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Playing the Long Game: The United States Targets Russia's Sovereign Debt

Financial sanctions that limit Russia's borrowing are ineffective as the country has three surpluses and doesn't need credit lines.

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The United States is close to sanctioning U.S. sovereign debt. **Wikicommons / Pixabay**

The United States is close to banning U.S. nationals from buying or dealing in Russian sovereign debt. An amendment to that effect is included in the U.S. draft defense budget for 2020, which has already been passed by the House of Representatives, the lower chamber of the U.S. Congress.

The proposed measures have attracted a lot of attention, but when evaluating their future effectiveness, it must be remembered that the harsher the political regime against which sanctions are being introduced, the more impact short-term rather than long-term consequences will have on it. The Russian regime's willingness to ignore the long-term

effects of sanctions can be explained by the fact that they are not strongly felt. Tactical considerations take precedence over strategic ones.

U.S. sanctions on Russian sovereign debt will not have an immediate effect either: they are strategic measures whose impact will only be felt much later. For now, the lack of an immediate effect from the measures will likely be presented as yet another victory for Russia. Yet, as the Prussian general Carl von Clausewitz said, strategic errors can't be compensated for with tactical successes.

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All the previous sanctions can be divided into three groups: personal, financial, and sanctions against the companies of specific businessmen. Of those, only sanctions against the companies of two major businessmen, Viktor Vekselberg and Oleg Deripaska, had an impact that was noticed and felt at a national economy-wide level.

The companies of these tycoons sustained significant damage, and the businessmen were forced to change the ownership structure and management system of their companies. In some regions, work was disrupted at their enterprises, seriously increasing social tension.

A bigger effect, though hard to measure, stems from the fact that nearly all major Russian businesspeople thought about what would happen if they came under similar sanctions. It's likely, therefore, that the growth in capital outflow from Russia was no coincidence.

Personal sanctions turned out not to be very effective: a significant proportion of those who found themselves named on the sanctions list were unable to travel abroad anyway due to official restrictions related to their work.

Financial sanctions that limit Russia's borrowing are for now ineffective, as Russia currently has three surpluses: in the federal budget, balance of trade, and current account.

In these conditions, no restrictive measures on lending will have an effect: the Russian state and most Russian business (at least the kind of business that could in theory raise investment abroad) simply don't need major credit lines.

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The low rate of economic growth that the Russian economy has seen in recent years doesn't require foreign capital. For at least as long as the price of oil remains significantly higher than the minimum $40 set out in the budget, the Russian economy's existing financial resources will be more than enough.

Furthermore, the long-term fall in interest rates in Russian banks is clear confirmation that there is plenty of money in the country. The difficulty lies mainly in the lack of suitable projects in which to invest. It is this, and not a lack of capital, nor interest rates, that restricts lending by Russian banks.

When running a budget surplus, the Russian state doesn't particularly need to increase its sovereign debt. At present, Russia's international reserves not only exceed sovereign debt (which is quite small); they also exceed all external debt, both state and private put together. For now, those reserves are growing steadily.

Potential turbulence

When U.S. sanctions against Russian sovereign debt are officially announced, the Russian market will naturally react, perhaps even with some turbulence. But this will be a purely speculative reaction, characteristic of a currency market. As soon as the market starts to perceive that this decision by the United States will not have any serious immediate consequences, it will return to its previous levels.

Such a market reaction is quite predictable, so the Russian monetary authorities—primarily the central bank—will likely take certain precautionary measures, since they are always eager to avoid a panic. Limiting regular currency purchases in order to top up international reserves will probably be enough to dispel the concerns of market players.

The sanctions will only become truly effective when there is a deficit in the Russian federal budget. That is when the impossibility of raising such essential funding by increasing sovereign debt will be seen as a critical problem. But so long as the price of oil is well over $40 a barrel, and there are no limitations on buying Russian oil, any federal budget deficit is a long, long way off. And so, accordingly, is any meaningful effect from the sanctions.

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It's worth noting that the Russian leadership pays extremely close attention to the prospect of a budget deficit: such close attention that it sometimes seems excessive. Yet if we recall the relatively recent events of 1998, the reasons for that become clear.

A federal budget deficit is fundamentally a state's inability to fulfill its obligations. The most sensitive of those are pensions and the salaries of public servants and security service officials, followed by the inability to pay for state orders. It was the budget deficit that was the real cause of the 1998 default: the infamous pyramid of GKO government bonds (used to try to make up the budget deficit) simply played the role of a technical trigger.

The consequence of the default was a change in the country's leadership. This lesson is so stark that allowing a budget deficit is now considered the final sacrifice, after all other options have been exhausted. Inflation, devaluation of the ruble, cuts to the state sector, embarking on highly unpopular reform of the pensions system: anything may be tried rather than allowing the budget deficit to drift out of the safety zone of 3 percent of GDP.

This logic, combined with the Russian financial system's firm resilience to sanctions (and, more broadly, to external shocks), makes the heads of the central bank and Finance Ministry in many ways indispensable. They are absolutely vital to the sustained balancing of the budget and accumulation of international reserves.

Strange combination

These last two priorities explain the strange combination in Russian policy in which populist, patriotic rhetoric cohabits side by side with strict, Milton Friedman-style monetarism. Only the strictest monetarism (in which the focus is on keeping the money supply stable) guarantees there will be no budget deficit amid large fluctuations in natural resources rents. The successful traversing of the crises of 2008 and particularly of 2015 are the best advertisement for monetarism in the eyes of the Russian leadership.

But the monetary authorities don't have unlimited abilities. If revenues from exports stop being enough to sustain the basic standard of living of public sector workers and pensioners (the state accounts for about 70 percent of Russia's economy), then sanctions on Russian sovereign debt will start to make themselves felt. The impossibility of covering the budget deficit by increasing sovereign debt will reconstruct a situation very similar to the last stage of the Soviet Union, and big changes will then become possible.

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