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Jouko Rautava

Crimean crisis will cost Russia too



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Bank of Finland
BOFIT – Institute for Economies in Transition
PO Box 160
FIN-00101 Helsinki

Phone: +358 10 831 2268
Fax: +358 10 831 2294

Email: bofit@bof.fi
Website: www.bof.fi/bofit_en

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Abstract

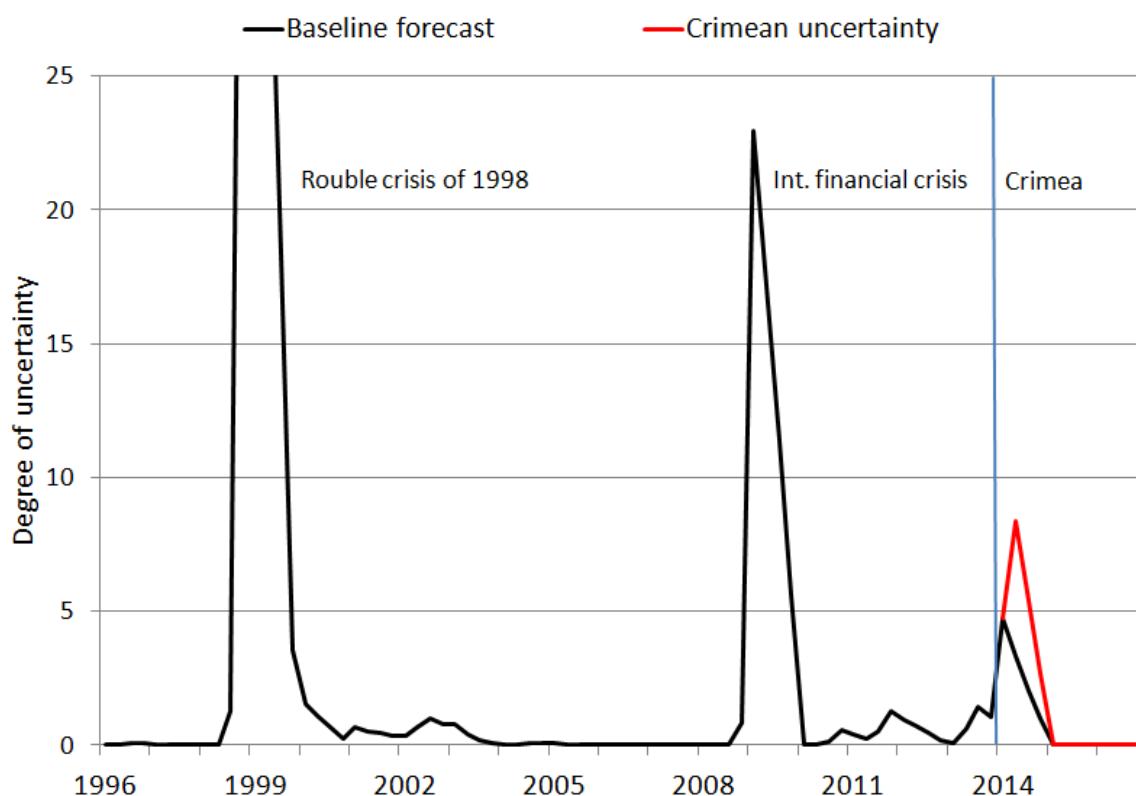
The activities of Russian troops in Crimea in late February – early March is not exercising the minds only of those interested in foreign policy and security issues; the events also have implications for the Russian economy. This memorandum seeks to assess the impact of the ‘Crimea weekend’ on Russia’s macroeconomic developments. The assessment is based on calculations conducted using BOFIT’s Russia model.¹

¹ The BOFIT Russia model, see J.Rautava (2013), Oil Prices, Excess Uncertainty and Trend Growth, <http://www.oenb.at/en/Publications/Economics/Focus-on-European-Economic-Integration/2013/Focus-on-European-Economic-Integration-Q4-13.html>

Uncertainty hits growth

Crises are attended by exceptional growth in uncertainty, and the recent weeks' events in Ukraine are no exception. Although measuring and modelling economically harmful uncertainty is not straightforward, financial market data can help in estimating its level. The amount of uncertainty harmful to the Russian economy that currently exists can be estimated from expectations over depreciation of the rouble, combined with other information.

Crises and uncertainty in modern Russia



In the attached chart, the degree of this 'harmful' uncertainty is depicted with a variable based on actual exchange rate movements. In the model used in the calculations, the variable depicts expectations of uncertainty. The variable is constructed such that growth in uncertainty in any given quarter is reflected in gradually weakening strength through the subsequent three quarters. The black line shows the history of the variable and an estimate of uncertainty in 2014 made prior to the events in Crimea. The red line is the updated estimate made at the beginning of March.

Of itself, the value of the variable does not lead to any particular interpretation, but it can be usefully compared with its value during previous crises. The rouble crisis of 1998 was in a class of its own, but thereafter there was very little harmful uncertainty until the outbreak of the international financial crisis. The chart also shows that uncertainty was already growing towards the end of last year and early in the present year before the events in Crimea at the end of February and beginning of March.

A dark shadow over the whole of 2014

The Russian armed forces' intervention in the events in Crimea caused serious disturbance on Russia's financial markets. On 3 March, the stock exchange value of Russian corporations lost USD 60 billion and there was a serious depreciation in the value of the rouble, even though the central bank raised interest rates by 1.5 percentage points and intervened to support the rouble on the foreign exchange markets.

Even were the situation in Crimea to calm down, the uncertainty caused by events so far will cast a long shadow and cost Russia in the form of slower economic developments. The size of the bill can be estimated by comparing the forecasts produced by the econometric model used by BOFIT for forecasting the Russian economy; the model's baseline forecast was produced using an uncertainty profile in use before the Crimean crisis, while the alternative scenario takes account of the increased uncertainty caused by the crisis (see the previous chart). The results are presented in the table below.

Russian GDP and real imports, annual change, %

	Baseline forecast		Crimean uncertainty	
	GDP	IMPORTS	GDP	IMPORTS
2012	3.5	9.5	3.5	9.5
2013	1.3	3.1	1.3	3.1
2014e	1.8	2.9	0.8	-1.0

According to the model calculations, as a consequence of the 'Crimea weekend' at the turn of the month February–March and the extra uncertainty it caused for the Russian economy, Russia's GDP growth this year could dip below 1%, that's one percentage point smaller than estimated before the crisis. At the same time, Russia's real import growth threatens to turn negative, with real imports 4 percentage points lower than estimated before the crisis. The calculations take into account the slight rise in the price of oil caused by the crisis, but this eases Russia's position only marginally.

Hard times ahead?

The pace of growth in Russia has faded in recent years, and in 2013 the country's GDP grew a mere 1.3%. The slowing of growth is not due to the trends in energy and other commodity prices, but to deeper problems stemming from the economy's one-sided structure and lack of competition. The slower growth makes it harder to resolve the existing problems and generates increased uncertainty over the future. Such uncertainty is poison to investment and economic growth. There is now a greater probability the Russian economy could drift into a crisis stemming from slow growth and an unimaginative economic policy.

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