

Even the Specter of Sanctions Is Hurting Russia (Op-ed)

Sometimes just the promise of sanctions is as damaging as the real thing.

By [Ben Aris](#)

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Maxim Shemetov / Reuters

Russia is now at war with America, according to Russian Prime Minister Dmitry Medvedev — well, an economic war.

This month Washington has introduced a bill with a set of extremely damaging sanctions: if passed the Defending American Security Against Kremlin Aggression Act (DASKAA), introduced by Senators Lindsay Graham and John McCain, among others, could effectively cut Russia off from Western capital markets.

Even if the bill is watered down — as is widely expected — it will do, and has already done, a

lot of damage to Russia's financial standing. Just the threat of the bill has probably already resulted in the Central Bank of Russia (CBR) postponing any more interest rate cuts this year and the Ministry of Finance and Economics have already downgraded their forecasts for growth this year as a result: the Ministry of Economy cut its GDP forecast to 2 percent and increased its inflation forecast to 3.4 percent from 3.1 percent on Aug. 22.

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The ruble has fallen to a level not seen for two years and that is what is causing the higher inflation at a time when real wage growth has slowed to next to nothing. Even if Medvedev's war is metaphorical it is a metaphor with tangible pain for the people and businesses of Russia.

The real damage from the bill is not in the terms themselves but the escalation they represent. The first sanctions imposed after Russia's annexation of Crimea in 2014 were largely symbolic: a list of visa bans for a few politicians and generals directly involved in the Crimea annexation. The DASKAA sanctions take things to a whole new level.

The draft would bar U.S. citizens from trading Russian sovereign debt, both the dollar denominated Eurobonds and the ruble denominated domestic treasury bonds (OFZs). It also carries provisions that forbid working with seven state-owned banks (and in keeping with the slapdash nature of Trump White House missives, it names Vnesheconombank twice) as well as banning currency swaps, among other measures. Oddly, the bill doesn't ban trading in sub-sovereign bonds like those of Gazprom and Rosneft, but even this would become harder if the bill goes through.

One of the reasons analysts think the bill will be watered down is because Russia's bonds are so widely held in the West. The pain they inflict on Russia will boomerang back and hurt Western banks and funds as badly as Russia — as Washington found out with the Countering America's Adversaries Through Sanctions Act (CAATSA) sanctions that targeted metals company Rusal in April that caused chaos on the metal markets.

One Western investment banker told me in the days after the April sanctions were announced that his compliance department was calling him to ask why he still had millions of dollars of Rusal bonds on his book. "Don't you know it's illegal to own them in three weeks time?" they told him, the investor said. "To which I answered: Well you try and sell them. Don't you know it's illegal to own them in three weeks time?" The U.S. Treasury Department (USTD) quickly relented and has delayed the deadline, but the basic problem remains: the bond holders can expect to get only pennies on the dollar for these bonds now. DASKAA takes this problem to a whole new level and could make Russia's entire country's stocks and bonds toxic.

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A ban on trading or owning OFZs, which are Finance Ministry's workhorse funding instrument for the budget, could cause serious problems. Putin's new May Decrees call for 8 trillion rubles of additional spending extravaganzas over the next six years to transform the

economy. To raise this cash, in addition to hiking VAT to 20 percent and squeezing the state-owned enterprises for more dividends, the Finance Ministry plans to more than double its OFZ issues next year to a whopping 2.5 trillion rubles — and a lot of that money is supposed to come from international investors.

Russia transformed its capital markets in 2012, hooking them up to the international clearing and settlement systems of Clearstream and Euroclear that allow investors in London or New York to buy bonds directly from the Moscow Exchange. The high-yielding Russian domestic bonds have been an investor's favorite until this year. Foreign ownership of OFZ peaked at the start of this year at 34 percent of the outstanding bonds, or around \$20 billion. However, as political tensions rose, foreign ownership of OFZ has already fallen and is currently around 27 percent. If DAKSAA is passed, foreign holding of OFZ will have to go to zero leaving the Finance Ministry with a large hole in its funding plans it will struggle to fill.

However, even if the DAKSAA bill is watered down, a lot of damage has already been done. The original 2014 sanctions may have been symbolic, but Russian assets still sold off heavily as compliance was not sure who would be put on the list next. As time passed and there were no new sanctions, compliance relaxed again, but this year there have been four sanctions events – January's DETER sanctions bill, February's "Kremlin report," April's CAATSA round and DAKSAA.

Even if the latest sanctions are stripped of their sharpest teeth, it seems likely the next round will be tougher still. It's compliance's job to contain a bank or fund's exposure to risk and now all Russian assets look risky. Even if Russia holds its own in this autumn's battle of words over sanctions, the war will probably continue to escalate and Russia is not famous for backing down when facing a fight.

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