U.S. Sanctions On Russia Are Financial Warfare

On June 17th, the US announced further sanctions against Russia because of its support for rebels in the Ukrainian civil war. The new sanctions are widely considered to be tough. But they are also difficult to understand. The extent of their legal and practical application is by no means clear (yet very clever). However they are interpreted, they are bad news for Russia.

Here is the first part of Treasury Executive Order 13662, outlining the nature, purpose and application of the sanctions. The emphasis in the first bullet point is mine:
WASHINGTON - In response to Russia's continued attempts to destabilize eastern Ukraine and its ongoing occupation of Crimea, the U.S. Department of the Treasury today imposed a broad-based package of sanctions on entities in the financial services, energy, and arms or related materiel sectors of Russia, and on those undermining Ukraine's sovereignty or misappropriating Ukrainian property. More specifically:

- Treasury imposed sanctions that prohibit U.S. persons from providing new financing to two major Russian financial institutions (Gazprombank OAO and VEB) and two Russian energy firms (OAO Novatek and Rosneft), limiting their access to U.S. capital markets;
- Treasury designated eight Russian arms firms, which are responsible for the production of a range of materiel that includes small arms, mortar shells, and tanks;
- Treasury designated the "Luhansk People's Republic" and the "Donetsk People's Republic," which have asserted governmental authority over parts of Ukraine without the authorization of the Government of Ukraine; and Aleksandr Borodai, the self-declared "prime minister" of the Donetsk People's Republic, for threatening the peace, security, stability, sovereignty, and territorial integrity of Ukraine;
- Treasury designated Feodosiya Enterprises, a key shipping facility in the Crimean peninsula, because it is complicit in the misappropriation of state assets of Ukraine; and
- Treasury designated four Russian government officials, including Sergey Beseda, a senior Russian Federal Security Service official.

These actions do more than build upon previous steps to impose costs on separatists and the Russian government. By imposing sanctions on entities within the financial services and energy sectors, Treasury has increased the cost of economic isolation for key Russian firms that value their access to medium- and long-term U.S. sources of financing. By designating firms in the arms or related materiel sector, Treasury has cut these firms off from the U.S. financial system and the U.S. economy.

The sanctions that are causing the most confusion are those applied to the energy companies Rosneft and Novatek, and the financial companies Gazprombank (which is the financial arm of the gas giant Gazprom – note NOT Gazprom itself) – and VEB (Vnesheconombank), the Russian state development bank. The confusion arises from the statement I have highlighted in the quotation above. Rather than prohibiting these companies from using US dollars, which has been the approach taken in other sanctions regimes such as those applied to Iran and Sudan, the US administration has banned "US persons" from providing them with long-term financing.

This means that contrary to reports, "US persons" may not lend ANY currency to these companies for more than 90 days. The sanction is not limited to US dollars.

For the financial companies, the sanction is not limited to lending, either. Further down the Executive Order is this statement (my emphasis):

"Treasury imposed measures prohibiting U.S. persons and persons within the United States from transacting in, providing financing for, or otherwise dealing in new debt of longer than 90 days maturity or new equity for Gazprombank OAO and VEB, their property, or their interests in property.

http://www.forbes.com/sites/francescoppola/2014/07/18/us-sanctions-on-russia-are-financ...
Basically, these two banks are completely barred from US bond and stock markets. Though they don’t appear to be banned from derivatives markets – yet.

For the energy companies Rosneft and Novatek, the sanction is limited to debt financing. They could still raise equity finance through US stock markets – for the moment.

But that could change:

"However, the scope of the prohibited transaction types and the number of energy companies may be expanded under the authorities of E.O. 13662, if the Russian government does not take steps to de-escalate the situation in Ukraine."

There is a similar statement relating to the banks. The US government retains the right to extend the sanctions to more energy companies and more financial institutions without issuing another executive order. And it also retains the right to extend the scope of the sanctions in unspecified and potentially unlimited ways. This is indeed draconian.

But it is also – perhaps deliberately – vague. What exactly does a “US person” mean? We could take it to mean an individual or company normally resident in the US. Or we could take it to mean an individual who is a US citizen, regardless of their domicile. And what about companies that are headquartered elsewhere but have operations in the US? Are they “US persons” for the purposes of this executive order? There will no doubt be extensive legal arguments about the interpretation of this order.
In theory, a “non-US person” (individual or company) could continue to buy new debt and equity issues from these companies denominated in any currency including US dollars, or lend to them in any currency including US dollars. But in practice, they would not be able to lend to these companies in US dollars, because they wouldn’t be able to settle the transactions. If you want to clear US dollar transactions, you need a US bank – and a US bank would not be able to “transact in” the debt of these companies. The effect is, as the US Treasury says, to close the US dollar lending window to these companies, not by preventing non-US entities from lending to them, but by making it impossible for those transactions to be legally settled except in physical cash, which for oil and gas companies – and banks – is simply impractical. It’s very clever.

But the US cannot prevent a non-US person from lending to these companies in a non-US currency – Euros, for example. It is at present unclear whether the EU will follow suit with sanctions, and if it does, what the nature and scope of those sanctions would be. It is perhaps not obvious why an energy company would want to borrow in Euros, since oil and gas are priced in dollars. But borrowing in Euros could be a way round the sanctions. Suppose Gazprombank borrowed Euros from a medium-size German bank that had no US operations (so could not possibly be considered a US person): it could swap those Euros for US dollars at the Russian central bank, which has large amounts of US dollar reserves. If Rosneft did the same the picture would be a little more complicated: it would have to swap the Euros at a Russian bank, with the central bank swap done at arms length. No-one is saying they can’t use derivatives, after all – or even just basic foreign exchange facilities. So the question is whether European banks would be willing to risk annoying the US regulators, and whether European governments would be happy to let them do so. After the recent BNP Paribas case, the answer might be “perhaps not”. So Euro funding might be rather hard to come by even if the EU doesn’t do much in the way of sanctions. It’s still clever.

But there is another obvious source of funding for sanctioned Russian companies. China. Will the Chinese cooperate with the US over these sanctions? Ambrose Evans-Pritchard thinks they would – they did so previously. Though the China of today is a much more powerful beast than the China of 2005, and it is undoubtedly strategically interested in Russia’s energy companies. It might not be so willing now to bow to US pressure. But actually it doesn’t really matter whether China cooperates or not. The costs of obtaining US dollar financing from Chinese sources are likely to rise considerably: China is a tough negotiator, and Russia’s bargaining position would be weak. As the stated objective of the US sanctions is to increase the cost to Russia of these companies doing business, it doesn’t matter whether China cooperates with the US or not: simply raising the cost of financing achieves the objective anyway. Again, it’s very clever.
The VEB has already stated that it expects support from the Russian central bank, and it seems likely that Gazprombank will do too. If the financial sector is supported by the Russian central bank, then Rosneft and Novatek would be able to obtain US dollar financing in breach of sanctions, though this would gradually run down Russian US dollar reserves. The timing of the announcement of the new BRICS bank is therefore exquisite. The BRICS have large US dollar reserves, and the creation of the new bank (or, more accurately, fund) means they are in effect pooling them. The attitude of China, Brazil, India and South Africa to the US sanctions is therefore crucial. If they support them, Russia’s available US dollar reserves for lending to sanctioned entities will be diminished by the amount committed to the new bank. If they do not, then Russia potentially has access to a much larger pool of US dollar financing. I have no doubt there is intense diplomatic negotiation going on. Both Russia and the US need the support of the BRICS. I wonder which one will win.

The rest of the Treasury order is clearer. The US assets of eight armament firms have been frozen and transactions involving them prohibited for US persons, though it should be pointed out that this does not prohibit anyone from trading Russian-made armaments already in circulation. The US assets of the two rebel-held Ukraine regions have also been frozen and transactions prohibited, along with the assets of a shipping company suspected of being involved in the “misappropriation” of Ukrainian state assets. And the US’s list of sanctioned Russians has been extended by another four people. This is all familiar stuff.

We do not yet know if these sanctions will bite, though they appear difficult to evade. When they were announced, the ruble and the Russian stock market both fell and share prices for the sanctioned companies slid: it seems the financial world thinks the sanctions could hurt Russia considerably. But if they don’t, the US has already prepared the ground for more extensive attacks on Russia’s fragile economy. This is financial warfare.