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Russia Economic Update - Brace for the Covid-19 Impact!

Russia's oil dependence will once again contribute to an economic downturn that most certainly will follow the Covid-19 outbreak in Russia as in other countries. The decline in oil prices alone could lead to a drop in GDP of more than 8 percent. On the positive side, Russia manages its macro economy well. However, its fiscal reserves are not unlimited and the recent massive fall in oil prices has not been matched by a similar decline in the ruble exchange rate which means potential extra problems for the budget. Furthermore, monetary policy will have less of a role to play in dealing with this type of crisis. This means that Russia like other countries will face difficult trade-offs in dealing with the crisis at a time when some of the previously announced economic policy changes have not been well received by the public.

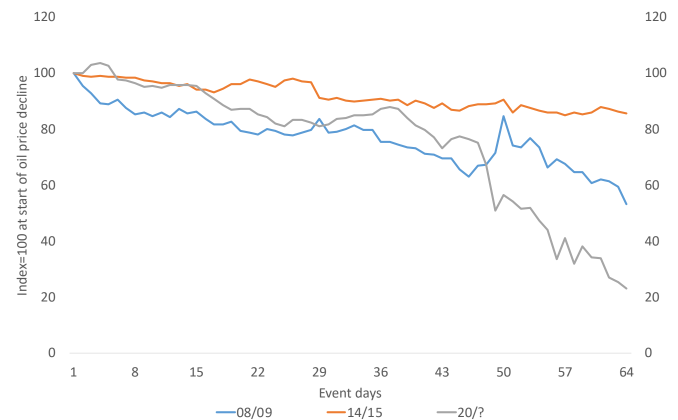
Introduction

The corona virus crisis will destroy both lives and economies as it spreads across the globe. Fortunately, the corona virus death toll in Russia so far is relatively modest compared to many other countries, but the economy is most certainly heading for very difficult times. This is (again) due to the fact that the Russian economy is too dependent on the developments of international oil prices (see e.g. Becker, 2016a,b). In recent years, Russia had to deal with two severe declines in oil prices that hit its economy, first in connection with the global financial crises 2008/09, and second, in 2014/15, when there was a fall in oil prices simultaneously with Russia being hit by international sanctions after the illegal annexation of Crimea. Although these episodes were very costly for the Russian economy, they also provided important lessons for policy makers on fiscal, monetary and exchange rate policies that come in handy today. They also contributed with data on the relationship between large movements in oil prices and the effects they had on GDP growth in Russia. This is useful at this stage to assess what can happen with the economy after the significant decline in oil prices that has followed in the course of the corona outbreak.

Dramatic Decline in Oil Prices

We still do not know when this crisis will be over, but when it comes to the fall in international oil prices the start has been far more severe than the two crises referred to above. Since the beginning of 2020, oil prices have fallen from around $60/barrel to around $15/barrel or as Figure 1 shows, a barrel is now worth around 25 percent of what it was worth three months ago. Furthermore, prices are rather volatile and will continue to be so and there will most certainly also be periods of sharp increases in oil prices going forward - but the overall result for the year compared to the previous year is most likely a very sharp fall in prices. This decline in oil prices has so far been much more dramatic than the two previous crisis episodes the Russian economy has experienced under Putin as president or prime minister.

Figure 1. Oil price developments in recent crises

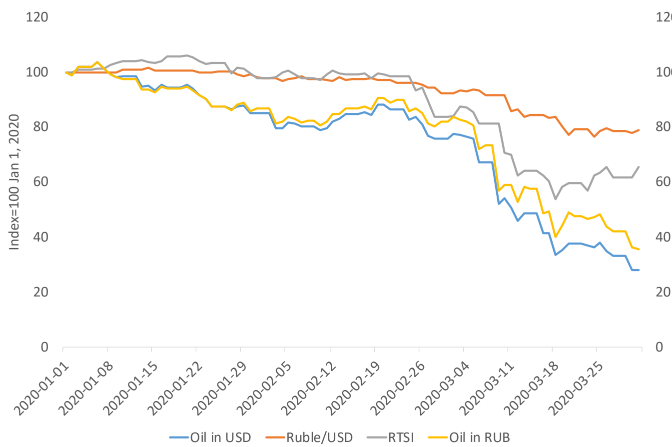


Note: This graph is based on the European Brent spot price FOB published by the U.S. Energy Information Administration and the axis shows trading days, so that the graph covers the period from January 1 to March 30. Different qualities of oil of course have different prices, but the patterns shown here are similar for other oil prices as well.

Exchange Rate and Stock Market

As in previous crises, the Russian stock market and exchange rate are following the evolution of oil prices. However, neither the stock market, nor the exchange rate has fallen as rapidly as oil prices. This can be due to many factors, but one likely explanation is that investors think that the decline in oil prices will not last for as long as it has in past crises. Whether this assumption is correct remains to be seen of course, but if oil prices stay low for an extended period, we can expect to see further declines in both the exchange rate and stock market.

Figure 2. Oil prices, exchange rate and stock market



Sources: Oil prices as in Figure 1, exchange rate from Central Bank of Russia, RTS index from Moscow Stock Exchange.

The fact that the exchange rate this time has "only" depreciated by 20 percent when oil prices have fallen by 70-80 percent means that the oil price measured in rubles has fallen much more dramatically in this crisis compared to the previous ones. In the 2008/09 global financial crisis, the oil price in ruble terms was in the end unchanged compared to the start of the crisis. In 2014/15 this was not the case, but the decline in the ruble oil price was a more modest 25 percent compared to the 60 percent drop right now. This has serious implications for the government's budget which is ruble-based and highly dependent on oil revenues.

Economic Policy

The Russian government now has plenty of experience in dealing with crises. The first lesson after the crisis at the end of the 90s was to have enough fiscal resources to deal with a crisis without having to go to the IMF again. The second lesson came in the global financial crisis when the fixed exchange rate had to be abandoned to avoid depleting the central bank's international reserves. A prudent fiscal policy backed by the National Wealth fund and a flexible exchange rate is still the backbone of the macroeconomic policies that can help mitigate the impact of lower oil prices.

The central bank is pursing inflation targeting and uses a 4 percent inflation rate as the target that guides its policy decisions. The main tool is setting the key interest rate at a rate that will achieve the inflation target. The key interest rate is currently 6 percent, significantly down from the high of 17 percent in January 2015. The central bank states clearly in its monetary policy documents that "Monetary policy lays the groundwork for economic development; however, it cannot be a source of a sustainable rise in economic potential" (see page 6 in Central Bank of Russia, 2020). This implies that the central bank will only lower the key interest rate if inflation falls, not to support growth or try to achieve other, potentially conflicting goals. This is good news for macroeconomic stability but may become an issue of political tension if there is a serious downturn in the economy while inflation remains higher than the target rate.

In mid-2019, the National Wealth fund was doubled and went from $60 billion to just over $120 billion (Ministry of Finance, 2020). This was done as a one-off transfer of surplus funds from the government's budget. However, at its peak in the global financial crisis, the combined reserve fund and wealth fund that existed then had assets of over $220 billion but by the start of 2011, the assets were down to $111 billion. In other words, a year and a half into that crisis episode, the government had used an amount from the funds that roughly corresponds to the total amount available in the National Wealth fund today. The fiscal space is therefore less impressive than it may look at a first glace and just burning through the cash in the National Wealth fund is not a

sustainable fiscal policy if this crisis continues a few more months.

Instead, the government will have to plan other measures as soon as the most immediate spending to deal with the crisis is done. This will entail difficult trade-offs since the health system will need increased resources at the same time as households and companies will need support to mitigate the impact from lost jobs and closed businesses in the wake of corona-induced shut-downs rather than the decline in oil prices, so adding to the pressure coming from declining oil prices. Increasing taxes in a time of already depressed purchasing power and profits is also not an appealing option and although there are still tax increases in the pipeline, the government has announced that these will not come in effect this year. Like in many other countries, the Russian government is proposing several measures to support the economy that will be discussed in more detail in a forthcoming FREE policy brief. However, these measures will add to the costs of the government at a time of falling revenues. From an economic perspective, reallocating resources from the military and security sectors to other parts of the economy seems like an obvious choice under these circumstances, but most likely not the outcome of this process given the government's geopolitical and domestic power ambitions. Again, the fiscal reserves will allow postponing these harder decisions, but if the crisis goes on for some time, alternative measures such as borrowing domestically or internationally will most certainly be discussed also in Russia. However, many governments will be in need of borrowing on international markets going forward and the rates required to access this type of funding may not be very attractive and still force domestic budget reallocations.

Growth Impact of the Oil Price Fall

It is of course too early in the crisis to make very precise forecasts on how the economy will fare in 2020. This will in the end crucially depend on how the Covid-19 pandemic develops and on government responses to the crisis not only in Russia but also in the rest of the world. A partial analysis of the impact of falling oil prices can however be done with the models presented in Becker (2016a) which link changes in oil prices to growth. This paper shows a few alternative specifications that differ in the GDP measure being in dollars or real rubles, and in some other dimensions. All specifications are highly statistically significant and able to explain between 60 and 90 percent of variations in GDP growth in the period 2000-2015. Focusing on the relationship between the percentage change in oil prices and growth in real ruble GDP, the estimated coefficient is 0.14. This implies that for every 10-percentage point drop of oil prices, GDP growth goes down by 1.4 percent. Currently, oil prices have declined by 75 percent since the beginning of the year. However, the model estimates are based on comparing how average oil prices change between years so this is the numbers we need to compute and compare. The average price of Brent oil (which is used in this model) was $64/barrel in 2019 but we obviously do not know what the average oil price will be this year. We therefore need to first "forecast" oil prices for the rest of the year before we can compute the impact on growth. If we make the simple assumption that oil prices stay at the current level and take into account that they were significantly higher the first couple of months this year, the average price would end up being $25/barrel. That would amount to a 60 percent decline in average oil prices between 2019 and 2020. The partial effect of this oil price decline would therefore make Russian real GDP drop by

8.5 percent in 2020. Again, this is the partial effect based on the estimated coefficient in a linear relationship between oil price changes and real GDP growth. In plainer English, we are not looking at the first order effect of closing stores etc. to avoid the virus from spreading but only the additional effect that we think will come from falling oil prices. In addition, the effect this massive decline in oil prices is assumed to have on GDP is derived by a coefficient that is estimated on smaller changes in oil prices and real GDP. Nevertheless, this exercise provides a first, and rather daunting, assessment of what can happen to GDP given the decline in oil prices alone.

Concluding Remarks with OPEC and IEA update

This brief has provided a first assessment of how the Russian economy may be impacted by the massive decline in oil prices that has followed in the course of the corona pandemic. It has shown that the economic downturn this time can be significantly worse than both the 2008/09 and the 2014/15 crises. A base line estimate suggests that GDP may fall by more than 8 percent only because of the fall in oil prices. The above calculation obviously includes neither the impact the health situation will have on companies or households, nor the government's ability to mitigate the negative consequences. If the other problems the economy is facing as a direct result of the health crisis also lead to a significant decline in supply and demand, Russia could easily see real GDP declining by more than 10 percent in 2020.

Our estimate is an important reminder that Russia's continued oil dependency is a risk to the economy and its citizens. Now is not the time for ambitious structural and institutional changes to generate growth, but hopefully the urgent crisis period passes without policy makers forgetting the risks the country's oil dependence entails. They learnt the fiscal and monetary lessons well from past crises, now is the time to learn something new. The most appealing road to sustainable economic growth is still building credible property rights institutions and rule of law in a framework that would make Russia the innovative business-oriented superpower it could be.

A few days after the first version of this brief was published, oil prices started to rise as the OPEC together with Russia started discussions to cut production to support oil prices. A tentative agreement was reached which is supposed to cut production by 10 million barrels per day in May and June, the largest cut in OPEC's history. Had this movements in prices continued, the forecast for the Russian economy would have been affected. However, this recovery in prices was soon reversed and oil prices started to fall again. The decline continued on April 15 as the International Energy Agency presented a dire forecast of oil demand and stated that this year may be the worst year ever in terms of declining demand. All in all, the price movements that have followed the OPEC meeting and the statements of the IEA do not change the baseline prediction this brief has provided.

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