Macro Notes – Russia Sanctions: Financial Sector Stabilizing

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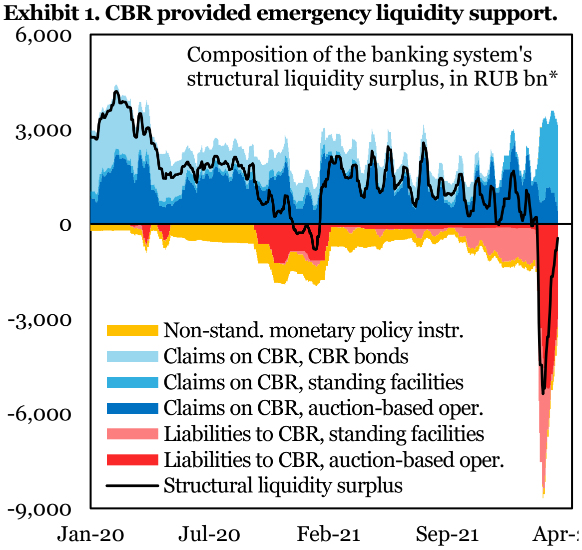
Elina Ribakova, Deputy Chief Economist, eribakova@iif.com, @ElinaRibakova
Benjamin Hilgenstock, Economist, bhilgenstock@iif.com, @BHilgenstockIIF

INSTITUTE OF INTERNATIONAL FINANCE

- Severe sanctions have focused on Russia's domestic financial system, ...
- With freezes of Bank of Russia assets among the most impactful steps.
- Emergency liquidity support by the CBR stabilized the banking system.
- The Ruble has also made up most of its losses due to capital controls, ...
- Together with large current account surpluses and tight monetary policy.
- We see a tightening of financial sector sanctions as likely going forward.

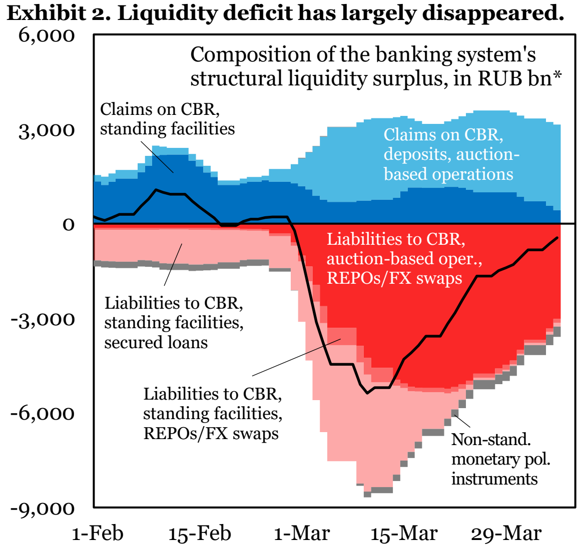
Shortly after Russia's invasion of Ukraine, the European Union, the United States, and their international partners imposed unprecedented sanctions on the Russian financial system, including the Bank of Russia (CBR). In this ***Macro Notes***, we take stock of developments over the past six weeks and discuss potential new measures that are likely to come in light of the Russian military's war crimes in Kyiv's northern suburbs. Financial sector sanctions began after President Putin's decree recognizing two separatist states on Ukrainian territory on February 21 with several countries taking action against specific Russian financial institutions, including U.S. full blocking sanctions on state-owned *VEB* and *Promsvyazbank* (PSB). Following the start of the war on Ukraine on February 24, U.S. Treasury extended these measures to *VTB*, *Novikombank*, *Otkritie*, and *Sovcombank*. Additionally, Russia's largest bank, *Sberbank* was disconnected from corresponding accounts in the United States. The U.S. was joined in its imposition of financial sector sanctions by Australia, Canada, the EU, Japan, the UK, and others. On February 26, international partners announced that seven Russian banks—the aforementioned institutions under full U.S. blocking sanctions as well as *Bank Rossiya*—would be disconnected from the global financial messaging system SWIFT. Finally, the EU and U.S. prohibited transactions with the CBR on February 28 which resulted in the freezing of around $300 bn of its assets.

Exhibit 1. CBR provided emergency liquidity support.



*Source: CBR, IIF *7-day moving average*

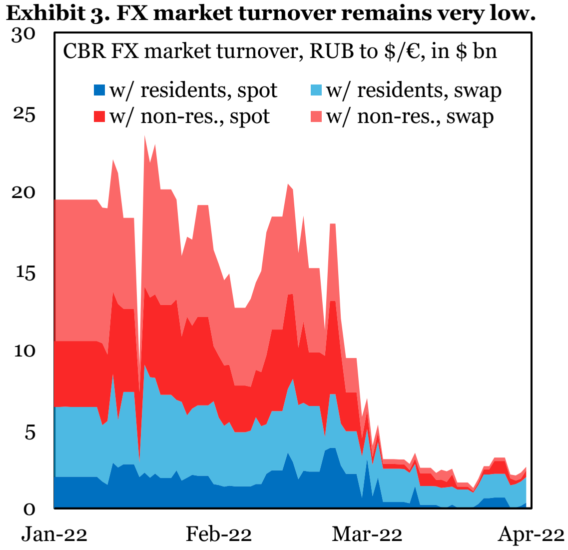
Exhibit 2. Liquidity deficit has largely disappeared.



*Source: CBR, IIF *7-day moving average*

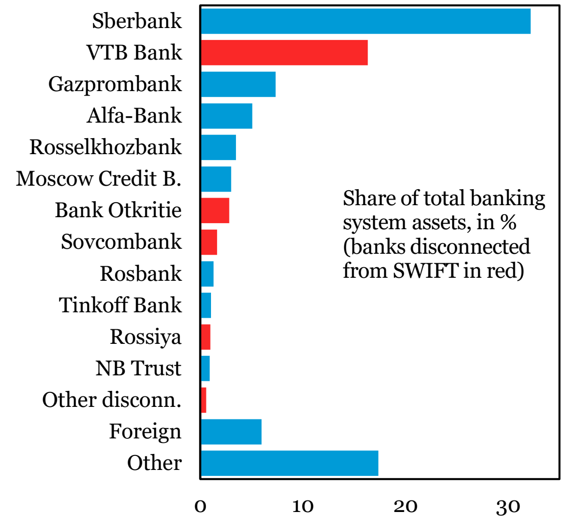
The Bank of Russia reacted to sanctions swiftly by more than doubling its policy rate on February 28 from 9.5% to 20%, providing targeted liquidity support to the banking sector (Exhibit 1), and introducing severe capital controls. In the early days of the crisis, the CBR intervened in the market to stabilize the Ruble which had come under pronounced pressure but was forced to stop following the asset freeze as was acknowledged by Governor Nabiullina at the emergency policy meeting. Still, the central bank lost $38.8 bn in reserves from February 18 to March 25, bringing total reserves down to $604 bn (including frozen assets). This number likely includes FX refinancing to local banks and losses due to valuation effects. In addition to the CBR's aforementioned actions, Russian authorities also closed the domestic stock market for a month and reduced the number of Ruble trading sessions. Trading remained volatile after the market's reopening on March 24 although only around 15% of listed shares could be traded and short selling was prohibited. While the CBR's reserve operations have been limited due to sanctions, historically-high current account surpluses—$39 bn in January-February, likely an additional $30-40 bn in March, and possibly above $250 bn for the full year (absent an energy embargo)—Russia should be able to regain *"lost"* reserves in a relatively short period of time.

Exhibit 3. FX market turnover remains very low.



Source: CBR, IIF

Exhibit 4. 22% of banking sector cut off from SWIFT.

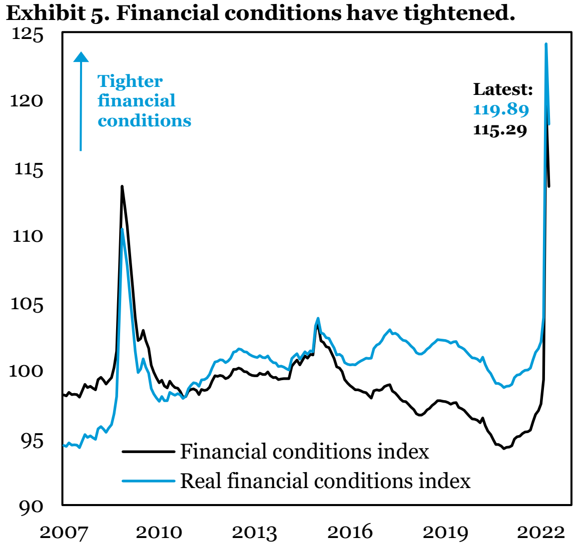


Source: banki.ru, IIF

During the height of the crisis when demand for cash and foreign currency peaked, even Sberbank's branches and ATMs were subject to bank runs and foreign-owned banks were not able to meet their clients' requests for FX conversion and withdrawal according to anecdotal evidence. However, Russia's financial system appears to be stabilizing now, with banks' structural liquidity deficit vis-à-vis the Bank of Russia much smaller than during the first half of March (Exhibit 2). In fact, the system could return to a structural surplus in the coming days. It is notable that Russia's banking system remains highly fragmented: while many banks had to rely on CBR liquidity support (red areas in Exhibit 2), some banks appear to have accumulated deposits with the CBR (light blue area in Exhibit 2) instead of releasing it on the interbank market—likely due to the high degree of uncertainty. On the foreign exchange side, however, CBR FX market turnover remains extremely low (Exhibit 3), indicating that access to FX is still very limited.

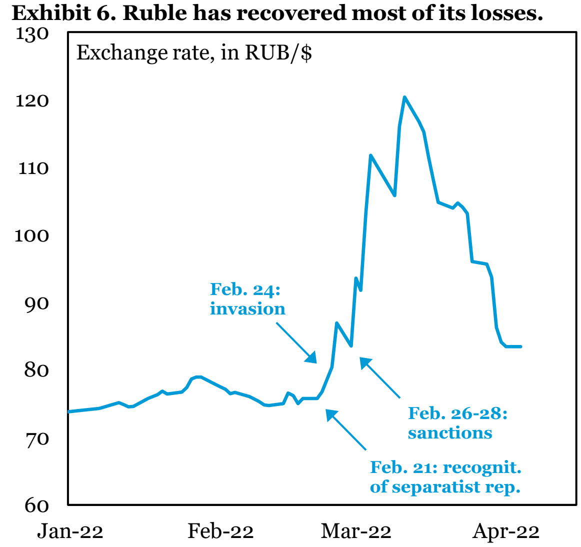
Due to recent reports about war crimes in Ukraine, many Western leaders have announced that an additional round of sanctions is imminent. We expect a further tightening and (compliance-facilitating) harmonization of financial sector-related measures to be an important element, in particular as a potential energy embargo remains controversial. Room for additional sanctions in the financial sphere exists: For example, Russia's largest bank, Sberbank, has so far been excluded from full U.S. blocking sanctions and only been disconnected from U.S. correspondent banking. In addition, while the cutting off of seven Russian financial institutions from SWIFT represented a significant step, long considered a *"nuclear option"*, these institutions only represent around 22% of the banking system's total assets—with VTB alone accounting for 16% (Exhibit 4). The main reason for partial measures was to differentiate between the state and the Russian population. However, for several reasons, including the dramatic effect of foreign companies' *"self-sanctioning"* on people's everyday lives and new developments in Ukraine, this argument may become less persuasive.

Exhibit 5. Financial conditions have tightened.



Source: Bloomberg, IIF

Exhibit 6. Ruble has recovered most of its losses.



Source: Haver, IIF

While financial conditions remain abysmal (Exhibit 5), the Ruble appears to have strengthened in recent weeks and is almost back to pre-crisis levels (Exhibit 6). This is due to a combination of factors: a commodity-price and import-contraction driven large current account surplus, severe capital controls, and tight monetary policy. Exporters are required to convert 80% of their receipts into Ruble, contributing to FX inflows to the local Ruble market. At the same time, individuals are not allowed to convert from than $10,000 until September of this year and there is anecdotal evidence that even this amount is hard to get from banks. Furthermore, Russian brokers must receive explicit approval for debt repayments to non-residents. Thus, the recent Ruble strengthening is not surprising and could reverse once again should sanctions be tightened further in the coming weeks.

As far as the recent decision by Russian authorities to request Ruble payments for natural gas exports is concerned, we believe this to be a largely symbolic move—and partially a preemptive one as the pressure in the EU had been building to join the U.S.'s embargo on Russian energy exports. Primarily, we believe that the country's threat to stop natural gas supplies if the demand for payments in Ruble is not met is intended to demonstrate the ability to implement consequential counter-sanctions. Having already banned exports of sugar and wheat to *"unfriendly"* countries, Russia could also target supplies of fertilizers, nickel, palladium, platinum, and titanium, to name a few, which could be damaging to the global economy. The move does have additional practical consequences as well, however. First, it marginally increases the share of export receipts exchanged for Ruble from the current mandated 80% to an effective 100% as the responsibility shifts to natural gas importers. Second, it would make the implementation of a *"gas for food"* program much more challenging. Under such a program, FX payments for natural gas exports would be placed in an escrow account and monitored so that can only be used for specific spending categories. Were buyers forced to buy Ruble on the market (in this case, via an account with *Gazprombank*), FX inflows would become almost impossible to trace.

Western sanctions have largely focused on the financial sector so far, even if some sanctions have de-facto become trade sanctions, partially due to self-sanctioning by international companies. However, as Russia's economy and financial sector adapt to a new equilibrium of capital controls, managed prices, and economic autarky, it is not surprising that some of the domestic markets stabilize. Furthermore, due to the policy response and likely large current account surplus, sanctions have become a moving target and will require adjustments over time to remain effective. We believe that the likely next steps will be a further tightening of financial sector sanctions, potentially the disconnecting of additional Russian institutions from SWIFT. Finally, while resistance to an energy embargo remains substantial in many European countries, including but not limited to Germany, it is increasingly unlikely that this position can be upheld for much longer should more evidence of Russian war crimes emerge.