Russia Update - Lower oil price will take its toll

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Russia update – Lower oil price will take its toll

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Summary

- **Russia managed to avoid a recession in 2014 as economic woes have mounted**
- **Already feeble investments were further eroded by the US/EU sanctions**
- **But it is the oil price decline from USD 110 to below USD 50 that is pushing Russia into a serious recession in 2015**

Recession avoided but a storm is building

While there has been much talk of recession, the oil and gas dominated Russian economy has continued to grow in 2014, although at a marginal pace of 0.6% (2013:1.3%).[1] Support came from private consumption which grew 0.6%, significantly lower than in 2013. Unemployment was at a record low of 4.9% as inflation was higher, but contained at 7.7%. Net exports contributed as exports were up 1.3% and imports were down, pushing the current account further into surplus: 2.6%. However, gross investment shrank by 7.3%. The government managed to achieve a marginal surplus of GDP. Stock variables still point to financial strength, with external debt remaining very low at 34% of GDP and public debt at 7.2% of GDP at the end of 2014 .

[1] This section draws on Economist Intelligence Unit (EIU) figures.

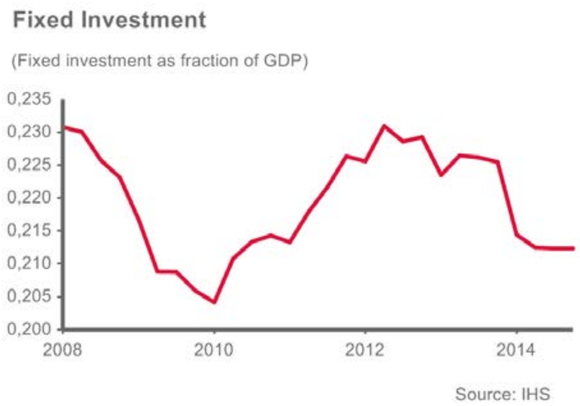
Foreign currency reserves at the Central Bank stood at USD 380 billion by mid-January 2015 or approximately 10 months import cover, still comfortable levels.

These figures paint a moderately positive picture of 2014. However at the same time there were clear signals that the economic situation was rapidly deteriorating. Gross investment plummeted compared to 2013 when it was flat. Foreign currency reserves shrunk more than 20% in 2014 as the Central Bank attempted, in vain, to halt the fall of the rouble. The rouble lost almost 50% of its value against the dollar, pushing up inflation to nearly 10% by the end of the year. The currency was hit by both International sanctions and, most importantly, the drop in the price of oil from USD 115 per barrel Brent to below USD 50 during autumn. The Moscow stock exchange fell by more than 60%, highlighting a severe loss of confidence. By the end of 2014, the Russian economy was effectively in a recession.

And this is only a start. In 2015 the economy is expected to shrink by 3.5% to 4%, with significant risk of an even deeper contraction. We will argue this in more detail discussing the three Russian economic woes: lack of investment, international sanctions as a result of Russian involvement in the Ukraine and the low oil price. Russia should brace itself for an unavoidable economic storm. Then, by 2016 some recovery may set in.

Investment woes continue

The 2014 data highlight the major underlying weakness of the Russian economy: a chronic lack of investment. It should be highlighted that this was already apparent in 2013, before the Ukraine crisis. Worried about the deteriorating business climate, many Russian firms choose to reduce inventories to meet demand rather than to invest, and major investment projects such as the North Stream pipeline and the Sochi Winter Olympics ran off. The result was stagnation and mounting capital outflows, to the tune of USD 65 billion in 2013.



Investment is badly needed to modernise the energy sector: production fields in Western Siberia, representing 90% of oil production, have passed their production peaks. Exploration of Arctic fields may be of help but they require USD 700 billion of investment up to 2035, according to the International Energy Agency (IEA). Other manufacturing sectors are also in need of investment. Russia produces automobiles, machinery and food products, and their competitiveness in international markets hinges on massive investment. Finally, investment is also needed to diversify the Russian economy away from its current, energy dominated profile.

International sanctions are no paper tigers

The Russian intervention in the Ukraine is not for free. Russia's active deployment of troops clearly has a cost. And what's more, in Crimea and parts of Eastern Ukraine now controlled by the Ukrainian separatists, further costs are incurred. The Crimea is a peninsula reachable from Russia only by boat, so bridges need to be built. The population of devastated areas, especially in Eastern Ukraine, will need basic services that the separatists cannot provide, as Ukraine is cutting off public services and even pensions to these areas. These costs may be bearable, but that may not be the case for the third cost of Russia's intervention: international sanctions, and, perhaps ironically, Russian countersanctions.

During the year the US and the EU have stepped up the pressure on Russia to withdraw from the conflict in Ukraine. The US and EU sanctions target Russian officials, as well as defence and energy firms, aiming to limit the military arsenal as well as future economic growth. The targeted firms, which include Gazprom, Lukoil and Rosneft, now face severe restrictions to their access to foreign technology and foreign finance, as the banking sector is also included.[2] Russia has responded with countersanctions on food and dairy products. This volley of sanctions and countersanctions affects the economy through various channels, hitting already weak spots.

Whereas sanctions on defence spending clearly affect military production and export, at least over time, the sanctions on energy firms are the ones most immediately effective. Indeed, with access blocked to US and EU energy technology, and without the means to purchase it elsewhere (as financing is constrained), investment by Russian firms, especially in the energy sector, is in jeopardy. Clearly, the sanctions are hitting the weak spot: investment.

Russians have added a self-inflicted element to the sanctions by mounting capital outflows, further restricting the financing of investment. The level of outflows was already very high in the first half of 2014 at USD 62 billion:[3] only USD 3 billion short of the full year 2013 figure. Critically, non-residents withdrew funds from Russia: a phenomenon not seen since the 2008 crisis. But since the summer, foreign assets have been repatriated by Russian residents, dampening the pace of the net outflow somewhat. This leaves the total amount of capital outflows in 2014 in the range of USD 130 billion, according to the International Institute of Finance IIF. As if investment woes and sanctions were not sufficient, by mid-2014 the oil price started to fall, at an accelerating pace.

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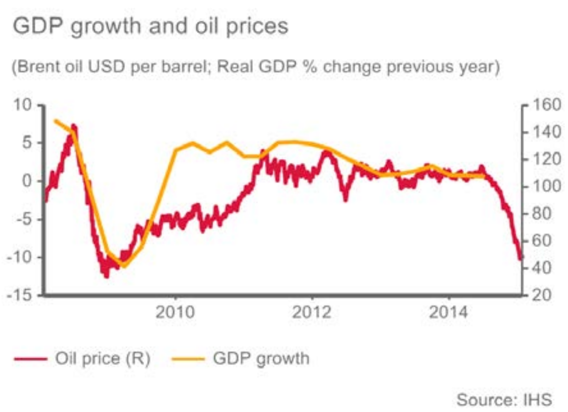
[2] The banking sector inclusion is crucial to prevent lending on to sanctions-hit firms after banks have tapped the international financial market.

[3] See Fitch Russian Federation, Full Rating Report, August 2014.

The oil price decline comes at a very bad moment

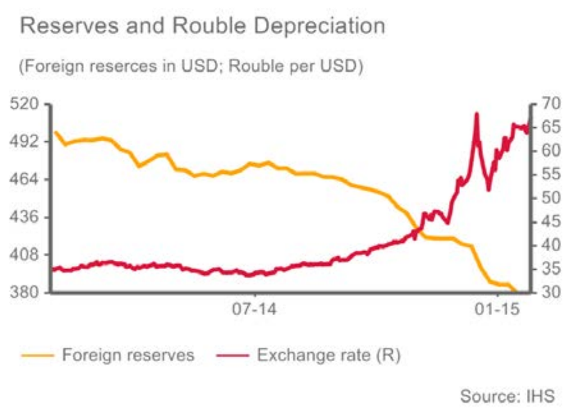
The oil price has been falling off a cliff dropping from USD 110 per barrel to USD 50 per barrel by the end of 2014. As we argue in a recent Research Note,[4] this is due to supply factors, most notably higher US shale oil production. Moreover, as became clear during the November OPEC meeting, Saudi Arabia is no longer willing to give up market share, even temporarily, to maintain a higher oil price. This has produced additional downward pressure on the oil price, which is currently hovering around, and even below, USD 50 per barrel. As at this level production is going to be curtailed, the price can be expected to recover to USD 75 in 2015, but with the current level much below it, there is a significant downside risk to this forecast.



Even the USD 75 per barrel is way below the USD 95 per barrel that Russia is assuming in its economic forecasts. The energy sector represents 30% of GDP in Russia, 70% of exports and 50% of the government budgets revenue. Indeed, the greatest threat to the Russian economy is a persistent drop in the oil price, according to the IIF.[5] A USD 10-15 drop in the oil price will knock 2%-3% off of GDP, pushing Russia into a recession by a wide margin: Fitch's 2015 GDP growth forecast for Russia was 1.5% assuming a USD 100 oil price. Export revenues of energy will be particularly hit, weakening the rouble that was already under pressure, and reinforcing the upward tendencies on inflation. Government revenues will be under pressure, but tax revenues in roubles will be boosted, significantly mitigating the impact, by roughly 50%.[6]

Rouble plummet causes inflation worries to mount

The rouble indeed started to depreciate in the early spring of 2014, when political uncertainty over the Crimea annexation started to rise and capital outflows surged. The Russian Central Bank initially attempted to stem the rouble depreciation with foreign currency interventions. Until mid-January 2015 more than USD 95 billion, or 25% of the total reserves, was spent. When the oil price started to decline and the rouble pressure mounted that policy became untenable. In early November the Central Bank announced it would effectively stop interventions, and let the rouble float.[7] Still, since early December USD 32 billion , foreign reserves had to be spent, to preserve financial stability and facilitate capital flows.



Meanwhile, rouble depreciation reached about 60%. Depreciation is a major issue as it exacerbates Russia's already high inflation rate and imports become more expensive. The cost of those imports, particularly food and dairy, has already risen as a result of the Russian countersanctions, because these goods have become more scarce.[8] Russian countersanctions, announced with much bravado by the government, are effectively shooting the Russian consumer in the foot. To address the threatening surge of inflation, the Russian Central Bank has been forced to raise the policy rate, in a number of stages, to 17.5% before easing to 15% at the end of January. Again, with a higher interest rate on rouble lending, investments will be further restrained.

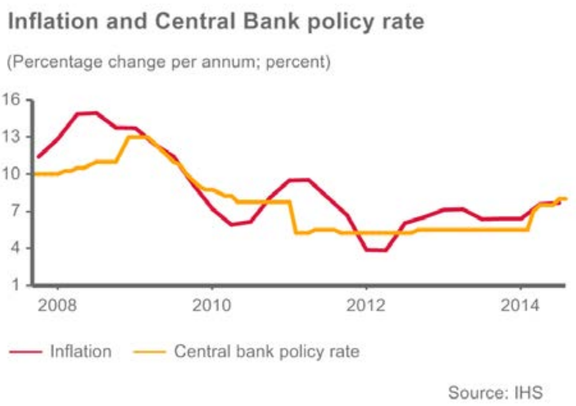
[4] See Atradius Oil Market Update: 'Cheap oil good news - for most', December 2014.

[5] IIF Emerging Europe: 'Living with Geopolitical Tensions', October 7, 2014.

[6] This is because the energy firms indeed have lower USD revenues as the oil price is lower, but the depreciated rouble in turn boosts their rouble revenues. Those rouble revenues are the basis for tax levy in Russia.

[7] Some 'soft' capital controls were imposed, by asking Gazprom and four other state owned exporters to bring the level of foreign currency reserves back to October 1, 2014 levels and sending in government officials to check on currency transactions in major banks.

[8] Food prices rose 11.7% year-on-year in September.



Bracing for the storm

We have pictured the Russian economy above as already feeble. It is being hit by international sanctions and a low oil price. It is very unlikely that a recession in 2015 can be avoided. The recession will be a significant one: the economy will shrink 3.5%-4% according to EIU. A figure that is even acknowledged by the Russian government. Investment is expected to decline another 16.5%, due to the factors summed up above, lack of confidence, lack of availability of technology, international sanctions and high interest rates restraining liquidity in the banking system and thus lending. Moreover, household consumption will not be able to support the economy. Indeed, the mounting level of inflation, eating into purchasing power, and weak confidence should cause a decline of more than 6%. We don't expect the government will come to the rescue either. Fiscal stimulus will be curtailed by demand from the private sector for bail outs. Some relief may come from the external sector as the weak rouble would boost exports in the non-energy sectors and lead to a 30% year on year contraction of imports, keeping the current account in the black. After the storm, in 2016, some recovery is perceivable, whereas later years will, assuming unchanged policies, bring growth but at a pace far below that of the first decade.

We should emphasise that this outlook hinges on recovery of the oil price to USD 75 per barrel in the course of 2015. Moreover, it is assumed that international sanctions will be eased in the summer of 2015 as the EU may not be as united anymore as national interests start to dominate. Both assumptions provide the downside risk. The current oil price is below USD 50 per barrel and there is no guarantee of a return to USD 80 in 2015. If that takes longer, or even worse, does not take place at all, the Russian economy may be hit much harder and an economic downturn of 7%-8% could be on the cards. Continued pressure on the rouble may exacerbate the situation, or even put it in motion: panic could arise accompanied by a bank run. Indeed, this is precisely the reason why the Russian Central Bank keeps spending foreign exchange – to prevent such panic. That spending, in turn, is putting pressure on foreign reserves levels, which in a panic could be significantly dented, or even depleted. In such a case there would be no international emergency lending, due to the sanctions. Russia therefore, is in a dangerous corner. Moreover, even if sanctions are partially lifted by the EU due to lack of unanimity, US sanctions are likely to be maintained. And in such case, their effectiveness should remain. To end on a positive note, Russia will be saved from this rather dark scenario if the oil price leaps up.

John Lorié, Chief Economist

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