How *Russia* Survived Sanctions

By Vidhya Logendran

And why parallel avenues for diplomatic engagement are vital.

The United States and the European Union have renewed, until 2016, wide-ranging sanctions imposed on Russia following its annexation of Crimea in 2014 and subsequent support for separatists in Eastern Ukraine. As a tool of economic statecraft, sanctions seek to coerce states to alter their political and economic behavior. In this case, the objective is to force Russia to abandon support for Ukrainian separatists. To this end, the financial sanctions seek to inflict pain on Russian banks by severely curtailing their access to international financial markets. Yet, as of mid-2015, Russian banks seem to have weathered the sanctions reasonably well despite the free-fall of the ruble at the end of 2014 and plunging oil prices. What are the reasons behind the relatively tepid short-term impact of the sanctions on the Russian banking system? What implication does this have for the effectiveness of sanctions as a tool for evincing a more conciliatory foreign policy from Russian President Vladimir Putin?

Russia had an imposing external debt burden of US$729 billion at the end of 2013, 90 percent of which was due from banks and corporates. As a result of the sanctions, cross-border lending to Russia shrank by 21 percent (US$48 billion) in 2014. International credit dried up through 2014, with syndicated loans and debt capital market issuances falling by 80 percent and 92 percent respectively. Unable to refinance existing debt, Russian firms were forced to repay their debts on schedule, resulting in an 18 percent reduction of external debt to US$599 billion at the end of

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THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
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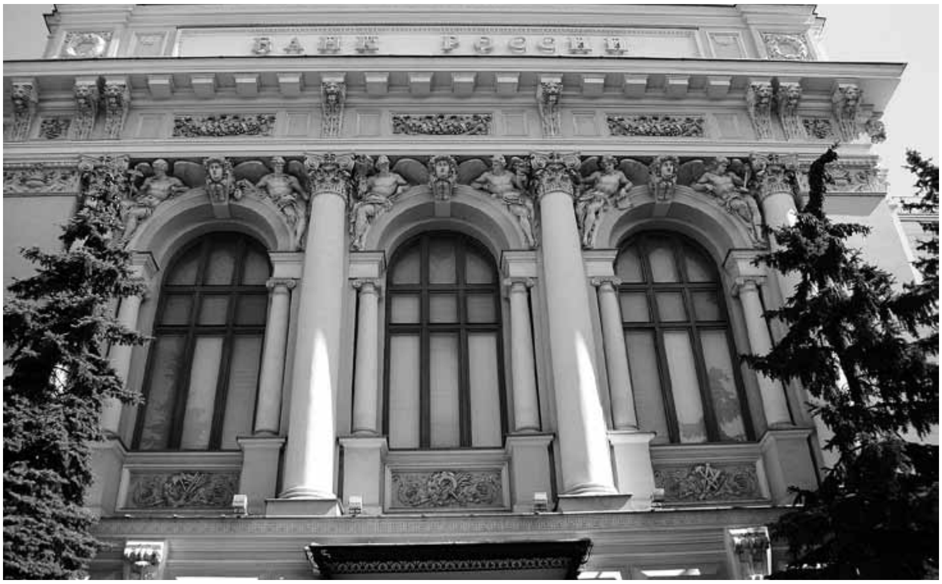
The Central Bank of Russia's [right] policies have helped the banks weather the negative impact of the triple whammy of sanctions, plunging oil prices, and ruble depreciation on the Russian economy.



2014. Capital flight intensified; private net capital outflows nearly tripled in 2014 to US$154.1 billion, representing 4 percent of GDP. Consequently, state coffers were raided to defend the ruble which plunged 45 percent against the U.S. dollar at its nadir. Plummeting oil prices threatened Russia's export earnings, 54 percent of which were from oil exports. Under such circumstances, an acute liquidity crisis crippling a weak banking system has been widely expected. Why has no such crisis materialized?

First, closer scrutiny reveals that while a substantial amount of debt has been repaid, not all of the steep reduction of US$130 billion is attributable to debt repayment. About a fifth of Russian foreign debt is ruble-denominated, in the form of Eurobonds and loans from offshore related companies. There was a nominal reduction in the foreign currency value of this debt due to the depreciation of the ruble, accounting for up to 60 percent of the reduction in external debt for 2014, according to some estimates. Crossholdings within corporate groups, typically loans from foreign-registered parent companies or subsidiaries to their Russian counterparts, account for 30 percent to 50 percent of foreign corporate debt. This debt can be easily rescheduled. In fact, Central Bank of Russia statistics

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showed that external debt had remained steady at US$556 billion for the first two quarters of 2015, after the steep decline in 2014. Russian banks and corporates have also accumulated significant liquid assets abroad which they were able to tap to repay debts as they became due. As of March 2015 (latest available figures), Russian banks and corporates had US$146 billion in short-term deposits abroad, sufficient to meet 2015 repayment obligations. The foregoing analysis suggests that the "hard" external burden was not imposing enough to cause lethal damage to liquidity in the banking system in the past year.

Russia's notoriously fragmented banking system of over eight hundred banks could have nevertheless posed a serious risk to the system, had they individually run into liquidity problems. The decisive steps taken by the Central Bank of Russia to avert potential problems are the second reason why the system has not folded as predicted. Russia's impressive foreign exchange reserves of over US$500 billion provided the Central Bank of Russia with strong ammunition to launch an aggressive defense. In August 2014, the government announced that it would acquire shares in VTB and Rosselkhozbank in exchange for outstanding debt of US$6.6 billion owed to the National Welfare Fund, one of the country's sovereign wealth funds. The move was intended to strengthen the two banks' tier-one capital. In December 2014, the Central Bank of Russia bailed out National Trust Bank, a mid-sized lender, to prevent bankruptcy. Simultaneously, the Duma passed a bill to provide US$16.5 billion to recapitalize the banking system. Additionally, the Central Bank of Russia relaxed some macro-prudential regulations, suspended mark-to-market accounting to assess banks' capital adequacy, and allowed banks to use the third-quarter 2014 exchange rate for reporting purposes. These measures have provided the banking system with temporary relief and prevented a crisis of confidence causing the system to implode due to the sanctions.

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whammy of sanctions, plunging oil prices, and ruble depreciation on the Russian economy. Various estimates have projected a GDP contraction of between 2.5 percent and 4.5 percent in 2015. The banking system has been affected by contraction in loan and deposit growth as well as deterioration of asset quality. After plunging into negative territory, the Central Bank of Russia reported that the deposit growth rate had finally climbed into the black in the first quarter of 2015, creeping up to a sclerotic 1.7 percent in March 2015. However, the sector's assets declined by 4.9 percent for the same period. High interest rates imposed to curb inflationary pressures have taken a toll on asset quality. Non-performing loans have increased, especially for retail loans which are predicted to rise to 8 percent by the end of this year. Profitability of the banking sector declined in 2014 and early 2015 as banks had to create huge loan impairment provisions, which had grown by 42 percent in 2014. But the financing provided by the Central Bank of Russia and the Ministry of Finance enabled banks to report a profit of RUB42 billion (US$7.4 billion at current rates) in March 2015 for the first time since November 2014. Michael Khromov of the Gaidar Institute notes that the profit for March 2015 was so large that a small quarterly profit was eked out for the first quarter of 2015 despite losses in the preceding two months.

Finally, Russia was also in a stronger position compared to 2008–2009 due to the strengthening of the financial system by institutions such as the Deposit Insurance Scheme created in 2008. Early media headlines prematurely proclaimed a disorderly collapse of about a fifth of Russia's fragmented banking system in 2015, but no such collapse has occurred. Consolidation of the banking sector had been underway before 2014, with about 100 licenses cancelled between July 2013 and April 2015. Enabling orderly bankruptcies is another means of further consolidating the sector, and the Central Bank of Russia has not shied from letting smaller banks collapse even in the current environment. Transportny bank, a medium-sized bank that collapsed in May 2015, is a case in point. A record US$800 million was paid out by the Deposit Insurance Agency to depositors of the bank. The IMF in its concluding statement of the 2015 Article IV consultation mission expressed confidence in the Central Bank of Russia, stating that "the authorities' use of regulatory forbearance and public support has been successful in stabilizing the banking system. The forbearance strategy was appropriately combined with intensified supervision."

Nevertheless, structural inadequacies continue to plague both the Russian economy, which relies too heavily on oil and gas exports, and the banking sector, which depends too heavily on the central bank for support. Softening of oil prices will threaten Russia's depleted reserves, on the strength of which much of the central bank's support is predicated. The Central Bank of Russia has embarked on a program to beef up reserves by regularly buying foreign currencies and gold since May 2015. Lack of investment in the longer horizon is likely to damage medium- to long-term growth prospects, especially as Western technology transfer has been hampered due to the sanctions. It will also impede Russia's ability to diversify its economy away from natural resource dependence. However, a financial crisis does not seem imminent in the short term.

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We must then ponder the effectiveness of financial sanctions as a tool to coerce Russia into ending its offensive in Eastern Ukraine. The slow burn of economic sanctions' debilitating effects on the Russian economy might not be very effective in meeting this rather immediate objective of ending hostilities on its western front. Perhaps the way forward should be to create parallel avenues for diplomatic engagement to address political, economic, and security dimensions that might have precipitated Russia's belligerent stance. As a Bertelsmann Foundation report states, only "by developing a strategy that combines assertiveness with engagement, can the West more effectively engage Russia in the months and years ahead." Already, sanctions have raised the specter of an increasingly isolated and nationalistic Russia seeking to forge alternative alliances. It has turned to China and Saudi Arabia for alternative sources of financing, and to the fellow BRICS nations for increased trade and investment activity. Clearly, the ability to show such defiance in the face of economic sanctions may further fan Russia's aggressive stance rather than curb it. ◆

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