The Russian economy: Three years of financial sanctions

Evsey Gurvich, Ilya Prilepskiy

Economic Expert Group, Moscow

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Sanctions against Russia: key elements

1) “Sectoral financial sanctions”: Bans on credit lines (except trade credits) and investing in securities of sanctioned entities (with maturity of more than 30 days)

2) Bans on supply of military and dual-use technologies

3) Bans on exports of equipment for Arctic and shale oil drilling

4) Travel bans and asset freezes

Measures 3) affect hydrocarbon output, but only in the longer term; measures 2) impact TFP growth, again in the longer term; scope of measures 4) is limited. We focus on the short-to-medium term, when the key sanctions’ effects are due to measures 1).

Sectoral financial sanctions: Brief timeline

- July 2014: first sectoral sanctions: the US prohibits operations with new debt of longer than 90 days maturity or new equity for Gazprombank, VEB, NOVATEK, Rosneft; the EU imposes similar measures for all state-owned banks
- September 2014: sanctions expanded (maximum maturity cut to 30 days; the EU adds energy companies to sanction list; the US adds both energy companies and banks)
- Sanctions continuously rolled over since then; the Ministry of Economic Development's latest (April 2017) official forecast assumes they will stay in place throughout the projection period (i.e. at least until 2020)

Literature review (1)

- Rautava (2014): BOFIT Russia model (a VAR model based on quarterly data starting from 1995Q1) used to estimate the impact of uncertainty due to the situation in Ukraine. Negative impact on Russian GDP growth assessed at 1.0 p.p. in 2014
- Sinyakov et al. (2015): DSGE model in continuous time applied to assess the sanctions' effect on GDP growth. Total loss of the private sector's access to foreign financial markets assumed. Negative impact is -0.5 p.p. during the first and -0.6 p.p. during the second sanction year
- Oxenstierna, Olsson (2015): sanctions "have achieved results in contributing to Russia's economic decline [in 2014-2015]", though the decline was magnified by a fall in oil prices.

Literature review (2)

- IMF (2015) : GDP losses due to sanctions are 1.0-1.5 p.p. "in the short term" and 9.0 p.p. "in the medium term" (exact time periods not specified)
- Kholodilin, Netsunjaev (2016): a SVAR model on quarterly data (1997Q1-2015Q4) for six variables (index of sanctions' intensity; oil price; real GDP growth in Russia and the Euro area; real effective exchange rates of ruble and euro) used to estimate sanctions' impact. Average annualized QoQ growth in 2014Q2-2015Q3 lower by 2.0 p.p. due to sanctions.
- World Bank (2016) : an "alternative baseline" scenario with the sanctions being lifted at the beginning of 2017 presented. GDP growth is higher by 0.9 p.p. than in the baseline scenario.

Financial sanctions: Key channels of impact on capital flows (1)

- Direct channel: New borrowings of sanctioned entities fall, old are not rolled over => reduction in their foreign debt liabilities
- Indirect channels: Country risk increases, borrowing conditions deteriorate => reduction in foreign debt liabilities of non-sanctioned entities. General rise in uncertainty and fall in economic growth prospects => reduction in FDI and portfolio equity inflow
- Overall result: a “sudden stop” in capital inflow

Financial sanctions: Key channels of impact on capital flows (2)

- Active reaction to the sanctions: resources needed to make payments on non-rolled-over debt => lower pace of foreign asset accumulation, including FDI outflows

Actual decomposition by channel and entity is a difficult task. Instead, we calculate counterfactual values of financial account components for the sanction period based on past patterns, and deem the deviations from actual values to represent the sanctions' effects.

Estimates for 2014 Q3-2015 Q3 (1)

- Foreign debt liabilities:
  - rollover rate was 120% in 2013 for both banks and nonbanks
  - it fell to 23% for banks and 84% for nonbanks
- FDI quarterly inflow model (2010q1-2013q4):

$$fdi\_in = \underset{(5.15)}{7.15} + \underset{(2.18)}{0.289} \cdot gdp\_g(-1) + \underset{(1.94)}{0.705} \cdot gdp\_gf$$

(t-statistics in parentheses, *gdp_g* is actual annual growth for year ending in current quarter, *gdp_gf* is the most recent IMF forecast for the current year)

Comparison with model results points at -$4.5 bn effect of sanctions on FDI per quarter.

Estimates for 2014Q3-2015Q3 (2)

- FDI outflow on average 2.75% of GDP in 2010Q1-2013Q4; $3.0bn per quarter lower during the sanction period
- Estimated sanctions' impact on portfolio equity flows close to zero
- Impact on "other" outflow: assumed to equal the volume of non-rolled-over debt for banks (the assumption holds cumulatively for 2014Q3-2015Q3); for non-banks, difficult to estimate due to concurring Bank of Russia's efforts to curb "grey" capital outflow
- Impact on cash foreign currency flow and investment of government securities difficult to disentangle due to simultaneous events (panic foreign currency buying in 2014Q4/sovereign rating downgrade in 2015Q1)

Overall estimates of capital flow impact based on 2014 Q3-2015 Q3 data, $bn

	2H2014	2015	2016	2017	Total for 2014–2017
Gross capital inflow, total	–56.4	–89.4	–58.0	–65.3	–269.1
Debt liabilities	–39.0	–67.3	–33.8	–44.0	–184.1
Foreign direct investment	–17.4	–22.1	–24.2	–21.3	–85.0
Gross capital outflow	–10.6	–45.6	–26.1	–30.9	–113.2
Net effect from the sanctions	–45.8	–43.8	–31.7	–34.4	–155.7

Macroeconomic impact channels

- Larger net inflow depresses domestic demand, particularly investment
- Exchange rate depreciation mitigates the effect on GDP, mainly through lower imports as exports' elasticity is low due to large hydrocarbon share
- Feedback loops between GDP growth and capital flows
- All these channels accounted in the Economic Expert Group's macroeconomic model. It is built upon econometric (including cointegration) estimates of the relationships between the key macroeconomic and fiscal variables from 1995 through 2013 and the macroeconomic identities connecting them.

Macroeconomic impact: Scenario analysis on the medium-term horizon (until 2017)

- **High or low oil prices**

	2015	2016	2017
High oil price, $/bbl	100	100	100
Low oil price, $/bbl	53	50	52

- **Sanctions or no sanctions throughout the projection period (2014H2 – 2017)**

Variable change, p.p./shock	Sanctions	Oil prices fall	
		Without sanctions	With sanctions
Fixed capital investment	–5.0	–22.6	–24.1
Retail sales turnover	–3.7	–17.1	-18.2
GDP volume	–2.4	–7.1	–8.0
Consumer prices at the end of the period	4.1	7.1	8.1
Real ruble exchange rate against the USD	–0.3	26.9	–26.8
Nominal fiscal revenues	1.2	–13.1	–13.0
Real fiscal revenues	–2.0	–18.9	–19.5

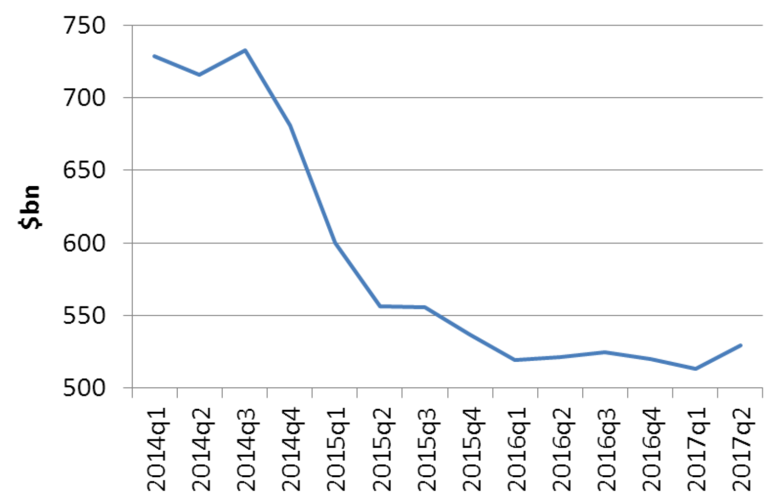
Key insights from analysis of the 2014 Q3-2015 Q3 data

- Direct and indirect effects of sanctions result in a reduction in gross capital inflow by some $270 bn in 2014 H2-2017. Reaction to sanctions (fall in capital outflow) offsets this by 40%, so the overall effect for net inflow is about $150 bn for the forecast period. The effect gradually decreases in 2016-2017.
- The calculated impact of sanctions on GDP was significant (-2.4 p.p. by 2017), but 3.3 times lower than the impact of the oil price shock . The smaller effect of the financial sanctions compared with the fall in oil prices is largely due to the active self-adjustment in the first case.

New data: What has changed?

- Net capital outflow dropped dramatically in 2016 to $19.2 bn ($58.2 bn in 2015, $152.1 bn in 2014)
- Key apparent factors behind that:

- pace of debt reduction slowed as external debt itself fell due to sanctions



- FDI inflow increased even when omitting the Rosneft deal

“Sanction year” view: strong improvement in foreign liabilities’ dynamics in 2015Q3-2016Q2

Selected components of the financial account, $bn (BPM5 signs)

	2013 Q3-2014 Q2	2014 Q3 – 2015 Q2	2015Q3 – 2016 Q2	2016 Q3 – 2016 Q4
Banks	-19.9	-9.4	24.5	13.5
Debt liabilities	0.1	-37.3	-18.7	-9.9
Assets	-20.0	27.9	43.2	23.4
Other sectors (without cash foreign currency)	-1.1	-56.7	-12.2	8.2
Direct investment	-13.1	-35.9	-12.6	16.4
Liabilities	38.2	-0.2	11.4	24.1
Assets	-51.3	-35.7	-24.0	-7.7
Loans	12.0	-20.8	0.4	-8.2
Liabilities	12.0	-20.8	0.4	-8.2
Cash foreign currency	-16.5	-10.0	-1.9	-6.4

2016: Changes in sanction impact estimates on financial account components

	2014Q3-2015Q3	2016
Foreign debt liabilities' rollover rate,%		
Banks	**23**	**47**
Nonbanks	**84**	**87**
FDI inflow quarterly impact, $ bn	**-4.5**	**-1.8**
FDI outflow quarterly impact, $ bn	**-3.0**	**-3.2**

Changes in overall estimates of impact on capital flows in 2016-2017, $bn

	Old estimates		New estimates		Cumu-lative change, 2016-2017
	2016	2017	2016	2017	
Gross capital inflow, total	–58.0	–65.3	-52.3	–44.5	+26.5
Debt liabilities	–33.8	–44.0	-45.1	–35.7	–3.0
Foreign direct investment	–24.2	–21.3	-7.2	–8.8	+29.5
Gross capital outflow	–26.1	–30.9	-29.0	–28.8	–0.8
Net effect from the sanctions	–31.7	–34.4	-23.3	–15.3	+27.3

Scenario analysis for 2017

- Baseline compared to counterfactual of sanctions being lifted from the start of 2017, change in p.p.

	Old capital flow impact estimate	New capital flow impact estimate
Investment	-4.01	-2.10
Retail sales	-2.65	-1.39
GDP	-0.61	-0.32
CPI, end of period	+0.60	+0.31
Real exchange rate to dollar	-10.24	-5.83
Nominal budget revenues	+0.39	+0.22
Real budget revenues	+0.10	+0.06

Possible factors behind a fall in sanctions' effects (1)

- Better understanding of the sanctions' perimeter? Likely yes (Euroclear resumes investors' access to new OFZ tranches; Rosneft partial privatization eventually goes ahead). This probably contributed to larger FDI inflows and debt rollover rates
- Circumvention? Unlikely (banks continued selling foreign assets until the end of 2016)

Possible factors behind a fall in sanctions' effects (2)

- Orthodox macroeconomic policies? Very likely. Initial fears of capital controls, asset seizures proved misplaced. ER flexibility, transition to IT regime and short-term fiscal stimulus followed by medium-term consolidation helped to instill confidence and, eventually, to promote FDI and ease borrowing conditions.
- Better-than-expected adjustment? Related to the previous point and very likely too. Investors saw that Russia's economy was not "in tatters" but actually adapted much faster and with less output losses to shocks that were more severe than in 2009. So, incentives for FDI returned.

Government’s measures and their effect (1)

- Sanctions and fall in oil prices increased external competitiveness of the tradable sectors. Government promoted import substitution through action plans to cement those gains
- Unclear basis for actions from economic/welfare standpoint. Results also mixed (domestic market share of domestically produced goods and services increased marginally in 2014-2016, while their output kept declining in constant price terms)

Government’s measures and their effect (2)

- Counter-sanctions were launched in August 2014 to “punish” sanctioning economies, promote food security and additionally incentivize investment in agriculture
- Progress on food security front since then has been impressive (though it started well before 2014), with import shares for key markets and retail trade in food in general falling. Social welfare implications likely negative (given misallocation of resources from more productive sectors and highly doubtful externalities from agricultural development)

Government's measures and their effect (3)

- Development of export support system and optimizing foreign trade regulations were also a key element of the Government's actions:

  - Russian Export Centre launched in 2015 to provide financial and information support

  - application of 0% VAT and excise rates for exporters simplified

  - number of documents to import/export and time for border/customs formalities reduced drastically

- Still, the effects will take time to materialize. Non-oil-and-gas exports grew by only 2.5% per year in 2014-2016 (in constant prices)

Government’s measures and their effect (4)

- “Turn to the East”: strategy dates back to APEC Summit in Russia in 2012, but has received increased attention since 2014
- Hopes for tapping Asian financial markets have largely been dashed. Banks’ liabilities to Asia-Pacific grew by just $0.5 bn in 2015-2016, and that too, only due to increased credit from China
- APEC’s share in Russia’s trade has been growing continuously. In 2016, it displaced the EU as Russia’s largest import partner. Still, in dollar terms, the trade turnover remains far lower than before 2014.

Conclusions (1)

- Sanctions' impact was always expected to diminish over time, but it actually fell even faster than we estimated earlier.
- Our assessment of net capital flow impact in 2016-2017 is now $25-30 bn lower than it was at the end of 2015
- Category-wise, re-assessment is pre-dominantly due to resurgence in FDI flows.

Conclusions (2)

- We view increased confidence in Russia’s macroeconomic management as a key factor behind lower sanctions’ effects, with clearer-defined sanctions perimeter also playing a role but circumvention being marginal
- Our assessment of the sanctions’ GDP growth effect in 2017 (-0.3 p.p.) halved as compared to end-2015 estimates; previous insight that oil price shock’s contribution to GDP dynamics in 2014 H2-2017 is much larger than that of sanctions is reinforced.

Thank you!