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Navigating the Uncertain Waters: An Analysis of the Near Future Profitability of the Russian Ruble

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Abstract: This paper aims to provide a comprehensive analysis of the near future of the Russian ruble, with a particular focus on its potential profitability as an investment asset. Amidst a backdrop of political tensions, economic sanctions, and ineffective forex interventions by the Russian Central Bank, the ruble has experienced significant volatility. The paper examines key factors influencing the ruble's value, including political climate, inflation, interest rates, and main exports. The study analyzes the causes and solutions of Russia's three major devaluations since the dissolution of the Soviet Union in 1992. By analyzing historical exchange rate and other economic indicators, the paper scrutinizes the internal and external indicators of ruble's devaluation and evaluates the various policy measures taken by the Central Banks of Russia to stabilize the currency, including redenomination and shifts in exchange rate mechanisms. The paper concludes that, given the current political and economic landscape, the profitability of investing in the Russian ruble is questionable and unrecommended. Through this multi-faceted approach, this paper aims to provide a nuanced understanding of Ruble's past and present, thereby offering valuable insights for policymakers, investors, and scholars interested in the foreign exchange market of Ruble.

Keywords: Exchange Rate, Sanctions, Export, Devaluation

1. Introduction

The Russian ruble (RUB), which serves as the official currency of the Russian Federation, has been used since the 13th century, making it the second oldest national currency in the world. Throughout the course of Russian history, the Ruble has experienced numerous reforms and adjustments. These transitions mirrored the socio-political transformation that Russia experienced over the centuries. From the feudalistic economic structure of the medieval Grand Duchy of Moscow to the capitalist model of the post-Soviet era, the Ruble has been a reliable barometer of the country's economic climate. The most recent significant transformation of currency was the redenomination of Ruble during 1998, where the Russian central bank decided to "drop three zeros off" the old notes, issuing new rubles notes and replacing the old rubles at a ratio of 1,000:1 [1]. The redenomination was a response to the urgent need to stabilize the exchange rate and to build a simplified yet robust monetary system that could support the transition of Russia from planned economy to market economy.

2. Devaluations of Ruble and Inflation

The ruble has experienced significant volatility throughout Russia's recent history. Its first substantial devaluation occurred in 1993, two years after the dissolution of the Soviet Union in 1991. During this period, the Russian economy grappled with hyperinflation, reaching an alarming rate of 874.2% [2]. This resulted in an exchange rate of RUB 5,000 per USD [3]. This economic turbulence was largely attributed to the political and economic instability that ensued after Russia transitioned to a market-based economy. Fortunately, the government's response was swift and effective, leading to a relatively rapid economic recovery. Between 1993 and 1998, the inflation rate plummeted to 6% [4]. The victory of combating hyperinflation was achieved using a heterodox stabilization strategy in which the government opted to issue securities rather than produce more currency. To stabilize the currency further, the Russian central bank introduced a fixed exchange rate in 1995. Moreover, after the ruble's redenomination in 1998, its value strengthened to RUB 5.9 per USD [3].

Another significant devaluation of the ruble took place in 1998, precipitated by Russia's financial and sovereign default crises. External factors such as the Asian financial crisis and declining energy prices exacerbated Russia's challenges, as Russia's main exports are fuel and energy products. The country struggled to manage approximately $120 billion foreign debt inherited from the USSR, as well as an internal public debt estimated between $60 and $80 billion [5]. In response, the Russian central bank discontinued the exchange rate corridor, switched to a floating exchange rate system, and defaulted on its internal debt. This led to an inflation spike of 85.7% and saw the ruble's value fall to RUB 24.62 per USD [2]. Nevertheless, the subsequent recovery was brisk, since the depreciation in the ruble's value enhanced the competitiveness of Russian exports globally. This factor, combined with rising oil prices and a $4.8 billion loan from the IMF, facilitated Russia's economic revival and its reintegration into international financial markets [6].

The most recent devaluation of the ruble was significantly influenced by Russia's invasion of Ukraine in February 2022. By March 2022, the inflation rate in Russia soared to 17.8%, and the ruble plummeted to a historic low, trading at RUB 128.44 per USD [7][8]. This vulnerability was exacerbated by the floating exchange rate system, making the currency more sensitive to political upheavals [9]. The situation was further aggravated when the United States, along with its global allies, imposed a series of sanctions on Russia in retaliation for its actions in Ukraine. These sanctions encompassed export restrictions and various other countermeasures. From February 2022 onwards, the U.S. Treasury Department implemented over 2,500 sanctions in response to Russia's aggressive stance [10]. These punitive measures severely impacted the Russian economy. However, in a strategic move in March 2023, the Russian Central Bank decided to peg 5,000 rubles to a gram of gold [11]. This initiative enabled other nations to exchange gold for rubles with the Russian Central Bank, facilitating the purchase of Russian oil and other exports. Consequently, by June 2023, the ruble rebounded to RUB 80 per USD, and the inflation rate stabilized at 3.3% [8][12].

3. Outlook

3.1. Short-term interest rate

The outlook for the Russian Ruble remains bleak, largely due to its heightened volatility, fueled by fluctuating short-term interest rates and its reactive monetary policies in the face of Russia's current political and diplomatic turbulence. Following the invasion of Ukraine in 2022, Russia swiftly raised its interest rate to 20% just four days post-invasion, aiming to counteract an abrupt surge in inflation [13]. This move saw the ruble's value drop to RUB128 per USD [8]. By July 2023, the ruble's position remained precarious, largely due to the continuing Russian-Ukraine conflict. Financial forecasts for 2023 anticipate an inflation rate between 5% and 6.5%, a decrease from the prior year but still

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exceeding the bank's annual target of 4% [14]. The ruble experienced a notable downturn, particularly after actions by Yevgeny Prigozhin and his Wagner Group against the government in June, pushing the exchange rate to over 90 rubles against the U.S. dollar, a rise from approximately 83 [8]. This currency depreciation has profound implications for Russia, given its import-dependent economy, leading to escalating prices. In an effort to temper the overheated economy, Russia elevated its interest rate from 7.5% to 8.5% in July 2023, a move influenced by increased military expenditures and the ruble's diminishing value [13]. While the augmented interest rate and the gold peg might offer some potential for the ruble's appreciation, its stability remains questionable, making a return to pre-war RUB to USD levels challenging. According to the research done by Shigeki Ono, the Russian monetary policy has little impact on consumer price index and exchange rate due to the dependency of Russian economy on its export of oil and gas [15]. Therefore, without a detailed evaluation of the link between exports and Ruble's value, it is hard to tell whether the recent monetary policy of Russian Central Bank's effectiveness on stabilizing the exchange rate.

3.2. Credit Default Swap (CDS)

The heightened Credit Default Swap rates indicate a perilous investment climate within Russia's economy. Due to the western sanctions imposed on Russia, the country experienced its first international bonds default in decades, leading investors to seek compensation through credit default swaps (CDS). With significant exposure by PIMCO and $2.54 billion in CDS outstanding, Russia's missed bond payment has activated CDS payouts, leaving the market in a state of uncertainty [16]. However, the situation has become more complicated with the United States banning the purchase of Russian securities in secondary markets. The current credit default swap rate of Russia is 13,775.17%, which has reached Russia's all time maximum, indicating a 100% probability of default [17]. Additionally, the CDS of Russia has remained fairly consistent throughout the past 2 years, suggesting that the situation would not be resolved quickly. Moreover, as rubles keep depreciating, the cost of repaying foreign-denominated debt rises, which can further widen the CDS spreads. This leads to a feedback loop, where the rising CDS spreads and a falling currency reinforce each other. Therefore, it would be extremely risky for investors to invest in rubles at this time.

3.3. Exports

As Russia grapples with its diplomatic challenges, its economy faces mounting pressures from Western sanctions that target its critical export sectors, leading to a depreciation of the Ruble and a weakened position in foreign exchange markets. Russia's economy heavily depends on exports, particularly oil and natural gas, which make up half of its federal budget [18]. The country's main exports are crude petroleum, refined petroleum, petroleum gas, coal briquettes, and gold. Its top trading partners include China, the Netherlands, the U.S., the U.K., and Italy [19]. However, the geopolitical landscape shifted after Russia's invasion of Ukraine. Numerous western countries initiated measures to curtail or halt their oil and gas imports from Russia, aiming to cut Moscow's financial inflow and counteract its military endeavors. The European Union stopped importing Russian oil by sea and plans to ban refined oil products from Russia starting February 2023 [20]. At the same time, the U.S. announced in March that it would no longer import Russian oil, and the U.K. banned both crude and refined Russian oil products in December 2022. Western allies set a price limit in December, ensuring Russia doesn't earn more than $60 per barrel of crude oil [20]. These sanctions have significantly reduced Russia's exports, leading to a decrease in foreign currency income and a reduced demand for the ruble. The reduced exports of oil and gas have led to the ruble's depreciation, weakening its stance in the foreign exchange arena. Another important series of factors that has ultimately led to the depreciation of ruble lies in the relationship between oil price and the value of

USD. The link between these two factors created a chain reaction that indirectly affected value of Rubles. In a study conducted by Tomas Urbanovsky which applied OLS time-series regression analysis on training data from 2013 to 2015 indicates that both the oil price and the appreciation of USD has strong correlation with Ruble's exchange rate. According to his findings, oil price and dollar value are negatively correlated, whereas the value of Ruble is positively correlated with oil price, indicating the negative correlation between the value of USD and the value of RUB [21].

3.4. Forex activities

The forex activities undertaken by the Russian Central Bank aimed to prevent the collapse of the ruble have been widely criticized for their ineffectiveness, contributing to the ongoing instability of the Russian currency. While the Central Bank's interventions were designed to stabilize the ruble by selling foreign currencies and buying rubles, these actions have not yielded the desired results. Instead, they have exacerbated the volatility of the ruble, making it an increasingly risky asset. The Russian forex market has recently undergone significant changes that have had a profound impact on the value of the ruble and the country's overall economic stability. Initially, the market was heavily influenced by transactions involving the Euro and the USD, which accounted for 52% and 35% of the market, respectively [22]. However, these proportions have now dwindled to 34% and 19%, indicating a clear shift away from Western currencies [22]. As the influence of these currencies has waned, the Chinese yuan has ascended in prominence. According to data from the Moscow Exchange in February 2023, the yuan has now replaced the USD as the most traded currency in Russia, signaling a growing dependence on the yuan and a strategic realignment of Russia's economic policies. This shift was further solidified in July 2023 when Russia's finance ministry announced a reduction in the daily sales volume of foreign currency. The ministry planned to sell 34.9 billion rubles' worth of foreign currency to compensate for lower oil and gas revenues, and notably, they chose to sell the yuan over Western currencies, which Russia perceives as antagonistic [23]. This decision highlights the increasing significance of the yuan in Russia's strategy for maintaining economic stability, especially in the face of Western sanctions. Initially, this strategy offered some short-term support to the ruble, stabilizing its rate of depreciation to around RUB 80 per USD throughout July [23]. However, this stability proved to be short-lived. The value of the ruble continued to depreciate and reached a peak on August 11, with the exchange rate hitting RUB 98.9 per USD [8]. This depreciation is likely attributed to the central bank's decision to revert the interest rate to 7.5%, following the temporary stabilization of the ruble in July [13].

Given the current political climate in Russia and its strained relations with Western countries, the likelihood of further depreciation of the ruble is high, putting investors into a "flight-to safety" situation, where investors are in urgent needs to sell their high-risk investments in exchange for a "safe haven". According to the study done by Azhar Mohamad who analyzed the cumulative abnormal returns (CARs) based on the minute data 24h before and after the invasion, that USD, yen, silver, Brent, WTI and natural gas are being perceived as safe havens by the investors [24]. However, the natural gas market doesn't seem to be the safest place for investors looking into replacements of high-risk investments in Russia. Based on the quantile regression neural network model analyzing risk spillovers in European gas and oil market constructed by Xinyu Wang, that under such an extreme condition where investments are exposed to significant risks, the European energy market is not a safe place to turn to because of its higher risk in gas market compared to oil markets [25]. In other words, the herding of investments flowing into other foreign assets that are viewed as low-risk could be potentially affected by the risk spillover of the Russian-Ukraine crisis, and the value of the investment could be falsely portrayed.

4. Conclusions

Given the current political and economic landscape, investing in the ruble appears to be a high-risk venture. The Central Bank's inability to stabilize the currency, coupled with external pressures like sanctions, makes the ruble's future profitability questionable. The ruble's path ahead is shaped by the ongoing Russia-Ukraine tensions and the weight of Western sanctions. With Russia's economy deeply anchored in oil and gas exports, any global market shifts can sway the ruble considerably. The Russian Central Bank's recent interventions, such as pegging the ruble to gold and sterilizing the forex market, all reflected its strategic attempts to stabilize the currency even though their long-term efficacy remains to be seen. High Credit Default Swap rates signal a prevailing skepticism among global investors about Russia's economic prospects. Given the current geopolitical and economic landscape, the ruble's immediate future appears challenging. Investors should remain cautious, anticipating potential volatility in the currency's value, and exchange their high-risk Russian assets into safe havens.

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