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EU Sanctions to Squeeze Russian Banks, Consumers

By Alexander Panin

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Market leader Sberbank is on Russia's list of top 10 biggest banks by asset volume.

The European Union's reported agreement on Tuesday to impose broad economic sanctions on Russia for its uncompromising position on Ukraine threatens to stop off the trickle of affordable capital from abroad that the Russian economy desperately needs to thrive.

The long anticipated "Phase 3" sanctions will cut off state-owned Russian banks' access to European capital markets while also striking the defense sector and sensitive technology, Reuters reported Tuesday evening, citing unidentified EU diplomats. Russia's gas industry, on which Europe is highly dependent, has reportedly been spared.

The EU had hesitated for months to take harsher measures against Russia, a major trading partner, but was finally compelled to action by the downing of Malaysia Airlines Flight MH17 earlier this month over an area of eastern Ukraine controlled by pro-Russian separatists.

Of the agreed measures, a ban on Europeans buying new bonds or shares issued by banks owned 50 percent or more by the Russian government could strike the hardest blow to Russia's economy.

Russia’s four largest state-owned banks — market leader Sberbank, Gazprombank, VTB and Rosselkhozbank — are all on Russia’s list of top 10 biggest banks by asset volume.

A ban on selling bonds to Europe would mean that these cornerstones of the Russian economy will be deprived of long-term financing and find it much harder to pay off their existing debts, which are substantial.

At the end of the first quarter, state companies' loans from abroad accounted for 43 percent of the $716 billion external debt accumulated by Russia's economy, according to a report on economic performance and the financial markets released Tuesday by the Higher School of Economics' Center for Development.

In the absence of European capital, state companies will have to fork out $43 billion to pay off their debt by the end of this year and drum up another $48 billion in 2015, according to the report. State-owned banks are on the hook for about half of these massive sums.

A cut-off of state-owned banks' market financing abroad would result in higher borrowing costs inside the country, hitting both consumers and Russian companies, according to Fredrik Erixon, director of the European Center for International Political Economy, a Brussels-based policy think tank.

"If sanctions are applied, this does not mean these banks will face bankruptcy. They may still find short-term financing," Erixon said. "But the capital costs for these banks will grow and they will be quite large, and the consequences will be taken straight away to their customers."

Financing has never come cheap in the Russian economy, and interest rates have risen steadily throughout this year as the Central Bank steadily hikes its key interest rate in an effort to quell burgeoning inflation. The regulator has raised interest rates a total of three times in 2014, with the last 50 percentage point increase on Friday bringing the key rate to 8 percent.

For individuals, lending rates start on average at 14 percent and can go as high as 22 percent and above.

Lending rates were in fact on the rise even before sanctions, which, combined with widespread uncertainty among investors over the Ukraine crisis, have only added to the general macroeconomic slump, other economists said.

"The rates have been growing and their driver is the increase of the key rate by the Central Bank," said Yelena Fedotkova, a debt market analyst at PSB Research. "The situation in Ukraine and the sanctions have had a further effect, adding to the uncertainty for investors and making everyone suffer."

In the case of a full external financial blockade, the government would have to hand over at least $40 billion worth of support to state banks in the next two years and up to $90 billion if the sanctions were to hit state companies in general, the Center for Development's report said.

"This would put a serious burden on Russia's reserves, adding to the $50 billion in liabilities recently awarded to Yukos shareholders by The Hague arbitration court," economists Valery Mironov and Alexei Nemchik wrote in the report. The shareholders in defunct Russian oil giant Yukos on Monday finally won their case against the Russian government, which was found guilty of purposefully bankrupting Yukos in order to appropriate its assets.

As financing dries up, some state-owned banks have already begun to look for funding elsewhere than the West.

Gazprombank, which issued a 1 billion euro ($1.34 billion), five-year bond at the beginning of July that was bought mostly by European institutional investors, last week held a two-day road show with debt investors in South Korea, Reuters reported Tuesday.

The bank said the meeting was held to develop its investor base in the Asia-Pacific amid growing ties with the region. Gazprombank is already facing U.S. sanctions which bar the company from purchasing dollar debt with a maturation period of longer than 90 days.

While banks can be expected to seek alternative financing, Erixon doubts that Asia can offer a substitute to the West's highly developed capital markets.

"Elsewhere, the markets are not very liquid. They are subjected to much greater volatility, and the sophistication of instruments you can use to raise funding on Western capital markets is much higher," he said.

Meanwhile, the latest statistics on Russia's economic performance do not give grounds for optimism.

Industrial production was down 0.4 percent in June while manufacturing decreased by 0.7 percent, mostly due to a slowdown in the food, petroleum and metallurgy sectors.

Car sales plummeted another 4.1 percent, adding up to an alarming 17 percent decrease since the beginning of the year, and are expected to fall even further.

Consumer demand fell 0.3 percent in June and consumers were reluctant to take out loans, as visible through a slight decrease in their total debt load, which had been growing steadily since the economic crisis of 2009.

See also:

Investors Rush to Sell Russian Corporate Bonds Before EU Sanctions

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