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Russian Central Bank Faces Uphill Battle to Halt Ruble Slide

By The Moscow Times

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While there is little sign that the fall is causing public panic, the Central Bank's goal of reducing inflation to 4.5 percent next year — from around 8 percent at present — means it cannot ignore the ruble's slump, which is pushing up import prices.

And if the currency's decline gains momentum as some predict, it could yet cause wider financial instability such as runs on bank deposits.

"There's a real danger that this becomes a self-fulfilling currency crisis if we're not careful," said Neil Shearing, chief emerging market economist at Capital Economics in London.

With the Russian economy teetering on the verge of recession, the Central Bank will be reluctant to raise interest rates.

However, the bank's deputy chairman said Wednesday that the bank would have to "seriously" think about rate increases if the current situation continues — something the IMF has urged Russia to do to anchor inflation expectations.

"At the moment they are not winning the battle. They need to do it the old fashioned way, that is increase rates by 150-200 basis points," said Michel Danechi, portfolio manager at EI Sturdza Strategic Emerging Europe Fund.

Any decision to raise rates would not be taken lightly.

The bank has already increased its benchmark rate three times this year, by a cumulative 250 basis points to 8 percent, and there are doubts about how effective even higher interest rates would be in encouraging investors to hold rubles. Skeptics said foreign inflows have largely been deterred by Western sanctions, while many Russian outflows are linked to debts that must be repaid in any case.

Russian companies have around $140 billion in foreign debt repayments by the end of 2015, a major factor behind the ruble's weakness.

Early Float?

Other analysts urge the bank to bring forward floating the ruble, planned for the end of this year, to provide more flexible options to manage the exchange rate.

So far the Central Bank has been sticking to its existing framework, under which it keeps the ruble inside a floating band against a dollar-euro basket, intervening when it reaches the edge of a nine-ruble-wide corridor.

The result has been to slow the ruble's fall — at the cost so far this month of around $15 billion in forex reserves — while doing nothing to stop the underlying selling pressure.

It may actually be making matters worse, as the predictable nature of the bank's moves is encouraging one-way bets against the ruble.

"The Central Bank is defending the exchange rate while giving everyone the opportunity to get into the trade [against the ruble]. This is creating additional speculative pressure," said Alexei Pogorelov, Russia economist at Credit Suisse.

A more effective policy, critics say, would be to scrap the corridor but make periodic interventions. That way, the bank could punish speculators by springing occasional surprises.

But not everyone agrees that floating the ruble ahead of schedule would make matters better — especially as the immediate consequence could be a further large fall.

"What the Central Bank is trying to avoid is a very abrupt adjustment in the ruble," said Shearing. "History would suggest that [a floating currency] plunges much further than it otherwise would have done — it overshoots, in other words."

Double Whammy

Ultimately, neither higher interest rates nor a more flexible intervention policy can address the underlying problems that are battering both the ruble and the Russian economy.

The root problem is a hole in the balance of payments, caused by the double whammy of falling oil prices and a freeze on foreign investment linked to Western sanctions.

Estimates of the size of this hole vary, depending on forecasts for oil prices, the ruble, the easing of sanctions and Russian companies' ability to boost sales.

Pogorelov at Credit Suisse predicts a $30 billion gap between Russia's forex earnings and outflows in 2015. Shearing from Capital Economics sees a $130-140 billion shortfall over the next 12 months.

Whatever the true figure, many analysts expect the Central Bank will have to keep dipping heavily into its $440 billion in reserves even after the ruble is allowed to float.

A recent scheme to provide up to $50 billion to banks through repo loans is seen as a step in the right direction. Yet it has done little to calm markets.

One problem is that the instruments on offer, with maturities of seven or 28 days, do not address the need for long-term financing.

The Central Bank has said that it is considering much longer-term measures requested by banks, including repo loans of up to three years.

But while its forex reserves are ample enough, the bank appears reluctant to use them to bail out banks, which would raise questions about how safely they are being invested.

"The risk is that the [borrowing] bank won't be able to redeem — this is potential pressure on the Central Bank reserves," said Natalia Orlova, chief economist at Alfa Bank.

"If the reserves are used by banks then the market will consider that this money is no longer available for [ruble] support, which could potentially translate into more pressure on the currency," she said.