The return of the ruble

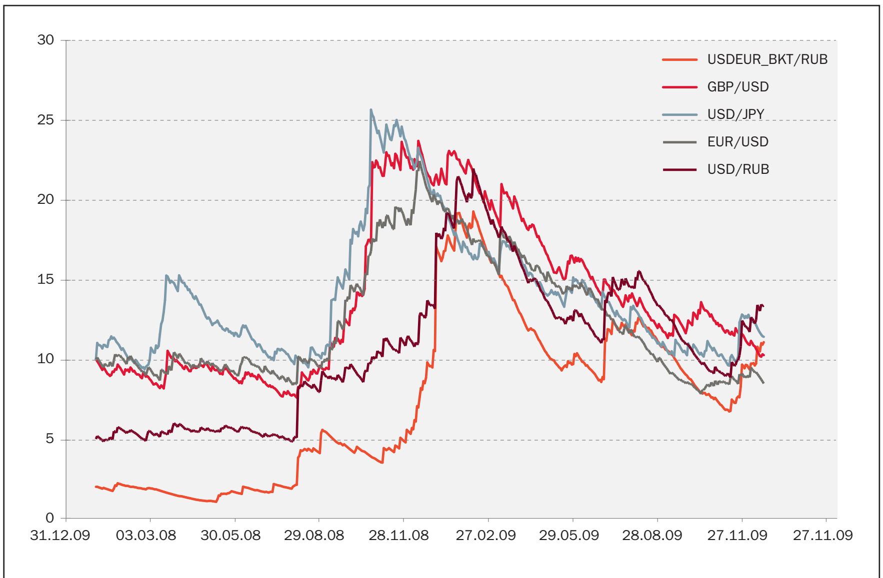
November 3, 2009 marked the 20th anniversary of the start of regular trading in dollar/ruble in Russia, in the form of auctions at that time. Despite frequent intervention by the Central Bank these auctions reflected the market forces of supply and demand, and provided the economy with a first market indicator. This was a milestone, symbolizing the start of Russia's transition to the market economy and the return of the ruble to the international stage.

History in brief

Since November 1989, the Russian FX market has weathered quite a few onsets of harsh economic climates including the one in August 1998 that was followed by the dramatic and barely controlled ruble devaluation. Looking back, this event might be viewed as a watershed between the turbulent and somewhat chaotic first period of the FX market's 20-year existence and its more stable second part.

The lesson to learn was: "While it is fine weather, mend your sails!", which was done. The fat years, with soaring oil and gas prices, were certainly of great help. As a result, Russia faced the last global crisis much more prepared, with USD 600 billion in reserves, the third largest safety cushion worldwide. This gave the government and the Central Bank the necessary room for maneuvering in order to relieve pressure on the ruble that was building up due to the sharply trimmed prices for energy resources and a notable flight of capital. Instead of letting the local currency drop sharply, as happened in some of the other emerging economies, the government pursued a policy of mild, stepwise depreciation. By February 2009 the ruble had lost 27% against its target basket (55% dollar and 45% euro) retreating from the pre-crisis level of 30 to 41 rubles against the basket and causing the reserves to shrink to USD 380 billion.

Since then the ruble has strengthened its position. Now the exchange rate is stable around the level of 35 rubles against the basket, which appears to be the equilibrium point. At the same time, the reserves are steadily on the mend. Given the current conditions, the Central Bank is returning to its policy of mid-term transition from control over the ruble exchange rate and direct interventions in FX market to inflation targeting by influencing interest rates. The Central Bank has announced to smooth only excessive fluctuations of the ruble exchange rate. Currently the band for daily deviations of the ruble's exchange rate against the basket is 3 rubles which is wide enough to allow the ruble to float freely most of the time with volatility at a comparable level to other currency pairs.



Annualized volatility (in %) of major currency pairs compared to ruble exchange rates.

Futures market

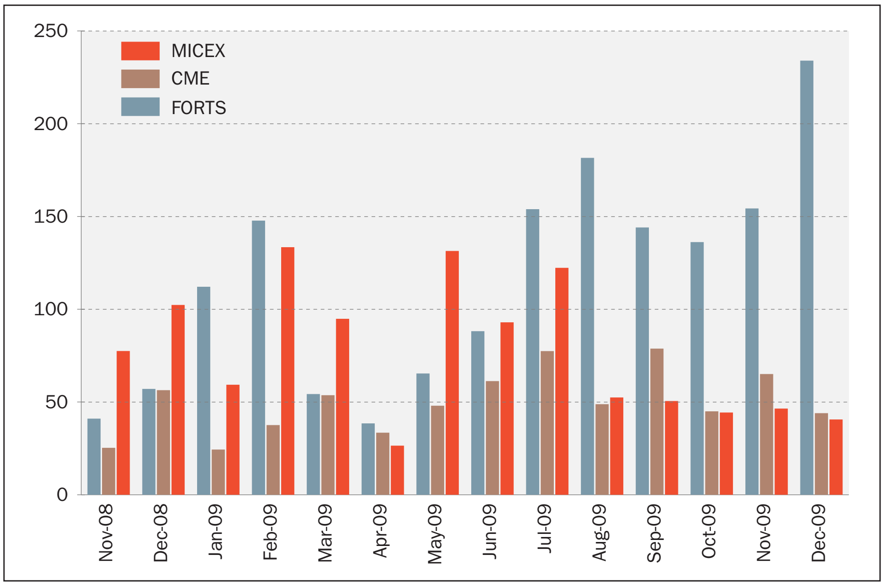
The remaining vulnerability of the ruble under stressful economic conditions that was demonstrated by the recent events coupled with its increased volatility put the task of FX risk management even higher on the agenda of financial institutions, companies and individual investors. Dollar/ruble forward and futures contracts are the oldest instruments on the Russian derivatives market, their history dates back to 1992. This again brings up the crisis of August 1998 as it uprooted the first generation of under-capitalized derivatives exchanges clearing the playing field for the two strongest: RTS and MICEX. In April 1998, a dollar/ruble future contract was also launched on CME.

For a long time, out of the three competing exchanges RTS, MICEX and CME, FORTS (the derivatives division of RTS) has had the smallest share in dollar/ruble futures trading. Initially FORTS was primarily focused on the development of its index and single stock futures and options. However, consistent efforts have been made to boost the FX segment as well. These made possible the dramatic progress seen recently: the FORTS dollar/rubles future has skyrocketed from 4.8 million contracts in 2007 to 46.4 million in 2009, and its share in the total FORTS trading volume increased from 3.3% to 9.8%. Now FORTS is a one-stop shop for derivatives traders (given its commodity division).

Measured by contracts traded, the same FORTS product ranked second in December among all FX exchange-traded products worldwide, after US dollar at BM&FBOVESPA.

Success story

This success might be attributed to three factors. First of all, the increased ruble volatility made the contract more attrac-



Average daily trading volume (in USD million) of USD/RUB futures.

tive to retail investors. Trading at MICEX and CME could be characterized as a wholesale interbank market, with the daily number of trades typically expressed by one-digit figures, whereas FORTS was handling about 15,000 trades a day in December 2009. Roughly half of the FORTS total volume comes from algorithmic systems that automatically identify trading ideas in all products available. It is worth noting that in a move to attract retail participation CME has recently launched E-micro Forex futures contracts with 1/10th standard contract size on 6 main currency pairs (however, the volumes were not significant so far).

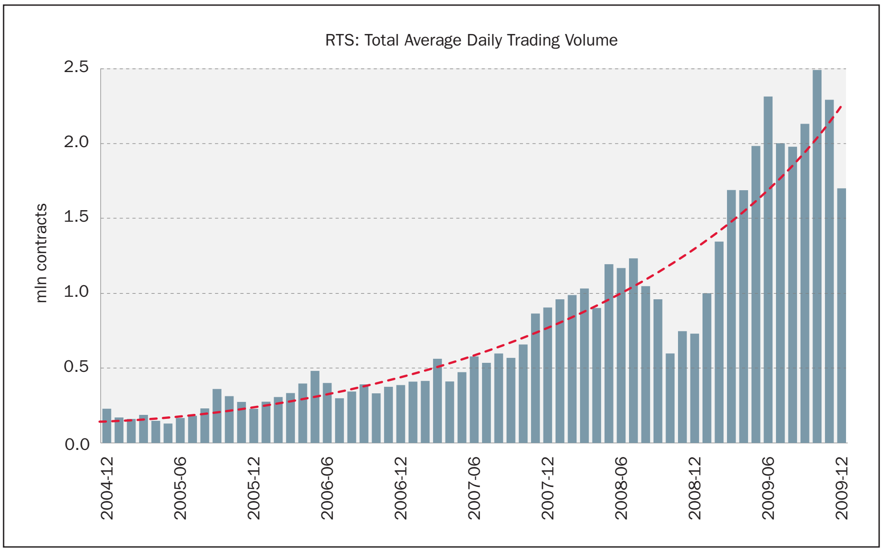
Second, FX trading at FORTS is supported by other contracts. Several commodity products as well as the flagship futures on the RTS Index, represent a kind of hybrid since they are denominated in dollars, and the variation margin is converted and paid daily in rubles according to the current dollar/ruble exchange rate. Thus these contracts contain an FX component which some market participants hedge via the dollar/ruble futures.

Last but not least: FORTS financial safeguards system. This derivatives market originated in a very volatile environment, hence the risk management methodology and procedures were designed to survive large market shocks. For example, FORTS implemented (and probably pioneered 10 years ago) total pre-trade control at each level of market participation: from clearing members and brokers to end clients.

Risk management passed the test

Since then, the risk management system has been continuously elaborated and reinforced, and a solid practical expertise in running a derivative exchange under strenuous conditions has been developed. The last crisis turned out to be a most serious test with the RTS Index plummeting from 2400 to 550 in 4 months and maximum index fluctuations exceeding ±20% during some days. The risk management system of FORTS has passed the test, and probably the best illustration to this is the dynamics of the total average trading volume at FORTS. There was a drop from October 2008 to January 2009 after which the market recovered quickly to continue the previous uptrend unlike most of the world's exchanges in 2009.

In addition to the dollar/ruble futures, FORTS is offering euro/dollar and euro/ruble futures. Both contracts were launched in February 2009 to meet the



Total average trading volume (in million contracts) at RTS exchange.

increasing interest of market participants in euro products. Out of the two, the euro/dollar future attracted more trading activity, and as a result the euro/ruble exchange rate is hedged indirectly via the dollar/ruble and the euro/dollar futures contracts.

The euro/dollar futures quickly entered the top-5 most liquid FORTS contracts. In September 2009, the Futures and Options World (FOW) magazine awarded the new FX contracts for "best innovation in product design 2009 – Eastern Europe". As FOW commented "the contracts took off like rockets", the euro/dollar futures became the 11th most traded FX contract on the world's derivatives exchanges, and the most active contract anywhere on a currency pair that does not include the exchange's home currency. The trading volume in the new contracts in 2009 amounted to over EUR 14 billion, or 32% of the total FX trading at FORTS. Given the demand for other currency pairs such as dollar/yen, dollar/pound, dollar/Swiss franc, FORTS is planning to introduce these futures contracts in the near future.

One important and long awaited innovation relates to taxation. As of 2010 changes to the articles of the Russian Tax Code that cover taxation of individual investors' securities trades and derivatives trades (futures and option contracts) came into effect clarifying the grey areas and defining taxation of currency derivatives to the benefit of retail investors.

There are indications that FORTS' FX segment follows the development pattern of its equity products segment with some time lag: initially "core" liquidity is created by retail and small and mid-size institutional investors, then one by one larger local banks and investment companies start joining the market, and finally global financial institutions take interest.

"FORTS' FX segment seems to follow the development pattern of its equity products segment, starting with retail and mid-size institutionals moving up the scale to larger local banks and finally global financial institutions."

Global perspective

Locally, the ruble is traded against other currencies in Moscow and St. Petersburg, globally in European financial centres including first of all London, and in other trading venues (New York, Tokyo, Hong Kong, Dubai). The domestic market is currently estimated at 30–50 billion dollars a day, which is more than a 50% decrease on the precrisis level, with derivatives representing only about 3%. By contrast, on the international markets the derivatives component prevails, including currency swaps, cash-settled and delivery forwards, and options. For trades that are negotiated between Moscow offices of international banks and their local counterparties the execution often takes place in London. According to some estimates the London traded volume of dollar/ruble swaps, forwards and options reaches respectively 4 billion, 2 billion and 0.5 billion dollars a day.

There are both macroeconomic and infrastructure factors that influence the role of the ruble internationally. In particular, targeting a larger global participation requires further development of ruble clearing and settlement systems, including RTGS, more active promotion of the ruble on various electronic platforms, and a safe regulatory environment.

Alexandre Balabushkin is Head of Business Development in the Derivatives Department at RTS Stock Exchange (FORTS). With a Ph.D. in Applied Mathematics, he carried out research in stochastic control from 1980 to 1993. Alexandre has over 10 years of experience with both major Russian exchanges (MICEX 1996–2000, 2004–2006, and RTS 2001–2003, and since 2009).