Currency Devaluation in Russia, Kazakhstan, Ukraine and Belarus and its Effects on Business

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Hardly a day goes by at the moment without some sort of negative news about Russia. I certainly hope this is not the case by the time the issue of Russia Briefing you are currently holding is published, however I fear that the bad news has not yet come to an end. In the meantime, it seems that this negative trend is having quite some spillover effect on Belarus and Kazakhstan. The situation in Ukraine is extreme to say the least, however this is certainly not the first time the country has had to face economic hardship.

Therefore, in this issue of Russia Briefing we will still be focusing on Russia, however we will also take a look at the other three countries mentioned. In all four countries we have seen a significant devaluation of the local currency. In Ukraine this was spread over the entire year, in Kazakhstan it occurred during the beginning of 2014 (with rumor of further devaluation of the Tenge in Q1, 2015) and the Russian ruble crashed at the end of the 2014.

Experience from previous years and crises shows that there is often another surprise during year-end closing, when the full effects of the changes in exchange rate are seen in terms of a firm’s equity. This creates the risk of statutory equity regulations not being met.

The current issue therefore focuses on the effects of the ruble devaluation, as well as what can be done to either avoid issues with local regulations or how to solve them should they arise.

The dramatic devaluations of the local currencies have certainly had quite negative impacts, particularly on Western exporters.

However, we should keep in mind that localization; setting up production locally in Russia, Ukraine, Kazakhstan and Belarus, has become cheaper and thus, in certain cases, more attractive. Those who believe in the long term prosperity of these countries may well recommend starting localization now, not only because of lower prices, but also because of the authorities being more open to such projects. And those who start this process now may well be the winners when the economy takes off again.

Kind regards,

Ulf Schneider
Managing Partner
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We support companies on matters concerning doing business in Russia, irrespective of their size and industry sector. Our team of over 500 experts advises on market entry structure, accounting and reporting, IT/ERP-connection and tax consulting in Russia.

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Reliance on Oil
Anyone doing business in Russia must be aware of the close relationship between the price of oil, the ruble and its combined effects on business and the economy. Being one of the largest exporters of oil, Russia’s budget heavily relies on oil as a source of revenue. Over the past years, as the price of oil has fluctuated, Russia has seen commensurate changes in the value of the ruble. Most notable was the great crash of 1998, followed by the financial crises of 2008 – 2009. Now, we are experiencing the financial crisis of 2014 – 2015. In all cases, the strength of the ruble closely mirrored the price of oil, with the ruble falling quickly after a fall in oil prices.

Interestingly, in July 2008, oil sold at USD147 per barrel and fell to less than USD50 by the end of the year. Again, in July 2014, oil sold at more than USD100 per barrel and was less than USD50 by the end of the year. In both cases, the ruble weakened considerably with some even questioning the stability of the financial markets.

However, by January 2009, we saw the price of oil recover, the crisis end, and the ruble resiliently rebound. Clearly, Russia is sensitive to changes in the price of oil, with many critics claiming too much reliance. But what is the relationship between oil and the ruble and why do they move in parallel?

Relationship between Oil and the Ruble
When the price of oil falls so quickly over a short period of time, it puts a tremendous strain on the economy in a number of ways. In 2008 and in 2014, after a sharp fall in oil prices, we saw an immediate weakening of the ruble.

According to Russian Finance Minister Anton Siluanov, “A one dollar decline in oil prices results in a 70 billion ruble reduction of revenue for the Russian budget. While a one ruble fall in the exchange rate leads to a growth of 180-200 billion rubles.”

By some estimates, 52-55 percent of the national budget comes from revenue on oil exports. Hence, when the price of oil falls, it has a tremendous effect on the budget. During the 2008 and 2014 crises, we often heard of the large deficit that is facing the Russian budget due to lost revenue. But on the other hand, these exports are sold in dollars and when the ruble weakens, the fixed dollar price should bring in additional ruble. However, as the price of oil decreases, so does the revenue and, in the end, Russia receives less rubles.

It’s clear to see how oil prices and the ruble are related and work together. But as the ruble falls, businesses must pay more money for imported goods – which by some estimates make up 30-40 percent of consumer goods – and this cost is passed down to the consumer in the form of higher prices, or inflation.
What businesses can do

For businesses that have been operating in Russia for many years, the recurring crises are no surprise and many businesses in Russia are keenly aware that doing business in Russia comes with some risk.

When looking at the effects on business, it is helpful to distinguish between those businesses that provide a service and those that provide goods. The latter is more sensitive to exchange rate differences because goods are often sourced from abroad, requiring more rubles to buy the same quantity as before.

For a business that imports goods and resells them within Russia, a strong, negative effect will be felt from the ruble devaluation. This is caused by the higher purchase price that the Russian entity should pay, which is recovered only with higher prices to the consumer. In such a situation, the company may have an opportunity to source the goods from within Russia as a way to reduce expenses. But often, the goods come from abroad for a specific reason, such as technological requirements, quality issues, or because they simply cannot be replaced with comparable goods in Russia.

For service-oriented businesses, such as consulting or architectural firms, the weakening ruble generally has a smaller impact because their largest expense is payroll cost and, if the majority of the employees are locals, the effects of a changing exchange rate will be minimal. Such businesses are in the best position to weather out a financial storm.

On the other hand, for a Russian business that is exporting a service or goods to another country and receiving payment in euros or dollars, the opposite effect will be felt. After converting the payment to rubles, these companies will now have more money on hand.

As the ruble weakens, there is a strong effect on import/export activities, the financial statement, and even on taxation. Commonly overlooked, is the effect the exchange rate has on foreign currency denominated accounts, such as bank accounts, debtors and creditors. In Russia, such gains and losses are taxable and when the ruble is decreasing, dollar accounts – when converted to rubles – increase in value, resulting in taxable gains.

In some cases, the taxable gains may completely overshadow a company’s loss for the period resulting in an unforeseen profit tax liability.

Looking forward

As the financial storm continues in both Russia and Ukraine, businesses must take a step back and first assess their own strategy and how they will endure the storm. For some businesses, this may mean implementing a contingency plan on how to cope with the current situation. Commonly, businesses will try to minimize its foreign currency exposure by conducting more trading within the boundaries of their own country and to minimize transactions in a foreign currency.

In these difficult times, having a good management team that is well informed about the economic events of the country and has the flexibility to react to changing events is important. For example, in crisis times, it would be prudent for the management team to delay a dividend payment until the exchange rate improves.

Despite the current situation, history shows us that business will continue uninterrupted as it has in the past and it will into the future because trade and business are at the foundation of human existence. Despite the financial crises, the overall banking and financial stability of the country remains unquestioned.
Effects on Imports and Customs

By Bettina Wisthaler, Head of Import Department
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One might think that companies which are not directly affected by the EU and US sanctions do not face any kind of problems in their daily business in Russia. However, this is not the case, as the devaluation of the ruble also influences very practical aspects of business, for example processes during customs clearance.

Currency issue in delivery agreements

In the past many Russian companies, mainly local subsidiaries of foreign manufacturers, decided to shift any kind of currency risks to the overseas headquarters by fixing the delivery agreement in Russian rubles. Over the last years, thanks to a rather stable currency exchange rate, this turned out to be a smart decision, also positively influencing the amount of customs payments due. This can be explained easily: customs payments are always calculated on the basis of the customs value, which is the value of the goods, including all kind of additional expenses, which occurred on foreign territory, i.e. before the goods reached the border of the Customs Union. If the value of goods is not set in Russian rubles but, for example, in euros or US dollars, the calculation is done according to the currency exchange rate of the day the customs declaration is registered.

Consequences for customs clearance

In the past, when a company had chosen to set their delivery agreement in Russian rubles, the importer was able to calculate beforehand the exact amount of payment due, unless, of course, the value was lower than the average of identical and similar goods and the customs value was corrected by the customs authorities. Now, the same importers are facing severe problems during customs clearance, as their ruble import prices have not changed, whereas the statistic value, which is set in US dollars per kilogram, has decreased dramatically.

An example: in the beginning of 2014 a UK company sold their goods for 1000 rubles per unit to their Russian subsidiary, reaching a statistic value of approx. USD 28.57/kg. One year later, without any changes in corporate pricing, the statistic value for the same unit is approx. USD 14.49/kg.

Even if the reason for the decrease is very simple and obvious to anyone, the so called “Risk management system” of the Russian customs authorities does not take this aspect into account. Thanks to this risk management system the value of the declared goods is compared to the one of identical and similar goods. If the declared statistic value of the above mentioned subsidiary is lower, and most of the times it is due to the currency exchange rate, the most likely consequence is the correction of the customs value. Such a correction implies that the importer is paying customs payments not according to the value he declared, but according to the value the customs authorities have set, referring to identical or similar goods.

On the other hand, contracts in euros or US dollars also currently foresee much higher customs payments, as they are being calculated according to the currency exchange rate of the day of registration of the customs declaration.

So which option should be chosen in order to avoid additional expenses and difficulties during customs clearance?
Options for the importer

Actually, there are two options: if the first company chooses to set their prices in euros or US dollars, they will bear additional expenses but avoid any kind of delays during customs clearance. This is acceptable only for those companies for whose products there apply no, or minor percentages, of customs duty, with the only minus being the temporary financing of import VAT, which may be returned afterwards.

For all other companies, option two is preferable, even if it is connected to a much higher time-effort and delays during customs clearance. When the customs authorities make the decision on the correction of the customs value, the importer has the possibility to choose a conditional correction, instead of a final one. Such a conditional release implies an immediate release of goods, under the condition that the corrected amount of payments is covered. Having provided this guarantee, the importer has approximately two months to confirm the previously declared value. If he is able to provide evidence about the real value of goods, production costs and pricing policy for the final customer, there is a very good chance of obtaining a positive decision from the customs authorities, with the guarantee being reimbursed to the importer.

Considering the current dynamic of the currency exchange rate, each importer needs to evaluate individually the customs clearance process of his products and take into account the different options. In case optimization is necessary, decisions on any kind of changes should be well coordinated with all the involved parties, especially with the customs representative and the customs authorities themselves.

Effects on Financial Statement & Tax Calculation

By Ulf Schneider, Managing Partner and Alexander Nuzhny, Finance Director
RUSSIA CONSULTING Group

Assets and loans in USD in the local balance sheet

It is quite common that the assets of or loans to a Russian subsidiary are denominated in foreign currencies such as USD.

Let us imagine an example where the Russian subsidiary of a foreign company has USD1 million in its USD bank account and there was no other economic activity. On 31/12/2013, this amount is valued on the balance sheet as RUB 33 million, but on 31/12/2014, the same amount is valued as RUB 56 million. From the point of view of the foreign parent company, which receives its reports in USD, nothing has changed here, but in accordance with the Russian legislation, the Russian subsidiary made an accounting profit of RUB 23 million before taxes, and must therefore pay profit tax of RUB 4.6 million (RUB 23 million x 20 percent). And one must not forget that in this way, the revaluation of the foreign currency assets increases the net assets of the subsidiary.

Now let us imagine the opposite example where a Russian subsidiary has received a loan of USD 1 million from its foreign parent company. In this case, as of 31/12/2013, the loan is valued on the balance sheet as RUB 33 million, but on 31/12/2014, the same amount is valued as RUB 56 million. According to the Russian accounting and taxation standards, the subsidiary has to post a loss of RUB 23 million here, and the deferred tax asset from this loss equals RUB 4.6 million. It is important to note that the net assets of the Russian subsidiary will decrease by RUB 18.4 million (RUB 23 million - RUB 4.6 million). A similar situation can be found in Belarus, Kazakhstan, and the Ukraine.
VAT issues with payments in USD

Now let us consider the impact of the changes in USD exchange rate when performing a long-term project in Russia. Let’s say a Russian subsidiary signed a respective contract with its foreign parent company worth USD1 million, including VAT. This often happens when a local company wins a local tender and the main contractor is a foreign parent company.

On 31/12/2013, the prepayment received under this contract was equal to USD1 million, including VAT. On the date of the prepayment, it is necessary to charge VAT on the prepayment in the amount of RUB 5 million (33 million / 118% x 18%) and to include this VAT in the VAT return for the 4th quarter of 2013 on 20/01/2014 with a respective tax payment into the state budget.

On 31/12/2014, the contract parties signed the act of acceptance for the performed works. On this date the VAT has been recalculated and now equals RUB 8.5 million (RUB 56 million / 118% x 18%). On 25/01/2015, the VAT was submitted to the tax authorities with an additional VAT payment of RUB 3.5 million.

Delivery contract in USD between local and foreign companies

Many of the subsidiaries involved in the import of goods and equipment to Russia extensively use payment by instalments for their delivery contracts. The next example demonstrates the impact of the ruble devaluation on the financial reporting of a Russian subsidiary.

A Russian company signs a contract with a foreign company that supplies equipment worth USD1 million. The delivery is carried out on 31/12/2013, so that the assets in the balance sheet rise by RUB 33 million and the liabilities for accounts payable rise by USD1 million, which is, at this moment in time, also equal to RUB 33 million. In the course of the year 2014, the delivered equipment has not been paid for, so that on 31/12/2014, when the exchange rate for USD1 has risen up to RUB 56, the liabilities for accounts payable become subject to revaluation and subsequently rise by RUB 23 million to RUB 56 million.

The revaluation margin of USD23 million is posted in the profit and loss statement as an operating expense, thus reducing the profit tax. At the same time, the value of the delivered equipment in the assets of the balance sheet does not change.

In this example one can see how the devaluation of the ruble has a negative impact on the financial reporting of Russian subsidiaries that have outstanding payments for supply contracts or, which is also very common, loans in a foreign currency.
### Date | USD Exchange Rate | Transaction | Transaction Sum (million RUB)
--- | --- | --- | ---
31/12/2013 | 33 | Full prepayment received | 33
 |  | Charged VAT from prepayment | 5
20/01/2014 |  | VAT return for the 4th quarter 2013 | 5
31/12/2014 | 56 | Act of acceptance signed in USD | 
 |  | VAT recalculated on the date of signing of the act of acceptance | 8.5
 |  | Revenue for income accrued tax (= 33 - 8.5) | 24.5*
25/01/2015 |  | VAT return with additional tax payment (= 8.5 - 5.0) | 3.5

*Alternative opinion: USD 847,000 x 33 RUB / USD = RUB 28 million.

### Contract parties | Value of the asset in the balance sheet on 31/12/2013 | Exchange rate differences in the period from 31/12/2013 to 31/12/2014
--- | --- | ---
Foreign LLC and OOO (documents and payments in USD) | RUB 33 million | RUB 23 million | RUB 23 million

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**Effects on Financing a Company**

By Tatiana Stepanenko, Head of Tax Department
RUSSIA CONSULTING

During the last three months companies doing business in Russia have faced a dramatic devaluation of the ruble. At the beginning of November the official exchange rate of the Central Bank was set at 53 rubles to the euro. However, currently the exchange rate exceeds 75 rubles to the euro (February 2015). The exchange rate for USD has been showing a similar trend. The devaluation of the ruble is having a negative influence on the financial position of Russian companies, especially for those which have currency liabilities against their foreign affiliates under delivery, loan and other agreements. Significant losses incurred due to the changes in exchange rates are reflected in the financial statements and in tax accounting. As a consequence, many companies show negative net assets on the balance sheet.

In accordance with paragraph 4 article 30 of the Federal Law “On Limited Liabilities Companies” Nr. 14-FZ, if the net assets of a company does not exceed the amount of its charter capital at the end of the financial year following the second financial or each subsequent financial year, the company must take the decision to either decrease its charter capital until the amount of its net assets, or to liquidate the company within six months of the end of the respective financial year. Similar requirements are outlined in the legislation regarding joint stock companies. In practice, the tax authorities sometimes try to enforce the liquidation of companies under such circumstances. Generally, the courts support taxpayers and decline such applications. However, most companies prefer to improve the situation in order to avoid potential disputes. Please note that undercapitalization of the company leads to obligatory application for “thin capitalization” rule if the company has outstanding loans received or granted by affiliates. As a consequence, a part or full amount of interest cannot be deducted as expenses for profit tax purposes and interest paid is qualified as dividend payment resulting in withholding tax.
There are many available options which allow Russian companies to improve the situation with the net assets or somehow eliminate the influence of losses incurred in connection with currency rate fluctuations.

**Improvement of the situation with net assets**

**Increase of the charter capital**

Shareholders might take the decision to increase the charter capital in order to improve the situation with the net assets and make a cash injection. However, the increase of charter capital also increases the amount of net assets as required by legislation as the amount of net assets shall at least reach the amount of the registered charter capital. In an economically volatile environment it might be difficult to meet such requirements in future periods. As a consequence, a decrease of the charter capital might be required. Therefore, the implementation of such an option makes sense only if the company is confident of its future financial position.

**Contribution to property**

Contribution to property as a rule may be performed in the form of a cash injection or transfer of assets. Such an option is available to LLC’s only (article 27 of the Federal Law Nr. 14-FZ). In accordance with Russian Accounting Standards (RAS) the contribution to property would be reflected in financial statements as equity (line additional capital of the balance sheet). Please note that contribution to property may be exempted from Russian profit tax if such an injection is made for the purposes of increasing net assets. From a legal point of view, a decision from shareholders on contribution is required. From a tax perspective it is important to indicate in the shareholder’s decision that the purpose of the contribution is to improve the situation surrounding net assets.

Please be aware that for many years the official authorities have been discussing the abolishment of profit tax exemption of such contributions. However, such a possibility still exists. The disadvantage of this option is that money contributed in such a way may not be returned back to shareholders, apart from in the case of liquidation.

**Debt forgiveness**

In difficult economic situation many Russian companies are not able to pay back loans granted by affiliated foreign entities as well as outstanding liabilities under concluded services and delivery agreements.

Therefore, in practice the question of debt forgiveness is raised more often.

**Loan forgiveness**

Generally, debt forgiveness generates taxable income of the loan recipient. However, exemption from profit tax might be granted if the forgiveness of the debt is performed by a shareholder for the improvement of the situation surrounding net assets, or if the shareholder holds more than 50 percent of shares in its Russian subsidiary.

Please be informed that the tax authorities insist that in both cases the interest accrued under the respective loan agreements is subject to Russian profit tax.

**Forgiveness of debt under delivery agreements**

Forgiveness of outstanding liabilities under delivery or service agreement is generally treated by the Russian tax authorities as giving goods or rendering services on a free of charge basis.

Please note that starting January 1, 2015 adjustments to the Tax Code which allow the deduction of market value of property received on a free of charge basis by further sale were introduced. However, such a possibility is granted solely in the case that the recipient has paid profit tax on the market value of the property in the period of its receipt.

Before the introduction of such provisions, the recipient of the property, in the case of debt forgiveness, was obliged to increase the profit tax base by the expenses incurred in regard to the
acquisition of goods and could not deduct these expenses when further reselling such goods.

**Elimination of exchange rate deviations**

Taking into account the current economic situation and weakness of the ruble, many companies with currency liabilities incur exchange rate losses, which lead to undercapitalization. Forgiveness of liabilities in foreign currencies allows avoidance of the losses incurred from exchange rate deviations. However, in many cases suppliers do not intend to fully release the subsidiary from its liabilities under delivery or service agreements.

In such a situation the parties may agree on novation of obligations in the foreign currency into rubles, and fix the liabilities at the existing rate stipulated on the current date. This option means that all risks connected with currency exchange rate fluctuations will be carried by suppliers.

The other way to eliminate losses from purchases in a foreign currency is to conclude agreements with domestic customers in so called 'conversional units', when the price agreed by the parties is calculated based on the amount stipulated in euros, however, the payment should be made at the exchange rate existing on the date of payment.

Such a measure might help to improve the financial position of the company, however its practical implementation might be complicated because of limited demand on goods and abilities of customers to pay back debts.

**“Thin capitalization” rule**

The other side of problems caused by the undercapitalization of the company is the obligation to apply the thin capitalization rule in regard to outstanding loan liabilities.

In accordance with the current version of paragraph 2 article 269 of the Russian Tax Code where a taxpayer, a Russian organization, has outstanding liabilities under a debt (loan) obligation:

- to a foreign organization which directly or indirectly holds more than 20 percent of shares of the Russian organization; or
- the obligation is warranted by a foreign organization mentioned in point 1 or a Russian affiliated organization; and the obligation exceeds more than three times the value of the net assets of the Russian organization (12.5 times for leasing companies) on the last date of the respective tax period the thin capitalization rule shall be applied.

Generally, this means that:

- interests may not be fully deducted for profit tax purposes
- interests shall be reclassified as dividends for withholding tax purposes

The dramatic ruble devaluation leads to an increase of liabilities (in particular, loan liabilities if the loan is granted in foreign currencies), and a growing number of companies are reaching the threshold of three (12.5) times value of net assets.

Taking into account this fact, the Ministry of Finance has suggested to fix the official exchange currency rate at the level existing on July 1, 2014 for the purposes of application of the thin capitalization rule. If this proposal becomes effective it will have a very positive impact on business, as it would help to prevent an artificial increase of liabilities falling under the capitalization rule.

Despite the fact that many Russian companies (primarily distributors of imported goods) suffer from the devaluation of the ruble there are several which benefited. The companies which invested in domestic production are not influenced so much by the negative impact of currency devaluation, and might receive competitive advantages in the difficult economic situation caused by a permanent decrease of oil prices and sanctions introduced against the Russian Federation. The companies which export goods as well have got benefits from the development of ruble.
The devaluation of the Belarusian ruble at the end of 2014 has led to a situation where almost all economic counterparties of the country, including both importers and exporters, have found themselves in a new business environment. Negative developments in the foreign exchange market, and their socio-economic consequences, have led to drastic personnel decisions at the highest political level of the country, namely, a complete change in the government and the National Bank. In 2015 the new composition of the National Bank and the government was assigned to contain the negative effects of the developments in the currency market and the economy as a whole.

Monetary control

One of the main planned solutions looked at increasing the trust of the players of the currency market, i.e. population and business, in the national currency. As of mid-February 2015 it became clear that the actions of the “monetary control” actually reduce the use of foreign currency in settlements in the territory of the Republic of Belarus, and the increase of the circulation of the Belarusian Ruble.

The regulations, which were published by the National Bank in the February, actually introduced a ban on businesses receiving foreign currency from people, leaving this role exclusively to banks. On the one hand, this measure will increase the reception of foreign currency by banks, and thus replenish foreign exchange reserves. On the other hand, representatives of tourist or insurance businesses, as well as roadside services, can further go into the shadows, taking foreign currency from clients illegally. This will, in turn, reduce tax revenues. As is usual in such cases, only time will tell whether or not these administrative decisions will be effective.

Given the fact that the Republic of Belarus is a transit country and the routes of major logistics players in the field of international transport go through its territory, the prohibition of the National Bank to pay for fuel at Belarusian gas stations in foreign currencies could force these companies to restructure their transport logistics to go through neighboring countries.

Price suppression

Another trend of administrative decisions taken by the government is the artificial suppression of prices in the domestic market. First and foremost it concerns the decisions of the Ministry of Trade and the Ministry of Architecture and Construction that are made when they find participants of trade responsible of non-compliance with the limits on purchasing prices of construction materials and imported goods. Traditionally, this mainly lead to freezing volumes of consumer imports. In fact, the government also pursued this goal of import substitution during the previous currency crisis in 2011, however this is the first time a moratorium on the rise in prices has been applied.

It is also worth noting that the devaluation of 2014-2015 differs from the previous one due to its close relationship with the currency devaluations in the countries inside the common customs area, namely in Russia and Kazakhstan. Since Russia is Belarus’s main export partner, negative developments in the foreign exchange market in Russia may lead to a decrease in turnover of the total replacement value and an increase in re-export.
transactions. In this regard, the Government of the Republic of Belarus was instructed to carry out trade with the countries of the Customs Union in currencies other than Belarusian ruble, namely the euro and the dollar. However, the other countries of the Customs Union did not support this initiative.

Among announced plans of action for 2015 is also governmental support for a number of companies producing products for export. Thus, the main task of the Belarusian Government is the diversification of export markets and the search for internal reserves to increase competitiveness of their products on the foreign market.

The Kazakhstani currency, the Tenge (KZT), was introduced in 1993 and replaced the Ruble that was still present from the Soviet economic system. Since its introduction, the Tenge has been through four abrupt and significant phases of devaluation; in 1994, 1999, 2009 and 2014. The latest devaluation took place in February 2014 when the Tenge lost 19% of its value in comparison with the US Dollar. As the Kazakhstani Tenge’s exchange rate is regulated by Kazakhstan’s National Bank and managed in accordance with a pre-defined exchange rate corridor to the US Dollar, it cannot be used as a real economic indicator, and heavily depends on the country’s economic strategy.

A lack of information due to the managed exchange rate, together with the difficult history of the Tenge, has, in recent months, caused much uncertainty for both investors and the Kazakhstani population. Rumors began to spread that the Kazakhstani community expected a devaluation to occur on February 11th, but nothing happened, as it is often the case with rumors.

In order to better understand the driving forces behind Kazakhstan’s economy and its currency, and to understand whether or not there will be another significant devaluation of the Kazakhstani Tenge in the near future, it is necessary to take a look at the following factors:

**Strategy of the National Bank**

In September 2013 the National Bank of Kazakhstan changed its strategy and pegged the Tenge to a basket of currencies containing the US Dollar, the Euro and the Russian Ruble. The basket was weighted 70/20/10 and was rather stable until February 2014, which is why the strength of the devaluation surprised most experts.

**Economic Environment in February 2014**

The economic environment that surrounded last year’s devaluation was strongly influenced by the worsening outlook of commodity exporting countries, and caused several devaluations in the region. As a result, the Tenge appreciated around 12 percent against the Russian Ruble since the beginning of 2013, with the bulk of this appreciation occurring in January 2014. Nevertheless, it should be noted that the Tenge was still less valuable in comparison to the exchange rate fixed in 2009.
Export statistics

Exports make up around 40 percent of the country’s GDP, consisting by more than 70 percent of commodities traded in foreign currencies. Taking into account the fact that Kazakhstan’s main export partner, China, did not do too well in 2013, as well as a stagnation of exports between 2011-13, the devaluation strongly helped in terms of Kazakhstan’s export competitiveness.

Import statistics

Fueled by Kazakhstan’s stable exchange rate, imports increased about 30 percent in the period 2011-13, while exports stagnated, questioning the country’s financial prosperity. Aided by the weakening ruble, Kazakhstan, at the beginning of 2014, saw an increase in imports from its main supplier. As a result of the devaluation, Kazakhstani imports decreased strongly and settled at the same level as was seen in 2011. As the latest National Bank statistics have revealed, imports from Russia shrank, up until November 2014, by even more than imports from Kazakhstan’s other trade partners.

Currency reserves

One may take the strong increase in import volumes up until the beginning of 2014, along with the stagnation in exports, as a sign of the Tenge being under pressure, but Kazakhstan’s stable currency reserves negate these assumptions.

Political dimension

When considering the meaningful cuts that Kazakhstani people and business had to take in 2014, it is understandable that the Government is trying to avoid another strong currency devaluation. Government officials stated that, as long as an average oil price of USD 75 can be achieved over the next 3 years, there is no reason why there should be another devaluation. Furthermore, officials stated that in case of a sustained low ruble exchange rate, it might be necessary to allow the Tenge to float freely earlier than expected.

Despite the ruble and oil price crisis, Kazakhstan is still aiming to achieve GDP growth of at least 1.5 percent, and so it seems likely that the Government will try to find solutions other than a sharp devaluation to deal with the challenges of 2015. Apparently the National Bank’s current approach is less pro-active, in comparison to February 2014, where the strong devaluation was performed in order to ensure the sustainability of the country’s competitiveness.

To summarize the above, there are real challenges for Kazakhstan in terms of hitting long term targets, caused by the sharp fall of the Russian ruble in late 2014 and low commodity prices. While analysts of Denmark’s largest bank, Danske Bank, expect a devaluation of the Tenge of up to 35 percent in H1 2015, it should be taken into account that the country’s stable budget and the slide recovery of oil prices may encourage the decision makers to avoid another devaluation in the next few months in order to ensure a stable economic environment.
For the majority of CIS countries the last few months have been characterized by dramatic currency devaluation, increases in the inflation rate and an uncertain economic outlook. And nowhere is ‘uncertain’ such a fitting way of describing the current social, political and economic situation than in Ukraine.

In December 2014, the annual CPI inflation rate reached 24 percent and the core inflation rate 22.8 percent. The main reason is the sharp devaluation of the hryvnia, which has come about amidst the reality of military conflict, geopolitical uncertainty and mass capital flight. And it certainly did not come as a surprise; in January 2015, the hryvnia was traded 10-20 percent higher than the official exchange rate provided by the National Bank of Ukraine (NBU), indicating strong depreciation expectations within the market.

So how has the NBU reacted? In short, the NBU has modified the operational framework for monetary policy implementation in an effort to increase monetary policy efficiency and transparency for market players. This consists mainly of two measures:

- Making the discount rate more instrumental as the benchmark monetary policy rate, and setting interest rates on liquidity adjustment instruments in line with the discount rate.
- Eliminating foreign exchange auctions (effective from February 5, 2015) and setting the indicative hryvnia exchange rate.

The goal is to tighten the NBU’s monetary position in order to reduce uncertainty within the market, enhance the effectiveness of the price setting mechanism for lending resources and foreign exchange available on the interbank market and to make NBU monetary instruments more effective.

Accordingly, the NBU decided to raise the discount rate from 14 percent to 19.5 percent per year (effective from February 6, 2015) and to adjust interest rates on the NBU’s liquidity related operations in an attempt to contain the ever threatening inflation risks.

These measures are part of a new government and NBU contingency programme, supported by the IMF, targeted at containing inflation rates as early as the first half of 2015. The NBU aims to achieve inflation rates of below 10 percent in 2016, a tall order when considering the current turmoil as well as forecasts of CPI inflation of 17.2 percent at the end of 2015. It is thought that negative impacts of higher interest rates on the stability of the banking system are relatively insignificant in comparison with the risk of further currency devaluation. Additionally, business activity should be relatively unaffected by the increase in interest rates as there are low levels of bank lending due to the strong risks in the business environment.

Whatever the case, it is clear that no economic forecasts can be made with any degree of certainty until the military conflict has calmed down, however the NBU is hopeful that it can achieve stable inflation rates by 2016, along with increased transparency for market players.
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