Russia Watch: Violent conflict in Ukraine ... default delayed for now — why?

Raiffeisen RESEARCH

May 25, 2022 7:30 CEST

Further hardening rather than easing signals dominate in the Ukraine war. In the economic sphere Russia is still trying not (yet) to be forced into a (technical) default (for corporate bonds technical defaults on external debts are mounting) — preserving a minimum degree of economic rationality. Meanwhile, an ultra-strong RUB can be sold as a policy success domestically. We remain on alert regarding further (Western) steps of "economic warfare" ahead (e.g. asset seizures, enforced external sovereign default).

Creeping further hardening and preparation of further escalation steps

Currently, **all indications** are pointing to a **further hardening** of positions in **war** in Ukraine **on the ground** as well as in regard to the **geopolitical positioning** in the **background** and in the days and weeks to come. Meanwhile, we see preparations for additional steps of "economic warfare".

- **Diplomatic/peace talks** between Russia and Ukraine got completely off track in recent days with no indication for a further continuation near terms. Ukraine remains committed to diplomacy on a Presidential level only. The fate of the Azov Steelworks fighters remains unclear, but they are more likely to face war crimes tribunals in the occupied territories or in Russia than a mere prisoner exchange.
- In **eastern Ukraine**, it looks like **Russia** now wants to achieve **further military sub-goals** with all its vehemence and determination. Following the ultimate capture of Mariupol local territorial gains are taking place in Eastern Ukraine. A certain lack of speed should not obscure from the fact that, according to official indications (such that of the Russian Defense Minister) Russia is setting itself up for a long conflict despite unprecedented pressure of sanctions. Meanwhile, it seems that the military strategy of Russia in other parts of Ukraine also aims at **destroying key economic infrastructure** and **facilities**. Moreover, there are indications that Russia (despite current official denials) may prepare for **further votings** on **joining Russia** or **recognition** of **new People's Republics** either on Ukraine territory and/or in other occupied territories (e.g. South Ossetia).
- At the same time, the conflict or **polarization** between the **West** and **Russia** continues to intensify. **Russia** is currently even being **actively accused** by the West of **deliberately causing** a **global hunger, poverty** and **refugee crisis** ("using food supplies as a weapon" like with energy). Russia blames the West and its sanctions policy for the emerging global food and poverty crisis, while the West probably also wants to support Ukraine with weapons systems (e.g. anti-ship missiles) that could help break the naval blockade. At the same time, further logistical support for Ukraine is being worked on. The EU is (still) calling on Russia to engage in dialogue on these

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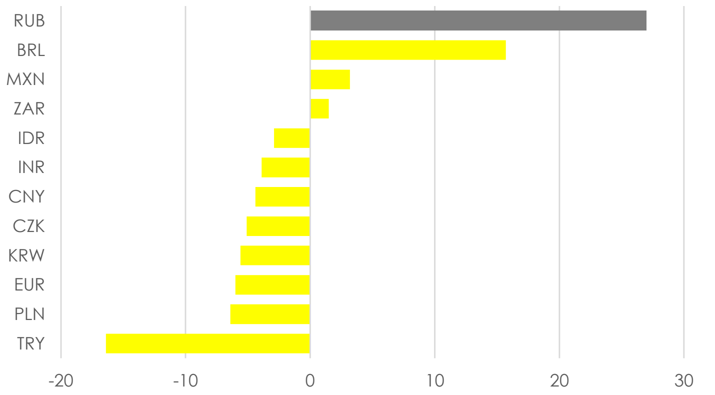
issues and unlocking Ukrainian food exports. An escort of cargo vessels by Western navies could lead to direct conflicts with Russia. Moreover, the last few days have again brought clear signals of diplomatic support for Russia by China (see, for example, joint military drills in Asia in the middle of US diplomatic activities there).

- Within the **EU, public calls** for the **confiscation** of **frozen Russian state** and **private assets** are **gaining significant momentum** in policy circles. Some EU countries (the three Baltic countries plus Slovakia) are currently actively advocating for such a move, while European Commission Chief von der Leyen confirmed the EU is looking at making use of frozen Russian assets (CBR assets & private assets). Legislative measures are also being prepared currently (at least for private assets), while some EU officials remain highly cautious on confiscating Russian state assets.
- Meanwhile, the **EU** has **not managed** to agree on **an embargo on Russian oil** yet, while this was possibly the assumption on behalf of Russia. It remains to be seen whether the EU will manage to broker a political solution in the coming days or if single EU countries will move on their own going forward.

The Ruble Conundrum - a sign of strength?

In some ways, Russia can claim **(supposed) success** on **financial markets**. The **USD/RUB** exchange rate has even broken through the 60 mark to the south on the local market in recent days, trading **much stronger** compared to **pre-war times**. The local currency remains supported by FX market restrictions and enforced conversion. Moreover, short-term market technicals like tax payments and conversion of payments for gas into RUB also play a role. Therefore, the RUB is among the **best performing global (EM) currencies** in **turbulent markets YTD** (currently leading the pack), while the analyst community (incl. us) do see the fundamental value at much lower levels. However, capital controls and dysfunctional markets are not supporting any (short selling) positioning against the RUB. Therefore, the exchange rate continues to trade at ultra-strong levels, while sovereign and corporate default topics do remain with investors (see next paragraph). Currently, the RUB might be already at too strong levels from a local perspective as indicated by the decrease of mandatory FX sales for exporters in recent days.

Exchange rates vs. USD (%, YTD)



Refinitiv, RBI/Raiffeisen Research

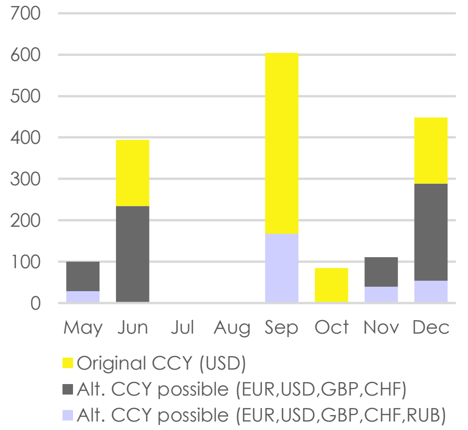
Russian sovereign default – a rehash of the topic or material change?

Since the launch of sweeping Western financial sanctions **Russia** has been **seen** already **few times** on a **cusp of an external (technial) sovereign default**, though so far making good on foreign obligations. This week, however, sees another landmark change in the sanction landscape as the **U.S. Treasury** is said to **not roll over the special waiver (license)** allowing the Russian FinMin to service external debt, hence making the technical default a matter of time. A non-renewal was decided, possibly also because Russia was probably too optimistic and pronounced that the USA would not "dare" to take this step.

Perhaps minding that the license expires on 25 May, the Russian FinMin took care of the two Eurobond coupons worth ~USD 100 mn (2026 USD and 2036 EUR) falling due on 27 May already last week.

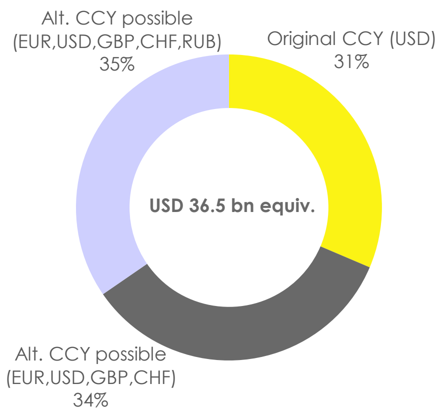
Respectively, **a formal non-payment might not occur as yet**, though few nuances should be noted. Both Eurobonds in question were issued through the domestic financial infrastructure and bear "RU" ISINs. This means the funds are distributed via the National Settlement Depository (NSD), which makes it less clear how smooth can be the transfer to foreign investors given the sanctions-driven disconnect between NSD and Euroclear/Clearstream. At the same time, both issues may be serviced in "alternative currencies" (EUR, GBP, CHF — for the 2026 bond; USD, GBP, CHF or RUB — for the 2036 bond) if principal or interest cannot be paid in the originally agreed currency for "reasons beyond control" of the Russian government. In fact, almost 70% of Russia's sovereign Eurobonds outstanding (by principal amount) are equipped with the "alternative payment currency" clause, where around a half contain an option to pay in RUB (including for all EUR-denominated issues).

RU Eurobond payments due in 2022*



** in USD mn equivalent for sovereign issues; Source: Refinitiv, RBI/Raiffeisen Research*

RU Eurobonds outstanding*



** principal amount for sovereign issues; Source: Refinitiv, RBI/Raiffeisen Research*

In other words, with the **OFAC waiver expiring**, the **risk of a missing payments** for **foreign creditors** is **disproportionately higher** on Russia's plain vanilla dollar bonds (no legal option to pay in RUB), where the nearest coupons are due in June (~USD 400 mn) having also a formal 30-day grace period on top. Having said that, **we do not expect** the **Russian government** to **declare bankruptcy** — rather, in case of technical (compliance) issues with money transfers it would pay in roubles and on local NSD accounts regardless of the bond documentation, i.e. in line with the established counter-sanctions regulation. A payout of the credit protection would be the base case here, however further **litigation strategies** for creditors **might prove limited** in the **current sanctions environment** given also additional challenges related to sovereign immunities.

A **lack of creditors' initiative** to **claim bond payments** we also see in the **corporate universe** where already about **twenty Russian companies have fallen overdue** with their **Eurobond coupons** because of the sanctions-driven restrictions since March. In total, these embrace around **USD 14 bn of bonds principal amount** that is **now in technical default** but prompting no legal action by creditors that we would be aware of. We note that the issuers' strategy varies here, as some companies pay in roubles (e.g. Sber, VTB, VEB) while others apply for an exemption (license) that would allow them transacting in hard currencies for the purpose of debt service (none has been granted so far to our knowledge).

All in all, it seems that at **some point in time** in the **coming months Russia cannot avoid** a **"default" label** being pretty much **forced into** a **technical non-payment event**.

One may question the rationale of this move from the U.S. side, since it does not change much Russia's (locked-out) position on the international financial market while scrapping a legit tool to deplete its fresh FX revenues and putting U.S. holders of Russian debt in the line of fire. However, this will still count as a **strong political statement** and escalation in the sanctions pressure. From the Russian side, it seems rational to delay this step as long as possible, as it could certainly entail **some imponderables** (such as how non-sanctioning countries can act with Russia). However, **we remain skeptical** that in a few weeks or months the circumstances will be such that **a technical (external) state default** — induced by Western sanctions — **can really be avoided**.

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Producer of this publication Raiffeisen Bank International AGAm Stadtpark 9, A-1030 Vienna

Creation time of this publication: 25/05/2022 7:30 A.M. (CEST) ;

First Dissemination of this publication: 25/05/2022 7:30 A.M. (CEST)