

Fighting Depreciation and Inflationary Pressures

Vasily Astrov

In Cooperation with



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Abstract

The Russian authorities have been battling strong depreciation pressures, with the rouble having lost around 30% of its value since early 2023 (and inflationary pressures having risen strongly). The main reason for this is the declining supply of foreign exchange from foreign trade transactions, due to (i) a steady rise in the share of export contracts denominated in roubles, and (ii) the declining share of export earnings in foreign currency converted into roubles. To address the latter problem, on 16 October the authorities imposed a surrender requirement for export proceeds, which has proved highly effective at stabilising the exchange rate. However, despite this and a sharp rise in the policy rate of 7.5 pp in total since June, inflation has continued to accelerate, reflecting the ongoing expansionary fiscal stance, but also the lengthy nature of some monetary transmission mechanisms.

Keywords: surrender requirement, exchange rate, inflation, credit growth

JEL classification: E31, E5, F31, F32

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Fighting depreciation and inflationary pressures

GENERAL ECONOMIC SITUATION

The recovery of the Russian economy from last year's slump has continued, helped along by large military spending. Real GDP grew by 5.5% in Q3 and by an estimated 5% in October (on an annual basis), bringing growth in the first ten months to an estimated 3.2%.¹ Across sectors, the main drivers of growth in Q3 were wholesale and retail trade (+22.9% and +11.3%, respectively), manufacturing (+10.2%) and construction (+8%), the latter two benefiting from war-related public procurements: e.g. in September, the production of 'fabricated metal objects' and 'other transport vehicles' – both heavily military-oriented – recorded annual growth of 47.5% and 45.8%, respectively. Fixed capital investments performed exceptionally well, too, picking up by 13.3% (year on year) in Q3 and by 10% in the first nine months. In November-December, the pace of economic expansion will likely slow only slightly (mostly due to the higher statistical basis), bringing growth for the full year to around 3% or even above.

On a negative note, inflation has continued to pick up, to 7.5% on an annual basis as of 27 November, according to Ministry of Economy estimates. This is a clear indication that the economy is overheating and it has already prompted sharp hikes in the policy rate, totalling 7.5 percentage points (pp) since June. However, given the lengthy transmission mechanisms, the effects on prices of the recent policy tightening and exchange rate stabilisation will be fully felt only next year. These factors will suppress inflation, but they also raise the likelihood of a GDP recession in H1 2024: according to Bloomberg Economics, the odds of this could be in excess of 70%.² Despite rising inflation, the dynamics of real wages and incomes has stayed in positive territory (+7.4% and +4.8% year on year, respectively, in the first nine months), while the unemployment rate (LFS) plunged to an all-time low of 2.9% in October. Both these latter factors have been conducive to a recovery in private consumption: the growth in retail trade turnover accelerated to 12.7% year on year in October, and averaged 5.5% over the first ten months. The fiscal situation has improved vastly on the back of higher oil prices and economic recovery, so that the federal government deficit for the full year will likely end up being significantly lower than the 2% of GDP envisaged in the budget law.

The remainder of this report provides an in-depth analysis of recent developments in the exchange rate and inflation, as well as of recent policy measures aimed at containing inflationary pressures.

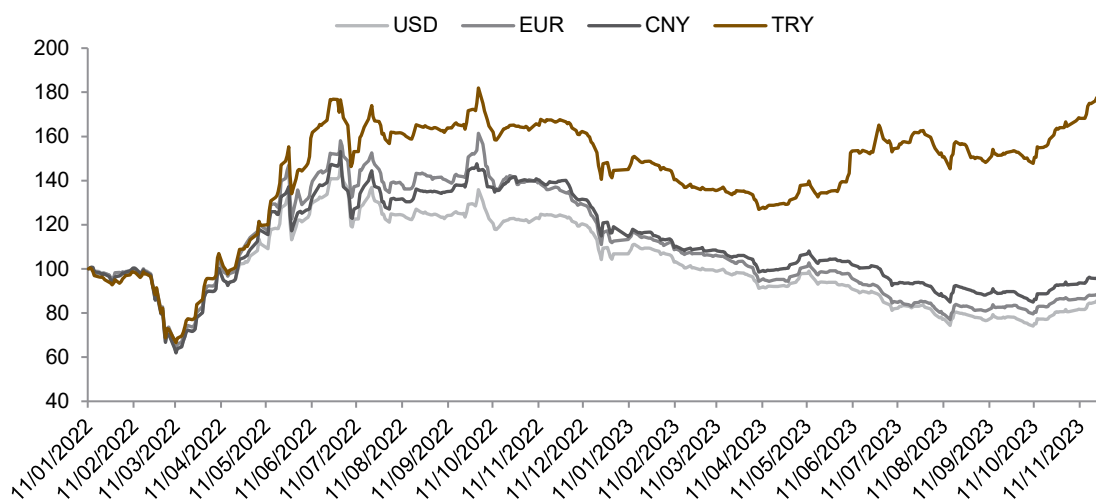
¹ Estimates by the Ministry of Economy, see <https://www.kommersant.ru/doc/6366473>.

² *ibid.*

SURRENDER REQUIREMENT FOR EXPORT PROCEEDS HAS HELPED STABILISE THE EXCHANGE RATE...

As already discussed extensively in the first issue of Russia Monitor,³ the Russian authorities have been battling strong depreciation pressures. Between January and mid-October 2023, the rouble lost around 30% of its value against most main currencies (**Fehler! Verweisquelle konnte nicht gefunden werden.**). In the first half of the year, rouble depreciation largely went hand in hand with unfavourable trends in foreign trade – mainly on account of the decline in the oil price (partly due to Western energy sanctions, which depressed the price of Russian oil, over and above the general decline in global oil prices). However, the stabilisation of exports and the rising current account surplus (on the back of lower foreign investment income) in Q3 failed to provide support for the exchange rate, which generally continued to slide and briefly surpassed 100 USD/RUB on two occasions: 15 August and 7-10 October.

Figure 1 / Nominal exchange rate of the rouble against main currencies, 11.1.2022 = 100



Note: declining (rising) line corresponds to depreciation (appreciation) of the rouble.

Source: Central Bank of Russia.

In-depth analysis suggests that the key driver of rouble weakness in Q3 was increased capital outflows. According to estimates by the Development Centre of the Higher School of Economics,⁴ net capital flight from the private sector surged by USD 9bn in Q3 (to USD 18bn, from 9bn in Q2) – outstripping the USD 7bn increase in the current account surplus (to USD 16.6bn, from 9.6bn in Q2).⁵ The bulk of this capital outflow represented an increase in trade credit extended to foreign buyers of Russian goods and services (that is, Russian exports were often paid for only following a significant delay, resulting in an accumulation of trade credit claims).

³ Astrov et al. (2024).

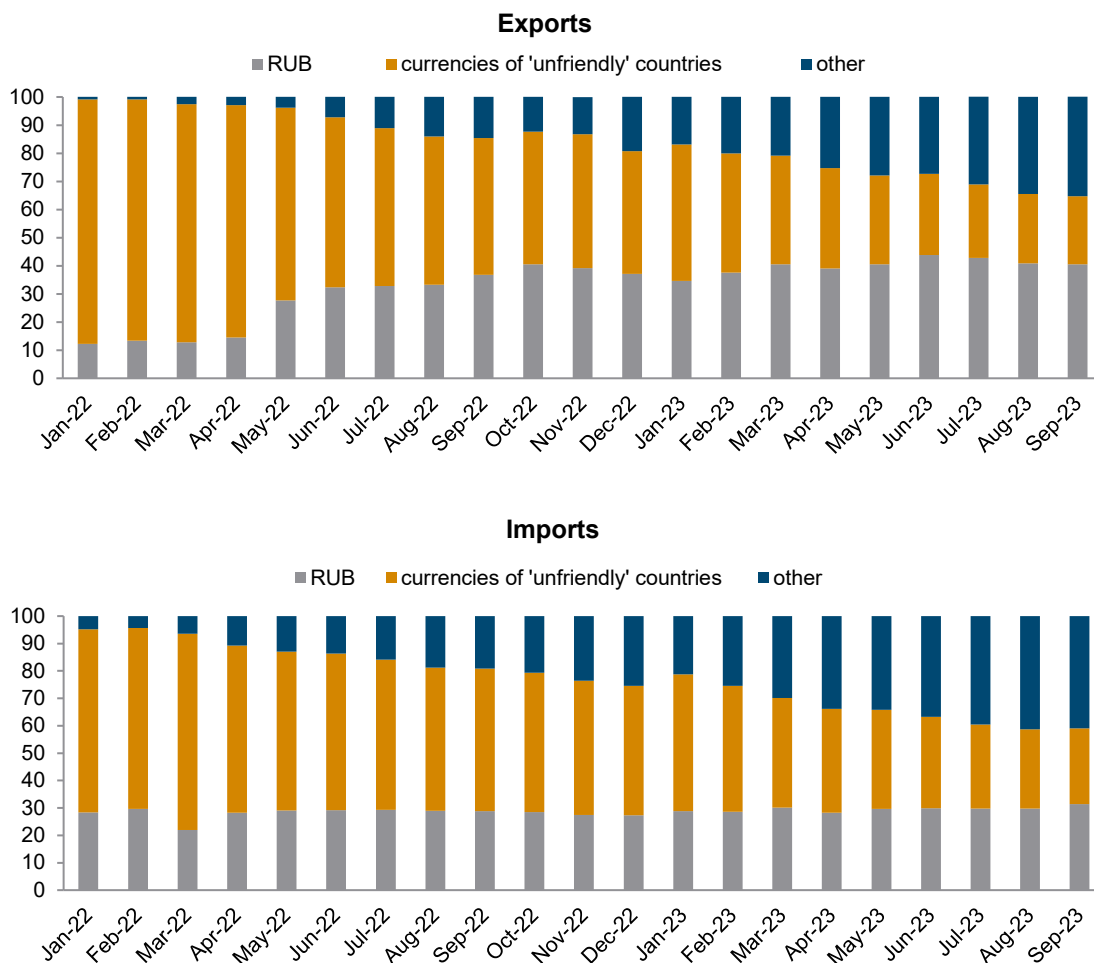
⁴ Development Centre (2023). This estimate includes 'errors and omissions' in the balance-of-payment figures, which are typically attributed to unrecorded capital movements.

⁵ Having said that, an estimated USD 48bn of net capital outflows from Russia in January-September 2023 pales in comparison to an estimated USD 243bn in 2022 as a whole (including USD 66bn in trade credit, USD 62bn in debt repayment, USD 47bn in money transfers abroad by households, and USD 40bn in FDI divestment) – see <https://iz.ru/1602633/mariia-stroiteleva/vyvoz-i-nyne-tam-chisty-ottok-kapitala-iz-rf-vyros-vdvoe>

Overall, the low supply of foreign exchange from foreign trade transactions could be attributed to two factors.

First, thanks to Russia’s efforts at ‘de-dollarisation’ of its foreign trade, since the start of the war there has been a **steady rise in the share of export contracts denominated in roubles**: from 12% at the beginning of 2022 to around 40% recently (Figure 2). This has not been matched by a corresponding increase on the import side: the share of import contracts denominated in roubles has been virtually stable throughout, at around 30%. As a result, and despite the improved trade balance in Q3, net export proceeds in foreign currency⁶ between April and August were essentially stable, at around USD 2bn per month – only a fraction of the trade surplus recorded during this period (USD 6-11bn per month).⁷

Figure 2 / Currency structure of foreign trade (goods and services), as % of total



Note: In Russian official terminology, ‘unfriendly’ countries are those that have imposed sanctions on Russia in response to its invasion of Ukraine.
Source: Central Bank of Russia.

⁶ Export proceeds in foreign currency minus the purchase of foreign currency by importers.

⁷ Development Centre (2023).

Second, **the share of export proceeds in foreign currency converted into roubles has typically been low**: between 34% and 43% in May-September, according to Development Centre estimates.⁸ This is partly related to the increased prevalence of the currencies of ‘friendly’ countries in the denomination of foreign trade contracts (e.g. the Chinese yuan and Indian rupee). The share of such currencies (denoted in Figure 2 as ‘other’) has risen by around 35 pp on both the export and the import side since the beginning of the war. Many of these currencies are not fully convertible, and repatriation of export proceeds denominated in them often occurs with a significant time delay – or sometimes not at all. A case in point is Russian exports to India (which has become the second most important destination for oil exports) denominated in Indian rupees.⁹

To support the rouble, several measures have recently been implemented. On 10 August, the central bank suspended the purchase of foreign exchange (which it would otherwise have carried out in line with the ‘budget rule’), and on 16 October a surrender requirement for export proceeds for selected exporters was introduced.¹⁰ The requirement stipulates that (i) at least 80% of export proceeds need to be transferred within 60 days to an account in a Russian bank; (ii) at least 90% of this amount needs to be converted into roubles within two weeks; and (iii) at least 50% of export proceeds need to be converted into roubles within 30 days of their receipt.¹¹

According to the central bank, the measure has proved highly effective: the sale of foreign currency export proceeds by the biggest exporters jumped to USD 12.5bn in October (from 9.2bn in September and 7.2bn in August), effectively reversing – in tandem with further monetary policy tightening (for more on that, see the next section) – the earlier trend of exchange rate depreciation.¹² By 29 November, the exchange rate had strengthened to around 88 USD/RUB – that is, by 13% since 10 October (**Fehler! Verweisquelle konnte nicht gefunden werden.**), allowing relaxation of some of the measures that were introduced earlier and that aimed at exchange rate stabilisation. For instance, the central bank announced on 27 November that, as from January 2024, it would resume foreign exchange transactions within the framework of the ‘budget rule’ (suspended on 10 August).¹³

The surrender requirement for export proceeds has been introduced for six months and is likely to be seen in the context of the approaching presidential elections in March 2024. The reason is that the exchange rate has historically had great political significance in Russia, with the strength of the rouble

⁸ *ibid.*

⁹ <https://iz.ru/1602633/mariia-stroiteleva/vyvoz-i-nyne-tam-chisty-ottok-kapitala-iz-rf-vyros-vdvoe>

¹⁰ The list of exporters subject to the new regulation has not been made public; but according to the government statement, it covers 43 big companies from the energy, metals, chemicals, timber and grain sectors (https://t.me/government_rus/9235). It is the second time since the start of the war in Ukraine that Russia has introduced a surrender requirement for export proceeds. The first time it was introduced soon after the start of the war but was revoked four months later as the exchange rate stabilised and recovered to pre-war levels.

¹¹ <https://thebellmirror2.com/krupnykh-eksporterov-zastavyat-prodavat-90-valyutnoy-vyruchki-zachislennoy-v-rossiyskie-banki>. Perversely, the surrender requirement also applies to export proceeds in roubles; the latter need to be converted into foreign exchange and then re-converted into roubles – see <https://www.vedomosti.ru/economics/articles/2023/11/14/1005646-biznes-soobschil-o-krugovorote-rublei-iz-za-pravil-vozvrata-viruchki>

¹² Central Bank of Russia (2023b).

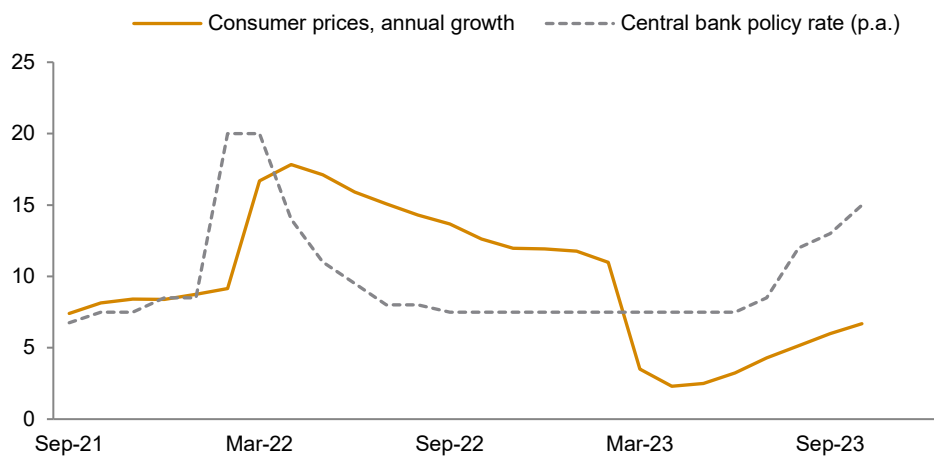
¹³ <https://www.cbr.ru/press/event/?id=17240>

generally regarded by the public at large as a sign of economic stability.¹⁴ Therefore, keeping the exchange rate reasonably stable – and above the psychological threshold of 100 USD/RUB – will be of the utmost importance for the authorities ahead of the elections.

... BUT INFLATION WILL TAKE TIME TO REIN IN

Since the low of 2.3% in April 2023 (on an annual basis), inflation has been rising steadily, to reach 6.7% in October (**Fehler! Verweisquelle konnte nicht gefunden werden.**). In Q3, inflation averaged 0.96% on a month-on-month seasonally adjusted basis (mom SA), which corresponds to 12.1% in annualised terms. This represented a marked acceleration from Q2, when inflation averaged a mere 0.42% mom SA. Price pressures in Q3 were generally broad based, with core inflation (0.77 mom SA) lagging only slightly behind headline inflation.¹⁵ This can be interpreted as a sign of economic overheating, with strong aggregate demand increasingly facing supply constraints, including on the labour market. Amid acute labour shortages (especially in manufacturing), the annual growth of nominal wages stood at 13.6% in September and averaged 13.2% in the first nine months, with the rising labour costs translating into higher prices (albeit only partly, suggesting a redistribution of income from capital to labour). Exchange rate depreciation has fuelled inflation as well. The prices of imported goods and services – such as household appliances and electronics, fruit, light vehicles and foreign travel – showed above-average growth in Q3, while conversely domestic tourism became cheaper.¹⁶

Figure 3 / Inflation and policy rate, in %



Source: wiiw Monthly Database, incorporating national statistics.

To tame the rising inflation, on top of the above-mentioned measures aimed at exchange rate stabilisation, monetary policy has been sharply tightened. Since June, the policy rate has been hiked by a total of 7.5 pp to 15%, with the most recent hike (of 2 pp) coming on 30 October. However, the

¹⁴ This squares with the recent findings by Levada Centre, according to which two economic variables – exchange rate and unemployment – have a statistically significant correlation with the level of support for the government, <https://t.me/cOldness/2509>.

¹⁵ Central Bank (2023a).

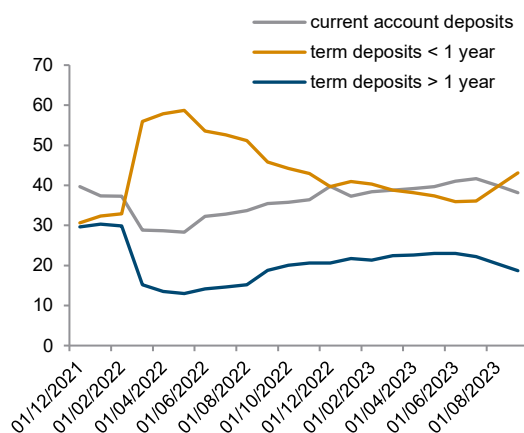
¹⁶ *ibid.*

inflationary pressures have so far not subsided, while the inflationary expectations of households have continued to rise. According to the most recent survey, in November households were expecting inflation one year hence to have increased to 12.2% (up from a figure of 11.2% in October).¹⁷

The sluggish response of inflationary dynamics to the recent tightening of monetary policy is partly due to the ongoing expansionary fiscal stance, but also to the lengthy nature of some monetary transmission mechanisms, as well as to the counter-productive one-off effects of policy tightening on short-term credit dynamics (with borrowers rushing to take out loans in anticipation of policy being tightened further). The structure of household deposits has reacted promptly to the changed monetary conditions, with the share of short-term rouble deposits rising by 7 pp and that of current account deposits declining by 3 pp in August-September (Figure 4), and the overall year-on-year growth of rouble deposits accelerating to 24% in September.

Credit dynamics have generally been much slower to react. At the end of September, corporate, household and mortgage credit volumes still recorded annual growth rates of 20.8%, 23% and 29.1%, respectively (Figure 5). However, in October some segments of bank lending started to show early signs of deceleration.¹⁸ For instance, the growth in consumer credit slowed to 1.1% mom (after 1.5% mom in September) in response to higher lending rates and tighter macroprudential requirements. The growth in mortgage loans slowed too, to 2.9% mom in October (after a record 4.2% mom in September), on account of higher lending rates in the market mortgage segment and a recent tightening of the downpayment requirement from 15% to 20% in the subsidised segment. Nevertheless, the growth in mortgage loans in October was still much higher than the average for H1 2023 (1.8% mom). Finally, corporate loans have been particularly resilient to policy tightening: in October, their growth picked up to 2.3% mom (from 2% mom in September), possibly reflecting expectations of another imminent hike in the policy rate.

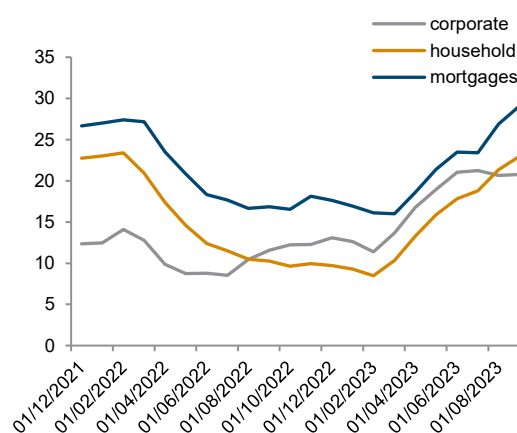
Figure 4 / Structure of household rouble deposits, in %



Note: current account deposits, incl. demand deposits.

Source: Central Bank of Russia.

Figure 5 / Credit growth, year on year, in %



Source: Central Bank of Russia.

¹⁷ <https://www.cbr.ru/press/event/?id=17228>

¹⁸ Central Bank of Russia (2023c).

Only in spring 2024 are the effects of recent monetary policy tightening on credit growth and domestic demand likely to be fully felt, resulting in a gradual slowdown in inflation. After a projected 7-7.5% this year, end-year inflation is set to subside to 4-4.5% in 2024 and 4% in 2025,¹⁹ thus hitting the official inflation target of 4%. Barring any major shocks, this projection looks broadly realistic. However, should the likely relaxation of capital controls after the March 2024 presidential election result in another wave of rouble depreciation, this target may be in jeopardy.

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¹⁹ The latest (October) consensus forecast of the central bank – see Central Bank of Russia (2023a).

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