The Impact of Global Financial and Economic Instability on the CIS

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The period from 2007 to 2012 was a period of increased turbulence in the global economy. After the US mortgage crisis (accompanied by the bankruptcy of major financial companies such as Bear Stearns and Lehman Brothers) caused
a drastic fall in economic activity and a slump in equity and commodity prices in 2008, economies and markets recovered considerably in 2009-2010 with the help of energetic fiscal and monetary incentives implemented by governments throughout the globe. The situation worsened in the second half of 2010 and, particularly, in late 2011 and early 2012, when the high government debt of some eurozone countries made investors doubt whether they could service it further. Over the past two years the European authorities have been looking for measures to mitigate the debt crisis by providing support to debtors through the European Central Bank (ECB) and newly created stabilisation mechanisms such as the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM).

In the meantime, the debt crisis began to affect the economic situation in developed countries throughout 2011. In the fourth quarter of 2011, the eurozone economy had negative growth and international organisations predicted that it would remain in recession throughout 2012. The economic downturn in Europe has affected international trade: after an average increase of 15% in 2010, the growth of the global trade dropped by 6% in 2011 and 2.7% in the first quarter of 2012 and the growth in exports by developed countries declined to 2.4% and of developing economies to 3%.

Today, several factors exist that could potentially worsen the world’s economic situation in 2012 and for the next several years.

a. Recurrences of the eurozone debt crisis

Since the stability of European economies with a high level of debt does not seem certain, many observers still believe their default and withdrawal from the eurozone to be the most probable outcome of the crisis. Despite the noticeable
The positive effect the measures undertaken by the European authorities had on debt quotes of the largest economies affected by the crisis (Italy and Spain), government bonds quotes in more problematic countries remain low and debt servicing remains expensive for them. Therefore, it is possible that the debt crisis will periodically recur in Europe, requiring debt restructuring in a wide range of eurozone countries. The unfavourable consequences of this process for the financial sector and budgetary savings measures will have a negative effect on the global economic situation. Its extent will depend on what countries will be affected by recurrences of the debt crisis. If it does not go beyond small countries of the European periphery the related negative shocks can be rather moderate. If the debt situation in larger countries gets out of control, the consequences will be very significant. The breakdown of the eurozone (which is, however, seemingly unlikely) will have consequences that will be more serious than those of the 2008 US mortgage crisis.

b. Fiscal consolidation in the US

A reduction in the US government’s expenditures because of the need to regain control over the growing public debt is another source of risks for the CIS countries. Despite the positive effect of this measure in the long term, its immediate effect will be a slowdown or a fall in economic activity in the US and, possibly, a decrease in the world prices of raw materials that form the exports of CIS countries. The lack of extensive direct trade ties with the US is not too important in this case: the trade in oil, metals and grain is of global nature and a decrease in demand for them in any part of the world will affect the prices of raw materials exported by the CIS.

It should be noted that the effect the situation in the US will have on the rest of the world will be considerably lighter than it was in 2008. First, even a rather decisive reduction in government expenditures will have a very limited effect on the country’s economy. There are no grounds to expect that this will lead to a financial catastrophe as it was in the Lehman Brothers’ case. Second, the political struggle in the US in the run-up to the presidential and parliamentary elections prevents radical measures from being taken in the sphere of budgetary policy, despite the intensity of the respective debates. In fact, we will only be able to talk about the tightening of the fiscal policy in the US from around 2013. Third, the overall situation in the American economy is changing for good. If this trend continues, fiscal consolidation, which is needed to recover the stability of public finance, can turn to be less radical than it seems necessary today.

However, earlier consolidation can be provoked by a large-scale crisis in another part of the world, most probably Europe, if, affected by it, investors become less confident of the reliability of the American government’s debt obligations.
c. Slowdown in economic growth and decrease in real property prices in China

The Chinese economy, whose renewed growth with the help of government incentives in 2009-2010 had significantly facilitated the recovery from the crisis for both China and the rest of the world, has again slowed down. This is partially due to a change in state policy in 2011: having faced overheating in the economy, which manifested itself in accelerating inflation and, in particular, a quick rise in real property prices, the authorities took measures to restrain the credit expansion, which have already brought results. As a result of this, inflation went down and the real property boom is fading out. In addition, the slowdown in China’s economic growth has been caused by a number of longer-term factors: the demand for Chinese exports is falling because of difficulties in Western economies, while increasing prices and wages in the country make them less competitive. At present, China’s monetary policy is being weakened to a certain extent since the previous year’s tightening made it achieve its objectives at large. If the Chinese economy avoids disruptive developments, in particular in the financial sector (which was accumulating considerable volumes of bad debts during the previous credit expansion), China could even become a source of positive effects for the global economy. The fact that the authorities still possess very significant financial reserves makes this rather probable; however one should not rule out the possibility that the situation will change unfavourably. The financial crisis in China, as well as the hasty financial consolidation in the US, which we discussed above, can be caused by unfavourable events outside the country, for example in Europe.

Figure 7.2. Land prices and real property rentals in China (12-month dynamics)

Source: CEIC database
If this happens, the crisis will have a considerable impact on the global economy.

d. Growing energy and food prices

We have described the factors that can lead to a decline in prices of the CIS exports or hinder access for banks and companies from these countries to global finance. There is another threat however: because of the recovery of the world’s leading economies, the soft monetary policies pursued by central banks, and the limited opportunities to boost production of the majority of energy and food commodities, energy and food prices could begin to grow in an unexpectedly quick fashion. In such an event, the situation will develop similarly to 2010, when energy and food prices also grew.

The CIS countries can very conventionally be divided into three groups that differ in terms of the condition of, and sources of finance for, their balances of payments and, accordingly, sources of tax revenues. These differences determine the channels for external negative effects on the economies in a certain group and, accordingly, the reaction of these economies to the development of the global situation and measures necessary to mitigate these effects. The following groups can be formed using these factors:

Group 1. Energy exporters (Russia, Kazakhstan, Azerbaijan, and Turkmenistan) have a significant export to GDP ratio, a positive balance of trade and a current account surplus. The share of raw materials exports in budget revenues is high. These countries have financial reserves which were accumulated during the favourable part of the 2000s, which however reduced considerably during
the 2008-2009 crisis. At present, these countries have a budget surplus, which is, however, considerably lower than in the pre-crisis period before 2008.

**Group 2.** The economies of Armenia, Moldova, Kyrgyzstan and Tajikistan are financed, to a considerable extent, by remittances from labour migrants and with the support of diasporas. Although the majority of these countries have certain (mineral and/or agricultural) resources, they are not large enough to make exports determine economic dynamics. These countries have considerable negative balances of foreign trade and current accounts. The tax base in these countries is primarily domestic economic activities. Because of the relatively difficult collection of taxes from this base (compared to taxes on raw materials exports), the budgets of the countries in the second group have chronic deficits and depend more or less on external finance.

**Group 3.** Belarus, Uzbekistan and Ukraine can be included in the third group. These countries have a diversified structure of exports and a considerable share of products with a relatively high level of processing, while they still have considerable raw materials exports. Their foreign balances are historically better than those in the second group. The budgetary policy in these countries is also

<table>
<thead>
<tr>
<th>Exporters of oil and gas</th>
<th>Share of mineral products in exports (%)</th>
<th>Commodities accounting for more than 10% in exports</th>
<th>Current transfers (% of GDP)</th>
<th>Money remittances from Russia (% of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exporters of oil and gas</td>
<td>Azerbaijan 95% mineral products (95%)</td>
<td>1% 1.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exporters of oil and gas</td>
<td>Kazakhstan 76% mineral products (76%), metals (13%)</td>
<td>-0.3% -0.3%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exporters of oil and gas</td>
<td>Russia 66% mineral products (66%), metals (10%)</td>
<td>-0.2% -0.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exporters of oil and gas</td>
<td>Turkmenistan 71% mineral products (71%), textiles (20%)</td>
<td>0%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| Exporters of labour | Armenia 31% foodstuffs (17%), mineral products (31%), stone, cement, precious metals (16%), metals (28%) | 6% 10.1%                                     |                             |                                        |
| Exporters of labour | Kyrgyzstan 8% foodstuffs (13%), textiles (11%), stone, cement, precious metals (46%), other items (11%) | 29.1% 21%                                  |                             |                                        |
| Exporters of labour | Moldova 1% foodstuffs (48%), textiles (19%), machinery, equipment (11%) | 22.8% 13.4%                                   |                             |                                        |
| Exporters of labour | Tajikistan 4% foodstuffs (18%), textiles (16%), metals (57%) | 26.8% 38%                                  |                             |                                        |
| Exporters with a diversified structure of trade | Belarus 29% foodstuffs (13%), mineral products (29%), chemical products (16%) | 0.6% 0.3%                                      |                             |                                        |
| Exporters with a diversified structure of trade | Uzbekistan 24% foodstuffs (10%), mineral products (24%), chemical products (14%), textiles (23%), metals (13%) | 6.7%                                      |                             |                                        |
| Exporters with a diversified structure of trade | Ukraine 13% foodstuffs (19%), mineral products (13%), metals (34%), machinery, equipment (11%) | -6.1% 1.4%                                 |                             |                                        |
historically stronger than in the majority of countries in the second group, but
the stability of their public finance is fragile. Government budgets are balanced
or have a moderate deficit, but all countries have a significant deficit in quasi-
fiscal transactions.

In 2011, the economic situation in the region was somewhat different from the
global trend: despite the overall worsening of the economic situation in the
world, the CIS economies managed to speed up their growth to a certain extent.
The weighted average GDP growth in the region (in 2011) was 4.6% (compared
to 4.2% in 2010). Three economies (Azerbaijan, Belarus and Moldova) had a
slower growth than in 2010. The Russian economy, which accounts for 77%
of the region’s economy, remained at the level of 2010. A noticeable result
of 2011 was high growth in agriculture. In contrast, the growth in production
slowed down in the majority of the CIS countries because of the increased
prices of products and a lower demand for them.

The dynamics of the current accounts were determined, as before, by the
effects the favourable situation in the global raw materials markets had on the
balances of trade of the countries in the region and, primarily, the first group
(exporters of oil and gas). At the same time, increased oil and food prices have
worsened the balances of trade in the other two groups, which are primarily
importers of oil products. However, in these countries the effect of increased
prices of imports was compensated to a certain extent with high prices of their
main exports, in particular gold, aluminium and cotton. The growth of the
Russian and Kazakh economies had a positive effect on money remittances.
The countries that are dependent on transfers to the most significant extent
have received additional opportunities to finance their trade imbalances, which
had worsened because of increased import prices. Despite the considerable
outflow of capital from the economies in the first group, the balance of
payments in the region has produced an overall net increase in the reserve
assets of central banks.

On one hand, increased export revenues and the revival of economies
in the region had a positive effect on budget revenues. On the other hand,
these contributed to an insignificant growth in social spending and salaries of
government officials, compared to state revenues. Kazakhstan’s traditionally
well-balanced budgetary policy resulted in a considerable budget surplus in the
consolidated budget. Russia’s fiscal results were also better than forecasts made
in the beginning of the year. In those countries of the region that face chronic
public finance deficits and rather high government debt, favourable conditions
led to a certain improvement in economic situation.

A lower growth in the world prices of raw materials and food products and
tightened (to a certain extent) monetary policies have restrained inflation in
all countries of the region. At the same time, Belarus faced an acute crisis in
its balance of payments caused by excessive stimulation of domestic demand.
After the devaluation of the Belarusian currency in spring and summer, the government’s measures and the urgent assistance from the EurAsEC Anti-Crisis Fund and other donors have significantly stabilised its economy and helped to stop the drastic weakening of the national currency and restrain growth in prices.

The scenario for the nearest years suggests that global imbalances will continue to be eliminated. The growth in developed markets will remain low until the population decreases its debts, which could require several years. In eliminating global imbalances, Western countries with high government or private debt will change the structure of their economies by strengthening export-oriented sectors and reducing consumption. At the same time, the dynamically developing Asian countries – China in particular – will increase their domestic consumption to the detriment of their export potential. This process won’t be painless for the West, or for the Asia-Pacific, as the economic correction it suggests is very significant.

However, there are grounds to believe that the global economy will retain insignificant, but stable growth, as a slowdown in the development of certain economic sectors or certain countries will be compensated by accelerated growth in other sectors and countries. The IMF and the World Bank suggest that the economic unevenness of developed and developing countries will gradually be eliminated. According to their recent forecasts\(^2\), the global economy will have a growth of 2.5-3.5% in 2012, with an insignificant acceleration to 3-4% in 2013-2014. The growth in developing economies will slow down slightly in 2012, and accelerate to 6% on average in 2013-2014, while, in developed countries, it will remain at a relatively low level of 1.4-2.5%. The most probable scenario is that the eurozone authorities will retain control over the situation around problematic countries through debt relief and support of debtors. However, the fear of recurrences of the debt crisis in Europe will continue to affect the world’s economic activity.

For the CIS countries this scenario is rather favourable, since Asian developing markets will still demand raw materials. In addition, raw materials prices will be supported by investment demand underpinned by soft monetary policies in the West and the weakness of main reserve currencies, primarily the US dollar, in the nearest years. EDB forecasts that if Brent oil prices remain high (at $115 per barrel), the region will grow by 4-5% on average in 2012-2013. However, the main risks, which we described above, threaten higher growth rates in the CIS economies. For this reason an alternative scenario has been prepared, which suggests that oil prices will fall to $90 per barrel on average in 2012 and 2013. This will slow down the growth of the CIS economies to 3.2-3.9%.

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We have grounds to believe that even in the event of dramatic developments in the world, prices of raw materials won’t go down in such a radical fashion and the lending activity of the global financial sector won’t stop as it happened after the collapse of Lehman Brothers. A comparison of the current situation in the world and the CIS countries with the situation which had place before the crisis of 2008 suggests that the changes that happened in the last three years did not impact unambiguously the scale of possible negative events and the resistance to them on the part of the countries in the region. The essential differences include the absence of overheating in both the global economy and the economies of the region. Another important factor, which seems to be the most important now, is that the possibilities to support economic growth in the eurozone, with monetary and fiscal policies (monetary policy in particular), have not been exhausted to date.

Therefore, the following realistic scenarios exist which demonstrate the effects of negative developments in the world on the CIS in the nearest years:

1. Debt crisis in the eurozone. The consequences of a default by one or two peripheral eurozone countries (Greece and possibly Portugal) will depend on the measures taken in this situation by European authorities, but we have grounds to believe that these consequences will be moderate. A significant portion of debts of these countries has been de facto already written off by their creditors. In addition, financial institutions that are holders of these debts had sufficient time to form adequate reserves in case of default. For these reasons we have grounds to hope that in a moderately negative scenario, financial markets will continue to function normally and the corporate sector of the CIS economies won’t face a sudden discontinuation of access to external funding. Nevertheless, economic damage in this case will be considerable: Europe will be in deep and lengthy recession, which will probably last throughout 2012 and a part of 2013. Prices of all raw materials can be expected to decrease to a certain extent. We can expect that Brent oil prices in this scenario will fall to approximately $90 per barrel and remain at this level for a year (the level of prices determined by the budgetary situation in Saudi Arabia and marginal oil production costs). The effect this crisis will have on the CIS countries will be significant but not catastrophic: growth rates in the region will remain positive.

2. Financial crisis in China. We can suppose with some certainty that Chinese authorities will manage to avoid the crisis development of the problematic situation in the country’s financial sector. We deem the possibility of a financial crisis in China as an additional negative factor in case other negative scenarios develop, primarily the scenario of a large-scale crisis in the eurozone which is described above. China is the world’s leading consumer of energy resources, and a slowdown in its economy will result
in reductions in oil prices. If its growth is slowed down to 4–5% a year, this will be a challenge to all the CIS economies, especially Central Asian economies which are more closely tied to China.

3. Fiscal consolidation in the US. As we suggested above, more or less serious measures to restore budgetary balance in the US will most probably be taken not earlier than in 2013. Earlier consolidation can be provoked by a large-scale crisis in another part of the world, most probably Europe, if because of it investors become less confident about the reliability of the American government’s debt obligations.

4. Unexpectedly quick growth in energy and food prices. There is a risk that relatively favourable developments in the world (the renewed growth in Europe and the US and still very soft policies by central banks) will cause an unexpectedly quick rise in raw materials prices instead of their decrease and this can be dangerous for the most vulnerable CIS economies. The CIS countries that are vulnerable to unexpectedly quick growth in food prices are the countries with the highest poverty level, such as Kyrgyzstan and Tajikistan. Both these countries were listed by the UN Food and Agriculture Organisation (FAO) among the countries in danger of food crisis. The situation in this sphere could worsen, as agriculture in these countries depends on oil imports. A drastic increase in oil prices can also damage the CIS countries with high energy consumption which do not have their own significant oil and gas reserves and lack stability in external balance. This can affect Belarus and, although to a considerably lesser extent, Ukraine. In this case, the CIS countries above may need support from neighbours in the region.

<table>
<thead>
<tr>
<th>Exporters of oil products</th>
<th>Trade with European Union (share, %)</th>
<th>Trade with China (share, %)</th>
<th>Trade with the CIS (share, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Azerbaijan</td>
<td>42%</td>
<td>3%</td>
<td>16%</td>
</tr>
<tr>
<td>Kazakhstan</td>
<td>47%</td>
<td>17%</td>
<td>26%</td>
</tr>
<tr>
<td>Russia</td>
<td>47%</td>
<td>9%</td>
<td>15%</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>20%</td>
<td>21%</td>
<td></td>
</tr>
</tbody>
</table>

| Exporters of labour      |                                   |                             |                               |
|--------------------------|                                   |                             |                               |
| Armenia                  | 31%                               | 9%                          | 30%                           |
| Kyrgyzstan               | 8%                                | 15%                         | 52%                           |
| Moldova                  | 45%                               | 6%                          | 36%                           |
| Tajikistan               | 6%                                | 34%                         |                               |

<table>
<thead>
<tr>
<th>Exporters with a diversified structure of trade</th>
<th>Trade with European Union (share, %)</th>
<th>Trade with China (share, %)</th>
<th>Trade with the CIS (share, %)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>25%</td>
<td>4%</td>
<td>55%</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>16%</td>
<td>16%</td>
<td></td>
</tr>
<tr>
<td>Ukraine</td>
<td>29%</td>
<td>5%</td>
<td>40%</td>
</tr>
</tbody>
</table>

Table 7.2. Geographical distribution of trade in the CIS countries

Source: Trademap
The channels, through which external economic events influence the situation in the region, did not change compared to 2008–2009. If oil prices drop, the CIS countries (where raw materials exports play a key role in economy) will suffer reductions in export revenues and narrower access to external funding, which is important to their private sector. Exporters of labour will be affected by lower financial remittances from their citizens who work abroad, primarily in neighbouring countries within the region. On the other hand, a drastic increase in energy prices will impact favourably on the trade surpluses of the net exporters of raw materials and bring additional revenues to state budgets and international reserves of these countries. At the same time, this increase will significantly worsen the balances of trade of oil and gas importers, which will be compensated by increased remittances by labour migrants.

Money remittances are the key mechanism, with the help of which benefits and losses of energy and food exporters, in the event of changes in prices of their exports, are distributed among all countries in the region. Despite all the difficulties, this risk sharing mechanism helps the majority of the CIS countries to mitigate the increasing risks to a certain extent and resist the slowdown in the global economy.