INSTITUTE OF INTERNATIONAL FINANCE

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MARKET INTERVENTIONS:

THE CASE OF U.S. SANCTIONS ON RUSSIA

EXECUTIVE SUMMARY

Economic sanctions are a critical element of the foreign policy toolkit of both national governments and international bodies. Their value lies in the fact that they are perceived to be a lower-cost and lower-risk way to change another country's behavior compared to, alternatively, some form of military action. However, sanctions are a form of government market intervention and can have significant unintended and uncertain consequences—particularly if they are placed on an economy highly integrated into the global economy and the international financial system. In this respect, the measures taken by the United States and its allies against Russia beginning in 2014 represented a paradigm shift. They proved to be effective in limiting the flow of foreign funding into the country, forcing substantial fiscal adjustment and the deleveraging of corporates. Partially as a result of sanctions, GDP growth has remained underwhelming for many years.

Now six years after the initial imposition of sanctions on Russia, a handful of new, additional sanctions are being discussed in the halls of the United States Congress. Specifically, new sanctions would target participation in the market for domestic sovereign debt, known as OFZ, which has performed extremely well in recent years. However, it is far from certain that further sanctions targeting external funding would have the desired effect. The Russian economy is in a dramatically different place now compared to 2014: The country's economic institutions are credible, macroeconomic vulnerabilities are extremely low, and buffers such as foreign reserves have been built up. Additionally, Russian debt plays an important role in the international financial system, so the range of unintended consequences is potentially large.

This paper will focus on the implications of sovereign debt sanctions—for both the Russian economy and global markets. We will look in detail at a number of critical segments, such as the asset management industry, international banks, and the broader market infrastructure. Furthermore, we will assess how sanctions on Russian sovereign debt could inadvertently strengthen the position of Russian financial institutions. The paper will distinguish between restrictions on the issuance of new debt, e.g. primary market sanctions, and measures targeting the secondary market for OFZs. Separately, we will discuss implications for market participants outside of the U.S., which would not be formally bound by sanctions. The importance of access to the U.S. financial system may influence companies' risk management considerations and lead to compliance with U.S. measures out of an abundance of caution.

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1. ECONOMIC SANCTIONS IN AN INTERCONNECTED WORLD

Sanctions are and will continue to be an important part of any foreign policy toolkit, as they represent a major force that can dramatically alter economic and political relationships between countries. In recent years, increasing use has been made of so-called "smart" sanctions—those designed to apply pressure on specific groups or segments of a society, rather than on an economy as a whole. Many of these types of sanctions bear on global financial interconnectedness.

However, the impact of financial sanctions on asset valuations and economies has not been researched extensively in the same way that sanctions have been looked at from an international relations or foreign policy perspective. This is a major gap in the analysis given that sanctions may also impact the functioning of key global markets, for example, the use of the Dollar as a reserve currency or the functioning of global payments systems.

Though there are an increasing number of examples, this paper will mainly focus on U.S. sanctions on the Russian Federation as a case study. Our focus is on sovereign debt sanctions, narrowly defined, because such measures are the most relevant for global markets.

In a series of future publications, we will cover different sanctions regimes and will also focus on the application of other types of economic and financial leverage to achieve economic, foreign policy, and national security objectives.

2. RUSSIA SANCTIONS: EXISTING MEASURES AND CURRENT INITIATIVES

a. Existing Sanctions on Russia

In March of 2014, following Russia's annexation of Crimea and the start of military conflict in Eastern Ukraine, the United States imposed sectoral sanctions against entities operating in the financial, energy, and defense sectors of the Russian economy via inclusion on the Department of the Treasury's Sectoral Sanctions Identifications (SSI) List pursuant to Executive Order 13662.[1] Among other provisions, these sectoral sanctions prohibit the participation of U.S. persons in the issuance of new debt securities with maturities above certain thresholds.[2]

- Congress has since then codified Russia sanctions, originally imposed via executive action, in August 2017 through passage of the *Countering America's Adversaries Through Sanctions Act (CAATSA)*. CAATSA imposes additional sanctions, including a) with respect to cybersecurity activities; b) relating to crude oil and pipeline projects; c) on financial institutions; and d) on the Russian defense and intelligence sectors. CAATSA also includes secondary sanctions, which target all foreign persons involved in the evasion of previously imposed sanctions as well as transactions with human rights abusers.
- Sanctions in April 2018 targeted oligarchs and their affiliated companies, including aluminum producer Rusal. Trading of the sanctioned companies was suspended, and sanctions had a significant effect on Russian and global aluminum markets, disrupting supply chains in the short-term, particularly for European companies. After a number of extensions and following a change in Rusal's ownership, the sanctions were lifted. Had they continued, finding alternative suppliers could have taken significant time.
- A few months later, the first round of sanctions under the *Chemical and Biological Weapons Control and Warfare Elimination Act (CBW Act) of 1991* was imposed in response to the poisoning of former Russian intelligence officer Sergei Skripal and his daughter in the United Kingdom. The second round was enacted in August of 2019. The U.S. imposed sanctions on Russian sovereign debt for the first time, prohibiting U.S. financial institutions from participating in future primary issuance of non-Ruble-denominated sovereign debt.[3] The sanctions were narrowly defined and did not have a noticeable effect on Russian or global markets.

[1] See the SSI List and Executive Order 13662.
[2] See the Treasury Department's directives.
[3] See Executive Order 13883 and the Treasury Department's related CBW Act Directive.

Eurobonds, the sanctioned asset class, rallied, likely as a result of scarcity effects.

These sanctions importantly exclude a) local currency-denominated debt (OFZs); b) participation in the secondary market for Russian Eurobonds; c) existing holdings of such securities; and d) transactions with the Central Bank of Russia (CBR)'s ruble bonds OBR or Russian state-owned enterprises (SOEs). In consultation with global providers of financial market infrastructure services, the Russian Ministry of Finance announced that they plan to continue Eurobond issuance, but not in Dollar, as that would likely require involvement of a U.S.-based institution for settlement.

- In late 2019, Congress passed the *National Defense Authorization Act (NDAA) of 2020*, which included sanctions on companies involved in the construction of the Nord Stream 2 and TurkStream pipelines (see Box 2). These are actually secondary sanctions since the companies affected are largely non-Russian enterprises.

b. Current Legislative Initiatives

Six years after the first round of sanctions on Russia, voices both in the Administration and on Capitol Hill are signaling the potential for additional sanctions on the Russian Federation. The two key draft bills are the *Defending American Security from Kremlin Aggression Act of* 2018 (DASKA) and the *Defending Elections from Threats by Establishing Redlines Act of 2018 (DETER)*.

- DASKA would impose additional sanctions in response to the alleged interference in U.S. elections by amending CAATSA. Among the provisions are the extension of sanctions under Sec. 224(b) of CAATSA to a) certain political figures and oligarchs; b) individuals within the Russian cyber sector; and c) financial institutions supporting interference in U.S. democratic processes. The bill also imposes sanctions on certain Russian sovereign debt and includes restrictions on investments in energy projects.

  Sovereign debt is defined in DASKA in relatively broad terms, including a) bonds issued by the CBR, the National Welfare Fund, the National Treasury or their agents; b) foreign exchange swap agreements with these institutions; c) any other financial instrument issued by a Russian financial institution on behalf of the Russian government; and d) any instruments determined by the President to represent sovereign debt. Excluded are instruments with maturities of less than 14 days (see Appendix 2 for the legislative text of Sec. 602).

- The Sherman-Waters amendment to the NDAA would have included provisions similar to DASKA, both in terms of the definition of Russian sovereign debt as well as maturity exceptions and timing. The amendment, which passed the House of Representatives, was ultimately not included in the final bill that emerged from conference (see Appendix 2 for the legislative text of Sec. 1240B of the NDAA as passed by the House on July 12, 2019).

- DETER differs from DASKA insofar as it does *not* immediately impose any additional sanctions. Rather, it specifies several mandatory measures to be taken if Russia were found to have interfered in a future U.S. election. These measures include a) the blocking of assets of certain state-owned Russian financial institutions and restricting their corresponding accounts in the United States; b) the prohibition of new investments in the Russian energy sector; c) the blocking of assets of entities in the Russian defense and intelligence sectors; d) the prohibition of transactions involving certain sovereign debt; and e) the blocking of assets of senior political figures and oligarchs and their exclusion from the United States.

  DETER would prohibit all transactions by U.S. persons or within the United States in Russian sovereign debt. The bill includes a general phase-in provision insofar as it declares that "the President shall, [impose sanctions] not later than 30 days after such a determination is made."

  In terms of the definition of sovereign debt, DETER goes beyond the provisions of DASKA as it applies to a) government bonds and b) "debt of any entity owned or controlled by the Russian Federation" (see Appendix 2 for the legislative text of Sec. 202 (4)). Furthermore, without further clarification from the Department of Treasury, it would apply to instruments of any maturity.

In the subsequent sections we analyze how sanctions on Russia's sovereign debt impact Russia, global markets, and other international players. We are using a narrow definition and focus solely on financing to the Russian sovereign, excluding the CBR and state-owned Enterprises. We also explicitly exclude sanctions on derivative instruments. Finally, we assume that the purpose of sanctions would be to limit flows of funding to the Russian budget, rather than disturb monetary operations.

3. IMPACT ON RUSSIA: LESS SENSITIVE TO FOREIGN FUNDING SHOCKS

On a macroeconomic level, sanctions could theoretically hurt a country's economy through a combination of a) the fiscal channel, i.e. by forcing the government to raise taxes or cut spending; b) the balance-of-payments channel, i.e. by forcing a country to cut back on its imports or to increase its exports in the face of lower capital inflow; or c) the balance sheet channel, i.e. by forcing the government or state banks and SOEs to deleverage.

Sanctions imposed by the United States are of particular significance due to the global role of the Dollar for trade, finance, and payments systems. Furthermore, the size and attractiveness of the U.S. market may be enough for companies to comply with U.S. sanctions even if they are not directly applicable to them.

The 2014 sanctions on Russia were particularly effective as they used U.S. and European economic leverage where it intersected most with Russia's economic vulnerabilities. At the time, Russian corporates were heavily reliant on foreign debt and equity financing. Sanctions worked via the balance sheet and the balance-of-payments channels, limiting FX flows into the economy and the budget (similar to an adverse oil price shock). Authorities in the U.S. and Europe were concerned about global spillover risks and therefore held back on additional measures such as restrictions on sovereign debt and payments systems.

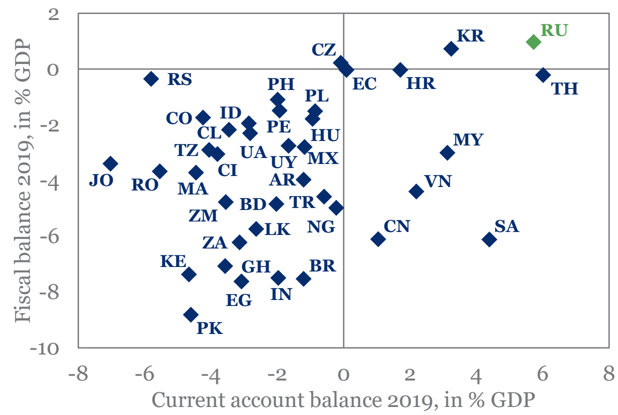
The Russian economy of 2020 is in a much stronger position than it was after the 2014 sanctions were imposed. The Ruble has been allowed to float freely since 2014 and functions as a key shock absorber. Russian corporates were forced to deleverage following their loss of access to external financing and are now significantly less reliant on such funding sources. Furthermore, both current account and fiscal balance are in surplus (Exhibit 1). Finally, public debt is low (12.3% at the end of 2019Q3), external borrowing is small, and FX reserves are the second largest in EM after China.

a. Strong Fiscal Position

We believe that the Russian economy has the ability to largely insulate itself from the impact of new sanctions through its sound fiscal policies.

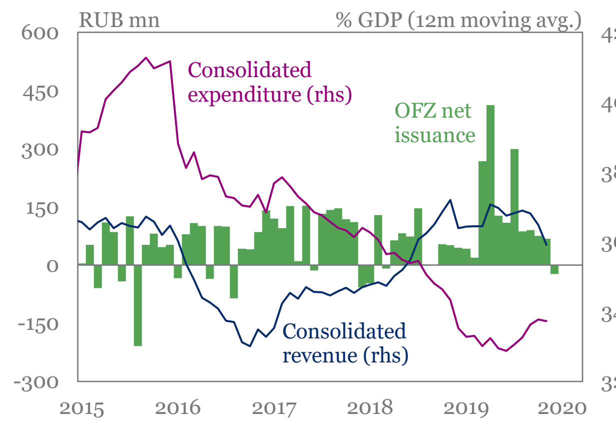
Russia's fiscal accounts have improved significantly. In 2014, authorities felt vulnerable since domestic markets alone would not have been able to fund growing fiscal deficits. The seasonally adjusted consolidated deficit reached its peak of 7.6% of GDP in 2015Q1. However, as a result of higher tax revenue as well as substantial expenditure cuts, the deficit swung to a surplus in 2018 for the first time since 2011, reaching 2.9% of GDP (Exhibit 2). As a result, the fiscal

Exhibit 1. External vulnerabilities are extremely low.



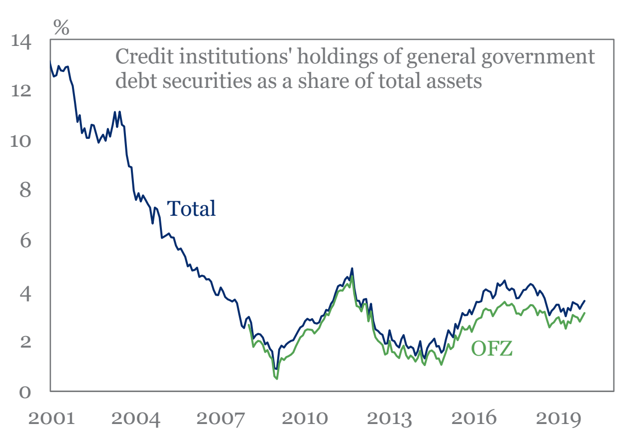
Source: IMF, IIF

Exhibit 2. Fiscal consolidation has been significant.



Source: Central Bank of Russia, Ministry of Finance, IIF

Exhibit 3. Domestic banking sector could absorb more OFZ.



Source: Central Bank of Russia, IIF

break-even oil price now stands at less than $50 per barrel compared to over $100 per barrel in the past.

A fiscal rule was reinstated in 2017/18 and requires the government to put aside all oil revenues in excess of $40 per barrel. Positive net issuance is a result of over-funding in order to boost the National Welfare Fund. In case of a shock, authorities could suspend the fiscal rule and focus exclusively on debt roll-over.

The size of debt issuance appears manageable relative to domestic savings. Domestic banks' holdings of general government debt securities as a share of total assets are modest and have fallen below 3%, low by historical standards (Exhibit 3). If necessary, domestic banks appear to have enough liquidity to keep rolling over sovereign debt and could buy out approximately 90% of foreign investors' debt ($60 bn in liquidity surplus vs. $68 bn in debt held by foreigners), even at par (Exhibit 4).

While Russia's banking sector is sizable and appears to be financially sound as a result of the supervisory and regulatory efforts of the CBR, other parts of its financial system are less so (Exhibit 5). Therefore, they could only contribute on the margin to debt absorption. The heavy lifting would need to be done by domestic banks.

Finally, Russia could look at other sources of funding such as the privatization of SOEs or bilateral agreements with places like China or members of the GCC. However, it would no doubt be challenging to attract private investment.

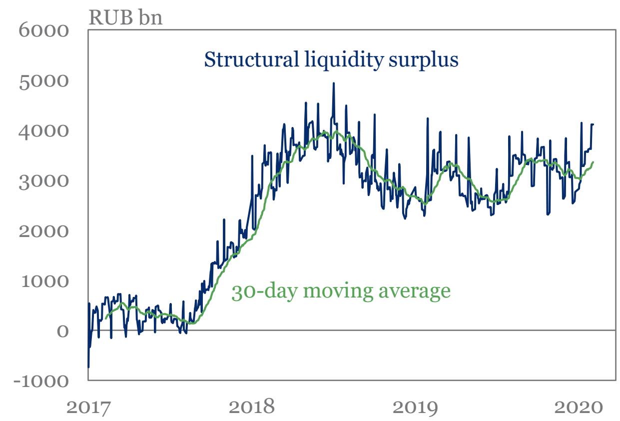
b. Low External Vulnerabilities

Compared to 2014, Russia is dramatically better positioned to absorb a shock to FX inflows. The free-floating Ruble functions as the first line of defense to balance-of-payments shocks, and the CBR has kept real rates elevated at the upper end of its own neutral rate estimate range of 2-3% in real terms (Exhibit 6). Furthermore, the inflation targeting regime is credible and ample reserves—around $540 bn—allow for FX liquidity support if needed (Exhibit 7).

Yet, we see such an intervention as highly unlikely. Fiscal rule FX purchases could be suspended as has been done in previous years. In the case of an extreme threat to financial stability, we could imagine further interventions or a reactivation of FX liquidity provision windows.

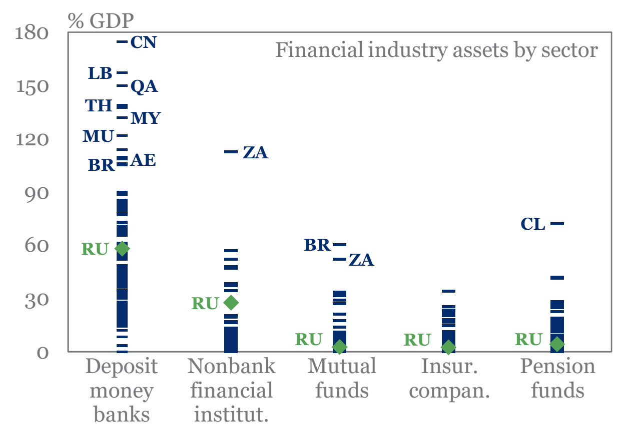
At the peak of the 2014 sanctions shock, the stock of FX repo instruments (Emergency Liquidity Facility) stood at about $40 bn. At the time, FX liquidity was needed to meet external repayments in excess of $250 bn. With total non-resident holdings of OFZs now at about $46 bn, FX liquidity needs would be significantly smaller and easily met from reserves.

Exhibit 4. Sufficient liquidity is available in the system.



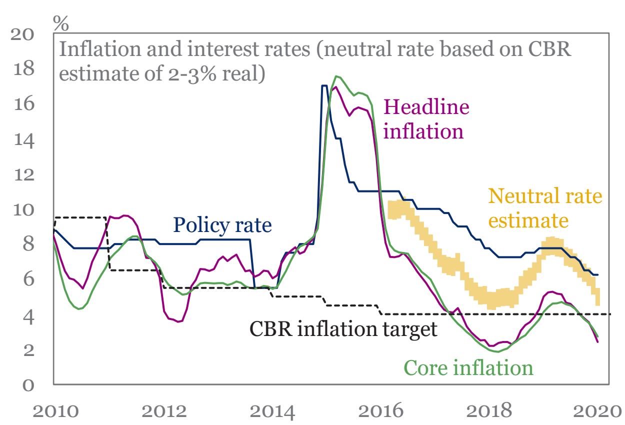
Source: Central Bank of Russia, IIF

Exhibit 5. Banks dominate Russia's financial system.



Source: IMF, World Bank, IIF

Exhibit 6. Monetary policy is broadly neutral.



Source: Central Bank of Russia, ROSSTAT, IIF

While the current account balance reached an all-time high in 2018 and is expected to come in above 5% of GDP in 2019, Russia may be forced to cut back on imports, in light of lower capital inflows and in the case of significantly lower oil prices.

c. Robust Balance Sheets

Russian banks' and corporates' balance sheets could likely absorb further loss of access to foreign funding. State-owned enterprises, in particular corporates, had levered up significantly in the aftermath of the Global Financial Crisis as recovering commodity prices drove their borrowing costs lower. Due to the insufficient size of the domestic financial system relative to large state-owned commodity exports, corporates had to rely on the U.S. and European supply of debt and equity funding, resulting in large external liabilities.

Following the imposition of sanctions in 2014, Russian banks and corporates were effectively cut off from these sources of funding and were forced to deleverage (Exhibit 8). For banks, external assets are now higher than liabilities, while for corporates they are similar in size. Russian companies have already begun exploring other regional capital markets and could be forced to accelerate such efforts if further sanctions were imposed.

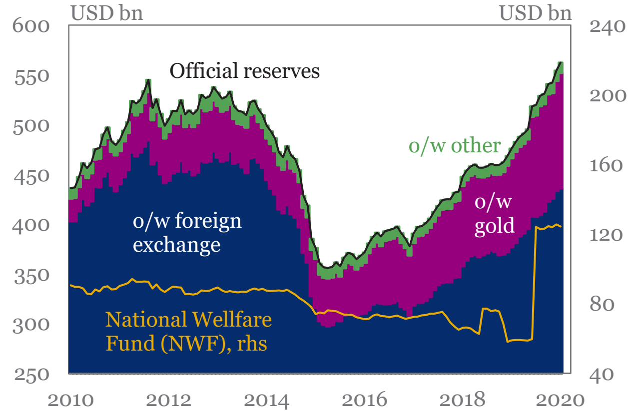
d. Potential Growth Impact

Immediately after the imposition of sanctions in 2014, Russian authorities began to focus on insulating the economy from external shocks. Contractionary monetary and fiscal policies, however, came at the cost of slower growth. High real rates were necessary to bring currency depreciation-driven inflation under control. Most importantly, these policies acted as an incentive for foreign investors to engage in the domestic sovereign debt market, thereby providing time for the needed fiscal adjustment.

By 2019, authorities felt that macroeconomic buffers such as fiscal space and reserves had reached largely adequate levels and announced a pivot towards growth-supportive policies. The government has allocated 3% of GDP per year over 2019-24, or a total of RUB25.7 tn (more than $400 bn), to so-called 'national projects'. Together with other cyclically supportive policies, they are likely to boost growth to just over 2% in coming years (Exhibit 9).

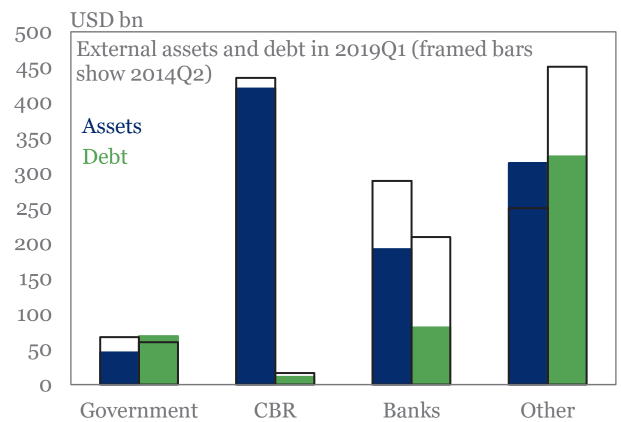
Sanctions on sovereign debt are unlikely to hinder spending on national projects since most of the spending will be budget neutral, financed by a redistribution of funds within the budget and the 2019 VAT increase. In the long run, however, budgetary restrictions as a result of higher cost of funding will impact fiscal policies, requiring either spending cuts or higher taxes. Furthermore, any sanctions could continue to weigh on confidence and productivity, and therefore reduce potential growth.

Exhibit 7. Large buffers exist in the form of reserves.



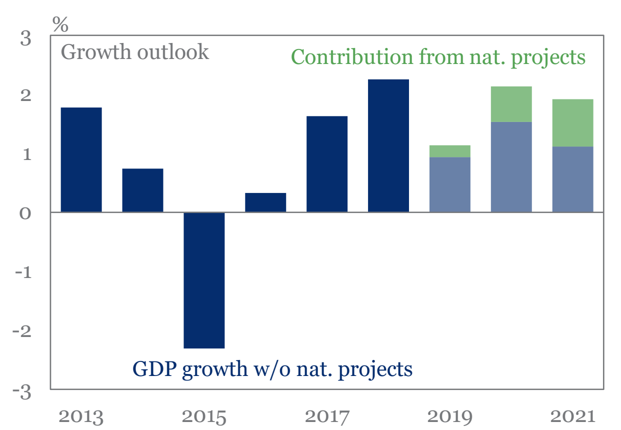
Source: Central Bank of Russia, Ministry of Finance, IIF

Exhibit 8. External liabilities have fallen sharply.



Source: Central Bank of Russia, IIF

Exhibit 9. Fiscal spending to boost growth.



Source: ROSSTAT, IIF

4. MARKET SPILLOVERS: UNCERTAINTY AND UNINTENDED CONSEQUENCES

Anticipating potential market spillovers of new sanctions on Russian sovereign debt is inherently difficult, as the range of "unknown unknowns" is vast. This is in part due to Russia's integration into the global financial system and its systemic importance.

Russia is fundamentally different from previous targets of comprehensive sanctions regimes—including Iran, North Korea, and Cuba—so these cases provide little guidance. Spillovers from sanctions may be felt well beyond the borders of Russia or the sanctioning country.

In certain cases, it may be possible to control for a wide range of unintended consequences in the sanctions design process. In the past, the U.S. has used waivers or extensions to address problematic spillover effects. However, the damage may ultimately be hard to reverse.

The complexity of the issue is exacerbated in the U.S. not only by conflicts between the executive and legislative branches of the federal government, but by the number of executive branch agencies responsible for sanctions, including the Departments of the Treasury (OFAC), State, Commerce, Homeland Security, and Justice. In many cases, the White House has also taken a strong interest.

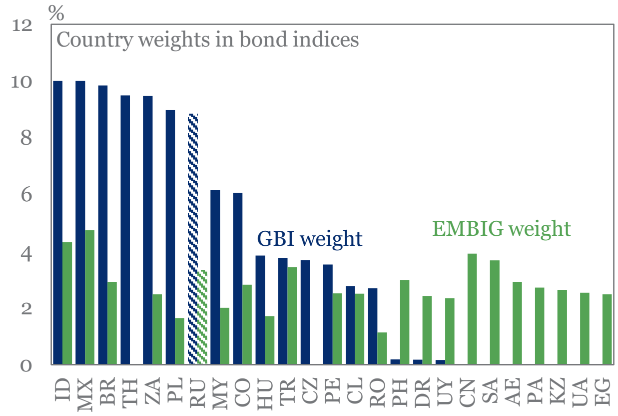
As mentioned above, the importance of Russian sovereign bonds within the global financial system complicates the anticipation of spillovers. Such securities are part of all key emerging market indices (Exhibit 10) and investors hold them for returns. Additionally, they underlie a range of derivative products and provide for a sovereign yield curve. The CBR, furthermore, relies on government bonds for monetary policy operations, while banks use them for liquidity management and to meet regulatory requirements.

Due to the complex nature of the issue, we will focus on a number of critical market segments: a) asset management, b) international banks, and c) market infrastructure. We find that asset managers and banks likely have the most to lose from sovereign debt sanctions. Impacts on market infrastructure cannot be ruled out, but spillovers are harder to foresee.

a. Asset Management Industry

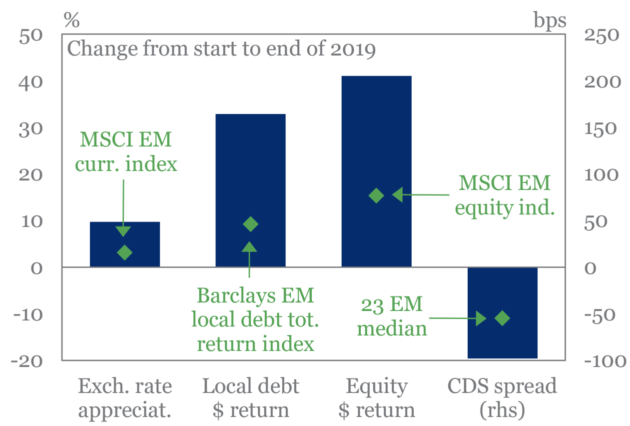
Russian markets outperformed across asset classes in 2019 (Exhibit 11). A combination of high real rates (Exhibit 12), a conservative central bank, and low financing needs (see Chapter 3) was particularly attractive for fixed income investors. As the risk of additional sanctions appeared to recede last year and new measures imposed by the U.S. in August 2019 were narrowly defined (see Chapter 2), Russian markets continued to attract sizable inflows, particularly into Ruble-denominated federal loan bonds, known as OFZ.

Exhibit 10. Russia plays a major role in bond indices.



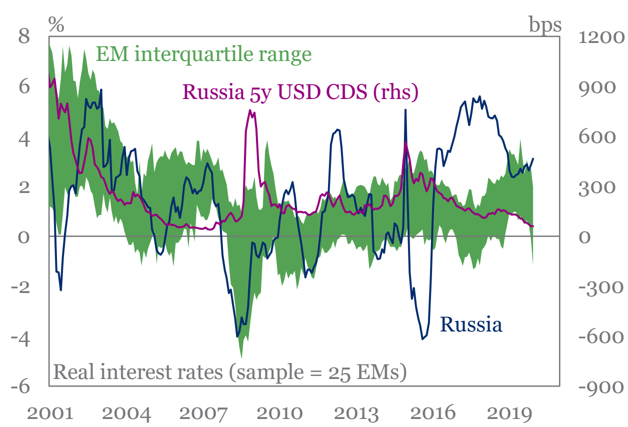
Source J.P. Morgan, IIF

Exhibit 11. Russian assets outperformed EM peers.



Source: Bloomberg, IIF

Exhibit 12. Real rates remain comparatively high.



Source: Bloomberg, national authorities, IIF

i. Foreign OFZ Market Participation

Foreign investor participation in the OFZ market currently lies at over 30% of total outstanding debt. Excluding less-liquid instruments, it is closer to 50%. The OFZ market attracted around $16 bn in non-resident flows in 2019 alone (Exhibit 13), and such inflows made up more than two-thirds of net OFZ issuance. To put this number into perspective, the total outstanding OFZ stock at this point is $142 bn.

OFZ ownership by country can only be determined for a portion of the stock held by non-residents—approximately 21% or $9.5 bn. More than half of these non-resident holdings are accounted for by U.S.-based investors, while roughly 40% are held by European companies. Asian investors and other North America-based institutions are responsible for only around 4% each (Exhibit 14). As a result, sanctions on Ruble-denominated sovereign debt would likely have a larger impact on U.S. investors compared to their international peers.

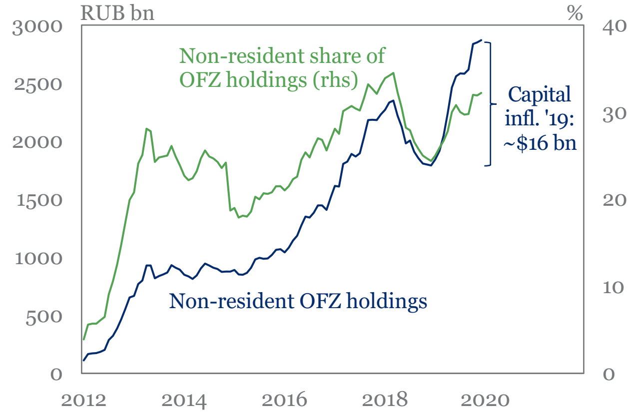
ii. Sanctions on the Primary Debt Market

U.S. sanctions on the primary market for such debt securities would mean that U.S.-based financial institutions would not be allowed to buy bonds directly from the Russian government. A precedent exists in the form of August 2019 sanctions imposed by the U.S. on Russian Eurobonds, as defined by the Department of the Treasury's Office of Foreign Asset Control (OFAC) as those solely applying to the primary market. This measure had a negligible immediate impact on the asset management industry. Most institutions, including those that are U.S.-based, remained invested in these Eurobonds (Exhibit 15).

The impact was also limited because Russia's reliance on foreign currency-denominated debt is very low. While slowly rising in recent years, outstanding Eurobonds only account for slightly above 2% of GDP (around $40 bn as of 2019Q3). Furthermore, sanctions may lead Russia to issue even less FX-denominated debt going forward. The scarcity effect likely muted any negative impact on Russian Eurobonds, while strong fundamentals and a supportive global environment certainly played a role as well.

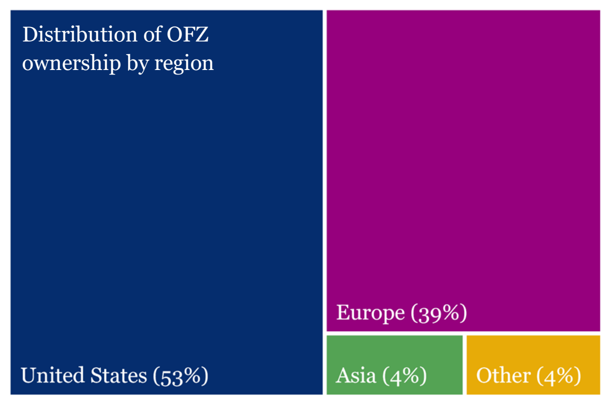
These sanctions imply that primary bond issuance could not be settled in Dollar, as this would require a final settlement involving a U.S.-based institution. Therefore, Eurobond restrictions put in place by the U.S. can be understood as a case of implicit secondary sanctions, where non-U.S. institutions are effectively barred from the primary market of Dollar-denominated Russian government bonds (for the effect of explicit secondary sanctions see chapter 5).

Exhibit 13. Foreign investors have reengaged in OFZ.



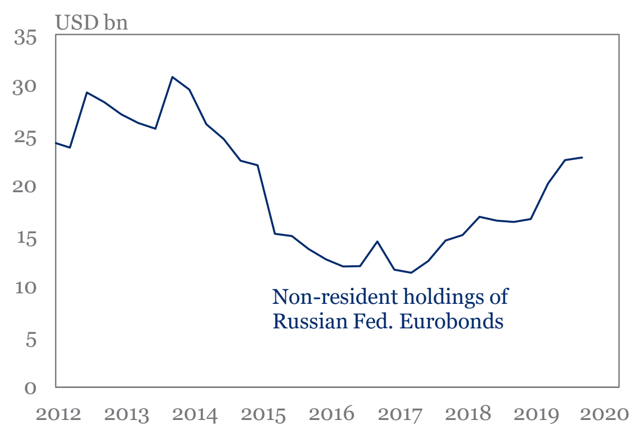
Source: Central Bank of Russia, IIF

Exhibit 14. U.S. investors hold large share of OFZ.



Source: Bloomberg, IIF

Exhibit 15. Sanctions did not affect Eurobond investments.



Source: Central Bank of Russia, IIF

However, various channels exist through which Russia could theoretically continue to issue Dollar-denominated Eurobonds. First, it is technically possible to issue a Dollar-denominated Eurobond with settlement occurring in a different currency. Recent Eurobond issuances indeed already include a "sanctions clause" that allows for settlement in other currencies. However, if the Russian government were to reopen the issuance of an earlier bond, this potentially may fall under primary market sanctions.

Russian Eurobonds remain in key emerging market indices, and global providers of financial market infrastructure services continue to provide settlement services for them. Russia's Ministry of Finance recently announced that it will continue issuing Eurobonds in non-Dollar currencies. While new issuance is therefore possible, we believe that U.S. asset managers would hesitate to trade such bonds right away. They would likely monitor a number of different factors before deciding to engage, including when and how the three large credit agencies rate the bond, if global banks are actively trading the securities, and how their peers approach the situation. As many institutions will probably not want to be the first to act, the secondary market for newly issued Russian Eurobonds could be affected even though sanctions only formally affect the primary market.

Nevertheless, the Eurobond precedent leads us to conclude that primary market sanctions on local debt would have a limited direct impact on asset managers. Even though OFZ primary market sanctions have been under discussion for quite some time, recent demand for OFZ has been so strong that primary auctions at times even traded at a discount to the secondary market—an extremely rare phenomenon.

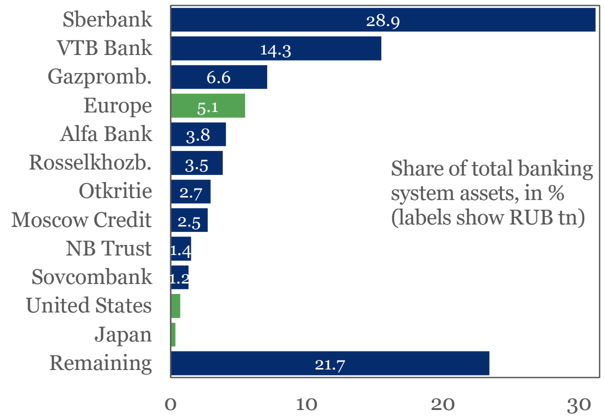
Primary market sanctions could have an impact, however, as they would signal the beginning of further escalation, and secondary market sanctions on Russian sovereign debt—either hard currency or Ruble-denominated—would represent the logical next step. Anticipation of further measures would change market participants' behavior even in the absence of formal measures.

iii. Sanctions on the Secondary Debt Market

In contrast to sanctions on the primary OFZ market, secondary market sanctions would likely have significant implications. Much depends on the comprehensiveness of such sanctions, which could range from forbidding U.S. financial institutions from trading in Russian domestic debt to, at the extreme, a requirement to divest their holdings during a pre-specified grace period.

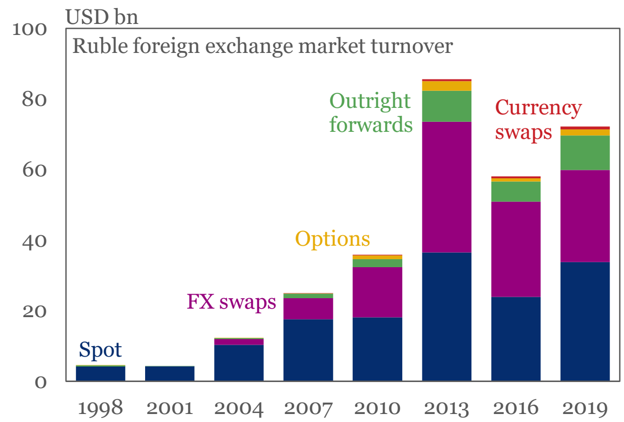
As we have seen in the case of Venezuela (Box 1), U.S. institutions would likely struggle to find an intermediary to facilitate their divestments, as the risk of running afoul of OFAC could prove too high for most intermediaries.

Exhibit 16. State-controlled banks dominate.



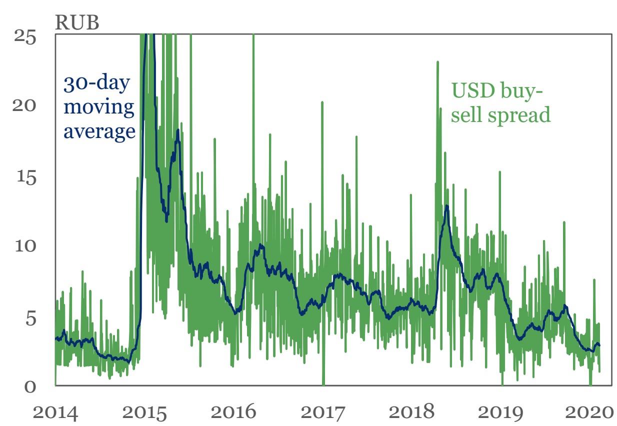
Source: banki.ru, IIF

Exhibit 17. The Ruble is actively traded.



Source: BIS, IIF

Exhibit 18. Ruble liquidity issues have subsided.



Source: Bloomberg, IIF

ussia and possibly substantially hurting the interests of heir clients, which include large pension funds and public ector retirement systems.

b. International Banks

ussia's financial sector is dominated by state-controlled anks. The share of foreign-owned banks is relatively small t 6.5% of total assets (Exhibit 16), with that of U.S. banks lmost negligible. Nonetheless, foreign institutions have raditionally been the key providers of banking services to lobal corporates and this relationship appears to have ntensified after the 2014 sanctions. The share of foreign anks in OFZ trading, for example, is more significant than hat of domestic banks.

he imposition of sanctions on the primary market of OFZs ould benefit domestic banks, including those that are tate-controlled. This is due to the fact that domestic nstitutions would strengthen their position as ntermediaries, acquiring OFZs from the sovereign and elling to foreign institutions on the secondary market. anctions beyond the primary market would likely increase heir position further, as they would be able to acquire overnment bonds at a discount.

n such a scenario, foreign institutions could be forced to xit the market, as operations without access to OFZ for iquidity management as well as regulatory compliance onsiderations—and no ability to hold correspondent ccounts with the CBR—would make a presence in Russia ntenable for most foreign banks.

o the extent that foreign corporates remain in Russia, they vould have to rely on domestic players for basic banking ervices. Administrative uncertainty is likely to arise as well egarding banks with foreign ownership and joint projects.

c. Market Infrastructure

Vhile we assume that the primary purpose of sovereign lebt sanctions is to limit access to funding for the Russian overeign, indirect effects including on monetary policy, anking supervision, and reserve management cannot be uled out. In this section, we highlight a number of possible nd important channels.

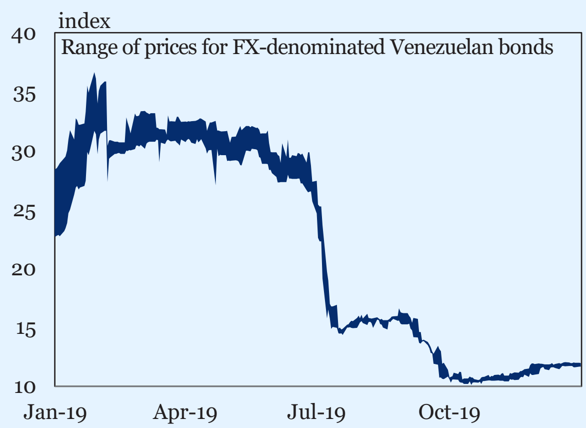
- The Ruble is among the most actively traded emerging market currencies according to [the BIS Triennial Survey] (Exhibit 17), with a significant volume of derivative products linked to it. The currency is traded on-shore as well as off-shore. Foreign institutions' subsidiaries are key providers of Ruble liquidity and foreign corporates rely on Ruble liquidity for their trade with Russia. In the past, liquidity has dried up during periods of market turbulence, including those related to sanctions (Exhibit 18).

  The imposition of sanctions on OFZs has the potential of rendering the Ruble market highly illiquid. This is a direct consequence of the fact that banks use such securities as a way of managing Ruble liquidity and to facilitate Ruble transactions efficiently and at low cost. OFZs are key for such liquidity management especially at longer maturities.

In January of 2019, the United States announced broad sanctions against Venezuela's state-owned oil company PDVSA, banning U.S. persons from buying any debt linked to the company. Shortly after, the Treasury Department's Office of Foreign Assets Control (OFAC) extended these restrictions to Venezuelan government bonds. While U.S. creditors are still able to hold debt securities, they can only sell them to foreigners.

The sanctions had an important impact on the market for Venezuelan sovereign bonds, bringing trading essentially to a halt. An announcement in July 2019 to wind down the inclusion of such debt from a key emerging markets benchmark index forced index-tracking investors to sell their positions at a heavily discounted price. Furthermore, finding an intermediary willing to facilitate a sale to a non-U.S. resident proved a challenge due to compliance concerns. Contagion to other markets was limited as bonds were already traded at near default prices.

The example of Venezuela has limitations due to the government's inability and, possibly, unwillingness to pay even before imposition of sanctions. However, it is important to study as the only precedent of secondary market sanctions on an actively traded market.



management primarily since the interbank market remains highly fragmented due to credit risk. Banks' credit lines on each other are low. Consequently, banks with liquidity surplus place excess Ruble liquidity in OFZs or in correspondent accounts with the CBR. If restrictions on the secondary market for OFZ were imposed, foreign subsidiaries would likely not be able to rely on the interbank market for liquidity management.

Furthermore, the OFZ curve is important for pricing of other Ruble instruments and indirectly impacts banks' ability to provide Rubles.

- Several derivative instruments are linked to Russia's sovereign debt. These include total return swaps and credit linked notes. Since foreign investors have gained direct access to the domestic market, these instruments have become less popular. However, financial institutions not under sanctions could use such derivative products to provide synthetic access to the OFZ market even to U.S.-based institutions.

- Russia is the second-largest holder of foreign reserves in EM after China and the Central Bank of Russia is an active market participant in countries of reserve holding currencies such as the Dollar, Euro, and Yuan. An unexpected market spillover issue arose in August 2019, when some U.S. institutions interpreted limitations on lending to Russia as a restriction on transactions with the CBR on the U.S. repo market.

- Additional sanctions could also have an impact on international payments systems. Russian authorities will most likely view sanctions on sovereign debt as a signal of a ratcheting-up of tensions. Authorities already believe that the development of domestic systems for uninterrupted processing of domestic bank card transactions is key to the sovereignty of the national payment industry. Without access to global bank messaging systems, Russian banks and corporates would not be able to transfer money across the country's borders. This would affect their ability to receive money for critical items like oil and gas sales or debt repayments. In 2014, the CBR began developing the Financial Communications System (SPFS).

  So far, Russian payments system alternatives have limited use outside of Russia. China began developing its own national payments system—the China National Advanced Payments System (CNAPS)—in 2015. Recently authorities announced that the SPFS and CNAPS have been linked, but it is not yet clear if the link is operational. Members of the Eurasian Economic Union (EAEU) and BRIC partners, as well as Turkey Russian-Chinese payments system.

  Similar to the national payments communication system, Russia, in 2014, launched a domestic alternative to U.S.-based card payment companies. The National Payment Card System Joint Stock Company (NSPK JSC) is the operator of the MIR National Payment System.

  New sanctions would likely accelerate the implementation of Russian-based systems and put global bank messaging systems and U.S.-based card payment companies at a disadvantage.

- The U.S. Dollar remains the dominant global currency and access to the Dollar is critical for institutions, in addition to access to the U.S.-based payment systems infrastructure. Foreign central banks, including the CBR, are major holders of U.S. Treasuries. Over 80% of foreign exchange transactions and nearly 50% of all debt securities are settled in Dollar. The Dollar also dominates clearing and settling of global wire transfers.

IMPACT ON INTERNATIONAL PLAYERS: BENEFICIARIES AND BYSTANDERS

a. Impact on Non-U.S. Institutions

. sanctions, even if limited to restrictions placed on U.S. sons and institutions, can have a major impact beyond r specific remit, including on U.S. allies such as the opean Union. In the case of Russia, this is quite iificant since—according to the most-recent data by ostat—Russia represents the fourth-largest destination U exports and the third-largest origin of EU imports as 018. Some member states like Finland, the Baltics, or garia are even more dependent on trade with Russia. l more generally, most EU member countries rely vily on energy imports from Russia.

ile the EU has also put Russia sanctions in place–recently nded until end-July 2020—it has not implemented any ie U.S.'s post-2014 measures. Sanctions regimes that lack rdination create uncertainty for EU companies and ks, impacting both existing and new business.

st Russian cross-border trade is financed via Russian e-owned banks due to their market share and the uliarities of the Russian financial market. Hence, ctions against Russian state-owned banks have an nediate impact on the trade-related credit portfolio of ks in exporting countries. Without appropriate guarding measures (like winding-down provisions) this ls to an increased risk of default for outstanding loans an increase in risk-weighted assets (RWA).

b. Sanctions Risk Management

ctions compliance is only one part of financial itutions' overall risk management efforts, but it is an ortant element of the compliance regime. As a result, -U.S. institutions may follow U.S. sanctions even in es where they are not directly applicable.

re are two important reasons for this. First, uncertainty exist with respect to the implementation of existing ctions legislation. This results from the fact that gressional actions frequently contain provisions which not automatically implemented but come into play, at es suddenly, at the discretion of the executive branch. s, they could hang over a non-U.S. institution's business sions. This also means that even in the case of sanctions ef, an institution's risk calculus may not change and, thus, r business practices may not resume. This was the case nany EU banks after Iran received sanctions relief as part ie *Joint Comprehensive Plan of Action (JCPOA)* in 2015. en banks and other corporates that rely on access to the . financial system approach such issues with extreme ion, opportunities may open up for other players.

BOX 2. SANCTIONS ON NORD STREAM 2

In December of 2019, as part of the National Defense Authorization Act (NDAA) for FY2020, the U.S. Congress imposed sanctions on Nord Stream 2, a natural gas pipeline connecting Russia and Germany which would double the capacity of the existing Nord Stream infrastructure. Furthermore, the legislation targets the Turkstream pipeline in the Black Sea. The United States had been highly critical of both projects, as they would allow for even more Russian natural gas to be exported directly to Western Europe while bypassing Ukraine's gas transit network.

Central elements of the previously considered *Protecting Europe's Energy Security Act* were incorporated into the NDAA. Most importantly, the new sanctions do not target Russian authorities or companies but rather the largely Western European construction consortia involved in the project. Specifically, the provisions focus on these companies' assets in the U.S. Thus, they can be considered an example of secondary sanctions.

The threat proved to be highly effective; companies stopped construction activities almost instantaneously. As a result, the completion of Nord Stream 2, originally anticipated for early 2020, could be delayed quite substantially, as similar expertise is not easily available. Not surprisingly, the measures were not well received by U.S. allies in Europe, namely Germany.

c. The Extreme Case: Secondary Sanctions

In the absence of multilateral sanctions and despite compliance by many non-U.S. institutions, U.S. firms might still be disadvantaged. Could secondary sanctions mitigate these negative effects? Secondary sanctions exert pressure on non-U.S. institutions to stop engaging in specific activities with specific U.S.-sanctioned entities, using their need for access to the U.S. financial system as leverage. In the case of U.S. sanctions on Iran, as well as those recently imposed on Nord Stream 2 (see Box 2), this threat has proven to be highly effective. At the same time, the argument has been made that the threat of secondary sanctions extends the U.S.'s jurisdiction beyond its borders and could therefore be considered coercive in nature.

CONCLUSION

x years after the U.S. and EU imposed sanctions on the ıssian Federation in the aftermath of the annexation of :imea and the outbreak of conflict in Eastern Ukraine, new ınctions measures are being discussed in Congress. New easures would likely focus on Russian domestic loan ›nds—known as OFZs. These securities have performed :tremely well in recent years and are highly integrated into obal markets. Thus, restrictions on OFZs may lead to ıintended and unpredictable consequences that could :tend beyond the Russian financial system.

ıe Russian economy is in a dramatically stronger position ›w than it was in 2014 to weather the impacts of sanctions. lditional sanctions on Russia's sovereign debt may timately prove less effective today than in previous ›isodes, given the shifts in the country's macroeconomic cture over the past few years.

ıportantly, we also examined implications for financial arkets in such a scenario. Asset managers and ternational banks are likely to fare worst, but outcomes eatly depend on the specifics of new sanctions; strictions on the secondary OFZ market would likely have e most significant effect. Inadvertently, new sovereign :bt sanctions would likely benefit Russian financial stitutions, including those that are state-owned.

ınctions occupy a unique space in the foreign policy olkit, in that they represent a type of market intervention ;ing coercion to change a target's behavior, as opposed to e riskier and costlier alternative of military action. In a ries of upcoming publications, we will analyze other rms of non-market mechanisms used to achieve :onomic, foreign policy, and national security objectives.

APPENDIX 1. REFERENCES

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APPENDIX 2. LEGISLATIVE TEXTS

Countering American Adversaries Through Sanctions Act (CAATSA)

Defending American Security from Kremlin Aggression Act of 2019 (DASKA)

National Defense Authorization Act of 2020 (NDAA), as passed by the U.S. House of Representatives

Defending Elections from Threats by Establishing Redlines Act of 2019 (DETER)

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