RUSSIAN SANCTIONS – WHO WILL BLINK FIRST?

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INTRODUCTION

For most of 2014, Russia supported and encouraged a major insurgency in Eastern Ukraine, using its special forces and intelligence agencies, acting through local 'separatists' and providing heavy weapons, including artillery, armored vehicles and sophisticated anti-air missiles to local proxies. Initially, despite extensive rhetoric, the response from the European Union (EU) seemed self-interested, pedestrian and half-hearted, in line with uncertain leadership from the US. However, the destruction of Malaysian Airlines Flight MH17, coupled with continued Russian intransigence, transformed a localized conflict in Eastern Ukraine into a major international crisis and resulted in a progressive increase in diplomatic and economic pressure by the US and the EU on Russia.

Initial guidance on the circumstances and likely outcomes associated with the subsequent sanctions regime imposed by the US, the EU and their partners (principally Australia, Canada and Japan) was contained in the Thomson Reuters White Paper Russian Sanctions: Navigating Choppy Waters. This paper described in detail the initial range of sanctions, discussed the possible effects on the Russian economy, as well as the targeted individuals, banks and companies, and speculated on the likely risks that would arise as a result.

Much of this guidance remains valid, especially with regard to the means by which Russia would seek to mitigate the impact of sanctions and the precautionary measures that banks and financial institutions would need to take to ensure compliance with national regulatory requirements and due diligence. This new paper reviews the current situation with regard to sanctions against Russia and makes suggestions about future outcomes and risks.

THE CURRENT STATE OF PLAY

During 2015, US and EU leaders have continued to use mainly diplomatic and economic instruments to contain the crisis in Ukraine and to deter Russia from further adventurism. In a series of communiqués[1], they have consistently reiterated their commitment to a 'non-recognition' policy of what they consider to be the illegal annexation of Crimea and Sevastopol and the 'continued violation of the sovereignty, independence and territorial integrity of Ukraine and of international law'. In parallel, NATO has taken what it considers to be appropriate readiness and defensive measures, sufficient to deter Russian aggression against its members, principally the Baltic States and allies bordering the Black Sea.

With regard to Ukraine, the conflict is largely being held in check, at least for the time being and despite sporadic outbreaks of localized violence, by a ceasefire implemented as part of the Minsk Agreement of February 2015, between the US, the EU, Russia and Ukraine. The Agreement included the establishment of a ceasefire based security zone separating the combatants' heavy weapons by 50 km, a comprehensive verification and monitoring regime and the withdrawal of Ukrainian combat formations from the vicinity of Donetsk and Luhansk. There were also significant concessions to the separatists in terms of allowing interim self-government and amnesties in Eastern Ukraine, with the prospect of decentralized government and 'special status' for the region in future. The Agreement also dealt with social transfers such as pension payments, incomes and revenues, payments of

1 http://europa.eu/newsroom/highlights/special-coverage/eu_sanctions/index_en.htm
http://ambafrance-us.org/spip.php?article6485
http://www.state.gov/secretary/remarks/2015/05/242214.htm
http://www.ambafrance-mt.org/Ukraine-Communique-issued-by-the

all utility bills and the reinstatement of taxation. Consequently, Ukraine was urged to reinstate control of the segment of its banking system in the conflict-affected areas, while accessing an international mechanism to facilitate these transfers.

Despite the Minsk Agreement and because the conflict in Ukraine initially continued to spread and intensify, the US expanded its sanctions regime to take in more Russian and Ukrainian entities, encompassing 14 defense companies and prominent regime individuals, while imposing targeted sanctions on, and preventing financing to, six large Russian banks and four energy companies. The US also suspended credit finance that supported exports to Russia and economic development projects in Russia, as well as prohibiting the provision, exportation, or re-exportation of goods, services (not including financial services), and technology in support of exploration or production for offshore, Arctic or shale oil projects involving five major Russian energy companies.

Meanwhile, the EU in March 2015 extended a series of travel bans and asset freezes on Russian politicians, military officers and officials who supported the regime or the annexation of the Crimea and were involved in violations of Ukrainian territorial integrity, sovereignty and independence[2]. These amounted to over 150 people and 37 entities in Russia and Ukraine and would remain in place until July 2015. In addition, further sanctions limited access to EU capital markets for five major state-owned financial institutions, three major energy firms and three defense companies. The EU also banned weapons sales, civilian goods that could be dual-used for military sensitive technologies and services supporting energy exploration and exploitation, as well as economic restrictions on trade with the Crimea. The President of the European Council stated that the Council stood 'ready to take further decisions if necessary'.[3]

Nevertheless, there was considerable disagreement between European countries about how sanctions should proceed and warnings about harm to the European economy. This reflected a suspicion among European countries that the burden of sustaining the sanctions regime would be less severe on the US than on Europe. This attitude was reinforced by a statement by the US Vice President that 'it was America's leadership and the President of the United States insisting, oft times almost having to embarrass Europe to stand up and take economic hits to impose costs'. There were also stridently contrary voices in the business communities of Italy and Germany, while the Hungarian Prime Minister Viktor Orbán claimed that Europe had 'shot itself in foot'. Similarly, the Bulgarian Prime Minister Boiko Borisov said, 'I don't know how Russia is affected by the sanctions, but Bulgaria is affected severely'[4] and politicians in the Czech Republic argued that the sanctions would be ineffective.

In the end, EU sanctions against Russia came to be aligned to the implementation of the Minsk Agreement, which was anticipated to be capable of completion by 31 December 2015. It was realized that, in order to remain in place beyond July 2015, approval by all 28 countries would be required at a summit of the European Council in late June 2015.

Russia had previously retaliated to the earlier round of sanctions by imposing reciprocal sanctions in August 2014 against senior US politicians, officials and advisors, as well as

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2 http://www.reuters.com/article/2015/03/19/us-ukraine-crisis-eu-idUSKBN0MF1FF20150319

3 http://www.consilium.europa.eu/en/press/press-releases/2015/03/25-report-tusk-european-parliament/

4 EU press conference on 4 December 2014. http://www.voanews.com/content/bulgaria-says-it-is-suffering-from-eu-sanctions-on-russia/2545974.html

thirteen Canadian parliamentarians and senior officials, and has subsequently barred selected European politicians from travelling to Russia for bilateral and multilateral meetings. Russia also imposed an effective embargo for a year on imports of most agricultural products from countries of origin that had either 'adopted the decision on introduction of economic sanctions in respect of Russian legal and (or) physical entities, or joined the same'.[5] These notably targeted the US, the EU, Norway, Canada and Australia, including a specific ban on fruit, vegetables, meat, fish and dairy imports[6]. The food and food products ban mainly affected the countries that are geographically close to Russia, such as Poland and Finland, as well as agricultural producers in France, Spain,Italy andGreece As a result, Russians are expected to spend more than half their income on food this year.

So far, there is little indication from regulators or government agencies that there have been systemic attempts to by-pass the current sanctions regime by US and EU financial institutions, although there has been widespread private capital flight from both Russia and Ukraine. As might be expected, there is also mounting evidence that transactional flows are taking place through those countries that have not joined the US-led sanctions regime – notably Iran, China and various Central Asian republics - and through well-established third party and shell arrangements. Chinese banks in particular have been active in providing finance for offshore and other oil and gas projects, together with the Russian government and export-credit agencies.

EFFECT ON RUSSIA

It is reasonable to assess that Putin and his circle will have calibrated the likely effect of sanctions on the Russian economy and their grip on legitimacy and power, most notably with regard to Russia's holdings of about $660 billion in foreign exchange reserves. However, they would not have anticipated the sudden fall in oil prices and its effect on revenue and taxation receipts. Together with the pressure of sanctions, these have led to a loss of export revenues, the withdrawal of $150 billion of foreign investment and an outflow of foreign currency reserves of more than $160 billion since the crisis in Ukraine started. Inflation is running at almost 17 per cent, retail lending has reduced by 32 per cent and wages are falling in real terms, with an IMF assessment[7] that Russia's GDP will shrink by up to 4.7 per cent over 2015, with inflation running by then at about 10 per cent. Worst of all, higher interest rates have meant that consumers and corporations have faced dramatically higher borrowing costs as the ruble lost about 41 per cent of its value in 2014 against the dollar. Finally, as a result of intervention in currency markets to support the ruble and capital outflows, Russia's foreign exchange reserves have fallen to $416 billion, compared to an external debt owed by Russian banks, companies, and state bodies of nearly $700 billion.

However, in 2015 a modest rise in oil prices, a recovery of exports (reflecting the cheaper ruble) and optimism about the Minsk Agreement has stabilized the situation and has, by April 2015, led to a stabilization of the currency, along with increases in the value of Russian bonds and stocks and a fall in interest rates (from 14

5 http://www.garant.ru/hotlaw/federal/558039/
http://www.bbc.com/news/world-europe-28687172

6 Before the embargo, food exports from the EU to Russia were worth around €11.8 billion, or 10 per cent of the total; from the US €972 million and from Canada €385 million.

7 https://www.imf.org/external/country/rus/

to 12.5 per cent). In addition, the Central Bank of Russia (CBR) lent dollars to companies at a preferential rate to service their debts, while unwittingly enabling them to gain returns by investing in high yield enterprises. However, in dealing with about $100 billion of external debt, it is unlikely that the CBR will be able to bail them out again, despite holding $298 billion in convertible foreign currencies[8] and especially in view of a high government deficit and recent capital flight.

Despite evidence of a rally, the overall effect of these cumulative pressures on Russia could result in serious damage to the economy, including a stock market crash (the Russian Trading System (RTS) index dropped 45 per cent in 2014), a potential credit rating downgrade from the current BBB rating to below investment grade and possible capital controls, if oil prices fall still further and more severe sanctions are applied. They could even lead to an eventual debt default based on Russia's debt-to-GDP ratio doubling to almost 70 per cent, a situation exacerbated by the effect of sanctions. Meanwhile, in both geo-political and geo-economic terms, the sanctions have increased Russia's dependence on China and slowed its attempts to establish a Eurasian Economic Union in Central Asia, at a time when both Belarus and Kazakhstan have shown signs of nervousness at Russia's approach to Ukraine and are attempting to broaden their foreign relationships.

More widely, sanctions have severely restricted the amount of technology transfer and investment available to exploit new oil and gas fields, especially offshore and in the Arctic, and have delayed several military modernization programs. At the same time, there has been an increased Russian readiness to sell advanced weapon systems and technologies, notably to China and Iran, but also to others, reflecting the need for Russian defense businesses to sustain their product lines and acquire foreign currency.[9]

The experience of sanctions is likely to encourage the Putin regime to continue to explore, with China and Iran, the viability of an alternative international banking and payments regime that is not denominated in dollars and not dependent on US good will and forbearance. This strategic ambition would not only serve to reduce Russian vulnerability to sanctions in future, but also support Russia's geo-political aspirations in Europe, the Arctic and Central Asia, while providing liquidity and investment for its projected Eurasian Economic Union. Just as the European Union has tried to limit its energy dependence on Russia as a result of the crisis, Russia has sought to reduce its financial interdependence with the US and EU. It has explored alternative ways of funding its debts, as well as engaging with novel financial instruments and institutions. The CBR has also been buying significant amounts of gold, (now 1,238 tonnes), largely reflecting the desire to lessen its commitment to the US dollar.

Importantly, although the sanctions have seriously affected Russia's financial health and prospects for economic growth, they have not undermined the domestic legitimacy of the Putin regime. In fact, the sanctions have effectively limited Russia's interaction with the US and the EU and enabled the regime to restrict Internet activity, repatriate Russian assets and cash resources and exert greater controls on individual freedoms. However,

8 IMF calculation (www.imf.org).

9 http://edition.cnn.com/2015/04/14/europe/russia-iran-air-defense-system-sale/

with a less than robust economy, constrained by sanctions and lower oil prices, Russia might be tempted to assert itself through military means, rather than compete on economic terms with the EU and US. Nor is it likely that a comprehensive sanctions regime will be sustained over the longer term, with Greece, Hungary, Italy and Cyprus, in particular, expressing their concerns about the effects on their own economies of maintaining pressure on Russia. Significantly, among attendees of the 9 May Victory celebrations in Moscow, [were] the Czech Republic, Slovakia, various Balkan countries and Cyprus.

EUROPEAN NEXT STEPS

An EU Council Summit on 25 - 26 June 2015 will be the next indicator of European resolve and determination to deal with the crisis in Ukraine, even though dependence on Russian energy products remains the most effective restraint on more stringent European sanctions. Nevertheless, as the terms of the Minsk Agreement have yet to be implemented and Russia shows no sign of further restraining its proxies in the East of Ukraine or returning the Crimea (a highly unlikely prospect), it seems that the EU, as indicated by Angela Merkel on 27 April,[10] will decide to continue with sanctions. This decision, which has to be agreed unanimously, will be taken despite the very different views of the EU Council members, with those in the geographical front-line, such as the Baltic States and Poland, proposing a tough approach, while Germany, France, Spain and Italy fret about the economic impact of sanctions and counter-sanctions and would like to see a diplomatic solution to the conflict. They are also concerned with maintaining EU unity.

Meanwhile, Hungary, the Czech Republic, Slovakia and Bulgaria seek a balance between their membership of the EU and NATO and their interest in attracting Russian investment and securing cheap energy imports. Both Hungary and Cyprus have been wooed by Russia, with the prospect of investment and favourable loan conditions, while Cyprus has offered Russia the use of port and airfield facilities for Russia's armed forces. Finally, Greece is attempting to exploit progressively closer affinities with Russia to provide leverage with its fellow EU countries with regard to its economic crisis. It relies on Russia for its natural gas and its current government manifestly does not support sanctions. Critically, the issues of the expiry of Greece's bailout extension and possible exit for the Eurozone will roughly coincide with the EU Council summit on sanctions in late June.

RUSSIA AND UKRAINE

Analysis of Russia' actions so far would suggest that Russia's geo-political priority is to ensure that Ukraine does not join the EU or NATO, with the hope that it could be incorporated into the Eurasian Economic Union. Russia is unlikely to pay more than lip service to the Minsk Agreement, while maintaining its influence and support to pro-Russian elements and attempting to dominate decision-making in Kiev through economic incentives and implicit coercion. It will consolidate its political grip on Eastern Ukraine and, as a matter of urgency, seek to establish stronger transport and infrastructure links between Russia and the Crimea, by means of a land corridor, either as a result of annexation, or as a formally agreed transit route, in order to support the geographically beleaguered peninsula. Recent

10 http://www.nato.int/cps/eu/natohq/topics_111767.htm
http://www.europarl.europa.eu/meetdocs/2014_2019/documents/afet/pr/1053/1053203/1053203en.pdf

troop concentrations and periodic mortar attack by pro-Russian forces against the important port city of Mariupol (in clear violation of the Minsk Agreement) are clear indicators of Russia's interest in this area.

It is also apparent that Russia, or at least elements in government and among Putin's closest allies, as well as Russian nationalists in Eastern Ukraine, hanker after the extension of the conflict in order to take in the territory formerly known as Novorussiya (or New Russia). This territory stretched across the south of Ukraine all the way to Odessa and the border with Moldova in the west of the country, encompassing populations that are either part Russian ethnicity or part Russian speaking in terms of identity. If achieved, this would give Russia its land connection with the Crimea and leave Ukraine with a rump of a state base on Kiev in the North West and cut off from the (Black) sea.

At the same time, Ukraine probably accepts that, without Western military support, it has little chance of reclaiming its lost territories, securing its borders and facing down Russia. It is therefore likely to concentrate on resisting any further advances by pro-Russian rebels, developing the country's economy and strengthening the political, financial and military institutions within the territory that it still controls.

An important feature of the crisis that introduces considerable ambiguity and complexity, as well as opportunities for disguising sources of wealth, is that the economies of Russia and Ukraine are closely linked, although the latter is trying to reduce its dependence and calling for more rigorous sanctions. The two countries have extensive trade ties and closely integrated industrial sectors. Moreover, at the start of the crisis the share of Russian and Cypriot FDI to Ukraine was to 5.9 per cent and 29.9 per cent respectively, while German FDI flows to Ukraine stood at 12.5 per cent. Russian banks still have Ukrainian subsidiaries, which hold over $6 billion in assets while Ukraine's total direct and guaranteed debt to the Russian state and Russian banks (some of which are subject to sanctions) totals over $4 billion, the equivalent of about 12 per cent of the country's external debt. Surprisingly, Franklin Templeton Investments, the US-based investment company, is Ukraine's single largest creditor, but it would seem sensible for the EU, in particular, to have a dormant strategy ready for the moment when Ukraine might default on Russia. It also seems certain that Ukraine will need considerable financial assistance from the EU in the form of loans and grants, as well as debt restructuring and inward investment.

In addition, Ukraine's energy sector is also linked to Russia. VS Energy International owns a share in eight of Ukraine's 27 regional energy suppliers, as well as 30 per cent of the power distribution, including control of supplies to the Odessa and Kiev regions. Electricity shortages that have resulted from the loss of some of Ukraine's coalfields have required the purchase of additional electrical power from Russia. In response, Ukraine has tried to secure natural gas through Slovakia, Poland and Hungary, but, until these countries are able to meet demand, Ukraine will continue to rely on Gazprom. Far from reducing Ukraine's economic and financial dependence on Russia, the continued links between the two countries will allow Russia to exert pressure on Ukraine, mainly through its banking and energy sectors, even as it seeks to avoid the worst consequences of sanctions.

On balance, Russia is likely to want the crisis to remain 'frozen', with the ability to launch occasional probes to test Ukrainian resolve and capability, with outward compliance with the Minsk Agreement in order to have the sanctions regime reduced or removed. This reflects the fact that Russia is weak in terms of economic levers, but strong relative to Europe in terms of political will, especially in its willingness to employ direct or indirect violence, whereas for Europe the reverse is true, with stronger economic levers and weaker political will and military instruments. As a result, the position of the US is critical to the maintenance of the sanctions regime, the containment of the crisis and deterrence of further aggression. The concern is that, instead of bowing to sanctions and coming to terms, Putin will initiate a military or hybrid, paramilitary-led response, either in Ukraine or in some other part of the borderland between Russia and Europe in order to complicate geo-political calculations and regain some initiative. Alternatively, he might feel that with a mandate to rule until 2018 (or possibly 2024), he is likely to outlive his democratic counterparts in the West, who mostly would have to retire or seek re-election between now and then.

Whatever happens, Russian actions are likely to include continued military intimidation of European countries, attempts to erode the fragile consensus achieved by European countries and more determined efforts to divide Europe and the US. They are also likely to incorporate ways in which its isolation from dollar-based investment and access to liquidity could be circumvented. Therefore, barter, credit swaps and other arrangements with countries not engaged in sanctions, most notably with China, Iran and India, will most probably be developed. In the last five years particularly, Russia has been turning more to China for investment, especially in development and energy projects and in mineral companies.

Russia will also look to benefit from the projected six-fold increase in the Chinese fund management industry over the coming years. There are even plans to develop indigenous credit rating agencies, to provide a measure of protection in the face of adverse sovereign credit assessments (not to mention the additional costs of borrowing) and to introduce an alternative payments scheme to SWIFT.

Even though a further initiative and action plan are likely to be adopted at the EU summit in June, it is difficult to see where Western sanctions against Russia can reasonably exert further pressure, unless they are extended to individual sectors of the Russian economy and the wholesale withdrawal of visas for Russians travelling to Europe and the US. It remains a game of who blinks first, with the Putin regime accustoming the Russian people for the long haul and for the possibility of less traditional forms of both transnational and internal financing.

CONCLUSION

Overall, the existing sanctions regime seems only capable of stabilizing and containing the conflict in its current form. There is little appetite, and even less agreement, especially among European countries, about how to encourage the Putin regime to address the issues of the Crimea and the restoration of Ukraine's territorial integrity. It would appear that, as long as the territorial issue remains largely static and there is not significant armed conflict in relation to Eastern Ukraine and the Crimea, further significant sanctions are unlikely to be imposed. The US and Europe are still relying on the cumulative effect of existing sanctions on Russia and its economy over time to bring the Putin regime to the negotiating table.

Consequently, both the conflict in Ukraine and the countervailing sanctions regime have assumed the characteristics of a 'frozen' situation, with little indication of how the current impasse could be resolved. There is no indication at present that the Western powers are ready to increase the pressure on Russia to come to terms (beyond further asset freezes and travel bans)[11] and the Putin regime for its part seems determined to 'tough' it out. Only a significant escalation in the fighting, in the form of a renewed Russian-backed offensive against Ukraine, or a substantial intensification of the application of US and EU sanctions is likely to break the deadlock, which otherwise will most probably continue to be punctuated by periodic outbreaks of small-scale violence and repression in Eastern Ukraine.

This situation will present a dynamic challenge for regulators and compliance teams alike, mainly because of the complex inter-relationships and existential differences that exist between those countries imposing sanctions, Russia and Ukraine. As such, the guidance from Russian Sanctions – Navigating Choppy Waters is worth repeating:

'Banks and financial institutions will require access to forensic skill and vigilance in detecting and exposing not only direct attempts by Russian organizations to acquire capital and investment, but also indirect methods of operation involving third parties, shell companies and informal networks. These will necessarily include criminal and non-compliant business links, some with connections to legitimate government activity and sovereign wealth management authorities. The complex interplay of named individuals, targeted banks and companies and the involvement of the Russian state all make the tracking of interests and connections difficult without a systemic analysis and coherent assessment of how all these entities and individuals relate to each other'.

11 Even though some members of the US Congress have proposed isolating Russia from the international bank-transfer system, which Russian officials have denounced as an act of war.

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After reading Modern History at Jesus College Oxford, Chris Parry spent 36 enjoyable, rewarding years in the Royal Navy as an aviator and warfare officer. He commanded the destroyer HMS GLOUCESTER, the Amphibious Assault Ship HMS FEARLESS, the UK's Amphibious Task Group and the Maritime Warfare Centre. He also had five Joint appointments with responsibility for operational and developmental issues relating to all three Services. As a Rear Admiral, he was responsible for determining the future strategic context for operations and leading the conceptual development of all three armed forces out to 2030.

As well as sailing every sea, he experienced regular operational tours and combat operations in Northern Ireland, the Gulf and the Falklands, where he was mentioned in dispatches for his part in rescuing 16 Special Forces troopers from a glacier in South Georgia and for the detection and disabling of the submarine SANTA FE.

Nowadays, he runs his own strategic forecasting company, advising governments, leading commercial companies and banks about strategic issues, high-level leadership and systemic risk. With Blue Chip companies, he helps generate competitive advantage through the forecasting of future geopolitical developments, emerging trends and investment opportunities. He also has wide expertise in the technologies and techniques involved in dealing with all aspects of organised crime, terrorism and trafficking.

The founding Chair of the UK's Marine Management Organisation, he is an internationally recognised authority on existing and emerging trends in the marine and maritime warfare environment. He is a Fellow of the Royal United Services Institute, the Chartered Management Institute and the Institute of Directors, as well as a visiting lecturer at universities in the UK, US and elsewhere. He is also President of a Rugby League Club.

A regular broadcaster and commentator in UK national newspapers and magazines, he is an active author, most recently the best-selling 'Down South - a Falklands War Diary', published in February 2012, and 'Super Highway: Sea Power in the 21st Century', published in May 2014.

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