Russia
The 2014 Financial Crisis and Related Aspects
The situation in Russian financial markets has become significantly more dramatic in recent days. A rapid drop in oil prices on global markets, economic sanctions imposed by the EU and the USA on Russia and the growing difficulties that the Russian economy is facing have all taken their toll. The financial markets often react spontaneously, even though the risks have been accumulating for several months now. Paradoxically, the current phase of the crisis was triggered by the Central Bank of Russia, which surprisingly increased the basic interest rate by 650 basis points to 17 percent. This action was taken in an attempt to stop the decrease in the exchange rate of the ruble and to gain control over inflation. However, the financial markets interpreted this decision as a sign that the situation is very serious.

The Dramatic Situation on the Financial Markets

The Russian ruble exchange rate fell to such an extent that it exceeded the 70 RUB/USD limit. After the intervention on the foreign exchange market by the Ministry of Finance, the currency slightly recovered to reach 65 RUB/USD. Since the beginning of the year, the ruble exchange rate practically doubled and suffered the greatest loss of all currencies (followed by Argentina, which experienced another state bankruptcy this year). The plunge may become even steeper. Based on option prices for the RUB/USD exchange rate, ie their risk reversal combinations, of all global currencies, the Russian ruble is most prone to weakening.

Other markets are also going through turbulent times. The yield on a 10-year state bond increased to reach 15 percent, while at the beginning of the year, it was at 7.9 percent. This was partially attributable to the Central Bank’s increase of interest rates in its endeavour to protect the ruble. However, the factor that is primarily responsible for the growth in yields is increasing credit risk. At the beginning of the year, the CDS for Russian state bonds was selling at 166 basis points, whereas currently it is at 601 points. The equities market has also suffered significant blows. The MICEX Index has lost 5.3 percent since the beginning of the year. This occurred even though the share prices of Russian companies are abnormally low in terms of standard criteria.

What Comes Next?

The Central Bank has several options at its disposal, which it can use in an attempt to stabilise the situation. One of them is to further increase interest rates. In May 2008, when the previous Russian financial crisis was at its peak, the Central Bank pushed its interest rate all the way up to 150 percent. The down side of this policy was the drop in domestic demand as well as a significant increase in corporate bankruptcy risk; this was due to the companies’ inability to repay loans with such high interest rates.

Another option is to continue in foreign exchange interventions. This was the method of choice for the Russian Central Bank until November. The drawback to such an approach is that foreign currency reserves are limited. At the beginning of the year, the volume of reserves amounted to USD 510.5 billion. The interventions then accounted for their decrease to the current USD 416.2 billion. After spending a fifth of its reserves in an effort to protect the ruble, on 5 November, the Central Bank announced that it would no longer continue in its interventions. However, this decision was soon to change. The Bank was once
again forced to intervene on the foreign exchange market on 1 December, when the ruble was pulled down together with rapidly dropping oil prices. The current amount of reserves is still high enough to tempt the Central Bank to keep trying to use these tactics, but strong market pressure could lead to the reserves decreasing at a fast rate.

Another option that could be considered is selling part of the gold reserves. The Russian Central Bank now has 1,169.5 tonnes of gold at its disposal. Given the current price of gold (USD 1,196.7 per troy ounce), the Russian gold has a value of USD 45 billion.

Introducing capital controls/foreign exchange transactions would be another option. The side effect would be a deterioration of Russia’s rating, which would lead to increased credit premium and bond yields and to the Russian market’s exclusion from the MSCI Emerging Markets group. This would in turn cause funds investing based on the MSCI qualification as well as active investors to sell Russian shares.

As opposed to the year 1998, it is now highly unlikely that Russia would be helped by the International Monetary Fund through the opening of a credit line. This is certainly the case as long as its political approach to Ukraine stays the same. It would not make sense for the USA and the EU to continue applying their sanctions against Russia if the IMF was simultaneously lending money to it.

**The Russian Economy**

The severe fluctuations on the financial markets are a reaction to the deteriorating situation of the Russian economy. The Russian economy had been short of breath even before the escalation of the situation in Ukraine. Last year, in late July and early August, the average estimates were that the Russian economy would grow by three percent. In the following months, however, the state of the economy was gradually worsening and the estimates were dropping. After Russia’s annexation of Crimea and the first wave of sanctions, the prognosis plunged to one percent. At present, the financial markets estimate that Russia’s GDP will increase by 0.5 percent, and a 0.2 percent decrease is anticipated for the following year. However, taking into account the slump in oil prices of the past few weeks and the sharp decline of the ruble, the drop in GDP may turn out to be much deeper than expected.

In the third quarter, GDP increased by another 0.8 percent year-on-year, but this was only thanks to a significant decrease in imports. Investments dropped by 2.1 percent. Once consumption starts to lag behind due to increasing inflation, the total GDP will also decrease; and Russia cannot quite rely on strengthening its export, as mineral resources account for over 70 percent of it. There tends to be a surplus of oil, natural gas and coal on the markets at the moment, as indicated by the recent sharp drop in prices. In the past three months, export from Russia has been decreasing quite significantly.

The negative outlook for the upcoming months is also supported by the drop in the composite index of purchase managers to 47.6 points (50 points being the boundary between growth and recession).

The situation has been aggravated by high and continually increasing inflation. In January, consumer prices inflation was at 6.1 percent, in November, it was 9.1 percent. Following the plunge of the ruble in the recent days, it is close to certain that it will soon reach a two-digit number.

**The Sanctions**

In reaction to Russia’s involvement in the Ukrainian crisis, the EU and the USA introduced several waves of economic sanctions aimed against Russia. One of these sanctions is the prohibition of selling, delivering, transferring or exporting dual-use goods and technologies listed in Regulation (EC) No. 428/2009. These include chemical or biological products, nuclear materials and technologies, optical and laser technologies, aviation technology and propellant systems, materials used in aviation electrical engineering, navigation electronics, marine technology and certain types of software.
Another sanction is the ban on providing services necessary for researching and drilling for oil in deep waters, for arctic research and drilling oil, or for projects focusing on oil-bearing shales.

An important sanction with regard to the current Russian financial crisis is limited access to capital markets for some Russian institutions.

A sanction of a different nature is the significant outflow of capital from Russia. Concerns about further developments in the Russian political and economic situation have led to a capital outflow in the amount of USD 102 billion from Russia in the past 12 months.

Connection of Russia with the rest of the world

Who will suffer from the deterioration of the Russian economy the most? Major importers to Russia include China (15%) and Germany (14%). Nevertheless, Russia is a relatively minor business partner for these countries, as the proportion of the aggregate export of Germany and China exported to Russia accounts for 3.5% and 2.3%, respectively. The neighbouring countries of Russia are much more dependent on the Russian economy. The stagnation or recession of the Russian economy has a major impact on Belarus (33% of the aggregate export of Belarus is exported to Russia), Ukraine (24%), Armenia (19%), Estonia, Lithuania (16% each), Latvia (11%), Finland and Kazakhstan (9% each).

Czech Republic and Russia

With respect to the foreign trade of the Czech Republic, the importance of Russia has gradually increased. In the past 10 years, the import to Russia has been gradually increased by an average of 24%, every year. The proportion of the aggregate export of the Czech Republic exported to Russia grew from 1.3% in 2000 to 3.7% in 2013, and then it slowed to 3.2% in 2014. The proportion, of the imports from Russia to the aggregate imports of the Czech Republic, has not seen any significant changes, fluctuating at around 5-7%. Increased export to Russia reduced the deficit in trading, with this country, from CZK 65 billion in 2000 to CZK 39 billion in 2014.

The structure of the export from the Czech Republic to Russia is dominated by machinery and transportation means (accounting for 66.6%; this predominantly includes road vehicles, heating and cooling devices, compressors, ventilators, taps, valves, fitting for pipes and boilers), industrial consumer goods (accounting for 12%; perambulators, toys, games and sports equipment, plastic goods) and market products assorted by material (accounting for 9.6%; products made of basic metals, constructions made of iron, steel, aluminum, glass and glass gods).

With a share of 1.8%, the Czech Republic is on the 16th place in the ranking of Russian importers to Russia.

The Czech Republic is largely dependent on Russia in the import of energy sources. In total, 41% of oil is imported from Russia. There is even greater dependency on the import of natural gas from Russia to the Czech Republic, accounting for 74%.

Due to the sanctions imposed on Russia by the European Union and the deteriorating Russian economy, there has been a year-on-year decline of 18.5% in the export from the Czech Republic to Russia in October. Given the volume of trade between the Czech Republic and Russia and the import demands of the Czech export production, it is estimated that a 20% decline in the export to Russia will decrease Czech GDP by 0.15%. A 50% decrease in the export to Russia would reduce Czech GDP by 0.38%.

The indirect impacts through other countries must also be taken into consideration. In the EU, export to Russia accounts for 6.9% of the aggregate export of the European Union, which makes Russia its 4th most significant business partner (following the USA, Switzerland and China). The export from the EU to Russia dropped by 12% in the first 10 months of 2014 and by a staggering...
14.5% in October 2014 alone. A smaller volume of export from the EU countries to Russia also leads to lower demand for sub-supplies from the Czech Republic to companies in other EU countries.

Considering the direct as well as indirect impact of the development in Russia on the Czech economy, it may be estimated that a 20% decrease in Russian imports will reduce the growth of Czech GDP by 0.2%; a 50% decrease would reduce Czech GDP by 0.5%.

If the Russian crisis also weakened the risk appetite on other markets, there would be by far more significant impacts on the global economy, the European Union and the Czech Republic.

Fortunately, the situation is counter-balanced by low prices of oil that will have a positive influence on the economy in the Eurozone and in the Czech Republic.

The impact on the financial sector must also be noted. The exposure of the Czech banking sector to the Russian market is relatively low; an exception only involves a selected group of smaller institutions that should not endanger the stability of the financial sector as a whole.

The Europe-wide context is more significant. The investments of European banks in Russia amount approximately to EUR 100-200 billion. In terms of Czech financial institutions, the highest activity in Russia is reported by Raiffeisen Bank, Société Générale, UniCredit Bank, Commerzbank and ING.
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