

Global oil glut and sanctions: The impact on Putin's Russia



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HIGHLIGHTS

- The impact of the recent decline in oil prices and western sanctions is analyzed.
- A vector autoregression model is used to do the forecast for Russia.
- The real GDP is likely to contract by 19 percent over the next two years.

ARTICLE INFO

Article history:

Received 19 June 2015

Received in revised form

28 November 2015

Accepted 8 December 2015

Available online 24 December 2015

Keywords:

Oil prices

Russian economy

Vector autoregressive model

Forecast

ABSTRACT

The Russian economy is highly responsive to oil price fluctuations. At the start of 2014, the country was already suffering from the weak economic growth, partly due to the ongoing crisis in Ukraine and Western sanctions. The recent plunge in global oil prices put even further strain on the Russian economy. This paper analyzes the dynamic relationship between oil price shocks, economic sanctions, and leading macroeconomic indicators in Russia. We apply a vector autoregression (VAR) to quantify the effects of oil price shocks as well as western economic sanctions on real GDP, real effective exchange rate, inflation, real fiscal expenditures, real consumption expenditures, and external trade using quarterly data from 1999:1 until 2015:1. Our results show a significant impact of oil prices on the Russian economy. We predict that Russia's economic outlook is not very optimistic. If sanctions remain until the end of 2017, the quarter-to-quarter real GDP will contract on average by 19 percent over the next two years.

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1. Introduction

For much of the past decade, oil prices have been high – bouncing around \$100 per barrel since 2010 – due to soaring oil consumption in countries like China and conflicts in key oil nations like Iraq. Oil production in conventional fields could not keep up with demand, so prices spiked. High prices benefited oil exporters like Russia at the expense of oil importers. Soaring oil prices spurred companies in the US and Canada to start drilling for new, hard-to-extract crude in North Dakota's shale formations and Alberta's oil sands. Then, over the last year, demand for oil in places like Europe, Asia, and the US began tapering off, thanks to weakening economies and new efficiency measures. Added to this is the fact that the oil cartel OPEC decided not to cut production as a way to prop up prices. By late 2014, world oil supply was on track to rise much higher than actual demand, as shown in Fig. 1. Since summer of 2014, the price of crude oil has declined by more than half. If back in June 2014, the price of Brent crude oil was up

around \$111 per barrel, in January 2015, it had fallen down to \$48 per barrel, as can be seen in Fig. 2.

At the start of 2014, Russia was already suffering from weak economic growth due to the ongoing crisis in Ukraine. In November 2013 Ukraine's President Viktor Yanukovich refused to sign a European Union Association Agreement (EUAS), which meant to create a framework for cooperation between Ukraine and the European Union (EU). Viktor Yanukovich's rejection sparked mass protests on the streets of Kiev. Russia backed ousted Yanukovich, annexed Crimea in March of 2014 and invaded eastern Ukraine. In response, the US and Europe levied sanctions on Russian government officials through assets freezes, visa bans, and controls on exports of energy technology that would have helped Russia develop its Arctic. Countering such actions Russia banned food imports from the West. Fig. 3 shows a detailed timeline for Ukraine-related sanctions.

The Ukraine crisis with several waves of Western economic sanctions imposed on Russia combined with a 50-percent drop in the global oil prices, Russia's key commodity, put even further strain on the Russian economy. After the country's 1998 financial crisis, most of the oil produced has come from drilling and re-drilling old Soviet oil fields, squeezing more black gold out of the

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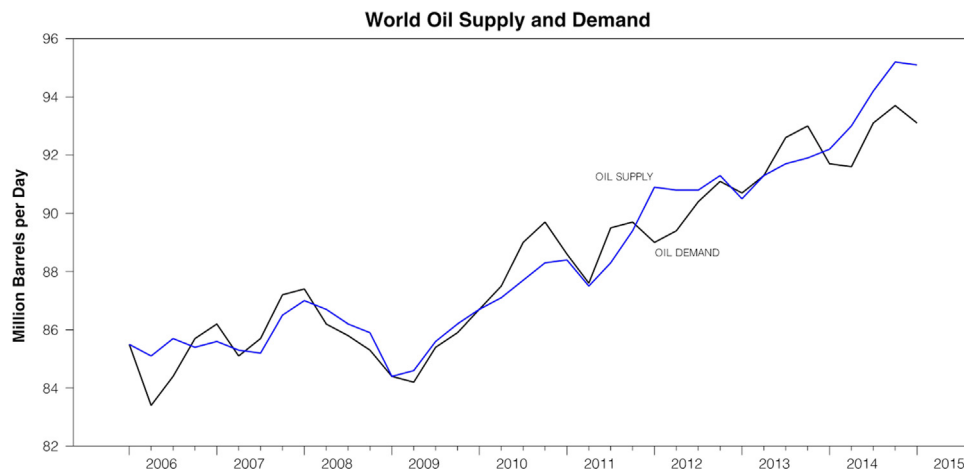


Fig. 1. World oil supply and demand. Source: International Energy Agency.

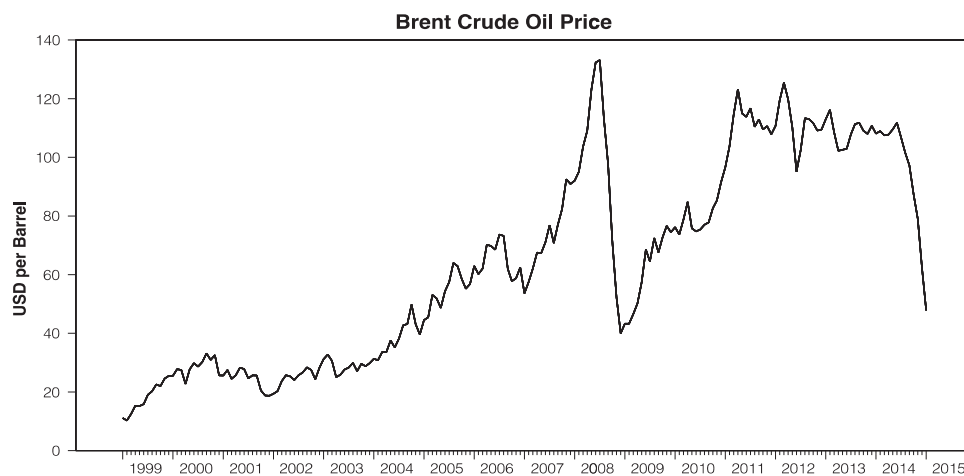


Fig. 2. Brent crude oil price. Source: Global Financial Data.

same ground. Over many years, almost no efforts were made to develop new fields. The oil wealth is drying up. In response to falling oil prices, the Russian economy started to fall into recession. Official data shows that in 2014 the real GDP grew by only 0.4 percent. Over the last year, the official annual inflation rate

increased from 6 percent to 9 percent. Food prices climbed by 25 percent. Between June and December 2014, the Russian ruble declined in value by 59 percent relative to the U.S. dollar. If in 2009–2013 private-sector net capital outflows averaged \$57 billion annually, in 2014 it increased sharply to \$152 billion, according to

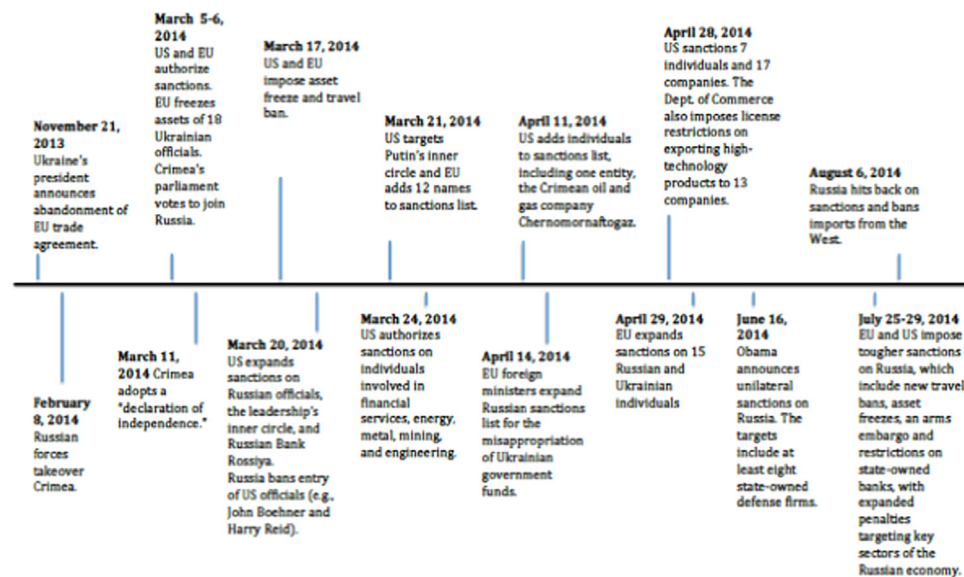


Fig. 3. Timeline for Ukraine-related sanctions. Source: Peterson Institute for International Economics.

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