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LOOSENING MAY HELP

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The U.S. and other Western countries have imposed economic sanctions to weaken the Russian economy and limit the Kremlin's ability to continue its aggression in Ukraine. Although sanctions have had a significant impact, they have had less impact than expected. Moreover, some of the sanctions related to the Russian financial sector have actually made it easier for the Kremlin to maintain economic stability. The solution: Instead of making it harder for Russians to move money outside the country, make it easier to depress the value of the ruble, make imports more expensive, and put pressure on Russian bank balance sheets.

KEEPING THE GOAL IN MIND

The effectiveness of economic sanctions depends on how clearly their objective is defined. The more ambitious the goal, the less likely sanctions are to succeed. If the aim was to stop the war and to cease actions that destabilize Ukraine or undermine its territorial integrity, sovereignty, or independence, then it is not surprising that sanctions have yet to achieve their goal. If sanctions could lead to a change of political regime, then neither Iran, Cuba, nor North Korea would have survived in their current form for decades.

If the goals of sanctions are defined in economic terms—"[sanctions impose] severe and immediate economic costs on Russia ... [their] pressures will further accumulate and suppress Russia's economic growth, increase its borrowing costs, raise inflation, intensify capital outflows, and erode its industrial base"—then the decisionmaking must consider the peculiarities of the Russian economy and its interconnections with the global economy.

OIL SANCTIONS? OR AN ALTERNATIVE?

The Russian economy is highly dependent on oil exports. That is why one of the first moves by the West was to impose sanctions to reduce Russia's oil revenues. Meanwhile, Russia supplies one out of six barrels of oil to the international markets, and two major consuming nations didn't join the sanctions regime. That undermined the effectiveness of oil sanctions to a significant extent. From the macroeconomic view, the desired impact of the oil sanctions should be broader than just the shrinking of budgetary revenues.[1] The Russian economy cannot produce many consumer and industrial goods and is significantly import-dependent. About a quarter of food products and about 60% of non-food consumer products sold in Russia are imported.

Devaluation of the ruble makes imports more expensive, accelerates inflation, and increases pressure on the entire economy. The devaluation results from the shifting balance between the supply and demand of foreign currency in the market. After the Central Bank of Russia's (CBR) foreign reserves were frozen, the Russian monetary authorities were limited in influencing the ruble's value using traditional currency interventions. Instead, the Kremlin imposed significant capital control measures, making the Russian currency selectively convertible.

A greater capital outflow would have increased the demand for foreign currency, pushing down the ruble and creating pressure on the balance sheets of Russian banks and leading to losses on their foreign currency exposure.

HOW IS THE CAPITAL LEAVING RUSSIA?

Russian households and companies traditionally used the dollar and euro as a way to save. According to the CBR data, by the end of 2021, Russian households had kept 10% of their savings abroad (excluding cash in their wallets). By the autumn of 2023 this share had exceeded 14%, and declined to 13% by end-March 2024.

Those Russians who had legal banking accounts in Western banks became more preoccupied with the safety of their savings after the Central Bank of Russia restricted access to foreign currency deposits in domestic banks in March 2022. For them, transferring assets outside of Russia could have been salvation.

Before the war, the household deposits outflow was stable ($300-$500 million per month). In February-March 2022, the outflow of deposits exceeded $5.1 billion, and after a slight reversal in April, it became tremendous: $3.8 billion per month from June-December. According to the Central Bank of Russia, between March 2022 and September 2023, individuals transferred more than 2.4 trillion rubles ($35 billion) to foreign bank accounts.[2] This is roughly equivalent to a $13 per barrel drop in the price of all crude oil exports by Russian companies during those eighteen months.

However, the intensity of the capital drain from Russia is declining, though not because of the strict limitations imposed by the Russian authorities. Indeed, the Central Bank of Russia promotes quite a liberal approach, limiting the size of international money transfers of Russian households by $1 million per

FIGURE 1

Monthly Russian households flows to foreign bank deposits

Source: Central Bank of Russia

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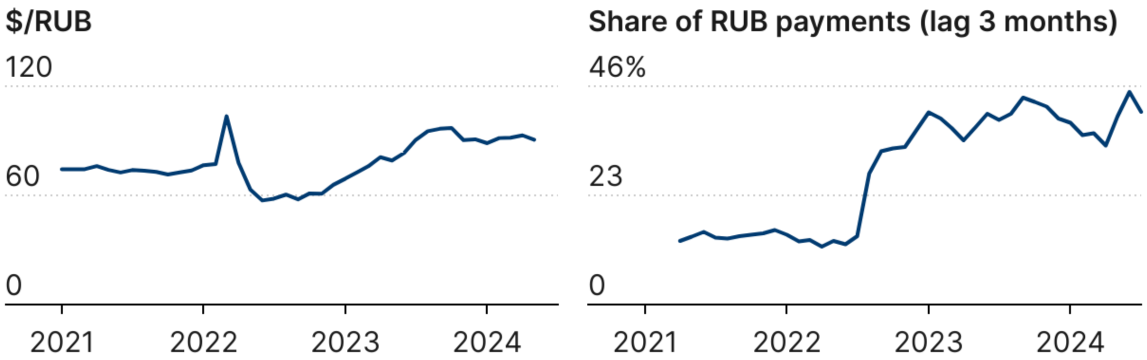
FIGURE 2

Share of the RUB in Russian exports payments and $/RUB rate



Source: Central Bank of Russia

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month. The decline happened when Western banks started blocking private payments from Russia without any legal basis, even those initiated by individuals and made through banks that are not on the sanction lists. (Banks block payments of all Russians regardless of their wealth and the size of the transfer. Transfers to Western banks are often blocked. Wealthy Russians have means to arrange all types of transactions, while ordinary Russians use banking transfers.)

By the end of 2022, after hundreds of thousands of Russians had left the country, one would have anticipated capital flight out of Russia to intensify. On the contrary, it started shrinking amid the European Union policy of imposing additional barriers to households' funds incoming to the European banking system from Russia. From mid-2023, following the EU directive, European banks started closing accounts of the Russian-owned companies, keeping more than €125 thousand if the owner had no European residence permit.

Though Swiss regulation does not prohibit Russian citizens from having bank accounts in that country, it limits the maximum amount that can be held in one account in one bank to 100,000 francs. Between 2022 and 2023, Swiss banks closed the accounts of Russian clients who had less than $1 million in their accounts.

By the spring of 2024, half a million Russians who fled the country after the beginning of the war returned home because of the impossibility of extending their residence permits or keeping an active banking account abroad. As a result, the intensity of the deposit outflow declined significantly. This makes Putin's life easier.

DOLLAR, EURO, RUBLE? IT DOESN'T MATTER

Though the most prominent Russian banks under sanctions cannot transfer in dollars or euros, existing opportunities via neighboring countries (ex-Soviet, first) allow deposits outflow in Russian rubles.

From the point of view of pressure on the Russian currency, it does not matter which currency Russian households use to transfer their assets abroad, whether in dollars, euros, or rubles. The net effect is to push down the foreign exchange value of the ruble. Here's what happens: Rubles are accepted by banks in neighboring countries that traditionally have a trade deficit with Russia (Turkey, Kazakhstan, Armenia, and Uzbekistan among others). Local banks convert rubles into the local or a foreign currency, then sell rubles to importers who use them to pay Russian companies. According to the CBR, the share of rubles in payments for Russian exports has grown from 12%-13% in January-March 2022 to 42%-43% in August-September

2023.[3] That means the amount of foreign currencies (offshore Chinese yuan included) that Russia is receiving for exports is declining. At the same time, the demand from the importers remains stable—the share of rubles in total payments for imports remains in the range of 28%- 31% in 2021-2023.[4]

This capital flight channel plays a vital role for migrant workers in Russia from Central Asian countries. They send ruble remittances to families using the Russian card payment system, Mir. Though the overall amount of those remittances significantly declined after the annexation of Crimea—from $15 billion per year in 2011-2014 to $5.7 billion in 2022 and $7.4 billion in 2023—it remains an essential element of the downward pressure on the Russian currency.

On February 23, 2024, the U.S. put Mir's operator on the sanctions' list and informed banks in the countries around Russia about the risks of the secondary sanction in case of using this system. At the end of March, Apple, Google, and Samsung blocked using their wallets' Mir cards. It is hard to imagine any damage to the Russian economy because of this decision except for restraining asset outflow.

ANOTHER CHANNEL

A significant barrier to capital outflows from Russia was created by the European Commission, which in June 2022 imposed sanctions on the National Settlement Depository (NSD) through which Russians could invest their funds in financial instruments registered with Euroclear, and the U.S. administration's November 2023 sanctions on the St. Petersburg Exchange (SPEX), which had an independent system of depository operations that allowed Russians to invest their funds outside the country.

Though volatile before the Russian invasion of Ukraine, Russian households' investment in Western financial markets was, on average, doubling the size of the

FIGURE 3

Monthly Russian households flows in non-resident stocks/bonds/ETFs

Source: Central Bank of Russia

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outflow via the deposit channel, $500-$1,000 million per month.

After the initial shock in late-February-March 2022, private investment into the capital markets recovered to become a "normal" size in May-June ($500 million/month). Starting in July, the outflow stopped amid the EU-imposed sanctions on the NSD, which blocked the Euroclear-NSD channel. I do not see how these sanctions harm Putin's interests while it is evident that dozens of thousands of ordinary Russians who are not sanctioned de jure lost access to their assets becoming sanctioned de facto.[5]

By April 2023, Russian households recognized a substitute—investing via the SPEX—and the capital outflow started gaining momentum. But in November 2023, the U.S. imposed sanctions on this exchange, blocking the channel of capital outflow.

RECOMMENDATIONS

For two years, the Western sanctions policy followed the tightening approach—any new decision should increase pressure on the Russian economy, and any official or unofficial recommendation should be "to ban" but not "to permit." Meanwhile, such an approach is not universally reasonable and helpful. Sometimes, it makes sense to step back and relax the nominal pressure.

If one hundred thousand Russians (or small companies) transfer $10,000 out of Russia each month using different channels, the total capital outflow from Russia would amount to $12 billion in one year. This amount is equivalent to a $6.80 per barrel discount to the price of annual crude oil exports from Russia.

If the sanctions policy envisages increasing tension in the Russian financial system and strengthening negative macroeconomic processes (devaluation, inflation), the following "loosening" steps should be considered:

1. European/U.S. banks continuing operations in Russia should give the green light to Russian households' outgoing cross-border payments and facilitate private outgoing cross-border payments for customers of other banks (if such payments are made between accounts of the same person and are no more than $1 million monthly).

2. U.S. sanctions imposed on the St. Petersburg Stock Exchange and the EU sanctions imposed on the National Settlement Depository should be partially lifted, unblocking the access of Russian households to their investment income (coupons, dividends, redemptions) and restoring the ability of Russian citizens to buy/sell foreign financial instruments traded on Western markets without the possibility of withdrawing funds/channeling funds to Russia but with an option to reinvest them in the Western markets.

3. Cross-border household card payments should be incentivized by allowing banks located in Russia's neighborhood to accept payments in Russian rubles, including via using the Russian payment system Mir and by recommending international payment systems to restore the partial functionality of bank cards issued by Russian banks, allowing outgoing cross-border payments.

Endnotes

1 Moreover, this effect could be neutralized by the devaluation of the Russian rubble, e.g. which happened in the first half of 2023.

2 For 2018-2019, similar transfers amounted to less than 500 billion rubles ($7.5 billion).

3 A caveat must be made that half of this increase is due to the Kremlin's demand for a switch to quasi-ruble payment for Russian gas exports, which occurred in May-June 2022.

4 In February-March 2024, this share jumped to 37.5-40%, resulting from a drop in imports due to growing problems with payments in non-traditional currencies (Chinese yuan, United Arab Emirates dirham, Turkish lira) outcoming from Russia.

5 In addition to closing the channel for Russians to withdraw capital from the country, the EU sanctions have resulted in significant assets of Russians being frozen; investors cannot receive the income due to them (dividends and coupons), although most of these Russians are not under sanctions. Attempts to organize a dialogue with the EU and Euroclear have yet to yield results; European authorities do not consider this a problem. A similar situation occurred with the assets of Russians, which they bought through the St. Petersburg stock exchange. It is well understood that Russians' anger, in this case, is directed against the U.S. and Europe, not against Putin. The icing on the cake: the Russian authorities have developed a special mechanism that may allow Russian investors to return capital to Russia. If this mechanism works, it will not be hard to see who investors will thank.

Disclosures and acknowledgements

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