

7. Spillovers from Russia to the CCA

In the face of sharply lower oil prices and geopolitical tensions and sanctions, economic activity in Russia has rapidly decelerated, resulting in negative spillovers to CCA countries. The extent of the impact is commensurate with the level of each country's trade, remittance, and foreign direct investment links with Russia. So far, policy action by affected countries has focused on mitigating the immediate consequences of spillovers. However, given the likely persistent effects of the shocks, stronger and more urgent medium-term-oriented policy responses are needed.

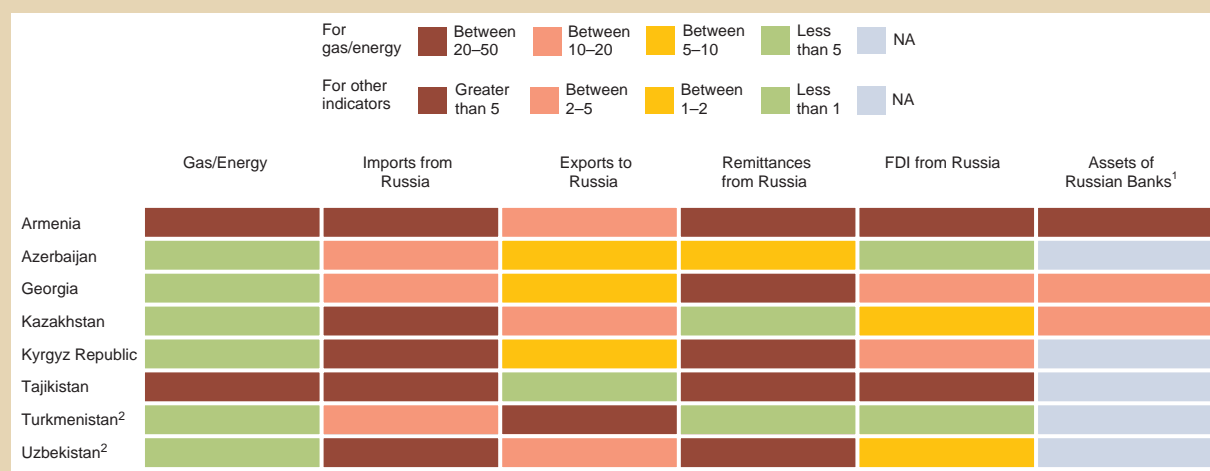
Outlook for Russia and Channels of Spillovers

The outlook for Russia's economy is for continued weakness, with low oil prices and sanctions expected to persist. Real GDP growth is expected to contract by 3.8 percent in 2015 before starting to recover in 2016. The fall in oil prices adds to preexisting structural bottlenecks and to the effects of sanctions imposed during 2014 and

then extended in mid-2015. The adverse external environment, coupled with large increases in risk premiums and capital outflows, led to a 45 percent depreciation of the ruble against the U.S. dollar between August 2014 and August 2015.

Negative spillovers from Russia to the CCA economies occur primarily through trade, remittance, and foreign direct investment (FDI) channels (Figure 7.1). Turkmenistan commands the largest share of exports to Russia (more than

Figure 7.1
CCA Links with Russia, 2014 (or latest available)



Source: IMF staff calculations.

Note: Gas/energy imports from Russia are scaled by country's energy consumption; other variables are scaled by GDP. FDI = foreign direct investment.

¹Including subsidiaries and branches.

²Indicates gas exporter to Russia.

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9 percent of GDP). The remittances channel is particularly prominent for CCA oil importers, the world's most remittance-dependent economies. The FDI channel is significant for Armenia and Tajikistan. The financial sector channel is more limited, given the relatively small presence of Russian banks, though depreciations could pose risks to financial stability.

Trade Channel

For many CCA countries, Russia remains an important trading partner. For example, exports to Russia account for about half of Azerbaijan's non-oil exports, while for Armenia, exports to Russia, mostly food and brandy, constitute about 20 percent. Turkmenistan and Uzbekistan export gas to Russia, though they have been increasingly diversifying toward other markets, primarily China.¹ Traditional trade links and preferential agreements (through the Eurasian Economic Union) with Russia may reduce the incentive of some countries to diversify export destinations away from Russia. Imports from Russia, especially energy, are also relatively large. For Armenia and Tajikistan, energy imports from Russia amount to about 30 percent of their total energy consumption.

Remittances Channel

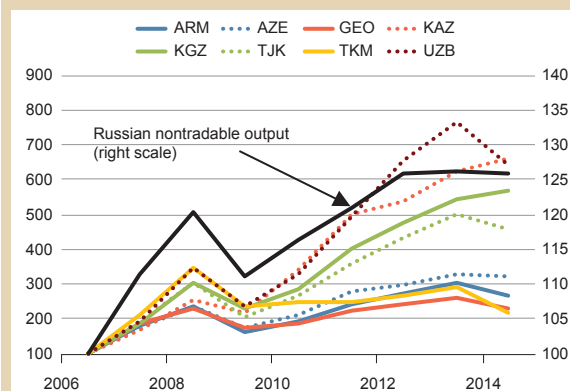
Remittances are a key channel for transmission of shocks from Russia to CCA oil importers. Remittances, mostly originating from Russia, constitute about 43 percent of GDP in Tajikistan, 30 percent of GDP in the Kyrgyz Republic, and 20 percent of GDP in Armenia as of 2014. They have grown substantially over the past decade and appear closely correlated with activity in Russia's nontradable sector, most notably construction (Figure 7.2). The large presence of migrant workers in Russia makes these countries

¹ Russia accounts for about 25 percent of Turkmenistan's gas exports, down from about 70 percent during the global financial crisis.

Figure 7.2

Remittances from Russia

(Indices, 2006 = 100)



Sources: Central Bank of Russia; IMF, World Economic Outlook database; and IMF staff estimates.

Note: Country abbreviations are International Organization for Standardization (ISO) country codes.

vulnerable to risks of surges in unemployment and social tensions in the event that migrants are forced to return.² Remittances affect consumption, investment, and bank deposits in the recipient countries.

Financial Channel

Spillovers via the financial system appear more limited, although Russian FDI is large in some countries (see Figure 7.1):

- Banking linkages—direct cross-border lending from Russia is relatively small, while the asset share of Russian banks is significant (in the range of 10 percent of total banking system assets) in some countries.³ Azerbaijani and Kazakhstani banks have subsidiaries in Russia, but their assets are limited (about 2 percent of the home country's GDP). Exchange rate

² Although returning migrants can bring new skills and contacts back to their countries, they also create additional pressures on labor markets by increasing unemployment, putting downward pressures on wage levels, and increasing the need for social assistance.

³ Sberbank has subsidiaries in Kazakhstan; VTB bank has subsidiaries in Armenia, Azerbaijan, Georgia, and Kazakhstan, and Gazprombank in Armenia.

movements (given the highly dollarized CCA banking systems) and declining remittance income could, however, affect CCA banks through the debt repayment capacity of bank clients and balance sheet effects.

- FDI—the stock of FDI from Russia is the highest (more than 5 percent of GDP) in Armenia and Tajikistan. The slowdown in Russia could decrease FDI flows, affecting long-term investment and growth prospects for these countries.

Current and Expected Impact on CCA Countries

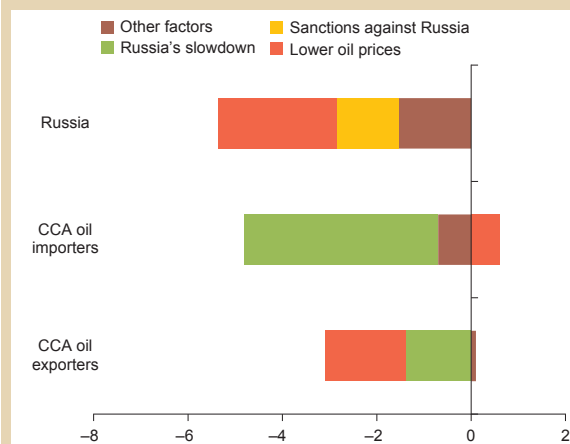
Russia's growth slowdown has had major adverse effects. Economic growth in the CCA economies has already decelerated and is expected to fall further in 2015. In addition, following the ruble's depreciation, exchange rates in many CCA countries weakened sharply against the U.S. dollar, while inflation is rising in some countries and risks are building up in financial systems. More specifically:

- The negative spillovers contributed to sizable downward revisions to growth forecasts across the CCA economies. For CCA oil importers, particularly, adverse spillovers from Russia in 2015 account for more than 2½ percentage points of downward growth revision, relative to April 2014 (Figure 7.3). For CCA energy exporters, negative spillovers from Russia contributed to a downward revision of 1½ percentage points in the growth forecast.
- Currencies of most CCA economies depreciated (or were devalued) reflecting weaker confidence, loss of competitiveness, and expected declines in foreign currency inflows from Russia (see Figure 3.3).
- Despite slowing growth, inflation pressure is rising with pass-through from exchange rate depreciations because the majority of imports, even from Russia, are denominated in U.S. dollars.
- Spillovers from Russia could have financial stability implications, given high dollarization,

Figure 7.3

Revisions to Real GDP Growth, 2015

(April 2015 versus April 2014, percent)



Sources: IMF, World Economic Outlook database; and IMF staff estimates.

falling demand, and remittances. However, the impact so far has been limited, owing to relatively low financial sector exposure to Russia and to a transmission lag.

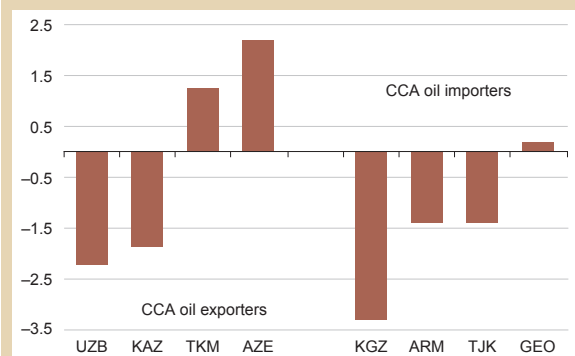
- Remittances to CCA countries have declined between 25 percent and 50 percent during the first half of the year.
- Although there is no evidence of a decrease in FDI inflows yet, reinvested earnings are expected to slow down.

Policy Responses

The policy responses in the CCA have so far focused on addressing the short-term impact of spillovers. Most countries tightened monetary policy and eased fiscal policy. Despite interventions by central banks, national currencies have depreciated relative to the dollar or have been devalued in nearly all CCA countries.

In the fiscal area, many countries responded to shocks with expansionary policies in 2015, though to varying degrees (Figure 7.4). In most cases, countries chose to let the automatic stabilizers work, while spending increased as a function of available fiscal space and financing.

Figure 7.4

Change in Cyclically Adjusted Fiscal Balances*(Percent of GDP, 2015 over 2014)*

Sources: National authorities; and IMF staff calculations.

Note: Cyclically adjusted non-oil balances for Azerbaijan, Kazakhstan, and Turkmenistan. Country abbreviations are International Organization for Standardization (ISO) country codes.

- The fiscal policy response of CCA oil exporters—countries with buffers—was mixed. Kazakhstan took a proactive stance, enacting a large fiscal stimulus to counteract lower growth from the external shocks.⁴ Uzbekistan cut some taxes, including the corporate income tax, in order to stimulate economic growth. However, Turkmenistan and Azerbaijan cut spending plans because of capacity constraints and earlier large investments.
- For CCA oil importers with low buffers, increasing spending to support growth is conditional on securing favorable financing. Financing under IMF-supported programs allowed Armenia and the Kyrgyz Republic to implement countercyclical policies. In addition, some governments (Armenia, Tajikistan) have sought additional donor support, particularly for capital spending projects and on-lending to small and medium-sized enterprises. The Kyrgyz Republic is implementing an intensive externally financed public investment program.

⁴ The stimulus, financed from the oil fund and multilateral developments bank, could total up to 6 percent of GDP over the next three to five years and is expected to focus on infrastructure projects. The government also requested \$2 billion (about 1 percent of GDP) in budget support from the World Bank to help finance the expected larger deficit.

Nearly all CCA countries have allowed some nominal depreciation/devaluation in 2014–15. The policy response has involved central bank foreign exchange (FX) interventions,⁵ while allowing gradual depreciation, and three cases of step devaluation.

- Though they initially resisted exchange rate changes through interventions, CCA oil importers have allowed their exchange rates to depreciate. Armenia and Tajikistan have sought to limit this with large FX sales—an increasingly unsustainable policy—while Georgia and the Kyrgyz Republic have allowed their exchange rates to move more freely.
- In contrast, most CCA energy exporters have tightly managed exchange rates and resorted to step devaluations, or moved to more flexible regimes. Following the preemptive 19 percent devaluation in February 2014, Kazakhstan continued to manage its tenge/dollar exchange rate before moving to the floating regime in August 2015. In response to the ruble depreciation and falling energy prices, Turkmenistan devalued its currency by 19 percent against the dollar (January 2015) and Azerbaijan devalued the manat by 34 percent vis-à-vis the dollar (February 2015). Uzbekistan has maintained the same pace of adjustment of its crawling peg as in 2014, but the spread between the official and parallel market exchange rates has more than doubled in 2015. In most cases, the exchange rate adjustments have been poorly communicated, weakening confidence.

Monetary policies were appropriately tightened in response to rising pressures on currencies and inflation in a majority of countries. Armenia, the Kyrgyz Republic, and, to some extent, Tajikistan used a wide set of instruments to tighten monetary policy, including raising policy and other rates and mopping up excess liquidity. However, given impaired interest rate transmission channels and,

⁵ In some countries, FX sales have reached more than 20 percent of gross reserves and currencies continued to depreciate.

in some cases, barely positive real policy rates, the effectiveness of monetary policy was limited. Uzbekistan's policy stance was mixed: while tightening monetary policy by restricting growth of monetary aggregates, the authorities relaxed their policy by keeping interest rates low.

In the financial sector, some countries have reacted to increased dollarization by introducing macroprudential measures. The policy response involved increased reserve requirements for foreign currency deposits (Armenia, Tajikistan), higher provisioning for foreign currency lending (Kyrgyz Republic), and tightening consumer and mortgage lending (Azerbaijan).

The long-lasting nature of the shocks reinforces the case for strengthening domestic policies to boost potential growth and ensure financial stability. A more severe scenario for the Russian economy would call for faster implementation of structural reforms.

- In the near term: continuing external imbalances point to the need for further exchange rate adjustment, which should be allowed without resisting the trends (Kyrgyz Republic, Tajikistan). To alleviate balance of payment pressures, Uzbekistan would need to accelerate the pace of nominal depreciation. In Armenia, after large foreign exchange sales to date and a fall in reserve coverage, the central bank should limit further intervention and allow the dram to move flexibly if market pressures reemerge. In Kazakhstan, following the decision to float the tenge, strengthening monetary policy instruments and liquidity management will enhance the policy framework and address macroeconomic imbalances. Given high dollarization, financial sector stability

should be managed carefully and CCA central banks should step up risk monitoring and strengthen crisis management frameworks. Monetary conditions may need to remain tight, if depreciation results in sustained inflation pressures (Kyrgyz Republic, Tajikistan, Uzbekistan). Fiscal policies need to ensure that near-term accommodation (Armenia, Kazakhstan, Kyrgyz Republic) is sustainable in the medium term and that spending is well targeted, both to the poor to mitigate the shock, and also to meet medium-term growth objectives. In Georgia, automatic stabilizers should be partially allowed to strike a balance between reducing external imbalances and cushioning growth.

- In the medium term: rationalization of the public sector and increasing the efficiency of public spending may help create the necessary fiscal space in countries with limited policy buffers to avoid forced procyclical behaviors. In countries with fiscal policy space, lifting potential growth and ensuring fiscal sustainability in the medium term should be priorities. With exchange rate adjustment, high interest rates, and slow growth, central banks should further strengthen bank supervision—especially of systemic banks—and pursue de-dollarization policies. Further improvements to macro-financial policy frameworks, including greater transparency, better communication, and enhanced practices and tools, are vital for mitigating future shocks. Faster implementation of structural reforms to improve institutions, enhancing the efficiency of labor and product markets, and streamlining business regulation would lift up medium-term growth and increase resilience to negative spillovers.

