Russian economy faces deep crisis **17 december 2014**

Despite Monday night's sharp interest rate hike, the Ruble (RUB) depreciated extremely sharply on Tuesday. Russia was already quickly falling into recession even before the RUB crisis exploded, but a far more painful economic situation now lies ahead. The currency crisis probably requires more policy measures and may even include capital controls. The best Russian authorities can hope for is that oil prices start to rise again and that economic sanctions are lifted. But the likelihood of this happening anytime soon is rather small. That said, although the latest events could weigh on financial market sentiment, the wider economic fallout of the Russian crisis is likely to stay rather limited.

In a bold move to stop the RUB from depreciating further after it fell more than 11% on Monday, the Central Bank of Russia (CBR) sharply hiked its main policy rate (from 10.5% to 17%). Yet, this could not prevent the RUB from falling further the next day. Leading indicators were already pointing to an imminent recession, but an outright crisis situation is now more likely. Inflation is set to spike and increasingly tight financing conditions will have seriously negative effects on domestic demand. Moreover, even though the overall balance sheet of the Russian economy is more than decent, approximately USD 650bn of outstanding liabilities (around 30% of GDP) is denominated in foreign currency (mostly USD). And while the plunge of the RUB may not cause many problems for companies and sectors whose revenues are also mostly in USD, it will almost certainly lead to some defaults for indebted companies largely depending on RUB revenues. This remains the case even when USD emergency liquidity lines are set up by the CBR in order to help Russian companies out in this respect. It's highly uncertain what will happen next. It was long clear that Russia would come out as the single most important loser from the Ukraine dispute with the West, particularly in the context of rapidly falling oil prices. Russia has clearly lost control over the situation and there is little authorities can do to turn things around. A short-term oil price increase and a lift of imposed sanctions would be highly welcome but the chances of this happening in the near future are slim. Past currency crises in EM have demonstrated that even a sharp tightening of monetary policy may not be enough to stop the currency from falling further (for example Indonesia in 1998). The reason is that more interest rate hikes will only aggravate the Russian economic situation resulting in more capital fleeing the country. At this point, the introduction of capital controls may be more effective as this would allow policymakers to stabilize the economy by lowering interest rates. A gradual relaxation of the capital controls could then take place as soon as energy prices start to climb again and geopolitical tensions ease.

The Russian economy now faces a deep crisis. Under the assumption that the oil price stays at current levels (around USD 60 per barrel), the CBR predicts that the economy will shrink by almost 5% in 2015 and more than 1% in 2016. However painful for Russia, the direct economy spill-over effects to the rest of the world and Europe in particular remain rather small. Russia accounts for only 2.6% of global GDP while only 1% of total Eurozone exports go to Russia. Admittedly, the impact of a further intensification of the Russian turmoil on financial markets may not be negligible. Moreover, several oil-producing EM could face more downward currency pressure if contagion spreads. The upshot, however, is that the impact on global economic activity should be counterbalanced by the boost provided by the recent fall in energy prices.