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Will the Russian Economy Accelerate in 2015?

ECONOMIC SANCTIONS + FALL IN OIL PRICES + OUTFLOW OF CAPITAL + DEVALUATION = ECONOMIC BOOM?

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Paradoxically, some healthy economic developments occurred in Russia in 2014 owing to its conflict with the West and the decline in oil prices. The "forced" reversal of some mistaken economic policies of the past—an overvaluation of the ruble and virtually tariff-free imports of food—has created an upward push for the national economy that may be stronger than the downward push caused by the outflow of capital, decline in oil prices, and Western economic sanctions.

The longer-term impact of sanctions on the Russian economy is still indeterminate. Western sanctions against Russia since its incorporation of Crimea in March 2014 have been rather modest, even symbolic (See **Appendix—Sanctions Overview**). By comparison, Russia's response in August 2014 banning food imports totalling $9 billion annually from the EU, United States, Canada, Australia, and Norway was harsh. If a scalpel was the Western instrument, Russia used an axe. Hit hardest were the export markets of Poland (fruits and vegetables), Norway (salmon), the Netherlands (cheese), and Spain (fruits and vegetables).

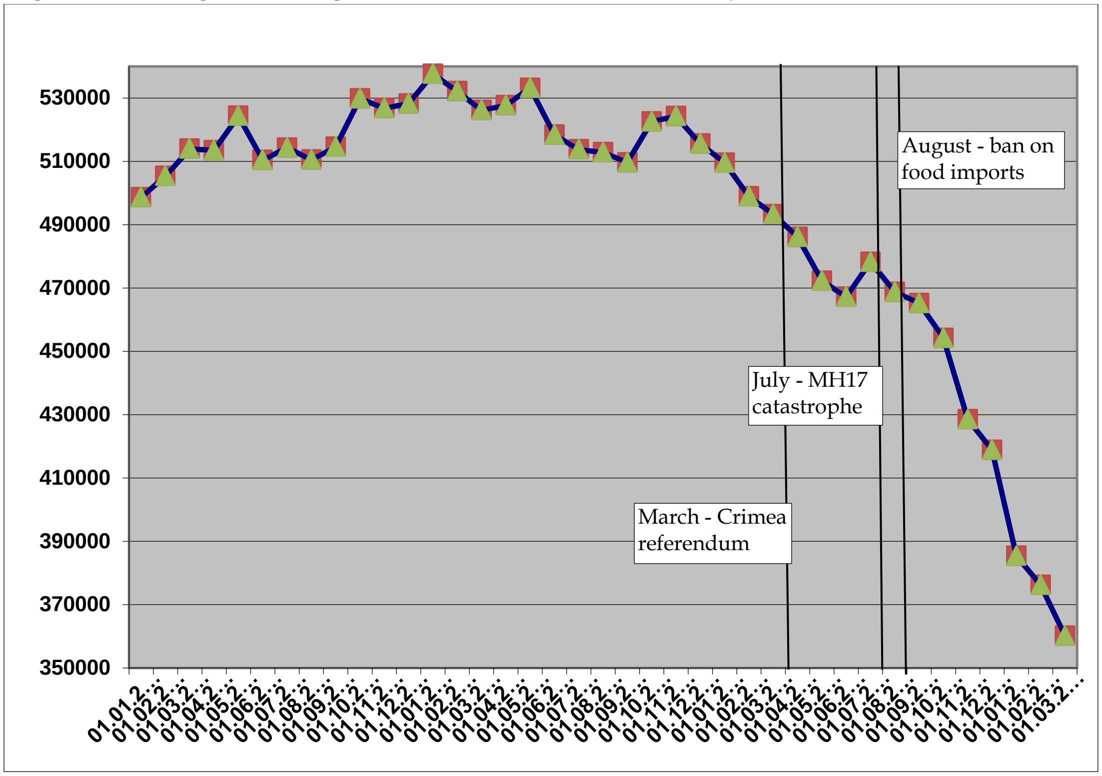
For now, the sanctions have had some effect, if mostly indirect by damaging Russia's overall investment climate. They have led to lower trade levels and a greater outflow of capital, which had begun already in early 2014 but accelerated after the Crimean referendum in mid-March.

In early August, before Russia responded with its countersanctions, Oxford Economics forecast a GDP contraction of 0.1 percent in 2014 and growth of just 0.7 percent in 2015. The decline in Russian foreign exchange reserves that began in 2013 accelerated in 2014; from February to September, reserves fell by nearly $50 billion, and from September 2014 to February 2015, they fell by nearly $100 billion (see **Figure 1**). Finally, oil prices declined, falling from around $100 a barrel in 2011-13 to $50 by the end of 2014 (see

[1] The views expressed in this policy memo are solely those of the author.

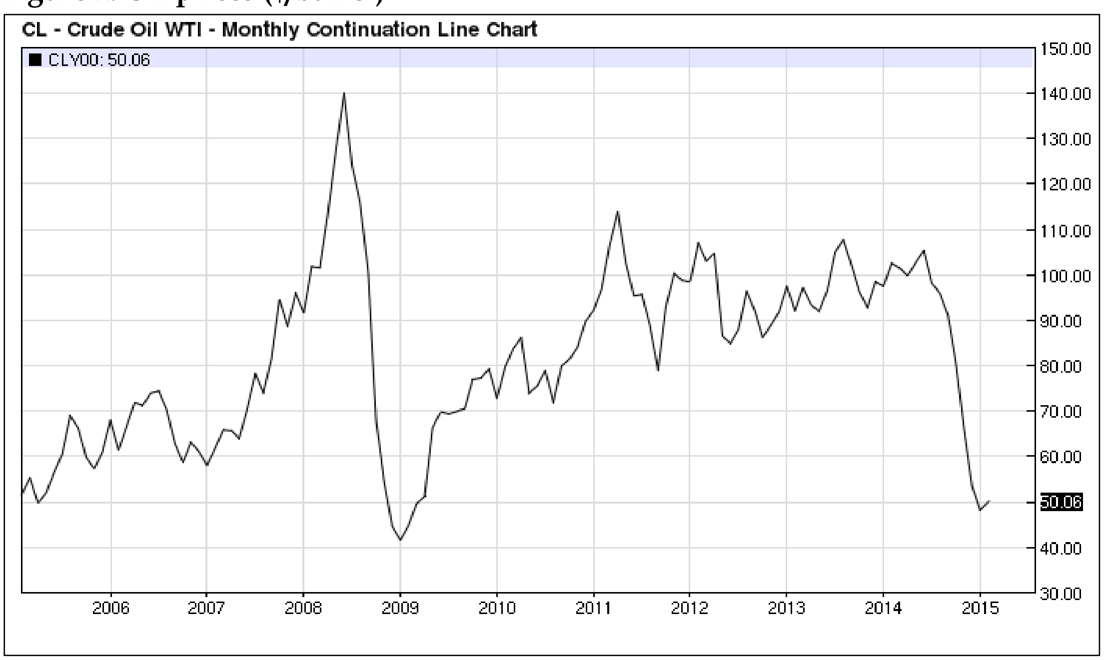
Figure 2). All these developments served to decrease aggregate demand and suppressed economic activity in Russia.

Figure 1. Foreign exchange reserves ($ million; monthly)



Source: Central Bank of Russia

Figure 2. Oil prices ($/barrel)

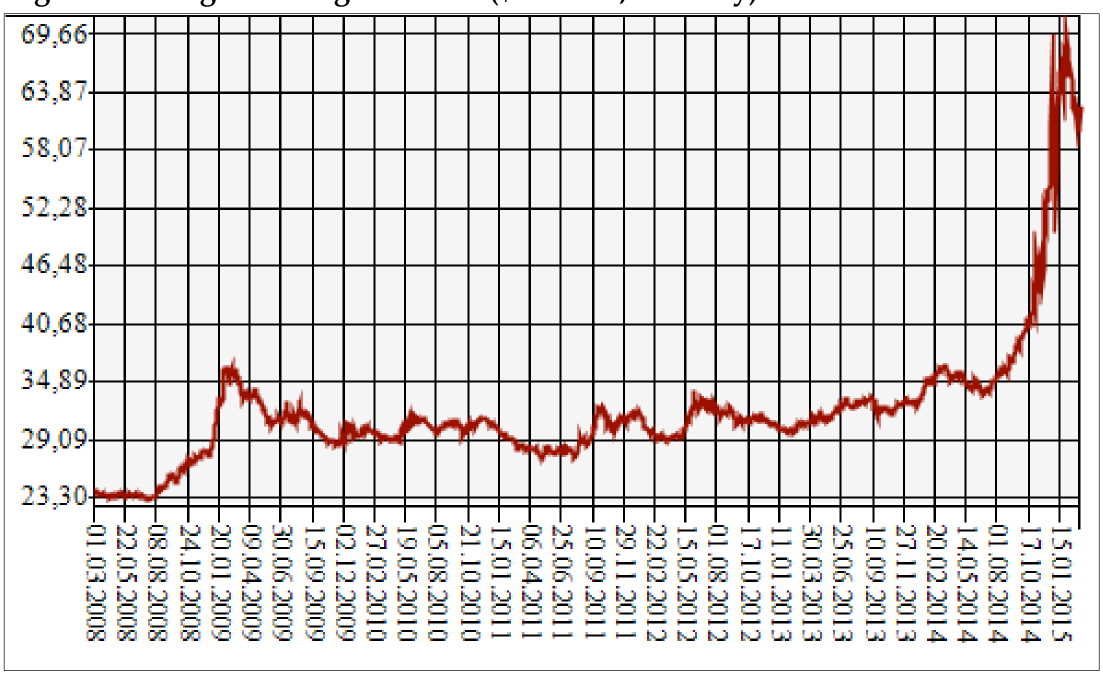


Source: Smarter Analysis

On the other hand, the combined effect of sanctions, the oil price decline, and Russia's reactions to the crisis has likely been more stimulating than depressing. Russia reacted to declining revenues from oil exports and the outflow of capital not only by reducing its foreign exchange reserves but also by devaluing the ruble (see **Figure 3**). This had a stimulating effect on the national economy, despite dire predictions to the contrary. Likewise, the prohibition on certain food imports had a stimulating effect on agriculture and the food industry. A certain import diversification happened as well. To compensate for the reduction of imported food products affected by the ban, Russia increased food purchases from a number of other countries, such as Argentina, Egypt, and Turkey.

The devaluation of the ruble by 50 percent in November-December 2014 may actually lead to an increase in output. In 2014, Russia's GDP increased by 0.6 percent despite predictions of decline. The seasonally-adjusted index of industrial output of the Federal State Statistics Service reached a maximum in December 2014 and declined a bit in January and February 2015, whereas the same index by the Higher School of Economics (it uses a slightly different methodology of seasonal adjustment) reached a maximum in October 2014 and was stagnant since then (only 0.5 percent lower in February 2015 than in October 2014). These dynamics do not appear to indicate the start of the recession that many had predicted; the January 2015 IMF forecast for Russia envisaged a GDP contraction by 3 percent in 2015 and another 1 percent in 2016.

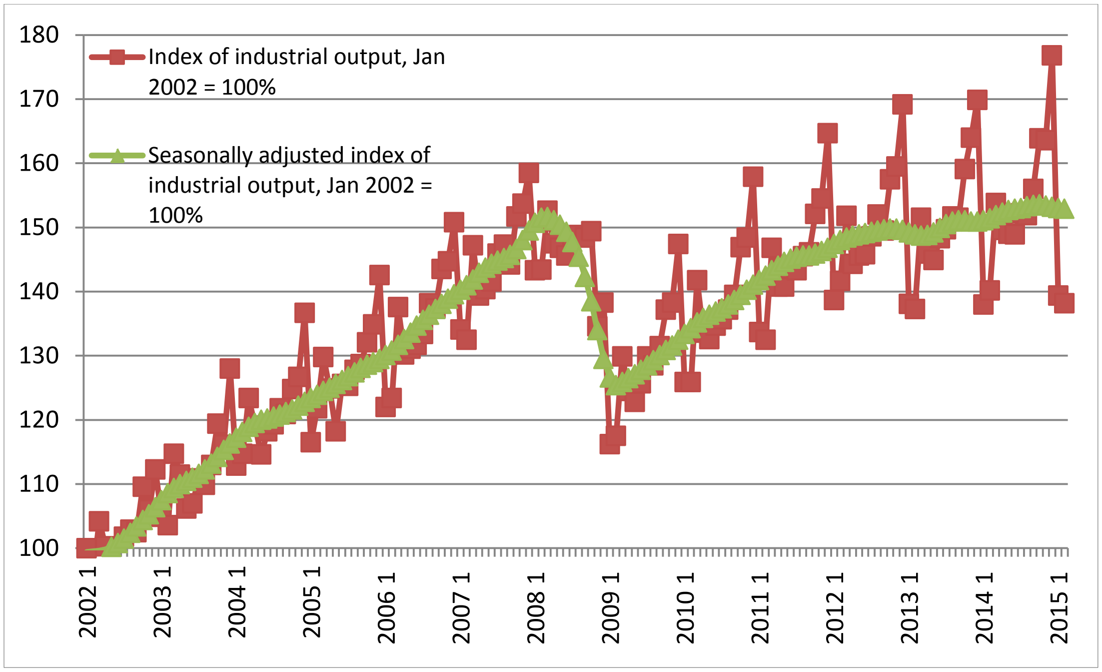
Figure 3. Foreign exchange reserves ($ million; monthly)



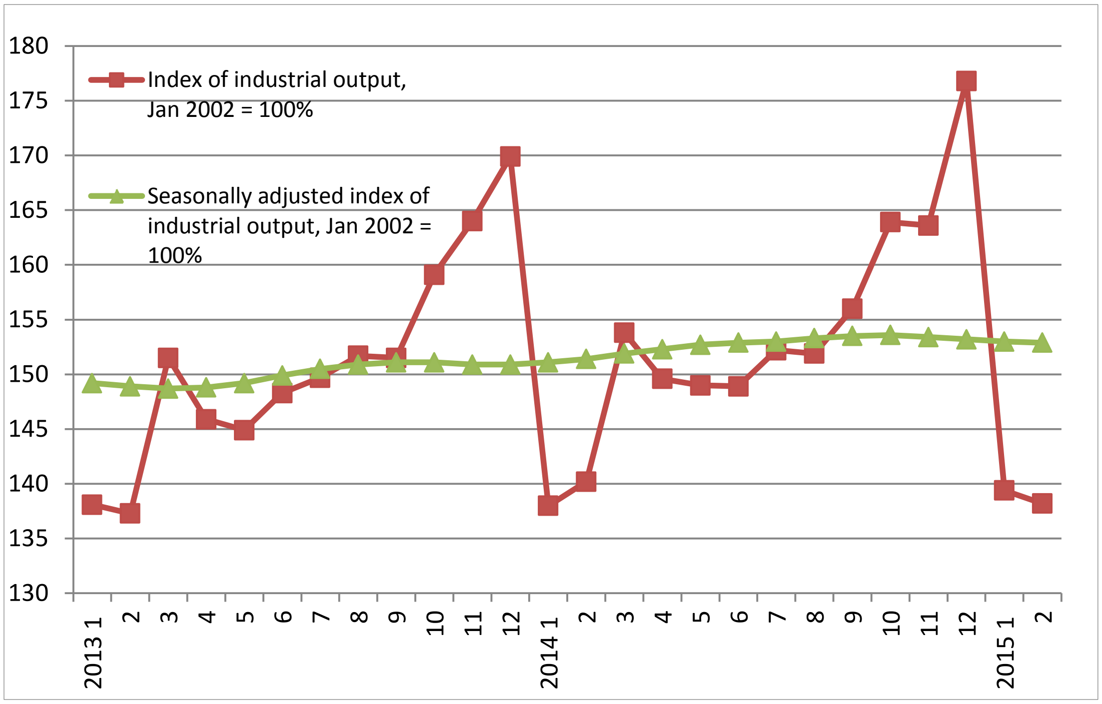
Source: Central bank of Russia

Figure 4 (A and B). Monthly index of Russian industrial output (January 2002 = 100%; green line indicates seasonally-adjusted industrial output)

A.



B.



Source: [Higher School of Economics Statistical Archive]

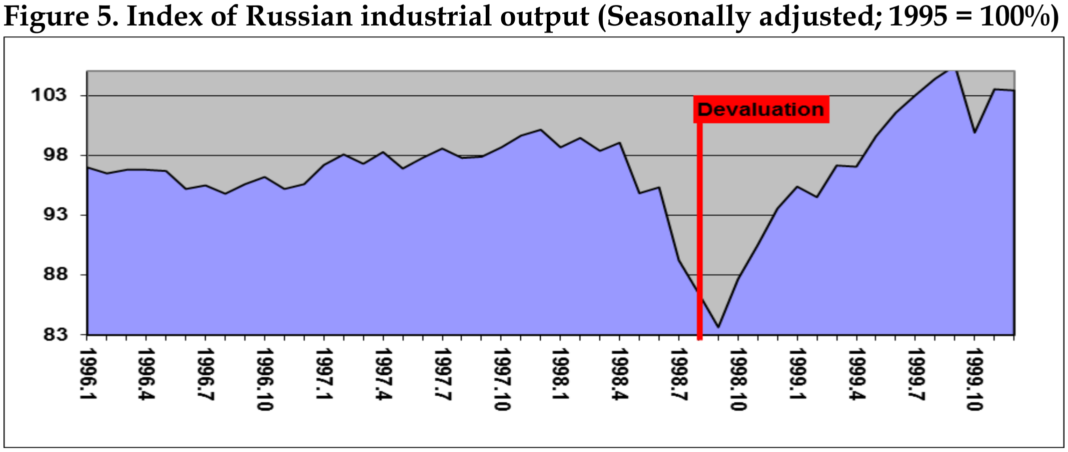
Russia's immediate economic future depends on two major unknown factors: oil prices and government policy. If oil prices fall no further and government economic policy is at least moderately expansionary (no revaluation of the ruble and no major reduction in government spending or money supply), there will be an upturn rather than a downturn. If this happens, it will be further proof that the overvaluation of the ruble since the mid-2000s was hurting economic growth and that high oil prices and the absence of control over capital inflows had caused a bubble.

In any case, the market reaction to the Ukraine conflict, sanctions, and the fall in oil prices have corrected past mistakes of the Russian government and central bank. Western sanctions have fueled enough patriotism to allow Russian consumers to endure a reduction of real income due to devaluation and the ban on food imports (which should have been introduced for economic reasons 25 years ago). As a result, there may be an increase in the profitability of businesses and a growth of output in 2015, not *despite* sanctions, devaluation, and the outflow of capital, but *because* of them.

Looking back, the devaluation of August 1998 had the same effect—an immediate increase in output after ten years of reduction and stagnation—and it proved that before August 1998 the ruble was grossly overvalued. The devaluation of the ruble in 1998 not only cured, if for a short period of time the "Dutch disease" of the overvaluation of the exchange rate, but also created the undervaluation of the ruble, which became a powerful instrument for an industrial policy that stimulated import substitution and export-oriented development.

Figure 5 shows that output was falling before devaluation (due to low oil prices and the outflow of capital), but once devaluation happened in August 1998, output started to increase almost immediately, from September 1998. By comparison, during the global economic recession of 2008-09, Russia did not respond to the outflow of capital and decline in oil prices with substantial devaluation (see **Figure 3**), so there was a sharp reduction of output (GDP fell by nearly 8 percent in 2009).

Figure 5. Index of Russian industrial output (Seasonally adjusted; 1995 = 100%)



Source: Federal Statistical Service of RF

Evidence suggests that countries that respond to an outflow of capital with devaluation, rather than a reduction of foreign exchange reserves and national money supply, experience a milder recession than states that preserve fixed exchange rates at the expense of domestic demand. It is true that during the Asian 1997 currency crisis, output in Asian countries fell only after devaluation, not before, unlike Russia in the wake of its 1998 currency crisis and Argentina in the wake of its 2002 currency crisis. However, these crises were of a different nature. In East Asia, exchange rates were not overvalued; the root of the crisis was overextension of private debt, which resulted in an outflow of capital and a credit crunch. Devaluation helped national producers, but was unable to counter the impact of the bankruptcies of financial institutions. In Russia and Argentina, private and even government debt was not that high—the roots of these crises lay in the overvaluation of the national currency. Once devaluation occurred, industrial competitiveness was restored and economic growth resumed.

Conclusion

It is difficult to predict all the economic consequences of the conflict in eastern Ukraine, which can obviously have longer-run detrimental effects on Russia's investment climate, to say nothing of Ukraine or even Europe as a whole. But the devaluation that resulted from the fall in oil prices (which was not linked to the conflict) and outflow of capital, combined with measures to protect domestic food production, have had a large stimulation effect on the Russian economy. After extremely sluggish GDP growth in relatively favorable 2012-13 (3.4 percent in 2012 and 1.3 percent in 2013) and almost no growth at all in 2014 (0.6 percent), Russia may finally see an acceleration of growth in 2015 and beyond.

Appendix—Sanctions Overview (from March 2014)

United States, EU, and other OECD member sanctions on Russia:

- Asset freezes and visa bans for dozens of high-ranking government officials.
- Prohibition on doing business with a number of Russian (and Crimean-based) companies and banks, including a ban against Visa and Mastercard dealings with these banks.
- Prohibitions against long-term borrowing in U.S. capital markets on certain state-controlled oil companies, banks, and defense sector companies.
- Ban on sales of certain defense-related products and services.
- Ban on certain oil and gas sector exploration and production technologies.

Russian countersanctions against the West:

- Visa bans for dozens of Western officials.
- Bans on certain food imports (meat, dairy, fish, nuts, and produce) from the United States, EU, Norway, Canada, and Australia valued at about $9 billion.

Ukraine and Russia introduced a number of sanctions against each other, including a Ukrainian prohibition against the export of defense goods to Russia.

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