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ANALYSIS

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Abstract
Russia's economy is currently suffering from two simultaneous, partly interdependent crises. Since 2014, Russia has been prepared for one of them: an oil market shock for which it is partly to blame. However, Russia is only partially prepared for the simultaneous spread of the Covid-19 pandemic. Overcoming this crisis is becoming a systemic issue. More cooperation at the international level is desirable in the short term. Domestically, the Kremlin's economic policy response remains modest. Companies and the middle class will help to overcome the crisis, while the government has yet to take meaningful action. The Russian leadership calculus could change if the Covid-19 fallout on the Russian economy becomes more predictable.

Prepared for an Oil Price Shock/Market Share Conflict

Macroeconomic downside risks posed to Russia by quarantine measures to contain the spread of Covid-19 are definitely higher than those posed by an oil price shock. This holds true even if such an oil price collapse is accompanied by a global/local financial market shock—including a drastic rouble devaluation to a four-year low, as was the case recently. In 2020, the rouble saw its second-largest devaluation shock since 2014. However, concerns about Russia's macro-financial stability were not apparent. The retreat from international capital markets since 2014 as well as the de-dollarisation in the local banking sector have reduced macro-financial vulnerabilities decisively. In addition, Russia accumulated ample budget and foreign exchange reserves—at the expense of austerity and weak growth. Thus, the Russian authorities continuously were able to lower the oil price required to balance the state budget. Fiscal break-even oil prices in Russia are half the level needed in Saudi Arabia (40 vs. 80 US-Dollars per barrel). Therefore, a drastic oil price shock such as that experienced in March is manageable for Russia. At current oil prices, Russia can continue functioning for at least several quarters and well into 2021 or 2022.

In addition, Russia's local economy improved in Q4 2019 and the first months of 2020. At the beginning of this year, the country was prepared for a market share conflict on global oil markets and was simply waiting for an occasion to act. Such an escalation must start when prices are already low in order to have the desired impact. Otherwise it is impossible to force competitors out of the market, whether they are within OPEC or outside of it. This holds especially true for U.S. shale oil drillers. According to the Federal Reserve Bank of Dallas, the regional branch of the U.S. central bank, private U.S. shale oil drillers need oil prices around USD 35 to 40 to stay afloat; and such leveraged producers have less leeway than state actors in Russia or Saudi Arabia. Russia's escalating behaviour was rationally calculated, though Western observers were surprised that it was seeking direct confrontation with the USA, the world's largest oil producer. The logic held at least until the unpredictability surrounding the Covid-19 pandemic began to undermine the strength of the global and Russian economies.

Covid-19 Losses in Russia—Greater Than an Oil Price Shock

The extremely diverse risk profiles of an oil price shock vs. the Covid-19 pandemic disruption can be illustrated on the basis of the following estimates. Due to deleveraging in recent years, the build-up of reserves and associated stabilisers, Russia's economy can achieve growth of 0.5 per cent or slightly more over a 12–24 month horizon at an oil price of USD 35. Even at 30 dollars there is "only" the threat of stagnation. The situation is totally different with the Covid-19 related restrictions. The planned 4–5 weeks of national holidays, paid leave and quarantine measures will lead to a GDP slump of at least 3 percent for the whole year (assuming that still some 70% of the economy is functioning). The looming recession will be as broad-based as in 2016, including sharp setbacks in private consumption and industrial production. A minor spurt in investments seems probable in 2020, due to presumed state activity in H2 2020. If restrictions on social and economic life are tightened (lasting 5 weeks, but more restrictive), economic output could collapse by 5 to 9 percent on an annual basis, depending on the mix of measures. If current restrictions were extended, each additional week would translate into an additional 0.5 percentage point in output loss. Currently, we anticipate at least a 2-week prolongation of the restrictions, possibly coupled with a minor tightening. Therefore, our current GDP call for 2020 is for drop by close to 5%. This forecast clearly illustrated that anticipated economic losses from the pandemic are significantly higher than those that would result from an oil price shock alone.

In addition, the Covid-19 crisis is less predictable and calculable for the administration than an environment marked only by an oil price shock. The Covid-19 pandemic also brings the oil market much further away from equilibrium than it already was when the Russian–Saudi escalation started. Due to weak economic activity in major economies, the demand for oil—in an already oversupplied market—is likely to collapse by an additional 30–40 percent. Hence, the OPEC+ agreement reached in mid-April to take approx. 10–15 percent of production off the market will bring the oil market closer to equilibrium again only in 2021 at the earliest. This holds especially true as the agreement is associated with implementation risks.

High Losses—Albeit Lower in the Short Term Than in Complex Economies

The drastic economic consequences of the quarantine measures explain why 2020 GDP estimates for Russia are currently extremely divergent. Forecasts range from slightly negative values to -6 percent. At present any serious economic forecast is based on a hypothetical assumption about the duration of the state of emergency, which implies a high degree of uncertainty. Whereby it currently seems realistic that for Russia it could be feasible to get away with five scheduled non-working weeks (plus May holidays making 6 May the first full working day). This timeframe assumes that in economically important cities, the rules are fully complied with. Russia's capacity to monitor its own population also suggests that Russia could follow China's path in Covid-19 containment in its key economic centers rather than the more liberal policies of some Western societies, including the U.S., UK and parts of the EU in particular. Therefore, national containment of the Covid-19 pandemic is also becoming a systemic global leadership issue—both socio-politically and economically.

Although work-free weeks mean noticeable economic losses, actual GDP declines in Russia should be less than in much more complex economies. Russia is less integrated into global and multifaceted supply chains. Also, the tourism sector and small and medium-sized enterprises (SMEs) are less relevant to the economy than in countries facing more severe downturns. Additionally, Russia's economy depends on raw material industries that cannot be stopped easily, and which will continue to produce. Moreover, exports are conducted via less complex and robust infrastructure. The monocentric extraction of raw materials could continue even under more stringent quarantine conditions. And even if extracted and processed raw materials are not exported, they contribute to growth in GDP via stockpiling. Given those structural conditions, economic downsides in Russia in 2020 are more limited than those facing complex, integrated and possibly more leveraged economies, such as the U.S., UK or Germany. Due to intensified economic relations with China, Russia should also benefit from the discernible containment of the corona virus there. As a result, energy consumption in China should collapse less than at the global level. Therefore, foreign trade with China should prevent the worst in terms of slumping Russian energy exports. However, Russia's specific economic structure will also imply a less pronounced recovery in 2021 than in many other countries, particularly those with the most advanced economies. The Kremlin's media discourse will compensate for this comparative disadvantage, if necessary, by stressing its successes in the global strategic competition pitting authoritarian vs. liberal societies.

Cautious Geopolitical Positioning, But Few Economic Policy Responses

The simultaneous crises (oil market & Covid-19) are hitting the U.S. economy hard, short-term most likely even harder than the economy of Russia. The privately organised US energy sector also faces massive challenges. From a Russian viewpoint, it no longer makes sense to be seen as a disruptor following the drama of its falling out with OPEC in March. Thus, the mid-April OPEC+ agreement seems like a reasonable move, especially since it is unlikely to bring a rapid oil price recovery. Therefore, Russia will achieve most of its goals on the oil market anyways. However, without any concessionary signals, the anti-Russia hardliners in Washington could assert massive political pressure supporting oil market interventions or sanctioning Russia. Such a scenario is not in Russia's self-interest in the short term—despite all the preparations made to address the permanent U.S. sanctions threats. Russia still faces short-term capital flow risks if the U.S. imposes tough financial sanctions. Even today between 30 and 60 percent of Russian trade is still conducted in dollars. From a financial market perspective, Russia should definitely seek to avoid US sanctions in 2020, a year in which Russia may be running a current account deficit for the first time since the early 1990s, while the rouble already trades near four-year lows. That said, Russian elites have little interest in taking on more risks. In view of Russia's low public debt, a more decisive economic policy response against the 2020 recession would be better achieved—if needed—via tapping international and domestic capital markets, but not necessarily by rapidly depleting reserves, which are buying Russia its geopolitical policy space.

Covid-19 containment measures are causing massive slumps in private consumption and drastic revenue losses in the service sector. SMEs and freelancers face particularly difficult tests. Normally, consumption bolsters GDP in economic crises. For this reason, massive support measures have been announced in Western economies, especially for exposed sectors. To date, Russia has outlined no comprehensive aggregate economic policy response. Hence, it can be concluded that Russia's political priorities lie elsewhere. The cautious economic policy response also reflects the entrenched policy focus on stability and maintaining reserves—at the expense of (long-term) economic development.

So far, only modest fiscal measures amounting to 1–3% of GDP have been arranged in Russia (by comparison: some major industrialized countries are currently implementing fiscal and guarantee packages of 10–30% of GDP). In Russia support measures include support for individuals through a moratorium on loan payments (including a suspension of fines on unpaid mortgages and for debtors whose incomes are cut by more than 30 percent due to the pandemic), support for businesses through a six-month moratorium on bankruptcy filings, and support for SMEs, which can postpone both credit and tax payments while benefiting from reduced social security contributions. Nevertheless, according to the Kremlin's current political creed, wealthy households and corporations rather than the state should provide the cushion for this crisis. Therefore, the government has raised taxes on payments and dividends from offshore companies from 2 to 15 per cent and imposed a new tax on people holding bonds and bank deposits. Some measures clearly affect the savings of the middle class, such as the increased taxation on bank deposits over RUB 1 million (approx. USD 12,000–13,000). Recent tax changes were probably already in the works and have not now been opportunistically implemented. Due to the cautious aggregate economic policy responses, no rebound should be expected in Russia in 2021. Rather, Russia is acting as a free rider, counting on a significant global economic recovery driven by stimulus elsewhere.

Further Monetary and Fiscal Policy Support Possible in the Course of 2020

In the course of 2020, some support from expansionary monetary policy is to be expected. To date, the Russian Central Bank (CBR) has remained cautious and has not lowered key rates below current six-year lows at 6 percent, partly in order to support the rouble. In recent weeks the CBR had to support the rouble for the first time in five years with foreign currency sales (i.e. RUB purchases) well beyond the scope of what had been planned. Some monetary leeway for rate cuts should open up, since through the quarantine measures the transmission effects from the weaker rouble into inflation should be smaller than in previous crises. Some CBR support has already been provided through a comprehensive RUB 500 billion credit line for SMEs at 4 percent. Nevertheless, such individual measures, even combined with further CBR easing, most likely will not induce a rebound.

However, the referendum on constitutional amendments, postponed from April, may take place later in 2020 and the 2021 Duma elections also will be part of political-economic calculations. In this respect, depending on the course of the crisis, pressure for more public sector spending may increase. However, significant fiscal stimuli are not likely until H2 2020, when the Covid-19 related damage on the Russian economy can be better assessed and there is more certainty about oil market trends. It should then be possible to boost economic growth by 0.5 to 1 percentage point through more significant fiscal stimuli—as happened in 2018 through targeted projects. Such investments could be focussed on more distant districts and the energy industry, even if the Covid-19 pandemic has not yet been contained in all parts of the country.

Economic Advancement Out of Reach—Selective Health and Social Exacerbations

In view of the expected economic trends for 2020 and 2021, Russia's self-proclaimed ambitions are obsolete. The absolute and relative income levels reached before the 2014–2016 crisis are out of reach for the next few years. Russia will likely descend to the income levels of global emerging markets becoming relatively poorer; there is little hope that it will catch-up with more developed economies. This might temporarily be excusable given the imminent worst global recession seen in decades, especially since Russia itself could get away with a smaller GDP slump than the more developed economies and differentiated societies in 2020. After that, however, there might be more pressure for income redistribution and economic policy stimulation than the leadership currently plans. Even if the Covid-19 crisis is contained to the economic capitals and resource-focused parts of the economy in 2020, there is a real threat of a health crisis breaking out in more distant parts of the country, followed by perilous socioeconomic developments.

About the Author

Gunter Deuber heads the Economics department at Raiffeisen Bank International AG in Vienna, one of the largest foreign banks in Russia, specializing in Eastern Europe and Russia. In 2019 he participated in the International Visitor Leadership Program (IVLP), the US Department of State professional exchange program. This article reflects the personal opinion of the author and not necessarily the opinion of RBI AG.