Central Banks policy under sanctions: critical assessment of the Central Bank of the Russian Federation experience

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Abstract

The article provides a critical assessment of The Central Bank of the Russian Federation policy in response to the sanctions of the US, the EU, the UK, Switzerland, Japan, South Korea and a number of other countries. The effect of sanctions on the Russian economy and its financial market is viewed through the prism of credit, interest rate, and currency risk, and the risk of a decline in business activity. Special attention is paid to the inflationary component and inflationary expectations of the Russian Federation, as well as to the forecasts for a decline in business activity in Russia. A critical assessment is given to the actions of the Central Bank of the Russian Federation and the economic bloc of the government of the Russian Federation as a whole in response to the sanctions of the civilized world, which disable the normal existence of the economy and the main purpose of which is not to destroy the economy of the Russian Federation but to ensure the end of hostilities on the European continent. The results of our study will be useful to everyone who studies the problems of the effect of economic sanctions on the resource-based economy and the processes of stimulating political decisions by economic methods.

Keywords: credit markets, development markets, inflation, inflation target, monetary policy, monetary regime, monetary transmission, prime rates, sanctions.

Introduction

The start of the full-scale military aggression of the Russian Federation against Ukraine was a stroke not only for the economy of the European region, but also for the world economy as a whole. The war between the two countries, which remain prominent producers of agricultural raw materials (cereals, oilseeds, and other agricultural crops), was instantly reflected in the dynamics of prices on the world market. It is also important to consider the reaction of the aggressor country to the sanctions of civilized countries. The sanctions were intended not to destroy the Russian Federation economy but only to create additional incentives to start effective peace negotiations.

The economic interpretation of the sanctions and the analysis of their consequences for the Russian economy are very important for the correct interpretation of the goals of these sanctions and the restoration of the economic and agricultural balance in the region. The reaction of the Russian economy to sanctions and the effectiveness of countering these sanctions by the Russian authorities have not been studied yet, making this research pioneer. Moreover, in the course of the study, we came to rather non-standard conclusions that economic protection against sanctions does not work as such, and sanctions themselves, like military actions, are force majeure

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circumstances that cannot be stopped by economic methods. These conclusions were made on the basis of studying the first reaction of the Russian authorities to the economic sanctions of civilized countries, as well as studying further scenarios for the development of the situation and a possible change in the intensity of sanctions pressure.

Material and methods

In our study, we relied primarily on official statistics and reports from The Central Bank of the Russian Federation (CBRF), as well as on news reports from leading news agencies, the quality of which has been repeatedly tested by time: Reuters, Bloomberg, Interfax. We admit possible data inaccuracies since the primary sources are the state authorities that are currently in a war state, placed under conditions of violation of the basic principles of freedom of speech and democracy. Also, in the study, we used such methods as analysis, synthesis, and historical comparison.

Results and discussion

The economic sanctions imposed by the US, the UK, the EU, Japan, and other countries had a multidirectional character. These sanctions can be divided into several classes:

1. Freezing of gold and foreign exchange reserves of CBRF and The National Welfare Fund of the Russian Federation.

2. Freezing of assets of a number of banks on correspondent accounts outside the Russian Federation.

3. Prohibition on direct or indirect purchase and import of US dollar and Euro cash banknotes into the territory of the Russian Federation.

4. Sanctions against individual banks that were disconnected from the SWIFT international transfer system.

5. Sanctions against insurance and reinsurance companies, a ban on the presence of European ratings for insurance or reinsurance companies.

6. Personal sanctions against officials of the Russian Federation and the Republic of Belarus who were involved in the aggression.

7. Sanctions against big businessmen (oligarchs) who have earned their fortune due to warm relations with the Russian authorities.

8. A ban on the export to the Russian Federation of high-tech products, as well as products and services that are important for the development of the oil and gas industry and other key sectors of the Russian Federation.

9. Ban on the export of transportation and traffic-related services, such as aircraft certification.

10. Trade sanctions that provide for a complete or partial ban on the export of goods and services to the territory of the Russian Federation, as well as a complete or partial ban on the import of energy resources from the Russian Federation.

In total, all 10 groups of sanctions produce the following types of risks: currency risk, risk of the decline of business activity, credit risk, and interest rate risk. Each of the risks will be considered now in its practical aspect.

1. **Currency risk.** The main reason for the manifestation of currency risk in the Russian Federation was both a bunch of sanctions in general and the freezing of reserves of The Central Bank of the Russian Federation in the US, EU, UK, Japan, and South Korea. These countries have frozen approximately $400 billion of CBRF and The National Welfare Fund (NWF) reserves in total. And although the Ministry of Finance of the Russian Federation underestimates this amount by about $100 billion, comparative statistics from the US and the EU show that the amount of frozen assets of the CBRF and the NWF is closer to $400 billion. Only gold (approximately $135 billion worth) and several tens of billions of Chinese yuan remained in the management of the CBRF from the gold and foreign exchange reserves.

In the second decade of March 2022, it became clear that the CBRF did not expect a freeze on reserves and kept a very small part of them in cash dollars and euros. The situation was so critical that on March 9, the CBRF banned the sale of cash to the public. In response, the US and the EU banned the sale and import into the territory of the Russian Federation (directly or indirectly) of cash dollars or euros. With its ban on the sale of cash, the CBRF effectively admitted that it was unable to cope with maintaining the exchange rate, as it had lost its supply of reserve currencies, and the yuan is a very unpopular savings currency among Russians and Russian companies. Therefore, it was decided not only to ban the sale of cash currency but also a number of restrictions on imports, as well as a decision to force exporters to sell 80% of foreign exchange earnings for January and February 2022 (this decision was actually made retroactively).

As a result, it should be understood that by segmenting the foreign exchange market, CBRF introduced a plurality of ruble exchange rates: non-cash (for official transactions and critical imports), gray non-cash and black-market cash rates. The active information policy of CBRF and the habit of the main stakeholders to believe that the exchange rate of the ruble reflects the real rate made it possible to slightly calm the market. However, a deeper study of the situation leads to the discovery that from March 15 to March 20, 2022, they gave from 135 to 225 rubles for one US dollar on the black market of the Russian Federation, while the exchange rate on the exchange was 107-120 rubles per dollar. Also, the study of the cash market showed that even with a quote of 135 rubles, the black dealer did not always have cash currency for sale. In addition, surprising cases with additional commissions of banks were recorded. For example, when trying to withdraw cash in euros in one of the banks in the EU, the bank demanded an additional commission of 12.5% of the withdrawal amount. Thus, with the exchange rate, for example, 150 rubles per euro and the rate of the international payment system 155 rubles per euro, the real rate could be 175 rubles per euro.

The multiplicity of exchange rates in the Russian Federation became more pronounced when it emerged that citizens were allowed to withdraw no more than 10,000 US dollars from foreign currency deposits but with banks intensifying the situation with burdening these amounts with additional commissions that reached 15%. Later, the CBRF ordered the return of these commissions, but it appeared that the cash desks of banks receive cash at very high costs, which they are not able to cover.

By March 23, 2022, CBRF brought down the exchange rate to below 100 rubles per dollar, however, in the Moscow cash market, the maximum quotes for 1 cash dollar were at the level of 170-225 rubles per 1 US dollar. Temporarily, CBRF used the multi-rate technique to enable "elite" currency buyers to conduct more or less normal business activity and not affect inflation in the retail sails. However, this did not slow down the pace of devaluation, and the real selling rate of the cash dollar for the period from February 23 to March 23 increased from 80 to 170 rubles (with some effort, it was possible to buy a small amount from 135 rubles per dollar). As a result, the growth rate of the dollar against the ruble for the month amounted to at least 70%.

The effect of currency risk on the economy of the Russian Federation has a classic character of manifestation:

- the transfer of a rapid devaluation to inflationary processes in the consumer market;
- mass withdrawal of deposits from banks in rubles and conversion of rubles into US dollars or euros, with an outflow of resources from the banking sector;
- the maximum impact on inflation in the segment of unofficial supply, the formation of the maximum trade margin on goods that can only be smuggled into the territory of the Russian Federation at the black-market rate, including for sub-sanctioned goods;
- formation of a pool of problem loans from among foreign currency loans, the borrowers of which have lost all or the part of their foreign

exchange earnings (for example, Russian airlines).

In our opinion, in March 2022, the CBRF was unable to block any of the manifestations of the currency risk, perhaps only reducing the impact of devaluation on consumer inflation in the segment of bulk and official supply. In all other cases, the multiplicity of exchange rates only slightly delayed the manifestation of this risk but did not eradicate it.

2. Interest rate risk. In the first days after the invasion, the CBRF reacted with a sharp increase in the key rate: from 9.5% to 20%. With this decision, the Central Bank of Russia tried to stop the outflow of capital from the country, and most importantly, to reduce the outflow of deposits from banks. A few days after the change in the interest rate, Sberbank, which accounts for more than 50% of the deposits of the population of the Russian Federation, set the interest rate on short-term deposits at 18%, and some state-owned banks raised it to 22%. In the third decade of March 2022, many banks lowered deposit rates, believing that the outflow of resources from the banking system in the amount of 1.2 trillion rubles was overcome.

However, interest rate risk did only begin to destroy the Russian banking sector.

First, there was no victory in the return of 1.2 trillion rubles to the banking system of the Russian Federation. Money only described the circle: part of the population's deposits was withdrawn from banks ahead of time and spent on the consumption of goods and services, after which the money again went to banks, but no longer to current accounts of companies; part of the resources was replaced by CBRF through ruble refinancing. It turns out that in March 2022, the structure of the resource base of Russian banks changed towards an increase in more expensive and less urgent refinancing from CBRF instead of cheaper time deposits from the population. On the whole, the share of time deposits in the resources attracted by banks decreased.

Secondly, it turned out that about 40% of the volume of loans of the Russian banking system were issued at a floating rate, which was pegged to the CBRF key rate. Usually, the contracts fixed the coefficient by which the "market rate" was calculated. For banks, on average, this coefficient ranged from 1.2 to 1.5. But with the growth of the key rate to 20%, interest rates on loans soared from 24% to 30% per annum. Commercial companies, which previously paid 12-18% per annum, faced with the need for a sharp increase in interest costs. Some of the agro-industrial complex enterprises applied to the government to be included in preferential support programs. The federal government generously promised support not only to the agro-industrial complex, but also to other industries, the performance of which the population of the Russian Federation is very sensitive to. Such promises of the Russian government will become a budgetary burden already in the second half of the year and will require sequestration of the 2022 federal budget. But an almost twofold increase in the interest burden on borrowers in the Russian Federation will almost inevitably lead to a deterioration in the quality of bank loans and to the bankruptcy of small banks. The process of transformation of interest rate risk into credit risk in the Russian Federation may take 6-9 months, but the wave of the first defaults may begin in 3 months. It turns out that the desire of the CBRF to regulate the impact of currency risk on the financial system through a sharp increase in interest rates launched the flywheel of interest rate risk. And the desire of the government to issue more preferential loans will be a burden on the budget, the revenue plan of which will not be fulfilled.

3. **Credit risk.** While the currency and interest rate risk has just begun the transformation of Russian borrowers from good to bad quality of risk, a number of industries that have fallen under the sanctions of civilized countries have already become the epicenters of credit risks. For example, almost all Russian airlines whose aircraft are leased from foreign leasing companies are already in a default mode. After the imposition of sanctions, insurance

companies providing aviation insurance and lessors demanded that the aircraft leave the territory of the Russian Federation. In response, the Russian Federation blocked the return of the planes by stealing planes worth approximately 13 billion US dollars from the world market. The refusal of Boeing and Airbus to certify aircraft in the Russian Federation did not confuse the authorities, and they started internal certification. But now this means that imported Boeing and Airbus cannot fly abroad even to those countries whose skies are still open for the Russian Federation. For such flights, Russian airlines need to return old IL-76 or TU-134 aircraft or accelerate the production of the new ones. In practice, this led to a drop in airline revenue by several times. Not a single borrower can withstand such pressure. Defaults of Russian airlines towards banks will begin in the next 3 months, and for credit analysts, this is a credit risk that has already taken place.

The second point is the stock section of the Moscow Exchange, which has been closed since February 25. For a month now, banks, insurers, and other non-banking financial companies have been accounting for shares and bonds of Russian issuers in their portfolios at the rates that were formed in February at the start of the war between Ukraine and the Russian Federation. The opening of the stock exchange will lead to the fact that credit institutions and insurers will be forced to re-evaluate their securities portfolios upon completion of trading, which may lose up to 50% of their value. In this situation, 10-15 small banks that previously actively worked on the bond and stock market may leave the market. This will also be a direct implementation of credit risk in practice. So far, the CBRF has done nothing to combat the manifestation of credit risks in the banking or insurance sector. The Central Bank of Russia is only postponing the opening of the Moscow Exchange, and it cannot counteract the decline in business activity due to sanctions since it does not have the tools to do so.

4. **The risk of a sharp decline in business activity** remains the main sanction risk of the Russian Federation, which, although being outside the CBRF perimeter, directly or indirectly affects the structure of the sectoral markets of the Russian economy. Also, this risk is pushing the CBRF into an emergency fight against currency, interest rate and credit risks. In our opinion, the key factors for the decline in business activity in the Russian Federation under the influence of sanctions are:

- the oil embargo and the desire of the EU countries and the UK to reduce energy dependence on the Russian Federation;
- mass withdrawal of foreign companies from the Russian Federation (the number is already about 200 companies), which announced either a complete curtailment of activities or the cancellation of previously announced projects;
- mass withdrawal of banks with foreign capital from the banking system of the Russian Federation.

The direct share of the oil and gas sector of the Russian Federation amounted to about 16% of the country's GDP but it was very dynamic due to changes in the external environment and price dynamics. However, there were a lot of related industries related to the oil and gas industry, and many joint projects with foreigners. Together with subcontractors and dependent industries, part of the oil and gas sector accounted for up to a third of the Russian economy.

A reduction in oil and gas purchases from the Russian Federation could cause the Russian economy to fall by up to 15-20% in 2022. The Russian Federation has no alternative routes along which the Russian Federation will be able to quickly reorient gas and oil flows. Today, the Russian Federation cannot even quickly organize the sale of oil to China through Kazakhstan due to the small diameters of pipelines. The construction of gas pipelines may take 5-7 years, and their cost may exceed Nord Stream 2. Given the shortage of foreign currency in the Russian Federation, it is impossible to implement such projects in an accelerated mode without the help of China. In addition, it should be taken into account that URALS brand oil will not suit most oil refineries in the world, so its export range is limited to some countries of the former USSR, Africa and some Asian countries.

The mass exodus of foreign companies from the Russian Federation is dangerous by itself, as it produces a whole bunch of risks: currency (capital outflow), credit (destruction of industry ties), and the risk of mass unemployment in certain regions or cities.

Companies from the EU, the US, Japan, and other countries have stated that they do not want to work with and invest in the Russian Federation. Most of these companies, according to Russian laws, will begin to lay off personnel only a month after such a statement, i.e. the peak of unemployment from the departed companies will be visible only in April-May 2022. The impact on Russia's GDP will be noticeable according to the statistics of the third quarter of 2022. Because of the departure of foreigners, Moscow and St. Petersburg, the main consumers of imported products, may suffer primarily. The total number of unemployed only in Moscow and St. Petersburg by May 1 may reach 1 million people. And this is only direct unemployment associated with the departure of foreigners.

5. **Mutual migration of risks and results for the Russian economy**. As we saw from the previous 4 points, the risks awakened by sanctions tend to produce each other and strengthen their effect in practice. These processes can be cyclical or continuous. The chain, when the manifestation of currency risk leads to the monetary authorities increasing interest rate risk, which, together with currency risk, supplies bad borrowers to the bank loan market, leading to the flow of bad borrowers amplified by sanctions due to a fall in business activity in the country, always works. The authorities need to make a lot of efforts in order to break the cyclical transfer of risks from one to another, as well as their support of negative trends in the economy.

Today, we see attempts to stop the actions of the entire set of risks only from the government through preferential loans and preferential rates. This tool would be effective if it could make a surplus of the Russian Federation's federal budget. However, these programmes seem inefficient in fighting the sanctions, and the Russian budget is expected to undergo sequestration in the summer of 2022.

Russian Central Bank did not manage to break the chain of mutual risk support: currency, credit, interest rate. A high inflation rate could weaken the connections between the risks and formally decrease interest rate pressure on the borrowers, yet it would not make a difference in business activity decline. Inflation is a poor tool for tackling the risk correlation, as a high inflation rate does not imply a proportionate income increase between actors in the market. For instance, the boost of incomes in the food industry enterprises could outpace the income growth of importers of household appliances, which could be sold less in case of devaluation.

In turn, there are no signs that CBRF would use policy elements to suppress the functioning cyclicality of interest rate, credit and currency risks in the financial sector. There are only attempts to decrease the implications of these risks. This policy would lead to an increase in inflation and the unemployment rate in 2022.

Consequently, by the end of 2022, the Russian Federation will have experienced a 10-15% unemployment rate and increased inflation (according to the most modest ratings, up to 20%). Currently, the expectations on the inflation rate estimate up to 19%, but in some food industry sectors, it reached 45%. Sanctions do have a direct effect both on the inflationary spiral and unemployment rate. Therefore, it is impossible to suppress these negative phenomena with the CBRF's high-interest-rate policy. The Central Bank of Russia directors team is well-aware of it, which is evident from their public statements.

Nevertheless, instead of conveying the viewpoint of high-class professionals to the Russian political leadership and clarifying the consequences of imposing more severe sanctions, CBRF took the position of the formal perpetrator when anti-sanctions measures are taken with negative deliberative results for the economy. CBRF's position of "consent" with the functioning of the security structures mark its low independency level from the executive power vertical in Russia. It also indicates the collaboration of CBRF's board of directors (as management body) in financing the war in Ukraine. The degree of such involvement expanded and became tangible when in mid-March, CBRF issued a regulation that allowed insurers and lenders not to share details of their owners. CBRF interpreted this initiative as a desire to oppose sanctions. This way, CBRF in mid-March 2022 acted in a way that allowed civilized states to include the entire CBRF board of directors into the sanctions list, which would make its work with the external risks even more complicated.

It is also crucial to note the global economic consequences of war in Ukraine – the food shortage and the rise in the cost of food raw materials in some market segments. According to the government of Cameroon, the bread prices there increased up to 40% because of the disruptions in the grain supply from Ukraine. Nevertheless, there are reverted tendencies as well. In Ecuador, riots broke out among farmers. The sanctions imposed on the Russian seaports caused Ecuadorians not to be able to send 20000 tons of bananas to the consumers, which may cause a drop in banana prices on the global market soon. The banana market is a primary export market for Ecuador, and the longevity of such a situation may lead to a financial crisis there.

The countries of Eurasian Economic Communities do experience these problems too, such as Belarus, Kazakhstan and Armenia. For instance, the majority of anti-Russian sanctions were duplicated upon Belarus. The National Bank of Kazakhstan was forced to introduce currency restrictions on the export of foreign currency, as its chronic deficit from Russia spilled over Kazakhstan, formally not engaged in the war with Ukraine. Rising energy prices for Germany and France may accelerate inflation in the euro area, and the same trends may be observed in the UK. Thus, the responsibility for the global economic problems caused by military operations in Ukraine also lies with the authorities of the Russian Federation.

Conclusions

1. A set of sanctions from civilized countries evoked a number of the classic risks for the Russian economy: currency, interest rate and credit risks have already launched migration and vice versa. The CBRF and the economic bloc of the Russian government do not have sufficient tools and resources to counter the practical realization of these risks.

2. The catalyst for the work of currency, interest rate and credit risks in the Russian economy is the risk of a decrease in business activity under the influence of sanctions. CBRF does not have adequate tools to counter such a risk, which by itself can reduce the scale of the Russian economy, raise the unemployment rate to 15%, and inflation from 20% already in 2022.

3. All efforts by the CBRF to mitigate the consequences of sanctions delay the practical implementation of risks in time but do not solve the problem in essence. CBRF formed a currency reserve, forcing Russian exporters to sell 80% of foreign exchange earnings for January and February 2022, and did not cancel this norm in March. Such stock may run out already in April-May, and then the classic set of risks will make itself felt again.

4. CBRF's active anti-sanctions policy and CBRF's assistance to sanctioned persons in circumventing sanctions indicate that the CBRF Board of Directors was directly involved in financing the war in Ukraine and, therefore, should also be included in the sanctions list. We should also acknowledge the deficient level of independence of the CBRF from the vertical of the executive power of the Russian Federation and the inability of The Central Bank of Russia to pursue an independent policy, which certainly undermines confidence in the ruble and the

Russian banking system, which most foreign banks are abandoning. This trend is a problem for all the central banks of the countries of the Eurasian Economic Community, which are forced to work in current conditions not only with an unreliable partner but also with a source of additional risks.

5. The Russian economy and the war in Ukraine have become a problem not only for the European region. The economic echoes of the conflict are already being heard in Africa, Latin America, and the Eurasian Economic Community countries. If the Russian crisis is not localized, then even the prosperous countries of Europe will feel its consequences in the next month or two.

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