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RUSSIAN SANCTIONS – NAVIGATING CHOPPY WATERS

By Rear Admiral Chris Parry CBE

STATEMENT OF INTENT

This White Paper examines the strategic and financial implications of Russia’s actions in relation to Ukraine, especially as a result of the shooting down of Malaysian Airlines Flight MH17. It particularly addresses the likely effects of sanctions, imposed by the US, the EU and other western-oriented countries and the retaliatory measures that have been introduced by Russia. It considers the prospects for future confrontation and conflict in eastern Ukraine and more widely, as well as the implications of sanctions and unfolding events for the financial and corporate sector. In addition, it provides advice about what actions are needed to ensure compliance and identifies the broader, systemic risks that are likely to occur as a result of continuing tension and crisis.
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INTRODUCTION

For most of 2014, Russia has been reported to have been sponsoring an armed insurgency in Eastern Ukraine, principally using its Special Forces and intelligence agencies and acting through local ‘separatists’. It is reported to have been providing heavy weapons, including artillery, armour and sophisticated anti-air missiles and to be holding regular forces on its border with Ukraine at high readiness, with the implicit threat that they could invade if required. Initially, despite extensive rhetoric, the response from the EU seemed self-interested and half-hearted, in line with a lukewarm response from the US. However, the shooting down of Malaysian Airlines Flight MH17 reportedly by one or more Russian made, supplied and possibly operated BUK-1 anti-air missiles, coupled with continued Russian intransigence, has transformed a regional 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.

It is therefore sensible to consider the implications of these sanctions for the financial and corporate sector, in particular what actions are needed to ensure compliance and to identify the broader risks that are likely to arise as a result of continuing tension and crisis. It is important to recognize at the start that the sanctions against Russia are significantly different in scale and scope, from those imposed on Iran and are less stringent and straightforward. For example, the sanctions do not target Russia’s economy, but introduce complexities for large foreign energy companies, like Total, BP, Statoil and ExxonMobil, which all have significant investments and joint ventures in Russia. They will be able to operate with Russian firms, such as Rosneft, but they will not be able to facilitate financing or technology transfer. Difficulties are also likely to arise with regard to pre-payment deals, whereby development loans are repaid from the promise of future energy supplies.

US AND EU SANCTIONS

In order to comply with the range of sanctions, institutions should carefully examine and observe the measures that have been progressively issued by the US and the EU1 since the beginning of the crisis in Ukraine, culminating in the so-called ‘Tier 3’ measures, which came into full force on 31 July 2014. The early travel bans and asset freezes on designated individuals have given way to more systemic sanctions of the same type. The precise details of the sanctions are available from the Department of the Treasury/Office of Foreign Assets Control (US) and the European Union Decision (COUNCIL DECISION 2014/512/CFSP) and Regulation documentation (EU), with interpretations and amplifications provided by individual member states. Large multi-nationals will ensure that they understand the subtle differences and what is prohibited or permissible in each case. Large multi-nationals will especially need to consider the liabilities of their partners and subsidiaries in terms of sector engagement, national law and geographic footprint. In addition, it will be essential to monitor capital flows, track the activities of named individuals (and their associated networks) and remain familiar with evolving applications of sanctions to ensure that both direct and indirect risks are minimized and reputational and commercial integrity is preserved. In the US, the penalties are severe: civil penalties up to US$250,000 or twice the amount of the underlying transaction are in place for each violation. Criminal penalties could amount to US$1,000,000 in fines and up to 20 years imprisonment.

THE EFFECT ON RUSSIA

The ongoing crisis and the announcement of US and EU sanctions have had an immediate effect on the Russian economy2, already evident in a loss of liquidity and access to capital. Inward dollar-denominated capital investment has fallen by two thirds in the first half of 2014 (from US$25 billion in 2013). Similarly, capital flight has resulted in US$60 billion leaving the country in the first quarter of 2014, with a net capital outflow of around US$24 billion. As a result, the Russian rouble has fallen by two thirds in the first half of 2014 (from US$25 billion in 2013). Similarly, capital flight has resulted in US$60 billion leaving the country in the first quarter of 2014, with a net capital outflow of around US$24 billion.

The sanctions specifically limit the ability of Rosneft, Gazprombank, Novatek and Vnesheconombank to raise funds maturing in more than 90 days. The US and EU capital markets will be severely constrained; new syndicated loans were not included.3

In the financial sector, the principal US measures prohibit Russia’s access to Western capital markets, with the consequence that their debts will be harder and more expensive to pay. At the same time, the EU prohibited Russian state-owned banks from selling shares or bonds in the world’s main capital markets, although syndicated loans were not included.4

Clearly, those institutions wishing to remain compliant with regard to the full range of sanctions will need to differentiate between the two different sanctions regimes (US and EU), to ensure that they understand the subtle differences and what is prohibited or permissible in each case. Large multi-nationals will especially need to consider the liabilities of their partners and subsidiaries in terms of sector engagement, national law and geographic footprint. In addition, it will be essential to monitor capital flows, track the activities of named individuals (and their associated networks) and remain familiar with evolving applications of sanctions to ensure that both direct and indirect risks are minimized and reputational and commercial integrity is preserved. In the US, the penalties are severe: civil penalties up to US$250,000 or twice the amount of the underlying transaction are in place for each violation. Criminal penalties could amount to US$1,000,000 in fines and up to 20 years imprisonment.

1 Reuters.com/article/2014/08/06/us-ukraine-crisis-nato-idUSKBNOG613M20140806
2 The precise details of the sanctions are available from the Department of the Treasury/Office of Foreign Assets Control (US) and the European Union Decision (COUNCIL DECISION 2014/512/CFSP) and Regulation documentation (EU), with interpretations and amplifications provided by individual member states.
3 The sanctions specifically limit the ability of Rosneft, Gazprombank, Novatek and Vnesheconombank to raise funds maturing in more than 90 days.
4 The EU also invited the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD), to suspend new lending to Russia.
5 Russia’s economy is already decelerating; in 2013 GDP growth was 1.3 per cent. In 2014, it seems likely to be in recession.
outflow of US$100 billion predicted over the whole of 2014. The rouble has lost 8 per cent of its value during 2014, pushing up consumer prices and inflation, while bond sales since March 2014 have amounted to only US$4.1 billion worth, compared to nearly US$20 billion worth in the same period in 2013.

In the coming months, Russia will be vulnerable with regard to its debt (over US$700 billion, or 34 per cent of GDP and counting), of which two-thirds is public debt. In addition, Russian banks and companies will need to service US$161 billion worth of foreign debt over the next 12 months alone, while state-owned enterprises are highly leveraged and dependent on the Central Bank for liquidity to fund external asset purchases. Meanwhile, Russia’s extensive linkages to US and EU capital markets increase its vulnerability to sanctions. In addition, Russian businesses have about US$165 billion in dollar and euro denominated bonds and more than US$100 billion in offshore syndicated loans currently outstanding. They have also raised more than US$40 billion by selling US and global depositary receipts since 2000. Similarly, there will be an increase in the proportion of non-performing loans, which will result in the medium term in constrained levels of domestic capital as banks build up their capital bases. This will roll forward into the longer term as weak business and household demand and reduced investment.

However, Russia’s Central Bank has US$472.5 billion in foreign currency and gold reserves to support ease liquidity and assist its banks in the short term. As long as EU sectoral trade sanctions do not emerge, transfer risk will probably remain containable, as the high foreign exchange reserves and a healthy current account surplus should allow about 10-12 months of import security (as well as favourable credit ratings). Nevertheless, fiscal expansion will be constrained by concerns about inflation and the drive to modernize its armed forces, while monetary policy adjustments would be limited by the potential damage that would be inflicted by the market on currency and stocks. It has already tried to stem capital outflow by raising interest rates twice and allowing the exchange rate to depreciate. Meanwhile, the Central Bank is funding state spending through a variety of instruments, such as infrastructure bonds and joint ventures, potentially excluding new private sector lending. In the longer term, Russia needs secure and stable access to capital for its economic development and to exploit its natural resources, if Putin is to sustain the Russian economy and international profile on which his political legitimacy depends. It also requires investment for modernising its armed forces, constructing new energy pipelines in eastern Russia and, urgently, for development in the Crimea, as well as building the facilities and infrastructure needed for the 2018 World Cup.

The most pressing requirement is to sustain small and medium sized Russian companies through access to enterprise and development capital from Russia’s larger firms and state-run banks. They, in turn, despite their reserves, will need to access wider sources of capital, such as China, where they can find it. These will incur higher costs of borrowing and loans will most likely, in China’s case, be accompanied by demands for privileged access to Russia’s energy and mineral resources. Typically, Rosneft, which has a US$12.7 billion loan payment due in December, will rely on advanced funding from long-term Chinese crude contracts, while Gazprombank, with US$2.2 billion due this year, will rely on Central Bank assistance. Again, Rosneft is already due to receive US$63 billion of advances under long-term crude-supply contracts from 2014 to 2018, mostly from Chinese clients (which coincidentally covers Rosneft’s US$65 billion of debt). However, it has yet to be proved that alternative funding from China, South Korea, Qatar or the United Arab Emirates would prove sufficient to replace lenders in Europe and the US in the longer term. Even so, additional resort to Chinese investors will increase the dependence and geo-political alignment of Russia with China.

There is a possibility that Russia, in order to continue with its geo-political ambitions, will adopt a fortress mentality and turn in on itself, resulting in the isolation of the Russian economy for some time to come, characterized by a protectionist, state-controlled economic policy. This possibility has already been reflected in volatility in Russian bonds (down 6.9 per cent) and equities (down 9.6 per cent). Historians have highlighted that Russia is used to enduring hardships in support of its vital interests and in the teeth of international opposition to its actions. It is also possible that the urgency with which Putin is seeking to retain Ukraine in Russia’s orbit reflects its perceived vital role, along with Belarus and Kazakhstan, in Russia’s Eurasian economic model, its alternative to the EU.

Even so, the likelihood is that Putin will back down only when the economic pressure threatens his legitimacy and power base, centred on the major banks and energy giants. Here, the regime and its most wealthy supporters are likely to be cushioned from the effects of sanctions by their control of foreign currency, mostly dollars, held in offshore accounts, tax avoidance schemes and illicit money transfer arrangements, which continue to include criminal, specifically, money laundering schemes. The West’s incremental approach to economic sanctions would only appear able to work over time. Russia was already weakened by the financial crisis of 2007-8 and, if the crisis continues or intensifies for a year or more, the damage to the Russian economy and to financial stability is likely to become progressively more severe. Without remedial measures, the abrupt stemming of capital flows could result in what commentators assess will be a 4 per cent fall in Russia’s economy during 2014 and into 2015.

**SPILLOVER EFFECTS**

Despite contributing 3 per cent of global gross domestic product (GDP) and significant energy exports, Russia’s low level of integration in global supply chains and international financial markets means that the effects of the crisis on the global economy are likely to be limited. However, if Russian financial institutions deleverage rapidly, there could be appreciable losses for Russian and international investors, coupled with a reduction in global risk appetite, with the result that traditional safe havens would be the beneficiaries. As such, financial market sanctions could affect not only on Russian financial institutions, but also the markets in which they operate. Russian banks hold significant derivative positions and sanctions on them could damage liquidity and market confidence. Additionally, should the Russian economy slow further, there are likely to

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6 There are already indications that these loans are 22 per cent lower than the same period last year and this trend will have knock-on effects on consumer spending and exports, which suggest that GDP growth will reverse in 2014.
8 The decision by Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine to join the EU’s Eastern Partnership in 2009 still rankles.
be increasing levels of payment and credit risk in the short term, leading to insolvencies and bankruptcies, especially for those transactions that are denominated in dollars or euros. Equally, disruption to payments systems could have cascading consequences, because of the interconnectedness of the complex financial markets of today.

More particularly, Europe would be significantly affected by long-term, particularly trade, sanctions because the EU is by far Russia’s most important business partner, with trade worth about €270 billion a year (with the US at €18.9 billion) and is the source of 75 per cent of foreign direct investment in Russia. 300,000 jobs in Germany depend on trade with Russia, with 6,200 German-owned companies active there and €20 billion invested. Germany also relies on its prosperity on regular, reliable sources of Russian gas and the UK’s financial markets are heavily engaged in the transfer of funds in and out of Russian concerns. The Netherlands not only has significant joint commercial ventures with Russia, notably in Royal Shell’s investment in oil and gas, but also acts as a centre for financial services and products in support of Russian corporate and individual beneficial owners.

Western sanctions would have direct effects on almost all the economies that are in the geo-political space between Russia and Europe. Poland, Lithuania and Finland have already indicated that their economies would be adversely affected, together with EU-leaning countries like Moldova and Georgia.

Europe would therefore be particularly averse to further sanctions that target Russia’s energy sector, as these would harm the EU almost as much as Russia, given that there are few immediately available alternatives to Russian gas. 30 per cent of gas and 25 per cent of oil imported by EU members comes from Russia. Other suppliers do not have the reserves, capacity or pipelines to replace Russian gas and Europe lacks the (Liquid Natural Gas) LNG infrastructure and unconventional impetus that is evident in the US. Increases in gas prices could be in the order of 20 to 40 per cent, while increases in oil prices, with the West seeking sources of supply in areas other than Russia, would be less likely. Indeed, after a short structural adjustment, oil prices might even fall if non-Russian producers release oil from reserves and increase output. For its part, Russia is unlikely to resort to cutting off exports of hydrocarbons to Europe. Its dependence on oil and gas revenue (65 per cent of exports and 35 per cent of revenue) means that it would be extremely risky for Russia to retaliate by threatening oil and gas embargoes, particularly if ongoing capital flight continues to put pressure on its international exchange reserves and currency.

Conversely, Russia will need to take into account that Belarus and Kazakhstan will be put under pressure because they are integrated into the Russian economy by means of the existing Customs Union, a wide range of personal and business connections and Russia’s plans for a Eurasian Economic Community, to be established in 2015. Belarus in particular is heavily dependent on Russia for crude oil and natural gas, as well as financing from the Russian-dominated Eurasian Economic Community, in particular Gazprombank, which operates as Bel gazprombank in Belarus. Also, Russia is Belarus’ largest export market 45 per cent (US$16.7 billion) of the country’s total exports. Even though it has offered to be flexible with Ukraine in relation to agricultural trade and oil exports, Belarus is seriously vulnerable to collateral damage, including travel bans and asset freezes, as a result of sanctions on Russia. Meanwhile, although Kazakhstan only sends 7 per cent of its total exports to Russia, it is dependent on the Russian financial and banking sectors - Sberbank and VTB Bank are major investors in industrial projects in Kazakhstan, with Russia providing 12.6 per cent of Kazakhstan’s credit market. Also, the Kazakh and Russian currencies are pegged and the Kazakh tenge’s vulnerability was demonstrated by its 20 per cent fall in March 2014. Further pressure from sanctions is likely to result in the use of foreign exchange reserves to bolster its currency.

**PRECAUTIONS**

As the situation develops, companies and financial institutions need to examine in detail the effects of US and EU sanctions regime on their dealings with Russian companies and institutions, in particular the state-run banks and government authorities. The sanctions are complicated in their application, not only because the US and the EU have sought to increase pressure on Russia progressively, but also because out of self-interest, they have allowed Russia some ‘wiggle-room’. The US has excluded Russia’s largest bank, Sberbank, from the proscribed list and most of the bans on technology transfer apply to the oil sector, but largely leave the gas industry, with a nod to Europe’s dependence on Russian gas, unaffected. Somewhat disingenuously, defence restrictions apply to future, not existing, transfers, allowing France to supply powerful Mistral-class amphibious ships (very useful for power projection operations in the Baltic and Black Seas) to the Russian Navy. Another complicating factor is that, apart from the US and EU countries, very few other states have backed the sanctions. Australia, South Korea and Japan have all explicitly said that they will not impose sanctions, while the other leading economies, including China and India, have chosen to retain their existing links with Russia.

Companies and institutions with investment and assets in Russia will therefore need to assess and price the political risk of their business ventures in the light of the ongoing uncertainty about Russian strategic intentions and the volatility of the situation with regard to Ukraine. Multinationals, in particular, have to be aware of the differing applications established by US and EU sanctions. There are also several potential pitfalls with regard to dual use technologies and other products, which bring an export control risk, and in relation to donations to NGOs and charities. Other complications will arise as Russia implements a programme of import substitution, involving alternative suppliers for those products and technologies it cannot acquire from countries that are imposing sanctions on Russia.

Commercial and financial institutions that have exposure to Russian enterprises should remain agile with regard to their financial profile and future strategy. Close tracking of counter-parties and deteriorating payment performance will provide warning suitable mechanisms. Companies will also need to provide themselves with suitable advice and risk assessments with regard to other geo-political disputes and crisis with which Russia might in future be engaged.

In addition, they will need to mitigate the possibility that the Russian regime might be tempted to threaten or implement retaliatory measures (there have already been reports of threats

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9 However, on 4 August 2014, Germany announced that it would not deliver a major combat simulator the associated technology, to Russia.

10 According to the US Energy Information Administration (EIA), European countries import 84 per cent of Russia’s total oil exports and about 76 per cent of its gas exports - the EU by far Russia’s largest export market.
Russian Sanctions — Navigating Choppy Waters

in relation to the top four Western accounting firms, and to the joint ventures of Total and Shell). With EU and US sanctions threatening to exert early pressure and the Russian economy now effectively in recession according to IMF forecasts, Russia has announced retaliatory sanctions, banning selected food imports from the US, the EU, Ukraine, Poland, Japan, Canada, Romania and Australia. Threats are being made to exclude EU (and presumably US and other sanctioning countries’) airlines from operating over Russia. Foreign or joint ventures are likely to come under pressure and need to be prepared for the threat or use of selective defaults by Russian companies, backed by the state. Here, they might need to consider political risk insurance. They could expect increased harassment of their businesses and employees, perhaps with legal challenges to their existing methods of operation and perhaps increased levels of arbitrary charges for basic services and documentation. Most importantly, they should ensure that their systems and operators are alerted and consider the possibility of cyber attack, infiltration and disruption by the Russian state, opportunistic criminals and nationalistic individuals.

Financial institutions and businesses, especially those with Russian and Ukrainian counterparts, should screen existing and future customers, clients, and accounts against the names of the persons subject to the sanctions. Given the fluidity of the situation, additional persons and groups are likely to be added in future. Existing long-term contracts with parties subject to sanctions will require renewed scrutiny and legal review. Most importantly, companies will wish to assure themselves that their dealings with named politically exposed persons (PEPs) and their associates are above reproach. Institutions and investors will need to be clear with whom they are dealing, both directly and indirectly, especially in consequence of an increased use of proxies, shell companies and third party involvement, especially offshore.

Companies should also review their business operations with, and within, Russia, and determine how best to manage their operations in light of existing and potentially tighter sanctions. For example, public companies might want to apply a Russia sanction risk factor to their reporting and accounting mechanisms, or migrate relevant assets away from Russia. Contracts would also need review to determine whether they can be terminated in the light of sanctions or their positions improved.

As well as ensuring that they do not contravene, either directly or indirectly, the existing sanctions regime, they will also need to consider reputational risk of conducting transactions that might be legal, but might not be regarded as legitimate by the media or public opinion in the light of circumstances and Russian actions.

Finally, companies should have plans and risk profiles in place in the event of two main outcomes:

a. In the event of a severe downturn in the Russian economy and the damage that this might induce, there could be knock-on effects, not only in the European, but also in the global economy. Fears of this happening have already prompted increased purchases of bonds (especially German bunds) and rumours of a further round of quantitative easing by the European Central Bank (ECB). This might be accompanied by a sudden increase in energy prices as the market struggles to acquire alternative sources in the wake of coercive or obstructive action by Russia.

b. Secondly, when and if the situation resolves itself and normal investment and financing patterns are resumed, institutions will have to take special care in their due diligence to ensure that the transactions and linkages that were established by Russian banks and companies during the application of sanctions were legal and free of risk for the future. There will also need to be a thorough examination of legacy partnerships and commitments.

PROSPECTS

In the months ahead, both Russia and the West will recalibrate their respective strategic postures in relation to events as they unfold. NATO countries, at their major summit in Wales at the beginning of September, are likely to reaffirm their emphasis on the collective responsibility for the defence of NATO territory and reinforce the commitment to the North Atlantic Charter’s Article 5, which declares that an attack on one country is an attack on all. There will also be specific military measures to re-assure allies, such as the Baltic Republics, Poland and other Eastern European countries that feel especially and immediately threatened by a revanchist Russia.

These measures will include the reinstatement of credible readiness postures and alert states, capable of generating forces that can deter and, if necessary, defeat incursions by Russia within warning timescales. They will also address how to counter the irregular tactics used by Russia in destabilizing Crimea and Eastern Ukraine. Other measures are likely to include increased surveillance of Russian military and covert activity, as well as improvements in cyber and electronic defence. Finally, there will be concerted attempts to strengthen the integration and institutional cohesion of civil societies in those countries within NATO (such as Latvia) that have significant Russian minorities and to offer capacity-building and institution-strengthening assistance to countries that lie in the no-man’s land between the EU and the CIS. Politically, it will be difficult to balance Russia’s insistence on its droit de seigneur in its near abroad with NATO and the EU’s distant support of the aspirations of the people living in these regions.

For his part, Putin is likely to want to draw back from immediate confrontation over Eastern Ukraine, distance Russia from the shooting down of MH-17 and continue the build-up and modernization of Russian armed forces. His key objectives will be to keep the Crimea and enforce the virtual autonomy of the breakaway region of Eastern Ukraine and the federalisation of the whole country. More importantly, he would want to ensure that a unified Ukraine did not join NATO or the EU in preference to Russian-approved and sponsored security and economic structures.

Putin would certainly find it difficult to contain the political fall-out at home if Ukrainian forces were able to suppress the rebels and seal the border of Eastern Ukraine with Russia. This currently is a distinct possibility. There are between 20 and 30,000 Russian personnel, with supporting special forces, armour, artillery and combat aviation stationed on the Russian side of the border. Based on the experience of Georgia in 2008, it is likely that these would be committed to prevent a ‘separatist’ collapse and, on the pretext of peacekeeping and protecting those of Russian ethnic and linguistic origin, would prevent the regaining of its lost territory by Ukraine. These operations are

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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.
12 Huffington Post - 12 August 2014.
likely to be supported by aircraft, artillery and missile systems operating from inside Russian territory.

As a result, there is a distinct possibility that sanctions will be extended in the months to come, if the existing measures are not seen to bite and Putin, instead of dissociating himself from events in eastern Ukraine, increases his support and moves more troops and long-range systems to the border, in the face of successful operations by Ukrainian forces against the separatists. Another reason for extension of the sanctions regime would be evasion of the sanctions by financial and trading entities keen to exploit the situation. Here, the US, in particular, has emphasized that it will apply further pressure to individuals and companies, if transactions are seen to be flouting the sanctions’ provisions, for example in disguising new debts and equity issues within innovative derivative contracts and novel financial instruments. Russia will seek other ways to evade sanctions. It could use proxies and third parties to evade both scrutiny and disruptions to its banking and financing operations. It might exploit more opaque and secure sources of capital and also conduct more transactions through intermediaries, shell banks and third parties. It could also resort to barter in those instances where it has something to trade (energy, military hardware, agricultural produce) and goods and service that it needs to acquire.

Russia has already started to explore ways in which it can cooperate with other countries to diversify its economy; on 4 August 2014, it was announced that Iran and Russia would cooperate to facilitate Iranian oil exports and develop energy, construction and agricultural markets. In this connection, Russia and China are likely to grow closer together as financial, geo-political and energy dependencies increase, based around recent and future exclusive energy agreements. It is possible that, in the medium to long term, sanctions on Russia might be the catalyst that leads to the de-coupling of Russia and China from the existing world economic consensus and globalized model. The pressing need for Russia to seek alternative sources of capital and investment that are not dependent on geo-political goodwill of the US and the EU, along with the growth of the Russian-sponsored Eurasian Economic Community with the coincident formation of the BRICS Development Bank, could indicate that a migration is happening, away from the Bretton Woods arrangements towards a more fractured global financial market. Therefore, taken together with the effects on their partners, it is difficult to know where the US and the EU can go next for increasing the economic pressure. Russia exports mostly energy, agricultural products and raw materials although, apart from energy, few find their way to the West. Nevertheless, in global pricing terms, the US would be concerned about the global supply and price of raw materials if Russia’s exports in these areas were targeted, while, as seen above, Europe would have difficulty in maintaining the stability and affordability of its energy supplies and would be concerned about the loss of an agricultural export destination calculated to be worth US$9 billion annually. These factors alone indicate where splits could occur between the US and the EU over the further tightening of sanctions. The success of sanctions against Russia could depend on which side blinks first in economic and fiscal terms and in the face of market pressure on currencies and trade.

**FINALLY**

As has been seen above, the Russian economy seems certain to contract, but with energy returns, foreign exchange reserves and subsidized state employment providing a measure of stability in the short to medium term. With a substantial Reserve Fund and National Wealth Fund, Putin is likely to try and tough it out economically in the short term, while striving to seek a political and strategic solution that enables him to maintain face and support at home and influence in Russia’s near abroad. The loss of access to capital in the West is likely to increase the reliance of the business and financial community on the state-run banks, which will in turn rely on regime support and access to alternative sources of capital. Over time, the situation will become critical for Russia and, by extension, the international community when Russia’s economy can no longer cope with the restrictions placed on it and is unable to find alternative and acceptable sources of capital to maintain its liquidity. This situation is likely to result either in increased dependence on China, accompanied by increase energy exports to Asia, or in sullen, limited demonstrations of military power in the geopolitical sphere.

While sanctions and restrictions on activities with Russian individuals and institutions remain in place, companies that wish to be compliant with their home or host governments’ policies will need to tread warily in their business ventures and transactions with regard to Russia. They 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, the 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.

There is a broader lesson for business that emerges from the crisis in Ukraine. It is that strategic decisions about investment have to be made with regard to the long-term context and risk profile within which return and yield are expected. Too often, risk is assessed on the basis of the future being like the present, only more so, with too little regard for the complexities of risk beyond the immediate horizon and narrow economic and financial indicators. In particular, long-term political, demographic and societal risks, both probable and plausible, have to be factored into business ventures, especially those with authoritarian regimes and unstable regions, and priced accordingly. It is not enough to establish and assess the short-term implications and benefits of commercial agreements, without regard for the sustainability of the investment or the vagaries of political decision-making. If nothing else, the Ukraine situation has demonstrated that, whereas economics is predominantly globalized, geo-politics are not. Political imperatives, including the imposition of sanctions, have a recurrent habit of trumping economic considerations.

14 This assessment must also take into account the diverse linkages and personal networks that exist between Russia and other major financial alternatives, such as China, but also those within the countries of the Commonwealth of Independent States (CIS) and the Russian diaspora.
About the Author

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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.


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