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Macro Research

Russian economy quickly falling into recession **5 December 2014**

Last week OPEC's decision to keep production levels unchanged knocked down oil prices, acting as a catalyst for another sharp depreciation of the Russian Ruble (RUB). RUB depreciation will send inflation even higher while leading indicators suggest that Russia is quickly falling into recession. However painful for Russia, the direct negative economic spillover effects to the rest of the world are likely to remain limited. That said, worries remain that geopolitical tensions build up again if Russia, in an attempt to distract attention from domestic problems, would steer for an escalation of the conflict in Ukraine. That, in turn, would put downward pressure on economic sentiment in the European continent.

The RUB lost around 15% of its value over last week. This comes on top of an earlier 15% depreciation against the USD since the beginning of the year. As OPEC decided to not cut its supply, the price of oil declined further pulling along the RUB in its fall. Needless to say, accounting for more than two thirds of its exports and more than 50% of its budget revenues, oil and gas are very important for the Russian economy. The fall in energy prices in combination with the international sanctions imposed on Russia related to the Ukrainian conflict gives the Russian economy hard times. Consumer and business confidence indicators are plunging, pointing to an imminent sharp recession. Inflation, at 8.4% already significantly overshooting the 5% target, will creep higher on the back of the RUB depreciation. Some observers have been making comparisons to the Russian crisis in 1998 but this seems overdone. The crisis back then was a textbook speculative currency crisis that followed the 1997 turmoil in Asia. Even though falling oil prices were also an important contributing factor to the crisis in the late nineties, the current situation is not comparable. An important difference is that the RUB was then closely tied to the USD in order to bring down inflation (expectations). While initially successful, at a time when the overall financial position of the Russian economy was very weak, this reinforced the self-fulfilling expectations that the narrow trading band with the USD was no longer sustainable. Russia's net foreign asset position, which measures the economy's overall (households, firms and government) wealth position vis-à-vis the rest of the world, shows that Russia's balance sheet is now much stronger. Moreover, the depreciation of the now (almost) free floating RUB seen thus far will cushion the impact for the economy, a mechanism that was not in place before the eventual 60% devaluation of the RUB in early 1999. For example, with oil and gas revenues in USD, the depreciation of the RUB now compensates the oil price decline for the Russian budget to an important extent. In addition, confidence in parts of the manufacturing sector is supported by the recent RUB depreciation as export conditions improve. Nevertheless, prospects for the Russian economy are very gloomy.

The main question remains what the impact will be for the rest of the world and Europe in particular. The short answer is that the direct impact, with only 1% of total Eurozone exports going to Russia, will remain fairly small. More importantly, the sharp drop in energy prices since the beginning of the year (30% for oil in euro) is a big windfall for European households and firms. This positive effect will be more important than the fact that Russia is falling into recession. That said, there remains a clear risk that Russian authorities want to distract Russian citizens from the economic problems at home. Although opinion polls show that the majority of Russians are against it, one obvious way to do this would be via a further escalation of the situation in Ukraine. In that case, more Western sanctions would follow, provoking new Russian countermeasures. The benefits of a weaker euro, cheaper energy and lower interest rates for the Eurozone economy would then be eroded by the negative effects on overall economic sentiment.

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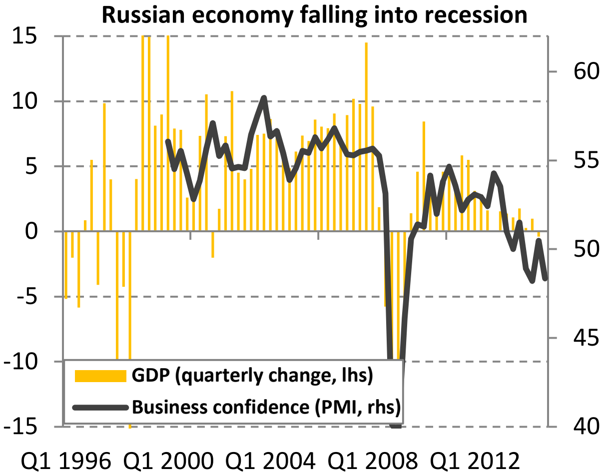

Financial position much stronger than in 1998