CRS Insights

Economic Crisis in Russia Rebecca M. Nelson, Specialist in International Trade and Finance (<u>rnelson@crs.loc.gov</u>, 7-6819) December 17, 2014 (IN10200)

Recent Developments

On December 15, investors started a massive sell-off of Russia's currency, the ruble. This accelerated depreciation of the ruble, which had been ongoing for several months. In order to stem its further depreciation, the Bank of Russia (Russia's central bank) announced its biggest <u>interest rate hike</u> since 1998, raising a key interest rate from 10.5% to 17%, at an emergency meeting on December 16. Despite this measure, the <u>ruble sharply depreciated</u> throughout the day, falling from 58 rubles per dollar to 80, before rising again to 70. The central bank is currently <u>intervening in foreign exchange markets</u> (meaning it is selling foreign currencies and purchasing rubles) to support the value of the ruble.

The proximate cause of the sell-off was likely a <u>deal announced between Russia's central bank and</u> <u>Rosneft</u>, a major state-controlled oil company, to help cover the company's debts. Many investors viewed the nearly \$11 billion deal as potentially inflationary and, given the favorable terms of the deal and the close ties between Rosneft and the Kremlin, a signal that the central bank may not be immune to political pressures.

Depreciation of the ruble will likely exacerbate inflation in Russia. <u>Consumers in Russia are rushing</u> to purchase durable goods, like cars, which are now viewed as more reliable stores of value than the ruble. A weakening of the ruble also raises the value of foreign-currency debt in terms of rubles. The Russian government has relatively little debt, but some Russian corporations are <u>more indebted</u>. High interest rates will likely have severe adverse consequences for Russia's growth prospects.

Background

In the 2000s, Russia benefited from rising oil prices, but it was hit hard by the global financial crisis in 2008-2009. Russia's economy sharply contracted by 7.8% in 2009. Growth rebounded in 2010, but has been falling in subsequent years. Economic pressures in Russia have been building in recent months, marked by capital flight, steady depreciation of the ruble, inflation, and lower economic growth.

Figure 1. Economic Trends in Russia



Source: CRS compilation of data from the IMF and the Bank of Russia.

- Capital flight: In the first three quarters of the year, <u>net private capital outflows</u> from Russia totaled \$85 billion, compared to net outflows of \$54 billion in all of 2012. In December 2014, <u>Putin announced</u> that one of Russia's sovereign wealth funds, the National Welfare Fund, would be used to recapitalize Russian banks.
- **Depreciation of the ruble:** Capital flight from Russia contributed to downward pressure on the ruble, which depreciated against the dollar by more than 50% between July 2014 and early December 2014, even before the events unfolding on December 15 and 16. <u>Russia's central bank spent \$80 billion</u> to support the ruble in 2014, before the most recent round of currency interventions.
- **Inflation:** In November 2014, inflation in Russia increased to 9.1%, the fastest acceleration since 2011 and well above the central bank's target rate of 5% to 6%. In addition to depreciation of the ruble, inflation has been caused by Russia's <u>ban on certain agricultural imports</u> from countries imposing sanctions, which has caused some food prices in Russia to rise dramatically.
- **Diminished growth prospects:** In October 2014, the IMF downgraded its forecast for Russia's economic growth in 2014, from 1.3% to 0.2%. It projected that Russia's economy will only grow by 0.5% in 2015. Although the Russian government had initially been optimistic about its economic growth prospects, in early December 2014, the Bank of Russia forecasted that the <u>economy could contract by 4.5%</u> in 2015.

Economic instability in Russia is likely driven by low oil prices, which have fallen by <u>more than 40%</u> <u>since June</u>. Russia is a major oil producer and exporter, and oil and gas account for <u>about half</u> of the government's revenues. <u>Targeted sanctions imposed by the United States</u>, the <u>European Union (EU)</u>

and other countries on Russian individuals and entities may also have been a factor, although it is difficult to assess to what extent. U.S., European, and other countries' financial institutions have reportedly <u>cut off</u> many major borrowers in Russia, even those not on the sanctions list. Other factors could also include questionable domestic economic policies; the general political crisis in <u>Ukraine</u>; <u>corruption</u>; and an economic slowdown in Europe, one of Russia's major economic partners.

Issues to Watch

Next steps for the Russian government? How long will Russia's foreign exchange reserves last if it continues to intervene in foreign exchange markets and provide support to selected Russian firms and banks? By most measures, Russia has large <u>foreign exchange reserves</u>, totaling \$374 billion at the end of November 2014. However, some <u>analysts question how liquid</u> Russia's foreign exchange reserves actually are. A former finance minister claimed the amount could be as low as \$200 billion. Some analysts have suggested that the Russian central bank could impose <u>capital controls</u> to stop money from leaving the country, but there are questions about the effectiveness and long-term consequences of capital controls.

Contagion to other emerging markets? Russia is a major player in the international economy: it has the world's ninth-largest economy and a population of more than 140 million. There are <u>questions</u> about whether investors will differentiate the economic challenges facing Russia as unique from those facing other emerging economies, such as India, South Africa, and Turkey, or whether the crisis will trigger broad capital flight from emerging markets to "safe havens," like the United States and the EU.

Spillover effects for the United States? Overall <u>U.S. trade and investment ties with Russia</u> are relatively limited, but some major U.S. firms, such as ExxonMobil, General Electric, Ford, and Pepsi, among many others, are active in Russia. An economic crisis or prolonged economic downturn in Russia could directly impact these firms. It could also create disruptions in the global economy that could impact the U.S. economy more indirectly, particularly as growth in many countries—including Europe, Japan, and China—has slowed. In particular, the economic impact of the crisis on Europe could have implications for the U.S. economy, given tight U.S.-EU economic ties.

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