RUSSIA'S FOREX MARKET: NO PANIC OUTLOOK

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The Bank of Russia on 11 December 2015 decided to keep the base interest rate unchanged at 11%, thus indicating that the bank will not move forward with easing monetary policy. Russia's Central Bank on 14 December resumed 12-month foreign exchange repo auctions with a view to pushing down demand for foreign currency. Thus, the Bank of Russia aims to avoid turbulence in Russia's financial markets, which may occur in response to a new downturn of oil prices amid raised Fed target rates[1].

Keeping the base interest rate unchanged, after stepwise cuts until August 2015, appears reasonable amid slower decline of inflation and higher risks to financial sustainability.

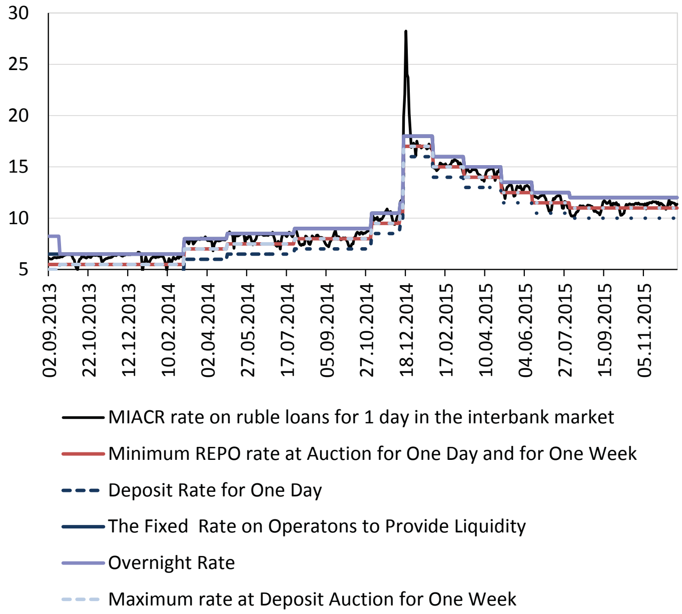
Inflation was declining at a very slow pace (15.7% in September, 15.6% in October, 15% in November compared to the same periods of 2014) after the year over year hike to 15.8% at end-August 2015. It would be unreasonable to cut the base rate amid high risks of inflation and further depreciation of the rouble, uncertain dynamics of oil prices, geopolitical tensions, investors' expectations that Fed's monetary policy would be further tightened. Nevertheless, the Bank of Russia has sent a signal to market participants that the monetary policy will be eased as long as inflation declines and the situation is stabilized.

The Consumers Price Index (CPI) in November 2015 gained 0.8% (1.3% in November 2014), 0.1 p.p. higher than the value seen in October 2015. Consumer prices during the first two weeks of December increased further 0.4%. Sluggish economy, moderate growth in money supply restrain inflation. However, the cumulative effect of the exchange rate pass-through to prices, as well as high risks of further depreciation of the rouble's exchange rate late in 2015 – early in 2016 are responsible for keeping inflation up, which may as well be higher than 13% at 2015 year-end.

It is noted in the Bank of Russia's monetary policy report for November 2015 that, according to surveys conducted by OOO INFORM (a limited liability company), in November inflation expectations were up 0.5 p.p. to 15.8%, because individuals expected that the rouble would depreciate by the end of the year. High inflation expectations is an obstacle to softer monetary policy, restraining slowdown of real inflation.

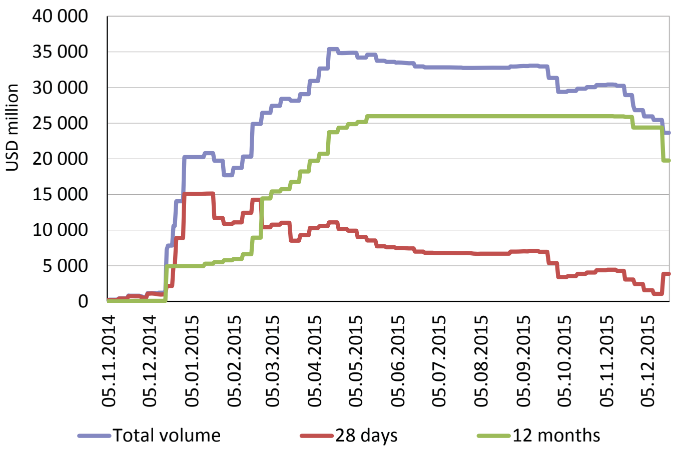
In the period between November and the first half of December 2015, the MIACR (Moscow InterBank Actual Credit Rate) on overnight interbank loans denominated in roubles didn't hit the interest rate band cap, staying at an average range of 11.3–11.4% (*Fig. 1*), thus evidencing that the Bank of Russia has been carrying out an efficient interest rate policy in terms of achieving the goal of converging interbank credit interest rates and the base interest rate.

1 This paper was originally published in *Online Monitoring of Russia's Economic Outlook* No.18.



Source: The Central Bank of Russia.

Fig. 1. The Bank of Russia interest rate band and the dynamics of the interbank lending market in 2012 to 2015, % p.a.



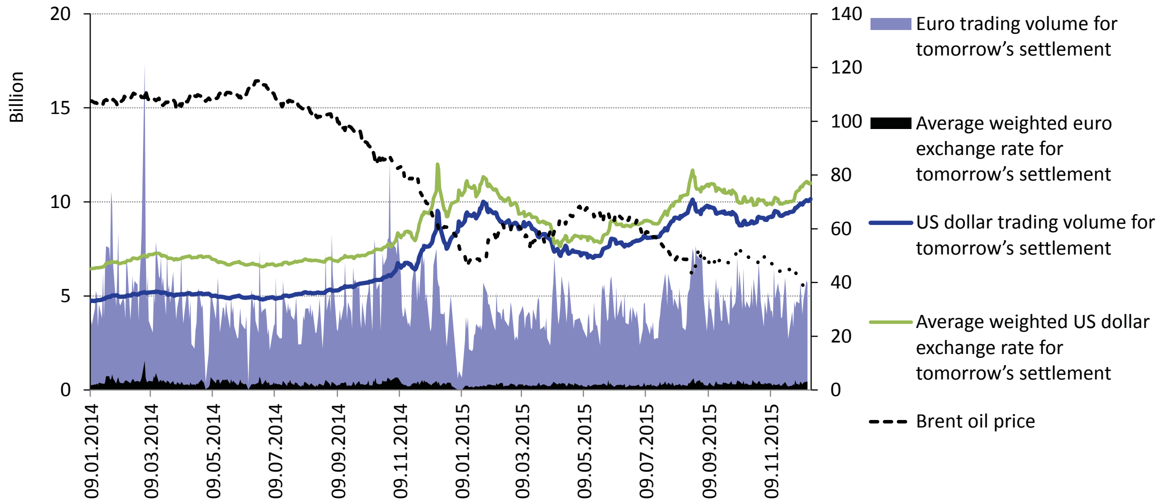
Source: the Bank of Russia.

Fig. 2. Banks' debt to Russia's Central Bank on foreign exchange repos in 2014–2015

At the same time, in the fall of 2015 credit institutions showed less demand for central bank's loans due to the fact that the monetary base increased as money of the Reserve Fund was spent. Banks' debt to the Bank of Russia on rouble-denominated repos in November decreased by 12% to Rb 1.0 trillion. Additionally, banks' debt on loans secured by non-marketable assets contracted by 8.3% to Rb 2.3 trillion. Banks' foreign exchange debt to Russia's Central Bank in November – first half of December decreased too, by 16%. According to the data as of 21 December 2015, banks owed \$23.7bn to Russia's Central Bank on foreign exchange repos, including \$19.8bn on one-year repos and \$3.9bn on 28-day repos. The reduction in the debt on 12-month loans (down 23.9% in November – first half of December 2015) contributed most to the contraction of banks' foreign exchange debt to the Central Bank (*Fig. 2*).

Hence, banks showed less demand for foreign exchange refinancing, despite a new weakening of the rouble's exchange rate, considerable foreign debt repayments in December (\$20.8bn of repayments of principal, \$2bn of interest payments according to the foreign debt repayment schedule) and a hike in Fed rates. It appears that credit institutions still have sufficient foreign exchange reserves, which were accumulated in the previous year. Furthermore, in an effort to push down demand in the forex market, Russia's central bank said on 27 November it would resume from 14 December 2015 foreign exchange repo auctions for a term of 12 months. Furthermore, the Bank of Russia increased the minimum rate for this type of actions by LIBOR plus 3 p.p. (previously, LIBOR plus 2.5 p.p.). As a reminder, the Bank of Russia on 18 May 2015 suspended one-year foreign exchange repos due to stable situation in the forex market.

Only \$201.3m was raised at 4.067%, with a limit of \$1bn, at a one-year repo auction held on 14 December. Note that low demand for the auction was determined by high value of funding. A foreign exchange repo auction for a term of 28 days was held on 14 December, which appealed more to commercial banks. Credit institutions raised \$2.9bn at 2.35%. With this inter-



Sources: Russia's Central Bank, ICE.

Fig. 3. Russia's forex market and crude oil prices in 2014–2015

est rate policy in place, Russia's Central Bank will facilitate changes in favour of one-month repo auctions in the composition of the foreign exchange debt owed by banks to the Central Bank.

Overall low foreign exchange demand by banks is indication that the forex market is being stable and there is low risk of panic similar to that seen late in 2015. This by no means indicates that the rouble's exchange rate may not depreciate if oil prices keep falling. In the period between November and the first half of December 2015, the rouble already lost 10.3% against the US dollar, from 63.8 to 70.4 roubles per US dollar, and the euro gained 9.4% against the rouble, up to 77.04 roubles per euro, while the value of the euro-dollar basket increased 10.5% to 73.9 roubles. As a result, the official rouble-dollar exchange rate on 19 December touched an all-time high of 71.32 roubles per US dollar (*Fig*. *3*). The decline in oil prices (down 22.7% in the period between November – first half of December 2015) was the key factor responsible for the rouble's depreciation.

According to our estimates, the rouble's real effective exchange rate is currently being nearly equal to the equilibrium value, which is determined by fundamental factors (oil prices, economic growth rates, capital outflows and government spending). Additionally, because of high inflation in 2015, despite the rouble's depreciation in August and October–November, the rouble's real effective exchange rate is 6.5% higher than that in December 2014 and nearly equal to that seen in June 2005. Hence, we do not expect that Russia's national currency would keep depreciating substantially if prices of energy resources are stabilized.