Analysis

Oil and the Economic Crisis in Russia

By Philip Hanson, London

Abstract

For better or worse, the Russian economy is heavily dependent on oil prices, particularly in terms of public finances, export revenue, and ability to purchase imports. The price of oil serves as an important signal for foreign capital, which has fled the country this year. An oil price in the $40 to $60 range would likely lead to the survival of economic Putinism, while a lower price would put much greater strain on the system, with unpredictable consequences.

Russia and the Global Economy

Russia is, these days, an open economy. It has therefore been severely affected by the global economic crisis.

VTB Bank Europe estimates from its surveys of purchasing managers that Russian GDP fell in December, and in the whole of the last quarter of 2008 grew by only 2 percent year-on-year. The Ministry of Economic Development (MinEkon) recently produced revised projections on which to base revisions of the 2009 budget. They include an average ruble-dollar exchange rate of R35.1 = $1, an average Urals oil price of $41/barrel and a federal budget deficit of 6–8 percent of GDP. Output (GDP) is projected to be flat or slightly up: 0–2 percent. The Troika Dialog investment bank projects an optimistic +3 percent or a pessimistic -4 percent for the change in GDP.

Nobody really knows what will happen. All we can be sure of is that there will be a dramatic change. Russia has had a nine-year period of 7 percent annual-average GDP growth, and an even faster growth of real incomes. That boom has ended.

There are four features that characterize Russia's involvement in the global turmoil, and two of them are related to oil.

- Credit sources have dried up, and Russian companies had borrowed heavily – and mostly rather short-term – abroad.
- Investors have fled from emerging markets, and developments in Russia in the spring and summer of 2008 had guaranteed that Moscow would be no exception; the TNK-BP and Mechel affairs and the conflict in Georgia all added to worries about the business environment in Russia.
- The fall in the price of Russian (Urals) oil from a monthly average of $130.8/barrel at the peak in July 2008, to around $45/b in December, hit the Russian public finances, export revenues and the terms of trade hard.
- Investors – and portfolio investors in particular – both Russian and foreign probably amplified the direct effect of the oil-price fall on the Russian economy. They saw falling oil prices as a signal to get out of Russian assets, whatever might be happening to emerging markets as a whole.

In short, the oil price is of critical importance. I will take the last two, oil-related, points in turn and then offer some thoughts about prospects. Those thoughts are even more tentative than they would normally be. We live, in the words of Evgenii Gavrilenkov, in non-linear times.

The Direct Effect of Falling Oil Prices

Any significant fall in world oil prices reduces, other things equal, the value of Russian exports. It also cuts government revenue. In 2008, according to estimates of the Ministry of Finance's Economic Expert Group, oil and gas revenues accounted for half of all federal budget revenue. And while a change in prices, export or otherwise, has no direct bearing on real GDP, any substantial drop in oil prices will worsen Russia's terms of trade with the rest of the world. That means that the real value of personal incomes, retained profits and government revenue – gross national income – will fall relative to the country's real output.

So far as exports are concerned, oil and gas have in recent times provided between three-fifth and two-thirds of Russia's merchandise export earnings. Most of Russia's gas exports are sold on long-term contracts with a pricing formula that links the gas price to be paid to oil products prices, with a lag of about six months. Gas prices received have not begun to fall at the time of writing, but they soon will. One estimate is that if oil remained for a year at $50/barrel, Russia's total export earnings would be about a half of recent levels. The preliminary figure for total exports in 2008 is about $469bn. That is for a year over which Urals oil averaged about $95/b. Troika Dialog's low and high export projections for 2009 are $180bn and $300bn.

Russia's public finances are now suffering. Moscow entered the crisis with, famously, eight years of budget surpluses behind it, and the world's third-largest gold and foreign exchange reserves. The federal budget will still register a surplus for 2008, but that surplus is dwindling. The budget will be in deficit in 2009. The oil and gas revenues come from a natural-resource extraction tax, profits taxes on oil and gas companies and – the largest single component – export duties. A precipitous fall in the export price wreaks havoc with these arrangements. The export duty on crude oil had been set on the basis of actual prices two months earlier, then that was shortened to a month, and still the companies are in trouble.

The export duty on crude oil was cut from $485.80 a ton in September to $192.10 in December. The December rate of duty works out at $26.30 a barrel. With the natural resource extraction tax at about $7.70 a barrel and with operating and transport costs as estimated by MinEkon, the average Russian producer stood in December to make a loss of about $9 on every barrel of oil exported at a price of $44.

Thus there has been an inexorable downward pressure on rates of export duty on oil, if only to preserve some incentive to export. Tax revenues therefore fall. To make matters worse, Russian oil and gas production and export volumes have been stagnating or declining, a development that pre-dates the fall of the oil price.

On the expenditure side, the Russian state seeks to maintain its previously-planned levels of spending in 2009. This will be done by drawing on the reserves built up in the Reserve Fund, basically from high oil (and latterly also gas) revenues, and by domestic borrowing. At the beginning of 2009 the Reserve Fund stood at $137.1bn. That makes it, at December exchange rates, equivalent to about two fifths of the federal budget revenue originally planned for 2008 and about a third of the 2009 budget revenue as planned in November last year. In other words, the Reserve Fund does indeed provide a substantial budgetary cushion.

It needs to be remembered, however, that the Reserve Fund, along with the smaller Fund of National Prosperity (intended more as a long-term sovereign wealth fund), officially forms part of the gold and foreign exchange reserves, and those reserves have been falling. They fell from a peak of $598bn on 8 August to $427bn on 9 January 2009. The diversion of some of the Fund of National Prosperity to domestic bailout packages, while the Reserve Fund is drawn down to support budget spending, looks likely to leave Russia with public finances that are far less robust than they were only a month ago. It is not surprising that the ruble has been falling. Nor is it surprising that the rating agency Standard & Poor's on 9 December reduced Russia's sovereign foreign-exchange credit rating from BBB+ to BBB, and classified the outlook as 'negative'.

In sum, Russian public finances remain healthier than those of most other countries, but they are weakening, and the future prospects for the Russian treasury depend overwhelmingly on the price of oil.

The impact on Russian terms of trade and incomes can be briefly stated. When oil, gas and metals prices on world markets were rising relatively to other prices, Russian production was gaining increased purchasing power over imports – which rose steeply. Real gross domestic income (GDI) and real personal incomes consequently rose faster than GDP. With oil prices falling, this relationship, so far as Russia is concerned, goes into reverse. The sum of personal disposable income, retained profits and government revenue must, in real terms, be falling more, or rising less, than GDP. The outlook for personal real incomes is therefore modest at best, in comparison with the recent past.

Foreign Capital Flows and the Price of Oil

Private capital flows in and out of Russia are driven by a variety of factors, of which the price of oil appears to be one. This is not primarily to do with investment in hydrocarbons; it is more to do with general investor sentiment about Russia. Much of the foreign capital entering Russia is footloose, and readily able and disposed to leave the country when danger signals flash. In 2008 as a whole the Russian stock-market, measured by the RTS dollar-terms index from end-2007 to end-2008, fell by 66.6 percent. This was worse than the Morgan Stanley index for emerging markets as a whole (down by 55.2 percent) and worse than the performance in any other market except China, where the SSEB dollar-terms index was down 71.5 percent.

There are structural reasons for this. The market capitalization of Russian companies is highly sensitive to the sentiments of foreign portfolio investment, because so many large Russian companies have a dominant main owner and the volume of trade in shares is modest. Furthermore, Russian domestic arrangements for long-term credit, combined with the closed character of most Russian corporate ownership, has meant that much of the inflow of external finance has been in the form of lending and, to a lesser extent, portfolio investment.

Much foreign borrowing by Russian banks and corporations in recent years has been based directly or indirectly on an expectation of continued high natural-resource prices. Even for companies that were not in the oil, gas, coal or metals industries, the operating assumption, both inside Russia and abroad, had been that the good times would continue. Russian growth might slow somewhat, but the oil price would probably stay high, so would Russian share prices, and the ruble would remain strong. Borrowing to finance acquisitions might use either the acquired assets or a portion of future oil or other resource-export earnings as collateral.

In fact, the market value of most Russian corporate assets fell from May onwards, precipitously; the oil price fell from July, and many big Russian companies faced margin calls on their loans.

In one way or another, therefore, the Russian economy's dependence on natural resource exports in general, and oil in particular, turned from a strength to a weakness.

Prospects: Oil Prices and Radical Change

At some point the Russian economy will begin to recover from the recession or slowdown it has now entered. For that to happen, there probably will have to be a more general recovery under way around the world. That in turn would entail at some stage a stabilization and then an increase in the oil price. Nobody can say with any confidence when that will happen. But perhaps two scenarios can help organize our thoughts about the future.

A reasonably optimistic scenario for the present Russian leadership would be one in which the oil price flattens out during 2009 somewhere in the $40–60/b range, at which planned levels of public spending are sustainable, and ceases to be highly volatile. In this situation, there should be an increase in investor confidence in Russia, once fears of further oil-price falls recede. The period of reduced oil-sector profit and increased uncertainty will have led to some postponement of investment projects in oil and gas around the world. That in turn restricts any quick recovery of hydrocarbons output, and will tend to push prices back up in 2010.

In this scenario economic Putinism – a reliance on oil-fuelled growth and top-down state management of the hydrocarbons and high-tech sectors – has a good chance of surviving. The leadership will have had a bit of a shock, but can probably return to its comfortable belief that it can have both detailed, corrupt, economic control and growth at the same time.

A less happy scenario – for the present leadership, and in the short run for everybody – is one in which uncertainty and economic weakness around the world last somewhat longer. In this scenario, the oil price during 2009 is around $30/b or is perhaps on average rather higher but with continuing volatility. Then elite confidence in the Putinist economic model is more severely dented, and at the same time popular support for the leadership comes under greater strain, perhaps with continuing unrest eliciting heavy-handed repression.

How that second scenario might play out over two or three years is unknowable. I suggest, however, that the global economic crisis will not deliver a turn to economic and political liberalism in Russia on soft terms. At worst, elite fears of social unrest may lead to more oppressive political control. Even at best, radical reform would probably come only after extensive and prolonged economic distress – not something one would lightly wish on any nation.

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