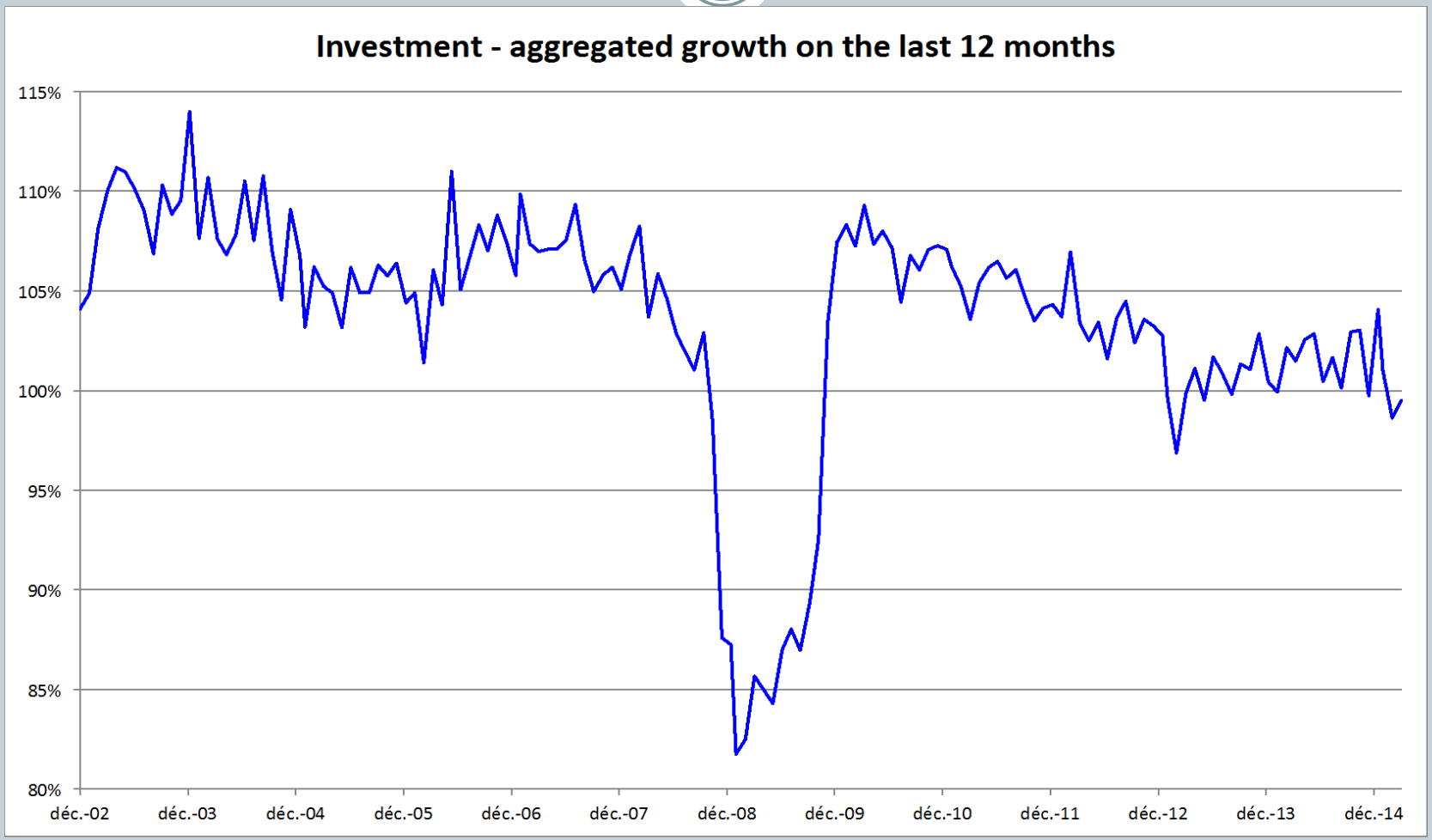
- 1. The sharp depreciation of December-January fuelled a strong bout of inflation.
- 2. However this is to be limited and inflation rate is to go down to 10%.
- 3. The 50/1 threshold is enabling CBR to replenish its reserves.
- 4. By doing so the CBR is to inject huge liquidity amounts in the economy: the (Russian) equivalent of a QE?

II. Prospects for the near future

The depreciation shock has hit to a considerable extant retail trade. However some indicators are telling us that the end result could be more positive than what it was assumed.


Retail trade (Y on Y)
120
115
110
105
100
95
90
janv.-02
janv.-03
janv.-04
janv.-05
janv.-06
janv.-07
janv.-08
janv.-09
janv.-10
janv.-11
janv.-12
janv.-13
janv.-14
janv.-15


Railroad Freight index (100=January 1999)
165
160
155
150
145
140
135
130
125
janv.-10
mars-10
mai-10
juil.-10
sept.-10
nov.-10
janv.-11
mars-11
mai-11
juil.-11
sept.-11
nov.-11
janv.-12
mars-12
mai-12
juil.-12
sept.-12
nov.-12
janv.-13
mars-13
mai-13
juil.-13
sept.-13
nov.-13
janv.-14
mars-14
mai-14
juil.-14
sept.-14
nov.-14
janv.-15
mars-15


Investment - aggregated growth on the last 12 months
115%
110%
105%
100%
95%
90%
85%
80%
déc.-02
déc.-03
déc.-04
déc.-05
déc.-06
déc.-07
déc.-08
déc.-09
déc.-10
déc.-11
déc.-12
déc.-13
déc.-14

Observations

- 1. The retail market index has dropped but less than during the 2008-2009 crisis.
- 2. The railroad freight index, a robust indicator of internal production (without hydrocarbons) is behaving relatively well.
- 3. Investment has far less reduced than during the 2008-2009 crisis.

Elements of hope for the near future

- Investment is production activities, but for very large companies, is largely funded be self-funding or by borrowing to other enterprises and not banks. This is mitigating the impact of a huge rates hike. By the way, small and medium sized enterprises are extremely sensible to the exchange rate, which translates very quickly into gains or losses.
- The number of households using consumption credits, if far larger than in the early 2000, is still quite low by comparison with Western standards. Consumption credits are used by 23% of households.
- The Central Bank if maintaining its intervention rates quite high is actually injecting since mid-April huge quantities of Ruble in the economy. If the weekly injection is around 4 billion USD, it will translate into 200 billion RR. This is, more or less the equivalent of a huge *quantitative easing* done certainly by other means, but still done. In such a situation we could expect a sharp drop in bank rates and will boost investment.
- The government has committed itself to an aggressive support of economic activity including tax break, tax and inspection shelter for small and medium enterprises, but also large budgetary support, be it at the federal level or at the regional one. Off course translation of economic orders into the actual life could be a quite protracted process.
- The unemployment rate is actually decreasing in April.

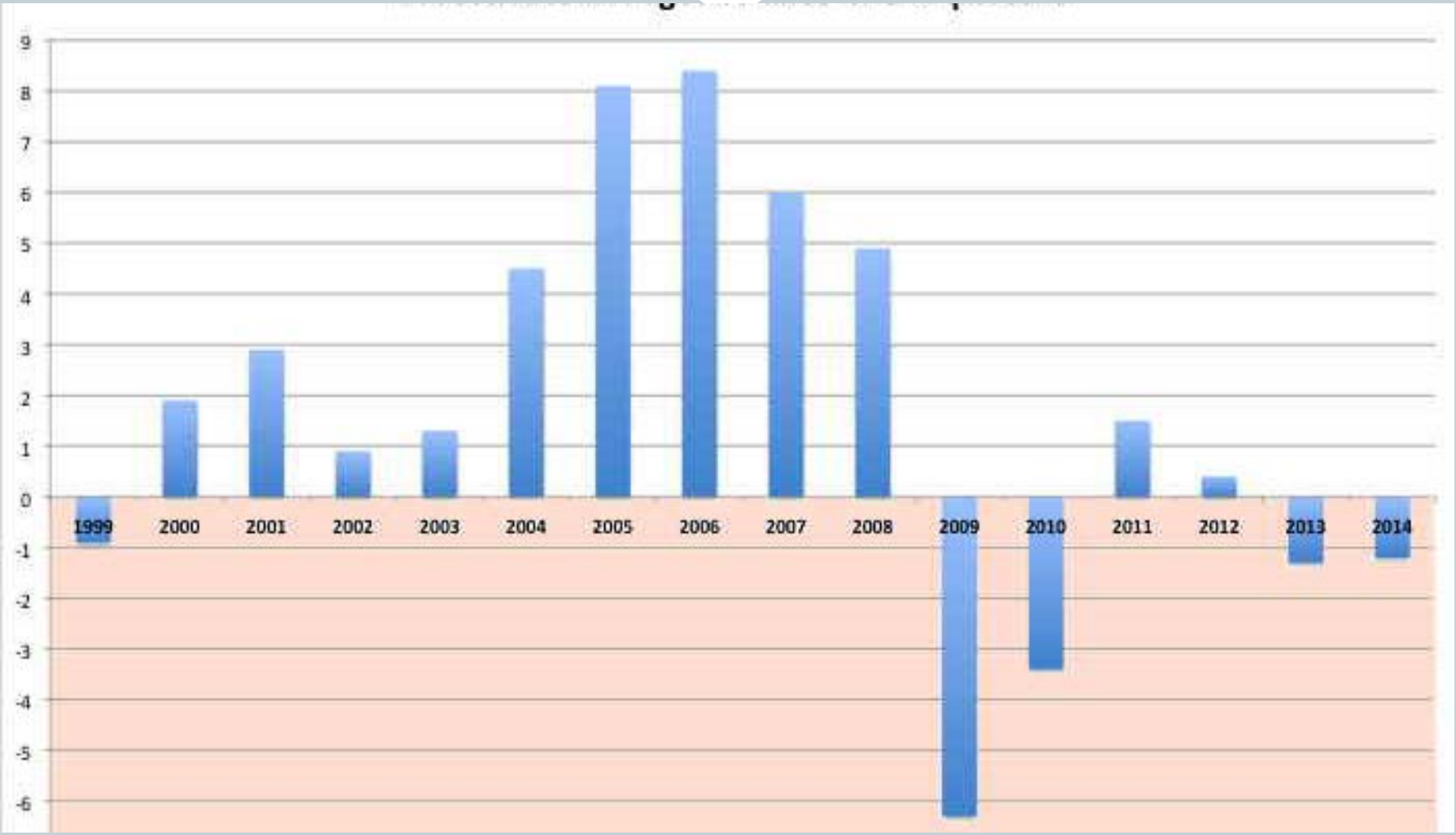
III. Lessons for the CBR monetary policy

- 1. In October 2008, the Central Bank of Russia (CBR) announced a change in its *explicit* policy. An important feature of this change was the switch to an inflation-targeting strategy
- 2. The most important thing was that the new CBR strategy made interest rates the main anti-inflation weapon for attempting to control monetary mass aggregates. This change was progressively introduced into actual practice and, by end December 2013, the switch to this “new” strategy was complete. But, the inflation-targeting strategy needed a free-floating exchange rate to use the interest rate as its main tool
- 3. This switch has been described as ill-advised and even utterly dangerous for Russia since 2010

A new monetary strategy?

- I. The first and most important priority seems to be a support to the manufacturing industry through an undervalued change rate. As explained before the 50 RR to 1 USD guarantee that such an undervaluation could stay for at least 18 months (and even longer would productivity gains in Russia be faster than ones in the US economy and in the Eurozone). Not only would such an exchange rate boost competitiveness of Russian-based producers on the internal and external markets, but through the increase in profitability (enhanced by tax breaks and tax shelters) would be of a great help for self-funding of investment.
- II. The second priority seems to be a fiscal one. The government seeks to reach an exchange rate corresponding, more or less, to an oil price of 66 USD a barrel (for BRENT prices). The Russian government can accept a level of deficit relatively important for 2015 as it knows that the debt burden will still diminish because of high inflation

Consolidated balance of the budget

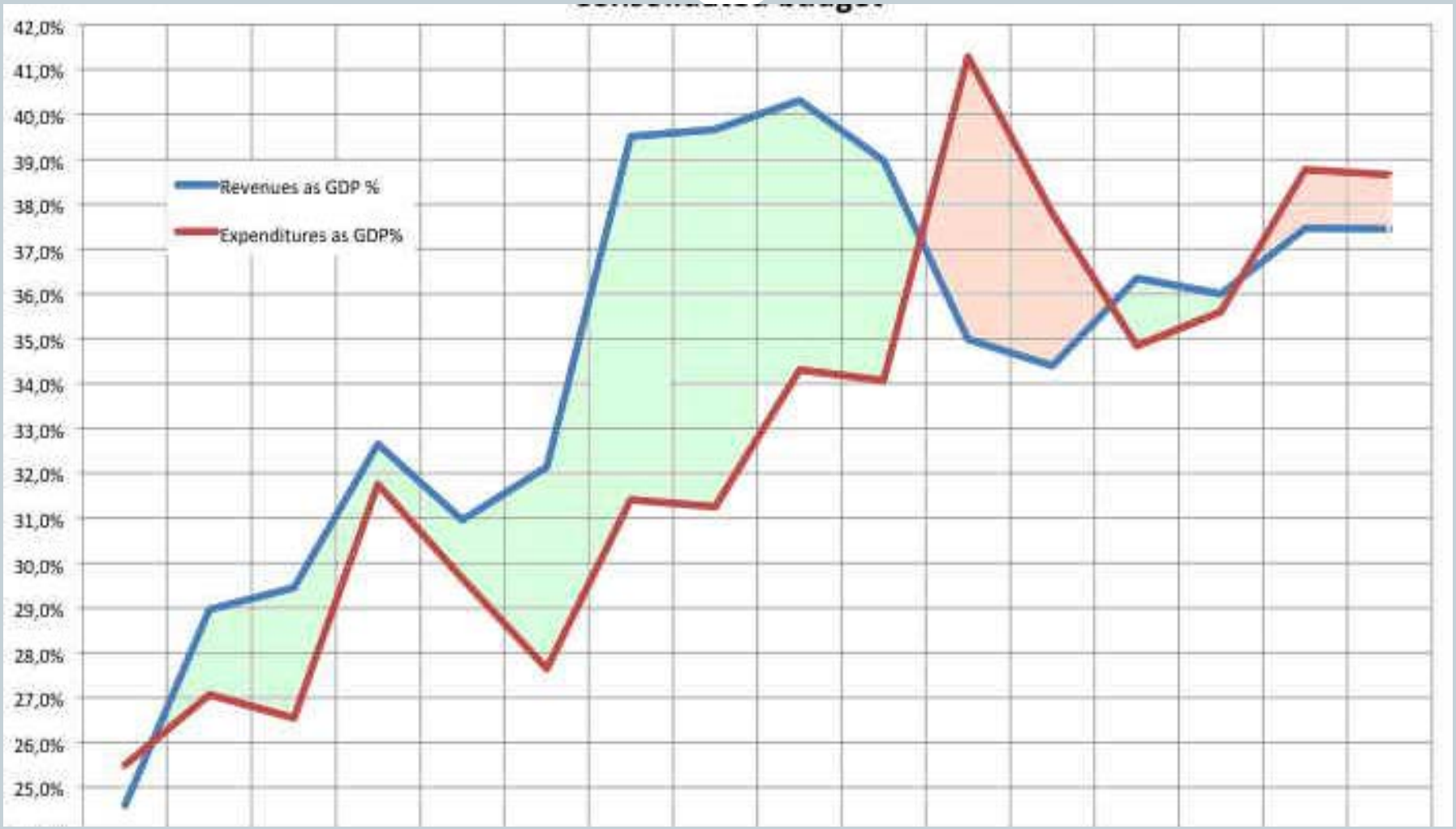


- III. A third priority seems to be the stability of the banking system (the classical “lender of last resorts” task) but also a steady alimentation of Russian economy in liquidity, amounting to a kind of Quantitative Easing implemented “Russian way”. The impact of such a policy on to the spread of interest rates and on lending rates provided by banks (and specifically large State-owned banks) is still to be seen but would be very positive from an investment point of view.

- IV. The fourth priority is the stabilization of the nominal exchange rate to rebuild confidence and enhance both economic and political stability.

- V. The fifth priority is a residual willingness to reduce the inflation rate to a tolerable level. To some extent that would explain why the critical exchange rate has been fixed around 50 RR to 1 USD and not to 55 RR or even 60 RR. This would also explain why interest rates are still pretty high. It seems that the government and monetary authorities have targeted non-conventional tools to fight inflation and mostly is some appreciation on the change rate and the fast development of import-substitution industries.

Revenues and expenditures of the consolidated budget



Observation

- 1. The turn from *inflation targeting* to a strategy supporting the economy could hardly have been more complete. The use of budget deficit as a more permanent tool for macroeconomic policy is also to be highlighted.
- 2. This could amount to a « victory » for people called « interventionists » over those labelled as « liberals »

IV. What are permanent changes in the Russian economy?

- 1. The prevalent development “model” of Russia has been the result of compromises, which have been evolving since 2000. These have allowed for the strong growth of the years 2000 to 2008. Their major traits have been preserved, including during the 2008-2010 crisis.
- 2. The present situation characterized both by a strong decrease in oil prices and by a showdown between the Western countries and Russia, renders these compromises largely inoperative

Huge gains in labour productivity

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Natural resources industries	**100**	109,2	117,2	124,6	128,7	132,7	133,8	147,0	153,4	157,5	157,5	152,6
Manufacturing industries	**100**	108,8	119,5	126,6	137,4	148,9	152,8	157,7	165,9	175,2	180,6	190,6
Construction	**100**	105,3	112,5	119,1	137,9	155,6	169,7	160,4	159,8	168,1	168,4	165,5

- **1.** The Russian government has deployed much effort in order to re-orient the international trade of Russia towards Asia and to develop a free-trade zone with some of the countries of the former Soviet Union
- **2.** The Eurozone crisis it has brought about an important change in the strategy of the government. From this point of view, one can talk of a pragmatic readjustment of the economic policy of Russia
- **3.** This raises the problem of a possible « de-globalization » of the Russian economy and, through this very fact, a re-examination of the balances perceptible in the development strategies

- **4.** The Russian reaction to sanctions was then to enlarge and widen its cooperation with China, but also with emerging countries. This cooperation embraces not only economic and financial aspects but military and strategic ones too
- **5**. But results of these move are to go well farther a simple success of Russia and will be extensive.

Conclusion

- I. These changes coupled to the remarkable resilience displayed by the Russian economy has given birth to a new discourse in the West, one about Putin's "victory".
- II. The non-intentional consequences of sanctions are that we are very probably witnessing the end of the second globalization, an end brought forward much more by tactical motives than by a large vision of the future