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Russia – limited international economic relations

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Russia's low level of involvement in the global economy is more of an advantage for other countries given the current weakness of the Russian economy. The openness of the Russian economy is based largely on oil and gas exports. Beyond that, external economic links are manageable in the aggregate perspective, so that negative spillover effects on the global economy are likely to be limited. Nonetheless, it must be taken into account that some countries, particularly small Eastern European economies, maintain close economic ties with Russia.

International trade flows, the links through direct investments and the banking system, as well as the reactions of the Russian financial markets to the crisis in Ukraine show Russia's limited integration in the global economy. The economic ties of individual countries can, however, vary greatly. Accordingly, the weakness of the Russian economy and the sanctions already introduced or will potentially be decided in the future in connection with the Ukraine crisis will impact individual countries differently.

Differences in trade links with Russia

Russia's significance as an export and import market differs for the euro zone, Germany and the USA. While Russia is Germany's eleventh most important export market, it ranks only 28th for the US. On the other hand, Russia is the most important export market for small Eastern European countries such as Estonia and Lithuania.

The importance of trade relations with Russia is also evident in the shares in the countries' respective gross domestic product (GDP, see figure 1).

When assessing the trade relations with Russia, it must be taken into account that:

- the trade relations of the EU countries with Russia vary greatly.

- there are spillover effects between economies, so that not only the direct trade relations of individual countries are relevant. Spillover effects, which could arise via a reduced external contribution to growth due to the lower demand of other countries, must also be taken into account.

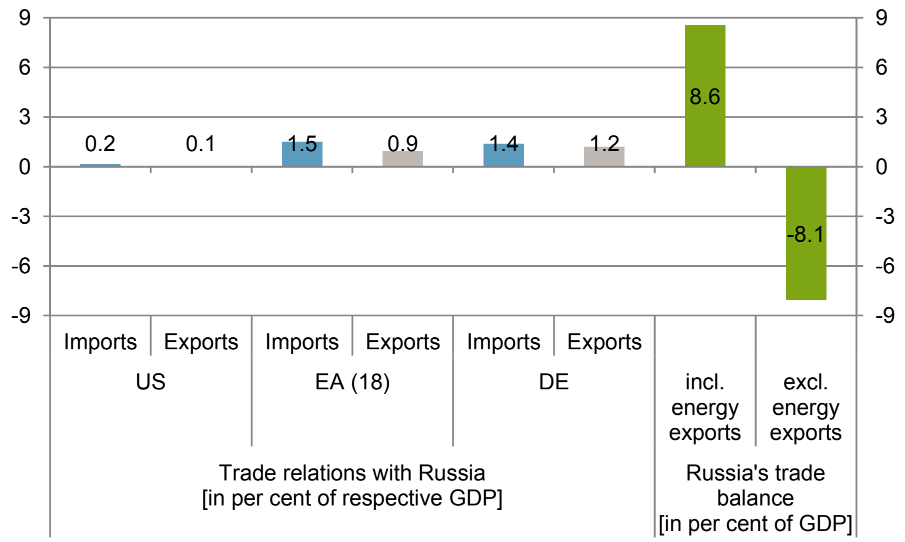
- goods are imported from Russia that are essential for international value-added chains. The EU countries' oil and gas imports are just one such example (see Focus on Economics No. 52: "Energy from Russia and the Alternatives", April 2014).

Russia's international trade links are based largely on oil and gas exports. Goods exports accounting for approx. one quarter of GDP and imports of around 16 % of GDP initially suggest a very open economy. This assessment is put into perspective when one realizes that, excluding oil and gas, the export share accounts for a meager 8 % of GDP (see figure 1). Accordingly, the current account surplus reverses into a deficit without the oil and gas exports.

Russia's foreign trade activity has already developed below average from 2012 to 2013. Foreign trade decreased sharply again at the start of the year – even before the outbreak of the Ukraine crisis (see figure 2). Except for imports from China, trade with the most important export and import countries declined in January.

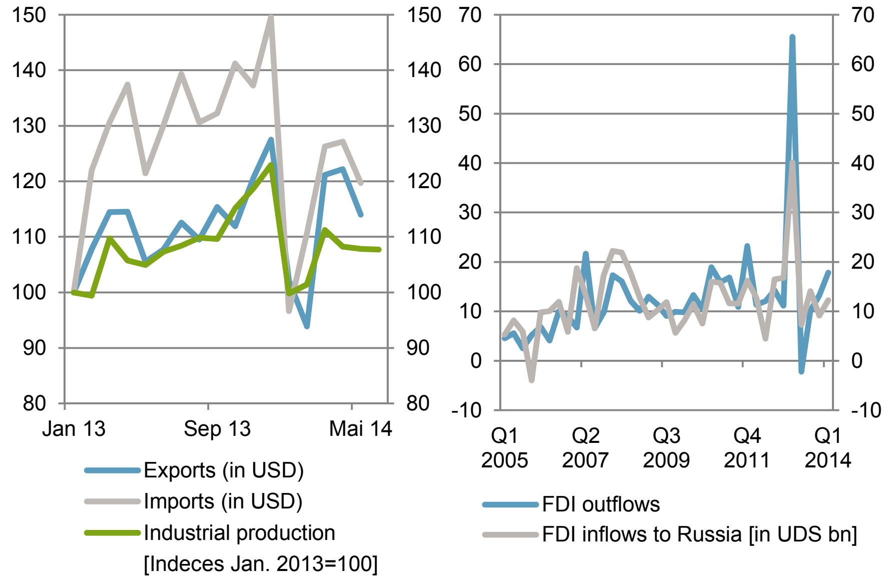
Both exports and imports managed to recover in March. However, the development of industrial output and the OECD's leading indicator for economic growth suggest that Russia's economic dynamics will not provide any impetus for foreign trade.

Figure 1: Russia's international trade links



Sources: Datastream; IMF, own calculations.

Figure 2: Russia's exports, imports and FDI



Note: FDI outflows peaked in Q1 2013 through a TNK-BP / Rosneft deal

Sources: Bank of Russia, Datastream; own calculations

Net direct investment often very low

At around 18 % in 2013, direct investment inflows into Russia accounted for a significant share of gross capital investment. FDI positions link the US, the euro zone and Germany to Russia by varying degrees:

- While the euro zone is invested in Russia with approx. 3.3 % of its GDP (as at year-end 2012), Russian direct investments in the euro zone amount to around 2.2 % of the EU18 GDP. The extent of the FDI links is dominated by the high figures for Cyprus and Luxembourg.

- The shares for Germany are 0.8 % and 0.3 % of GDP, respectively.

- The shares are also significantly lower for the US, at less than 1 % of GDP.

The net FDI positions to the most important partner countries are very low. Accordingly, the IMF (2014) assumes that better proprietary rights and tax advantages play a role in the corresponding direct investment.

The Ukraine crisis has not yet had any serious repercussions on direct investment inflows to Russia in Q1 2014. They are at the average level for 2012. Russia also invested more abroad in Q1 2014 than in Q4 2013.

While assessing those numbers, onehas to take into account that the Ukraine crisis did not start until the end of February, so that effects on direct investment whose preparations may take time are unlikely to take effect before Q2 at the earliest. A longer observation horizon is also necessary, as FDI flows are very volatile.

Economic links via the banking system

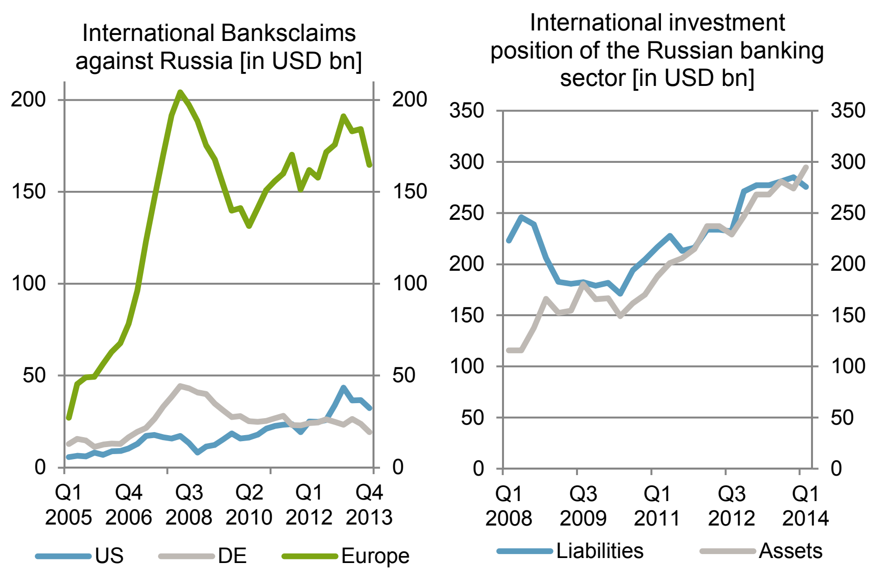
As is the case with the real economic links, the relatively limited economic relations between Russia and the US are also reflected in the link between the banking systems. According to BIS statistics, the size of consolidated claims of US banks is similar to that of German banks (see figure 3, left-hand side). However, the claims of the reporting European banks accumulate and are very unevenly spread between individual countries. Austrian banks, for example, are traditionally heavily engaged in Eastern Europe and in Russia (see IMF statistics).

Since the economic and financial crisis of 2008, the Russian banking system has significantly extended its assets and liabilities of its international investment position (see figure 3, right-hand side). Liabilities generally exceed assets, whereby a substantial share of the liabilities comprise foreigners' equity share.

Negative reaction of financial markets to every new escalation – followed by subsequent recovery

- The Russian equity index MICEX declined by around 5 % since the start of the year (as at 18th July 2014). Its reaction to the latest developments following the plane crash over the Ukraine was moderate initially (-3.6 % on Friday compared with Wednesday 16th July). This is considerably less than the drop of approx. 11 % on 3rd March after the start of the Ukraine crisis; the equity index has

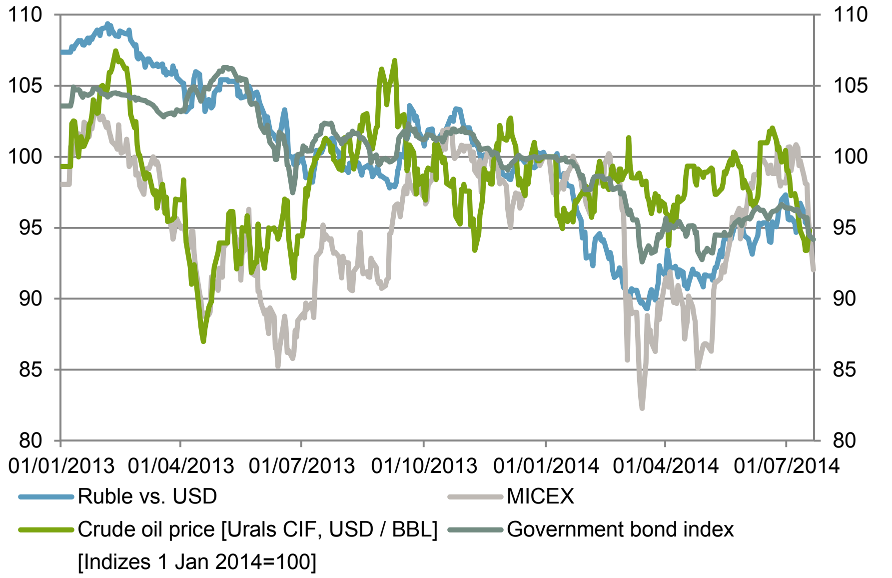
Figure 3: Links through the banking system



Note: BIS statistics of the European reporting banks

Sources: BIS, Bank of Russia

Figure 4: Overview of financial market data



Sources: Datastream; Thomson Reuters, Bank of Russia, Red Star Financial; own calculations

meanwhile recovered from this event (see figure 4).

- The ruble has depreciated by around 6 % against the dollar since the start of the year, with even greater losses in value observed at times. It managed, however, to recover – also because of intervention by the Russian central bank.

- The currency reserves have shrunk since the start of the year. In percentage terms, the decline between January and May is comparable to the last year's decline as a whole. Russia can exhibit a substantial cushion here. The currency reserves in 2013 amounted to around 286 % of short-term foreign debt. However, the currency reserves are also supplied by oil and gas revenues, and are actually intended as provisions if the finite natural resources come to an end.

- The price for crude oil (Urals) has also increased marginally since last Wednesday. Nonetheless, it is still down considerably from its high in mid-June 2014.

- The risk premium for Russian government bonds rose by 115 points to 241 basis points in March, when the crisis began, even though a large part of this increase could already be recovered. The price index for government bonds (MICEX TBILL RGBI) has also declined since the start of the year continuing its negative trend from the previous year. The Ukraine crisis is also reflected in corresponding fluctuation, albeit without a massive and sustained downtrend.

Faltering economy additionally burdened by Ukraine crisis

The economic sanctions because of the Ukraine crisis are striking an already weak Russian economy. While last year's growth rate of 1.3 % can be described as moderate, more than 2 % was forecast for 2014 at the start of the year before the outbreak of the crisis[1]. It is currently still at zero, although the onset of the effect of the current and possible subsequent sanctions are likely to reduce growth.

Industrial output appeared robust with clearly positive annual growth rates since the start of the year. The negative effects of the crisis now seem to be emerging with an essentially stagnating production volume year-on-year. However, the series is inherently volatile, so that further data are required for the final assessment.

The sentiment indizes paint a mixed picture since the start of the year. Consumers signaled a steady improving consumption climate since January. This development did not tip until June. In contrast, the purchasing managers' index developed counter to this trend with a five-year low in May but followed by a significant rise to 50.1 points in June (markit 3rd July 2014).

Conclusion

The relatively weak performance of the Russian economy in Q1 2014 is not attributable to the Ukraine crisis alone. The latter did not start until the end of February. Essentially, only the final third of the quarter was affected by the events. The negative effects are therefore likely to manifest themselves in the coming quarters.

These effects will also be felt by other individual economies. Expectations of even greater negative effects are dependent on how the Ukraine crisis develops and on possible subsequent international sanctions. The range of potential effects extend from a continuation of the status quo to the total economic isolation of Russia and the associated negative consequences for trading partners and via the financial system.

A comprehensive analysis would have to take into account value-added chains and spillover effects between economies. In addition, the negative effects on investor confidence and risk assessment for business activity in Russia should be considered in a longer-term approach. ■

[1] IMF (2014), World Economic Outlook, January 2014, p. 2