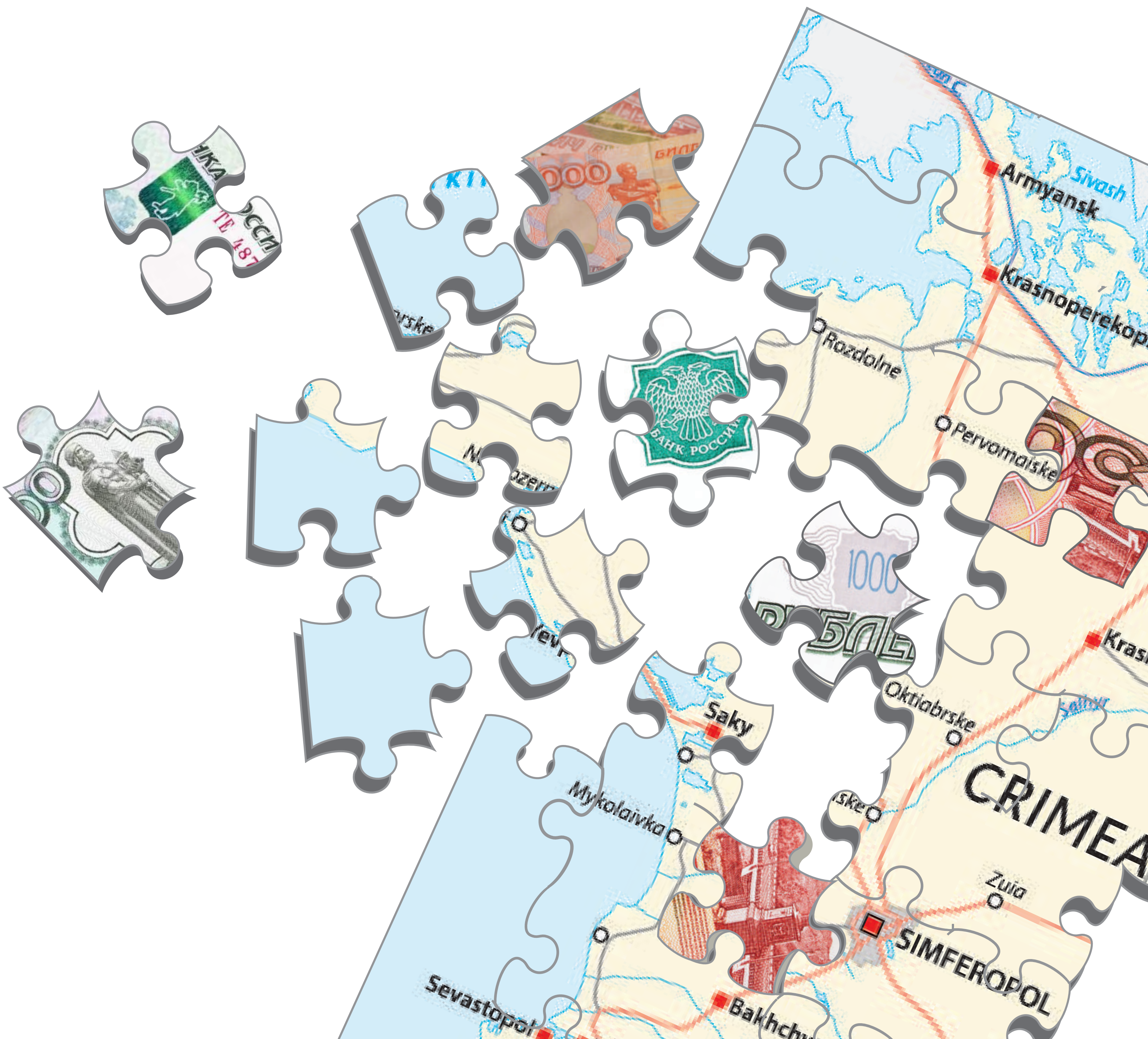
FOREIGN POLICY RESEARCH INSTITUTE | RUSSIA POLITICAL ECONOMY PROJECT

Geopolitics, Sanctions, and Russian Sovereign Debt Since the Annexation of Crimea

Maximilian Hess



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Executive Summary

Maximilian Hess

This report illustrates how the Russian Federation's foreign currency bonds have become an arena for interstate competition in the aftermath of Russia's 2014 annexation of Crimea. Sanctions, both real and threatened, on Russia's government, state-owned enterprises, and other major enterprises have induced Russia's government to adjust borrowing practices, currency management, and reserves allocation. Russia's Eurobonds, the primary instrument through which the Russian state borrows in foreign currency, have been altered to allow repayment in various currencies, including—in some cases—the ruble. The potential impact of proposed bans on Russian sovereign debt issuance are analyzed because these developments show that foreign investors face novel risks in investing in Russian debt and that further Russian debt sanctions may have major geopolitical repercussions.

Russia's Use of Sovereign Debt

In February 2019, President Vladimir Putin declared that the Russian Federation's reserves fully cover its external debts for the first time in history. This development was evidence, he declared, that who criticized the Kremlin's economic management can be dismissed.[1] Five years prior, its $486 billion in reserves[2] amounted to just amounted to just 69% of its $716 billion in external debt.[3] Putin, however, did not say that Russia's external debt (figure 1) had declined even further than the $140 billion decrease in Russia's international reserves and sovereign wealth funds had over the previous five years (figure 2). Rather than evidence of strong economic management, Russia's retreat from global debt markets was primarily a response to geopolitical competition, rather than evidence of strong economic management. The West began to introduce debt financing sanctions after Russia annexed Crimea in 2014 while Russia has responded by adjusting its debt issuance, reserve allocation, and currency management strategies. Russian reserves now cover its external obligations because its sovereign debt market has become a contested and politicized space.

Russia has issued sovereign debt abroad since the 18th century. Its debentures were one of the world's most widely traded securities before the Russian Revolution broke out in 1917. The Soviet Union's repudiation of Russian imperial debt was, by some measures, the largest sovereign default of all time.[4] More than 1.6 million people lost their investments in France alone, where Russian sovereign debt made up some 4.5% of the country's national wealth.[5] After the Bolshevik default froze Moscow out of foreign debt markets, the Soviet Union established its own financing networks, raising fears similar to those surrounding China's "One Belt One Road" program today.[6] A key feature of Russia's entry into the Western-led post-Cold War order was its entrance into global debt markets and related institutions, such as the International Monetary Fund (IMF) and the Paris Club, a forum were governments work together on matters of interstate loans.

> ***"The West began to introduce debt financing sanctions after Russia annexed Crimea in 2014 while Russia has responded by adjusting its debt issuance, reserve allocation, and currency management strategies."***

Sovereign debt issuances facilitate trade and attract investment abroad, while enabling foreign investors to participate in the Russian economy without direct investment. Russia's foreign debt market also serves as a barometer for how foreign investors interpret Russia's relations with the West.

Previously, the role of both domestic and international politics around Russian sovereign debt has proven to be critical. Russia's 1998 default left many Western

1 Putin, Vladimir. "Presidential Address to the Federal Assembly," 20 February 2019, en.kremlin.ru/events/president/news/59863.

2 Monthly Reserve Values. The Central Bank of Russia, https://www.cbr.ru/eng/hd_base/mrrf/mrrf_m/.

3 "External Debt of the Russian Federation in Domestic and Foreign Currencies (2012-2018)," External Sector Statistics, Central Bank of Russia, http://www.cbr.ru/vfs/eng/statistics/credit_statistics/debt/debt_cur-mat_new_e.xlsx.

4 Malik, Hassan. Bankers and Bolsheviks, (Princeton: Princeton University Press, 2018), pp. 217-222.

5 Oosterlinck, Kim (Translator: Bulger, Anthony). Hope Springs Eternal: French Bondholders and the Repudiation of Russian Sovereign Debt, (New Haven, Yale University Press, 2016), pp. 3.

6 Pereira, Derwin. "China's belt and road plan deserves the benefit of the doubt," South China Morning Post, 9 May 2017, https://www.scmp.com/comment/insight-opinion/article/2093532/chinas-belt-and-road-plan-deserves-benefit-doubt.

creditors in the lurch and took place within the context of a wider emerging market debt crisis, which it then helped perpetuate.[7] Moscow chose to default on its ruble-denominated debt rather than its dollar-denominated debt, a move heavily influenced by political considerations.[8] Such a default is rare, albeit not unprecedented,[9] in sovereign debt markets, as economists often assume that local currency defaults are avoidable because local governments can just print more currency. Nonetheless, foreign investors in Russian local debts suffered major losses.

Foreign investors continued to shun Russian debt for some time, even as Putin oversaw an oil-fueled economic boom.[10] However, this enabled Russian corporations to reestablish access to Western financial markets on which they had been dependent since the Soviet collapse.[11] Yet, the Russian government itself only returned to Eurobond markets in 2010.[12/13] This timing demonstrates Russian debt markets were not seen as politicized. The sale came near the height of the global financial crisis and just 20 months after the August 2008 Russo-Georgian War, which, while causing a brief spike in the Russian government's ruble bond yields,[14] did not have a lasting impact.[15] Russia's March 2014 annexation of Crimea would have a far greater impact.

The subsequent imposition of Western sanctions prompted major changes in Russia's debt issuance strategy. As in 1918, 1998, and 2008, Russia's foreign debt strategy was once again politicized. It remains politicized today, with Moscow's access to foreign debt markets contested as Britain and the U.S. consider proposals to ban Russian sovereign debt issuance. Should these pass, they would cut Russia off from the two largest markets for such bonds. Even if they do not pass, however, the threat of additional sanctions will remain for the foreseeable future.

The politicization of Russia's sovereign debt is by no means a one-sided affair. The West's primary tool is the use of sanctions. Russia, by contrast, has responded by adjusting its reserves management, debt issuance strategy, and even the wording of loans. The conflict seems poised to accelerate, as suggested by Conservative MP Tom Tugendhat during a Parliamentary debate on Russia policy in March 2018: "The Russian government, unlike other governments, does not use Russian sovereign debt merely to finance themselves; they are now using it to sanctions bust. We can use sovereign debt here too, as a tool and a weapon, because we are being fought on every single level in a cross-spectrum battle."[16]

7 Gilman, Martin. No Precedent, No Plan: Inside Russia's 1998 Default, (Cambridge: MIT Press, 2010), pp. 33-34.

8 Lu, Yinqiu and Takovlev, Dmitry. "Exploring the Role of Foreign Investors in Russia's Local Currency Government Bond (OFZ) Market," IMF Working Papers, Number 17/28, International Monetary Fund, 10 February 2017, pp. 4, https://www.imf.org/en/Publications/WP/Issues/2017/02/10/Exploring-the-Role-of-Foreign-Investors-in-Russia-s-Local-Currency-Government-Bond-OFZ-Market-44653.

9 Jeanneret, Alexandre; Paget-Blanc, Eric; and Slim, Souissi. "Sovereign Defaults by Currency Denomination." Journal of International Money and Finance, Volume 60(C), pp. 198, https://www.cass.city.ac.uk/__data/assets/pdf_file/0009/219978/120.-Jeanneret-v2.pdf.

10 Op. Cit. Gilman, pp. 188.

11 Op. Cit. Gilman, pp. 283.

12 "Sovereign debt: Russia resets sovereign risk perceptions," Euromoney, 4 May 2010, https://www.euromoney.com/article/b12kj07y-4wzsvm/sovereign-debt-russia-resets-sovereign-risk-perceptions.

13 It did restructure its bank debts into a Eurobond in 2000, but this is not seen as a new issuance as it did not raise new funds for the Russian government.

14 Clover, Charles. "Investors quit Russia after Georgia War." Financial Times, 21 August 2008, https://www.ft.com/content/60abb0d4-6fb1-11dd-986f-0000779fd18c.

15 Maurer, Noel. "Who cares about Georgia? Not the Markets," The Power and the Money Blog, 5 September 2008, https://noelmaurer.typepad.com/aab/2008/09/who-cares-about.html.

16 House of Commons Debate, 26 March 2018. "National Security and Russia." Hansard, Volume 638, Column 531, https://hansard.parliament.uk/commons/2018-03-26/debates/B5EF4CEE-D0E9-4613-81C4-DDD9F03015EE/NationalSecurityAndRussia.

Debt Financing Sanctions on Russia

After Russia's annexation of Crimea, U.S. President Barack Obama ordered the creation of a new, more targeted, form of sanctions, which became known as sectoral sanctions identification (SSI).[17] Various Russian defense firms, majority state-owned oil giant Rosneft, gas producer Novatek, and banks VTB and Gazprombank were the first SSI targets.[18] While inclusion on the U.S. Department of Treasury's specifically designated nationals (SDN) sanctions list precludes those designated from the U.S. financial system entirely, SSI designation can be tailored to block almost all debt and financing for listed firms.

Any actor in the U.S. financial system—broadly defined as any user of U.S. dollars, and thus effectively every major financial firm—was barred from "providing financing for or otherwise dealing in new debt of longer than 90 days maturity" to firms named under the sectoral sanctions' Directive 1 and Directive 2, for finance and energy firms, respectively. This measure was intended to restrict access to long-term dollar debt markets for Russian firms deemed to be malefactors by the U.S. The SSI list quickly expanded to all of Russia's leading state-owned firms—Transneft, Sberbank, VTB, and Gazprom, among others—as well as major private firms such as Lukoil, though not all were subject to debt limitations.

Only firms listed under Directives 1 and 2 are subject to debt financing sanctions. For example, Gazprom, which was not listed under Directive 2, has continued to tap Western financing, whereas Rosneft, which is listed under Directive 2, has been barred from doing so for all but the shortest maturities. The possibility remains that Directives 1 and 2 will be expanded and such financing limitations will apply to other firms.

"After Russia's annexation of Crimea, U.S. President Barack Obama ordered the creation of a new, more targeted, form of sanctions, which became known as sectoral sanctions identification (SSI)."

The SSI measures have been regularly tightened since they were introduced—first, in September 2014, when the Treasury restricted debt financing to 30 days or less for certain firms in the Russian financial sector. Again, in September 2017, Congress passed the Countering America's Adversaries Through Sanctions Act (CAATSA), reducing loans for listed financial firms to 14 days and to 60 days for listed firms in the energy sector.[19]

The U.S. was not alone in implementing these sanctions. Since 2014, the European Union has maintained a similar 30-day restriction on debt financing for five of Russia's largest banks—VTB, VEB, Gazprombank, Sberbank, and Rosselkhozbank—as well as three defense

17 "Executive Order 13662 Blocking Property of Additional Persons Contributing to the Situation in Ukraine," Federal Register, Volume 79, Number 56, 24 March 2014, https://www.treasury.gov/resource-center/sanctions/programs/documents/ukraine_eo3.pdf.

18 "US Announcement of Treasury Sanctions on Entities Within the Financial Services and Energy Sectors of Russia, Against Arms or Related Materiel Entities, and those Undermining Ukraine's Sovereignty," U.S. Department of Treasury Press Center, 16 July 2014, https://www.treasury.gov/press-center/press-releases/pages/jl2572.aspx.

19 "Issuance of amended Ukraine-/Russia-related Directives 1 & 2; Updated FAQs." U.S. Department of Treasury Resource Center, 29 September 2017, https://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Pages/20170929.aspx.

Source: Gazprombank

and three energy firms, including Rosneft.[20] Norway also implemented debt financing bans,[21] while Japan[22] and Switzerland[23] said they would not authorize transactions that violated EU or U.S. measures. Other Western financial institutions have also cut back lending—the European Bank for Reconstruction and Development, for example, cut Russia off from receiving loans in 2014.[24]

The debt financing sanctions were strongly felt in Europe, whose financial markets have closer ties with Russia than those in the U.S. Even though EU debt sanctions were not as extensive as U.S. ones, the intertwined nature of U.S. and EU financial markets meant European financial institutions largely adhered to U.S. prohibitions. Russian firms went from being amongst European financial institutions' largest borrowers to persona non-grata.

20 Baczynska, Gabriela. "Factbox: Existing EU sanctions against Russia over turmoil in Ukraine," Reuters, 28 November 2018, https://www.reuters.com/article/us-ukraine-crisis-russia-eu-sanctions-fa/factbox-existing-eu-sanctions-against-russia-over-turmoil-in-ukraine-idUSKCN1NX1A3.

21"Restrictive Measures Against Russia," Norwegian Ministry of Foreign Affairs, 15 August 2014, https://www.regjeringen.no/en/aktuelt/Restrictive-measures-against-Russia-/id765896/.

22 Kitade, Daisuke. "Considering the Effects of Japanese Sanctions Against Russia," Mitsui Global Strategic Studies Institute Monthly Report, Mitsui Global Strategic Studies Institute, July 2016, https://www.mitsui.com/mgssi/en/report/detail/__icsFiles/afieldfile/2016/10/20/160707m_kitade_e.pdf.

23 "Massnahmen zur Vermeidung der Umgehung internationaler Sanktionen im Zusammenhang mit der Situation in der Ukraine [Measures to Mitigate the Evasion of International Sanctions in Connection with the Situation in Ukraine]," Swiss State Secretariat for Economic Affairs (SECO), 6 March 2015, https://www.seco.admin.ch/seco/de/home/Aussenwirtschaftspolitik_Wirtschaftliche_Zusammenarbeit/Wirtschaftsbeziehungen/exportkontrollen-und-sanktionen/sanktionen-embargos/sanktionsmassnahmen/massnahmen-zur-vermeidung-der-umgehung-internationaler-sanktione.html.

24 Jones, Marc. "Exclusive - EBRD to shut 5 of 7 Russian offices in early 2018," Reuters, 3 October 2017, https://uk.reuters.com/article/uk-russia-ebrd-offices-exclusive/exclusive-ebrd-to-shut-5-of-7-russian-offices-in-early-2018-idUKKCN1C81PG.

Russian Debt and Reserves: Dealing with a Double Shock

Russia faced an additional challenge as the West imposed sanctions after its annexation of Crimea: a commodity collapse. Oil and gas prices—vital to the Russian economy—plummeted: the price for the Brent benchmark barrel of crude plunged from around $110 at the beginning of 2014 to just $50 at year's end. Russia followed its annexation of Crimea by launching a war in eastern Ukraine, and sanctions escalated throughout 2014 and 2015, further compounding the economic pain already felt by Russian citizens. As a result, Russia's GDP contracted 2.8% in 2015 and 0.23% the following year.[25]

How did the Kremlin respond to these developments through its reserve and currency holdings?

The 2014-16 oil price crash and the concurrent recession in Russia saw the country's reserves crater, as its budgets went from a surplus to sizable deficits. The Central Bank of Russia reported international reserves[26] of $527.7 billion at the end of March 2013. By April 2015, they had fallen to $356 billion.[27] Russia's Reserve Fund, one of the country's two sovereign wealth funds, held $87 billion at the start of the crisis in 2014, but was depleted by January 2018.[28]

Russia spent heavily to ensure foreign exchange was available to the economy and to counter declining foreign investment that resulted from the commodity-collapse and sanctions. Some of this spending came in the form of interventions on the foreign exchange market, with the Central Bank spending from its foreign currency reserves. The bulk of this spending came from dollar reserves, a sign that Russia preferred decreasing its dependence on the U.S. currency. Accordingly, gold reserves rose from 9.6% of cumulative foreign reserves in December 2013 to 13% two years later—a trend that has since continued (figure 3). However, the decline in the value of the ruble meant the overall share of Russian external debt held in foreign currencies actually increased even as overall external debt fell (figure 1).

"Russia spent heavily to ensure foreign exchange was available to the economy and to counter declining foreign investment that resulted from the commodity-collapse and sanctions."

External corporate debt—that is, loans and credit obligations borrowed from foreign creditors—fell by 21% between 2013 and December 2015.[29] The government's own external debt fell further: in 2014, it dropped from $61.7 billion to $41.6 billion, before shrinking to just $30.5 billion by the end of 2015.[30] The decline in Russia's external indebtedness was not just prompted by debt financing sanctions, but also by the downgrade of its sovereign credit rating to junk by two of the three leading rating agencies at the beginning of 2015.[31]

25 Russian GDP (annual %). World Bank National Accounts Data, World Bank, https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=RU.

26 Including gold, foreign exchange, reserves held at the IMF, and Special Drawing Rights (SDR) Funds at the IMF.

27 Op. Cit. Monthly Reserve Values.

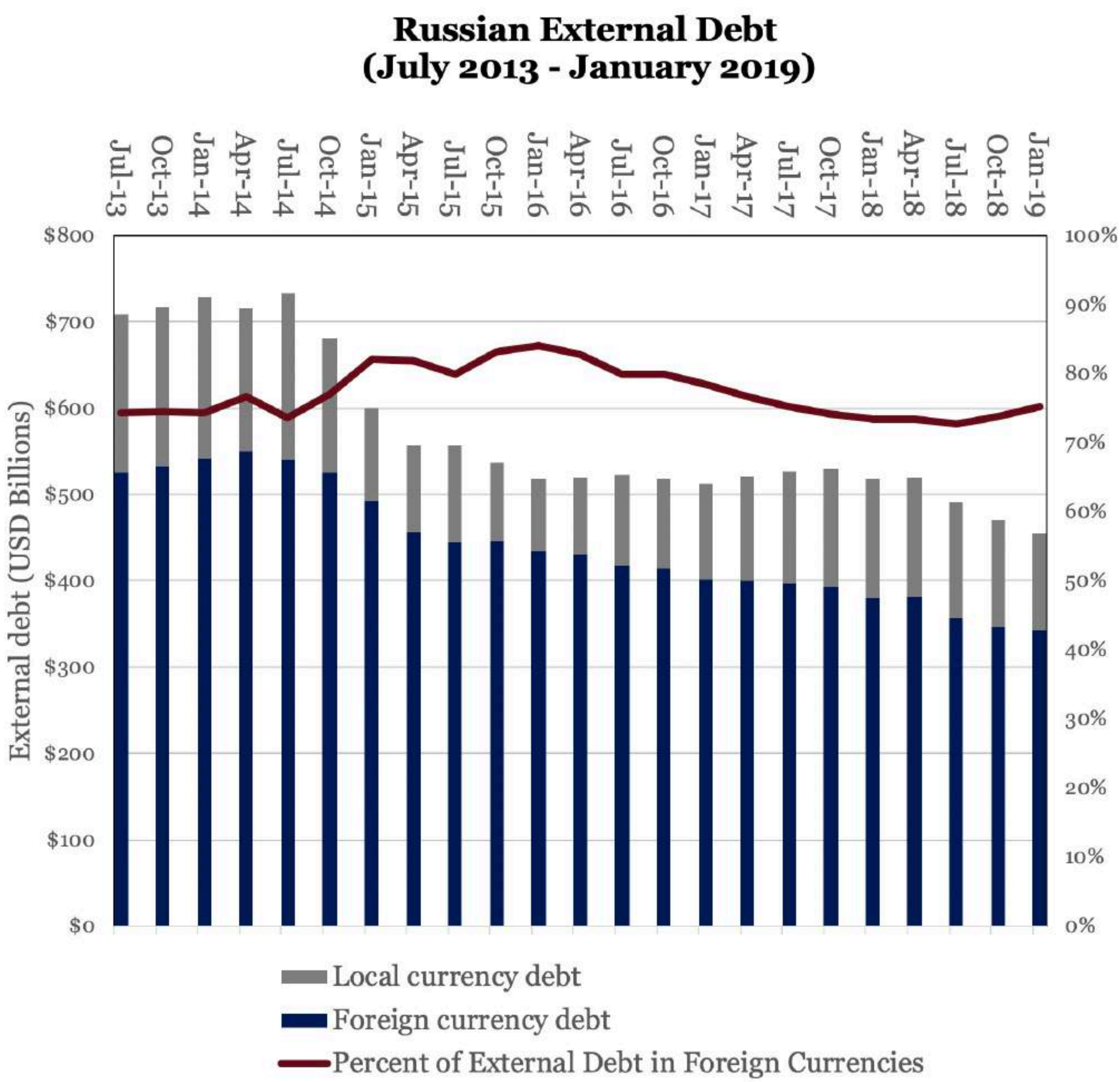
28 Mironenko, Peter. "Russia's Reserve Fund Runs out of Money 14 Years After Its Founding," The Bell, 12 January 2018, https://thebell.io/en/russias-reserve-fund-runs-money-14-years-founding/.

29 Farchy, Jack and Seddon, Max. "Russian companies emerge from bond market wilderness," Financial Times, 3 July 2016, https://www.ft.com/content/36f458e4-3f9d-11e6-8716-a4a71e8140b0.

30 Op. Cit. External Debt of the Russian Federation in Domestic and Foreign Currencies (2012-2018).

31 Beckerman, Josh and Kolyandr, Alexander. "Moody's Downgrades Russia to Junk Status," Wall Street Journal, 20 February 2015, https://www.wsj.com/articles/moodys-downgrades-russia-to-junk-status-1424469136.

FIGURE 1



Russian External Debt
(July 2013 - January 2019)
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External debt (USD Billions)
$800
$700
$600
$500
$400
$300
$200
$100
$0
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
Local currency debt
Foreign currency debt
Percent of External Debt in Foreign Currencies

Decreased borrowing was not the only way Russia adjusted its overall debt and reserves position. The depreciation of the ruble also played a role. As the ruble weakens, fewer dollars are needed to pay ruble-denominated debt, which makes up the bulk of Russia's overall government debt burden. The Russian government, and its Central Bank, chose to allow the ruble to weaken, only deploying its reserves in the market to manage the decline rather than attempt to re-establish the ruble-dollar rate from before the crisis.

The relationship between the ruble, Russian debt, and debt financing sanctions on Russia is best illustrated by the Central Bank's December 2014 bailout of Rosneft. At the time, Rosneft was launching repayments on debts of more than U.S.$20 billion due by the end of March 2015.[32] Rosneft's listing under Directive 2 of the U.S. sectoral sanctions meant that hindered it from issuing long-term debt abroad. Instead, it issued 624 billion rubles in domestic bonds, worth $10.8 billion at the time.[33] The Central Bank simultaneously announced Rosneft's new ruble bonds would be eligible for use as collateral for loans from the bank, including ones denominated in foreign currencies.[34] These machinations enabled Russian lenders to borrow dollars from the Central Bank, and loan them to Rosneft using only the firm's newly issued credits as collateral, essentially moving dollars from the Central Bank to Rosneft.

The bailout allowed Rosneft to overcome the challenges posed by debt financing sanctions, but it also caused significant pain in ruble markets. In early December 2014, the ruble was trading around 50 rubles-to-the-dollar, down from around 35 at the beginning of the year. The bailout caused a plunge to 80 rubles-to-the-dollar.[35] It later ended the year around 60 rubles-to-the-dollar, but only after a massive increase in the Russian Central Bank's baseline interest rate.[36] Former Finance Minister Alexei Kudrin, who remains a close advisor to the Kremlin, had criticized it as "opaque," warning of the market's negative reaction, but the bailout showed that Russia's Central Bank can be subject to political interference, as Rosneft's interests outweighed that of broader ruble markets.[37]

The Central Bank knew the move would weaken the ruble, which it had been defending throughout that year at the cost of 100 billion rubles (then worth $2.5 billion).[38] It can be argued that the Central Bank thought much of the rate increase would ultimately offset the decline in the ruble prompted by Rosneft's bailout, but even if this happened, the case still presents a strong example of how debt financing sanctions forced the Russian government to prioritize funding politically connected state entities such as Rosneft over wider macroeconomic stability.

The impact of these sanctions affected not just Rosneft, but the wider economy, pushing Russia out of foreign debt markets. External debt fell from $728.8 billion to $518.8

32 "Rosneft, other Russian firms face 2015 debt refinancing challenge-Moody's," Reuters, 22 July 2014, https://uk.reuters.com/article/russia-debt/rosneft-other-russian-firms-face-2015-debt-refinancing-challenge-moodys-idUKL2N0PX0R020140722.

33 Kuznetsov, Vladimir. "Rosneft Gets Central Bank Help Refinancing $7 Billion Loan," Bloomberg, 12 December 2014, https://www.bloomberg.com/news/articles/2014-12-12/rosneft-s-10-8-billion-refinancing-driven-by-central-bank-cash.

34 "O vklyuchenii tsennyx bumag v Lombarrdniy spisok Banka Rossiia [On the Inclusion of securities in the Lombard list of the Central Bank of Russia]," Central Bank of Russia, 12 December 2014, http://cbr.ru/press/PR/?file=12122014_091724if2014-12-12T09_15_38.htm.

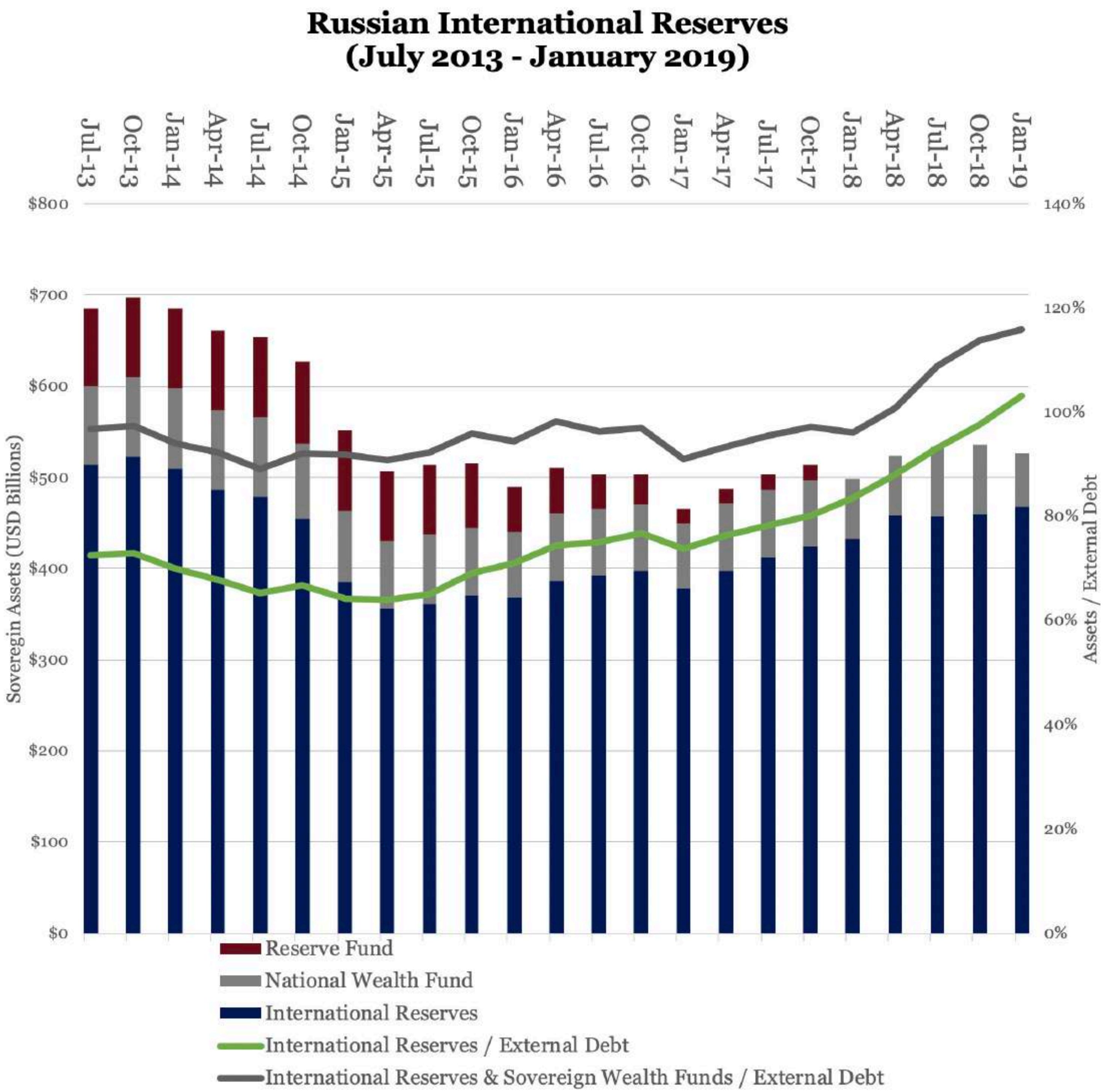
35 Miller, Chris. "Ruble Trouble: The Politics of Russia's Financial Crisis," Foreign Policy Research Institute E-Note, Foreign Policy Research Institute, December 2014, https://www.fpri.org/article/2014/12/ruble-trouble-the-politics-of-russias-financial-crisis/.

36 "Russian rouble in free-fall despite shock 17% rate rise," BBC, 16 December 2014, https://www.bbc.co.uk/news/business-30492518.

37 Kudrin, Alexei (@Aleksei_Kudrin). "Rynok Negativno razogrela neprozrachnaya sdelka po kreditu Rosnefti na 625 mlrd rubley. Krayne ne vovremya [The market negatively responded to the opaque deal for loaning 645 billion ruble to Rosneft. Very bad timing]," 15 December 2014, https://twitter.com/Aleksei_Kudrin/status/544621391770042368

38 "Russian Central Bank Spent $2.5 Billion to Defend Ruble," The Moscow Times, 29 October 2014, https://www.themoscowtimes.com/2014/10/29/russian-central-bank-spent-25-billion-to-defend-ruble-a40865.

FIGURE 2


Russian International Reserves
(July 2013 - January 2019)
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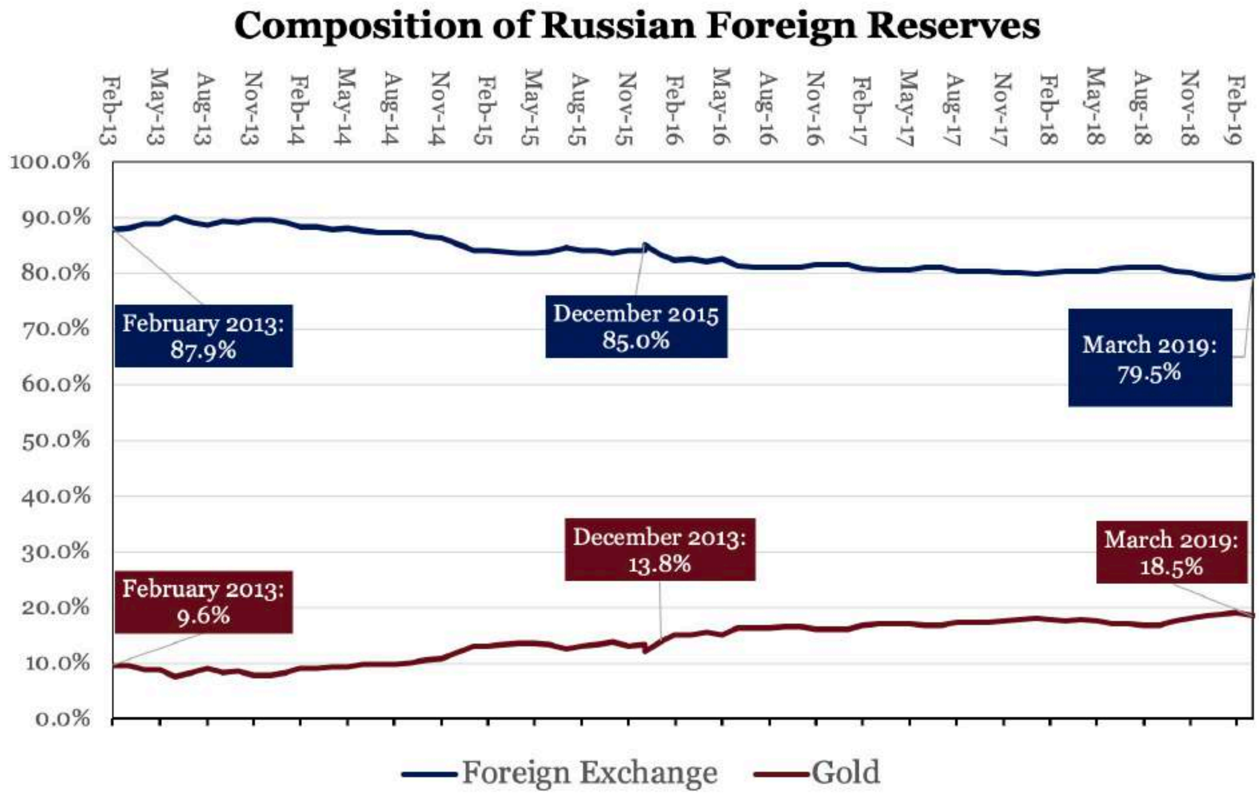
$0
140%
120%
100%
80%
60%
40%
20%
0%
Sovereign Assets (USD Billions)
Assets / External Debt
Reserve Fund
National Wealth Fund
International Reserves
International Reserves / External Debt
International Reserves & Sovereign Wealth Funds / External Debt

Figure 3



billion two years later.[39] The Central Bank continued to provide dollars to the economy when needed, but these moves ultimately show that Russia was attempting to decrease the economy's dependence on dollar debts even if this meant a weak ruble. Placing debt financing sanctions on Rosneft had a ripple effect on the wider Russian economy.

In short, the Russian Central Bank allowed the ruble to undergo controlled decline, deploying its reserves only at levels needed to prevent a freefall, and provide liquidity to prominent, politically connected enterprises. In 2017, oil and other commodity prices began to rise, validating the Central Bank's strategy: Russia's reserve position rebounded to $487.8 billion in March 2019, just $40 billion less than reported at the end of March 2013.[40] These changes in its debt and management efforts are not the only actions the Kremlin took to compete in the increasingly politicized monetary space: it also introduced remarkable changes in its foreign-currency sovereign debt contracts.

39 Op. Cit. External Debt of the Russian Federation in Domestic and Foreign Currencies (2012-2018).

40 Monthly Reserve Values. Data from the Central Bank of Russia, https://www.cbr.ru/eng/hd_base/mrrf/mrrf_m/.

Eurobonds as a Deterrent Against Further Sanctions

Russia did not issue any foreign-currency-denominated sovereign bonds, an instrument known as a Eurobond, from September 2013 until May 2016. This decision marked a stark reversal to the spate of issuances in previous years. Even amid the global financial crisis, Russia had little difficulty selling $3.5 billion in 2010 and $5 billion in 2012. In 2013, Russia had raised $7 billion via such bonds, a record high. The issuance included a Eurobond that was only due to be repaid in 2043, the longest maturity of any such loan in Russia's history.

Investors soured on Russian Eurobonds amid the political and economic crisis. Figure 4 shows how Russian debt began to trade at a substantially widened spread over an index of comparable debts.[41] Prior to February 2014, when Russia began seizing Crimea, the 2043 Eurobond traded at a slight discount to the benchmark index. In December 2014, as the conflict in eastern Ukraine raged and further sanctions loomed, the same bond briefly traded at a 2% premium to the benchmark. Foreign investors moved heavily out of Russian Eurobond investments, with the share held by non-residents' falling from 68% to 53.9% over the course of 2014 (figure 5).

It was not until September 2015 that the Eurobond again traded at a yield below that of the benchmark emerging market index. In February 2016, Russia began planning a return to Eurobond markets, but the imposition of sectoral sanctions had raised questions about its ability to do so.[42] Nevertheless, on May 24, 2016, it sold a $1.75 billion Eurobond, three years after its previous issuance. Euroclear, the central clearinghouse for European-traded securities, took more than two months to allow Russia's Eurobonds to be listed on its platforms.[43] Although 70% of buyers in the sale were foreign investors,[44] non-resident investors' share of Russian Eurobond holdings fell 4.3% in 2016 (figure 5). The most notable feature of the sale was that the bond's prospectus included a new clause: in the event Russia is prohibited from repaying the debt in U.S. dollars, Russia may repay bondholders in Swiss francs, British pounds, or euros. The impact of the introduction of debt financing sanctions following Russia's annexation of Crimea ranges from the highest level, such as the aforementioned ruble exchange rate, down to the legal text of its debentures.

Eurobonds investors and issuers value consistency and predictability. Recent research of 28 sovereign issuers found they rarely change indenture terms, for fear of upsetting the market.[45] Further research underlines just how resistant to change such contracts are: sovereign issuers only began to address a clause seen as a major risk factor 15 years after identifying it as such[46]—after a group of creditors used that very clause to

41 The spread is calculated over the imputed yield of the main index for such dollar-denominated emerging market Eurobonds, the JP Morgan Emerging Market Bond Index (EMBI).

42 Moore, Elaine and Seddon, Max. "Russia plans first bond issuance since sanctions," Financial Times, 7 April 2016, https://www.ft.com/content/2f52094a-cc27-11e5-be0b-b7ece4e953a0.

43 Seddon, Max. "Russia bond garners acceptance by key clearing house," Financial Times, 28 July 2016, https://www.ft.com/content/763f13cc-6791-33ed-9b85-a3184185d987.

44 Kelly, Lidia; Kobzeva, Oksana; and Zavyalova, Kira. "Russia raises $1.75 billion in first Eurobond since sanctions imposed," Reuters, 24 May 2016, https://www.reuters.com/article/us-russia-eurobond/russia-raises-1-75-billion-in-first-eurobond-since-sanctions-imposed-idUSKCN0YF2QR.

45 Gelpern, Anna; Gulati, Mitu; and Zettelmeyer, Jeromin. "If Boilerplate Could Talk: The Work of Standard Terms in Sovereign Bond Contracts." Law & Social Inquiry. April 2019. pp. 1-30. https://doi.org/10.1017/lsi.2018.14.

46 Choi, Stephen J.; Gulati, Mitu; and Scott, Robert E. "Variation in Boilerplate: Rational Design or Random Mutation?," American Law and Economics Review, Volume 20, Issue 1, Spring 2018, pp. 1–45, https://doi.org/10.1093/aler/ahx019.

trigger Argentina's default in 2014.

Yet, Russia's decision to adjust the wording of its 2016 issuance did not attract attention, nor did it when Russia sold Eurobonds again the next year. These bonds state that if the "alternative payment currency event" was triggered, the exchange rate for the alternative currency payments would be set by the British, European, and Swiss Central Banks, respectively, thereby minimizing the risk that bondholders receive repayment at a disadvantageous rate. But such a clause can also make a bond difficult to price, as exchange rates are influenced by the monetary policy of each country's Central Bank.[47]

First, the 2029 Eurobond allowed buyers to elect to receive payment in Russian rubles rather than U.S. dollars—something that would certainly not appeal to the vast majority of foreign investors. Kremlin spokesman Dmitry Peskov explained that this term, combined with a special legal regime for the bonds, meant they could be used as a tool to help Russian oligarchs, fearful of additional sanctions, to repatriate their wealth.[48] Finance Minister Anton Siluanov explained Russian investors could even purchase the bonds anonymously through Russian banks working with Russia's National Settlement Depository. This enabled buyers to avoid purchasing bonds through Euroclear,[49] an attempt to mitigate against sanctions risks.

This change was not the only one introduced in the 2029 Eurobonds, sold in March 2018.

As with the 2016 and 2017 issuances, the 2029 Eurobond's prospectus noted that if Russia could not repay bondholders in U.S. dollars, it could do so in Swiss francs, pounds or euros.[50] Yet, it also gave Russia the option to repay in rubles, a term arguably highly detrimental to non-Russian investors.

Despite this term, and the Kremlin billing the 2029 Eurobond as a "de-offshorization vehicle," Russian investors accounted for just 35% of its buyers at issuance.[51] Demand came primarily from abroad. Non-resident investors' share of Russian Eurobond holdings increased throughout 2018 (figure 5). It was an advantageous moment as S&P had lifted Russia's sovereign rating out of junk status

47 Receiving payment in these currencies could have major benefits for investors in these Eurobonds in certain situations, such as a major increase in the U.S. baseline interest rates compared to the Swiss, British, and European baseline rate, or alternatively cause substantial losses if the U.S. rate were to fall below those rates.

48 Bocharova, Svetlana; Sterkin, Filipp; Tovkaylo, Maxim; and Yashunsky, Giorgi. "Reuters named the author of the idea to issue Eurobonds for Russian oligarchs (Reuters nazval avtora idei vypustit evrobondy dlya rossiiskikh oligarkhov)," Vedomosti, 29 December 2017, https://www.vedomosti.ru/finance/articles/2017/12/29/746908-reuters-nazval-avtora-idei-evrobondov-dlya-rossiiskih-oligarhov.

49 Starostina, Yulia. "Siluanov revealed the scheme of issuing bonds for the return of capital to Russia (Siluanov raskryl skhemu vypuska bondov dlya vosrashcheniq kapitala v Rossiyu)," RBC, 22 December 2017, https://www.rbc.ru/economics/30/04/2019/5c-c865279a79472f2f061c42.

50 "Russian Federation – U.S.$1,500,000,000 4.375 per cent Bonds due 2029," Prospectus published by the Irish Stock Exchange, 20 March 2018, pp. 15, https://www.ise.ie/debt_documents/Prospectus%20-%20Standalone_a5c232e3-f908-45c8-9815-2d355f6ed87b.pdf.

51 Malyarenko, Evgenia; Mogilevskaya, Anna; Pustakova, Anna; and Tkachyov, Ivan. "British investors bought 39 per cent of Russia's new bonds [Britanskiye investory vykupili 39% rossiiskikh bondov]," RBC, 16 March 2018, https://www.rbc.ru/economics/16/03/2018/5aac1f919a79471db627b6fc.

FIGURE 4

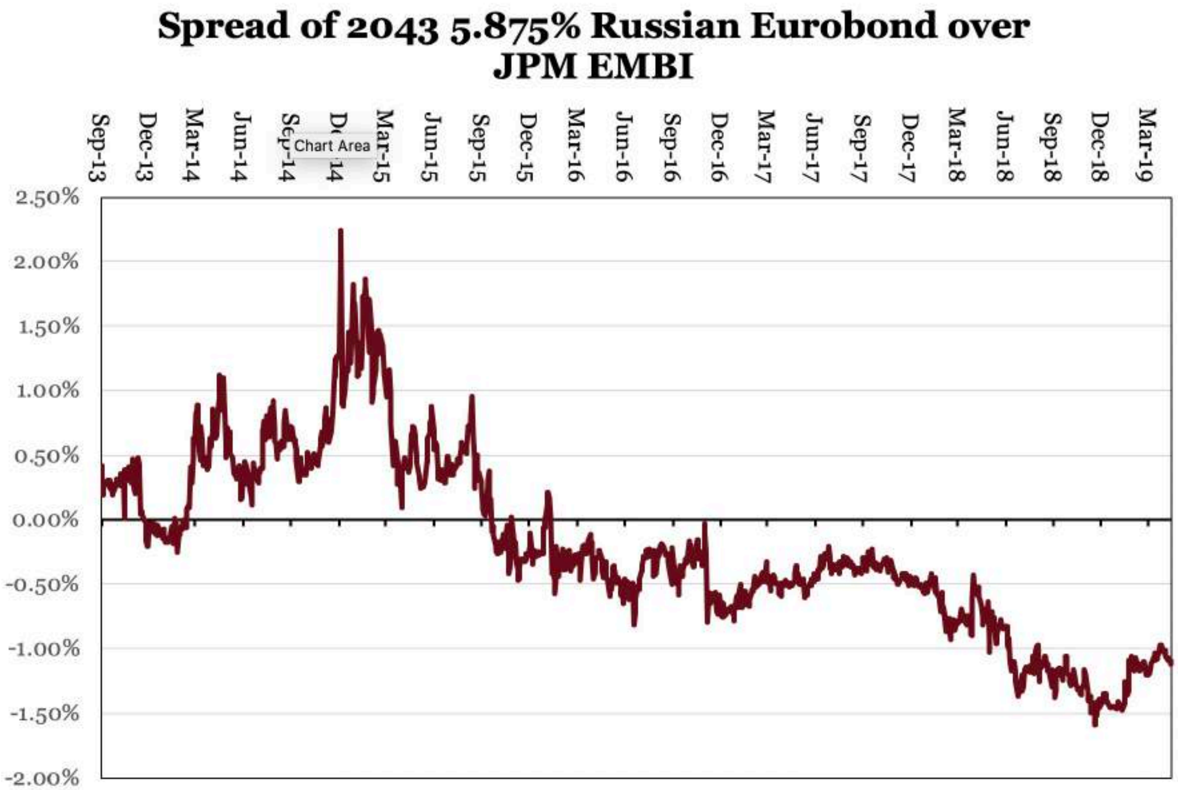
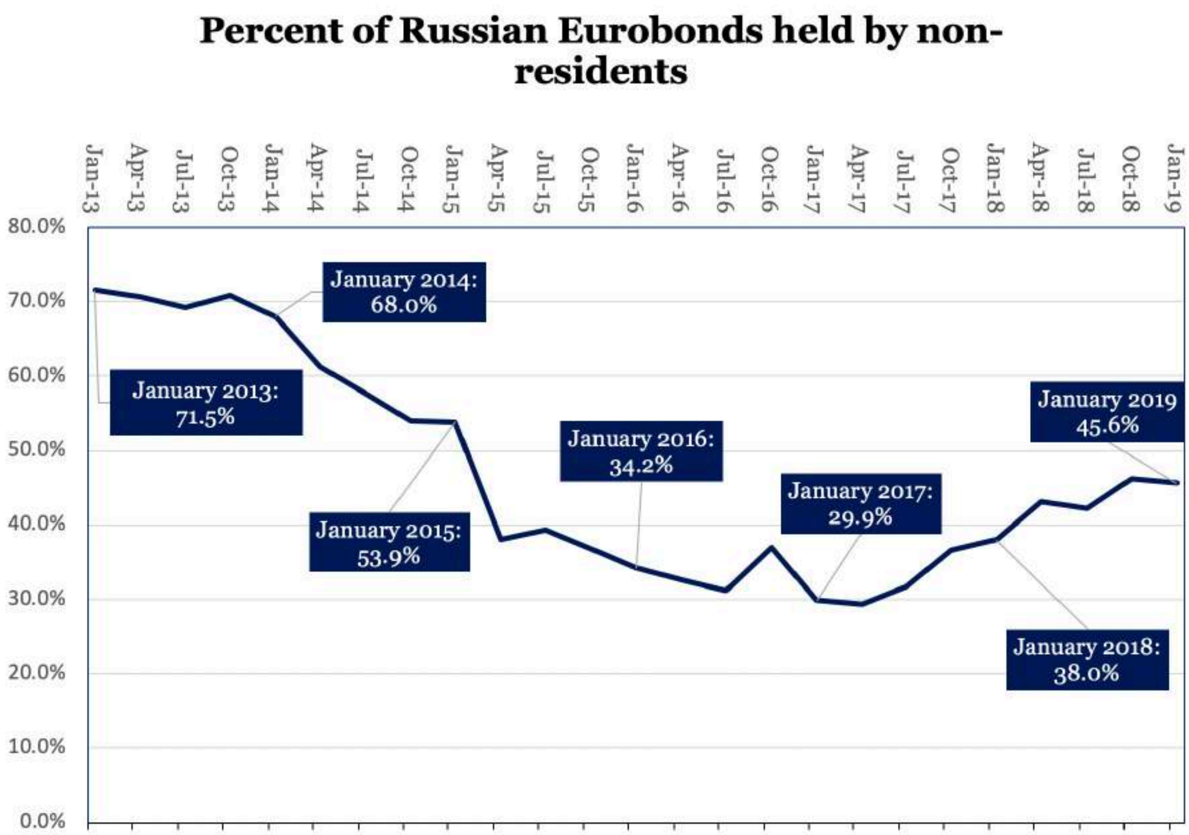


FIGURE 5



the previous month,[52] making it eligible for inclusion in additional investment-grade index funds.[53] The 2029 Eurobond raised $1.5 billion and a further $4 billion was raised by tapping one of the previous year's Eurobonds, a thirty-year debt due in 2047 that does not include the ruble repayment option.

In November 2018, Russia sold €1 billion in euro-denominated Eurobonds for the first time since 2013.[54] That bond too leaves open the possibility of payment in rubles if Russia cannot pay in U.S. dollars, Swiss francs, Euros, or pounds.[55] That month, Gazprom became the first state-owned enterprise to issue a Eurobond with a ruble-inclusive clause in November 2018, raising €1 billion.[56] Three months later, Gazprom sold a further $1.25 billion in such bonds, nearly half of which were bought by U.S. investors.[57] In March 2019, the Ministry of Finance issued a $3 billion ten-year Eurobond, its largest single note since 2013, containing the ruble-inclusive clause. It simultaneously sold an additional €750 million worth of the euro-denominated 2025 Eurobond.

The language of the ruble clause should be worrying to investors in Russia's 2025, 2029, and 2035 Eurobonds and the aforementioned Gazprom bonds. They may end up stuck with ruble-denominated bonds if the West imposes sanctions on Russian sovereign debt, and thus substantial losses. The move could be seen as a deterrent against such sanctions, as if they were imposed on Russian government debt, the alternative currency payment events could be triggered. Konstantin Vyshkovsky, who oversees sovereign debt issuance at Russia's Finance Ministry, has acknowledged part of its strategy for selling Eurobonds is the hope it "affects the probability that foreign governments will impose sanctions against Russia."[58]

Thus, $4.5 billion and €1.75 billion worth of Russian Eurobonds at risk of being re-denominated to rubles currently trade in global capital markets, as do $1.25 billion and €1 billion worth of Gazprom Eurobonds. Foreign investors thus far demand no premium for holding these notes (figure 7), although they would likely incur substantial losses if ruble payments were triggered.[59] The 2025 note—assisted by the disparity between U.S. and European interest rates, which makes it cheaper to borrow in Euros—trades at only a small premium to 10-year U.S. treasury bonds despite Russia's BBB- credit rating (figure 8).

52 Dye, Jessica. "S&P upgrades Russia, lifting it out of junk territory," Financial Times, 23 February 2018, https://www.ft.com/content/1a9f2a3c-18e2-11e8-9376-4a6390addb44.

53 Jones, Marc. "Russia's rising rating comes with sanctions stress," Reuters, 11 February 2018, https://www.reuters.com/article/us-russia-bonds-ratings-analysis/russias-rising-rating-comes-with-sanctions-stress-idUSKBN1FV0KO.

54 Pronina, Lyubov and Voitova, Olga. "Russia Tests Crimea Fallout With Bond Sale Days After Strife," Bloomberg, 27 November 2018, https://www.bloomberg.com/news/articles/2018-11-27/russia-spurns-greenback-with-first-euro-bond-sale-in-five-years.

55 "Russian Federation - EUR 1,000,000,000 2.875 per cent Bonds due 2025," Prospectus published by the Irish Stock Exchange, 30 November 2018, pp. 4, https://www.ise.ie/debt_documents/Prospectus%20-%20Standalone_3d1162d3-1cf9-49d4-b0c1-56e995a42458.PDF.

56 Kobzeva, Oksana. "Russia's Gazprom hedges currency risk with novel Eurobond clause," Reuters, 14 November 2018, https://www.reuters.com/article/russia-gazprom-eurobond/russias-gazprom-hedges-currency-risk-with-novel-eurobond-clause-idUSL8N1XP2YW.

57 "U.S. investors bought almost half of Gazprom's Eurobond - JP Morgan," Reuters, 11 February 2019, https://de.reuters.com/article/russia-eurobonds-gazprom/u-s-investors-bought-almost-half-of-gazproms-eurobond-jp-morgan-idUKL5N2065GN.

58Andrianova, Anna and Pismennaya, Evgenia. "Russia Sees Sanctions Insurance in Flood of Foreign Bond Buying," Bloomberg, 28 May 2019, https://www.bloomberg.com/news/articles/2019-05-28/russia-sees-sanctions-insurance-in-flood-of-foreign-bond-buying.

59 As seen in figure 6, the yields of the Eurobonds with the ruble clause are far lower than the yield of comparable ruble-denominated Russian government bonds, which means that if the ruble-clause were triggered, the price on the bonds would have to fall significantly to bring it nearer to the yield on those ruble bonds.

Bond Bans: The Next Step for U.S. Sanctions?

The changes in Russia's reserves management strategy, value of the ruble, and the wording of its Eurobonds did not come in a vacuum; they came in response to the debt financing sanctions discussed previously, as well as in response to potential further sanctions against Russian sovereign debt.

The first indication of potential sovereign debt sanctions came in the 2017 CAATSA bill, which required the U.S. Treasury Department to issue a report on such sanctions. However, when Treasury released its report in February 2018, it advised against implementing them, warning that they risked tumult in global financial markets.[60] Yet, it was in Europe, whose financial markets were most impacted by the debt financing sanctions, where the first explicit call for Russian sovereign debt sanctions was made.

On March 21, 2018, Conservative MP Tom Tugendhat, chair of the House of Commons' Foreign Affairs Committee, called for prohibiting Russian sovereign debt sales. Tugendhat argued Russia's sovereign debt was being used to bypass financing restrictions on sanctioned companies.

Such potential violations of the spirit, if not the word, of sanctions was not the only aspect of Russia's actions in sovereign and sub-sovereign debt markets that chafed British policymakers. Moscow had turned British courts into a battlefield over Ukraine's debt.[61] VTB sold €750 million of Gazprom Eurobonds at the exact moment British Prime Minister Theresa May blamed the Kremlin for using nerve agents in an attempted assassination in England earlier that month.[62] Russia's state-owned bank VTB, which led the sale, highlighted that most of the demand for the bond came from Europe.[63] Nonetheless, Tugendhat's proposal failed to gain traction. In November 2018, Russia sold Eurobonds with the ruble-inclusive clause two days after attacking Ukrainian forces.[64] For Tugendhat's proposal to have truly been effective, it would require Washington to implement such a sanctions as well.

"It was in Europe, whose financial markets were most impacted by the debt financing sanctions, where the first explicit call for Russian sovereign debt sanctions was made."

On August 2, 2018, a bipartisan group of U.S. Senators introduced the "Defending American Security from Kremlin Aggression Act" (DASKA), which included a ban on "transactions relating to new sovereign debt of the Russian Federation."[65] The measures were so strident that the act was dubbed "the bill from hell." DASKA failed to advance

60 Mohsin, Saleha and Wasson, Erik. "Treasury Warns of Upheaval If U.S. Sanctions Russian Sovereign Debt," Bloomberg, 2 February 2018, https://www.bloomberg.com/news/articles/2018-02-02/treasury-warns-of-widespread-effects-of-russian-debt-sanctions.

61 Gelpern, Anna. "Russia's Contract Arbitrage," Capital Markets Law Journal, Volume 9, Issue 3, pp. 308–326, 1 July 2014, accessed via Georgetown Law Faculty Publications and Other Works, 1448. pp. 7-23, https://scholarship.law.georgetown.edu/cgi/viewcontent.cgi?article=2460&context=facpub.

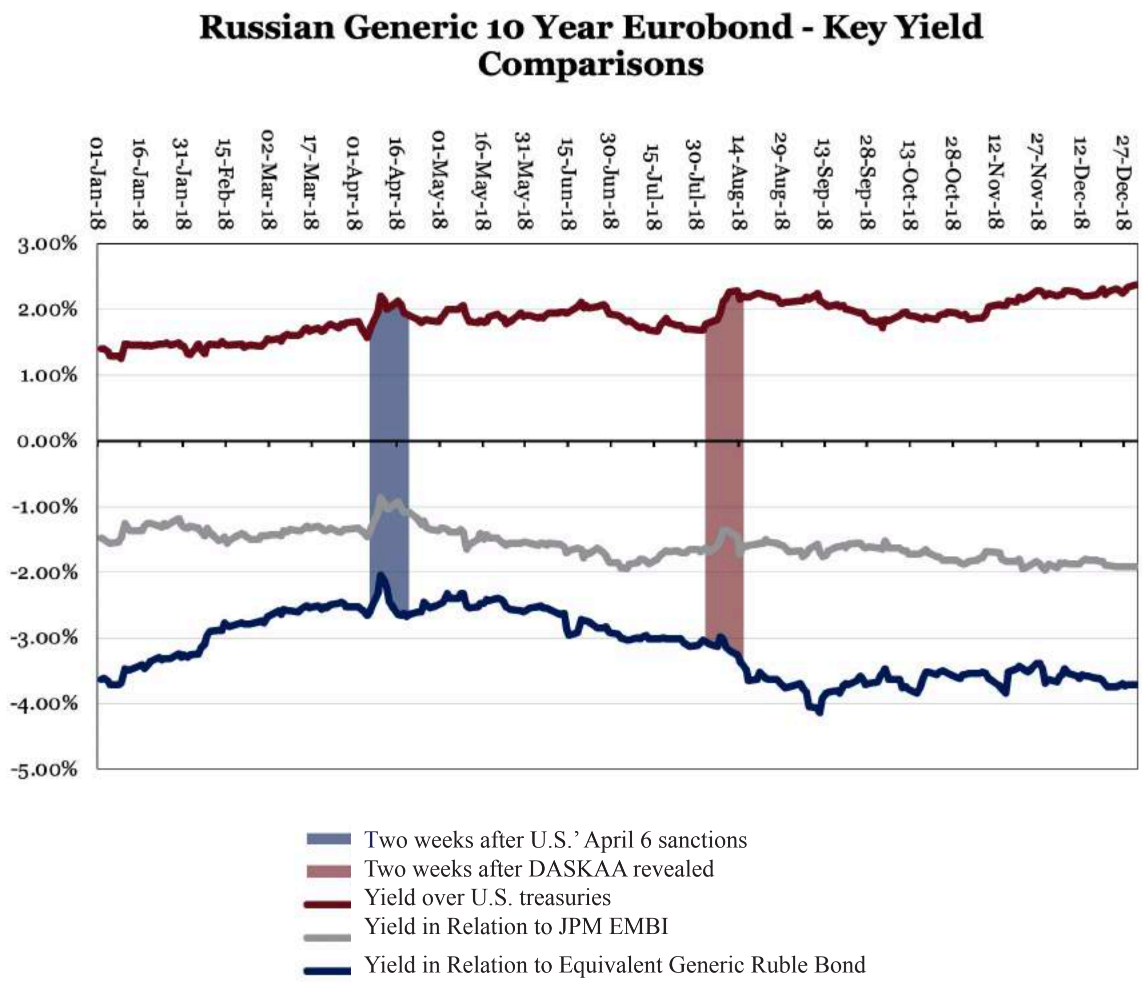
62 Doff, Natasha and Galouchko, Ksenia. "As U.K. Condemns Russia, Investors Pile Into Gazprom Bond Sale," Bloomberg, 15 March 2018, https://www.bloomberg.com/news/articles/2018-03-15/as-u-k-condemns-russia-investors-pile-into-gazprom-bond-sale.

63 Ibid.

64 Op. Cit. Pronina and Voitova.

65 "Graham, Menendez, Gardner, Cardin, McCain, Shaheen Introduce Hard-Hitting Russia Sanctions Package." Website of Senator Lindsey Graham, 2 August 2018, https://www.lgraham.senate.gov/public/index.cfm/press-releases?ID=E4AC5E4C-EFD0-4F25-9808-745E1737EF65.

Figure 6



in last year's Congressional session, but a new version was introduced in February 2019.[66]

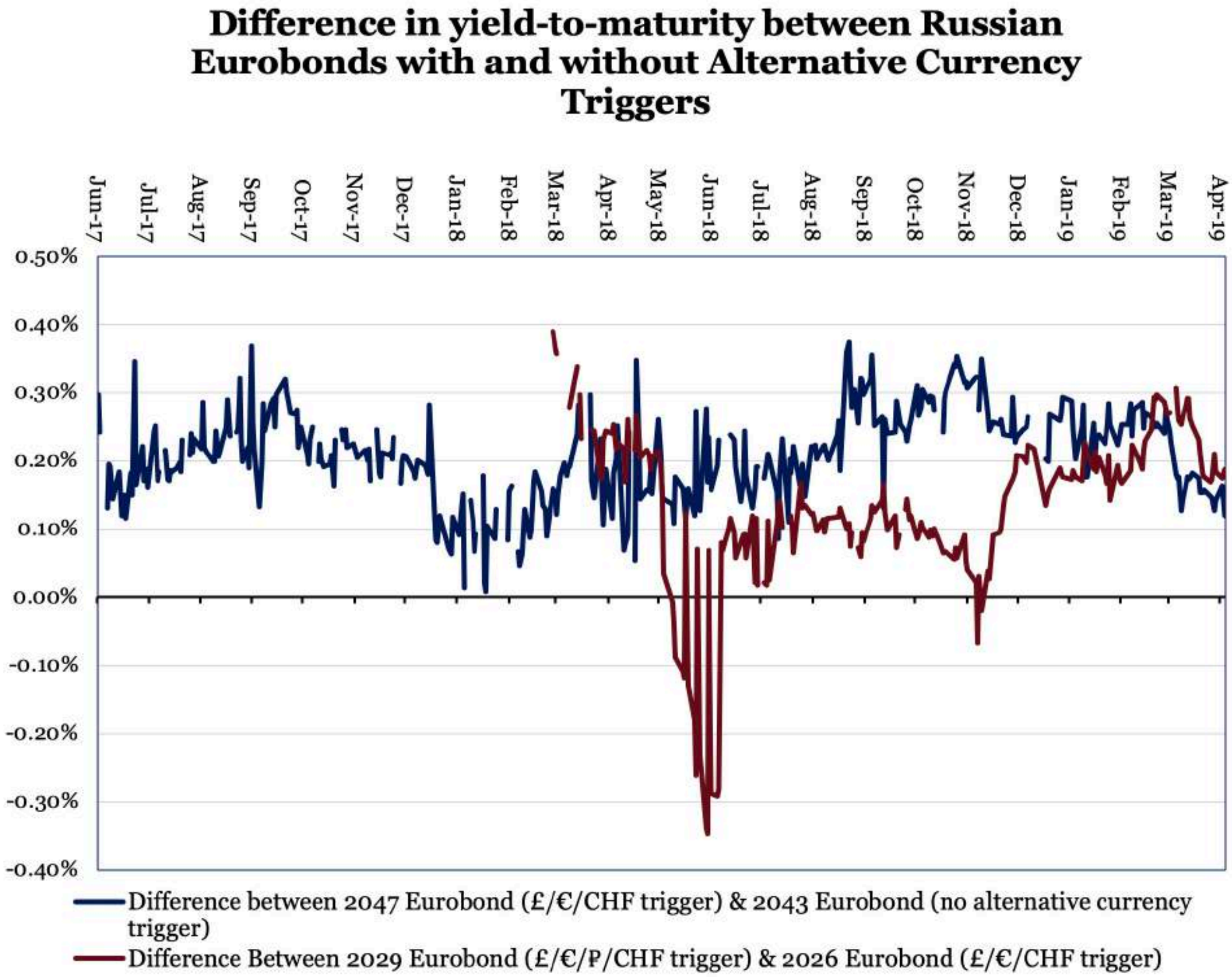
Another bill proposed in Congress, the Defending Elections from Threats by Establishing Redlines (DETER) Act of 2019,[67] does not call for an immediate ban of new Russian sovereign debt issuances. Instead, it states that such sanctions would be implemented if Russia is found to have interfered in the 2020 U.S. presidential election. As the bill's name implies, DETER proposes sovereign debt sanctions as a deterrent.

Trading in Russia's Eurobonds shows sensitivity to sanctions risk. On April 6, 2018, the United States sanctioned three major Russian oligarchs. Between April 5-11, 2018, the yield on Russia's 2043 Eurobond, which does not include an alternative currency payment clause, rose by 50 basis points, in comparison to the yield of the closest equivalent U.S. Treasury bond, ruble-denominated Russian sovereign bond, and the benchmark index (figure 6). The introduction of DASKA in August 2018, which called for banning dealing in all new Russian sovereign debt, prompted a spike in the same bond's yield relative to

66 Zengerle, Patricia. "U.S. senators to try again to pass Russia sanctions bill," Reuters, 13 February 2019, https://www.reuters.com/article/us-usa-russia-sanctions-exclusive/exclusive-u-s-senators-to-again-try-to-pass-russia-sanctions-bill-idUSKCN1Q22J9.

67 Defending Elections from Threats by Establishing Redlines Act of 2019. S.1060, 116th Congress, 2019, https://www.congress.gov/bill/116th-congress/senate-bill/1060/.

Figure 7



U.S. Treasuries and the benchmark index (figure 6). Enacting Russian sovereign debt sanctions would have a far greater impact on these markets.

Sovereign debt bans now form part of the sanctions tool kit. The Trump administration introduced them against Venezuela at the start of 2019, targeting both its government bonds and those issued by its state oil company, PDVSA. Those sanctions state that while U.S. investors can continue to hold PDVSA and Venezuelan government bonds, they can only sell them to foreign counterparts. This has effectively killed the market for Venezuelan debts.[68] As legislation containing Russian sovereign debt sanctions is debated, it is not just the potential impact on Eurobond markets that must be considered, but also the impact on Russia's wider economy and geopolitics as well.

68 Smith, Colby. "Puzzling new sanctions for Venezuela's bondholders," Financial Times, 4 February 2019, https://ftalphaville.ft.com/2019/02/04/1549296744000/Puzzling-new-sanctions-for-Venezuela-s-bondholders/.

Pushing Russia Towards China?

The crisis in Russian-Western relations since the annexation of Crimea, and particularly the use and threat of debt financing sanctions, has resulted in observable impacts on Russia's Eurobond markets, the financing of Russian state enterprises, Russia's reserves and debt management strategies, and the value of the ruble. Sovereign debt is always political—it is incurred by governments, after all. Sovereign debt issued under a foreign government's law and in foreign currencies, has an added geopolitical aspect. The geopolitics of Russian sovereign debt affects not just the Russian government's financial management, but its wider economy, as well as foreign investors.

The impact on foreign investors is most clearly demonstrated by the changes to the wording of Russia's Eurobonds. Although the bonds containing the ruble version of the alternative currency payment clause do not demand a notable premium (figure 7), if triggered, holders of these bonds may suffer sizable losses should Russia move to repay in rubles. Until global markets voice disapproval through higher yields or refusal to invest in such debts, Russia will keep these provisions in future Eurobonds. They provide Russia with an automatic response, and to some extent, a deterrent, against sovereign debt sanctions. Foreign investors now face increased geopolitical risk.

Western sanctions do not bear sole responsibility for the politicization sovereign debt markets. Russia did so with Ukraine in 2013, when it bought a Eurobond issued by Kyiv, which included remarkable changes to the standard wording of these contracts. These changes enabled Moscow to instrumentalize the debt in the subsequent Russo-Ukrainian War.[69] British lawyers for Kyiv and Moscow continue to spar over whether the debt must be repaid. If Russia's demand for repayment prove successful, it may push Ukraine back into default.

The politicization of sovereign debt is set to continue. The threat of such sanctions also has been used to attempt to deter Russian action, for example from intervening in the 2020 presidential elections. Increased tensions could cause Congress to pass a more strident ban. The impact of such sanctions would have far reaching impacts.

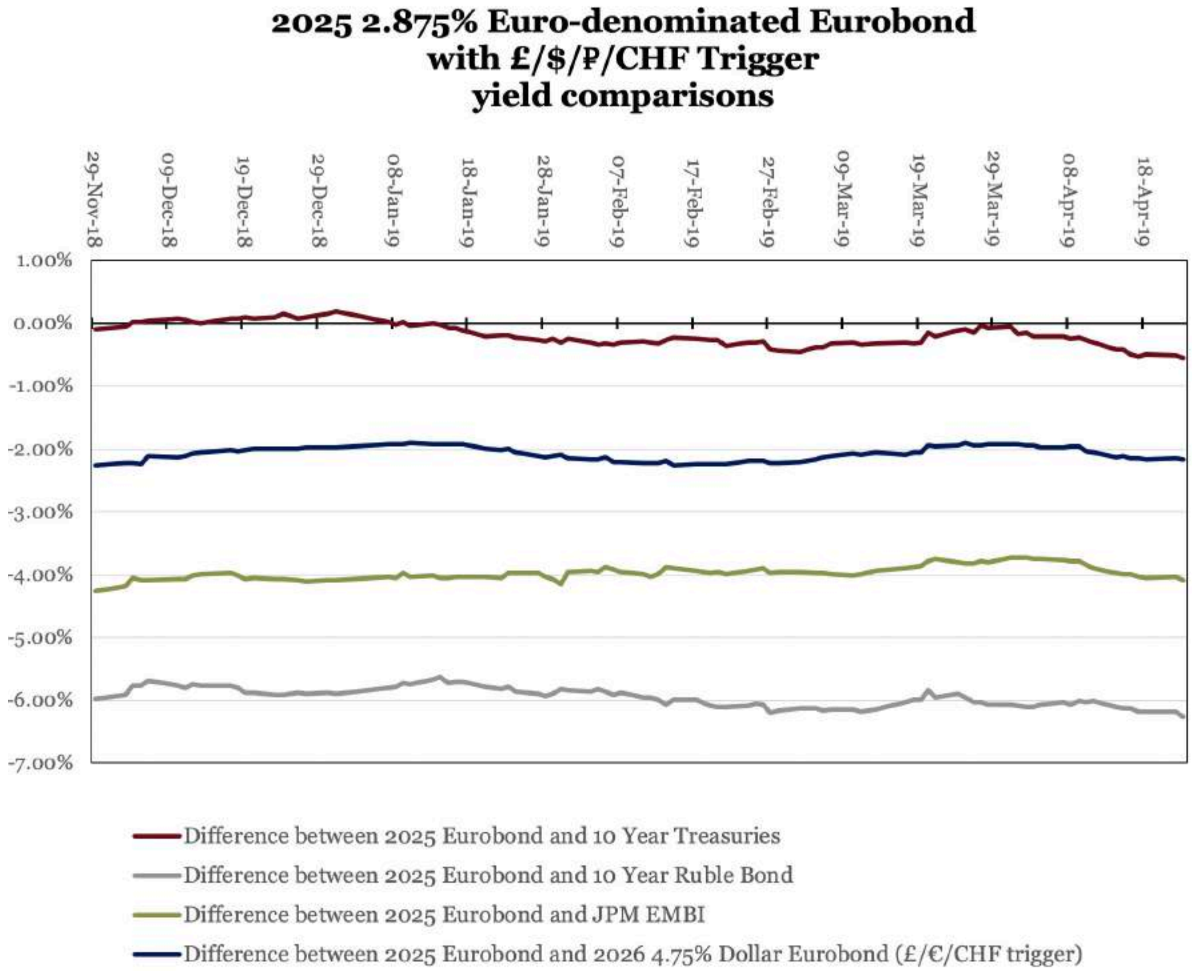
> ***"The politicization of sovereign debt is set to continue. The threat of such sanctions also has been used to attempt to deter Russian action, for example from intervening in the 2020 presidential elections."***

The U.S. dollar remains the dominant currency for facilitating Russia's foreign trade by some distance.[70] Sanctions on Russian government debt issuances would impact the ability of all Russian firms to secure financing. The return on sovereign debt establishes a baseline rate for lending, so barring Russia from issuing new debt on Western markets will make it difficult to establish financing rates for all Russian firms. At their most extreme, sovereign debt sanctions could sever Russian-Western financial flows, as seen in Venezuela. The U.S. Treasury Department has also warned such sanctions "could

69 Hess, Maximilian. "Bond of War: Russian Geo-Economics in Ukraine's Sovereign Debt Restructuring," FPRI Russia Political Economy Project, Foreign Policy Research Institute, 19 September 2018, https://www.fpri.org/article/2018/09/bond-of-war-russian-geo-economics-in-ukraines-sovereign-debt-restructuring/.

70 "Dollar remains the dominant billing currency in Russian foreign trade," BOFIT Weekly, Bank of Finland, 17 May 2019, https://www.bofit.fi/en/monitoring/weekly/2019/vw201920_2/.

FIGURE 8



hinder the global competitiveness of large U.S. asset managers and potentially have negative spillover effects into global financial markets and businesses"[71] as well. But the primary spillover may be geopolitical. Russia would have to rely on only its domestic ruble market, or seek new foreign capital markets, to finance trade.

The precedent for foreign powers banning Russian sovereign debt serves as a warning. In 1887, German Chancellor Otto von Bismarck issued his Lombardverbot (Lombard ban) barring Russian government debt from German capital markets.[72] Although Tsar Alexander III had pledged earlier that year to remain neutral in the event of a war between Germany and another European great power in the then-secret Reinsurance Treaty, Bismarck believed the move "would have an appreciable affect in the softening of Russian policies towards Germany in the political field."[73] But Russia subsequently shifted its financing base to France, and the Reinsurance Treaty was not renewed in 1890.[74] France and Russia would agree the Dual Alliance in January 1894 but although the Lombard ban was lifted later that

71 "Report on Effects of Expanding Sanctions to Include Sovereign Debt and Derivative Products," U.S. Department of Treasury, 29 January 2018, https://assets.bwbx.io/documents/users/iqjWHBFdfxIU/r5nYlUF7jwuU/v0.

72 Op. Cit. Malik, pp. 35.

73 Kennan, George. The Decline of Bismarck's European Order: Franco-Russian Relations 1875-1890, (Princeton: Princeton University Press, 1979), pp. 346.

74 Newnham, Randall. Deutsche Mark Diplomacy: Positive Economic Sanctions in German-Russian Relations, (University Park: Penn State Press, 2002), pp. 65-67.

year[75] and German banks again took part in numerous Russian bond issuances,[76] the Franco-Russian alliance prospered. Germany would find itself opposite the pair in World War I. Just as Berlin's ban pushed Russia into an alliance with Paris in the 19th century, a U.S. ban on Russian sovereign debt could push Moscow closer to Beijing in the 21st.

Even before the Crimean crisis, financial flows from China to Russia increased significantly, with Russia the largest recipient of Chinese development financing by 2014.[77] Russia's main state bank, VTB, recently announced plans to significantly boost financials ties with China.[78] Beijing has developed its own alternative to Eurobonds, known as Panda bonds, though the Russian state withdrew plans to potentially issue such debt in 201779 and remains disinclined to do so as of March 2019.[80] Nevertheless, if the U.S. were to sanction Russian sovereign debt, however, then Russia could turn to such debts to replace Eurobonds. Should the U.S. and Britain proceed with sovereign debt bans, it may cement Russia and China's geopolitical partnership.

Sovereign debt has, to use Tugendhat's term, become a "tool and a weapon" for both Moscow and the West. The politicization of Russia's sovereign debt has affected Russia's economy as well as financial and capital markets. Sovereign debt sanctions would have even more significant effects. The proposal of legislation using such bans as a deterrent, as well as Russia's adoption of a deterrence strategy in its Eurobonds, indicates how a blanket ban on sovereign debt would be the "nuclear option." The debate around Russian sovereign debt sanctions will determine the future of Russia's political and economic relationship with the rest of the world.

75 Wegner-Korfes, Sigrid. "Zur Gesichte des Bismarkschen Lombardverbots für russische Wertpapiere (1887 bis 1894) [On the History of the Bismarkian Lombard Ban for Russian Bonds (1887 until 1894)]," Jahrbuch für Wirtschaftsgeschichte (Economic History Yearbook), Volume 23, Issue 3, 1982, pp. 73-77, https://doi.org/10.1524/jbwg.1982.23.3.55.

76 Op. Cit. Malik, pp. 52.

77 China Power Team. "Where is China targeting its development finance?," China Power, Center for Strategic and International Studies, 8 December 2017, https://chinapower.csis.org/china-development-finance/.

78 Seddon, Max and Weinland, Don. "Russia's VTB looks to China for lending expansion," Financial Times, 18 September 2018, https://www.ft.com/content/4de01548-ba61-11e8-94b2-17176fbf93f5.

79 Korsunskaya, Darya and Ostroukh, Andrey. "Russia's plan to borrow in yuan stumbled over Panda bonds: deputy finance minister," Reuters, 6 June 2017, https://www.reuters.com/article/us-russia-finmin-bonds/russias-plan-to-borrow-in-yuan-stumbled-over-panda-bonds-deputy-finance-minister-idUSKBN18X1C0.

80"PRYAMAYA RECH - Intervyu glavy dolgovogo departamenta Minfiina RF Konstantina Vyshkovskogo [Direct Speech - Interview with Konstantin Vyshkovsky, Head of the Russian Ministry of Finance's Debt Department]," Reuters, 29 March 2019, https://ru.reuters.com/article/businessNews/idRUKCN1RA0MF-ORUBS.

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