Sieps
Swedish Institute for European Policy Studies

European Policy Analysis
MAY · ISSUE 2015:9epa

By Torbjörn Becker[*]

Russia's economic troubles – a perfect storm of falling oil prices, sanctions and lack of reforms

Abstract

Russia is the largest non-EU country with borders to several EU countries; a very significant supplier of energy to the EU; and an important destination for exports of goods and capital from the EU. At the same time, Russia used its relatively strong economic position in the recent past to rebuild the military muscles that they are now flexing in Europe. Therefore, the EU has a lot riding on the health of the Russian economy. The Russian economy is now facing serious challenges as a result of falling oil prices, sanctions and several years without reforms aimed at diversifying and modernizing the economy. Although many official forecasts paint a gloomy picture of the Russian economy in 2015, they may still be overoptimistic. Recent trade data suggests that Russia is heading for a full-blown sudden stop scenario this year. The recent uptick in oil prices is not sufficient for Russian policy makers to avoid making serious reforms, including ending the conflict with Ukraine and rebuilding ties with the EU, Russia's most important trading partner. It is time that Russian policy makers stop praying for ever-increasing oil prices and instead take control over the country's economic future.

1 Introduction

Understanding the Russian economy is of interest not only to Russia itself but also to the world more generally and the EU in particular. As a large economy, important energy provider and military giant at its door step, the health of the Russian economy and its implications for Russia's economic and security policies are of vital importance for decision makers in the EU. This article focuses first on the driving forces of the Russian economy and the important links Russia has to the global economy in general. It then moves on to a closer look at the trade and energy links with the EU and Sweden. It then concludes with a discussion of the Russian outlook and the implications this may have for the EU. In short, Russia still faces serious economic challenges in 2015, and part of the solution to this would be to rebuild ties with its important partners in the EU and the rest of Europe by contributing to an end to the conflict in Eastern Ukraine.

2 Russia, oil and links to the global economy

The Russian economy has strong ties to the global economy and the EU is by far Russia's largest trading partner. Strong ties to the global economy are of great value to Russia, but as for all countries, also carries some risks. This was evident in the global financial crisis in 2009 when many highly developed countries went into recession and Russian GDP fell by 8 percent. But it was also clear in the decade before, when Russia experienced very strong growth and per capita

* Director of the Stockholm Institute of Transition Economics at the Stockholm School of Economics. Email: torbjorn.becker@hhs.se, web: www.hhs.se/site.

incomes doubled as international oil prices quadrupled in real terms (Figure 1). In short, the ups and downs of Russia's economic well-being depends on the global economy and the price of its most important export, oil, is set on international markets. That economic development depends on other countries holds true for basically any other modern, successful economy in the world today and there are few, if any, cases where less trade or isolation has been a way to enhance the welfare of a nation. This general lesson needs to sink in at all levels of the Russian society for it to become as economically successful as its potential suggests it could be.

Although the natural resource sector may not account for a very large share in the productions side of the national accounts, around 10 percent, its overall impact on the economy is hard to overestimate. In 2013, the total exports of Russia were worth 526 billion USD and oil alone accounted for more than half of this value. Adding gas, metals, and other natural resource related exports with varying degrees of value added to the raw materials, the share is close to 90 percent.

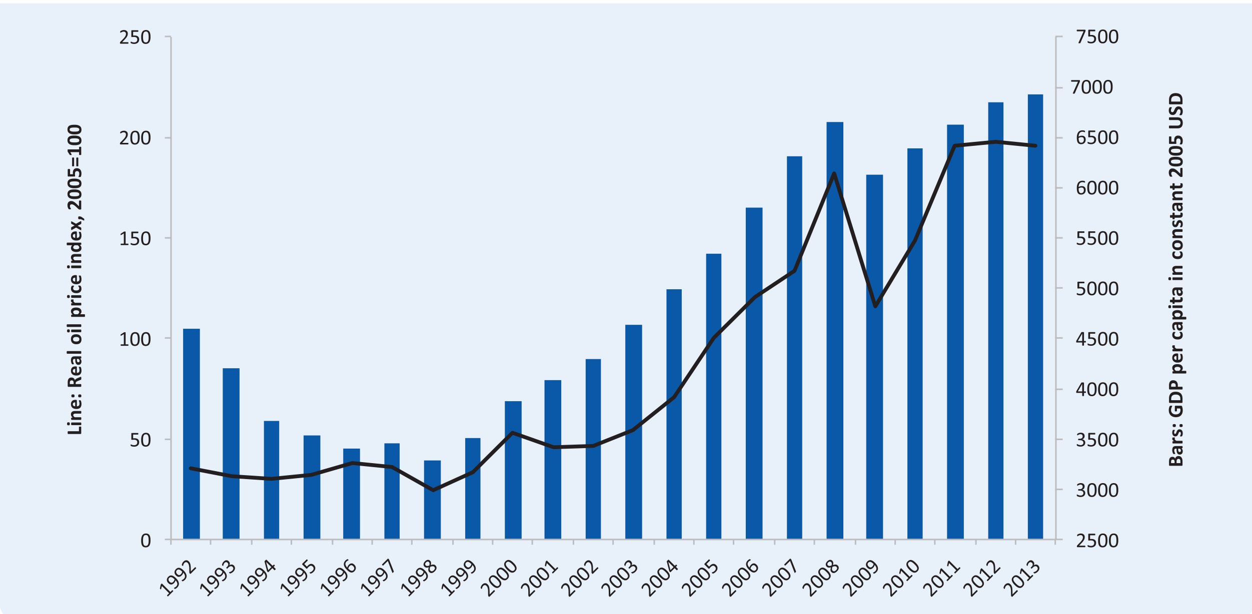
Russian imports have a very different composition, with machinery and related products accounting for almost half of the imports, and food for almost 15 percent. In modern manufacturing economies, there is often a pattern where imports and exports are in the same categories since domestic companies are integrated in global value chains, but for Russia this feature is largely absent in the trade data.

In sum, Russia's exports are very intense in natural resources with relatively little value added after it is extracted, while imports are heavily focused on manufactured goods with high value added. Given the natural resources Russia possess this is not surprising, but at the same time, it is a very clear indication that decades of talking about diversification has not led very far. The renewed calls for more self-reliance in wake of sanctions are understandable but in light of this picture not very promising from a Russian perspective.[1]

The export shares in the figure vary over time as both prices and quantities of the various exports change between years. Looking at the two main export earners, oil and gas, it is clear that the main source of variation in export earnings come from changes in international prices rather than changes in exported quantities. For gas, the quantities have been stable or falling slightly over the last 15 years while prices for most years have been on the raise or relatively stable.

The pattern for oil is quite different from gas. Oil prices increased very sharply before the global financial crisis, then

FIGURE 1 RUSSIAN INCOME AND OIL PRICES



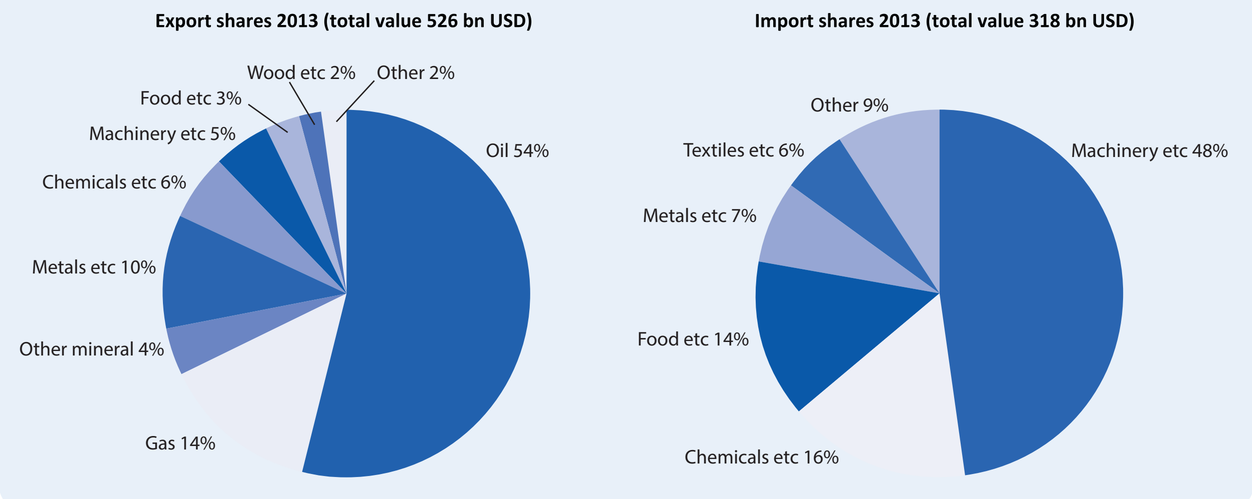
Source: World Bank (GDP per capita in 2005 USD) and IMF (real oil price index)

[1] For a detailed account of the various sanctions, see PISM (2015).

crashed down in 2009 before rebounding out of the global crisis. The more recent fall in oil prices does not show here since this is yearly average but is something that will be discussed further below. During this period of increasing and volatile oil prices, exported quantities have changed relatively little since 2004. The rapid rise in oil production before, and stagnation after, the Yukos affair has been discussed at length elsewhere, but the point here is that most of the variation in export revenues for Russia comes from changes in international prices and not the countries own production decisions.

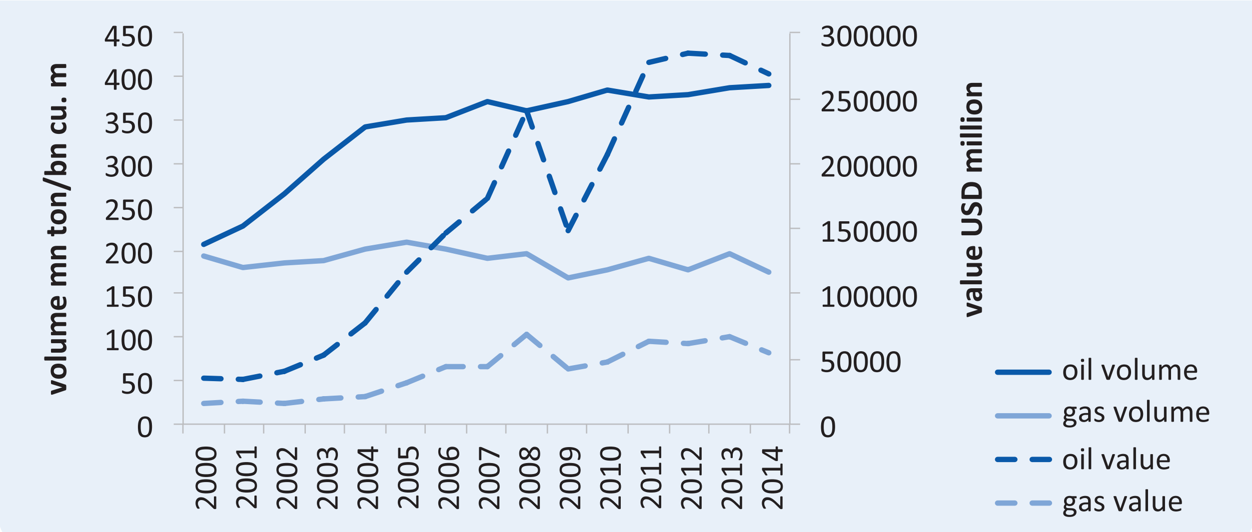
In short, this means that Russia has relatively limited scope to affect its export revenues and has a very significant vulnerability to fluctuations in international oil prices. This is of course reinforced further by the fact that around half of the federal government's revenues come from extracting and selling natural resources. However, the move to a flexible exchange rate mitigates the direct impact on the budget, since falling oil prices tend to depreciate the value of the ruble. This on the other hand has implications for inflation, but is then primarily a problem for the Central Bank rather than for the Ministry of Finance (although inflation creates

FIGURE 2 COMPOSITION OF RUSSIAN TRADE



Source: Federal Statistic Service of Russia (Goskomstat, GKS) and Central Bank of Russia (CBR)

FIGURE 3 EXPORTS OF OIL AND GAS



Source: CBR

demands on the expenditure side of the budget as well). In short, the importance of international oil prices on the health of the Russian economy is hard to overstate and fluctuations in oil prices affect all areas of economic policy making in the country.

In addition to trade, Russia has important financial links to the global economy, both in terms of external assets and liabilities. The Central Bank of Russia (CBR) holds significant international reserves, but even they are affected by changes in oil prices since the CBR has intervened to support the ruble when oil prices have fallen. On the liability side, Russian companies, both state-owned and private, have borrowed substantial amounts outside of the country. This external debt is not on the federal government's balance sheet (which has very little debt) but is nevertheless important at the macro level since it relates to many of the most important Russian companies (many of which also have significant government ownership).

Before the global financial crisis, the CBR's international reserves were larger than the external debt of the country, but this has change dramatically since 2011. In mid-2014, external debt was over 250 billion USD more that international reserves. However, after the sanctions were introduced, it has become harder for Russian entities to borrow in international capital markets and as a result, external debt has fallen somewhat faster than international reserves. Significant repayments of external debts are scheduled in 2015 and 2016, and the question is how Russian entities will handle this. The reserves of the CBR will probably take some of the hit as it has done so far, but in general, this cannot be the long-term solution for funding Russian companies.

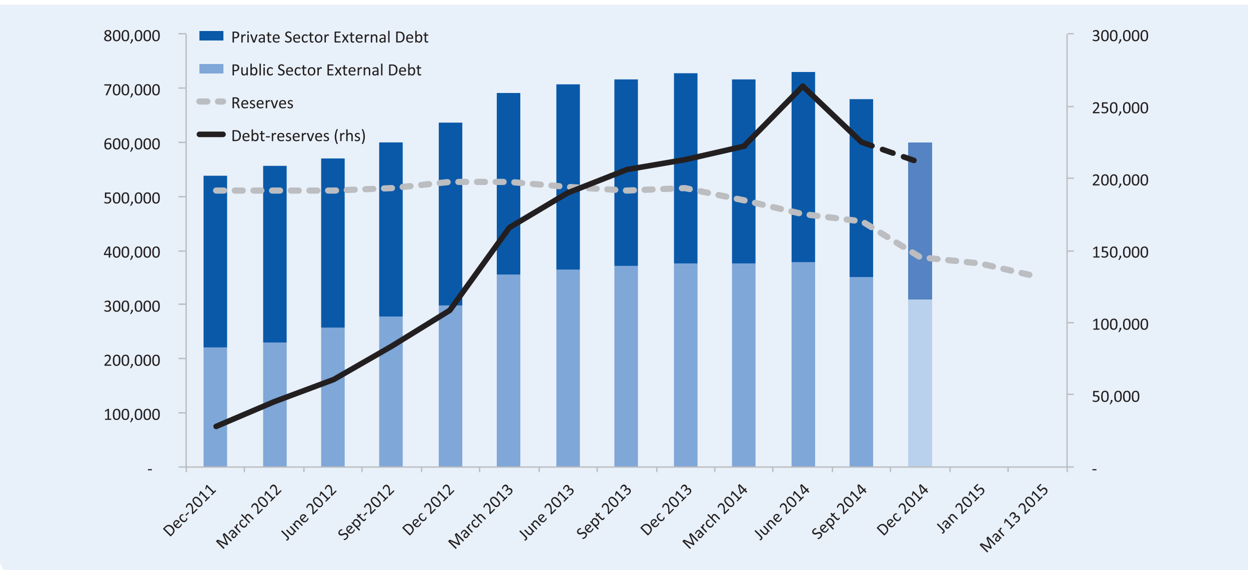
3 EU links are strong

The EU as a region is by far Russia's largest export market and was the destination for more than half of its exports in 2013. The CIS countries accounted for less than 15 percent of exports the same year, similar to the three largest Asian export destinations (China, Japan and South Korea) combined. Within the EU, Netherlands accounts for the largest share, but much of this is due to its shipping facilities rather than final demand. Italy and Germany are otherwise the two largest export countries within the EU, followed by Poland and the UK.

Imports are a bit more evenly spread over the world, with China being the largest supplier of imports to Russia. The EU, headed by Germany, Italy and France, is also a significant source of imports and accounted for more than 40 percent of Russian imports in 2013. In contrast, the CIS countries together supply Russia with less than 15 percent of its imports. In light of what has happened in Ukraine, it is of special importance to note that the country was Russia's most important trading partner among the CIS countries in 2013, with a 5 percent share of both exports and imports.

As discussed above, Russia's exports are predominantly oil, gas and metals. The EU is a large and important market for

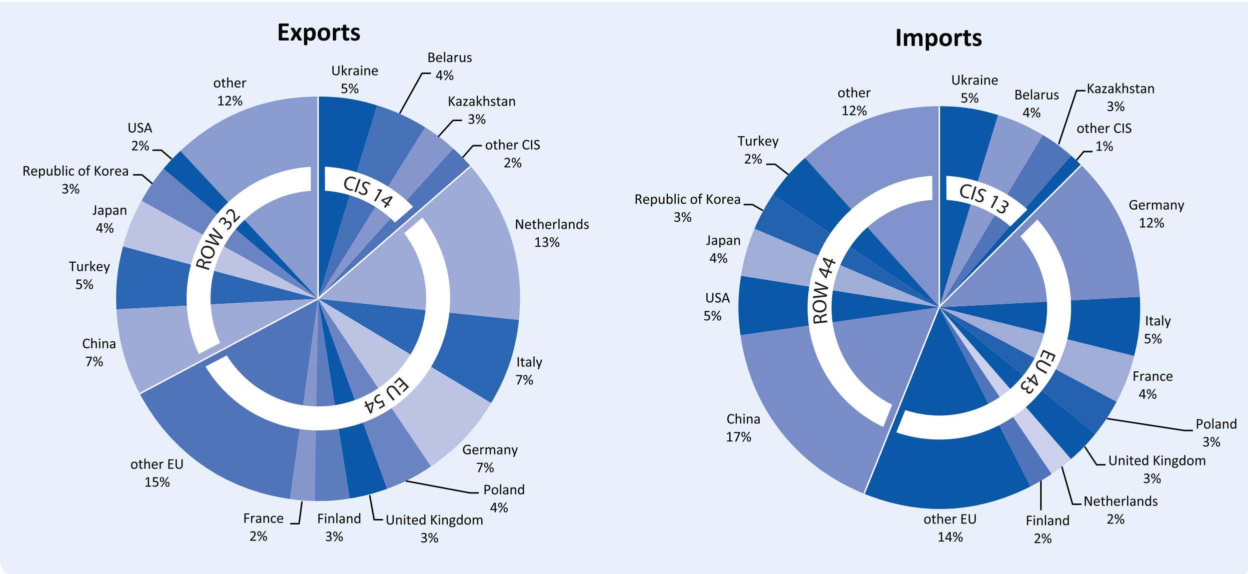
FIGURE 4 EXTERNAL DEBT AND INTERNATIONAL RESERVES (USD MILLION)



Source: CBR

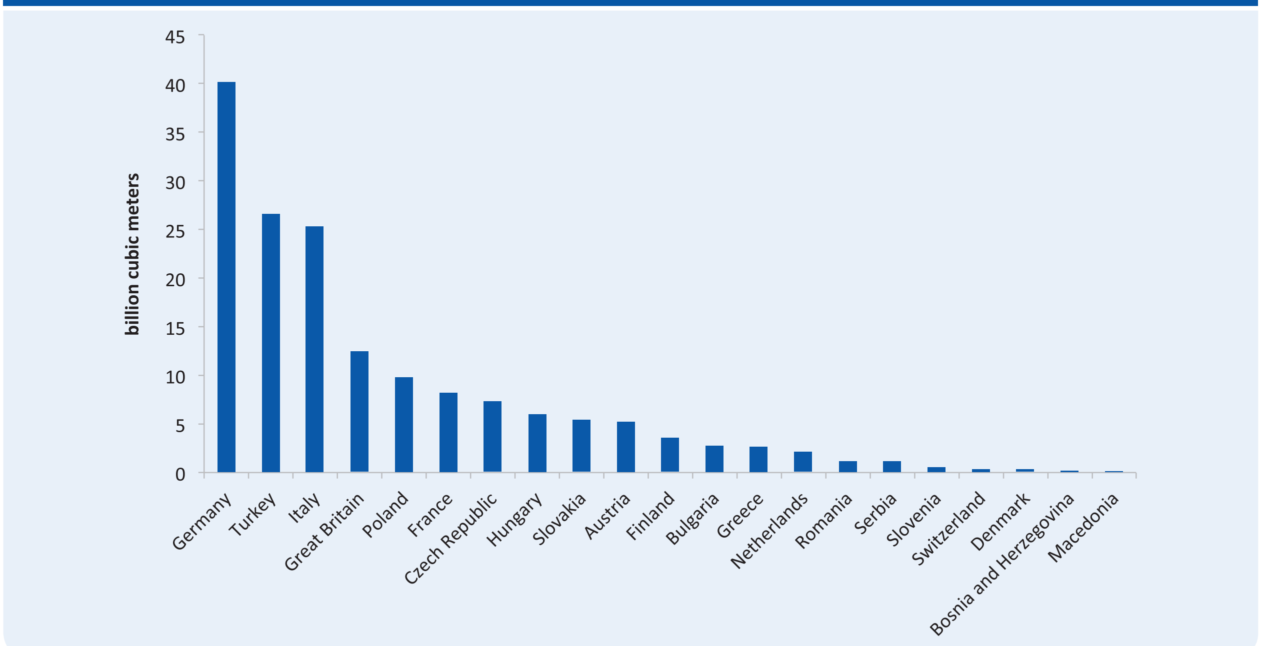
all of this, but gas has the particular feature that it is hard for both the exporter and importer to make significant changes to the trade relationship in the short run given the pipeline infrastructure needed to transport much of the gas. This explains why so much of the European discussions about the links with Russia focus on gas, despite the fact that for Russia, oil generated four times as much export revenues as gas did in 2013. Germany is the largest importer of Russian gas in the EU, followed by Italy, which contributes to the importance of a German view and voice in discussions with Russia on a wide range of issues.

FIGURE 5 EXPORT DESTINATIONS AND IMPORT SOURCES FOR RUSSIA 2013



Source: GKS

FIGURE 6 GAZPROM GAS EXPORTS TO EUROPEAN COUNTRIES



Source: Gazprom

4 Russian-Swedish trade uneven

Russian-Swedish trade is uneven both in the sense that the value of the Russian exports to Sweden is twice the value of the Swedish export to Russia and that the composition of exports is very different. For either country, the bilateral trade only accounts for a few percent of total trade, except for Swedish imports from Russia that reached almost five percent in 2014, which will discussed in more detail below. The relatively small shares of total trade still add up to significant amounts in absolute numbers and the trade is of vital interest to several of the companies involved in the trade. However, it is hard to argue that marginal changes to these trade volumes have significant macro economic consequences for either country.

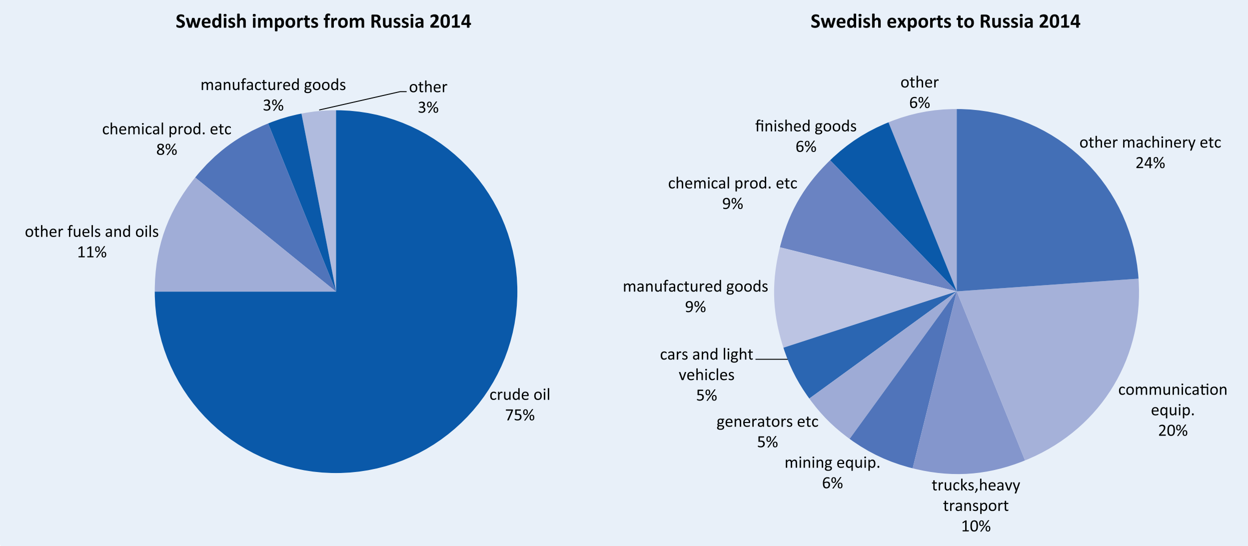
As for Russian exports in general, oil dominates, but even more so for exports to Sweden than in Russia's total exports. Crude oil alone accounted for 75 percent of Swedish imports from Russia, and other fuels and chemical products for another 19 percent. Manufactured goods only accounted for 3 percent of Russian exports to Sweden.

Swedish exports to Russia is much more diverse and dominated by various categories of industrial and manufactured goods, with communication equipment leading the way with a share of 20 percent after an increase of almost 40 percent in 2014 compared to 2013. In 2014, Russia's share of total Swedish exports was barely two percent. Different types of trucks and lighter vehicles as well as mining equipment and other machinery combine for another 45 percent of Swedish exports to Russia. However, exports of trucks, light vehicles and parts fell significantly from 2013 to 2014, which is also consistent with the more general picture of poor sales of vehicles in Russia in 2014.

Somewhat surprisingly given the counter sanctions Russia imposed on imports from the EU, Swedish exports of margarine and similar products increased by over 140 percent in 2014. This could either be a sign that the counter sanctions were not functioning but it could also be related to the exact goods Sweden traded with Russia during this period (and the aggregate data used here does not reveal this). However, there are many stories of companies in other countries that have been hurt by the Russian counter sanctions. It has also had implications for the prices of some key farm products, like for example milk, that have hurt farmers in Europe (but at the same time given consumer cheaper milk). Some products from the EU may also have entered the Russian market through new trading routs that avoid the sanctions. Seen from the Russian side though, there are many reports of missing high-end food products from Europe in the shelves of Russian stores, so there is some effect for sure. In short, the Russian counter sanctions have basically hurt Russian consumers and European farmers somewhat while helping consumers in the EU.

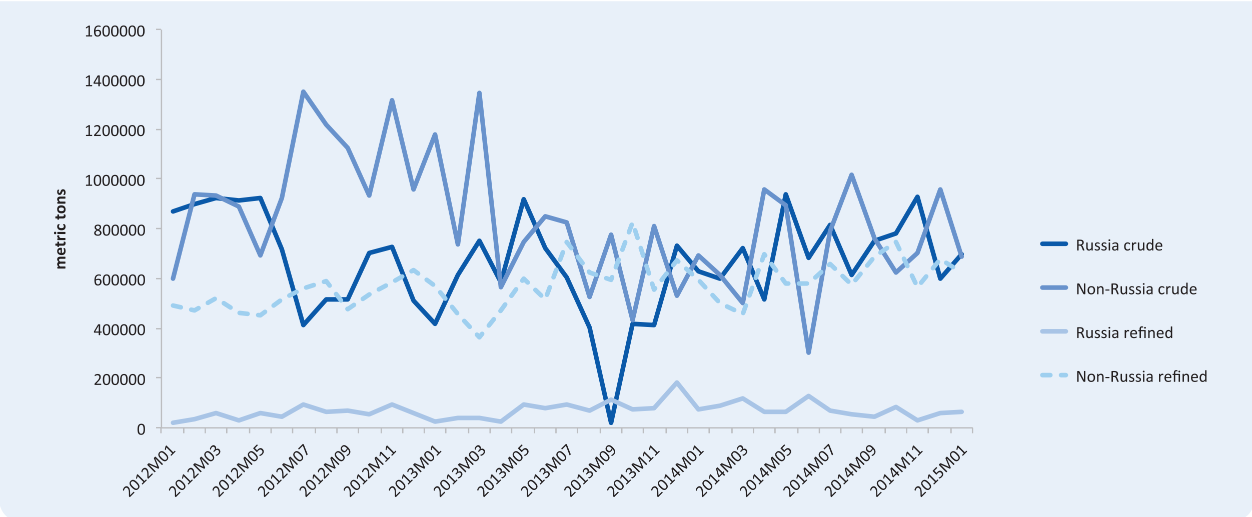
Although Russia overall is not a very large trading partner for Sweden, the crude imports from Russia is around half of all of Sweden's crude oil imports on average, while very little refined products come from Russia. There have

FIGURE 7 SWEDISH TRADE WITH RUSSIA



Source: Statistics Sweden (SCB)

FIGURE 8 SWEDISH OIL IMPORTS



Source: Statistics Sweden (SCB)

been significant swings in the crude imports from Russia, and in September 2013 – a time of intense geopolitical developments – it almost stopped entirely. Looking at the implied prices of crude oil from Russia versus other sources, it is clear that there were large relative price swings around that time and some of the Russian crude oil was replaced by oil from other sources. However, the substitution was far from complete. Since crude oil is used in Sweden to produce refined products that are exported, the drop in Russian crude imports had a significant effect on Swedish exports of refined products a for a few months, to the tune of a couple of billion Swedish kronor in reduced export revenues.

5 A Russian sudden stop – oil prices and sanctions hitting hard

The double hit from falling oil prices and sanctions imposed after the illegal annexation of Crimea and continued fighting in Eastern Ukraine is currently hitting the Russian economy with full force, which will have implications for Russia as well as its important trading partners and not least the EU. However, since the massive drop in the value of the ruble and the stock market in late parts of 2014 have stopped and reversed somewhat, many policy makers and commentators seem to think Russia's economic problems are already over. This is a premature conclusion.

To recapitulate some of the recent economic roller coaster rides, figure 9 shows how oil prices, the ruble and the stock market (Russian Trading System Index, RTSI) has developed since January 2014. First of all, the close correlation between the oil prices and the value of the ruble and stock market is striking. At the same time, it is clear that the stock market, as expected, moves on other news and runs ahead of the ruble an oil prices at times. The massive drop in all three variables from mid-2014 to the end of the year was very much synchronized. The exception was in mid-December when the ruble came under particularly severe pressure as capital left the country and the stock market reached its low point. At that point, both the stock market and currency had lost half of its value in half a year.

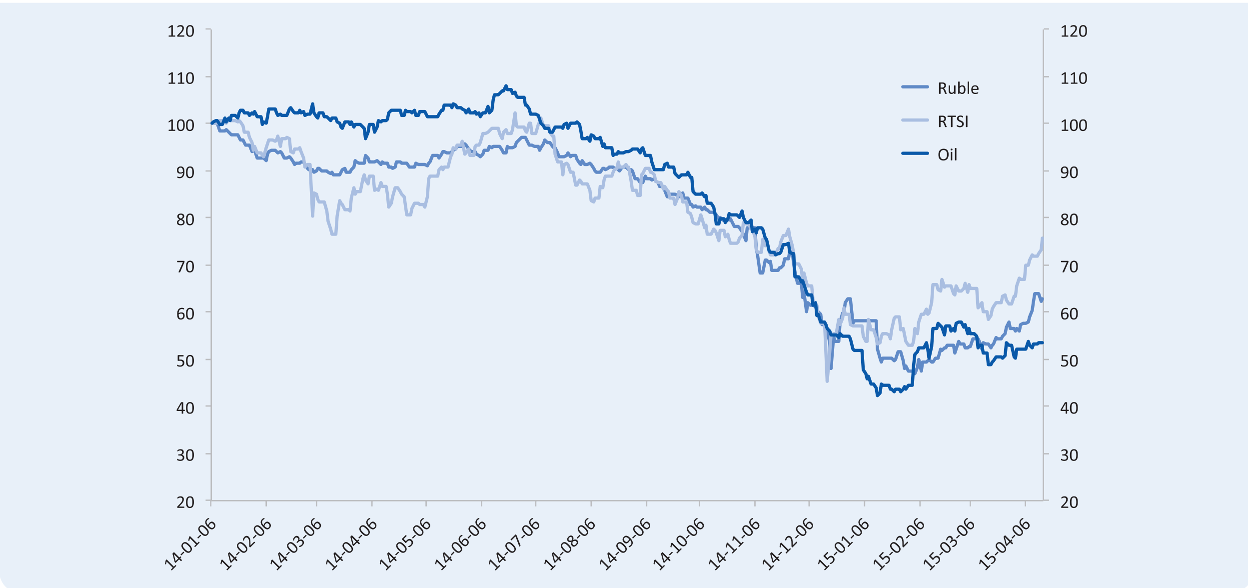
Net private capital outflows for 2014 were also substantial and reached over 150 billion USD for the full year, with over 70 billion USD leaving in the last quarter alone. Some argue that a significant share of this is related to technicalities (shifting assets to dollar accounts) or even a show of strength (paying back foreign loans), but at the end of the day, it is an important signal of the level of distrust that was associated with Russian assets and severed international financial links in 2014 and it will have real effects down the road in terms of less investment and consumption in Russia.

In more recent months, oil prices have recovered and a cease-fire has been negotiated for Eastern Ukraine which both have contributed to increased confidence in Russian assets. In mid-April, the stock market is at around 75 percent of its value in January 2014, the ruble at just above 60 percent and oil at only 55 percent. Although the recent trends are up, the oil price has a long way to climb before the impact on the real side of the Russian economy will not be significant in 2015.

One very worrying sign for the real economy is the trade data for January 2015. With less money to purchase imports – as export revenues have fallen, the currency depreciated and private capital has left the country – imports in January 2015 were only 60 percent of the same month in 2014. This is the real side of the ruble and stock market slide in the second half of 2014 and first month of 2015. Export revenues have also fallen dramatically, and in January 2015 were only 70 percent of the corresponding month last year.

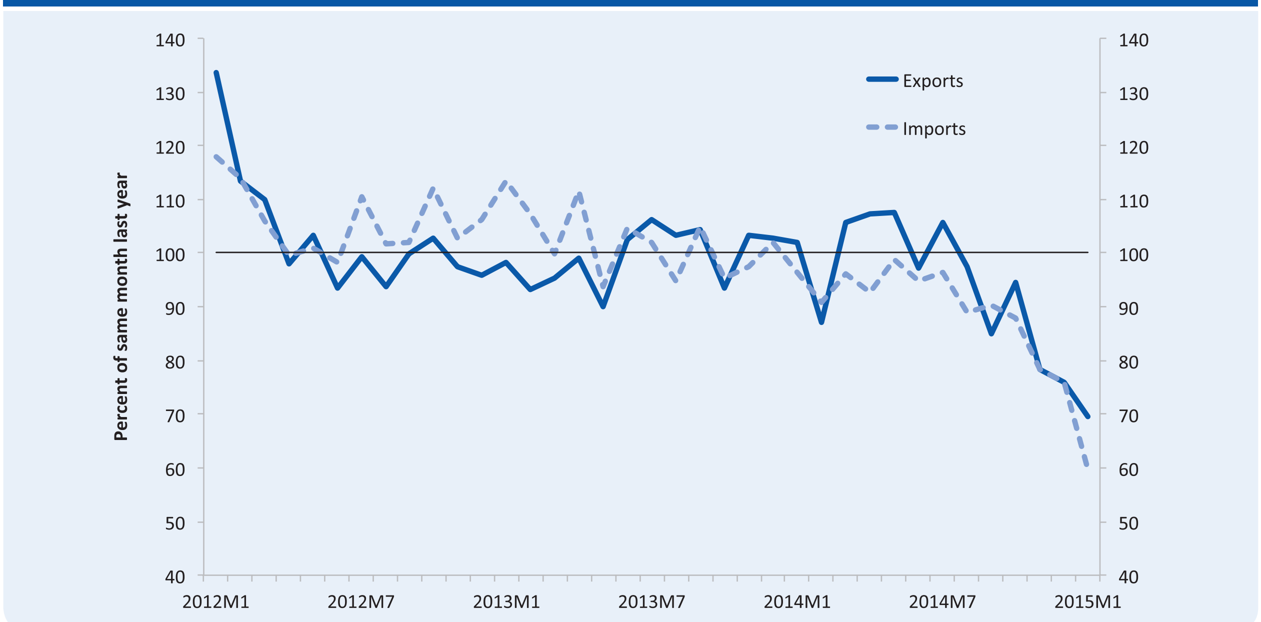
Although the fall in imports and exports taken together suggests an increased trade surplus in the beginning of 2015, it is not good news for the real economy. When imports decline as a result of lower consumption by households and

FIGURE 9 OIL PRICES, EXCHANGE RATE AND STOCK MARKET (ALL INDICATORS CONVERTED TO INDEX=100 IN JANUARY 2014)



Sources: CBR, US EIA, MICEX

FIGURE 10 RUSSIA'S TRADE COLLAPSE



Source: CBR

less investments by companies, it will result in a decline in GDP because of the second round effects the drop in consumption and investment has on GDP despite the fact that a higher trade surplus in itself increase GDP. This mechanism is a regular feature of sudden stop dynamics seen in countries where capital flows are reversed and confidence lost. Sudden stops have been the most costly type of shock hitting emerging markets over the last half century and the real effects can be both large and long-lasting.[2] In the last 15 years, this pattern has also been evident in Russia in a more compressed version; in the quarters when imports contracted, so did GDP.[3]

The question is then which countries reduced trade with Russia. There are no data on imports and exports separate for individual countries for the recent months, but trade turnover (i.e., exports plus imports) is available. For 2014, the EU was still by far Russia's most important trade partner, accounting for almost half of all trade. APEC countries added another 27 percent of trade, while the CIS countries around 12 percent. All regions experienced large declines in trade in January 2015 compared to the same month last year. For the EU, the trade was only 61 percent this January compared to last. This was perhaps not surprising given the sanctions, but the CIS countries were not far behind with trade of only 64 percent of the last January, in line with the decline in trade with China. For Ukraine the fall in trade was even larger for understandable reasons. Also when the six last available months are compared with the same period a year earlier, the declines are significant. However, it is clear that trade took a particularly hard hit in January 2015 and trade with the EU was particularly poor.

Reduced trade with Russia will come at a cost in terms of lower export earnings and growth for the EU countries that trade the most with Russia and even more so for the individual companies that have a significant presence in the Russian market. This may lead to renewed calls within the EU for different compensation schemes for the countries or companies that are particularly hit by falling Russian demand. One complicated issue for any such compensation scheme is to disentangle what the effects are of various sanctions and what can be attributed to a more general decline in the Russian economy. As the title of the article suggests, Russia's current economic troubles are a mix of low oil prices, lack of structural reforms and the sanctions imposed by the EU and other countries. It is obvious that the EU could and should not provide companies or countries with general export guarantees that eliminate fluctuations in the demand of various importing countries, including Russia.

TABLE 1 TRADE TURNOVER WITH RUSSIA FOR SELECTED REGIONS AND COUNTRIES (SHARES AND COMPARED WITH SAME PERIOD A YEAR EARLIER, ALL IN PERCENT)

	Share 2014	Jan '15/ Jan '14	Aug '14- Jan '15/ Aug '13-Jan '14
Total	100	67	83
EU	48	61	78
APEC	27	75	92
CIS	12	64	71
ROW	13	78	92
China	11	64	89
Ukraine	4	43	42
Turkey	4	87	87
US	4	82	86
Japan	4	133	92

Source: GKS

The outlook for Russian GDP growth in 2015 looks troubling. In its recent April World Economic Outlook, the IMF forecasts a decline of GDP of 3.8 percent. The EBRD is painting an even gloomier picture of the Russian economy with a projected fall of 4.8 percent. Given how much the oil price has declined, the significant capital outflows and massive drop in imports in the first month of 2015, it may be the case that even these negative forecasts are overly optimistic.

In a recent paper, I regress oil prices changes on growth in GDP per capita in 2005 USD terms (the same data as in Figure 1). The simple regression was able to account for over 60 percent of the variation in GDP per capita growth.[4] The coefficient on oil price changes in the regression imply that if today's oil prices sustain for the rest of 2015, the impact of this alone takes off almost 7 percentage points of Russian GDP per capita growth. The regression does not constitute a structural forecast model of the Russian economy, but the relationship has been remarkable strong over the 17 years worth of data that went into the regression.

2 Becker and Mauro (2006).
3 Becker (2014).
4 Becker (2014).

6 Discussion

The question is what policy actions will be taken to mitigate the effect of lower oil prices. In particular, the picture has to be complemented with a forecast of Russia's continued actions in Ukraine and what they imply for sanctions that affect both trade and capital flows. As has been outlined above, these factors also have serious implications for any realistic forecasts of the Russian economy regardless of what some policy makers would like to believe.

What can Russia do to avoid a full-blown sudden stop scenario that is now a very significant risk given the trade data for January? The standard macro economic policy levers would be fiscal and monetary policy. Russia had previously set itself on a course toward inflation targeting this year. This has been postponed to 2017, with an inflation target of 4 percent. Inflation in February 2015 was running at close to 17 percent, a long way off the 2017 target, and leaving little room to ease interest rates if that target is to be taken seriously. At the same time, the financial sector is facing serious challenges in 2015 as a result of the economic and financial troubles, which will further complicate the CBR's interest rate decisions.

Fiscal policy has taken a hit on the revenue side because of falling oil prices and a slowing economy. Although the sharp depreciation of the currency has mitigate the fall in oil prices, it is clear that spending has to be curtailed compared to previous plans in order to avoid a deterioration of the fiscal balance. The reserve and wealth funds still hold significant amounts of reserves (152 billion USD combined in March 2015) that can be used to cover a fiscal deficit. However, they can only provide temporary relief if oil prices do not move up more substantially in the coming months. As a reference, more than 110 billion USD of the reserve fund was spent to support the economy in the global financial crisis.

This reduced fiscal space will force Russian policy makers to make hard decisions in terms of what the spending priorities are. Although the goal of Russian policy makers may differ from policy makers in the EU, they still face the reality of budget constraints that limit the goals they can achieve. The very ambitious plans for further strengthening of military capacity have to be put against pensions, hospital and schools at some stage. Even if military strength and flexed muscles in Europe have generated significant support among the Russian population, cuts in public services and benefits will be met with unhappiness sooner or later. Hopefully this will temper military ambitions and make Russian policy makers more interested in reinvigorating economic growth that contributes to prosperity and security in Europe, but this may of course just be wishful thinking by an economist.

A more long-term economic policy, not based on just hoping for increasing oil prices, to ensure a return to healthy growth must be based on structural reforms aimed at building institutions needed for a modern society and rebuilding trade and financial ties with the EU and other external partners. Although the EU is currently itself struggling to generate growth, it is still Russia's most important trading partner and a source of much needed investments in the form of both capital and knowledge. The idea that Russia should turn its back on Europe in favor for China or Asia more generally is perhaps tempting but not a feasible solution in the near future and probably not particularly desirable in the longer run. Russia needs healthy relations with all its neighbors to prosper and provide a better economic future for its citizens.

References

Becker, Torbjörn, 2014, "A Russian Sudden Stop or Just a Slippery Oil Slope to Stagnation?", BSR Policy Briefing 4/2014, Centrum Balticum, Turku.

Becker, Torbjörn and Paolo Mauro, 2006, "Output drops and the shocks that matter", IMF Working Paper, WP/06/197, Washington, D.C.

IMF, 2015, World Economic Outlook, April, Washington, D.C.

EBRD, 2015, Russia overview at http://www.ebrd.com/where-we-are/russia/overview.html

PISM, 2015, "Sanctions and Russia", Polski Instytut Spraw Międzynarodowych, (The Polish Institute of International Affairs), Warsaw.

European Policy Analysis available in English

2015

2015:9epa
Russia´s economic troubles – a perfect storm of falling oil prices, sanctions and lack of reforms
Author: Torbjörn Becker

2015:8epa
Entering a World of Footloose Tax Bases: Can the EU Generate Its Own Income?
Author: Daniel Tarschys

2015:7epa
Britain and the EU: a negotiator´s handbook
Author: Roderick Parkes

2015:6epa
Europe´s pivotal peace projects: Ethnic separation and European integration
Author: Lynn M. Tesser

2015:5epa
Groundhog Day in Greece
Author: Thorsten Beck

2015:4epa
The Greek elections of 2015 and Greece´s future in the eurozone
Author: Dionyssis G. Dimitrakopoulos

2015:3epa
The diplomatic role of the European Parliament´s parliamentary groups
Author: Daniel Fiott

2015:2epa
Social Policy and Labour Law during Austerity in the European Union
Author: Niklas Bruun

2015:1epa
International Trade Union Solidarity and the Impact of the Crisis
Authors: Rebecca Gumbrell-McCormick and Richard Hyman

2014

2014:9epa
Making Sense of Subsidiarity and the Early Warning Mechanism – A Constitutional Dialogue?
Author: Jörgen Hettne

2014:7epa
A Comparative Framing of Fundamental Rights Challenges to Social Crisis Measures in the eurozone
Author: Claire Kilpatrick and Bruno De Witte

2014:4epa
Why vote at an election with no apparent purpose? Voter turnout at elections to the European Parliament
Author: Mark N. Franklin

2014:3epa
The EU Budget and Balance of Powers Between the European Parliament and the EU Governments
Author: Sara Hagemann

2014:2epa
Between a rock and a hard place: the future of EU treaty revisions
Author: Carlos Closa

2014:1epa
Scrutiny in Challenging Times – National Parliaments in the eurozone Crisis
Authors: Katrin Auel and Oliver Höing