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Realization of foreign exchange risk in Russia as a result of sanctions' impact

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ORIGINAL ARTICLE

Abstract. The article is focused on the analysis of realization of foreign exchange risk in Russia due to the imposing of sanctions of 2022. The economic sanctions of 2022 have had a big impact on Russian economy in its entirety, and FX risk presents one of the biggest threats in case of its realization without proper countermeasures as it affects both international trade and capital value, primarily in the form of savings. This fundamental nature of this risk makes it crucial to understand its main points of effect and how to mitigate its negative impact, especially due to its wide spread across all sectors of the economy. Thus, the goal of our research is to analyze how FX risk has impacted Russian economy since February of 2022 and how efficient were the measures taken by the government to fight it. The objectives of this research are to: define the category of FX risk and where it comes from; analyze what impact has sanctions played in the realization of FX risk; analyze what measures have been taken to minimize the consequences of FX risk realization. To carry out the research, statistical data of the Central Bank of the Russian Federation were used. The authors draw attention to the fact that, despite the positive dynamics in short term, long term is uncertain and presents certain risks, amongst which is the currently decreasing value of Russian ruble to US dollar.

Keywords: foreign exchange risk; exchange rate; currency; sanctions; risk management

JEL codes: G15, G17

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Introduction

Starting 2022 Russia has been subject to unprecedented sanctions to its economy overall, and its financial sector in particular. This has manifested in a large number of limits being imposed on its international activities. Amongst them were new barriers created to hinder international trade by both direct prohibitions or indirect complications connected with the use of payments systems and access to foreign currency.

Foreign currency in particular presents an interesting point of research, as it is interconnected with all sectors of economy due to its nature of means of payment and capital accumulation. The sanctions of 2022 caused massive shifts in established trading routes and forced Russia to take necessary measures to stabilize its economy and find a new position of balance. This includes changes in foreign currency use because access to the main trade currencies, such as US dollar and euro, has been blocked and requires finding ways to bypass it.

Trade limits caused overall depreciation of Russian ruble to US dollar and euro, complicated the act of getting foreign currency, and impacted currency reserves that Russia kept in other countries. All of the above makes FX risk to be one of the crucial elements to focus on in overcoming the new economic reality.

Methodology

Foreign exchange risk (FX risk) is the risk of losses occurring due to changes in exchange rates or any limits imposed on the usage of a foreign currency. This means that a situation in which a company has reserves in one currency that has become more difficult or impossible to execute transactions in also qualifies as realization of foreign exchange risk.

FX risk occurs during foreign trade, credit, investment, settlement and conversion transactions, as well as transactions on stock and commodity exchanges due to changes in prices of assets, liabilities, monetary claims and obligations caused by fluctuations in exchange rates [6].

Additionally, FX risk can be divided into three types:

1) operational risk – the risk of lost profit due to changes in exchange rates on expected cash flows;

2) translation risk – the risk of imbalances or losses occurring in revaluation of assets and liabilities in national currency;

3) economic risk – the risk of negative impacts changes in exchange rates may have on a company.

In our case, we are looking broadly on the economic risk in the scope of the whole country. Moreover, we are looking into the sanctions' part in the realization of that risk based on the statistical data for the period 2022-2024.

The sanctions of 2022 have affected the realization of FX risk indirectly: the limits that have been imposed overtime since February of 2022 and up to this day have complicated economic relationships (or even blocked some of them) which in turn caused shifts how foreign currency is handled. For companies, it has become vital to find ways to obtain foreign currency that is considered toxic (USD, EUR, JPY) or switch to alternative currencies (CNY, INR). The people experienced confusion and panic due to sudden changes in geopolitics, which also played part in the increasing volatility of the FX market. That, alongside the counter measures taken by the government, has led to shifts and changes we are analyzing in this paper.

Results

In order to identify the impact FX risk has had on the economy, we should start by analyzing the exchange rates of the main trade currencies and their dynamics. On the graph below (Fig. 1) we have depicted the dynamics of exchange rates of USD, EUR and CNY to RUB from 2022 to 2024.

Figure 1. Dynamics of exchange rates, 2022-2024, RUB

Source: Dynamics of the official exchange rate of the currency[1]

As we can see, the two currencies USD and EUR experienced a sharp growth in value around March of

[1] *Dynamics of the official exchange rate of the currency. Bank of Russia. URL: https://www.cbr.ru/currency_base/dynamics/ (Accessed: 01.11.2024)*

2022: by 11.03.2022 the exchange rate of USD to RUB had gone up to 120.3785 (a 60% growth when compared to the beginning of the year) and the EUR/RUB currency pair had reached 132.9581 (a 56% increase from 11.01.2022). The noticeable growth started on February 26, precisely after the initiation of the first sanctions measures.

Those drastic changes had led to immediate response from the government's side. First of all, on February 28 by the decision of the Central Bank of Russia, the key rate was raised from 9.5% to 20% in order to protect the people's savings from depreciating and overall stabilize the economy in that shock state. Additionally, the Central Bank also prohibited non-residents from selling Russian securities with a goal of stopping capital outflow from the country and further devaluation of ruble [2].

On February 28 the Ministry of Finance also imposed a decision by which 80% of foreign currency income must be sold for rubles. That measure had led to overall increase of ruble's share inside the country which was another step of gradually shifting from the now considered toxic currencies.

Lastly, on March 23 by the decision of the president of Russia, the trade of Russian gas would go from foreign currencies as the means of payment to ruble. That had also played a positive role in regards to ruble's position [4].

The measures taken had proven to be effective in short term (those measures, naturally, affected all foreign currencies, including Chinese yuan). Despite that, since the beginning of 2023 Russian ruble started gradually weakening compared to other currencies, and by May of 2023 the pre-sanctions FX rates had been reached with ruble continuing to depreciate even further up to this day.

Such dynamics could be explained by several factors. First of all, the earnings from export of oil and gas experienced a significant decrease starting 2023: according to the data of the Ministry of Finance, in the first six months of 2023 they dropped by 47% compared to the same period in 2022. This change was due to both the drop in exports and the decrease of prices for oil and gas. The decline in exports also occurred due to a weak demand for resources on world markets, associated with expectations of a recession in the world's economy and a large discount to the price of oil and gas for India and China.

In addition to the imbalance of exports and imports, the weakening of the national currency was affected by capital outflow, a decrease in the current account balance, the restoration of supplies from abroad and a decrease in prices for Russian goods in the world.

Another aspect worth noting in our research is the Russian reserves in foreign currency. Their dynamics from 2022 to 2024 is depicted on the graph below (Fig. 2).

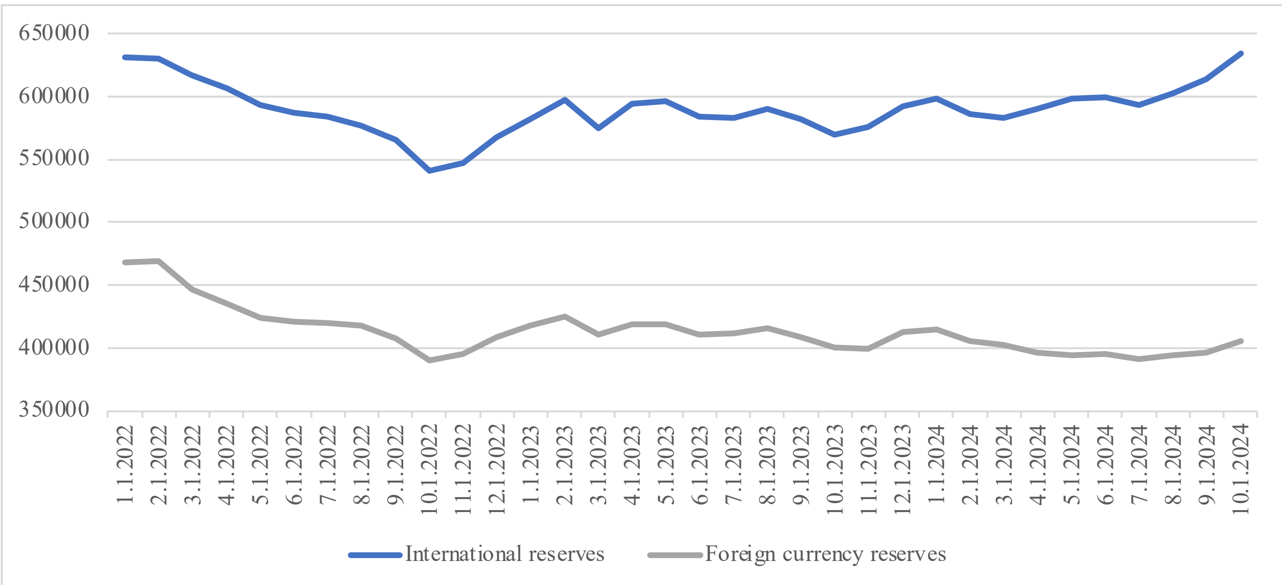

Figure 2. International reserves of the Russian Federation, 2022-2024, mln USD

Source: International reserves of the Russian Federation[2]

[2] *International reserves of the Russian Federation. Bank of Russia. URL: https://www.cbr.ru/hd_base/mrrf/mrrf_m/?UniDbQuery.*

As evident by the graph, the reserves in foreign currency show negative trend overall: by October 1 2024 they amounted to 405 081 million USD, which is 13% lower than on January 1 2022. One of the key factors of these dynamics is the freezing of around 300 billion USD worth of Russian reserves in other countries due to sanctions in 2022.

At the same time, looking at the volume of international reserves overall (international reserves include foreign currency reserves alongside accounts in SDR, reserves in IMF, and reserves in monetary gold) we can see that despite the drop in 2022, by 01.10.2024 they have returned to their volume before the sanctions. This is mainly explained by positive revaluation of reserves, especially due to growing prices on monetary gold.

To see how Russian economy is reacting to the measures taken by the government, let's analyze the currency structure of export (Fig. 3) and import (Fig. 4).

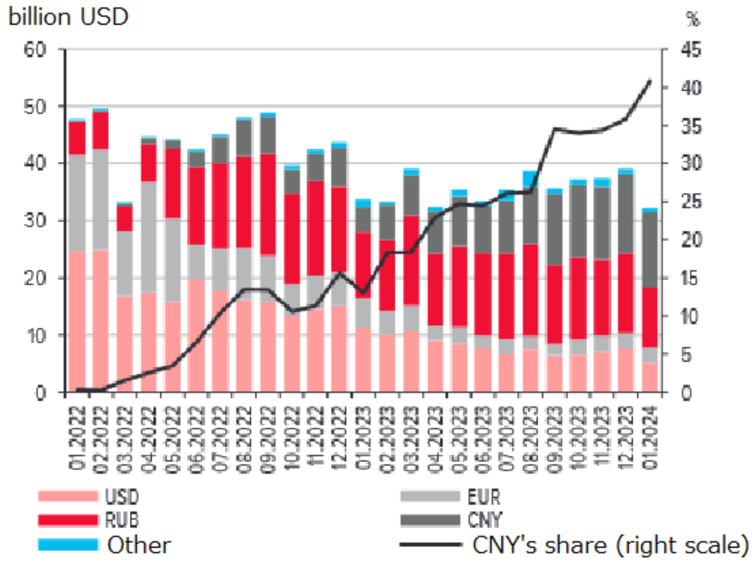

Figure 3. Currency structure of Russian export, bn USD

Source: Overview of the risks of financial markets[3]

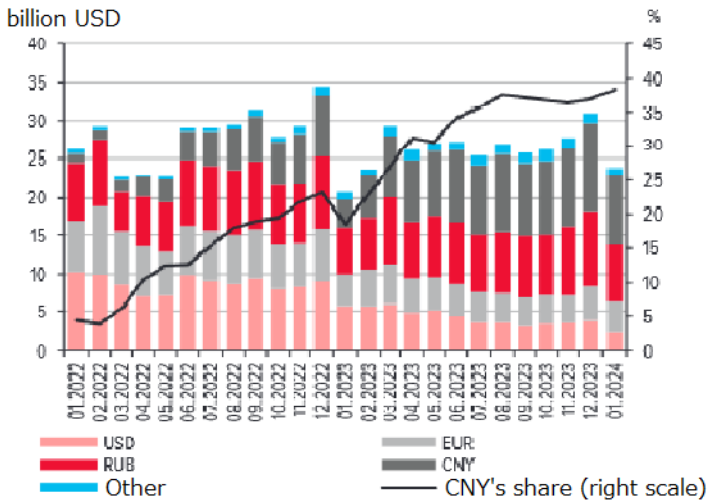

Figure 4. Currency structure of Russian import, bn USD

Source: Overview of the risks of financial markets[4]

Posted=True&UniDbQuery.From=01.2022&UniDbQuery.To=10.2024 (Accessed: 01.11.2024)

[3] *Overview of the risks of financial markets. (2024). 2(83). Bank of Russia. URL: https://cbr.ru/Collection/Collection/File/48958/ORFR_2024-02.pdf (Accessed: 01.11.2024)*

[4] *Overview of the risks of financial markets. (2024). 2(83). Bank of Russia. URL: https://cbr.ru/Collection/Collection/File/48958/ORFR_2024-02.pdf (Accessed: 01.11.2024)*

Amid a decline in foreign trade volumes in January, the share of the yuan in export revenue increased to 40.8%, and in payments for imports – to 38.5% (in value expression – 13.2 and 9.1 billion USD, respectively). In January, the share of transactions in rubles in export revenue decreased by 3.1 percentage points, up to 32.6%, and in payments for imports – by 0.5 p.p., up to 31.2%.

We should also note that the share of Chinese yuan has been stably growing in both export and import. While this is a positive trend from the point of view of refraining from toxic currencies that present a higher FX risk and are generally more complicated to operate in nowadays (such as US dollar and euro), this also increases a risk connected with using only yuan as the main means of payment.

Conclusion

Using the statistical data of the Bank of Russia, we analyzed the effects the of sanctions on the national economy through the prism of FX risk and its realization. We have defined FX risk as any potential losses caused by both fluctuations in exchange rates and any other limits regarding the use of foreign currency, as in our case it is integral to touch upon that aspect as well since sanctions have both economic and jurisdictional effects.

For the purpose of our research, we have looked at data from 2022 to 2024 and have come to several conclusions. The dynamics in exchange rates of USD/RUB, EUR/RUB and CNY/RUB have shown the serious effect the sanctions had on the economy overall. Despite that, the measures taken by the government, amongst which the most important are the increase of the key rate, prohibition of selling of Russian securities by non-residents, obligation to sell 80% of revenue in foreign revenue and the decision to turn payments for Russian gas to ruble, have proven to be effective in short term, drastically improving the position of Russian ruble in relation to other currencies. Moreover, the changes in international reserves in foreign currency show gradual stabilization of the trade balance caused by the shift to other currencies and positive revaluation of existing assets, specifically monetary gold. The trend of switching to alternative currencies is backed up by the currency structure of export and import of Russia which shows noticeable decrease in the share of US dollar and euro with a simultaneous growth of Chinese yuan. These figures allow us to conclude that so far, the government has done a relatively good and efficient job at countering the sanctions of 2022.

At the same time, we should also think about long term perspective for Russia. While the shift to alternative currencies is a positive step, we mustn't ignore the risk connected with focusing on one currency in particular, which Chinese yuan presents at the moment, so there needs to be work done on diversification of currency usage in foreign trade. This could be done with changes in jurisdiction that would stimulate Russian companies to settle in more currencies. Additionally, as trade routes have been gradually restored, to some extent, the trend of Russian ruble depreciating to US dollar and euro also presents a threat and requires attention, as it also affect ruble's position in relation to other currencies. One of the ways the Central Bank is currently using is increasing the key rate and keeping it high. More measures are also being taken, such as Ministry of Finance's interventions, as well as planned measures aimed at limiting capital outflow and further increasing foreign currency revenue selling requirement in 2024-2026.

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CONFLICT OF INTEREST

The authors declare that there is no conflict of interest.

AUTHOR'S CONTRIBUTIONS

Igor P. Legky – formal analysis; data curation.
Aleksei V. Kuznetsov – conceptualization; writing – original draft.

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