Russia risk scenario: Deep recession in 2015 if oil prices fail to recover

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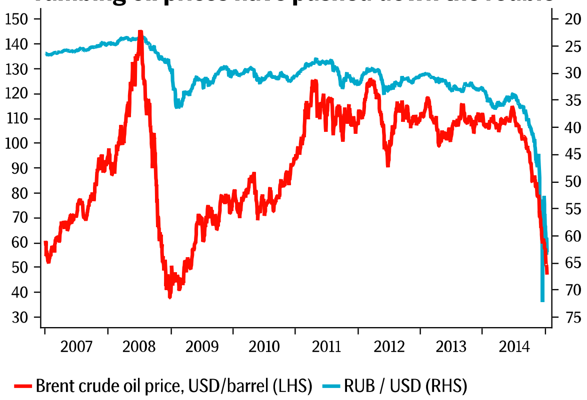
After the unexpected slide in oil prices and the rouble in late November and early December, **SEB revised its forecast of Russian GDP growth in 2015 downward from -0.2 per cent to -4.0 per cent** (latest Bloomberg consensus: -1.8 per cent). The forecast is based on the assumption that the price of Brent crude oil will average USD 70/barrel in 2015, rather than USD 85 (*Nordic Outlook*, November 2014). The oil price is expected to recover in H2 2015. SEB expects the rouble to remain vulnerable in the short term despite further measures by the Central Bank of the Russian Federation (CBR) measures, but to return to 50-55 against the USD by the end of 2015 (currently close to 65), not far from fair value of 45.

According to this main scenario, despite the financial turmoil and sanctions, **Russia has financial muscles that will provide a short-term buffer** for the financial system, at least during 2015. Substantial foreign exchange reserves (USD 388.5 bn on December 26, 2014), low public debt and the large National Welfare Fund will allow authorities to manage USD liquidity and the funding impact of the economic sanctions and help major banks and energy companies to meet their refinancing needs.

Tumbing oil prices have pushed down the rouble



Source: Macrobond

Risks on the downside

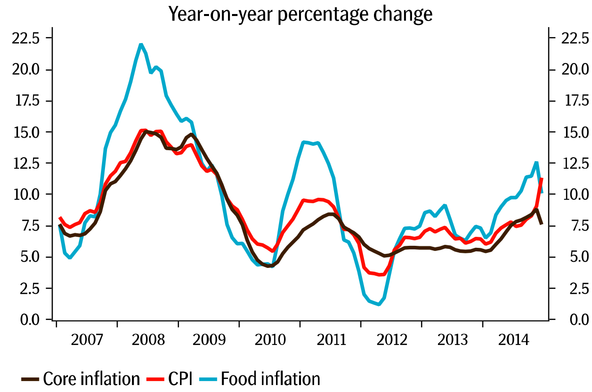
A darker scenario for the Russian economy, including a deeper recession and renewed financial turmoil, **cannot be ruled out**. Oil prices are the crucial factor for Russia, since oil accounts for some 60 per cent of exports and more than half of budget revenue. **In a risk scenario, assuming a lower oil price trajectory, implying a 2015 annual average of 50 USD/barrel** – current price around 45 USD/barrel – **GDP is expected to decrease by around 7 per cent in the current year**. **Model simulations** by the IMF and others suggest that the growth impact of a permanent USD 20 decline in oil prices would result in a **negative GDP effect of around 3 per cent**. However, the Russia-Ukraine conflict and economic sanctions against Russia imply that **the effect of lower oil prices could be larger than the models suggest**. Restrictions on access to international capital markets for Russian banks and major energy companies have led to a USD liquidity shortage.

Negative effects on the real economy

GDP will be affected through two main channels: private consumption and capital spending. Private consumption will take a severe hit in the first half of 2015 via a sharp acceleration in inflation and higher interest rates that reduce household real disposable income. Since the outbreak of the Russia-Ukraine conflict early in 2014, 10-year government bond yields have surged from slightly above 8 per cent to above 14 per cent today. Inflation accelerated from 6 per cent to more than 11 per cent in December.

Rouble weakening is pushing up inflation

Year-on-year percentage change



Source: Russian Federal State Statistics Service

Accelerating inflation is largely explained by rouble depreciation, which has pushed up prices of imported goods. The ban on food imports has also contributed to higher inflation by raising food prices. The USD 50 oil price risk scenario implies stronger downward pressure on the rouble, thereby precluding a currency recovery in 2015. The rouble is expected to remain weak and highly volatile in H1 2015. It cannot be ruled out that **the rouble could even be pushed lower than in December, when it briefly broke through 80 per USD**.

However, the shift in monetary policy regime from the “rouble corridor” to a floating exchange rate in early November 2014 has made predicting the rouble exchange rate more difficult. Furthermore, the CBR stated that it will intervene when financial market stability is threatened. In December, when the currency was around 70 to the dollar, Russian authorities claimed that the rouble was “extremely undervalued”. This implies that currency intervention will continue.

A lower rouble trajectory means that inflation will be higher than in the main scenario: **inflation is expected to peak at 20-25 per cent in Q2** compared to roughly 15 per cent in the main scenario. Household consumption will also be depressed by higher short- and long-term interest rates on consumer loans and higher servicing costs for loans in foreign currencies due to the weaker rouble.

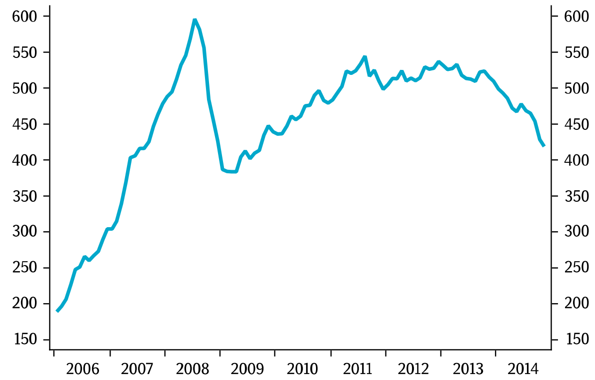
A dramatic worsening of confidence in the Russian economy, combined with sharply rising interest rates, will further dampen the already weak investment trend. According to official data, in November 2014 capital spending fell by close to 5 per cent in year-on-year terms, the largest decrease since January 2014. Capital spending has been falling year-on-year since July 2014. A weak trend for investments is one of the major structural problems affecting GDP growth in recent years.

Sharper CBR measures

During the autumn the CBR intervened heavily to try to support the rouble. On December 15, 2014, the central bank hiked the key rate by 650 basis points to 17.0 per cent. Going forward, according to the risk scenario, the CBR will use a combination of monetary policy tools: primarily massive key rate hikes and heavy interventions. Furthermore, the CBR will probably implement capital controls by limiting the ability of households to convert deposits to USD and EUR and by escalating the requirement that corporations convert their foreign-currency export earnings into roubles.

Substantial but shrinking currency reserve

USD bn



Source: Central Bank of the Russian Federation

An additional downside risk for the Russian economy is the Russia-Ukraine conflict. Should economic sanctions be intensified, Russia is now in a much more vulnerable position than before the currency crisis. GDP growth prospects for 2015 are markedly weaker. Escalated sanctions would hurt already weak and fragile market confidence and worsen capital flight, putting even more pressure on the rouble. In the first three quarters of 2014, net private capital outflows totalled USD 85 bn compared to USD 54 bn in 2013. In November the CBR forecast total 2014 outflows of USD 128 bn. The central bank expects outflows to hit USD 120 bn in 2015.

Mikael Johansson, Head of CEE Research,
SEB Economic Research
+ 46 8 763 80 93

Andreas Johnson, Russia and Ukraine Analyst,
SEB Economic Research
+ 46 8 763 80 32