ANALYSIS

What is Happening to the Ruble?

By Philip Hanson, London

Abstract
The ruble has fallen dramatically against other currencies. The reasons for this drop and the major consequences are assessed. Near-term prospects are briefly considered. There are multiple causes and multiple consequences of the ruble's depreciation but the causal chain *oil price—exchange rate—inflation* stands out. The ruble will stabilise.

On 18 February, 2015, the business newspaper *Vedomosti* gave the following current quotations for the ruble: 62.40 rubles to the US dollar and 71.08 rubles to the euro. The average rates in February 2014 were 35.22 and 48.06, respectively.[1] The Russian currency, in other words, had almost halved in value against the world's leading reserve currency, the US dollar, and fallen by almost as much against the euro, in the course of a year.

Why? What are the consequences? What are the prospects for the near term? Those are the questions that I shall try to shed some light on in this article.

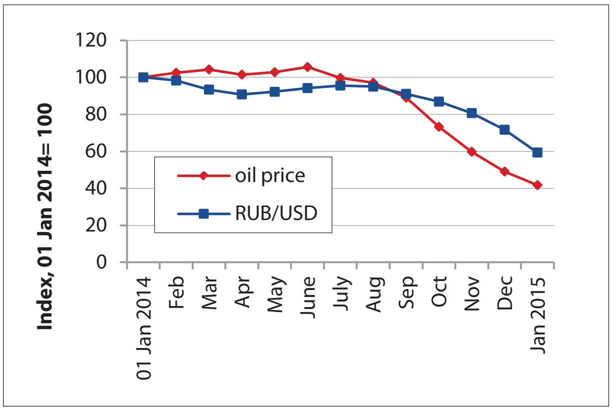
The Oil Price and the Ruble

One simple explanation that is commonly offered is that the oil price drives the Russian ruble. This is indeed an important part of the story. But the total supply and demand for rubles depend on a range of factors. In 2014 the most important have been the following:

- The oil price
- Western sanctions, blocking Russian banks' and companies' access to external credit and forcing them to purchase more euros and dollars to redeem existing debt
- The greater-than-usual net outflow of capital, over and above debt redemption, reflecting heightened perceptions of both economic and political risk in Russia
- The policies of the Central Bank of Russia (CBR), both in providing ruble liquidity and (until the introduction of a nearly-free currency float on November 10, 2014) predictably selling foreign currency from the reserves to prop up the ruble.[2]

The link with the oil price has been strong. The fact that there has been such a strong relationship, especially since summer 2014, however, raises further questions. Figure 1 shows monthly data for the Brent oil price (to which the Urals oil price is closely linked) and the ruble/dollar rate during 2014.

Figure 1: Brent Oil Price in Dollars Per Barrel and the Ruble/Dollar Exchange Rate During 2014 (Indices, 1 January 2014 = 100)



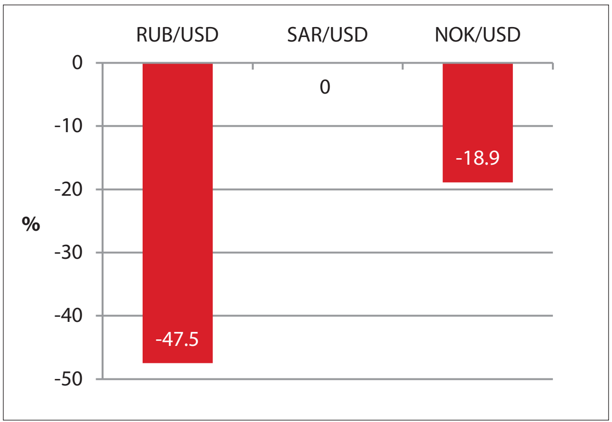
Sources: Derived from Central Bank of Russia (exchange rate) and <www.investing.com> *(oil price).*

In the course of last year, evidently, the ruble/dollar rate, looked at on a monthly basis, has not been tightly tied to the oil price. A plausible conjecture about the first half of the year is that, initially, heightened perceptions of economic risk, and then of political risk arising from Russia's Ukraine adventure and the West's response, somewhat depressed the ruble, but when the oil price began to fall in the summer, so did the currency, and much faster than before. A sharply falling oil price has certainly meant, in recent years, a sharply falling ruble, and so it has proved in 2014 and into 2015.

It does not follow, however, that Russia's being a major oil exporter accounts for the ruble's volatility, let alone for the country's current economic weakness in general. This explanation did not stand up in the 2008–09 crisis and it does not stand up now. In 2008–09 oil prices fell dramatically, and so did Russian GDP: by 7.8%; but other major oil exporters suffered either a much smaller decline in GDP or none at all. The effect on the ruble this time seems again to be unusually large. Figure 2 illustrates.

1 <http://www.cbr.ru/statistics/print.aspx?file=credit_statistics/ex_rate_ind_14.htm&pid=svs&sid=analit>
2 See <http://echo.msk.ru/blog/nikolaev_i/1435010-echo/> where Igor Nikolaev offers a fairly similar list (posted November 11, 2014).

Figure 2: Russia, Norway and Saudi Arabia: % Change in Exchange Rates Against the US Dollar, Year to 11 February, 2015.



Source: The Economist, 14 February 2015, p. 88.

The fall in the Norwegian krone is substantial, but still of a smaller order of magnitude than that of the ruble, while the Saudi riyal simply held its peg to the dollar (at 3.75 Saudi riyals = 1 US dollar).

The reasons for this apparently exaggerated Russian sensitivity to the oil price are not properly understood. Yes, oil and gas have been making up about two-thirds of Russian merchandise exports, and revenues from them have been accounting for about a half of federal (not total) budget revenue. But similar figures apply to other major oil-and-gas exporting nations. The reasons must lie elsewhere.

Causes

One account that may provide a clue is that of Gaddy and Ickes: of an economic system in which the authorities are 'addicted' to a wasteful use of hydrocarbon rents, including the channelling of funds to prop up inefficient, Soviet-legacy enterprises.[3] The implication of this account would be that a great deal of Russian economic activity, beyond the oil and gas industries and those firms supplying goods and services to them, is vulnerable to a fall in hydrocarbon revenues. In other words, the economy is in part a house of cards, rather insecurely stuck together with oil, and the edifice tumbles when the oil price falls.

The ruble's fall has been one aspect of the general weakening of the Russian economy. That weakening has occurred in the face of what is now routinely but accurately described as a perfect storm. Long-term structural features of the Russian economy like the declining workforce and the growth-constraining character of the Putinist social order (weak rule of law, weak competition) have combined with conjunctural factors, such as the slowdown in global growth, the rise in global oil supply and the approaching end of quantitative easing in the US, plus the steep rise in political risk associated with the war in Ukraine, to push Russia into recession.

These influences interact in ways that make things worse. In the second half of 2014 there was a net decline in numbers of immigrants if Ukrainian asylum seekers are excluded.[4] This has been provoked in part by the decline in the dollar value of earnings. Net immigration, mostly from Central Asia, had been partially offsetting the demographic decline in the working-age population. That offsetting influence is now failing.

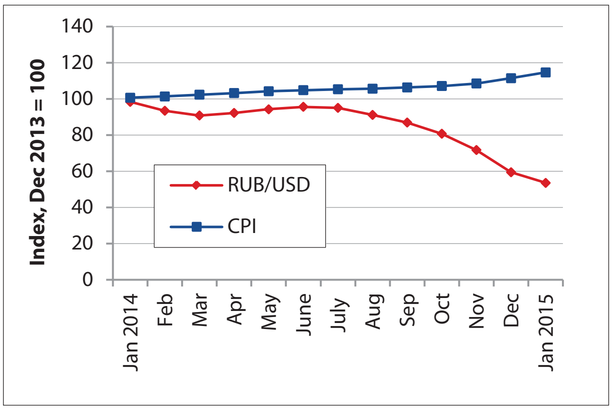
Consequences

The most conspicuous effect of the ruble's depreciation has been its impact on inflation and therefore on the real incomes of the population. I will leave aside in this section the implications for imports and exports, and pick it up in the final section. Less obviously, but still significantly, ruble depreciation has affected federal-budget revenues, the banks' capital adequacy, net migration flows and the well-being of the super-rich.

Alfa-Bank analysts have estimated that in 2014 a 10% fall in the ruble exchange rate (say, from 60 rubles = 1 US dollar to 66 rubles = 1 US dollar) would raise the consumer price index (CPI) by 1.0 to 1.5% (at an annual rate).[5] The effect is lagged, but the lag may be of the order of only a month.

Figure 3 illustrates the recent relationship between the CPI and the ruble.

Figure 3: Russia: the Ruble–Dollar Exchange Rate and the Consumer Price Index, 2014–2015 (Month-End Figures, December 2013 = 100)



Source: CBR.

3 Clifford G. Gaddy and Barry W. Ickes, 'Russia after the Global Financial Crisis,' *Eurasian Geography and Economics*, 51 (2010), no. 3, pp. 281–311, and *Bear Traps on Russia's Road to Modernization*, London: Routledge, 2013.

4 Mikko Hietikko, 'Q414: Slowdown continuing—banking sector under pressure,' East Office of Finnish Industry, *Quarterly Review of the Russian Economy*, February 12, 2015, at p. 8.

5 AlfaBank, 'Macro Insights,' December 5, 2014.

The CPI is less volatile than the exchange rate, but the acceleration of inflation roughly coincides with that of ruble depreciation. However, there is another major influence on inflation that came into play in summer 2014: the Russian government ban on most food imports from countries imposing sanctions on Russia. Some 44% of Russia's total imports of these items in 2012 was affected.[6] What proportion they constitute of Russian household consumption is a question that has yielded a wide range of answers. Aleksei Kudrin has asserted that 50% of Russian food consumption consists of imports (from all sources),[7] but that may be too high. At all events the food embargo has added to inflation and is expected to continue to do so. One estimate of the impact on the CPI this year is an addition of 1.5% to the annual figure;[8] that annual figure has more recently been put at 12%.[9]

The effect of the ruble's slide on the soaring rate of inflation (15.6%, at an annual rate, in early February 2015[10]) is strong, in other words, but it is not the only influence.

The other main consequences of the ruble's fall (excluding trade for the moment) can be swiftly, if sketchily, summarised.

The federal budget benefits from ruble depreciation because dollar-denominated oil and gas revenues form about half of its revenue, and amount to more in rubles as the ruble depreciates. However, the fall in the oil price works in the opposite direction. The net result in 2014 was a very modest deficit equal to 0.5% of GDP.[11]

Russian bank assets, denominated in rubles, have risen as the ruble has depreciated, but have risen faster than bank capital, reducing their capital adequacy. The CBR has relaxed its regulation temporarily to accommodate this development. The banking sector is now in a rather fragile condition, attracting state support.[12]

The main point about migration has already been made. Migrant workers are more vulnerable to sacking than Russian employees, but the departure of so many is probably due primarily to the reduced dollar value of their ruble pay.

The top of Russian society has also, after its own fashion, suffered. *Forbes* estimates that between February 12 and December 16, twenty Russian billionaires lost 73 billion US dollars[13]. A large part of this fall was the decline in the dollar value of ruble-denominated assets.

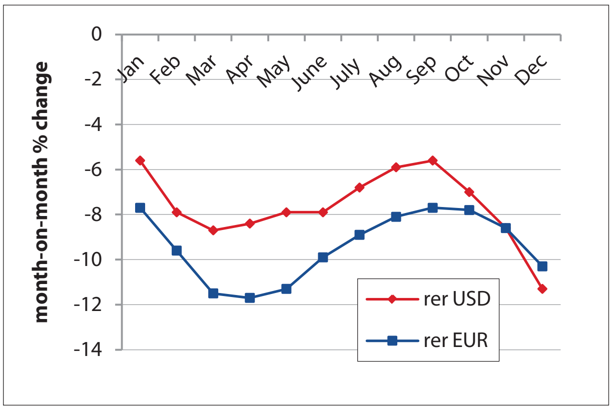
Prospects

Extreme economic uncertainty makes any attempt to forecast Russian developments hazardous. This certainly applies to the exchange rate of the ruble. At present, however, it looks quite likely that the oil price will stop falling in the course of 2015 as higher-cost production is taken out of operation, and the sanctions imposed on Russia may not be intensified, even if present restrictions remain in place. That would appreciably lessen the downward pressure on the Russian currency.

Where might the ruble settle, if it settles at all, in the medium term? It has been argued that at 32 rubles to the dollar at the end of 2013 the currency was overvalued.[14] However IMF estimates for GDP at purchasing power parity (PPP) in 2013 suggest, on the contrary, that the currency was undervalued. The PPP rate was 19.1 rubles to the US dollar.[15] The verdict of an overvalued currency may be based on Moscow prices for consumer goods and housing; prices across the whole range of GDP[16] and the whole country are more to the point.

Figure 4 shows the real (inflation-adjusted) exchange rates for the ruble against both dollar and euro during 2014.

Figure 4: Real Effective Exchange Rates of the Ruble Against the US Dollar and the Euro During 2014 (Monthly % Change from the Previous Month)



Source: <www.cbr.ru>

6 <https://theconversation.com/hard-evidence-who-will-reap-rewards-from-russia-farm-sanctions-32338> By Jim Rollo. Posted October 8, 2014.

7 Aleksei Kudrin, 'Pravila igry,' *Kommersant*, October 9, 2014 (<http://www.kommersant.ru/doc/2585078/>)

8 Ol'ga Kuvshinova, 'Rossiiskuyu ekonomiku zhdet dvukhlyetnyaya retsessiya,' *Vedomosti,* October 6, 2014, citing Natal'ya Orlova of Alfa-Bank.

9 East Office of Finnish Industries, op. cit.

10 US-Russia Business Council, *Daily Update*, February 11, 2015.

11 *BOFIT Weekly*, January 30, 2015.

12 East Office of Finnish Industries, *op. cit.* See also Alfa-Bank, *Macro Insights, 'Banking Sector in Focus,'* February 2, 2015.

13 <http://www.forbes.ru/rating-photogallery/276109-minus-73-mlrd-kak-bedneyut-bogateishie-lyudi-rossii/photo/1>

14 Maksim Mironov, 'Nam vsem global'no pereplachivali,' *Vedomosti*, November 6, 2014.

15 IMF World Economic Outlook database, October 2014.

16 More precisely, the whole range of tradeable goods and services in GDP.

The chart shows that when rates of inflation in Russia, the US and the eurozone are allowed for, there was still a great deal of volatility, but the real exchange rate was moving relentlessly away from the PPP rate estimated by the IMF. There are many reasons why market-driven exchange rates deviate, even substantially and in the long term, from the PPP rate, and it looks as though the ruble, even when it does 'settle down', will remain substantially undervalued in relation to its domestic purchasing power.

Will the devaluation of the ruble stimulate exports and curb imports? It would be odd if it did not do so in some degree, but two considerations suggest that the effect will be limited. The first is that Russian industrial production, whether for export or as a substitute for imports (e.g., of cars) has a high import content. The second is that domestic production lacks flexibility and the stimulus of competition.[17]

Imports, as Gurvich and others have argued, are likely to be curbed by a combination of higher ruble prices and state-imposed restrictions on the indexation of public-sector incomes and social benefits. Russian households will bear more of the cost of this crisis than they did in 2008–09.

The ruble will not go on falling indefinitely. It will stabilise, probably during this year. That will be good news for Russian citizens. What will happen to the main constraint on Russia's development, the Putinist social order, is less predictable.

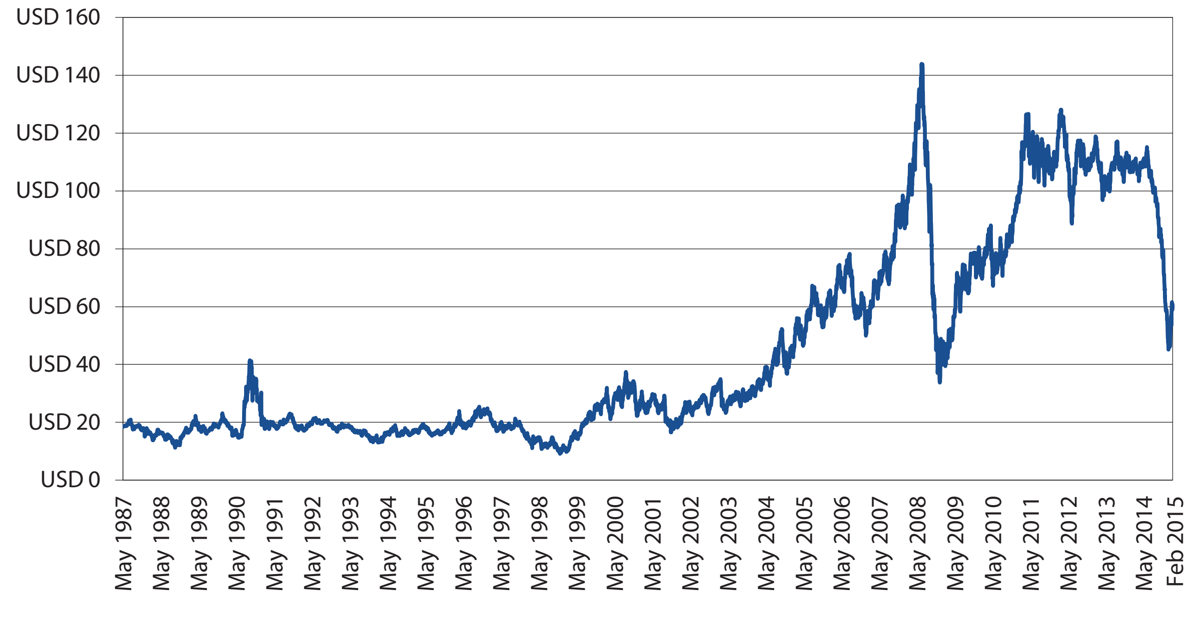
About the Author

Philip Hanson is an associate fellow of the Russia and Eurasia programme at Chatham House.

STATISTICS

Oil Price and Ruble Exchange Rate

Figure 1: Europe Brent Spot Price FOB (Dollars per Barrel), May 1987–February 2015



Source:: <http://www.eia.gov/dnav/pet/hist_xls/RBRTEd.xls>*; web site:* <http://www.eia.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=RBRTE&f=D>*, accessed 28 February 2015*

17 Yevsei Gurvich cited in Ol'ga Kuvshinova, Filipp Sterkin and Aleksei Nikol'skii, 'Minfin podgotovit voenno-sotsial'niy manevr,' *Vedomosti*, February 11, 2015.