

A Russian Sudden Stop Still a Major Risk

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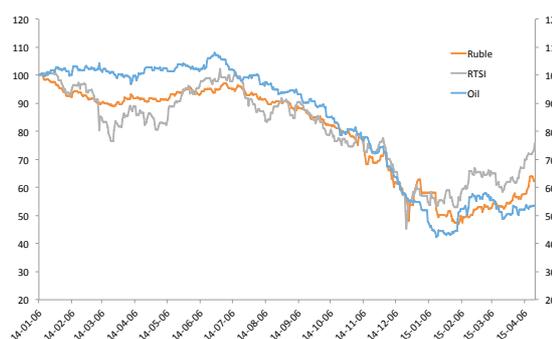
The Russian economy is facing serious challenges in 2015 even after the currency and stock market have strengthened on the back of (expectations of even) higher oil prices. Policy makers that ignore these challenges may be in for a rude awakening when more statistics on the real economy are now coming in. It is time that actions are taken to deal with Russia's structural problems, mend ties with its neighbors that are also important economic partners, and refocus political priorities towards generating growth and prosperity for its population. In the long run, this is what creates the respect and admiration a great nation deserves.

Recent developments

The value of Russian assets, including shares and the currency, was more or less in free fall in the second half of 2014 and into the beginning of 2015. The annexation of Crimea and continued fighting in Eastern Ukraine and the associated sanctions contributed to a general loss of confidence in Russian assets, but the fall in international oil prices was an even more decisive factor (for a detailed account of the sanctions, see PISM (2015)).

Figure 1 shows how the stock market first took a big hit at the time of the invasion of Crimea, but then recovered before the massive downturn in mid-2014 as oil prices collapsed. The ruble followed a similar path, but with less volatility than the stock market, which is not too surprising given that the Central Bank of Russia (CBR) intervenes to stabilize the currency. However, the ruble had a short time of extreme volatility in mid to end-December when the uncertainty about the impact of financial sanctions was very high.

Figure 1. Oil price, Ruble and Stocks



Sources: CBR, US EIA, MICEX

Financial sanctions were particularly troubling since Russian companies, both private and state owned, have significant external debt that became increasingly hard to refinance. The magnitude of this external debt is also such that it is not a trivial matter for the government or central bank to handle despite the fact that public external debt is very low and international reserves are among the largest in the world. As a matter of fact, external debt was around \$250 billion more than the value of CBR's international reserves at the peak, but the difference has come down somewhat to around \$200 billion as external

loans had to be paid back when new external funding was not available at attractive terms.

Sudden Stops

Before turning to the outlook for the Russian economy, a short discussion of sudden stops is warranted. “Sudden stops” is short for sudden stops or sharp reversals in international capital flows. Sudden stops and its effects on the real economy have been analyzed for some time now (see Calvo (1998) for an early contribution). Becker and Mauro (2006) concluded that sudden stops have been the most costly type of shock for emerging market countries in terms of lost GDP in modern history. In their study the average country that experienced a sudden stop had a cumulative loss of income of over 60 percent of its initial GDP before recovering back to its pre-crisis income level.

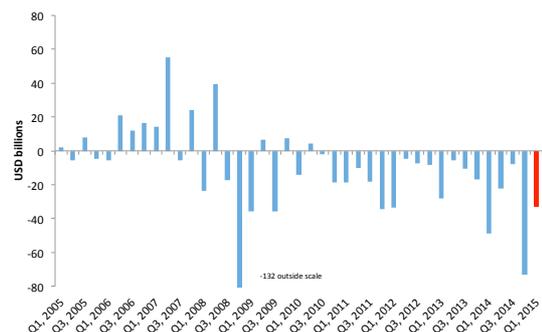
Sudden stops in capital flows have such large effects on the real economy because of the adverse effects reduced external funding has on imports. A first look at the accounting identity for GDP ($GDP=Y=C+I+G+X-M$) makes it hard to see how reduced imports can be a problem since imports (M) enter with a negative sign. This in itself suggests that reduced imports should increase GDP. However, imports are used for domestic consumption (C) or investment (I), two factors that enter the same identity with positive signs, which means that when they fall so does GDP. If this were the full story, the net effect on GDP from falling imports would be zero since the positive direct effect from imports would be exactly offset by reduced domestic consumption and investment.

Unfortunately the accounting identity does not make clear the dynamics that follow from this reduction in consumption and investment. For example, the foreign car (or machine) that is no longer imported and will not be sold, will also not require a domestic sales person, annual service, a parking space etc., so the eventual decline in consumption (or

investment) will be much larger than the first round effect that is captured by a static accounting relationship. This is one reason why “improvements” in the trade balance stemming from the sudden decrease in imports is not necessarily a good thing for the economy.

Russia is also part of the international financial system with important capital flows both in and out of the country. As such, it is also subject to the risk that changes in sentiment and large capital outflows can affect imports and the real economy. For a time before the global financial crisis, net capital flows to Russia tended to be positive. However, this changed in 2009 and since then most quarters have been showing outflows.

Figure 2. Private Sector Capital Outflows Continue (Q1 2015 in red)



Source: CBR

The speed of outflows picked up dramatically in 2014, reaching more than \$150 billion for the year. The general picture of outflows has continued in the first quarter of 2015, with outflows of around \$35 billion (which for comparison is twice the \$17.5 billion IMF package that was agreed for Ukraine in March 2015). Although Russia still has resources to support a high level of imports, the more capital that leaves, the less money there is to spend and invest in the country.

The Outlook

Everyone knows that Russia generates most of its export revenues from natural resources in

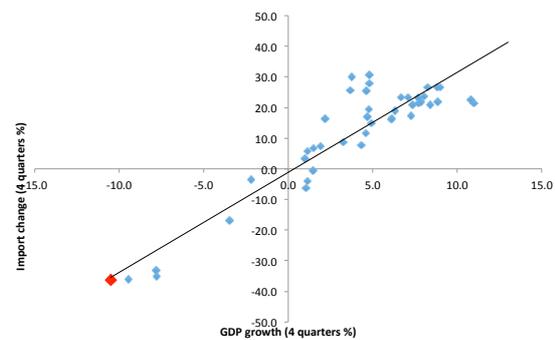
general and from oil more specifically. The fact that the health of the economy is closely related to international oil prices is no secret either and Figure 1 showed the tandem cycle of oil prices, the ruble and the stock market. But how important is oil prices as a determinant of GDP growth? This is of course a big question that requires sophisticated thinking and modeling to figure out at a more structural level. But if we are just looking for a back of the envelope estimate, a simple regression of growth of oil is potentially interesting. Perhaps somewhat surprisingly, oil price growth has very high explanatory power: regressing annual changes in GDP per capita in real dollar terms on annual changes in real oil prices (and a constant) for the period 1998 to 2014 generates an R^2 of 0.64! Not bad for a one variable macro “model” of the Russian economy. The coefficient on real changes in oil prices is estimated to be 0.15 and hugely significant and the intercept, which could be interpreted as the underlying growth rate in this “model”, of 2.4%.

Using the same IMF data on the real oil price for the first three months of 2015 and comparing that to the average oil price for the full year 2014 implies a drop in the real oil price of 46 percent. Using this oil data as the forecast for all of 2015 and plugging this into the estimated equation suggests that the oil price drop in itself would be associated with a decline in income of almost 7 percent. Adding back the underlying growth rate of just over 2 percent still means a negative growth rate of almost 5 percent in 2015, without even starting to think about sanctions, capital flows or structural problems.

However, there is more data that points in the directions of the economic troubles that lay ahead in 2015, which is trade data. We just discussed the importance of sudden stops and associated drops in imports in explaining large drops in output in emerging markets. Figure 2 already showed the continued capital outflows, and Figure 3 provides a scatter plot of changes

in imports and GDP growth. Over the years, Russia has displayed a strong positive correlation between import growth and GDP growth that is in line with the description of sudden stop dynamics.

Figure 3. Imports and GDP Growth (Q1 2015 in red)



Source: Author's calculations based on CBR and the Federal State Statistics Service (GKS) data

Figure 3 shows the import change in Q1 2015 (i.e., Q1 in 2015 compared to Q1 2014) as a red diamond and puts it on the linear regression line of past observations to get the implied GDP growth number for Q1 2015. First of all, the 36 percent drop in imports is at an all time high for the decade and at roughly the same level as in the worst quarter of 2009 in the global financial crisis. The implied drop in GDP is 10.5 percent (compared with a drop of 9.5 in the worst quarter of 2009). Again, this is not a formal model to generate GDP forecasts, but it is certainly a signal that suggests that the Russian economy has problems to deal with.

Concluding Remarks

The IMF (2015) just released its latest forecast for Russia together with the other countries of the world. The projection for 2015 is a decline of real GDP of 3.8 percent, which is not a great growth number by any means but less negative than what was discussed at the end of 2014. The Economist (2015) in its latest issue is also quoting a banker who says that the

situation is not as bad as was previously imagined. The upward revisions have also led to statements among policy makers that seem to suggest that the problems for the Russian economy are behind the country.

Although the free fall associated with the sharp drop in oil prices is halted, recent data on capital flows and imports suggest that the problems for the Russian economy are far from over. If oil prices stay at current levels, capital outflows continue, and imports remain as suppressed as they were in the first quarter, the fall in GDP may be in the same order as in 2009. At that time GDP declined by 8 percentage points, or more than twice the recent forecasts for 2015.

Russian policy makers need to make serious structural reforms and mend ties with its important economic partners near and far to put the country on a more healthy growth trajectory. Simply praying for increasing oil prices is not enough; it is time that Russia becomes the master of its own economic faith.

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