POLITICAL AND ECONOMIC RESULTS OF DECEMBER 2014

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In December 2014, Russia's authorities faced a severe foreign exchange crisis, which forced them to increase the CBR key interest rate to 17% and to order a number of major state-owned companies, including Gazprom and Rosneft, that their foreign exchange reserves should be brought back to the levels of 1 October 2014 – in other words, that a considerable part of thesereserves should be sold. However, Russia's financial position has remained strained due to the continuing drop in oil prices, the forthcoming heavy foreign debt repayments to be made by Russian companies, and the generally tense international situation. In his annual Presidential Address to the Federal Assembly, Vladimir Putin promised a full amnesty for Russian individuals who would return capital to Russia (although no decision has been taken as yet on the most important issue of whether or not the amnesty should be extended to legal entities). He also proposed that 'holidays from inspections' should be established for small businesses ('if a company has acquired a good reputation and if there have not been any serious charges against it for three years, then for the next three years it should be exempted from routine inspections…'). In addition, he expressed his full confidence in the innocence of Vladimir Yevtushenkov (who would be immediately released from house arrest in the aftermath of this statement). All these developments sent reassuring signals to businesses, although their effect was somewhat weakened by the inexplicable administrative ban on grain exports, imposed by the RF authorities later in December in spite of the fact that Russia's grain harvest in 2014 had been huge, and there was no shortage of grain on her domestic market.

The main political and economic event of December 2014 was the flare-up of Russia's foreign exchange crisis, whose severity exceeded everything since the 1998 crisis, including the 2008 financial troubles. The graveness of the crisis was vividly reflected by the behavior of the exchange rate of the ruble[1]. The ruble, which used to be exchanged at below 40 per dollar as late as September, had slipped to above 50 per dollar by early December, thus breaching an important psychological threshold, and then continued to steadily decline. On 15 December 2014 (dubbed the ruble's Black Monday), the ruble's exchange rate against the dollar shot up by 6 rubles. On 18 December it climbed to its historic high of 64 rubles per dollar, and then began to rapidly decline. On 19 December the ruble's exchange rate against the dollar dwindled to 59 rubles per dollar, and continued on a downward trend until the end of the month. On 23 December it returned to 54 rubles per dollar. Over the course of December, the buy-sell spreads sharply increased, to several rubles, even at the MICEX, while at the retail FX market they periodically climbed to over 5 rubles. This hit the panic button on FX. In a number of Russian regions, some banks completely ran out of foreign exchange. Banks curbed crediting, including to each other and to the population. *Trust Bank*, one of Russia's thirty biggest banks, went bankrupt. Import cars sales ground to a halt. All those developments were typical of the cycle of events that mark the beginning of any major foreign exchange crisis.

At a first glance, in contrast with 2008, the ruble demonstrated a very strong, almost linear, dependence on oil prices. It is noteworthy that in 2008, the price of oil dropped *threefold* over the course of *six months*, causing the ruble's devaluation by a mere 30%, while in 2014 the price of Urals crude oil dwindled *twofold* over the course of the *whole year* (from $ 110 to $ 55 per barrel), but mostly in the autumn, when it dropped from $ 99 to $ 55 per barrel. At the same time, the ruble, which exchanged at 33 per dollar as of the beginning of 2014, slipped to 37 per dollar as of early September 2014 and to over 50 as of early December 2014. The currencies of the other main oil-exporting countries declined much less radically – by 15 to 20%.

However, financial experts believe that the ongoing escalation of the foreign exchange crisis could also be caused by the following factors: the Bank of Russia's actions (opinions and conclusions were many and varied, but some of them were mutually exclusive); the aggravation of the credit problems faced by big Russian companies, resulting from their loss of access to the cheap credit markets of the USA, Japan and the EC; and a very bizarre central bank-backed deal obtained by the state-owned company *Rosneft* on 11 December, on the eve of the 'Black Monday' (*Rosneft* issued 625 billion rubles in new bonds and sold them to Russian banks, which then deposited those bonds with the Central Bank). Among the other noteworthy factors

1 Traditionally understood in Russia as the rubble's exchange rate against the US dollar.

exacerbating the foreign exchange crisis were a general atmosphere of pessimism and the fact that economic agents' trust in government had been severely sapped by the notorious '*Bashneft* case' and the numerous amendments to Russia's tax legislation rushed through parliament in the autumn of 2014 without even attempting to seek formal approval from the RF Government.

It a is well known fact that the senior managers of the Bank of Russia oppose the adoption of the radical measures recommended by a number of left-wing economists, including the introduction of mandatory sale of foreign exchange earnings and the reintroduction of export controls or the re-imposition of restrictions on the cross-border movement of capital. Russia's experience of the 1990s has indicated that when such measures are applied in a country with the state apparatus of poor quality, their effectiveness will be low – they will hamper legal economic activities, but will by no means hinder the performance of any illicit industry, because crime bosses usually have a knack for getting any permissions and licenses they want. As, for obvious reasons, the effectiveness of these measures in China is much higher than in Russia, any attempt to 'transplant' a specifically Chinese set of experiences into the Russian environment will be doomed to failure, in spite of what the aforementioned leftist economists say to the contrary. On the other hand, we cannot but totally agree with Mr. Putin's statement at his December news conference that the Central Bank should have moved '*at least half a pace faster*' to apply such traditional measures of economic regulation as raising the key interest rate[1]. Over the course of the past two decades, this classical measure was applied by many countries hit by financial crisis, including Iceland, Hungary, Latvia, Mexico, the United Kingdom, etc. Even China, which did not experience the spread of a foreign exchange crisis to its financial sector, sharply increased the key interest rate during the global economic crisis of 2008–2009. As a consequence of the RF Central Bank's procrastination, its cheap liquidity was routinely offered for sale at the high-reward foreign exchange market.

The situation on Russia's foreign exchange market was further aggravated by the forthcoming heavy foreign debt repayments to be made by Russian companies hamstrung by mounting difficulties with refinancing their foreign debts. According to the Bank of Russia's estimates, their net foreign debt (including interest) amounts to over $ 867bn. In Q3-Q4 2014 alone, Russian companies and state structures were scheduled to repay over $ 120bn, with a redemption peak looming in December ($ 33bn). In 2015 they will have to repay over $ 100bn. At the same time, over the course of the second half of 2014, large Russian managed to attract only a handful of foreign credits: *Gazprom* (not included on the list of the European Union' sanctions) attracted two credits from European banks, and the corporations *Otkritie* and *Evraz* attracted a number of credits via their subsidiaries in the USA. Apparently, contrary to all expectations, no credits were attracted from China. Moreover, it has turned out that the much-vaunted framework agreement to build a gas pipeline to China does not stipulate an advance payment.

On 11 December 2014, *Rosneft* held the largest in Russian history ruble bonds placement for Rb 625 bn. The bonds were sold at yields below those on equivalent Russian government securities (OFZ), and the bid-offer acceptance time was limited to one hour. The deal immediately sparked deep worries in the financial market. According to the senior managers of VTB, neither the Russian Wealth Fund nor Vneshekonombank participated in this transaction. Suspicions emerged that *Rosneft* would be financed, in effect, with an emission of rubles from the RF Central Bank. These rumors were amplified by the fact that on 15 December (later to be called 'Black Monday') the Bank of Russia was to hold an unprecedented 700 billion-ruble Lombard credit auction. After receiving no bids, this Lombard auction was cancelled. Most likely, the 625 billion rubles raised by *Rosneft* will be spent on repaying its huge external debt (which exceeds the sovereign debt of the Russian Federation). It should be added that *Rosneft* has $ 20bn of debt repayable in the next few months (and only $ 15bn in its bank accounts), its net profit in Q3 2014 dropped to Rb 1bn (vs. Rb 280bn in Q3 2013). However, the senior managers of *Rosneft* have announced that the money raised in the recent bond issue will be internally invested, and will not be spent on buying foreign currency. We believe that the soundness of this decision is open to doubt because foreign exchange might help *Rosneft* cope with hard times, bearing in mind the collapse of oil prices and the company's dwindling production and plummeting profit.

The aforesaid key interest rate hike carried out by the Bank of Russia was not the only step taken by the Russian authorities in December 2014 with the purpose of mitigating the severe foreign exchange crisis engulfing the Russian economy. Thus, on 17 December, the RF Government issued a directive ordering Russia's five biggest state-owned exporters (*Gazprom*, *Rosneft*, *ALROSA*, *Zarubezhneft* and *Kristall Production*

1 In 2014, the Bank of Russia repeatedly raised its key interest rate: from 5.5% to 8% in the middle of the summer; to 9.5% on 31 October; to 10.5% on 11 December; and to 17% on 16 December.

Corporation, the largest polished diamonds manufacturer in Russia) and their subsidiaries to bring their net foreign exchange assets back to the levels of 1 October 2014. The deadline specified by the directive was set for 1 March 2015. According to expert estimates, in order to implement the Government's directive, the aforesaid companies will have to sell at least $ 40bn. No limits on the foreign exchange assets held by private companies and state-owned banks have been imposed so far. In a separate development, a draft law authorizing a 1-trillion ruble recapitalization of banks was rushed through Russia's lower house of parliament. On 19 December, legislators in the State Duma approved the draft law in all three readings. Thus history repeated itself once again – a similar law had already been passed by Russia's parliament in 2008. Once the law is approved by the upper house and the RF President, it will allow the Finance Ministry to issue up to 1 trillion of rubles of OFZ treasury bonds, which it will transfer to the Deposit Insurance Agency. The Agency would then give the bonds to 'key' banks. To make the long story short, instead of the money they need, the 'key' banks will get treasury bonds (which can then be used as collateral against the Bank of Russia's loans). It is supposed that the money raised by the pledge will then be loaned to the real sector of the economy. At the same time, the mechanism for regulating the whole process remains unclear, and it is still doubtful whether or not the banking sector's liquidity could be curbed effectively by using such a method. In December, in a traditional year-end procedure, the RF Ministry of Finance withdrew about Rb 1 trillion of treasury deposits from the banking system. This massive deposit withdrawal was only partly compensated for by the RF CB's 150 billion ruble liquidity auction. In a move designed to help banks attract deposits, the RF State Duma passed legislation increasing compensation for bank depositors from Rb 700,000 to Rb 1.4m.

In December, President Vladimir Putin delivered his annual Presidential Address to the RF Federal Assembly. Putting aside all the myths and propaganda, the Address is noteworthy in two respects: that it promises nothing new in the field of Russia's internal policy, and that it contains a number of reasonable ideas regarding her economy. However, it remains to be seen whether they will be effective in practice.

In his annual Presidential Address, Vladimir Putin proposed a full amnesty for Russian individuals returning capital to Russia. '*[…] If a person legalizes his holdings and property in Russia, he will receive full legal guarantees that he will not be summoned to various agencies, including law enforcement agencies, that they will not 'put the squeeze' on him, that he will not be asked about the sources of his capital and methods of its acquisition, that he will not be prosecuted or face administrative liability, and that he will not be questioned by the tax service or law enforcement agencies'*. The proposed amnesty will be a second such amnesty launched during Putin's two presidencies. The first amnesty (in 2007–2008) yielded very modest results – contrary to expectations, the funds repatriated to Russia due to that amnesty amounted to just a few billion rubles instead of many billions of dollars. The new amnesty had been discussed widely both in and outside of government in connection with the forthcoming adoption, by Russia, of a rigid 'anti-offshore' law. In the course of that discussion, many experts suggested that the amnesty should also be extended, on some or other conditions, to legal entities. However, no final decision has been taken as yet as to whether or not the amnesty should be extended thereto. As far as the proposed amnesty for Russian individuals returning capital to Russia is concerned, we have some straightforward reasons to believe that its results will be relatively meager.

Also Mr. Putin proposed 'to freeze the existing tax parameters as they are for the next four years'. Russia's business community had already tried to raise this issue with RF Prime Minister Dmitry Medvedev at his autumn-2014 meeting with Russian business leaders. At that time, their advice had fallen on deaf ears. Instead, the authorities had increased a number of taxes. However, if they keep their word not to increase the rates of such taxes as PIT, VAT, profits tax and social payments, and not to introduce new taxes, it will be a very positive development indeed.

President Putin promised that '*a special register will be launched next year, with information on what agency has initiated an inspection, for what purpose, and what results it has produced'*. The President also proposed establishing '*holidays from inspections'* for small businesses: '*if a company has acquired a good reputation and if there have not been any serious charges against it for three years, then for the next three years it should be exempted from routine inspections'*. So far so good, but there remains the question of what charges should be deemed to be 'serious' and what businesses should be recognized as 'small' ones – at present, according to existing legislation, in order to be placed in the 'small business' category an enterprise should have an annual income of below Rb 400m (excluding VAT) and comply with a number of additional criteria (the share of its charter capital held by the state may not exceed 25%, the number of workers may not exceed 100 persons, etc.). Let us hope that these criteria will not be tightened too severely.

Also, the Address contains the following rather mystifying statement: '*As we have agreed, two-year tax* *holidays will be provided to small businesses registering for the first time'*. Apparently, this passage in Putin's speech refers to the RF Government-initiated draft law which was introduced into the State Duma in late October 2014.

As far as macroeconomic tasks for Russia are concerned, the Address contains a call for the rate of inflation to be brought down to 4% in the medium term. It should be said that bearing in mind the current economic situation in Russia, this task could be accomplished in the distant future rather than in the medium term.

At his press conference held in late December, President Putin further elaborated on these matters, keeping his cards, as usual, close to his vest. As a sop to the business community, he announced that the Investigative Committee had failed to provide substantial evidence of any wrongdoing on the part of JSFC *Sistema*'s owner Vladimir Yevtushenkov, and that the charges against him had been dropped. Mr. Putin then explained that the blame for *Bashneft*'s problems should not be pinned on Yevtushenkov, while the crux of the matter was the wrongful transfer of *Bashneft* '*from Russian Federation ownership to regional ownership',* which had been carried out more than twenty years earlier. The President then invited Mr. Yevtushenkov, freshly released from house arrest, to a meeting with other businessmen before the end of the month. 'I want to meet with our leading businessmen ahead of the new year. I do this regularly. Mr. Yevtushenkov is also invited to this meeting', Mr. Putin said. (The meeting took place behind closed doors, and no details leaked out). Thus, from a purely pragmatic point of view, Vladimir Yevtushenkov cannot be deemed an outright loser: having bought *Bashneft* and then the license for development of the Trebs and Titov oil fields for about Rb 90bn, he received a dividend of approximately Rb 190bn. However, it should be taken into consideration that he bought *Bashneft* with borrowed money, amidst the 2008 crisis, thus exposing himself to profound commercial risk. So, in some respects, his dividend should be considered as a well-earned medal rather than a vulgar money grab. Despite its relatively happy end, the '*Bashneft* case' has left an unpleasant aftertaste, and the business community will long remember that a major asset can be recognized as wrongly registered twenty years earlier, and its current owner be arrested and charged with 'stealing' it. This unsavory affair will certainly impede investment in Russian energy resources, making them an exclusive investment zone for biggest Russian corporations and their transnational counterparts, where most of the Russian businesses will find themselves at the very bottom of the pecking order.

Having harvested a record-high 100 million tons of grain in the autumn 2014, Russia faced a scandalous situation on her wheat export market. On 20 December, Vladimir Yakunin, Head of *Russian Railways Co*, stopped railway grain loadings for export. Yakunin's decision was backed by the RF Ministry on the lame pretext that the partial stoppage of grain exports was necessary for curbing domestic grain prices in Russia (despite the superabundance of grain, including that in huge state reserves, and despite the fact that bread and cereal products prices in Russia are not on the rise). Then the RF Government announced that Russia would urgently introduce a (yet unspecified) grain export duty. It should be said that the introduction of a prohibitive grain export duty in 2008 completely stopped Russia's grain exports (it must be remembered though that in 2008, unlike in 2014, Russia's grain crops were poor due to drought). Thus, the validity of the Government's promise to refrain from the introduction of new taxes is being rapidly eroded by the relentless tide of events. Most unfortunately, Russia is rapidly destroying her hard-won good reputation in the highly competitive international grain market, with her competitors, such as Kazakhstan and Ukraine, are avidly waiting in the wings for this to happen.

In December, the conflict zone in eastern Ukraine at last saw a lull in the fighting, which had continued almost on a daily basis in spite of the Minsk Agreements. On 9 December, the OESCE-brokered 'Day of Silence' came into effect and was generally respected by both sides in the Ukraine conflict. However, a new round of negotiations took place only on 24 December. Maybe in anticipation of this event, the POW swap had ground to a halt, and there had been a number of other worrying developments.

In December 2014, the presidents of Russia, Belarus, Kazakhstan, Armenia and Kyrgyzstan signed a package of documents relating to practical aspects of the launch of the Eurasian Economic Union. On the eve of that event, Russia had stopped her trade war against Belarus by lifting the ban on pork imports from Belarus. As regards the prospects for the Eurasian Economic Union, they will remain vague at least for the time being. It should be noted that its economic importance for Russia is not high (Russia's trade turnover with her partners in the Union accounts for less than 10% of RF foreign trade turnover). The main bone of contention between Russia and the other members of the Union will remain to be export duties on crude oil, natural gas and petroleum products. These duties are planned to be abolished by 2015, while at presence there exists a mechanism of supply quotas of duty-free oil, gas, etc.