Searching For A Silver Lining

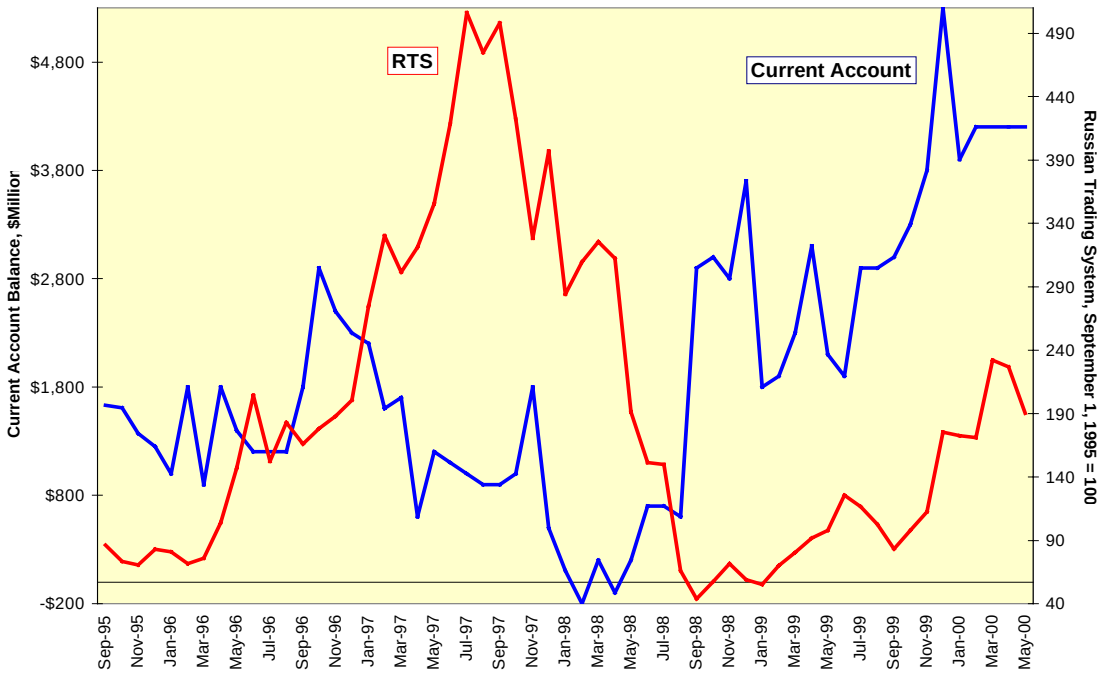
Cold War economists used to tell a real knee-slapper: At the tail end of the massive May Day parade, after the troops, and tanks, and missiles rolled by, a solitary figure came strolling through Red Square, hands in pockets. A hush fell over the crowd, and Brezhnev, befuddled, leaned over to an aide and asked, "Who is that?" The aide responded, "That's an economist, Comrade. You wouldn't believe how destructive they can be!"

The financial crisis of August 1998 proved this too well. Nothing in forty years of Cold War came so close to unhinging the world as did the Russian default on their Treasury securities, GKO's. And what a surprise: The Soviets, knowing they were held to a different standard, had always honored their international debts.

Part of Russia's problem stemmed from commodity price deflation in the aftermath of the ongoing Asian financial crisis. Russia, a large exporter of natural resources, saw its current account balance fall from a surplus of $1.8 billion in November 1997 to a $200 million deficit by February 1998. The current account returned to strong surplus at the height of the financial crisis, as the collapse of Russian credit crippled Russia's ability to import. The Russian Trading System (RTS) stock index, needless to say, fell apace, the ruble (RUB) plummeted in the currency markets, and interest rates surged on whatever debt instruments were still liquid.

The recovery in commodity prices, especially for crude oil and natural gas, will likely support the Russian current account surplus and RTS. The direct effects on the RUB will not be direct, but will operate through a mechanism discussed below.

Russian Current Account Balance And Trading System

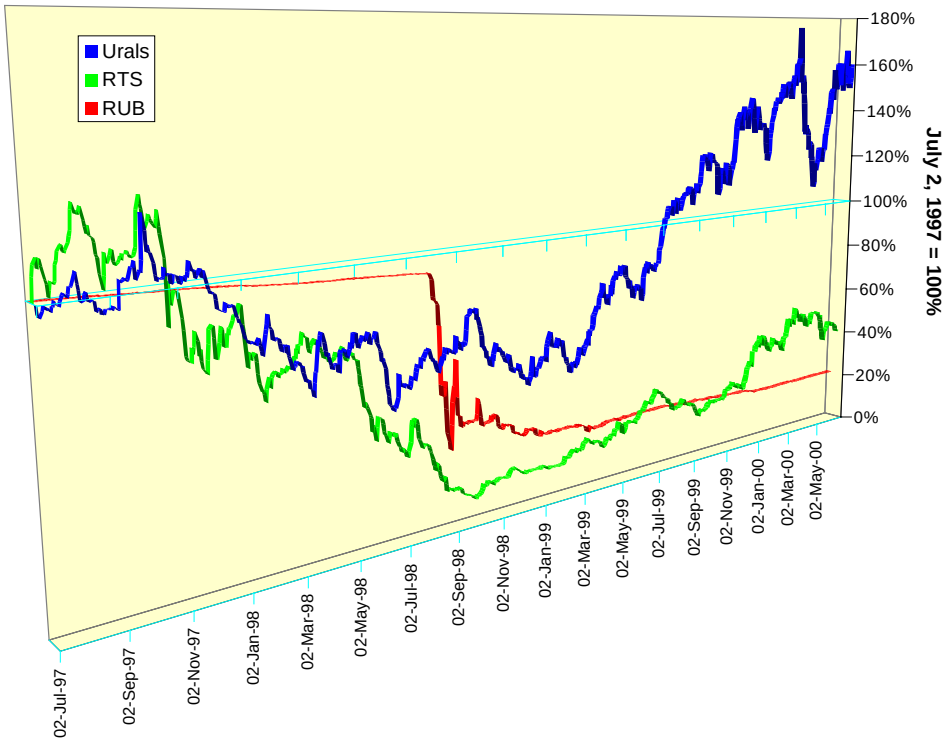


Oil And The Ruble

Over the period since the devaluation of the Thai baht on July 2, 1997, the RUB has tracked two variables closely, the RTS and the price of Urals-grade crude oil delivered to refining centers in Northwest Europe. The simple correlation between the RUB and Urals was a positive number, .49, which implies a weaker RUB as a function of contemporaneous higher crude oil prices. We can fit the following regression equation to the relationship:

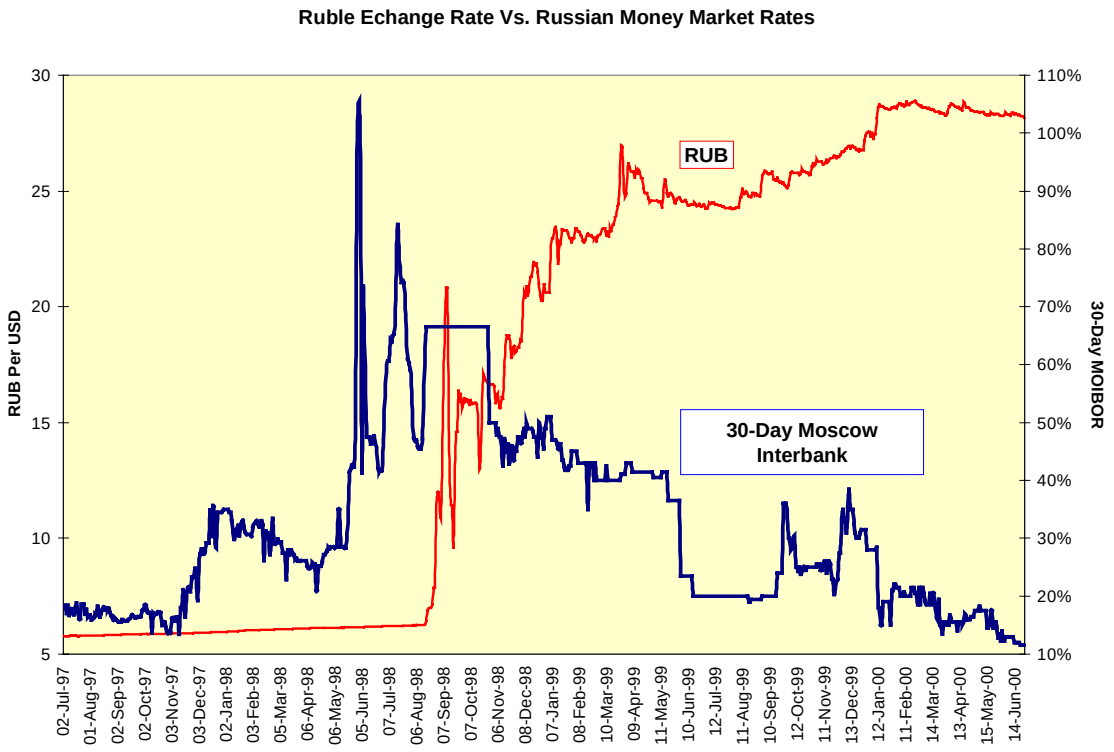
$$RUB = 9.606 + 1.041 * Urals - .049 * RTS, r^2=.797$$

While which is cause and which is effect is subject to debate; both the RTS and Urals crude oil declined well before the collapse of the RUB. While it is typical of emerging markets to have a stock selloff produce a currency selloff, and vice versa, the chart below suggests the RUB was fairly immune to the decline in both the RTS and Urals until the default crisis.



A Matter of Interest

The stability of the RUB since early 1999 is interesting in the sense it was not achieved at the expense of crippling interest rates. After all, we have confirmed time and again that a government can peg its currency at any artificial exchange rate so long as it is willing to allow any level of interest. While we have to be suspect of the data quality, the rate on the 30-day Moscow interbank offer rate (MOIBOR) has declined steadily over this period.



If we take data from the post-devaluation period only, we find we must change our factor model of the RUB to include only the price of Urals crude oil and MOIBOR:

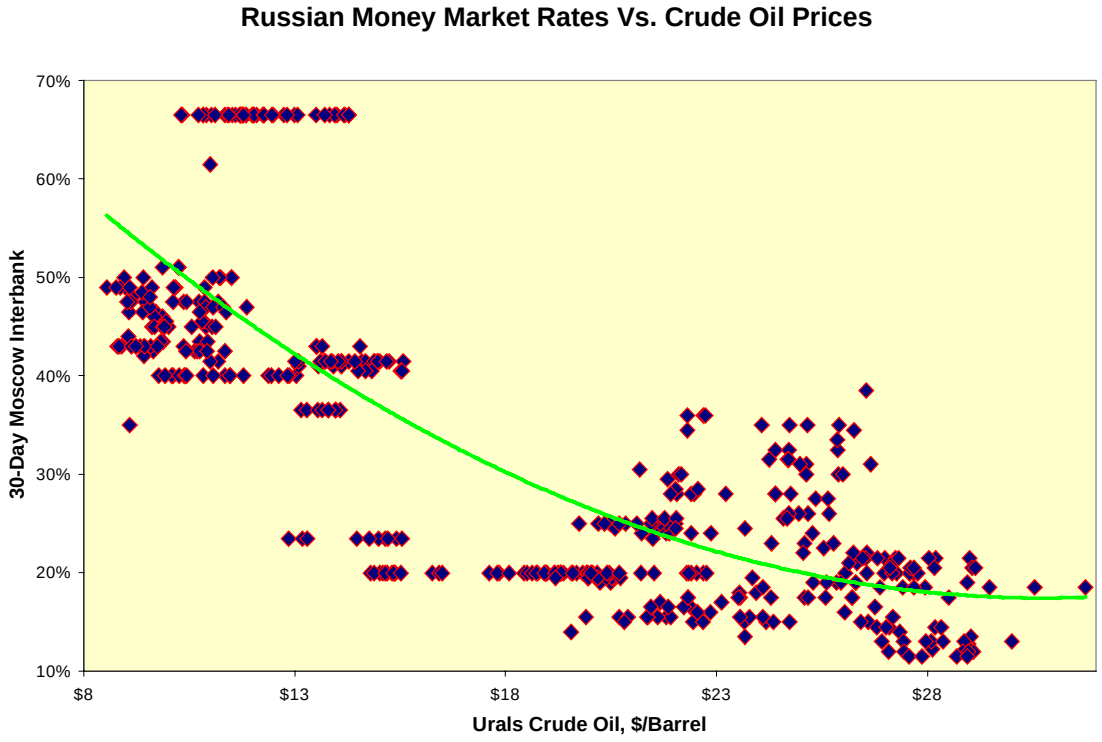
$$RUB = 29.61 + .096 * Urals - .221 * MOIBOR, r^2=.75$$

A similar situation pertains if we make the RTS the dependent variable:

$$RTS = 83.258 + 4.295 * Urals - 1.376 * MOIBOR$$

The relationship between the RUB and the RTS is weak. This stands in stark contrast to markets such as the Mexico and Brazil, where the stock market and currency track each other closely. The higher price of oil may help the Russian economy, which needs to run a surplus in order to finance its imports, and it certainly helps the RTS, which is dominated by oil and gas firms.

The real effect, however, may come through this mechanism: Higher oil prices increase the Russian current account surplus, which increases the Russian creditworthiness and reduces Russian interest rates. The relationship between Urals prices and MOIBOR has been strongly negative since the default. The lower interest rates attract investment capital, which tends to support the RUB in the face of lower interest rates.



This sounds as if it has the makings of a virtuous cycle. But there are other factors involved in investing in Russia, such as sanctity of contract. Until then, there are better investment plays centered on higher crude oil prices.