The Moscow Times
30 YEARS
INDEPENDENT NEWS FROM RUSSIA

Russia Will Weather This Financial Hurricane

By James Beadle

January 29, 2015

Finance is such a dry, intangible business that investors, economists and other practitioners are more obsessed than most other professionals with the use of metaphors. Among the many metaphors, tidal movements are a popular way to describe the waxing and waning of asset prices and economic activity. Indeed, in his 2001 annual letter to investors, Warren Buffet immortalized the tidal metaphor with his comment that when the tide goes out we can see who is swimming naked.

Buffet was referring to the companies and assets that were riding the easy gains of an upward market without doing the hard work of building solid economic bases to underscore their value. Well, the proverbial tide turned spectacularly on Russia in 2014, and many around the world have been gleefully expecting a subsequent collapse, having spent years criticizing the country's failure to conduct reforms and build a strong, diversified economic base.

It is true that the country could have been far better equipped for the challenges it is experiencing. Strong institutions could have been erected, independent of the power vertical, allowing an environment of confidence and trust to blossom; such reform would have unleashed Russia's abundant creative zeal and entrepreneurial energy.

Resources could have been carefully and honestly directed toward economically appealing projects and infrastructure improvement could have rolled out faster, accompanied by business friendly policies.

Senior Russian politicians have been quick to state that crisis is an opportunity and they will use the current crisis to bring forth long-promised but systemically trapped reforms. In other words, the crisis will lead to a U-turn on many failed practices and policies of the past.

This is welcome, of course, but it would be self-deception to describe such change as seizing the opportunity. Russia needs to use the crisis to fix such problems, but doing so will only get it back to ground zero, from where the hard slog of long-term development begins.

While Russia is far from able to turn this crisis into an opportunity to soar to new highs, it is not doomed as many have suggested either. True, the ruble has fallen by about 50 percent. But any honest Russophobe would have to admit that with oil at $45 per barrel, Russia is coping relatively well to have a ruble-dollar rate of 69 and Central Bank reserves still close to $400 billion.

The crisis has been a horrible and painful experience for many, but if it has a silver lining, then it should be to shine the light on the true state of the country, which is neither catastrophic nor utopian. True, the country's credit rating is declining with some ratings agencies even putting it back into speculative territory, but the bigger picture is that Russia entered this crisis with massive defenses and has deployed them carefully. And already now, in late-January, there are grounds to look toward a better future.

Oil has fallen further and faster than many thought possible, even beating pessimistic forecasts made after the Organization of the Petroleum Exporting Countries unleashed its campaign to protect market share back in October. But prices are now well below global production costs, so they can be expected to improve over the course of 2015. It is broadly recognized that the first quarter of 2015 will be the worst period of supply-demand imbalance, so by March, when futures contracts for oil delivery in April expire, oil prices may well have bottomed.

If this happens, then the ruble will also be finding new stability, and punitive Central Bank rates will be declining once more. Under this base-case scenario, Russia's impressive reserves will have seen it weather the financial equivalent of a hurricane.

Of course, it would be extreme folly to put all your eggs in one basket, so astute investors, while looking for a positive shift on the Russian market this year, will also be hedging their risks and preparing for the possibility of a less benign outcome. A near-term bottoming of oil prices is likely, but cannot be guaranteed.

Equally, a sharp price rebound is unlikely in any scenario, as it would simply unleash further expansion of North American oil production, leading to a repeated supply-demand imbalance. While oil is unlikely to plunge afresh, it remains pressured. So a more challenging scenario for 2015 involves oil falling moderately further and not rebounding.

In such a case, Russia will face a more rigorous test, but it ought to cope adequately, utilizing a balance of reduced government spending and careful reserves management.

Under the base-case scenario, Russia can ride out the crisis with ease. If things prove somewhat worse, then Russia may have to batten down some more hatches, though it still has sufficient resources to survive.

Of course, a truly prudent investor would be ready for worse than a hurricane — a freak 100-year storm, if you like. There is an imaginable scenario where oil prices don't just splutter around current levels, but instead plunge further. In 1998, for example, barrels of oil were trading for less than $20 at one stage.

Even in those days, that was an absurdly low price. If such a scenario were to occur, with oil collapsing from here and showing signs of staying at such low levels, then Russia would find itself facing serious challenges. We should ask ourselves then, is this plausible? If yes, what would be the cause?

Thus far, financial markets have been bristling at lower energy prices. The nervousness comes from the scale and velocity of price declines, rather than from their pernicious effects.

For most of the world, lower oil prices are a blessing, and almost everyone agrees that the global economy will benefit from OPEC's aggressive maneuvers. In fact, stimulating global demand was the overarching motivation when OPEC let prices fall in the first place.

But if lower prices are good, why are markets stressed and what might lead to a further collapse? The only clear possible driver is the collapse of a large global economy. Which economies are most at threat? Those dependent on oil exports. Among those, which is the largest and most significant systemic risk? Russia.

But we've deduced above that Russia isn't swimming naked, even if its swimsuit is a little skimpy. The worst case scenario looks unlikely then. Russia should expect to come safely through this difficult storm in the coming months.

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