

How Russia Avoided a Financial Crisis and What to Do Next An Analysis of International Financial Sanctions Against the Russian Federation

By Benjamin Hilgenstock

Introduction

In the context of Russia's invasion of Ukraine, the United States, the European Union, and others imposed unprecedented sanctions on the country, including its economy and financial system.

As a recent paper by the *Institute of International Finance* stated, this constitutes a third phase of such measures.¹ The first followed Russia's annexation of Crimea and the beginning of the military conflict in Eastern Ukraine in 2014; the second took place in the following years and largely consisted of unilateral actions by the U.S., including restrictions on sovereign debt.

While sanctions span a broad range of sectors, this note will focus on issues pertaining to the financial industry. The system has dealt with the challenge rather well, prompting concerns over the efficacy of sanctions and posing questions regarding possible additional measures. ***This paper argues that room for a meaningful further tightening of restrictions remains.***²

Imposition of Sanctions

Banking Sector Sanctions

Sanctions on Russia's financial system should be regarded as comprehensive, especially in comparison to measures imposed, or rather not imposed, on other sectors (Chart 1).

As far as the U.S. is concerned, the Treasury Department is operating through its *Specially Designated Nationals and Blocked Persons List (SDN) List*, which now includes a substantial number of Russian financial institutions accounting for roughly two-thirds of the banking system's total assets.³ Addition to the SDN List, also known as "full blocking sanctions," triggers the freezing of institutions' assets in the U.S. and prohibits U.S. persons from conducting business with them. Effectively, it means the loss of access to the U.S. financial system and U.S. Dollar.

The European Union has imposed similar measures as part of several sanctions packages under *Annex I of Council Regulation (EU) No 269/2014*. The partial overlap of U.S. and EU restrictions means that close to 60% of the Russian financial system are cut off from the world's two most important financial markets and reserve currencies.

Finally, the U.S., EU, Canada, and the United Kingdom announced in late February that seven Russian banks would be disconnected from the global financial messaging system SWIFT; three more were added later. This includes *Sberbank* and *VTB*, by far the two largest institutions (Chart 2). While international transactions are still possible, this represents a significant development that had long been viewed as a "nuclear option".

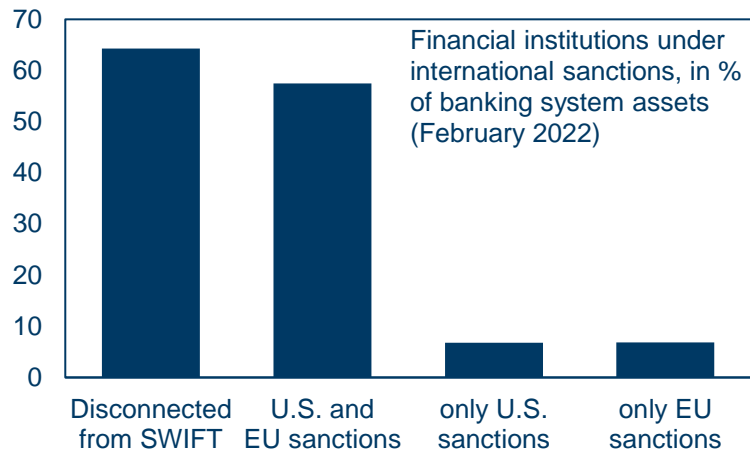
Considering the share of foreign banks, this leaves roughly 23% of the system in Russian institutions not currently under sanctions. *Gazprombank* alone, which has so far been excluded due to its critical role in energy trade, is responsible for close to 8%.

¹ See [Russia Sanctions: Adapting to a Moving Target](#) from June 8, 2022.

² See also [International Working Group on Russian Sanctions](#) from June 22, 2022.

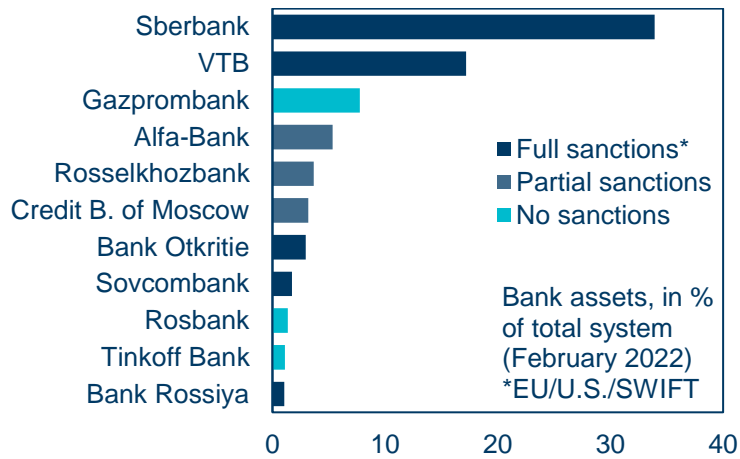
³ Asset data as of February 2022.

Chart 1: A large share of the Russian financial system is under sanctions.



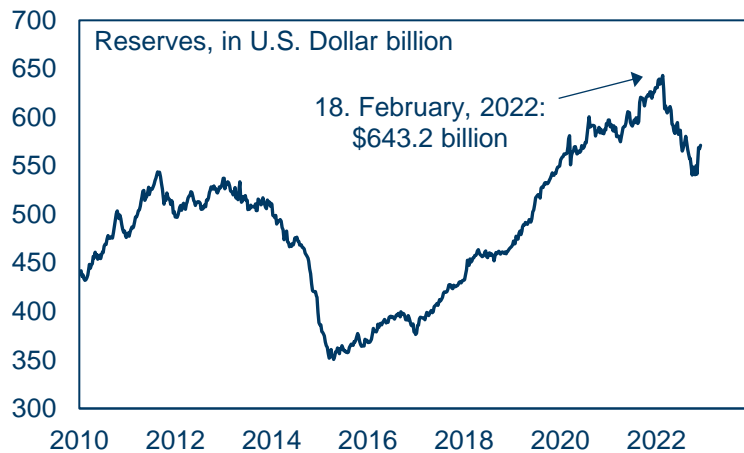
Source: European Commission, U.S. Treasury Department, banki.ru

Chart 2: Gazprombank has so far been spared due to its role in energy trade.



Source: European Commission, U.S. Treasury Department, banki.ru

Chart 3: CBR reserves have declined by roughly \$72 billion.

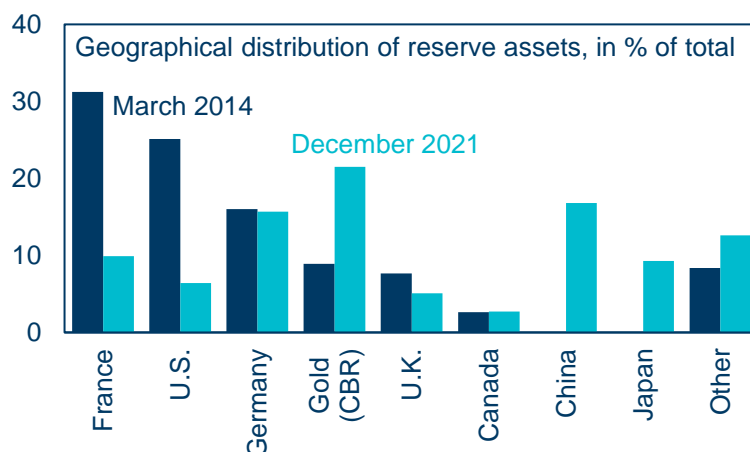


Source: Bank of Russia

Sanctions on Central Bank Assets

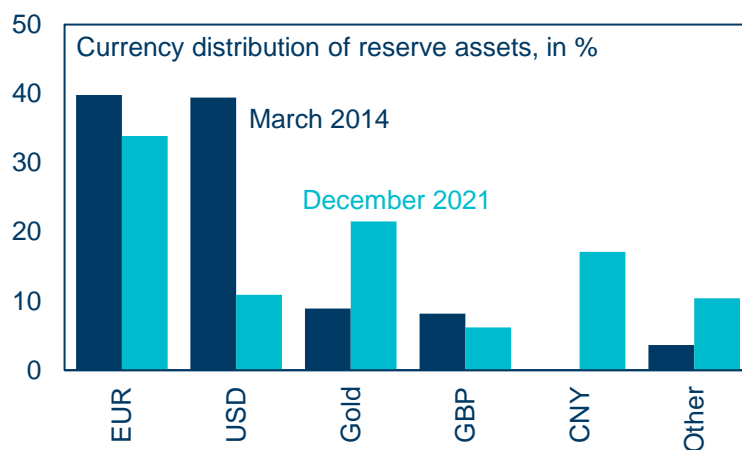
Restrictions on the *Bank of Russia (CBR)* have been one of the most critical elements of the sanctions regime. The U.S. and EU prohibited transactions with the central bank on February 28 and froze assets under its respective jurisdictions. As a result, the CBR lost access to a substantial share of its FX reserves, which, at the time, stood at above \$640 billion (Chart 3). As of December 2021, the last available data point, reserve assets located in sanctions imposing countries accounted for almost 50% of the total, or \$315 billion (Chart 4). Transactions with Russia’s \$200 billion sovereign wealth fund (*National Welfare Fund/NWF*) were also forbidden.

Chart 4: Assets under sanctions could account for up to 50% of total reserves.



Source: Bank of Russia

Chart 5: The CBR had changed the currency composition of its reserves.



Source: Bank of Russia

Sanctions on the CBR had a meaningful effect despite a concerted effort by Russian authorities in recent years to insulate its economy and protect macroeconomic buffers—part of what many observers are calling the *Fortress Russia* strategy.⁴ In the case of the central bank, this meant the restructuring of its reserves’ currency composition and geographical distribution.

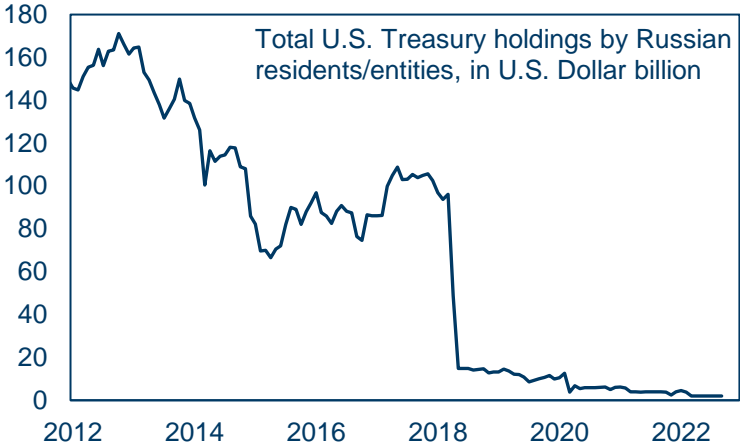
Since the first round of international sanctions in the aftermath of the annexation of Crimea in 2014, the CBR had significantly reduced the share of reserves held in U.S. Dollar and Euro while increasing the share of Yuan-denominated assets and gold (Chart 5). Even more striking was the geographical reallocation away from EU countries and the U.S. Nonetheless, such

⁴ See [Bruegel](#) policy brief from October 26, 2022.

changes cannot be made overnight, leaving a large share of assets under the jurisdiction of countries which ended up imposing restrictions in 2022.

Part of the reallocation efforts was a disinvestment from U.S. Treasuries (Chart 6). While total holdings by Russian residents and entities had already fallen by close to 50% since late 2012, a decisive adjustment took place in April-May of 2018 when they fell from \$96 billion to \$15 billion. As of September of 2022, the value is negligible at \$2 billion.

Chart 6: Russia almost fully divested from U.S. Treasuries in recent years.



Source: U.S. Treasury Department

Response and Implications

Financial sector sanctions had a rather immediate impact but effects have since subsided—due to the central bank’s skilled policy response as well as the system’s overall resilience. Enhancing the latter had been a primary focus of policy makers’ efforts since 2014 and involved, among others, the development of domestic financial infrastructure.

Impact on Banking System Liquidity

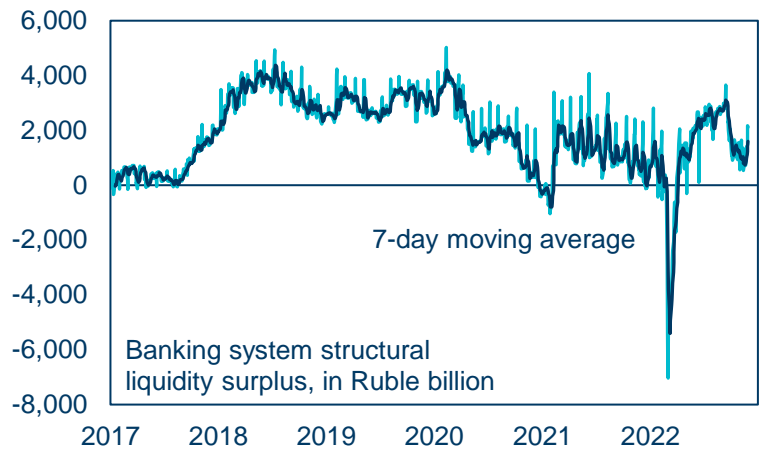
Within days of the imposition of the first round of banking sanctions; structural liquidity in the system collapsed according to the CBR, shifting from a 200-300 billion Ruble surplus to a 7 trillion Ruble deficit (Chart 7). During this period, many Russian financial institutions, including systemically important ones such as *Sberbank*, experienced bank runs and concerns over an imminent financial crisis with serious implications for the real economy emerged.

However, the CBR quickly supplied institutions with needed Ruble liquidity and the banking system returned to pre-war liquidity levels by the end of March. A closer look at asset and liability details points to some stress in the interbank market with both claims on the CBR and liabilities to the CBR growing simultaneously (Chart 8).

The system experienced another, much smaller drop in liquidity in the fall but the surplus remains close to its post-Covid and pre-invasion average. As a result, a financial crisis did not materialize. This is the primary reason why many observers now expect the Russian economy to perform much better in 2022 than originally predicted. Rather than a double-digit drop in GDP, a contraction of 3-6% is now considered a realistic expectation.

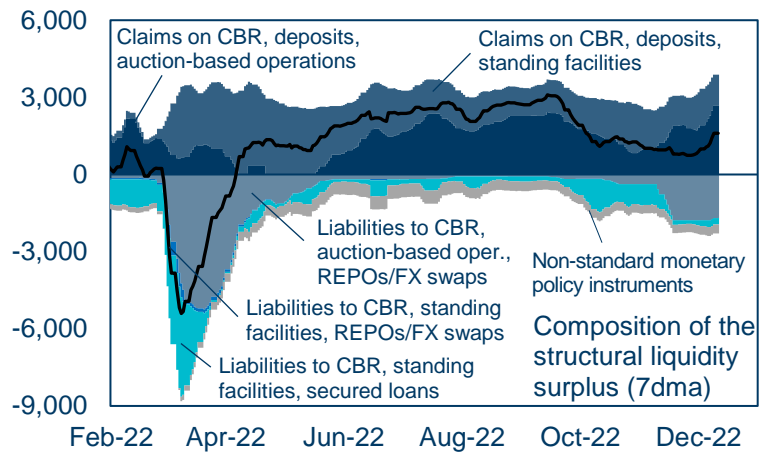
Importantly, Russian banks were able to provide the private sector with sufficient credit. Following a marked decline in March-June, new loans have now more than recovered, and major effects on the economy due to tight financial conditions are unlikely (Chart 9).

Chart 7: The banking system's structural liquidity recovered quickly.



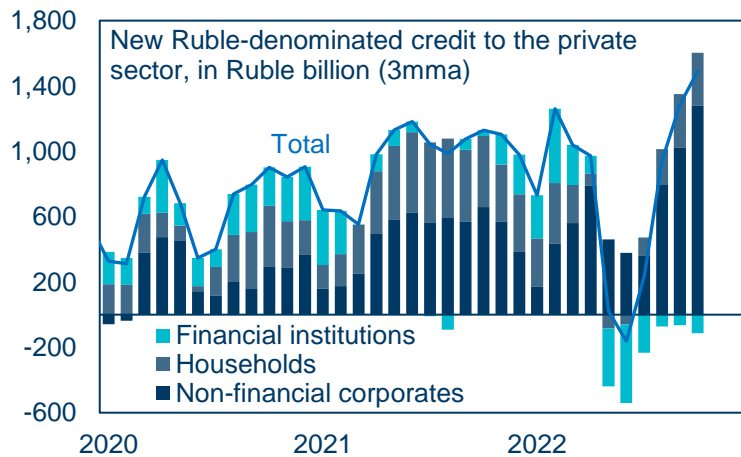
Source: Bank of Russia

Chart 8: The central bank's policy response avoided a financial crisis.



Source: Bank of Russia

Chart 9: Strong credit to the private sector supports economic activity.



Source: Bank of Russia

That is not to say, however, that the financial system will not experience any detrimental consequences. According to the CBR, Russian banks had already lost more than \$25 billion by mid-September due to the war and sanctions, largely on business in foreign currency.⁵ As an end to sanctions will not happen any time soon, the cut-off of many Russian financial institutions from the world’s two biggest financial markets will inevitably weigh on the system going forward.

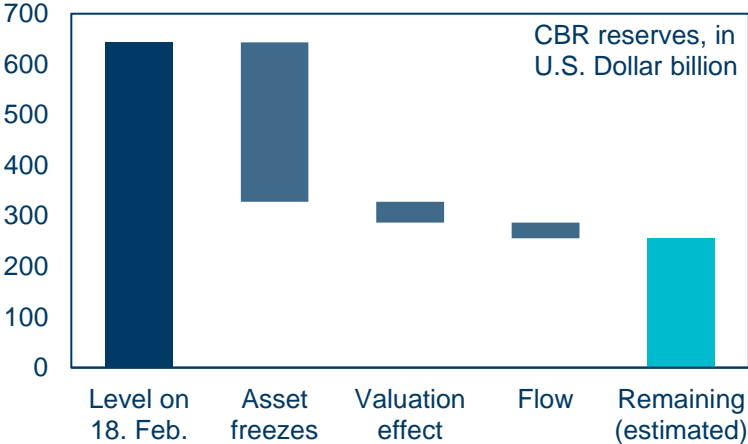
The CBR remains committed to provide the necessary support, but its maneuvering room will likely shrink considerably. Extremely favorable external dynamics with high current account surpluses allowed the central bank to actively provide credit and stabilize the financial system, while hiking interest rates aggressively to support the Ruble and address rising inflation.

With inflows expected to be much weaker in the coming months as the EU embargo on crude oil and petroleum products as well as the oil price cap begin to impact exports, and as Russia continues to deliver significantly less natural gas to Europe, the simultaneous pursuits of financial and monetary stability will inevitably come into conflict.⁶

Impact on Reserves

As mentioned above, freezes of CBR assets meant that the central bank lost access to up to \$315 billion in reserves. In addition, the remaining stock declined by more than \$72 billion since the start of the war, with an estimated \$40 billion due to the U.S. Dollar’s strength weighing on the valuation of assets in other currencies. Altogether, this leaves the CBR with around \$250 billion in usable assets (Chart 10). However, favorable current account dynamics have allowed for a rebuilding of reserves outside of the CBR’s accounts in recent months. Thus, sanctions should be considered a “moving target,” where frequent readjustments are needed.⁷

Chart 10: At least \$250 billion in reserves remain accessible to the CBR.

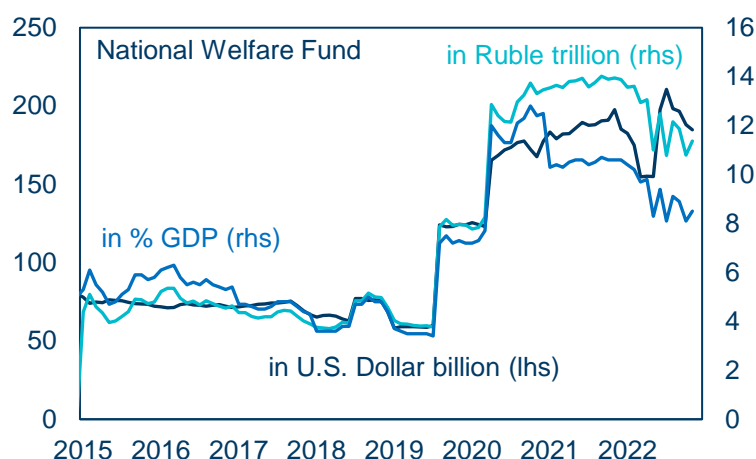


Source: Bank of Russia

Assets of Russia’s National Welfare Fund stand at close to \$185 billion as of November 2022 (or 11.4 trillion Ruble), representing roughly 8.5% of GDP (Chart 11).⁸ The NWF has been built up through foreign currency purchases by the Ministry of Finance which are mandatory under the country’s fiscal rule. In October-November, Russia relied on the NWF to the tune of 560 billion Ruble to finance growing deficits. As the government is planning to do so in the coming years as well, important buffers are set to shrink considerably. Substantial NWF funds—close to 500 billion Ruble in our estimation—have also been allocated to businesses to provide support during the shock from war and sanctions.

⁵ See [Reuters](#) article from September 23, 2022.
⁶ See [International Working Group on Russian Sanctions](#) from November 28, 2022.
⁷ See [Bruegel](#) policy brief from October 26, 2022.
⁸ Foreign exchange holdings of the NWF count as part of the reserves reported by the CBR.

Chart 11: The National Welfare Fund is another important macro buffer.



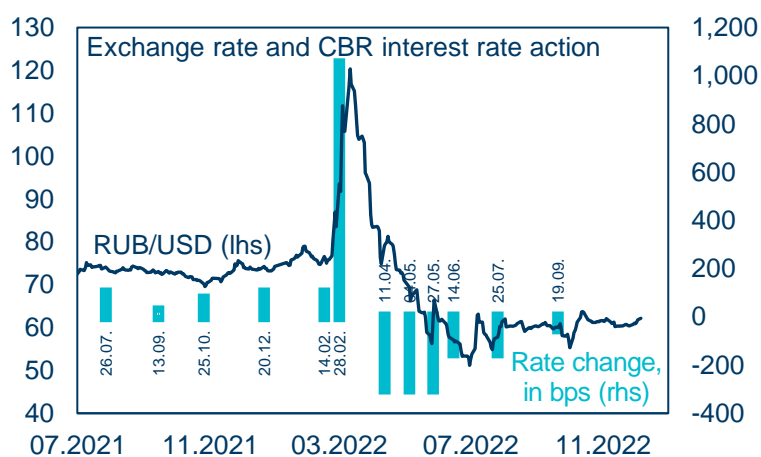
Source: Ministry of Finance

Regarding Russia's reserves, the much bigger problem, however, is that the country's authorities are seriously constrained in the way that these assets can be used. Specifically, in several jurisdictions, including the U.S., EU, and UK, transactions with the central bank and the NWF are prohibited. FX sales (and purchases) remain possible through other countries but the loss of access to a large share of the global financial system still constitutes a significant burden.

Impact on the Ruble

The recovery of the Ruble exchange rate following a brief stress period in March during which the currency lost one-third of its value, has led some observers to conclude that sanctions failed to have a meaningful effect on the Russian economy. This is not correct, however. The relative strength of the Ruble is more a result of CBR policy measures and lower trading volumes than a reflection of fundamentals (Chart 12). The suspension of FX purchases under the fiscal rule also plays an important role.

Chart 12: The Ruble's recovery has allowed the CBR to normalize monetary policy.



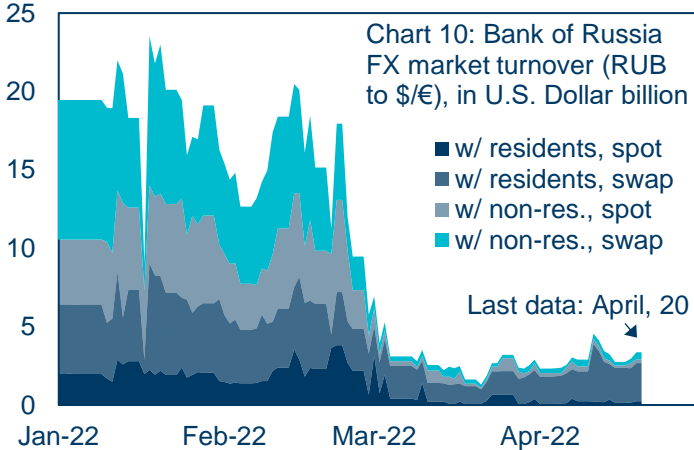
Source: Bank of Russia

Sanctions on cross-border transactions and capital controls instituted by the CBR to stabilize the financial system led to sharply lower volumes, which is evident in the central bank's data on FX market turnover (Chart 13). For an extended period, cash withdrawals from foreign currency-denominated retail accounts were capped at \$10,000. And while the cap has now been lifted and Russian citizens can transfer up to \$1 million per month, FX supply is limited

and withdrawals can take considerable amounts of time. In addition, international banks are wary of facilitating any transactions for compliance reasons.

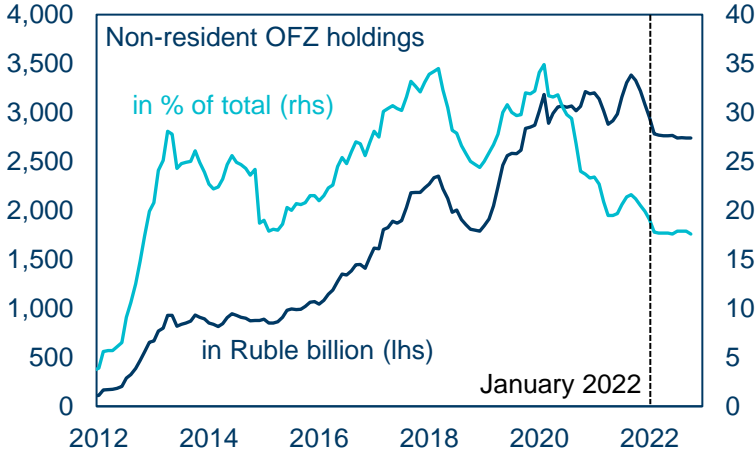
Another important factor are favorable external dynamics due to lower imports and persistently high prices for key exports; a surplus in excess of \$200 billion this year substantially reduces any pressure on the currency. In addition, authorities, starting on February 28, required exporters to convert 80% of their revenues into local currency—before reducing the share to 50% in late May as concerns over Ruble weakness and FX liquidity subsided.⁹ With the current account surplus expected to decline markedly in the coming months, the Ruble should come under renewed pressure in 2023, which will also lead to passthrough to inflation.

Chart 13: FX market turnover declined sharply in the aftermath of the invasion.



Source: Bank of Russia

Chart 14: Foreign investors have not been able to disinvest from sovereign debt.



Source: Bank of Russia

Impact on Financial Markets

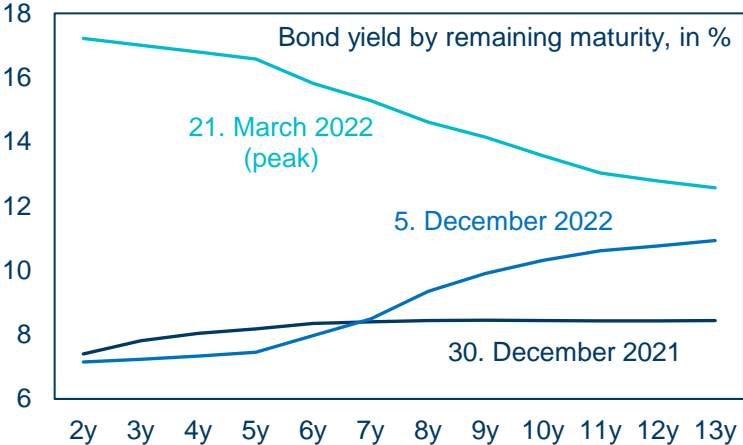
Sanctions on Russian sovereign debt predate the invasion of Ukraine by several years. The U.S. Treasury Department first prohibited participation in the primary market for non-Ruble-denominated government bonds (i.e., Eurobonds) in 2019 and extended restrictions to Ruble-denominated debt (i.e., OFZ) in 2021. The U.S. then imposed sanctions on the secondary market for all new debt, Ruble- and FX-denominated, on February 22, 2022.

⁹ See Reuters articles from [February 28, 2022](#) and [May 23, 2022](#).

At the end of January, non-residents held roughly 3 trillion Ruble in local currency-denominated debt—or 19% of the entire stock (Chart 14). Due to sanctions and Russian capital controls, foreign investors have largely not been able to exit the market, leaving holdings of 2.7 trillion.

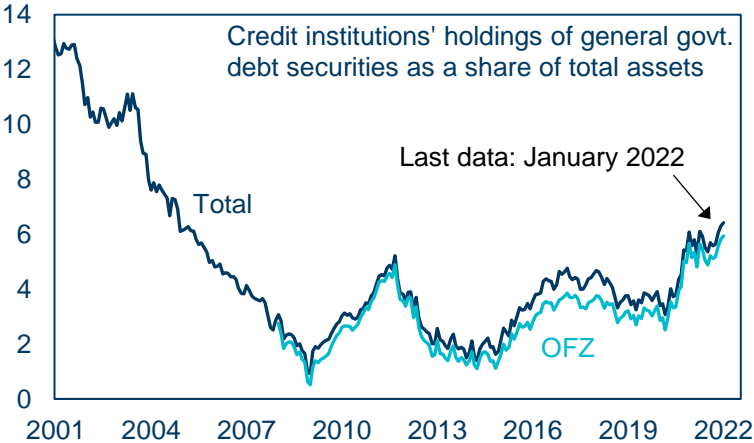
Changing conditions in the market for these securities can be observed through movements in the OFZ yield curve, however (Chart 15). Yields jumped sharply in the immediate aftermath of the invasion and the imposition of sanctions, but have moderated significantly, especially on the short end of the curve where they have returned to pre-war levels or even fallen below. Financing the operation of government and the war effort has, thus, become somewhat more expensive for Russia but not dramatically so.

Chart 15: Financing has become somewhat more expensive.



Source: Bank of Russia

Chart 16: Domestic banks will be able to absorb domestic debt issuance.

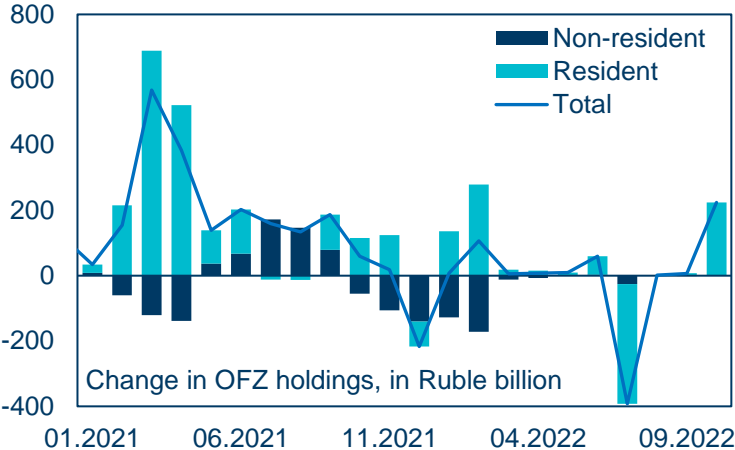


Source: Bank of Russia

A related question concerns the domestic financial system’s ability to absorb new debt issuance in the absence of international investors, which had played a critical role in the past. Data on such holdings was discontinued in January but, at the time, they accounted for 6% of total banking system assets—moderate in historical comparison (Chart 16). Net issuance of OFZ has overall been limited since the beginning of the war; thus, domestic institutions’ holdings should not have changed dramatically and absorption capacity continue to exist (Chart 17). However, recent auctions indicate that financing pressure is rising considerably as fiscal dynamics worsen; in November and December alone, new OFZ issuance reached around 2.2 trillion Ruble (or 1.7% of 2021 GDP).

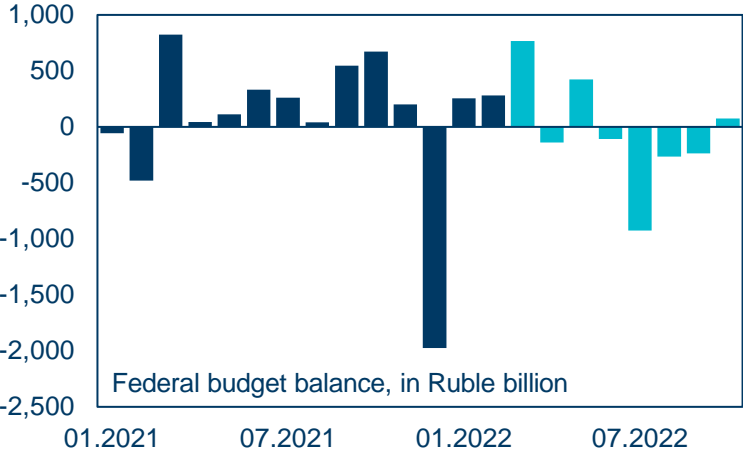
With state-owned institutions making up roughly two-thirds of the banking system, financing deficits will likely not present a major challenge for the time being. In addition, while fiscal dynamics have somewhat worsened in recent months due to weaker revenues (Chart 18), the full-year deficit should not come in much higher than 2% of GDP.¹⁰ The situation is expected to change with the oil price cap's implementation, which could weigh heavily on revenues.¹¹

Chart 17: New debt issuance has overall been moderate.



Source: Bank of Russia

Chart 18: Fiscal dynamics are turning more negative.

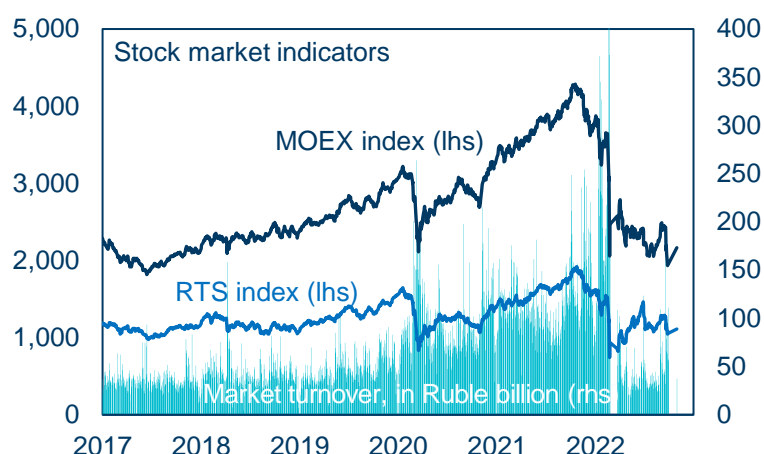


Source: Ministry of Finance

A segment of the market that has been impacted quite significantly is equities. The *MOEX Index* (traditionally favored by domestic investors) is trading almost 40% lower and the *RTS Index* (preferred by foreigners) more than 20% compared to the end of January (Chart 19). Following the February-March sell-off, market turnover is also down sharply.

¹⁰ In October, a 400 billion Ruble payment from Gazprom, the first of three tranches, led to a small surplus.
¹¹ See [International Working Group on Russian Sanctions](#) from November 28, 2022.

Chart 19: Sanctions have had a strong impact on the equity market.



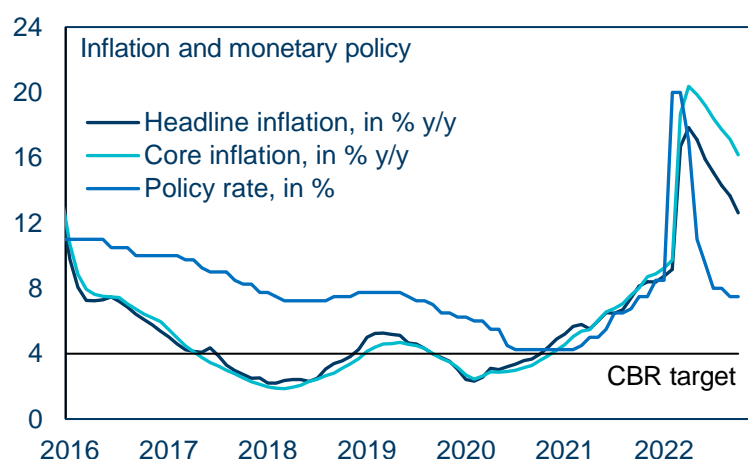
Source: Bank of Russia

Impact on Inflation

The Bank of Russia was one of the first emerging market central banks to begin hiking interest rates in the aftermath of the Covid pandemic. Headline inflation first moved above the CBR target of 4% in November of 2020, triggering a cumulative policy rate increase of 425bps between March 2021 and mid-February 2022. Both headline and core inflation, which had reached 9.2% and 9.7%, respectively by January of this year, jumped sharply following the start of the war—to a peak of 17.8% and 20.4%, respectively, in April (Chart 20).

However, aggressive action by the CBR in the form of an emergency rate hike of 1,150bps on February 28 quickly reversed these dynamics. Headline and core inflation falling continuously since April, to 12.6% and 16.2%, respectively, has allowed the CBR to more than reverse the hike and the policy rate now stands below its pre-war level, at 7.5%.

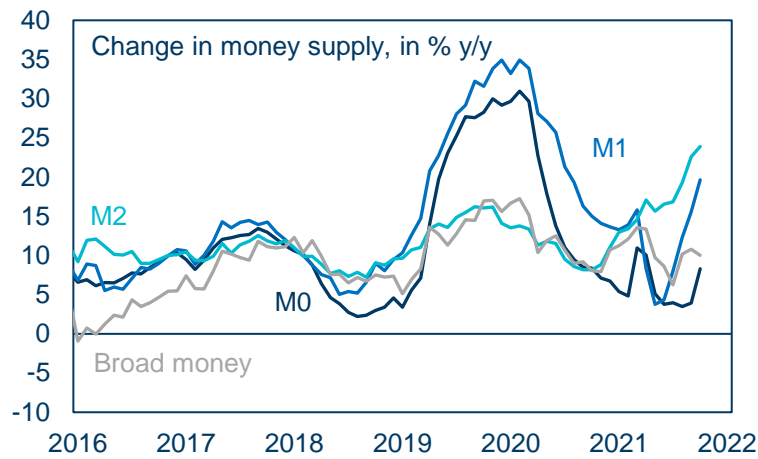
Chart 20: Inflation started to come down in May but remains a challenge.



Source: Bank of Russia

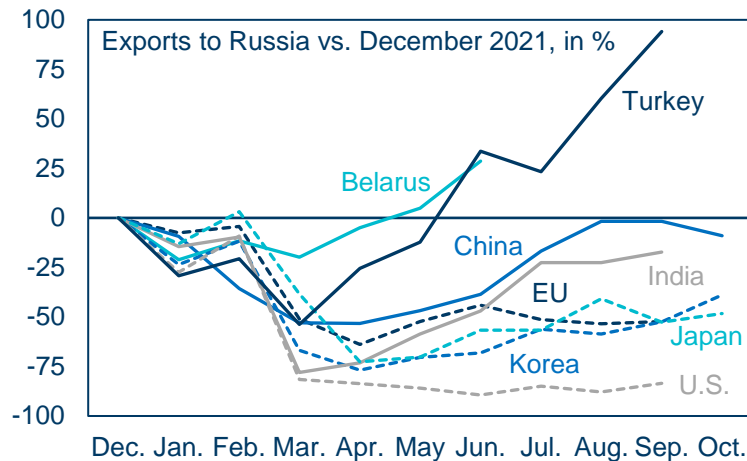
While inflation measures are trending downward, the growth of money supply remains elevated, although not at levels experienced during the Covid shock (Chart 21). The disconnect between the two dynamics is likely a result of a decrease in the velocity of circulation as is often experienced during a recession. Nonetheless, the CBR has certainly managed risks effectively so far, supported by the recovery in the Ruble exchange rate which has reduced the pressure from imported inflation.

Chart 21: At the same time, money supply growth is still elevated.



Source: Bank of Russia

Chart 22: Trade patterns are shifting away from traditional export markets.



Source: national authorities

What It All Means and What to Do Next

Restrictions imposed on Russia's financial sector, including its central bank, are almost unparalleled. The Iran case is somewhat similar but Russia's economic size as well as integration into the global economy and financial system are significantly stronger.

Nonetheless, important loopholes remain in place. And a financial crisis, which appeared imminent in late-February and early-March has not materialized. The CBR managed the situation competently and efficiently. Aside from that, Russia's financial system proved to be overall more resilient, partially due to efforts in recent years to insulate the country from the impact of additional international sanctions.

If we understand the current sanctions regime as an attempt to impact Russia's military aggression in Ukraine, it has not succeeded in reducing the financial system's ability to finance government expenditure. The logical question, then, is what else can be done to achieve this objective? In a way, the key issue with almost all measures imposed since the start of the war is that they will likely have a significant impact on the Russian economy in the medium and long run but fail to trigger any immediate changes.

Additional financial sector sanctions can broadly be placed in two categories. The first contains the **expansion of existing measures to the remainder of the Russian financial system.**

This would include the loss of access to the U.S. and European financial markets and currencies. Cutting-off additional institutions from the SWIFT financial messaging system should also be considered; however, this measure has proven to be less effective than originally anticipated. Cross-border payments may have become more cumbersome, but they remain possible for the most part in the absence of other wide-ranging measures.

With the EU embargo on crude oil now in place, similar restrictions regarding petroleum products taking effect in February, and natural gas flows to Europe down sharply, arguments in favor of exempting *Gazprombank* from sanctions are now much weaker. As this concerns a systemic financial institution, it would significantly strengthen the sanctions regime. Based on the most recent data, an additional 15% of the system, in asset terms, are accounted for by other Russian institutions that could be targeted by the U.S. and EU.¹²

As far as foreign banks still operating in Russia are concerned, regulators such as the *Fed* and *ECB* could establish clear deadlines for a full exit from the Russian market. In practice, these institutions represent another critical loophole.

The second category consists of ***sanctions imposed by countries that are currently not participating*** in the sanctions regime and are responsible for a significant number of cross-border transactions, e.g., China and Turkey. Russian goods imports from China have recovered to their pre-war level and those from Turkey are up by 100% (Chart 22).

The absence of sanctions does not only support Russian trade and financial ties to the outside world but also complicates efforts to enforce existing restrictions. For example, it is improbable that the increase of Turkish exports is solely a reflection of Russian importers finding alternative suppliers. Rather, re-exports of goods originating in countries that have imposed sanctions and export controls likely account for a substantial share.

For the effectiveness of the sanctions, the fact that many countries are maintaining economic relations with Russia is clearly problematic. What to do about it is a difficult question, however.

Theoretically, the U.S. has the ability to force actors outside of its immediate jurisdiction to implement certain policy measures—through what are called “secondary sanctions”. In essence, it means that the Treasury Department threatens them with severe penalties, including asset freezes, loss of access to the U.S. financial system and U.S. Dollar, and inadmissibility of individuals. Such a strategy was used in the Iran case but also regarding *Nord Stream 2*.

The issue with secondary sanctions is twofold: One, the political price can be high, which is why they are often applied in a selective way. Currently, such measures are under discussion in the context of a price cap on Russian oil, specifically, importers that do not intend to comply with the cap. Secondary sanctions could also be applied to financial hubs such as Dubai and/or Hong Kong, which play a key role in sanctions evasion and circumvention.

Two, while a disconnection from the U.S. financial system and the world’s most important reserve currency represents an existential threat for the majority of companies, it does not do so in all cases. In some countries, authorities have developed financial infrastructure that is not dependent on such access and can be used to maintain relationships with sanctioned entities.

In summary, this paper argues that despite the scale of existing financial sector sanctions, room for a tightening of restrictions remains and should be used given the continuation of Russia’s war in Ukraine.

¹² The [European Commission](#) is proposing to sanction three additional financial institutions, including the *Russian Regional Development Bank*, as part of the EU’s 9th sanctions package.