Schroders Quickview: Russian recession looms

Craig Botham, Emerging Markets Economist
11 Aug 2014

Latest estimates suggest Russia has entered technical recession. With the impact of the latest round of sanctions yet to be seen, the outlook is not good.

Economic growth slowed in Russia during the second quarter, with GDP growth of 0.8% year on year, down from 0.9% growth in the first quarter. This is only a flash estimate, and more information will be released in mid-September, but for now it looks like Russia has entered technical recession. The year on year growth numbers suggest a quarterly contraction of GDP for two consecutive quarters.

Higher frequency data for July will follow in a few days, but both industrial production and retail sales flagged in June, with real wage deceleration likely weighing on consumer demand. While the most recent manufacturing surveys showed some improvement, we are yet to see the impact of the latest round of sanctions. The outlook is not good.

The financial sanctions are likely to prove the most significant of the EU's measures, in terms of economic impact. The central bank will act to support Russian banks hit by the sanctions, and with reserves of around $480 billion is well placed to do so. However, some $80 billion in external debt is maturing this year, and the central bank is already using its reserves to defend the ruble (reserves were $30 billion lower in the second quarter, year on year). Clearly this is not something that can be managed indefinitely. Reflecting this, the central bank has already hiked rates to slow capital outflows, and further hikes may be coming if the situation is not resolved. Retaliatory sanctions by Russia against various food imports will also push up inflation and necessitate further hikes. The cost of credit in Russia will increase sharply, particularly as state-owned banks account for over half of banking system assets, hitting already poor investment.

Business and investor sentiment is likely to be depressed further both by widening the scale of sanctions as well as increased uncertainty over potential further changes. Also, US restrictions on the export of equipment and technologies for the oil sector are negative for investment in future production, and hence state revenues (oil and gas account for half of federal budget receipts).

Finally, Russia's own embargo on Western food imports will have economic costs for Russia. Domestic consumption exceeds production for a number of the banned items, so Russia will not be able to fill the gap domestically. The shortfall will result in inflation, which of course is already elevated in Russia. This will add to pressure on the central bank to extend its hiking cycle. The uncertainty generated by the sanctions has also led to additional currency depreciation, adding to inflation pressures. At a time when sanctions from the West have already pushed up financing costs and forced banks to seek domestic financing, domestic interest rate hikes will have a greater impact than usual. Credit and economic growth will suffer, and it is difficult to see 2014 improving for Russia's economy.

Related articles GDP sanctions Russia Craig Botham Economic views Emerging markets