Russia's Policy Framework in a Multifaceted Macroeconomic Risk Environment

Review of Integrative Business & Economics Research

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ABSTRACT

In a resource dependent emerging market like Russia, the recurrence of the oil crisis and the ensuing slowdown in the aftermath pointed towards structural vulnerabilities in the growth model adopted by them hitherto. Macroeconomic risks emanating from crude-price fluctuations and exchange rate movements imposed significant costs of the federal budget in terms of loss of revenue. This uncertainty in the budget is destructive for a state-controlled economy. The recession triggered by oil crises of 2014 brought back the long-standing issue of diversification. Weakening of household demand along with private investment and significant deceleration of credit growth in 2015 dwindled the possibility of domestic demand supporting growth forever. Faced with this scenario, we analyze how Russia's policymakers are trying to overcome these structural fragilities in the growth model through export promotion, diversification and tackling the banking crises along with other measures aimed to increase FDI in non-oil sectors.

Keywords: Oil crises, macroeconomic risks, budget, household demand

1. INTRODUCTION

Russia is a major player in the oil market recording largest daily oil production for the past three years. Due to lack of diversification, Russia has become a commodity-intensive economy with oil and natural gas driving its growth. Its revenues are majorly dependent on the oil exports. In 2015, the revenues from oil and gas made up to 44% of the federal budget. Now with the current oil rout and the sanctions imposed due to Ukrainian intervention, Russian economy experienced rising fiscal deficit and inflation accompanied by worst recession the country has seen in this century. The triggering of a recession following an oil crisis reinvigorated policy makers' attention on the issue of diversification. Being heavily dependent on oil, the economy is exposed to the risks of crude-price dynamics as well as exchange rate movements. The 2014 oil crisis reduced the GDP growth rate to -0.5% in the Q2, 2014. Since dollar is traditionally acceptable means of payment for oil-related sales and purchases, Russia's export earnings have also been exposed to the risk of fluctuations in dollar/ruble exchange rate. Historically, ruble/dollar exchange rate has had a close positive correlation with oil prices (Loo, 2015). This double-edged sword of macroeconomic risks highlighted the fragility of Russia's growth path. Hence,

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curbing exposure to dollar and diversifying to non-resource sectors was considered an important objective amidst the risks of strengthening of dollar accompanied by other political factors. Throughout this research, we observe that various changes in the geopolitical factors and events related to the oil like the introduction of the shale technology by the USA and the 2015 sanctions by the UN have deeply impacted the Russian GDP. Hence in order to mitigate these macroeconomic risks – namely oil dependency and exposure to exchange rate dynamics, Russia decided to reduce its USD dependency and started accepting ruble and yuan as a payment towards its exports, a trend being termed as "de-dollarization" coupled with an effort to diversify in other sectors. The building up of banking sector crises culminating in takeover of three major banks by CBR (leading to write-off of subordinated debt and bailout of creditors) limited the credit growth, especially in the consumer credit segment which provided further incentive to shift away from consumption-driven growth model.

2. LITERATURE REVIEW

The Russia Economic Report (WORLD BANK, 2016) highlights several important features about the state of Russian economy. First, Russia's dependence on oil exports proved to be a serious liability in 2015, as an increasingly adverse external environment resulted in a severe economic contraction. This oil-price shock, which occurred amid a worsening growth outlook for emerging markets, had a negative impact on Russia's oil-dependent economy. Russia's economy contracted by an estimated 3.7 percent of GDP in 2015. Second, The Russian economy adjusted to the worsening external environment through a sharp drop in income, which weakened consumer demand and discouraged investment. Gross domestic income is estimated to have dropped by about 10 percent, primarily due to negative terms-of-trade effects. Persistently low oil prices resulted in a steep depreciation of the ruble. The free-floating exchange rate enabled imports to rapidly adjust, with a 25.7 percent decline in import volumes boosting net exports in 2015 (Figure 1-2), yet the ruble's depreciation also led to double-digit inflation. The consequent decline in household purchasing power−as real wages and incomes did not keep track with inflation trends−sharply reduced consumption by an estimated 7.5 percent in 2015, its first contraction since the global financial crisis in 2008. In aftermath of ruble depreciation, some industries were able to take advantage of the weaker ruble to increase output and exports, but most manufacturing sectors continued to contract in 2015 implying high dependence on domestic demand to sustain growth. Third, the economic sanctions imposed on Russia have been extended, limiting access to global financial markets, restricting capital inflows and depressing private sector confidence. High capital costs and plummeting consumer demand have given Russian firms little incentive to expand, and as a result, gross capital formation dropped by 18.7 percent in 2015, contracting for the third consecutive year. Amidst this declining private investment, the economy's inclination towards deleveraging was observed. Russia's external debt decreased by about 10.0 percent adjusted for reevaluation effects to US$515.9 billion at end-2015 from US$599.9 billion at end-2014 (Table 1-2). After adjusting for the depreciation of the ruble, the total public debt stock dropped by 16.0

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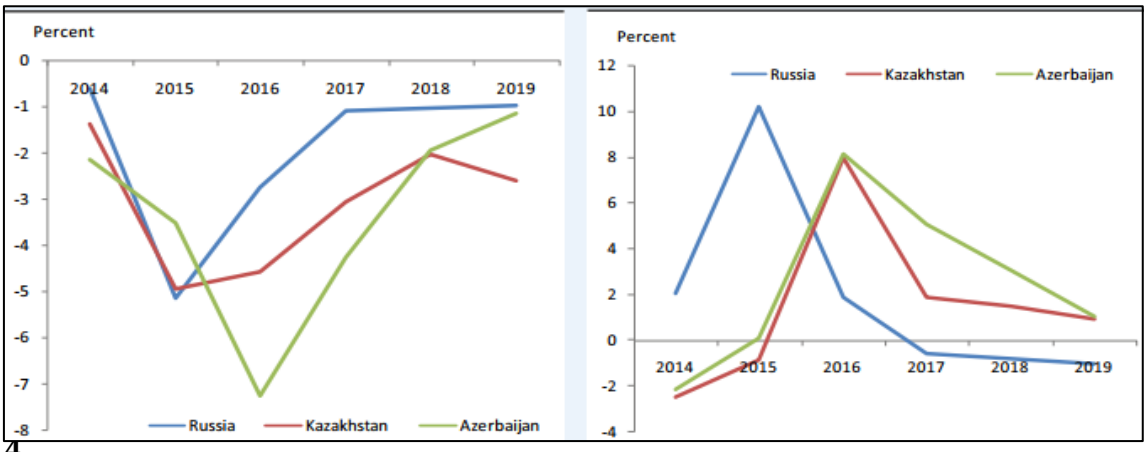
percent between end-2014 and end-2015. The banking sector's total external debt, adjusted for depreciation, shrank by 16.8 percent between end-2014 and the end of the quarter three in 2015. Fourth, the rising share of NPLs is increasing pressure on bank capital. High interest rates continue to exert upward pressure on funding costs, while credit levels are in decline and defaults are increasing. This threatens to create a vicious cycle in which tight credit constraints further discourage investment. The report goes on to highlight the restriction on FDI in oil (which is the major sector for FDI flows) and the problem of round-tripping which deprives the economy of the effects of technological spillovers from FDI.

3. RESEARCH OBJECTIVE

Consumption expenditure and oil exports have played a central role in supporting the economic growth in Russia. But the recession triggered by oil crises of 2014, UN sanctions and rising bad loans in PSBs seems to question the very viability of such a growth model as the external sector was hit due to the oil crisis (Figure 1) and the household demand was negatively affected due to the falling real wages and consistently rising bad consumer debt which raises the cost of risk and makes borrowing more expensive. In fact, weak domestic demand was the most nagging constraint to manufacturing. The twin blows led to a drop in GDP which sapped consumer demand and private investment. Lack of diversification and staggering GDP in the Russian economy led to uncertainty in employment and incomes of the populace which was reflected in the rise in the number of unemployed workers and a considerable decline in real incomes (Alexey Kudrin, 2014). Given the state's prominent role in the economy, many private firms rely on public contracts. As a result state's major role in the economy increases risks for households and firms when fiscal constraints tighten. So, it seems plausible to assume that policymakers might be looking for some reliable model of growth. In this paper, we aim to determine how the interplay of various macroeconomic factors and policy decisions guided the Russian economy towards an alternative and perhaps more reliable growth path.

Figure 1: Impact of Oil prices on GDP and Inflation



Source: WORLD BANK

4.

After the collapse of Soviet Union in early 1990's due to increased government control in the economy (leading to rising fiscal deficit, skyrocketing inflation, and stagnant

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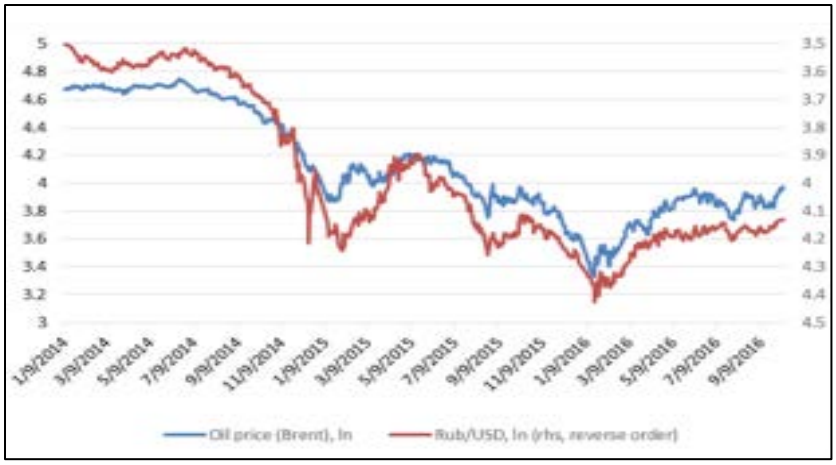
wages), Russia adopted a conservative monetary and fiscal policy (Alexey Kudrin, 2014). With limited access to international financial markets, Russia focused on lucid incentives to international lenders in order to attract foreign capital.

Reduction in fiscal deficit and debt repayment are often instrumental in attracting global finance. An inflow of capital would also provide policymakers some flexibility to do away with austerity measures. Presently an important task before the government was to restructure the economy in order to provide it a sustainable growth path by boosting exports in a substantial manner. To facilitate the growth of a vibrant export sector, a series of measures were required. Reducing exposure to USD and fulfilling capital requirements of production sector were the most significant amongst them. These requirements were fulfilled by incentivizing global finance through debt repayment. Debt repayment would also reduce dollar dependency.

Russian economy decided to reduce its dependency on the dollar due to growing risks of a downturn in ruble exchange rate because of plummeting global oil prices (Figure 2), that was caused due to US oil production (shale technology) in 2013. Real interest rates in the US were higher than those in Russia, leading to a risk of weakening of Ruble (WORLD BANK, 2016).

Figure 2: Oil Prices and RUB/USD



Source: http://www.cbr.ru

Owing to above-mentioned risks, Russia decided to reduce its External debt exposure by paying its US denominated debt and commencing de-dollarization of its trade settlements (Engdahl, 2017).

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Figure 3: Non Resident Deposits

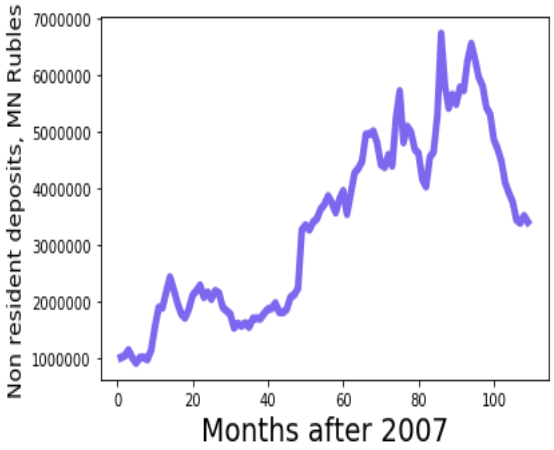
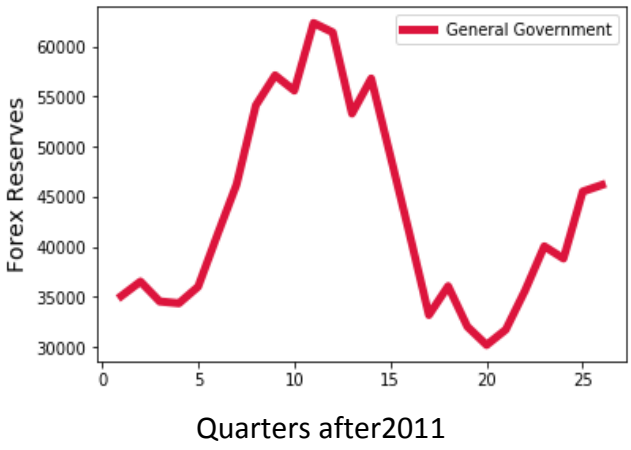


Figure 3: Foreign Exchange Reserves in Russia



Source: http://www.cbr.ru

Repayment of external debt involved a huge amount of USD outflows. Its demand was met by-

1. Using their foreign exchange reserves (Figure 3)
2. Using non-resident deposits (Figure 4)

Russian government set itself on a debt repaying spree in 2015. Debt liabilities of the government saw a considerable reduction by $11.1 billion and a substantial portion of this reduction came in the segment of foreign currency denominated securities. Banks' external liabilities also shrank by almost a quarter in the aftermath of liquidity flush in banks. External debt of other sectors fell by $39.7 billion (Figure 5) (WORLD BANK, 2016).

Figure 4: Long term External Debt Payment (MN RUB)

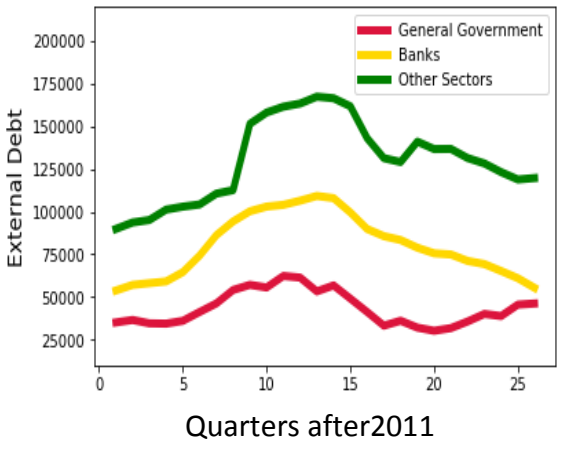
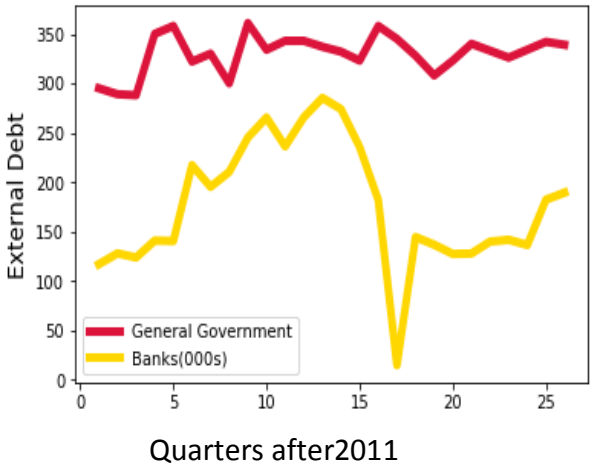


Figure 6: Short term External Debt Payment (MN RUB)



Source: http://www.cbr.ru

Depreciating Ruble also imposed a huge cost of servicing its foreign debt. An increase in the share of Ruble-denominated long-term liabilities (Figure 6) are indicative of the fact that government is preparing itself to invest in long-term projects probably

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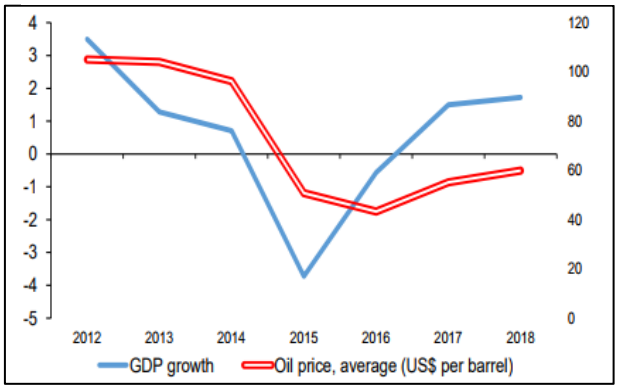
infrastructure and manufacturing and fiscal deficit will probably see a rise along with a control over revenue expenditures of government. This change could be attributed to Mr. Putin's call for further diversification of Russian economy in response to the global oil crisis in 2014 and Ukrainian Sanctions (LOSSAN, 2016).

After repaying its external debt, the government had a series of challenges to be tackled that included

1. The crisis in PSB's with a huge amount of bad subordinated debt (Jake Rudnitsky, 2017).
2. The sanctions imposed on Russia related to the Ukrainian intervention led to deep economic impacts, leading to a GDP growth of -2.2% for first quarter of 2015.(Figure 8) (WORLD BANK, 2016)

Above stated factors led to a crisis like situation in the economy causing a reduction in consumer activity (especially imports) in the domestic foreign exchange cash market compared to that in 2014 (INTERNATIONAL TRADE ADMINISTRATION, 2017).

Figure 6: Russian GDP growth and Oil price



Source: WORLD BANK

Figure6: Russian Imports (MN RUB)

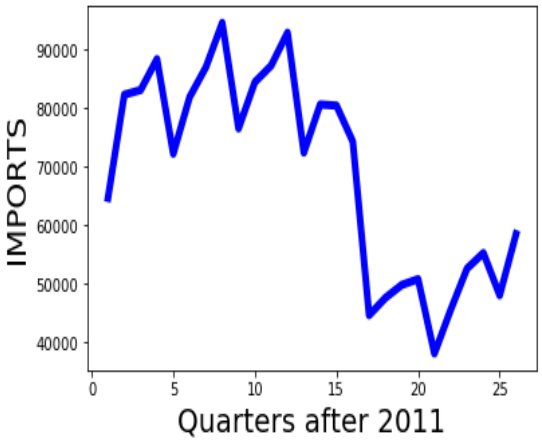


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Table 1: Macroeconomic Indicators

	2015	2016	2017	2018
Oil price (US$ per barrel, WB average)	51.9	43.3	55.2	59.9
GDP growth, percent	-3.7	-0.6	1.5	1.7
Consumption growth, percent	-7.5	-2.5	2.0	1.6
Gross capital formation growth, percent	-18.7	1.9	6.0	4.9
General government balance, percent of GDP	-3.5	-4.2	-2.5	-0.5
Current account (US$ billions)	69.0	27.6	26.5	25.4
Current account, percent of GDP	5.2	2.2	1.8	1.6
Capital and financial account (US$ billions)	-86.1	-27.4	-26.4	-25.4
Capital and financial account, percent of GDP	-5.3	-2.2	-1.8	-1.6
CPI inflation (average)	15.5	7.1	4.5	4.0

Source: http://www.cbr.ru

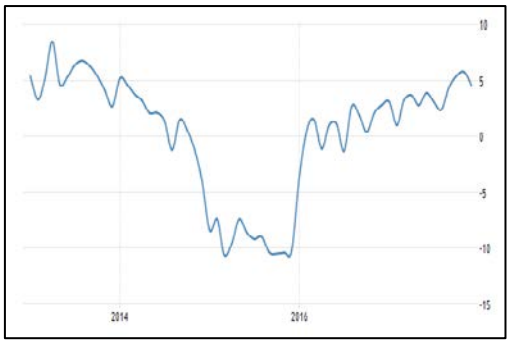
This crisis led to a shortfall in imports (Figure 9) as well as consumption of goods and services leading to recession in the economy with low demand and production. In order to provide the lost stimulus, the government went on to increase its money supply in the economy in 2015 as its monetary policy response. (KUCHMA, 2015)

Meanwhile, the PSB's position worsened (Figure 10) due to economic shocks of collapse in oil prices and international sanctions in 2014. More than 20% loans were bad in these banks (S&P). The state of Russia owned about 60% of the total share in these banks. This created another major problem for the government that had to be fulfilled along with other export-oriented incentives. (Jake Rudnitsky, 2017)

With this increased money supply, the already plummeting domestic demand was further hit by rising inflation in 2015. Troubled demand in the home country was an added incentive for firms to export.

Figure 10: Bad loans in the Russian Economy

Figure 9: Russia real wage growth



Source: Bloomberg

Now, in order to export, firms would require global competitiveness for their products as well as capital to meet the rising expenditures associated with expanding their businesses. Fall in real wages (Figure 10) complements the competitiveness of the export sector. This created a sentiment in the corporate sector to repay its debt as

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repayment of their external debt would enhance their profits by reducing foreign denominated interest expenditures (that were steadily depreciating) and consequently improve their competitiveness. Also, the additional capital requirement was met by directing private fund towards export-intensive sectors by reducing the deposit rates. Now, as deposit rates were kept low by the Central Bank for a sustained time period, private fund started looking for other avenues of investment. Low deposit rates coupled with high lending rates, in 2016, turned the direction of private funds towards the export sector. With depreciating currency and government's push for exports, export intensive sectors were expected to generate more than normal returns. Hence, the capital inflow was concentrated in these sectors. This way exports were allowed to grow at the cost of private consumption expenditure. In 2017, Monetary Policy coupled with the fiscal policy was used by the government to bail out its debt-ridden PSB's through its National Welfare Fund (Jake Rudnitsky, 2017).

These measures were aimed to create an incentive structure by the policymakers, indicating that Russian federation is aiming to pursue an export-led model of growth. This will provide the necessary boost to domestic firms. Russian economy is supposedly restructuring itself by protecting domestic firms through a ban on imports of some goods and encouragement to capital inflows (INTERNATIONAL TRADE ADMINISTRATION, 2017).

5. ANALYSIS

GDP has been regressed with respect to foreign exchange reserves, imports, and external debt. The model depicts a direct relationship between dependent variable i.e., GDP and the three independent variables.

Table 2: Regression Analysis

	Coefficients	*Standard Error*	*t Stat*	*P-value*
Intercept	36789.72005	1206.26563	30.4988546	1.70288E-19
EXTERNAL DEBT	0.013799821	0.007037925	1.960779634	0.062686759
FOREIGN EXCHANGE RESERVES	0.070472321	0.004735732	-14.88097857	5.76568E-13
IMPORTS	0.141250935	0.01881464	7.507501493	1.66721E-07

Regression Statistics	
Multiple R	0.97042116
R Square	0.9417172
Adjusted R Square	0.933769595
Standard Error	715.274802
Observations	26
F Value	118.490046

A positive relationship exists between the GDP and the External Debt. This is probably because the government reduced its external debt by paying off its USD denominated debt. The payment of debts in such a huge amount restrained government's budget resources. As a result, government expenditure in the economy fell which were of the

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utmost importance at a time when there were trade sanctions and banking crisis. Consequently, there was a negative impact on the GDP.

There exists a positive relationship between foreign exchange reserves and GDP. The government used its reserves as a tool to achieve its objective of reduced exposure to the foreign exchange. In the entire timeline, the foreign exchange reserves were first used to repay external debt and then probably used to bail out PSB's. In both cases, the government experienced a restraint in its resources causing a hindrance to its GDP growth.

There exists a positive relationship between GDP and imports. Russia is a net importer of all major commodities except oil, natural gas, and hydrocarbons. A steep depreciation of ruble in this time period increased the price of imported goods which are crucial for the production of other intermediate goods in the economy. It restrained the economy to conduct trade with other nations. As a result, the imports into the nation fell. It affected the production sector as a whole as supplies of goods were affected by other nations. Consumption sector was also affected as prices of goods and services increased. Hence there was a negative impact on GDP as a whole.

Note

1. Exports have been excluded from model due to high correlation with GDP, thus posing the problem of endogeneity.
2. The aforementioned regression analysis is based on the data from past seven years.

6. THE POLICY TRILEMMA

The policy trilemma or the impossible trinity is a macroeconomic theory which states that out of the following three;

- Autonomous monetary policy
- Free mobility of capital
- Fixed exchange rate

A country can choose only two. Countries which have tried to achieve all three of them simultaneously have failed. If the monetary policy is autonomous and capital is freely mobile, then exchange rate ought to fluctuate. However, if the country fixes its exchange rate, then monetary policy will move in tandem with capital flows and won't cater to need of domestic stability, inflation, and unemployment. In other words, monetary policy will not be autonomous.

The concept of policy trilemma can offer some insight regarding Russia's choice of autonomous monetary policy and free capital mobility. Russia is still an emerging market where interest rates are used as an important tool to regulate the money supply. When the government is reluctant to spend aggressively, monetary policy can be used as a tool to provide the necessary stimulus. Control over monetary policy and banking system becomes all more important in an economy whose access to international

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financial markets is constrained. In absence of competing financial instruments, capital provided by the banking system becomes necessary for businesses in such circumstances. Hence, autonomy over monetary policy is needed.

In the context of Russian growth story, the trilemma underwent through different stages at different points of time whereby one of the policy measures was sacrificed for the other two such that the economy could be diversified and made more export intensive. It can be seen in the following graph, the real exchange rate in Russia moves in tandem with the price of Brent crude oil (FRED, 2018). A fall in oil prices leads to a real depreciation of ruble, which acts a cushion against plummeting export earnings as a depreciated currency leads to roughly the same revenue in ruble terms. So, in a way RUB/USD exchange rate is pegged to the oil prices.

Now, prior to November 2014, the CBR maintained a soft peg against the dollar which was the reason for low volatility in the RUB/USD exchange rate. With oil prices at more than $100/barrel in mid-2014, ruble maintained a strong position against the dollar. But with compromised flexibility in the exchange rate, and some 'informal' restrictions on the outflow of capital, the efficiency in monetary policy was probably jeopardized. Real interest rates remained negative in the pre-2014 period implying little use of monetary policy in ensuring macro stability and handling inflation.

However, with a renewed slump in oil prices at the end of 2014 and with the advent of the economic sanctions regime, Russia's attention was once again attracted to diversifying export sector in order to mitigate the risk of falling crude prices. President Putin removed all restrictions on the flow of capital except on the FDI in sectors directly involved in oil production thereby directing the flow of foreign funds in non-oil sectors. In order to pursue this, exchange rates were allowed to float freely and autonomy in monetary policy was compromised. The real interest rates in Russia remained less than those in the US prior to 2012 and China prior to 2014 but overtook them in 2012 and 2014 respectively (Figure 10) implying intention to attract capital especially in the non-resource sector. Thus over the time period from 2011 to 2014, policy changes were focused on export promotion and due to the trilemma, only two could be achieved with sacrificing the third. Depreciating of the ruble against the dollar is a good sign for the export sector but poses risk of inflation as it leads to higher prices of imports. However, with the "de-dollarization" trend in full swing led by Russia and china, Russian coffers are filled with yuan with the majority of payment in exports being accepted in yuan and ruble. These yuan reserves can then be used to finance imports from China (Russia's major import partner). Along with price advantage due to depreciating ruble, Russia also needs technological spillovers from FDI to give a greater push to exports.

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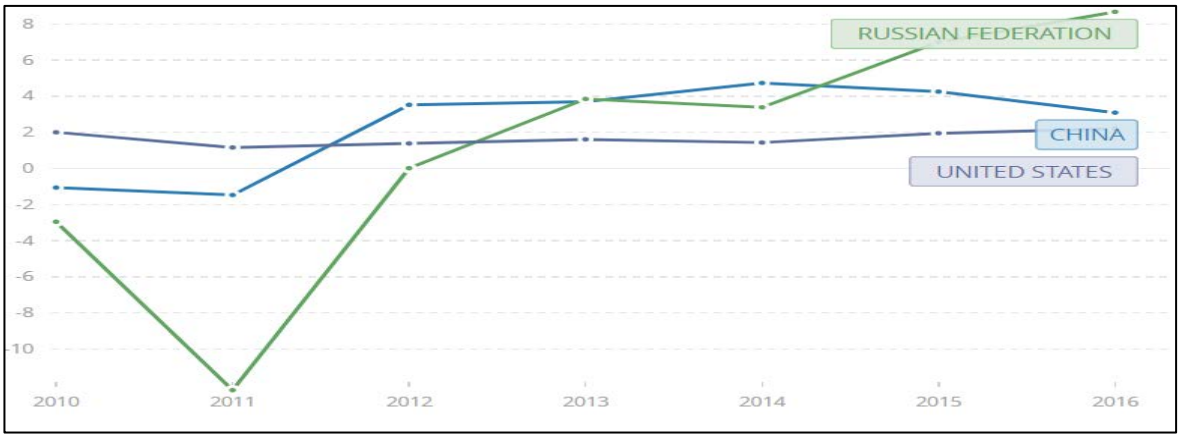
Figure 7: Real interest rates (%)



Source: World Bank

7. CONCLUSION

The recurrence of the oil crisis and its resulting implications on the economy have compelled the government to come up with a concrete action plan to drive growth. In response, the government came up with a movement from primarily a commodity-driven to a more diversified economy. The government had three challenges that are oil crises, UN sanctions, and the PSB's bad loans and it used three policy measures-external debt repayment, interest rates and the fiscal policy. It further planned and directed its movement on a more diversified and export-intensive growth structure. The trail of de-dollarization and trade partnership with major Asian countries shall define the future of Russian oil and non-oil exports and would be vital for nurturing its growth model and shall drastically transform the present Russian trade partnerships and flows.

8. FUTURE SCOPE

The time period of 1970's and 1980's was a period in which Asian countries exported to grow. This rapid growth was made possible by increased consumer demand for cheap foreign goods from industrial countries like America and countries in European Union. As these countries sustained massive current account deficits due to rising imports, they had to borrow in order to finance these deficits. These borrowings were financed by savings of households from the same developing countries which were exporting to pursue growth. This created massive trade imbalances with developing countries having trade surpluses and the developed ones running deficits. Thus, the exporting countries were becoming increasingly dependent on industrial countries to absorb the surplus produced by them. In this process, the developing nations created producer biased economies which led to difficulties in creating sustained domestic demand. Hence, the dependence on foreign demand continued to increase. Now, as the industrial countries are turning more towards protectionism and are facing stagnancy, the path to be followed by export-dependent nations is becoming more and more uncertain as their source of demand seems to be fading. In such a world, export-led

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growth is a distant possibility not only due to stagnancy in industrial economies and their push towards domestic production but also due to potential competition between emerging markets to export their goods. If the competition to export rises to unsustainable levels, the global prices would come down threatening the export earnings of these countries. The task before Russia's policymakers then essentially boils down to deciding the future scope after a thorough comparison of the costs associated with two alternatives – either regulating the existing macroeconomic risks or mitigating these risks through an alternative growth model, whose sustainability is itself in question given the current world order.

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