

Economic analysis

# Russia: navigating on troubled...regional waters

Cross Country Emerging Markets Unit

The Russian situation continues to raise questions about the future of the country and the potential economic and geopolitical spillovers to other nations. The Russian economic situation can spread through the channels of trade, energy, finance and risk aversion. The high share of FX denominated loans, which reduces the margin of depreciation, will be of key importance. The situation can also feed back into the geopolitical arena, reinforcing the political and economic pressures in the region.

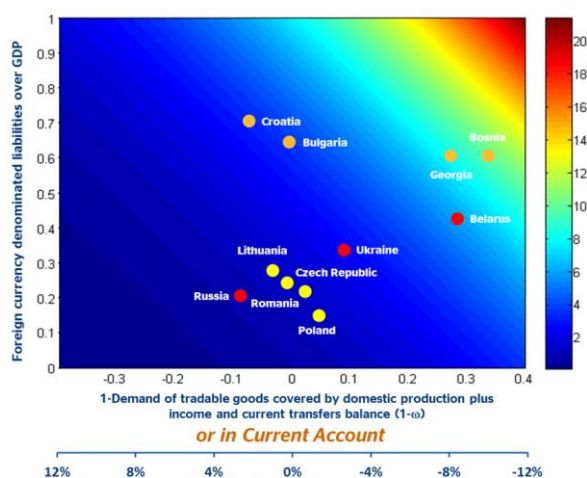
## Russian situation worsens

The Central bank of Russia had to intervene yesterday in support of the ruble. The official rate was raised from 10.5% to 17% to stop the spiral of depreciation. The effects of this on Russia will depend on the level of stress finally reached, but the situation is not a hopeful one.

If the official rate stays at 17% for a long period of time, our models suggest an extra drag on GDP growth of nearly 3%. Thus, GDP would contract by close to -4% (vs the official forecasts for 2015 of nearly -1%). Of course, the former scenario constitutes an unstable equilibrium. Thus, either the ruble continues to depreciate and more measures to contain it are needed (such as capital controls) or the exchange rate stabilises.

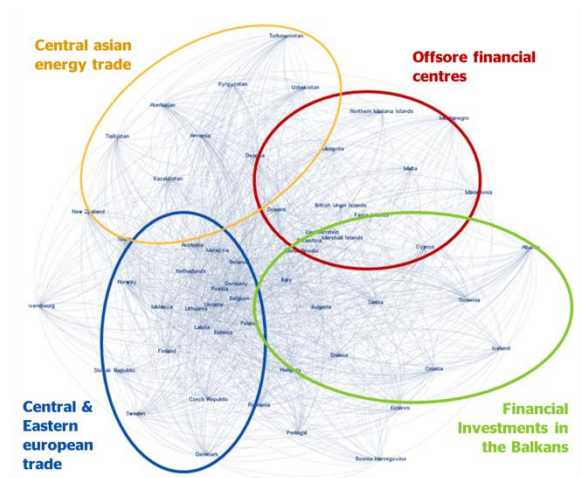
In the worst case scenario, the collapse of the economy may be quite significant, as occurred in 1998 (nearly 8%) and then, more hikes will be needed to contain the exchange rate and inflation spiral. Moreover, even in the case that the central bank succeeds in controlling the ruble's depreciation, part of the negative effect will be unavoidable. In this case, GDP will contract between -1% and -2% but it may recover in 2016.

Figure 1  
BBVA Research systemic sudden stop pressure map  
(Based on CAC domestic liability dollarization)



Source: BBVA Research and Calvo, Izquierdo & Mejia (2008).

Figure 2  
Russian economic sanctions network  
(Interconnectedness of Russian economy)



Source: BBVA Research and [www.qdelt.org](http://www.qdelt.org).

## Spill-over effects in the neighborhood: it's not only economics!

The **situation in Russia may spill over to its neighboring countries through different channels:**

- **The trade & energy channel:** the trade channel will be important but not a dramatic one (although significant for the Baltics, Ukraine and Moldova). The energy dependence channel will be more important, affecting the Baltics, the Balkans, Finland, Bulgaria, Serbia, Czech Republic and Slovakia. Besides, trade energy links with Central Asian countries could be affected (see Figure 2).
- **Financial links could play an important role:** as liability dollarization (the common practice of taking loans in FX denominated currencies) is extended in the region, the margin for foreign exchange rate depreciation is very low. If large, these depreciations could have significant effects in non-performing loans in some countries. This is specially the case of countries with huge external financing needs and high dollarization (Balkans and Ukraine). Based on our own research (updating the Calvo et al. model), the Figure 1 shows that some countries present both high shares of foreign currency denominated loans and current account deficits [red (dark blue) indicates high (low) probability of sudden stop]. Further, Russian investors were very active in the Balkans before the crisis (see Figure 2) and some of these investments came to halt, exposing these countries to further tensions.
- **Global Risk aversion:** Russia is an important country among the emerging markets and its significant share in global emerging market indexes can trigger margin calls.
- **Geopolitical Feedback:** the above channels show that countries like Ukraine, Moldova, Belarus and the Balkans are undergoing major economic risks. These could reinforce the political risk in the region which will complicate the solutions to the regional geopolitical conflict.

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