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The Russian Crisis: Early Days

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OVERVIEW

Bottom Line: It is tempting to rush to judgment on the Russian economic crisis. Russian Finance Minister Anton Siluanov is among those declaring the currency crisis over and promising rate cuts to follow currency stability. Conversely, many market analysts have warned of an imminent, full-blown economic crisis including a credit crunch, exchange-rate-driven inflation, sky-high interest rates, and rising unemployment. Both assessments are off the mark. The reality is that these are early days in the crisis; sanctions and oil together are imposing massive economic dislocations and those costs will rise over time as sanctions bind more tightly, limiting the resilience of the Russian economy. Russia still has substantial financial buffers and economic policies that it can use to delay an economic crisis, but market pressures are likely to return sometime in 2015.

A CLASSIC CURRENCY CRISIS?

Recent developments in Russia present many elements of a classic emerging-market crisis. A market selloff and loss in confidence fuels capital flight. Sharp interest-rate hikes (650 basis points) fail to stem currency depreciation (see Figure 1). Investment plunges and consumers race to get out of the currency (for example, through the purchase of durable goods). Against this backdrop, it is not surprising that growth fell in the fourth quarter by 0.5 percent over a year earlier, leading to renewed currency declines. Market forecasts of a 5 percent decline for 2015 now look optimistic.

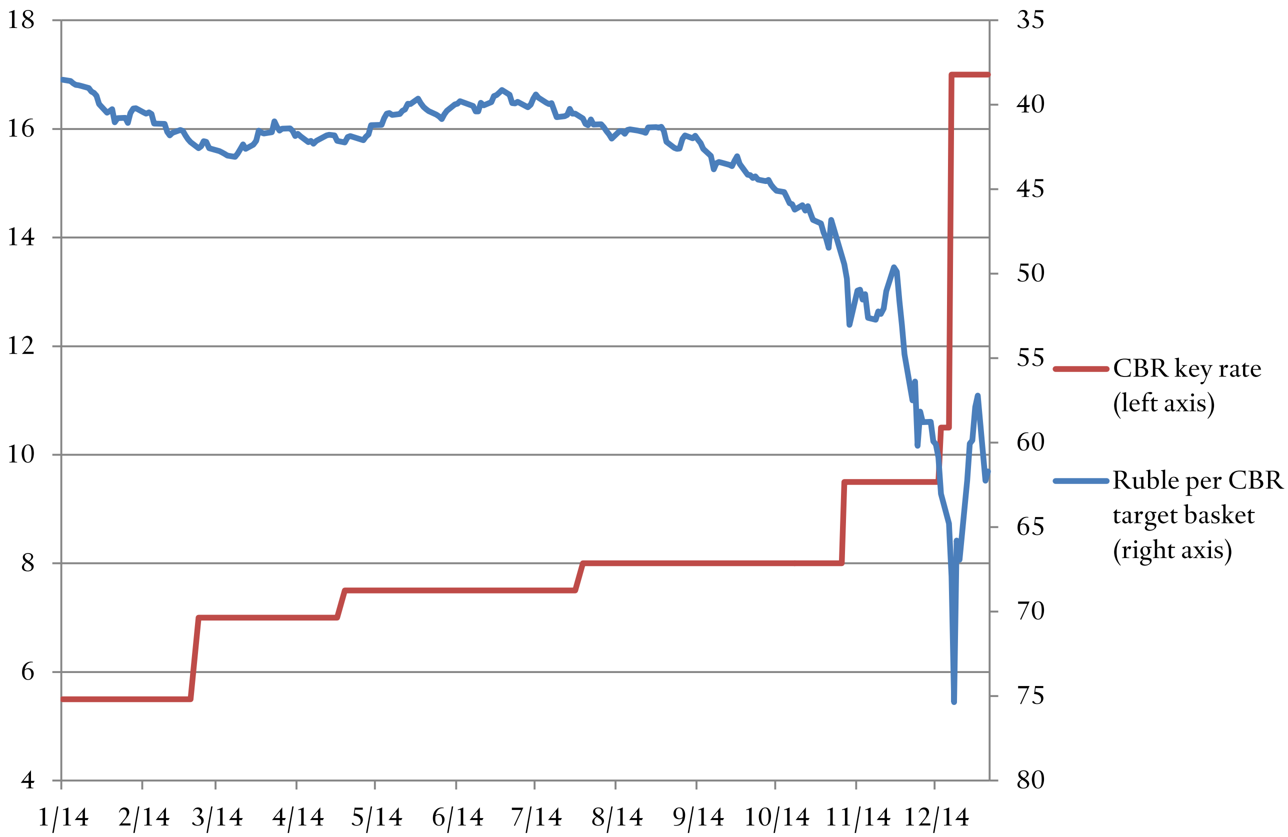
But it would be misleading to view these developments solely through a currency lens. The Russian economy was already struggling prior to the current crisis, as weak economic policies, a poor global environment, and adverse demographics undermined the promise of a strong recovery following the financial crisis.

The most likely trigger for a future crisis resides in the financial sector.

Oil has always been central to Russian economic performance, but weak fiscal policies have meant that increasingly higher oil prices were needed to keep the budget balanced. In 2014, the fiscal break-even price was around $110 per barrel, compared to estimates of $30 to $40 per barrel just a decade ago. With current oil prices around $50 per barrel, the fiscal and external shortfall is substantial and is likely to widen as the government steps in with rescue packages for companies in trouble. Even though a depreciated currency can help the budget by raising the ruble value of exports, fiscal policy looks unsustainable.

The most likely trigger for a future crisis resides in the financial sector. December's $2 billion bailout of Trust Bank, coupled with news of large and potentially open-ended support for VTB Bank and Gazprombank, highlight the rapidly escalating costs of the crisis for the financial sector as state banks and energy companies face high dollar-denominated debt payments and falling revenues. Rising bad loans, falling equity values, and soaring foreign-currency debt are devastating balance sheets. As foreign banks pull back their support, the combination of sanctions, oil prices, and rising nonperforming loans is creating a toxic mix for Russian banks. So far, a crisis has been deferred by the belief that the central bank can and will fully stand behind the banking system. If any doubt creeps in about the strength of that commitment, a run will quickly materialize. Therein lies the central challenge for the central bank. News of large or unexpected bailouts trigger renewed market pressures and risks a political backlash, but the trigger for a crisis may be more closely linked to any sense that the central bank will step back from its support for the system.

FIGURE 1: CENTRAL BANK OF RUSSIA'S (CBR) KEY RATE AND THE VALUE OF THE RUBLE



Source: Central Bank of Russia.

In this environment, further central bank rate hikes are likely to be counterproductive. Capital controls look increasingly likely, even though controls in Russia usually have been ineffective. Options range from those relatively benign to markets (for example, requiring state companies to sell foreign currency holdings) to repressive constraints on private deposits. In the end, evasion is simply too easy. The government has resources: international reserves fell $121 billion last year to a still-healthy $389 billion, but the government's willingness to spend further is uncertain. Still, Russian policymakers need to do something.

Russia could have weathered an oil shock or sanctions alone, but not both together.

SANCTIONS AS A FORCE MULTIPLIER

Sanctions are a force multiplier. Western sanctions have taken away the usual buffers—such as foreign borrowing and expanding trade—that Russia relies on to insulate its economy from an oil shock. Over the past several months, Western banks have cut their relationships and pulled back on lending, creating severe domestic market pressures. The financial system has fragmented. Meanwhile, trade and investment have dropped sharply. These forces limit the capacity of the Russian economy to adjust to any shock. Russia could have weathered an oil shock or sanctions alone, but not both together.

This was the argument made by President Barack Obama, who stated recently that "over time [sanctions] would make the economy of Russia sufficiently vulnerable that if and when there were disruptions with respect to the price of oil—which, inevitably, there are going to be sometime, if not this year then next year or the year after—that they'd have enormous difficulty managing it."

When crisis happens, exchange rates will move far and fast.

Another implication of sanctions is the reduced risk of contagion to the West. Unlike the 1998 Russian crisis, the fact that sanctions have caused Western financial institutions to pull back from Russia makes the West less leveraged, less interconnected, and therefore less vulnerable to contagion than was the case in 1998. It is not surprising, therefore, to see a modest reaction in U.S. markets so far, with the exception of energy companies that are affected by the global energy shock.

A RUSSIAN CRISIS: ARE WE THERE YET?

Measured by the severity of recent market moves, Russia is in crisis. But from a broader perspective, a comprehensive economic and financial crisis would cause a far greater degree of financial distress for the Russian people. Companies would find working capital unavailable; interest rates of 17 percent (or higher) and exchange rate depreciation would cause a spike in import prices; and capital expenditure would crater. All this would generate sharp increases in unemployment and a far greater fall in gross domestic product (GDP) than we have seen so far.

We are not there yet. Ultimately, though, the test of whether a crisis materializes is as much political as economic: an upturn in inflation and a deep recession would be the real test of whether sanctions would create conditions for peace, not just a move in Russian stocks and bonds. That is because it is only now that the broader Russian public is feeling the costs of President Vladimir Putin's policies. No doubt the searing experience with hyperinflation in 1998 still resonates with the Russian public. History also reminds us of the fragility of confidence. When crisis happens, exchange rates will move far and fast. But these are early days, and economists should mind the old dictum when it comes to financial crises: predict an outcome or a date, but not both.

Looking Ahead: Kahn's take on the news on the horizon

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Snap Greek elections will continue to unsettle European markets on concerns of a Greek exit from the euro and a renewed European crisis. European policymakers appear overly confident that an exit no longer presents systemic risks.

Time for a Plan B?
Ukraine's financing gap remains unfilled, amid standoff between the International Monetary Fund and Western governments.

Venezuela can't survive low oil
With oil prices at current levels, Venezuela appears headed for crisis.