International Commentary — April 6, 2022

Russia-Ukraine Update: April 2022

Summary

Russia-Ukraine developments remain fluid. Last week's positive headlines seem to be a false start as Russian hostilities continue. In response, the United States and Western allies have imposed new financial sanctions, which likely raise the probability of Russia defaulting on its sovereign debt obligations. Despite the severity of sanctions and the government on the brink of default, the Russian ruble has rebounded sharply. Counter-sanctions designed to support the currency are working, and in our view, these policies are likely to remain in place for the foreseeable future. In the context of effective and persistent counter-sanctions, the ruble has strengthened back to pre-invasion levels and we believe the currency can strengthen further over the longer-term.

Economist(s)

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Last Week Was A False Start

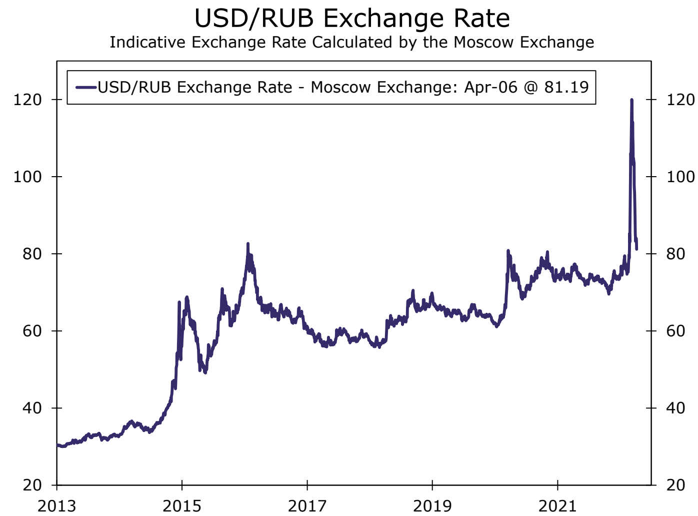
Toward the end of last week, headlines suggested the Russia-Ukraine conflict may have reached a turning point. Media reports suggested Russian troops could be pulling out of Kyiv and scaling back military operations in key cities across Ukraine. These media reports were substantiated by Russian officials confirming operations would recede and that a troop withdrawal out of Kyiv and Cherniv would be imminent. According to those same Russian officials, the change in tactics were aimed at reducing hostilities and de-escalating tensions, while also working on finding a way toward a peace agreement or some type of ceasefire. A meeting between Ukrainian President Zelenskyy and President Putin was also floated as a possibility by both Ukrainian and Russian negotiators. These developments took place on March 29, and while only less than a week ago, there have been significant developments since then. **In our view, the positive developments we saw last week seem to be a false start**. While reports suggest Russian military is indeed leaving Kyiv, Russian troops seem to consolidating in the Donbass region and reinforcing their positions in the Donetsk and Luhansk in an effort to establish stronger control over Southeast Ukraine. Russian shelling of the city of Kharkiv also continued, with little evidence the assault on the Northeast town is easing. And finally, footage over this past weekend revealed possible war crimes in the city of Bucha, a town in Kyiv Oblast, which is a province in Northern Ukraine, but does not include the capital city of Kyiv. Media reports suggest Ukrainian civilians, not military, were targeted in an attack on Bucha, leading President Biden and Western allied governments to announce new sanctions against Russia, and for European governments to strongly consider halting Russian energy imports.

The U.S. Treasury also took action against Russia, disallowing United States financial institutions to process Russian sovereign debt payments. While Russia has maintained its willingness to pay interest and principal payments up to now, **sanctions restricting U.S. banks from processing bond payments likely increases the probability of Russia defaulting on its obligations**. To that point, just this week Russia tried to make coupon payments on dollar-denominated debt; however, U.S. banks were blocked from processing transfers to bondholders. In an effort to stay current on debt obligations, the Russian government made interest payments in rubles rather than U.S. dollars. Since the start of the conflict, and before U.S. Treasury imposed sanctions, **credit rating agencies warned paying dollar-denominated debt with rubles would be considered a sovereign default**. Should rating agencies and regulators determine a "credit event" has occurred, according to Russia's sovereign bond covenants, **the government would enter a 30-day grace period where debts can still be paid in U.S. dollars and Russia would avoid technical default**. **Should Russia enter the 30-day grace period and not fulfill dollar-denominated obligations during that time, the likelihood of Russia being in default would be very high**. In the coming months, Russia will have to make multiple dollar-denominated payments to bondholders. While the payments are not particularly large, the same logistical and operational challenges, not necessarily liquidity or willingness issues, could result in Russia again paying dollar-denominated debts in rubles, and additional bonds entering the grace period and potentially being defaulted on. Russia will have to make $70M worth of interest payments in May and close to $400M of coupon payments in June. September obligations are more burdensome, as the government will have to make total payments of around $800M (~$370M of interest payments as well as pay off a sinkable bond worth ~$425M) (Figure 1).

Figure 1

Source: Bloomberg Finance L.P. and Wells Fargo Economics

Figure 2



Source: Bloomberg Finance L.P. and Wells Fargo Economics

Counter-sanctions Are Working In The Ruble's Favor

While the likelihood of a sovereign default has likely risen, the ruble's fortunes have turned and have become more positive. Over the last month, the ruble has recovered all of its recent decline in value in offshore markets and is back to pre-conflict levels against the U.S. dollar. Once 45% weaker against the greenback, the currency is now only down only 9.5% through the beginning of April. As of early April, the USD/RUB exchange rate on Moscow markets sits at RUB81.19, a staggering recovery from an intra-day weak point of RUB121.21 (Figure 2). In our view, **the ruble's rebound is a product of counter-sanctions and policies put in place designed to support the currency**. These policies include strict capital controls, mandating Russian companies to sell hard currency, forcing "hostile" countries to purchase Russian energy in rubles, aggressive monetary tightening, as well as Russia's sovereign wealth funds purchasing up to $10B in ruble denominated assets.

While the majority of these counter-sanctions are likely not sustainable over the long-term and will inflict damage on Russia's economy, an argument can be made that **counter-sanctions are achieving their intended goal**. The ruble has stabilized, and in our view, as long as counter-sanctions remain in place, we feel the ruble can gradually strengthen going forward. Even in the event that Russia is declared as in default on its sovereign bonds, we feel the ruble can continue to strengthen as a default will likely not result in capital controls or any other counter-sanctions to be lifted. In fact, a default could incentivize Russian officials to keep these policies in place for longer, as a default would likely result in a sudden stop of capital flows toward Russia. While the ruble has strengthened back to pre-invasion levels and already hit our medium-term targets, we feel the currency can continue to strengthen going forward. In that context, in our most recent *March International Economic Outlook* **we forecast the offshore USD/RUB exchange rate to strengthen to RUB78.00 by the middle of 2023.**

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