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EXPECTED LENGTH OF THE ECONOMIC EFFECTS OF THE GEOPOLITICAL CRISIS IN LATVIA

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Abstract. A geopolitical crisis emerged in Europe in 2014, which began with political tensions between Russia and Ukraine; later Western economic sanctions and Russia's counter-sanctions were introduced, which affected many countries, including Latvia, thus, endangering economic growth at least in the East European region. In 2014 in Latvia, the counter-sanctions affected most the following industries: dairy farming, the fruit and vegetable industry and the international road transport industry; later, the fish processing industry and other industries were also affected after the Russian rouble exchange rate fell and an economic crisis emerged in Russia. It is important to enterprises of the affected industries, banks and government institutions to predict the length of this crisis in order to design appropriate action strategies. The research aim is to forecast the length of the effects of the geopolitical crisis in Latvia. The present research is based on analyses of Russia's balance of payments, other indicators and the effects of the Western sanctions against Russia as well as on an assumption that after a certain period, Russia's economy faces serious problems, which may lead to political and economic situation change in Russia and, consequently, to the end of this crisis. Since Russia is quite dependent on Western financial capital and technologies, it cannot have tensions with the West for a long time. By using its foreign reserve assets, Russia can maintain its external and internal macroeconomic equilibrium and the pre-crisis level of wellbeing no longer than one full year, i.e. until 2016.

Key words: geopolitical crisis, sanctions, macroeconomic equilibrium.

JEL code: F41, F51

Introduction

In the end of 2013, Ukraine had to sign an association agreement with the European Union, thus, completely rejecting its potential joining the emerging Eurasian Union or the Eurasian Economic Union consisting of Russia, Kazakhstan and Belarus. Its former president did not do

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it, thus, making a large part of the Ukrainian society discontent and causing a political crisis in Ukraine. Ukraine's choice in favour of European integration caused a serious geopolitical crisis and deteriorating relations between Russia and the West as well as led to economic sanctions and counter-sanctions. This geopolitical crisis caused much far-reaching implications at least for the East European region, negatively affecting its economic growth. Since the modern world is economically integrated, all these developments influence Latvia's national economy and its growth, mainly through its exports. The effects of the crisis will persist as long as the political and economic situation does not change in Russia. This, in its turn, will be determined by Russia's government's possibilities to hold macroeconomic equilibrium in the national economy.

The research aim is to forecast the length of the effects of the geopolitical crisis in Latvia. The research tasks are as follows:

1. to describe the sanctions imposed by the West against Russia and their effects under an open economy and low oil prices;
2. to examine Russia's external economic situation and dependence on foreign financial capital flows;
3. to forecast how long Russia's government is able to maintain macroeconomic equilibrium in the national economy under an open economy and sanctions.

The present research employed the following research methods: the descriptive method, analysis and synthesis, deduction, correlation analysis, quantitative forecasting and time series analysis.

Research results and discussion

Western sanctions against Russia and their effects under an open economy and low oil prices

The West imposed the sanctions in response to Russia's policy over Ukraine. The sanctions involved various restrictions to selected sectors of Russia's economy: the financial sector (restrictions to lend financial capital to major government-owned banks for more than 30 days), the energy (oil and gas) sector (restrictions to sell technologies and lend financial capital to major government-owned energy enterprises) and the military sector. The first two sectors are the most important from the perspective of their size of economic activity and more data are available on them; hence, the paper will focus on the mentioned two sectors. In response, Russia imposed 12-month counter-sanctions, banning imports of food from the countries which imposed sanctions against it. These 12-month counter-sanctions may be prolonged if the sanctions against Russia are not lifted.

Nowadays almost any country's national economy is integrated into international flows of goods and services to a great extent and is subject to the macroeconomic laws of open economy. An open economy is well described, for instance, by the Mundell-Fleming model; according to it, a national economy must have both internal equilibrium – in the goods (and services) market and money (and other financial) markets – and external equilibrium – in the balance of payments (Salvatore, D., 2001).

Russia's exports and imports (of goods and services), as a percentage of GDP, are 30 and 22%, respectively (World Bank, 2014). Russia's key exports are energy commodities. Annually, Russia exports almost 400 mln tonnes of crude oil and oil products and approximately 200 bln cubic metres of natural gas, which account for 67% of the total revenue from exports of goods (Central Bank of Russia, 2014). Natural gas prices are pegged to crude oil prices; accordingly, changes in oil prices affect natural gas prices to the same extent. Part of Russia's oil and gas is extracted in Arctic regions by using Western technologies. For this reason, the West's ban on selling technologies to Russia's energy sector will reduce its output of oil and gas in the future. But this sector is negatively affected not only in this way. Russia's major state-owned oil and gas enterprises have borrowed funds not only in their domestic capital market but also in international capital markets. The Western sanctions do not allow them to refinance their debts abroad. Refinancing their ample debts at domestic banks is also problematic, as borrowing funds by other banks of Russia in Western capital markets is almost impossible due to the sanctions against state-owned banks. Besides, interest rates in Russia are high, as the Central Bank of Russia (CBR) implements a quite tight monetary policy in order to reduce the rouble's depreciation and inflation. The key interest rate of the CBR was raised from 10.5 to 17% at the end of 2014. However, the foreign debts of banks and other enterprises of Russia total approximately USD 700 bln, and both interest and principal sums have to be paid back but refinancing debts in Western capital markets is not possible and it is hard to do it in other international capital markets. So one can find that the two mentioned sectors face serious problems caused by the sanctions. In addition, oil prices started falling in the last months of 2014, which make even more difficult to repay foreign debts. It is associated with the decision by OPEC, the cartel of oil producing countries, not to decrease oil output under conditions when the output of shale oil and gas is increasing in the world, particularly in the USA. OPEC's oil output accounts for 43% of the total oil production in the world; hence, OPEC's decisions can significantly affect oil prices in the world (Organisation of the Petroleum Exporting Countries, 2014). Crude oil prices fell from their highest level of 115 USD/bbl in June 2014 to 56 USD/bbl at the very end of 2014, i.e. two times. It is possible that OPEC wants to increase its global market share what it lost due to the shale oil revolution and the oil output increase in arctic regions. However, there is a reason to suppose that oil prices will remain relatively low within a few next years. Yet, for Russia, such oil prices mean an essential decrease in export revenues and, potentially, even a critical situation in its national economy and financial system, given the effects of the sanctions as well.

Russia's external economic situation and dependence on foreign financial capital flows

To examine Russia's external economic situation and dependence on foreign financial capital flows, one has to analyse Russia's balance of payments, foreign debt and its repayment schedule, international investment position, foreign currency and gold reserves and their changes as well as other aspects. On the one hand, the falling oil prices and the Western sanctions against Russia decrease its revenues in foreign currencies and the financial capital inflow; yet, on the other hand, such a situation increases the financial capital outflow and, at least initially, expenditures in foreign currencies, as Russia's population, expecting high inflation and a decrease in the rouble's exchange rate, purchase durable goods, part of which are foreign goods, and prefer foreign currencies as an instrument of savings. Such a decline in revenue and a surge of expenditure hamper economic activity in Russia as well as it may lead to a substantial decrease in the level of wellbeing in the country. Given the fact that Russia is the third most significant partner in trade in goods for Latvia with a proportion of almost 12% (Central Statistical Bureau, 2014) as well as one on the largest partners in exports of services, decreases in the rouble's exchange rate and purchasing power in Russia will negatively affect Latvia's exports to this country; in addition, Latvia's residents may incur investment losses in the financial and economic problem-ridden Russia.

Table 1

Russia's key balance of payments characteristics, foreign debt, central bank foreign reserves and the average oil price in the period 2005-2014, bln USD

Indicator/year	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014 Q1-3
Current account, incl.	84.4	92.3	72.2	103.9	50.4	67.5	97.3	71.2	34.1	46.1
- exports of goods	240.0	297.5	346.5	466.3	297.2	392.7	515.4	527.4	523.3	496.9[1]
- trade balance	116.2	134.3	123.4	177.6	113.2	147.0	196.8	191.7	181.9	210.9[1]
- investment income	-17.4	-24.6	-21.5	-32.1	-31.0	-38.7	-51.0	-67.2	-80.3	-51.3
Current and capital account	72.0	92.6	61.6	103.8	37.9	67.4	97.4	66.1	33.7	35.9
Financial account[2]	-5.5	3.6	97.1	-139.7	-28.1	-21.5	-76.1	-25.7	-45.0	-85.7
Financial account	-67.0	-103.9	-51.8	-100.8	-31.5	-58.3	-88.7	-55.7	-22.9	-42.3
Change in foreign reserves[3]	-61.5	-107.5	-148.9	38.9	-3.4	-36.8	-12.6	-30.0	22.1	43.4
Discrepancy	-5.0	11.2	-9.7	-3.1	-6.4	-9.1	-8.6	-10.4	-10.8	6.5
Foreign debt (as of end of year)	257.2	313.2	463.9	480.5	467.2	488.9	538.9	636.4	728.9	599.5
Foreign reserves (as of end of year)	182.2	303.7	478.8	426.3	439.5	479.4	498.6	537.6	509.6	385.5
Capital inflow (+) or outflow (-)	-0.1	41.4	81.7	-133.7	-56.1	-34.4	-80.5	-54.1	-63	-151[1]
Average oil price, USD/bbl (Brent)	55	65	72	97	62	80	111	112	109	99

[1] – Quarters 1-3
[2] – foreign reserves excluded (author's calculations)
[3] „-„ sign means increase, „+" sign means decrease

Source: author's calculations based on the Central Bank of Russia and the U.S. Energy Information Administration

The balance of payments of Russia, just as that of any country, has its own specifics, the main of which are as follows: 1) a persistent and ample surplus in the trade balance (exports of goods less imports of goods); 2) a persistent but considerably smaller surplus in the current account, especially in recent years; 3) an almost persistent deficit in the financial account – due to the "capital outflow problem" for Russia. It should be added that examining the problem of the present paper does not require analysing annual changes of selected indicators, as max and min values of these indicators are important.

An analysis of almost a decade reveals that Russia has an ample and stable surplus in its foreign trade balance (i.e. foreign trade in goods, which is the key component of the entire current account). It ranges from more than USD 113 bln in 2009 when commodity prices and, first of all, the prices of oil – the key export commodity of Russia – were low (on average it was 62 USD/bbl), which was caused by the global financial and economic crisis in the autumn of 2008, to USD 197 bln in 2011 when the commodity prices reached comparatively high levels (the average oil price was 111 USD/bbl). Russia's key group of export goods is energy (crude oil, oil products and natural gas), for example, in 2013 the value of these export goods totalled USD 350 bln (Central Bank of Russia, 2014), accounting for 2/3 of the total value of exports of goods. Consequently, the total value of Russia's exports of goods and the trade balance (surplus) depend on oil prices. In the period of analysis, a correlation between the oil price and the total value of exports of goods reached 0.995, while a correlation between the oil price and the trade balance was 0.973, i.e. the correlations were very strong (author's calculations).

The data of Russia's balance of payments show that the country runs a comparatively large investment income deficit; the largest deficit was observed in 2013, reaching USD 80.3 bln. Even though Russia's government debt is small – about USD 57 bln or slightly above 2% of GDP (Central Bank of Russia, 2014), the debts of the country's banks and other enterprises are relatively large, amounting to USD 731.2 bln in the first half of 2014. Accordingly, Russia's expenditures on borrowed foreign capital are large. Due to the sanctions against Russia's financial sector, it is almost impossible for all its banks to borrow new funds or refinance their debts in Western capital markets but if it is partially possible, the interest rates are certainly higher under such circumstances.

However, on the whole, the current account presents surpluses due to the very positive trade balance. In 2008, it stood at USD 103.9 bln, whereas next year when oil prices fell it was only USD 50.4 bln. Russia's current and capital account (which takes into account also debt forgiveness and purchases of nonfinancial assets (e.g. real estate) etc.) does not considerably differ from the current account.

In contrast to the current account, which had stable surpluses, the financial account had almost persistent deficits, except two pre-crisis years (2006 and 2007), over the period of analysis. The author recalculated the financial account balance, subtracting the changes in the central bank reserves from it, as the CBR includes these changes in the financial account, thus, making more difficult to understand the situation with financial capital flows. A large outflow of financial capital is characteristic of Russia; it exceeds the inflow of capital, especially during periods of political or economic turmoil. The CBR provides data on the capital inflow/outflow that fully do not match but at least correlate with the financial account data – presumably, the CBR calculates the capital outflow based on its own methodology that takes into account the amount of foreign currencies bought by the population for the purpose of savings that does not flow out and remain in the country. Besides, it should be noted that it is impossible to record all transactions, as part of the money flow takes the form of cash flow, avoiding banks.

Even though Russia's current foreign transactions (the current account) provide a surplus of foreign currencies, problems are caused by the large financial capital flows, and in order to ensure stability in the foreign exchange (forex) market, the CBR significantly intervenes in it through buying any surplus of foreign currencies (mainly USD) or selling back the reserves if there is a deficit. Over the period of almost 10 years, a situation when a deficit in the financial account was greater than a surplus in the current account was observed only in 2008 when the global financial and economic crisis began in the second half of that year. Even in the next year of the crisis, in 2009, the situation changed to the opposite. Such a situation repeated in 2013 when a deficit in the financial account (USD 45 bln) slightly exceeded a surplus in the current account (USD 34.1 bln). This may be explained by the Ukrainian geopolitical crisis. As this crisis escalated in 2014, the gap between a surplus in the current account (USD 46.1 bln) and a deficit in the financial account (USD 85.7 bln) increased in the first three quarters, and the CBR had to cover this gap from its foreign reserves. Throughout 2014 the CBR sold more than USD 100 bln, and its foreign reserves declined to USD 388.5 bln (Central Bank of Russia, 2014). This trend undoubtedly is going to continue in 2015 and certainly in the next years if the sanctions are in place.

Table 2

Russia's payment schedule of external debt from 2014 H2, bln USD

Indicator/period	2014 H2	2015	2016 Q1-3	From 2016 Q1-3 onwards	Without schedule
Principal sum	106.3	110.7	53.1	369.1	49.5
Interest	14.6	23.2	15.0	81.7	-
Total	120.9	133.9	68.1	450.8	-

Source: author's calculations based on the Central Bank of Russia

Russia's payment schedule of external debt shows that in the second half of 2014 when the sanctions against Russia were introduced, the debt to be paid back totalled more than USD 120 bln, and during this period the CBR's foreign reserves decreased by about USD 70 bln. Next year, the amount to be repaid will be more than USD 133 bln. The burden of foreign debt will decline only in 2016, for which the CBR provides detailed data; however, no detailed data are available for a more distant period but the foreign debt is still almost USD 500 bln. It is not a huge debt but under the sanctions and due to an economic recession it may cause serious problems to Russia’s banks and enterprises and, after a certain period, lead Russia’s government to default as well.

Under such circumstances, it is important to Russia’s government not to let foreign capital flow out of the country in large amounts, but attracting new foreign capital under the sanctions, low oil prices and an expected deep recession in the economy is not even worth considering. Introducing financial controls is risky, as it increases the outflow of capital. Besides, Russia’s government is interested in repatriating part of Russia’s investments made abroad. At the end of 2014, Russia’s government proposed an offshore capital amnesty, which would motivate the return of capital to Russia. Russia’s international investment position (Table 3) shows that at the end of the third quarter of 2014, foreign investors had invested in Russia as much as USD 1178 bln, of which about half (USD 679.4 bln) was invested in financial instruments (bonds, loans, etc.). Russia’s residents have invested abroad about USD 957 bln, and together with the CBR’s foreign reserves (USD 454 bln) the foreign assets reached USD 1411 bln; so Russia’s net international investment position was positive, reaching USD 233 bln. Yet, it should be noted that the largest investor of foreign direct investment (FDI) in Russia is an offshore country, Cyprus, – of the total FDI of USD 566 bln, at the end of 2013, approximately 28% or USD 161 bln came from this country (Central Bank of Russia, 2014); analysts suppose this is Russian capital rather than foreign capital. Cyprus is not the only offshore country from which disproportionate investments come to Russia.

The data show that the sanctions have not made any significant impact on foreign investment flows in the first two quarters of 2014 compared with the pre-sanction year of 2013. The reason might be the ineffective sanctions of Level 1 and Level 2 imposed only on individuals in the first half of 2014.

Table 3

Russia's international investment position from 2011 to 2014 Q3, bln USD (as of the end of the period) and its change, %

Indicator	2011	2012	2013	2013/ 2011, %	2014 Q1	2014 Q2	2014 Q3	2014 Q1/ 2013, %	2014 Q3/ Q2, %
Assets, incl.:	1239	1375	1470	18.6	1445	1502	1411	-4.0	-6.1
FDI	367	410	479	30.5	450	485	467	-2.5	-3.7
portfolio investment	42	48	55	31.0	59	62	63	14.5	1.6
other investments	331	374	421	27.2	443	469	419	-0.5	-10.7
Liabilities, incl.:	499	538	510	2.2	486	478	454	-11.0	-5.0
FDI	1096	1239	1344	22.6	1229	1320	1178	-12.4	-10.8
portfolio investment	455	515	566	24.4	489	547	477	-15.7	-12.8
other investments	225	270	274	21.8	237	269	225	-17.9	-16.4
Reserve assets	410	449	499	21.7	496	500	467	-6.4	-6.6
Net international investment position	144	137	126	-12.5	216	181	233	84.9	28.7
Foreign debt	488.9	545.2	636.4	30.2	718.7	731.2	679.4	6,8	-7,1

Source: author's calculations based on the Central Bank of Russia

As shown in Table 3, increases both in foreign assets and in foreign liabilities were stable in the period 2011-2013. In contrast, all kinds of foreign investment into Russia started decreasing quite sharply in the third quarter of 2014, although a return of foreign capital was observed in the second quarter after the West introduced the very first sanctions in the first quarter. In contrast, foreign investment flows from Russia were two-way – an increase in portfolio investment and decreases in reserve assets, FDI and other investments.

One can predict that some outflow of foreign capital is observed, given the current conditions and Russia's specifics. As regards a decrease in foreign assets or the return of Russia's capital from abroad, this is unlikely, and a greater outflow of capital from Russia will be potentially seen, i.e. Russia's financial account will be negative. For this reason, in 2015 and onwards (if the sanctions are in place) the foreign debt will have to be mainly repaid from the CBR's foreign reserves.

Forecast of the length of macroeconomic equilibrium in Russia under an open economy and sanctions

Russia's economy is an open one and hence substantially subject to international economic processes, i.e. interaction with the external world through the exchange of goods, services as well as financial capital. Based on the analysis performed in Sub-part 2, one can find that in 2015 and 2016 the value of Russia's exports of goods will stand at the levels of 2009-2010, i.e. more than USD 100 bln less than in the previous years. Consequently, a surplus in Russia's current account is expected comparatively small because the country's relatively large foreign debt has to be serviced (foreign debt interest is recorded in the current account).

The next most important problem is the foreign debt (the payback of principal sums) that cannot be refinanced under the sanctions. The size of it exceeds USD 600 bln, which is more than the CBR's foreign reserves (approximately USD 400 bln). So, theoretically, Russia is not able to pay back all its foreign debt at low oil prices and under the sanctions. It has to be considered that the entire foreign reserves will not be used, as any central bank needs some foreign reserves for balancing shortfalls in the country's balance of payments. One can assume that the CBR might let its foreign reserves decline up to USD 100 bln. Besides, part of these reserves is included in the Reserve Fund and the National Wealth Fund (totally about USD 170 bln), part of which (at least USD 80 bln) has been invested in long-term projects (including infrastructure projects) and another part of the reserves is intended for covering deficits in Russia's Pension Fund. So these funds will not be used for maintaining the external macroeconomic equilibrium. For these reasons, the liquid foreign reserves of the CBR total approximately USD 300 bln; but, according to the former Russian minister for finance, M.Zadornov, the amount of liquid reserves is even smaller, standing at approximately USD 200 bln (Economist, 2014).

By attempting to maintain the standard of living in Russia as it was throughout the year 2014, in 2015 the CBR's reserves might decrease by about USD 130 bln (equal to the foreign debt to be repaid in 2015, assuming that the surplus in the current account and the deficit in the financial account are balanced) to about USD 250 bln; besides, the liquid foreign reserves might decrease to less than USD 100 bln. One has to add that the CBR has announced that it envisages selling only about USD 85 bln of its foreign reserves in 2015 in the forex market. The CBR's foreign reserves will have to be likely used to bail out banks and the largest and most important companies. It leads to a conclusion that the CBR's foreign (liquid) reserves are enough only for one full year, i.e. 2015, which is followed by the loss of the external macroeconomic equilibrium as well as the internal macroeconomic equilibrium in Russia's economy and bankruptcies of many banks and other enterprises and, potentially, the default of Russia's government like in August 1998. However, such a scenario – maintaining the pre-crisis standard of living and the external macroeconomic equilibrium by using the CBR's foreign reserves is unlikely. Russia's government and central bank will implement a policy of "golden mean" – reducing the standard of living through "external devaluation", i.e. a substantial fall in the rouble's exchange rate and associated higher inflation – which would allow decreasing imports of consumer goods (by seeking to implement import substitution policies) and improving the trade balance and, in its turn, the current account; this would decrease the need for the CBR's foreign reserves. Yet, given the relatively expensive financial resources in Russia (the CBR's key interest rate was set at about 10% per year; but with the rouble crisis starting on 16 December 2014, the rate was raised to 17%), the substitution of imports in great quantities is unlikely, as this process requires large investment in the national economy, which, in its turn, requires low inflation and stable accumulation of capital (instead of spending savings by the population on foreign hard currencies and purchasing durable (imported) goods) and cheap money resources.

By reducing the standard of living and seeking to implement import substitution policies, the period of the external and internal macroeconomic equilibrium may be lengthened; yet, with the CBR's foreign reserves decreasing, panic may start in Russia's financial markets, which can create serious problems for the entire financial system of Russia. The "weakest link in the chain" in the financial system of less developed economies is usually the forex market, which was confirmed by the rouble crisis on 16 December 2014 and which can, under the sanctions, repeat both in 2015 and, of course, in 2016 as the CBR's foreign reserves are expected to still be decreasing. It leads to a conclusion that it is likely that in 2015 no serious change in the relations between the West and Russia can occur, yet, in 2016 Russia's government will face real problems in maintaining the external macroeconomic equilibrium in the national economy, which may result in the political and economic situation change in Russia. This will lead to lifting the Western sanctions or part of them and Russia's counter-sanctions, the stabilisation of the rouble and purchasing power or even their increases in Russia, thus, positively affecting the industries of Latvia's national economy that suffered from Russia's counter-sanctions and the fall in the rouble's exchange rate.

Conclusions

1. The Ukrainian geopolitical crisis led to imposing economic sanctions against Russia, which, in its turn, introduced counter-sanctions, thus, causing a crisis for several industries of Latvia. This contributed to economic growth slowdown in Latvia and other countries.
2. Russia is quite dependent on economic interaction with the world, its exports and imports account for 30% and 22%, respectively, of GDP and its foreign debt exceeds USD 600 bln, while its foreign reserves are less than USD 400 bln; hence, the effects of the sanctions on Russia's economy are also significant.
3. Russia runs a surplus in foreign trade with goods, yet, this surplus is significantly decreased by other current account items; under unfavourable conditions (sanctions), the outflow of financial capital exceeds the surplus in the current account, which requires the Central Bank of Russia to intervene in the foreign exchange market and sell its foreign reserves that are quite limited.
4. To maintain the external macroeconomic equilibrium in Russia's national economy, the Central Bank of Russia will have to spend almost all its liquid foreign reserves already in 2015, and in 2016 Russia will face even more serious financial and economic crises in its economy. This situation creates opportunities for the political and economic situation change in Russia.

5. With the political and economic situation change in Russia, political relations between Russia and the West will improve, the sanctions against Russia and Russia's counter-sanctions will be lifted, which leads to the end in the crisis for several industries of Latvia.

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