



## Political Default. The Implications of Weaponizing Global Financial Infrastructure

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*In response to Russia’s unlawful invasion of Ukraine, the U.S. has led a broad-based global coalition to punish the aggressor with an “unprecedented” sanction regime. Those measures have targeted “the Russian government’s basic tools to manage its macroeconomy,” with a particular emphasis on its sovereign debt. That concerted focus, as this Article empirically demonstrates through analysis of bond and credit default swap data, ultimately resulted in Russia’s first foreign currency debt default in over a century — despite the nation’s ability and seeming willingness to pay.*

*Notwithstanding aptly-deserved “just deserts” considerations, a forced — or “political” — Russian sovereign debt default through the operation of sanctions raises unique policy and normative questions,*

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*while creating underappreciated risks for emerging markets at an extremely fragile time.*

*This Article, part of a broader series regarding the Ukraine conflict, is the first to explore these critical developments, detailing the associated potential risks and externalities, as well as mitigating factors.*

#### TABLE OF CONTENTS

INTRODUCTION .....	55
I. MACROECONOMIC “SHOCK AND AWE” .....	57
A. <i>Central Bank Reserves &amp; Currency</i> .....	60
B. <i>Targeting Sovereign Debt</i> .....	62
II. UNPRECEDENTED ACTIONS, “OPAQUE” OBJECTIVES .....	65
III. RISKS & EXTERNALITIES OF THE SANCTIONS “WEAPON” .....	68
A. <i>Current Russia Investors</i> .....	68
B. <i>Emerging Market Sovereign Debt</i> .....	72
C. <i>Global Financial Infrastructure</i> .....	75
CONCLUSION .....	76
APPENDIX .....	78

## INTRODUCTION

“Our purpose here is to methodically remove the benefits and privileges Russia once enjoyed as a participant in the international economic order,”<sup>1</sup> explained a U.S. official regarding sanctions levied against Russia following its “brutal assault on the people of Ukraine.”<sup>2</sup>

In response to Russia’s “unlawful war,”<sup>3</sup> the U.S. has led a multilateral coalition — including the EU, UK, Canada, Japan, and others<sup>4</sup> — to punish the aggressor with an “unprecedented wave of sanctions,”<sup>5</sup> equating to the “financial equivalent of ‘shock and awe’ tactics.”<sup>6</sup> Though at times less than crystalline, the goals of the sanctions have, broadly, been to severely reprimand Russia while also “weakening” its ability to wage war.<sup>7</sup>

The portfolio of sanctions deployed against the Kremlin comprises largely well-worn instruments, but is nonetheless distinctive for its

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<sup>1</sup> Jarrett Renshaw & Daphne Psalidakis, *U.S. Announces New Russia Sanctions over Ukraine Invasion*, REUTERS (Mar. 24, 2022, 8:15 AM PDT), <https://www.reuters.com/world/g7-eu-announce-measures-stop-russia-avoiding-sanctions-us-official-2022-03-24/> [<https://perma.cc/D72R-ECAE>].

<sup>2</sup> Presidential Speeches and Remarks, Remarks by President Biden on Russia’s Unprovoked and Unjustified Attack on Ukraine (Feb. 24, 2022), <https://www.whitehouse.gov/briefing-room/speeches-remarks/2022/02/24/remarks-by-president-biden-on-russias-unprovoked-and-unjustified-attack-on-ukraine/> [<https://perma.cc/TZ6E-F28X>].

<sup>3</sup> Adil Ahmad Haque, *An Unlawful War*, 116 AJIL UNBOUND 155, 155 (2022).

<sup>4</sup> Chad B. Brown, *Russia’s War on Ukraine: A Sanctions Timeline*, PETERSON INST. FOR INT’L ECON. (Nov. 18, 2022, 1:08 PM), <https://www.piie.com/blogs/realtime-economics/russias-war-ukraine-sanctions-timeline> [<https://perma.cc/74SX-4ABY>].

<sup>5</sup> Elena Chachko & J. Benton Heath, *A Watershed Moment for Sanctions? Russia, Ukraine, and the Economic Battlefield*, 116 AJIL UNBOUND 135, 135 (2022).

<sup>6</sup> Peter Thal Larsen, *Sanctions Shock-and-Awe Reverberates Beyond Russia*, REUTERS (Feb. 27, 2022, 10:09 AM PST), <https://www.reuters.com/markets/asia/sanctions-shock-and-awe-reverberates-beyond-russia-2022-02-27/> [<https://perma.cc/HJ2P-RM8Q>].

<sup>7</sup> Olivier Knox, *The U.S. Has a Big New Goal in Ukraine: Weaken Russia*, WASH. POST (Apr. 26, 2022, 11:51 PM EDT), <https://www.washingtonpost.com/politics/2022/04/26/us-has-big-new-goal-ukraine-weaken-russia/> [<https://perma.cc/7U7Q-49FR>]. *But see* Carol E. Lee, Courtney Kube, Ken Dilanian & Abigail Williams, *When the Secretaries of Defense and State Said Publicly the U.S. Wants Ukraine to Win and Weaken Russia, Biden Said Tone It Down*, NBC (June 16, 2022), <https://www.nbcnews.com/politics/national-security/secretaries-defense-state-said-publicly-us-wanted-ukraine-win-biden-sa-rcna33826> [<https://perma.cc/E87E-4RDZ>].

ferocity,<sup>8</sup> the nature of the target — a large economy and critical commodity producer<sup>9</sup> — and laser-focus on Russia’s core economic foundations, with a particular emphasis on its sovereign debt.<sup>10</sup> Indeed, the U.S. has expressed a clear goal of making Russia a “pariah” that will “face default.”<sup>11</sup>

Notwithstanding a healthy, well-deserved element of “just deserts,” a forced — or “political” — Russian default through the operation of sanctions raises critical policy and normative questions, while creating underappreciated risks for emerging markets at an extremely fragile time.<sup>12</sup>

This Article is organized in three parts. First, through analysis of Russian sovereign bond price reactions to sanctions developments, it empirically demonstrates the direct link between sanctions and Russia’s sovereign debt default.<sup>13</sup> Second, it discusses how such a sanctions-driven default represents a broadly unprecedented policy departure that fits rather uneasily with the sanctions’ stated objectives.<sup>14</sup> Third, it presents the underappreciated risks — illustrated by analysis of sovereign credit default swap (“CDS”) auction data — and assesses implications, particularly in respect of emerging market sovereign debt

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<sup>8</sup> Larsen, *supra* note 6.

<sup>9</sup> See Davide Barbuscia & Sujata Rao, *Russia’s ‘Political’ Debt Default Sets Emerging Market Precedent*, REUTERS (May 27, 2022), <https://www.reuters.com/article/ukraine-crisis-russia-default-idTRNIKCN2ND0NU> [<https://perma.cc/4MB7-GJ52>].

<sup>10</sup> Jeff Stein, *U.S. Pushes Russia Toward Default by Blocking Debt Payments*, WASH. POST (May 24, 2022, 3:00 PM EDT), <https://www.washingtonpost.com/us-policy/2022/05/24/treasury-russia-debt-default/> [<https://perma.cc/7CE9-XNBN>].

<sup>11</sup> Harry Robertson, *The White House Says ‘Pariah’ Russia Is Poised to Default on Its Bonds as a Hefty \$100 Million Payment Falls Due and Its Options Run Out*, BUS. INSIDER INDIA (May 27, 2022, 3:20 PM EST), <https://www.businessinsider.in/investment/news/the-white-house-says-pariah-russia-is-poised-to-default-on-its-bonds-as-a-hefty-100-million-payment-falls-due-and-its-options-run-out/articleshow/91832998.cms> [<https://perma.cc/2KW4-DUEP>].

<sup>12</sup> See Marcello Estevão, *Are We Ready for the Coming Spate of Debt Crises?*, WORLD BANK BLOGS (Mar. 28, 2022), <https://blogs.worldbank.org/voices/are-we-ready-coming-spate-debt-crises> [<https://perma.cc/NC4D-TDWW>] (estimating that “over the next 12 months, as many as a dozen developing economies could prove unable to service their debt”).

<sup>13</sup> See *infra* Part I.

<sup>14</sup> See *infra* Part II.

and global financial infrastructure.<sup>15</sup> The Article briefly concludes by discussing policy considerations for mitigating such potential risks and externalities.<sup>16</sup>

### I. MACROECONOMIC “SHOCK AND AWE”

Sanctions, in one form or another, have a “long history” and include myriad varieties of economic and non-economic measures.<sup>17</sup> Generally speaking, economic sanctions are understood to serve four complementary purposes: Deterrence, enforcement, punishment, and rehabilitation — all “classic objectives of criminal justice.”<sup>18</sup>

The use of economic and financial sanctions generally became more common in the post-WWII era, but experienced an inflection point over the last two decades, particularly as a tool of U.S. policy in the aftermath of the September 11th attacks.<sup>19</sup> This is in large part because sanctions are able to “achieve national security objectives” without the use of force by “leverag[ing] the United States’ asymmetric economic power”<sup>20</sup> — perhaps most significantly, the U.S. dollar’s status as the world’s reserve currency.<sup>21</sup>

Leveraging these strengths, the global sanctions regime promulgated by the U.S. and its allies in the wake of Russia’s invasion of Ukraine has directly targeted the “the Russian government’s basic tools to manage its

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<sup>15</sup> See *infra* Part III.

<sup>16</sup> See *infra* Conclusion.

<sup>17</sup> Barry E. Carter & Ryan Farha, *Overview and Operation of U.S. Financial Sanctions, Including the Example of Iran*, 44 GEO. J. INT’L L. 903, 903 (2013).

<sup>18</sup> Gary Clyde Hufbauer & Megan Hogan, *How Effective Are Sanctions Against Russia?*, PETERSON INST. FOR INT’L ECON. (Mar. 16, 2022, 8:15 AM), <https://www.piie.com/blogs/realtime-economic-issues-watch/how-effective-are-sanctions-against-russia> [<https://perma.cc/8LGP-TRJU>].

<sup>19</sup> Carter & Farha, *supra* note 17, at 903; see William Mauldin, *U.S. to Press Financial Weaponry in Talks with European Allies on Russia*, WALL ST. J. (June 1, 2014, 8:43 PM ET), <https://www.wsj.com/articles/u-s-to-press-financial-weaponry-in-talks-with-european-allies-on-russia-1401667455> [<https://perma.cc/6AEP-EK33>].

<sup>20</sup> David S. Cohen & Zachary K. Goldman, *Like It or Not, Unilateral Sanctions Are Here to Stay*, 113 AJIL UNBOUND 146, 146 (2019).

<sup>21</sup> Joshua P. Zoffer, *The Dollar and the United States’ Exorbitant Power to Sanction*, 113 AJIL UNBOUND 152, 152 (2019).

macroeconomy,”<sup>22</sup> including its central bank reserves, currency, and sovereign debt. The assault on Russia’s sovereign debt has been particularly ferocious, pushing the nation to its first default since 1998 — and the first foreign currency default in over a century.<sup>23</sup>

Indeed, following the February 24, 2022 invasion of Ukraine, Russia has been on the brink of default on a monthly basis — despite having the money, and seemingly wanting to pay.<sup>24</sup>

This has occurred through a number of interrelated sanctions measures, including, most pertinently for our purposes, the following actions:

- **February 28, 2022.** Multilateral U.S. and EU sanctions prohibiting transactions with Russia’s central bank.<sup>25</sup>
- **March 2.** U.S. Treasury Office of Foreign Asset Control (“OFAC”) General License 9A (“GL-9A”)<sup>26</sup> prohibited purchases or sales of “debt or equity of Russian financial institutions,” including Russia’s central bank, with a limited, time-barred safe-harbor for receiving interest payments expiring on May 25.<sup>27</sup>
- **April 6.** Executive Order 14071 (“EO 14071”) banned “new investment in the Russian Federation by a United States person, wherever located.”<sup>28</sup>

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<sup>22</sup> Patricia Cohen & Jeanna Smialek, *The West’s Plan to Isolate Putin: Undermine the Ruble*, N.Y. TIMES (Feb. 28, 2022), <https://www.nytimes.com/2022/02/28/business/russia-sanctions-central-bank-ruble.html> [<https://perma.cc/9SDL-JB6U>].

<sup>23</sup> See generally Lev E. Breydo, *Russia’s Roulette*, SAN DIEGO L. REV. (forthcoming 2023) (detailing Russian bonds’ unique legal features and associated interplay with prospective sovereign debt default).

<sup>24</sup> *Id.* (manuscript at 25-29) (discussing Russia’s post-invasion bond payments).

<sup>25</sup> Brown, *supra* note 4; Off. of Foreign Assets Control, Directive 4 Under Executive Order 14024, 87 Fed. Reg. 32,303, 32,306-07 (May 31, 2022) (to be codified at 31 C.F.R. pt. 587). The U.S. also prohibited transactions involving Russia’s Ministry of Finance and National Wealth Fund. *Id.*

<sup>26</sup> Off. of Foreign Assets Control, General License No. 9A, 87 Fed. Reg. 55,267, 55,269 (Sept. 9, 2022) (to be codified at 31 C.F.R. pt. 587).

<sup>27</sup> *Frequently Asked Questions: Russia Harmful Foreign Activities Sanctions*, U.S. DEP’T OF THE TREASURY, <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/updated/2022-03-02> (last updated Mar. 2, 2022) [<https://perma.cc/BS7X-WS7V>].

<sup>28</sup> Exec. Order No. 14,071, 87 Fed. Reg. 20999 (Apr. 8, 2022). This had the effect of making inoperable a Russian bond payment “workaround” which required investors to

- **May 24.** Consistent with earlier indications,<sup>29</sup> the U.S. Treasury formally declined to extend the interest payment safe harbor provision of GL-9C (which succeeded GL-9A)<sup>30</sup> — in effect “blocking Russia from paying American bondholders.”<sup>31</sup>
- **June 7, 2022.** U.S. Treasury guidance prohibited U.S. persons from making secondary market purchases of Russian debt and allowed sales, but only to non-U.S. persons.<sup>32</sup>

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open bank accounts in Russia. *See Russia Readies New Bond-Payment Plan in Bid to Avoid Default*, BLOOMBERG (May 29, 2022, 4:12 PM PDT), <https://www.bloomberg.com/news/articles/2022-05-29/russia-to-settle-eurobond-debt-in-mirror-of-eu-payments-for-gas?sref=OOpRUZ8l> [<https://perma.cc/9LVZ-YA4U>].

<sup>29</sup> On May 17, 2022, Treasury Secretary Yellen stated: “[w]e’re actively involved in an evaluation of the risks and impact of not renewing the license.” Alan Rappeport, *U.S. Expected to Begin Blocking Russian Bond Payments to Americans*, N.Y. TIMES (May 17, 2022), <https://www.nytimes.com/2022/05/17/business/russia-bond-payments.html> [<https://perma.cc/5Q8T-3SQU>]. After the May 17 announcement, Russia’s CDS curve sharply steepened, reflecting market expectations of a near-term default. *See* Lev E. Breydo, *Russia’s Bond Roulette: May 25 Payment Safe Harbor Expiration Pushes Odds of ‘Nightmare’ \$40B Sovereign Default Near 90%*, BUS. L. TODAY (May 20, 2022), <https://businesslawtoday.org/2022/05/russia-bond-roulette-may-25-payment-safe-harbor-expiration-odds-40b-sovereign-default/> [<https://perma.cc/68PL-52AW>].

<sup>30</sup> GL-9C succeed and superseded, but in this respect did not alter, GL-9A. *Notice of Russian Harmful Foreign Activities Sanctions General License 9C*, U.S. DEP’T OF THE TREASURY (May 24, 2022), [https://home.treasury.gov/policy-issues/financial-sanctions/recent-actions/20220524\\_33](https://home.treasury.gov/policy-issues/financial-sanctions/recent-actions/20220524_33) [<https://perma.cc/U4JB-KG59>]; Off. of Foreign Assets Control, General License No. 9C, 87 Fed. Reg. 55,267, 55,270 (Sept. 9, 2022) (to be codified at 31 C.F.R. pt. 587). The primary change relative to GL-9A “foreclosed the possibility of debt service payments flowing directly from accounts in the name of Russian entities through U.S. financial institutions, which include the financial institutions’ foreign subsidiaries, but still allows creditors to receive them.” Juan P. Farah Yacoub, *The Legal Profile of Russian Eurobonds: Engineered Against Speed* 16-7, (World Bank Grp., Pol’y Rsch. Working Paper No. 10030, 2022), <https://documents1.worldbank.org/curated/en/099904004292222497/pdf/IDU085887472of2ac043cc08ae5019c6feadcafi.pdf> [<https://perma.cc/H3QU-EA5A>].

<sup>31</sup> Brown, *supra* note 4.

<sup>32</sup> *Frequently Asked Questions: Russian Harmful Foreign Activities Sanctions*, U.S. DEP’T OF THE TREASURY (June 6, 2022), <https://home.treasury.gov/policy-issues/financial-sanctions/faqs/added/2022-06-06> [<https://perma.cc/97MX-T9FM>]; Alexander Saeedy & Soma Biswas, *Russian Debt Ban Leaves Investors with Questions*, WALL ST. J. (June 9, 2022, 4:40 PM ET), <https://www.wsj.com/articles/russian-debt-ban-leaves-investors-with-questions-11654801508> [<https://perma.cc/J2F4-WFEW>].

*A. Central Bank Reserves & Currency*

Prior to the invasion of Ukraine, Russia built a literal war chest with over \$630 billion of multi-currency reserves<sup>33</sup> — a stockpile *The Economist* gauged to be “more than enough to weather sanctions.”<sup>34</sup>

However, as a practical and technical matter, utilizing assets held abroad requires working with financial intermediaries, such as banks.<sup>35</sup> Thus, the February 28, 2022 prohibition on transacting with Russia’s central bank had the practical effect of “freezing” about \$325 billion of Russia’s foreign reserves held in U.S., European and Japanese financial institutions.<sup>36</sup>

“The crux of why the Western allies have such leverage comes down to a reality of the modern financial system: Although Russia’s central bank owns the assets, it doesn’t control them.”<sup>37</sup> This is because, in highly simplified terms, for a central bank, the assets have their highest utility — particularly in respect of currency management — when situated abroad and denominated in different currencies.<sup>38</sup> In this case, however, that dynamic also left the reserves unexpectedly exposed.

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<sup>33</sup> *International Reserves of the Russian Federation*, BANK OF RUSS. (Feb. 2022), [https://cbr.ru/eng/hd\\_base/mrrf/mrrf\\_m/](https://cbr.ru/eng/hd_base/mrrf/mrrf_m/) [<https://perma.cc/B2TF-3GQS>].

<sup>34</sup> *A War in Ukraine Could Have Global Consequences*, ECONOMIST (Jan. 29, 2022), <https://www.economist.com/leaders/2022/01/29/a-war-in-ukraine-could-have-global-consequences> [<https://perma.cc/3H9Z-K2D7>].

<sup>35</sup> Claire Jones & Joseph Cotterill, *Russia’s FX Reserves Slip from Its Grasp*, FIN. TIMES (Feb. 27, 2022), <https://www.ft.com/content/526ea75b-5b45-48d8-936d-dcc3cec102d8> [<https://perma.cc/KV3U-HAQQ>].

<sup>36</sup> See Lev E. Breydo, *Putin’s Matryoshka*, COLUM. J. TRANSNAT’L L. (forthcoming 2023) (manuscript at 16-20) (detailing the composition and legal characteristics of Russian foreign currency reserves).

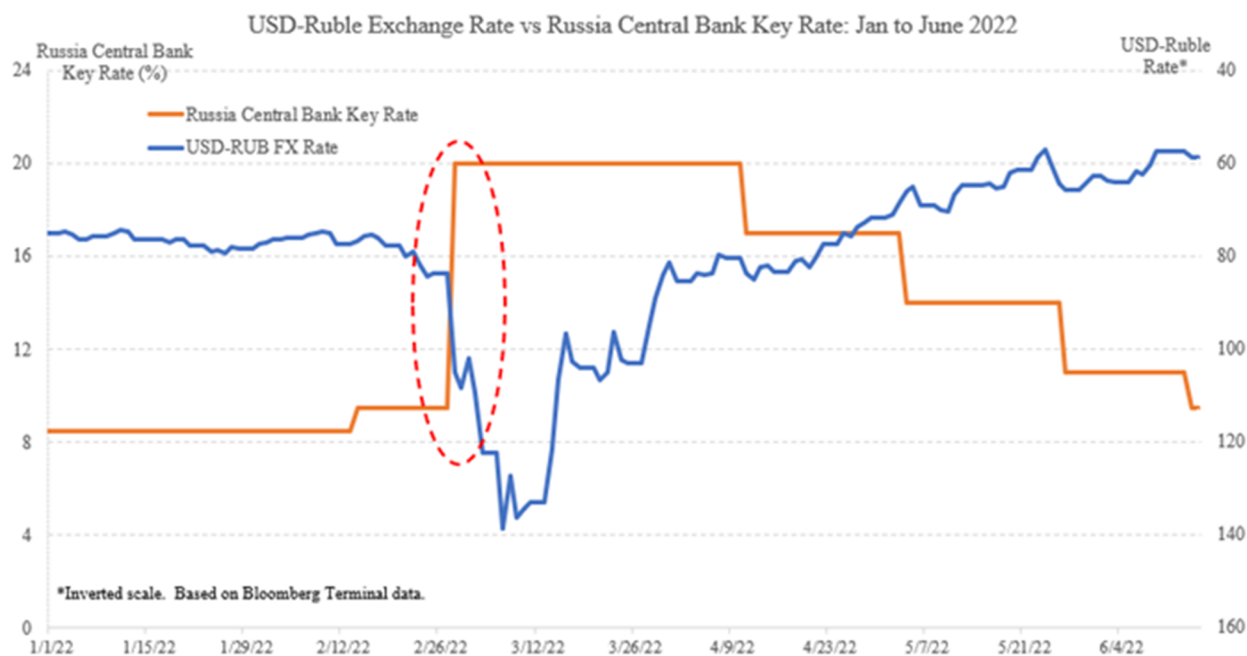
<sup>37</sup> Cohen & Smialek, *supra* note 22.

<sup>38</sup> See Nicholas Gordon, *Banks Are Stopping Putin from Tapping a \$630 Billion War Chest Russia Stockpiled Before Invading Ukraine*, FORTUNE (Mar. 2, 2022, 11:08 PM PST), <https://fortune.com/2022/03/03/russia-sanctions-central-bank-ruble-us-eu-foreign-reserves/> [<https://perma.cc/2G3F-ETMR>] (“Although a country can hold foreign reserves in its own banks, governments often choose to keep their reserves overseas to avoid costly cross-border transactions and gain direct access to foreign currency and debt markets.”).



Dovetailing closely with other actions against Russia’s central bank, the U.S. has also, albeit, indirectly, targeted Russia’s currency — reducing “the ruble . . . to rubble,” as President Biden proudly declared.<sup>39</sup>

The strength of a currency, somewhat like that of a bank, is innately rooted in faith; particularly in emerging markets, such confidence can prove rather ephemeral. Doubt spreads quickly — for instance, regarding post-sanction ruble utility — leading to a quasi-bank run of sorts, as a rush to sell the currency creates a self-fulfilling downward spiral.



As shown in the chart above, following imposition of sanctions, the ruble collapsed — losing over 60% of its value between February 24 and March 7, 2022.<sup>40</sup> Russia’s central bank quickly reacted, imposing currency controls and effectuating a single-day key-rate hike exceeding 10%, shown by the orange line above. As a result, the ruble has more than

<sup>39</sup> Kate Davidson, *Biden Turned the Ruble into Rubble. Then It Quickly Came Back*, POLITICO (Mar. 31, 2022, 5:00 AM EDT), <https://www.politico.com/news/2022/03/31/ruble-recovery-russia-biden-sanctions-00021850> [<https://perma.cc/8K9P-4MQ5>].

<sup>40</sup> See Cohen & Smialek, *supra* note 22.

stabilized; by April 2022, it actually increased in value relative to its pre-invasion baseline. Commentators, however, view the ruble's recent performance as "partly artificial," buttressed by central bank policies and Russia's commodity exports, suggesting the figures downplay significant pain to Russia's economy,<sup>41</sup> which is expected to contract significantly in 2022 and beyond.<sup>42</sup>

### B. Targeting Sovereign Debt

In the months following the invasion, the Russian Federation surprised market participants with a seeming commitment to making bond payments. Yet, beyond freezing Russia's reserves, with each post-invasion payment deadline, the U.S and its allies steadily tightened the noose around Russia's financial system, reducing its range of motion and bringing the sovereign closer to default. The most recent actions included in effect "blocking Russia from paying American bondholders,"<sup>43</sup> and subsequently disallowing secondary market debt transactions.<sup>44</sup>

The chart below shows prices for Russia's \$3 billion 2023 Eurobond between February 1 and June 1, 2022, denoted by the white line.<sup>45</sup> Each bubble represents a key event;<sup>46</sup> the grey trendline charts the path to default, which tells most of the story. The Appendix details the underlying data and computations.<sup>47</sup>

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<sup>41</sup> Caitlin McCabe, *Russia's Economy Is Tanking but the Ruble Soared. Here's Why*, WALL ST. J. (May 26, 2022, 5:52 PM ET), <https://www.wsj.com/articles/russias-economy-is-tanking-but-the-ruble-is-soaring-11653559916> [<https://perma.cc/5T7Y-YMLK>].

<sup>42</sup> Georgi Kantchev & Paul Hannon, *Sanctions So Far Fail to Dent Russia's War Effort*, WALL ST. J. (June 16, 2022, 8:51 AM ET), [https://www.wsj.com/articles/sanctions-so-far-fail-to-dent-russias-war-effort-11655383912?mod=series\\_rusukrainenato](https://www.wsj.com/articles/sanctions-so-far-fail-to-dent-russias-war-effort-11655383912?mod=series_rusukrainenato) [<https://perma.cc/XL5A-CAUQ>].

<sup>43</sup> Brown, *supra* note 31.

<sup>44</sup> Laura Benitez & Daniel Flatley, *US Treasury Prohibits Investors from Buying Russian Debt*, BLOOMBERG (June 7, 2022, 9:57 AM PDT), <https://www.bloomberg.com/news/articles/2022-06-07/us-steps-up-sanctions-bars-investors-from-buying-russian-debt?sref=OOpRUZ8l> [<https://perma.cc/K886-S8JQ>].

<sup>45</sup> Chart based on Bloomberg terminal data and author review of legislative developments. Data solely reflects 2023 maturity bond.

<sup>46</sup> See *supra* Part I.

<sup>47</sup> See *infra* Appendix.

The first red bubble at left denotes Russia's Thursday, February 24 invasion.<sup>48</sup> The 2023 bond dropped 30% that day but pared back some losses the following day to close the week at 83 cents-on-the-dollar — a total, post-invasion decline of 18%.<sup>49</sup>

On Monday, February 28, the U.S. and EU froze Russia's central bank deposits,<sup>50</sup> as shown by the second bubble; the bonds collapsed from 83 to 22.8 by market close on Tuesday, March 1 — a cumulative 72.5% drop.<sup>51</sup> This helps demonstrate the power of the sanctions levied against Russia. Based on market reactions, invading Ukraine shaved \$532 million off that single bond's market price; the central bank asset freeze was more than three times as impactful, costing \$1.81 billion.<sup>52</sup> The impact across Russia's broader \$37 billion foreign-currency debt structure was proportionately larger.<sup>53</sup>

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<sup>48</sup> Presidential Speeches and Remarks, Remarks by President Biden on Russia's Unprovoked and Unjustified Attack on Ukraine (Feb. 24, 2022), <https://www.whitehouse.gov/briefing-room/speeches-remarks/2022/02/24/remarks-by-president-biden-on-russias-unprovoked-and-unjustified-attack-on-ukraine/> [<https://perma.cc/8C2N-RSU8>].

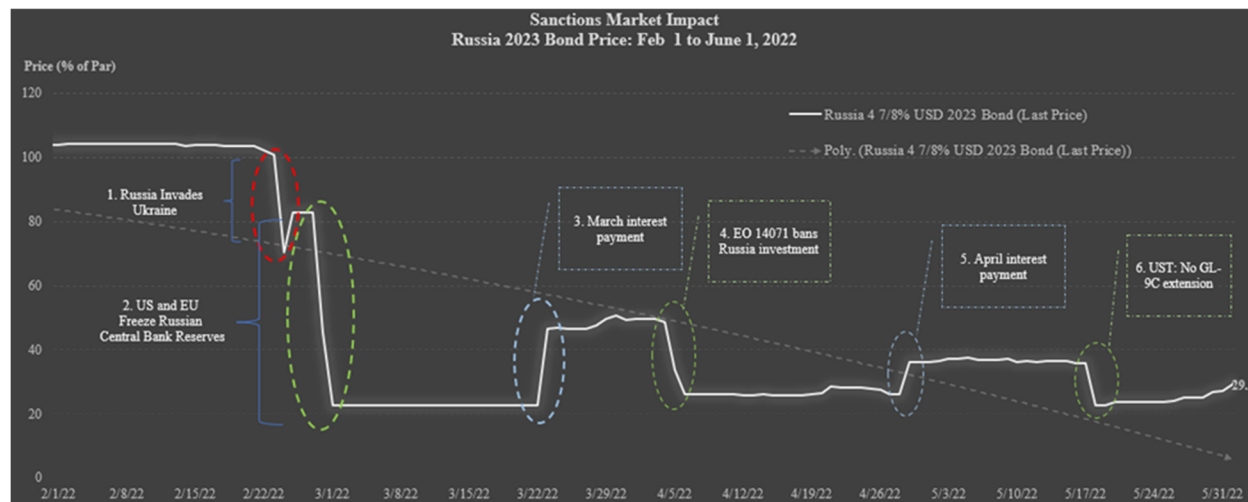
<sup>49</sup> See *infra* Appendix.

<sup>50</sup> The U.S. also prohibited transactions with respect of Russia's Ministry of Finance and National Wealth Fund. ANDREA GACKI, OFF. OF FOREIGN ASSETS CONTROL, DIRECTIVE 4 UNDER EXEC. ORDER 14024 (2022); Press Release, U.S. Dep't of the Treasury, Treasury Prohibits Transactions with Central Bank of Russia and Imposes Sanctions on Key Sources of Russia's Wealth (Feb. 28, 2022) (on file with the U.S. Dep't of the Treasury); Press Release, Council of the Eur. Union, EU Adopts New Set of Measures to Respond to Russia's Military Aggression Against Ukraine (Feb. 28, 2022) (on file with the Eur. Council).

<sup>51</sup> See *infra* Appendix.

<sup>52</sup> See *infra* Appendix.

<sup>53</sup> Breydo, *Russia's Roulette*, *supra* note 23, app. I, at 43.



After the initial market declines, subsequent events came to resemble a high-stakes, global game of “whack-a-mole,” with Russia finding a monthly payment work-around and the U.S. swiftly moving to block the avenue.

The third, light-blue bubble corresponds to Russia unexpectedly making its March interest payment, which sent the bond up 104%, from 22.8 to 46.6,<sup>54</sup> as markets internalized Russia’s surprising willingness to pay. Two weeks later, Executive Order 14,071 banned new investment in Russia, and the bonds quickly surrendered those gains, as shown by the fourth bubble.<sup>55</sup>

Russia’s April payment — made deep into the obligations’ contractual grace-period — further surprised the market, sending the bond up about 40%, to 36.32, per the fifth bubble.<sup>56</sup> The reprieve did not last. On May 17,

<sup>54</sup> See Daniel Flatley, *U.S. Treasury Confirms Russia Not Barred from Servicing Bonds*, BLOOMBERG (Mar. 17, 2022, 10:54 AM PDT), <https://www.bloomberg.com/news/articles/2022-03-16/u-s-treasury-confirms-russia-not-barred-from-servicing-bonds?sref=OOpRUZ8l> [<https://perma.cc/9EL3-9GW6>].

<sup>55</sup> April 6 Executive Order 14071 banned “new investment in the Russian Federation by a United States person, wherever located.” Exec. Order No. 14,071, 87 Fed. Reg. 20999 (Apr. 8, 2022).

<sup>56</sup> Alan Rappeport & Eshe Nelson, *U.S. Blocks Russia’s Access to Dollars for Bond Payments, Heightening Risk of Default*, N.Y. TIMES (Apr. 5, 2022), <https://www.nytimes.com/2022/04/05/business/russia-debt-dollars.html> [<https://perma.cc/6L7U-TYBZ>].

2022, the U.S. Treasury indicated that it would not be extending an interest payment safe harbor, sending the bonds back into the low 20s, illustrated by the sixth bubble.<sup>57</sup>

Russia has attempted a number of workarounds to get funds to bondholders, but given the interest payment prohibition,<sup>58</sup> investors were unable to get paid — effectively forcing Russia into a default.<sup>59</sup>

## II. UNPRECEDENTED ACTIONS, “OPAQUE” OBJECTIVES

Sanctioning Russia for a brutal, “unlawful” war is unambiguously correct — as a matter of law, policy, and morality.<sup>60</sup> Yet, the targeting of its sovereign debt marks a meaningful departure from prior cases and represents a strategy that is difficult to reconcile with the sanctions’ broader objectives.

“We’ve never done this to an economy like this before,” observed a former treasury official with respect to Russia’s impending default.<sup>61</sup> Political dimensions have surely influenced prior sovereign distress; however, the Russian situation would be the most consequential in this respect, marking the “first time a major emerging market economy is pushed into a bond default by geopolitics, rather than empty coffers.”<sup>62</sup>

The two closest, or at least most prominent, analogues may be sanctions against Iran and Venezuela.

In 1979, following an attack on the U.S. Embassy in Tehran, the U.S. froze Iranian deposits in U.S. banks. This rendered the sovereign unable to service U.S. dollar (“USD”) debts, resulting in a default. “Set-offs, litigation and seizure of Iranian assets” by the private sector “soon followed.”<sup>63</sup> Because of this, some scholars have posited that the U.S.

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<sup>57</sup> See *supra* notes 29–30 and accompanying text.

<sup>58</sup> See *supra* notes 29–32 and accompanying text.

<sup>59</sup> The operability of default mechanics raises a number of complex technical considerations beyond the scope of this analysis. For further discussion, see Breydo, *Russia’s Roulette*, *supra* note 23.

<sup>60</sup> See Haque, *supra* note 3.

<sup>61</sup> Stein, *supra* note 10.

<sup>62</sup> Barbuscia & Rao, *supra* note 9.

<sup>63</sup> Lee Buchheit & Mitu Gulati, *Forced Sovereign Debt Defaults*, FIN. TIMES (June 1, 2022), <https://www.ft.com/content/75da5a01-12e6-42ae-abea-3fa7a3cc1647> [<https://perma.cc/4A6B-5A2U>].

Treasury may desire a Russian default to “conscript the commercial investor community into applying pressure” on the recalcitrant sovereign.<sup>64</sup>

Yet, even with respect to Iran, the U.S. amended its freeze to allow Iran to make loan payments using “additional funds”<sup>65</sup> — a possibility foreclosed for Russia through expiration of the interest payment safe harbor.<sup>66</sup> The Iran situation also differed in that it implicated a closer nexus of conflict between the U.S. and Iran, with corresponding implications for geopolitical interests and the range of applicable executive powers.<sup>67</sup>

In Venezuela’s case, the sovereign debt and sanctions interplay was also distinct from the present matter. There, the U.S. significantly increased long-standing financial sanctions following a contested, widely-criticized election and subsequent presidential crisis which saw Nicolás Maduro “usurp” power from Juan Guaido, the broadly-acknowledged democratically elected leader.<sup>68</sup> Before sanctions were imposed, however, Venezuela was already highly distressed, with a restructuring appearing likely.<sup>69</sup> Unlike in the current instance, U.S. sanctions against Venezuela were not intended to effectuate a default. Rather, those sanctions were put in place largely to punish a government the U.S. viewed as illegitimate, with the second-order effect of precluding

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<sup>64</sup> *Id.*

<sup>65</sup> Robert A. Bennett, *Iran Said to Default on Loan*, N.Y. TIMES (Nov. 22, 1979), <https://www.nytimes.com/1979/11/22/archives/iran-said-to-default-on-loan-interest-not-paid-on-500-million-from.html> [<https://perma.cc/H7EU-JADW>].

<sup>66</sup> *See supra* Part I.B.

<sup>67</sup> *See* Breydo, *Putin’s Matryoshka*, *supra* note 36 (manuscript at 21-28) (discussing the scope of presidential powers in respect of freezing and potential seizure of foreign assets).

<sup>68</sup> *See* Juan Guaidó, *Maduro Is an Usurper. It’s Time to Restore Democracy in Venezuela*, WASH. POST (Jan. 15, 2019, 3:42 PM EST), <https://www.washingtonpost.com/opinions/2019/01/15/maduro-is-usurper-its-time-restore-democracy-venezuela/?noredirect=on> [<https://perma.cc/E3C2-D875>].

<sup>69</sup> Katia Porzecanski, Patricia Laya, Ben Bartenstein & Christine Jenkins Tanzi, *Venezuela Will Seek to Restructure Debt, Blaming Sanctions*, BLOOMBERG (Nov. 2, 2017, 3:39 PM PDT), <https://www.bloomberg.com/news/articles/2017-11-02/venezuela-will-seek-to-restructure-debt-as-sanctions-take-hold?sref=OOpRUZ8l> [<https://perma.cc/2JL8-4X56>].

a restructuring or rescue financing transaction that could benefit that regime.<sup>70</sup>

A forced Russian default may also be distinguished by what scholars have described as “opaque” goals.<sup>71</sup> Most facets of the economic and financial sanctions regime against Russia fit logically within broad-based objectives of punishing the aggressor and degrading its ability to wage war. This is particularly true with respect to measures precluding Russia from accessing fresh capital. That logic also generally extends to secondary market trading prohibitions — which can, at least directionally, increase the issuer’s cost of capital<sup>72</sup> — and would be consistent with many market participants’ voluntary “self-sanctioning.”<sup>73</sup>

It is less obvious how ensuring that Russia defaults on its existing debt fits within this framework or serves the sanctions’ broader objectives. Unlike new borrowing, Russia long ago received the money from its outstanding funded sovereign debt; preventing repayment only allows it to keep the cash. The analysis could differ if Russia, like Venezuela, needed to borrow in the near term — which a default may hinder. However, the Russian sovereign is effectively cut-off from the global

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<sup>70</sup> The U.S. has had sanctions against Venezuela in place for at least fifteen years; however, in 2019 under the Trump administration, the extent of sanctions significantly increased. See CLAIRE RIBANDO SEELKE, CONG. RSCH. SERV., IF10715, VENEZUELA: OVERVIEW OF U.S. SANCTIONS (2022) (“After recognizing Juan Guaidó, president of the democratically elected, opposition-led National Assembly, as interim president, the Trump Administration further tightened sanctions on Venezuela’s state oil . . . central bank, and government to pressure [President] Maduro to leave power.”).

<sup>71</sup> Buchheit & Gulati, *supra* note 63.

<sup>72</sup> Max Frumes, *Funds ‘Should Not Get Involved’ in Distressed Russian Corporate Debt*, SAYS BROWDER, LINKEDIN (Mar. 10, 2022), <https://www.linkedin.com/pulse/funds-should-get-involved-distressed-russian-corporate-max-frumes> [<https://perma.cc/6S86-3MP4>] (noting that “secondary market liquidity for a debt issuer can lower its cost of capital, with some caveats in the current situation given all the economic sanctions that have been imposed”).

<sup>73</sup> One prominent investor, for instance, equated Russian investments to buying “German equities during the Holocaust.” Ariel Zilber, *How Wall Street ‘Vultures’ Are Looking to Make a Killing off Russian Debt*, N.Y. POST (Mar. 30, 2022, 12:06 PM), <https://nypost.com/2022/03/30/wall-street-vultures-look-to-make-killing-off-russian-debt/> [<https://perma.cc/7SDW-AYL4>].

financial system, unable to issue debt due to “cosmic” borrowing costs,<sup>74</sup> and further appears to have limited near-term borrowing needs given estimated energy earnings of nearly \$100 billion in the war’s first 100 days.<sup>75</sup>

At the same time, U.S. action may, paradoxically, provide Russia with legal defenses against a default, which it has already begun to preview, including arguments around impossibility and related doctrines.<sup>76</sup>

### III. RISKS & EXTERNALITIES OF THE SANCTIONS “WEAPON”

A forced — or “political” — Russian sovereign debt default raises unique and potentially significant risks and externalities. The kinetics can be taxonomized at three levels of impact: current investors in Russian bonds, emerging market sovereign debt, and global financial infrastructure.

As detailed below, the impact has already been experienced by the first category of investors in Russian bonds — evidenced by whipsawing bond prices and a highly unusual CDS auction — but the broader effects in respect of the second and third levels of impact are yet to be determined.

#### A. Current Russia Investors

The first-order impact with respect to investors in Russian sovereign obligations encompasses asset owners and managers around the world. Russia has a total sovereign debt of about \$300 billion — a non-trivial figure, but one that is unlikely to constitute a “systemic risk” to the financial system, according to the IMF.<sup>77</sup> The vast majority of Russia’s

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<sup>74</sup> *Russia to Halt Bond Sales, Threatens Legal Action over Default*, BLOOMBERG (Apr. 10, 2022, 2:56 PM PDT), <https://www.bloomberg.com/news/articles/2022-04-10/russia-to-halt-bond-issuance-for-rest-of-2022-siluanov-says#xj4y7vzkg?sref=OOpRUZ8l> [<https://perma.cc/59VF-JRBQ>].

<sup>75</sup> CTR. FOR RSCH. ON ENERGY AND CLEAN AIR, FINANCING PUTIN’S WAR: FOSSIL FUEL IMPORTS FROM RUSSIA IN THE FIRST 100 DAYS OF THE INVASION (2022), [https://energyandcleanair.org/wp/wp-content/uploads/2022/06/Financing-Putins-war-100-days\\_20220613.pdf](https://energyandcleanair.org/wp/wp-content/uploads/2022/06/Financing-Putins-war-100-days_20220613.pdf) [<https://perma.cc/V3UM-8YLS>].

<sup>76</sup> See Breydo, *Russia’s Roulette*, *supra* note 23 (manuscript at 33-35) (describing Russia’s prospective legal arguments with respect to the failure to pay event of default).

<sup>77</sup> Andrea Shalal, *Russian Default No Longer ‘Improbable’, But No Trigger for Global Financial Crisis—IMF*, REUTERS (Mar. 13, 2022, 2:19 PM PDT), <https://www.reuters.com/markets/europe/russian-default-no-longer-improbable-no-trigger->



debt is ruble-denominated,<sup>78</sup> but it also has about \$37 billion of foreign currency bonds, with \$31.7 billion USD-denominated and the balance denominated in Euros.<sup>79</sup>

Foreign investors are estimated to hold about one-fourth of Russia's total bond debt — with positions across USD, Euro, and Ruble-denominated bonds — suggesting aggregate external exposure around \$75 billion.<sup>80</sup> Pimco, a California-based asset manager with \$1.8 billion of Russian bonds, has reportedly lobbied the U.S. Treasury about the impact of a default, citing potential damage to U.S. pension funds and positing that a default only enriches Russia, allowing it to retain funds otherwise payable to creditors.<sup>81</sup>

Sanctions have also complicated operability of Russian credit default swaps (“CDS”), a crucial market tool for managing sovereign credit risk, with the governing body having to delay the Russian sovereign CDS auction following the prohibition on secondary market trading.<sup>82</sup> Though a subsequent U.S. Treasury directive allowed the auction to proceed,<sup>83</sup>

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global-financial-crisis-imf-2022-03-13/ [https://perma.cc/CFC2-K32F] (noting IMF view from March 2022 of Russian default no longer being “improbable,” but also observing that “[t]he total exposure of banks to Russia amounted to around \$120 billion, an amount that while not insignificant, was ‘not systemically relevant’”).

<sup>78</sup> See *id.* (manuscript at 8-10) (detailing the composition of Russia's sovereign debt).

<sup>79</sup> *Id.* (manuscript at 9-10).

<sup>80</sup> *IMF Staff Country Reports: Russian Federation*, INT'L MONETARY FUND (Feb. 9, 2021), <https://www.imf.org/en/Publications/CR/Issues/2021/02/08/Russian-Federation-2020-Article-IV-Consultation-Press-Release-Staff-Report-50068> [https://perma.cc/Z5YJ-XSUH].

<sup>81</sup> Laura Benitez & Loukia Gyftopoulou, *Pimco Warned US Treasury that Russia Sanctions Will Hit Pensions*, BLOOMBERG (June 14, 2022, 3:15 AM PDT), <https://www.bloomberg.com/news/articles/2022-06-14/pimco-warned-us-treasury-that-russia-sanctions-will-hit-pensions?sref=OOpRUZ8l> [https://perma.cc/73UG-LV4V] (PIMCO has “also made the point that a Russian default would allow President Vladimir Putin to keep foreign currency reserves that would have otherwise been paid to creditors, giving him more money for war efforts”).

<sup>82</sup> George Collard, *Investors Hope for Solution as Committee Defers Russia CDS Decision*, GLOB. CAP. (June 13, 2022, 1:23 PM), <https://www.globalcapital.com/article/2a833s4a3dfyb74gv5z4/emerging-markets/cee-bonds/investors-hope-for-solution-as-committee-defers-russia-cds-decision> [https://perma.cc/GY78-ZJKS].

<sup>83</sup> Alexander Saeedy, *Russia's Bonds Regain Market Appeal as Trading Defrosts*, WALL ST. J. (Aug. 31, 2022, 5:30 AM ET), <https://www.wsj.com/articles/russias-bonds-regain-market-appeal-as-trading-defrosts-11661938201> [https://perma.cc/U4UR-ER4P] (“Russian

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changes in market prices in the interim delay period materially reduced payouts to holders of the insurance-like product.<sup>84</sup>

The unexpected outcome and underlying trading dynamics of Russia's CDS auction illustrate the uncertainties injected into the market as a result of sovereign debt-focused sanctions against Russia. The table below details the results of the nine sovereign CDS auctions on record since 2009,<sup>85</sup> including the date of the auction, the initial market midpoint, and the final price.<sup>86</sup>

The CDS auction is a two-part process that operates through a so-called Dutch auction mechanism. First, a two-way market is supplied by dealers of the defaulted assets, with those bids used to set the "initial market midpoint." Second, physical settlement requests (to buy or sell the defaulted bonds) are submitted, and the initial market midpoint is

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sovereign bonds have staged a comeback this summer as investment banks have warmed up to trading the Kremlin's debt again and investors outside the grip of Western sanctions on Moscow are buying bonds," pushing prices up to 45 cents-on-the-dollar for some obligations).

<sup>84</sup> On June 7, 2022, the EMEA DC published a statement finding that a "Failure to Pay" credit event occurred with respect to Russia, and that the date of the failure to pay was May 19, 2022. *EMEA DC Meeting Statement*, CREDIT DERIVATIVES DETERMINATIONS COMMS. (June 7, 2022), <https://www.cdsdeterminationscommittees.org/documents/2022/06/emea-dc-meeting-statement-7-june-2022-russian-federation.pdf> [<https://perma.cc/9LCQ-4DS5>]. However, due to sanctions, the auction could not proceed on the usual timeline, with the CDS ultimately not settled until September 2022. See Christopher Whittall & Christopher Spink, *Stakes Are High for Historic Russia CDS Auction*, INT'L FIN. REV. (Aug. 12, 2022, 8:04 AM), <https://www.ifre.com/story/3473276/stakes-are-high-for-historic-russia-cds-auction-l5kypypw3> [<https://perma.cc/H3W2-F5RG>] ("Russian CDS was ruled to have triggered over two months ago after Moscow failed to make some small interest payments on its external debt. Since then, the group of banks and investors charged with setting the terms of an auction to calculate CDS payouts have been making painstaking preparations . . . [because] CDS users know a botched outcome would undermine the value of these contracts as an effective hedge.").

<sup>85</sup> Data set excludes the Commonwealth of Puerto Rico, as Puerto Rico is not a sovereign, but rather a territory of the United States. As a result, Puerto Rico's bonds are traded in the U.S. municipal market rather than the sovereign debt market and are thus subject to distinctive dynamics and market mechanics.

<sup>86</sup> Data available at <https://www.creditfixings.com/CreditEventAuctions/fixings.jsp> [<https://perma.cc/Y5LC-C8AK>].

adjusted accordingly.<sup>87</sup> This second part of the process determines the auction final price, which corresponds to the value at which the underlying bonds change hands amongst investors at the conclusion of an auction.<sup>88</sup> Holders of CDS protection are paid the difference between that figure and par value; thus, a higher final price at auction means a lower payout to protection holders.<sup>89</sup>

#### Sovereign CDS Auctions Summary

Sovereign Name	Auction Date	Initial Market Midpoint	Final Price	Difference
Ukraine	9/28/22	18.000	17.875	-0.13
Russian Federation	9/12/22	48.375	<b>56.125</b>	<b>7.75</b>
Argentine Rep	6/12/20	34.500	31.500	-3.00
Rep of Ecuador	5/19/20	34.500	34.875	0.38
Lebanese Rep	4/23/20	16.375	14.125	-2.25
Bolivarian Republic of Venezuela	12/12/17	23.500	24.500	1.00
Argentine Republic	9/3/14	40.250	39.500	-0.75
Hellenic Republic	3/19/12	21.750	21.500	-0.25
Republic of Ecuador	1/14/09	32.375	31.375	-1.00
Average ( $\mu$ )		29.958	30.153	0.19
Standard Deviation ( $\sigma$ )		10.159	12.028	2.92

Source: Based on data provided by Creditex and Markit, available at [creditfixings.com](https://creditfixings.com).

Russia's CDS auction set two notable records. First, it exhibited the single highest difference between the initial market midpoint and the final price — totaling 7.75, equal to 2.66 standard deviations above average — suggesting underlying auction dynamics distinct from the

<sup>87</sup> See MARKIT & CREDITEX, CREDIT EVENT AUCTION PRIMER (2010), [https://www.theice.com/publicdocs/Credit\\_Event\\_Auction\\_Primer.pdf](https://www.theice.com/publicdocs/Credit_Event_Auction_Primer.pdf) [<https://perma.cc/53KL-FUJJ>].

<sup>88</sup> See *id.*

<sup>89</sup> Karin Strohecker, *Russia CDS Auction Values Defaulted Sovereign Bonds at 56.125 Cents*, REUTERS (Sept. 12, 2022, 8:42 AM), <https://www.reuters.com/article/ukraine-crisis-russia-cds/update-3-russia-cds-auction-values-defaulted-sovereign-bonds-at-56-125-cents-idUSL8N3oJ23X> [<https://perma.cc/M44L-B5AG>] (“The final pricing reached in the second part of the auction determines the value of the bonds and the amount of payout a CDS buyer will receive — in this case allowing the holder to recoup 44 cents for every notional dollar protected.”)

usual processes.<sup>90</sup> Second, the Russian CDS auction logged the highest final price on record: 56.125, nearly double the average of just 30.153.<sup>91</sup>

Some have posited that the unusually high final price figure was due to “sellers want[ing] to cap their exposure by inflating the price of Russian bonds, thereby reducing what they owe to protection buyers” — an unusual outcome made possible by the unprecedented lag between Russia’s credit event and the date of the ultimate CDS auction.<sup>92</sup>

### B. Emerging Market Sovereign Debt

The anticipated first-order impact on investors becomes even more consequential because of its interplay with prospective second-order effects on emerging market sovereign debt as a broader asset class.<sup>93</sup> That is because the potential for “political” defaults may force a “re-

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<sup>90</sup> As a technical and formal matter, this outcome was driven by Goldman Sachs placing about \$1.3 billion of orders to buy Russian bonds, likely submitted on behalf of sellers of Russia CDS protection. That unusually high demand pushed up the final price, driving the spread between the initial market midpoint and final outcome. See Robert Hogg & Christopher Whittall, *Pimco Bets on Russian Debt Recovery in CDS Auction*, INT’L FIN. REV. (Sept. 15, 2022, 3:00 AM), <https://www.ifre.com/story/3516497/pimco-bets-on-russian-debt-recovery-in-cds-auction-hcnvwhhgop#> [https://perma.cc/Q7NV-XMDY] (noting that “[i]n Monday’s historic CDS auction, which many had feared may never take place because of US sanctions against Moscow, Goldman Sachs placed about US\$1.3bn of orders to buy Russian bonds on behalf of sellers of Russia CDS protection. Banks act as brokers in CDS auctions to place buy and sell requests on behalf of clients, which are not named publicly, and also to enter orders for their own account if needed. That process allows firms to settle their derivatives contracts physically”).

<sup>91</sup> In contrast, Ukraine’s CDS auction, held just two weeks after Russia’s, logged a final price of 17.875. Dan Alderson, *Ukraine Auction Settles CDS Below Expected Recovery*, DEBTWIRE (Sept. 29, 2022), <https://www.creditflux.com/Funds/2022-09-29/Ukraine-auction-settles-CDS-below-expected-recovery?d=1> [https://perma.cc/6QU9-TDNQ].

<sup>92</sup> Alexander Saeedy, *Russian Swap Auction Prompts Strong Investor Demand for Moscow’s Debts*, WALL ST. J. (Sept. 12, 2022, 3:22 PM ET), <https://www.wsj.com/articles/russian-swap-auction-prompts-strong-investor-demand-for-moscows-debts-11663010572> [https://perma.cc/M47E-ZRCJ].

<sup>93</sup> It is not clear whether, or how, market participants may directly respond to these events. Potential reactions could include changes to the sovereign debt contractual architecture – for instance, through sanctions-specific ‘fallback’ provisions, akin to some of Russia’s bonds – which may ultimately prove to have a broader negative impact.

assessment of geopolitical risks in emerging markets”<sup>94</sup> — ultimately, translating to higher costs of capital.

For the inherently high-risk endeavor of emerging markets investing, a level of investor confidence in contracts and policy provides some much-needed consistency, which is crucial to facilitating capital formation. In part because of this, over the last few decades, emerging nations’ sovereign bond markets have matured due to increased availability of lower-cost capital.<sup>95</sup> Though highly imperfect, the paradigm has generally been at least directionally positive.<sup>96</sup>

A critical feature of twenty-first century sovereign debt markets is the “presumption of perpetual market access at tolerable interest rates.”<sup>97</sup> As a result, nations rarely plan to repay their debts in the traditional sense, and instead typically expect to refinance and “roll over” the obligations.<sup>98</sup>

The potential utilization of sovereign debt as a “sanctions weapon” represents an additional layer of external political risk and a significant complication for investors, likely to be realized in the form of an additional risk premium. Coupled with exogenous factors — including global monetary tightening and rising benchmark rates — the result may translate to materially higher borrowing costs, rendering some nations unexpectedly unable to refinance their debt.

The timing could hardly be worse. Shortly before the war in Ukraine, in December 2021, the IMF estimated that 60% of low-income nations were in or near financial distress,<sup>99</sup> while the World Bank has forecast “as

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<sup>94</sup> See *supra* notes 29–30 and accompanying text.

<sup>95</sup> An alternative source of funds for more developed nations, in turn, allowed international financing institutions, like the IMF and World Bank, to focus resource deployment towards the more vulnerable states.

<sup>96</sup> See Lev E. Breydo, *Health of Nations*, NEV. L.J. (forthcoming 2023) (manuscript at 7-18) (describing the evolution and structure of sovereign borrowing markets and restructuring processes).

<sup>97</sup> Lee C. Buchheit, *Sovereign Debt in the 21st Century*, 27 J. INVESTING 31, 32 (2018).

<sup>98</sup> *Id.* (observing that “Sovereign borrowers today borrow in the sure and certain hope that when the debt matures they will repay it from the proceeds of a new loan . . . . When that new debt falls due, they will borrow again to repay it. And so on . . . in perpetuity”).

<sup>99</sup> Kristalina Georgieva & Ceyla Pazarbasioglu, *The G20 Common Framework for Debt Treatments Must Be Stepped Up*, IMF BLOG (Dec. 2, 2021), <https://blogs.imf.org/2021/12/02/the-g20-common-framework-for-debt-treatments-must-be-stepped-up/> [<https://perma.cc/VJA2-RPXR>] (“60 percent of low-income countries are

many as a dozen” defaults over the next twelve months.<sup>100</sup> In other words, it appears increasingly likely that the world may be at the early stages of a significant sovereign debt crisis.<sup>101</sup>

The situation has been further exacerbated by “severe economic dislocation” caused by the conflict, as well as sanctions against a critical commodity supplier, resulting in “global economic effects far greater than anything seen before.”<sup>102</sup> This has translated to highly elevated energy prices and food shortages that risk the “greatest global food security crisis of our time,” according to Secretary Blinken.<sup>103</sup>

Potential investor skittishness from an additional set of sovereign debt risks could complicate these already-fragile dynamics. Investor support — if not confidence — is critical to successful sovereign debt restructuring and is a prerequisite for subsequent investment in the nations.<sup>104</sup> The potential for reduced investor participation, or structurally higher required rates of return, may ultimately translate to the IMF and World Bank shouldering greater levels of risk. That, in turn, may strain the international financing institutions, particularly if their core sponsor nations are themselves experiencing recession or slowing growth, reducing appetite for increased contributions.

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at high risk or already in debt distress” with “economic collapse” increasingly likely without “debt restructurings”).

<sup>100</sup> Marcello Esteveao, *Are We Ready for the Coming Spate of Debt Crises?*, WORLD BANK BLOGS (Mar. 28, 2022), <https://blogs.worldbank.org/voices/are-we-ready-coming-spate-debt-crises> [<https://perma.cc/TZ5A-69F7>].

<sup>101</sup> See Breydo, *Health of Nations*, *supra* note 96 (manuscript at 1).

<sup>102</sup> Nicholas Mulder, *The Sanctions Weapon*, INT’L MONETARY FUND (June 2022), <https://www.imf.org/en/Publications/fandd/issues/2022/06/the-sanctions-weapon-mulder> [<https://perma.cc/LLD5-87MP>].

<sup>103</sup> Andrea Gazzani & Fabrizio Ferriani, *The Impact of the War in Ukraine on Energy Prices: Consequences for Firms’ Financial Performance*, CTR. FOR ECON. POL’Y RSCH. (Oct. 7, 2022), <https://cepr.org/voxeu/columns/impact-war-ukraine-energy-prices-consequences-firms-financial-performance> [<https://perma.cc/5DSM-VYHB>]; Matt Murphy, *Ukraine Invasion Could Cause Global Food Crisis, UN Warns*, BBC NEWS (May 19, 2022), <https://www.bbc.com/news/world-europe-61503049> [<https://perma.cc/48TH-32GH>].

<sup>104</sup> This is particularly acute in respect of exit yields — the rate at which investors discount restructured sovereign bonds — because that, in turn, impacts the level of debt relief creditors are willing to provide.

### C. Global Financial Infrastructure

A “political” sovereign default may catalyze a potentially broader, third-order impact with respect to global financial infrastructure.

Infrastructure refers to “shared ends to many means;” it does not directly produce goods or services but provides the “underlying framework” or “foundation” to facilitate processes that do.<sup>105</sup> Though typically associated most closely with airports and public transit, global financial architecture — including banking, payment and clearing systems — represents a critical form of shared resources that supports a globalized, interconnected world economy. Much of this superstructure was developed in the post-WWII era, anchored by the United States and by extension the U.S. dollar, which underpins global trade, payments, and sovereign debt, with most nations’ foreign currency debt USD-denominated.<sup>106</sup>

The dollar’s ubiquity is foundational to America’s “asymmetric economic power” through sanctions.<sup>107</sup> Perceived “weaponization” of the U.S. dollar, particularly in the sovereign debt context, may fray this delicate construct. That could, in turn, have three effects.

First, as the IMF has warned, the ferocity of sanctions against Russia “threaten[s] to gradually dilute the dominance of the US dollar,” which has been observed to constitute a declining portion of central banks’ reserves.<sup>108</sup>

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<sup>105</sup> BRETT M. FRISCHMANN, *INFRASTRUCTURE: THE SOCIAL VALUE OF SHARED RESOURCES* 4 (2012).

<sup>106</sup> Robert Burgess, *Dethroning King Dollar Won’t Be an Easy Feat*, BLOOMBERG (Mar. 3, 2022, 2:00 AM PST), <https://www.bloomberg.com/opinion/articles/2022-03-03/dethroning-the-dollar-as-the-world-s-reserve-currency-won-t-be-easy?sref=OOpRUZ8l> [<https://perma.cc/JH4T-5TP8>]; Joseph P. Joyce, *The Dollar’s Primacy*, INT’L MONETARY FUND (Mar. 2022), <https://www.imf.org/en/Publications/fandd/issues/2022/03/book-review-dollar-primacy-joyce> [<https://perma.cc/UP47-6TE7>]; Anshu Siripurapu, *The Dollar: The World’s Currency*, COUNCIL ON FOREIGN RELS. (Sept. 29, 2020, 10:00 AM EST), <https://www.cfr.org/background/dollar-worlds-currency> [<https://perma.cc/TD9U-3MAP>]; Daniel Tenengauzer, John Velis & Geoff Yu, *An Existential Threat to the US Dollar*, BNY MELLON (Sept. 2020), <https://www.bnymellon.com/us/en/insights/aerial-view-magazine/an-existential-threat-to-the-us-dollar.html> [<https://perma.cc/D4DG-ZH7T>].

<sup>107</sup> See Cohen & Goldman, *supra* note 20, at 146.

<sup>108</sup> Serkan Arslanalp, Barry J. Eichengreen & Chima Simpson-Bell, *The Stealth Erosion of Dollar Dominance* (Int’l Monetary Fund, Working Paper No. 22/58, 2022); Jonathan Wheatley & Colby Smith, *Russia Sanctions Threaten to Erode Dominance of US Dollar*,

Second, over time, it may lead to a “more fragmented international monetary system,”<sup>109</sup> with countries developing alternative systems to mitigate sanctions risk.<sup>110</sup> Such deliberations are not limited to Russia. China has been working to “build a competing financial infrastructure,”<sup>111</sup> while India is reported to be mulling means to ensure the U.S. “could never do” to them “what it has just done to Russia.”<sup>112</sup> Indeed, U.S. power over shared global financial infrastructure — through dollar dominance, and otherwise — may represent a double-edged sword: “The more we use it, the more other countries are going to diversify due to geopolitical reasons.”<sup>113</sup>

Third, taken together, reduced dollar dominance and a potential decoupling of financial infrastructure may weaken the efficacy of future economic measures, leaving the U.S. and its allies with fewer policy options and potentially heightening the risk of direct confrontation.

#### CONCLUSION

While the specter of a “political” Russian sovereign debt default raises a number of unique considerations and potential risks, the worst permutations of such contingencies can likely be mitigated, if not altogether avoided.

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*Says IMF*, FIN. TIMES (Mar. 30, 2022), <https://www.ft.com/content/3e0760d4-8127-41db-9546-e62b6f8f5773> [<https://perma.cc/LB7H-4GGX>].

<sup>109</sup> Wheatley & Smith, *supra* note 108.

<sup>110</sup> This factor is likely only exacerbated by America’s relatively common use of unilateral sanctions across presidential administrations. Peter Harrell, *Is The U.S. Using Sanctions Too Aggressively?*, FOREIGN AFFS. (Sept. 11, 2018), <https://www.foreignaffairs.com/united-states/us-using-sanctions-too-aggressively> [<https://perma.cc/D3WQ-54ZV>].

<sup>111</sup> See Zoffer, *supra* note 21, at 156 (discussing “China’s dual efforts to internationalize its currency and build a competing financial infrastructure” following imposition of sanctions against Iran and Russia).

<sup>112</sup> Fareed Zakaria, *Biden’s Sanctions Against Russia Are a Double-Edged Sword*, WASH. POST (May 12, 2022, 5:47 PM EDT), <https://www.washingtonpost.com/opinions/2022/05/12/biden-sanctions-russia-could-erode-dollar-power-financial-economic/> [<https://perma.cc/2KHY-56GZ>].

<sup>113</sup> Karen Brettell, *Analysis: As Sanctions ‘Weaponize’ U.S. Dollar, Some Treasury Buyers Could Fall Back*, REUTERS (Mar. 28, 2022, 10:06 PM PDT), <https://www.reuters.com/business/finance/sanctions-weaponize-us-dollar-some-treasury-buyers-could-fall-back-2022-03-29/> [<https://perma.cc/TW4E-D4H7>].



From a broader emerging markets perspective, the perception that sovereign debt can become part of the sanctions “toolkit” could indeed prove highly sub-optimal. However, it is also at least equally possible for markets to internalize Russia’s situation as being limited to the facts, given the highly distinctive dynamics. Further, the broader portfolio of sanctions — of which sovereign debt provisions are just one facets — reflects a response to an “unlawful,” full-scale war strongly condemned by the United Nations, rather than bilateral animus.<sup>114</sup> This is reinforced by the fact that the sanctions regime is promulgated by a broad-based, multilateral coalition, rather than unilateral U.S. action.<sup>115</sup>

That being said, longer-term changes to global financial infrastructure could prove problematic if they reduce aggregate welfare benefits from the current system’s expansive network effects, economies of scale, and scope. The global financial infrastructure is fundamentally built on shared confidence, largely regarding the strength of legal constructs and institutions. Great care must be exercised to avoid sowing doubt in the validity of those foundations. Yet, the resilience of the system should also not be underestimated, which in part explains why competing efforts have seen limited adoption thus far.

Ultimately, the long-term prospective policy impacts of a “political” Russian default will depend on future actions. There, a guiding framework should emphasize a forward-looking impact on calibrating expectations, with national and international law providing something closer to a floor than a ceiling in respect of policy appropriateness and conduct safeguards.<sup>116</sup>

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<sup>114</sup> Indeed, some scholars have posited that “Russia’s armed aggression activated . . . the right of any state in the world to fight alongside Ukraine in collective self-defense . . .” Haque, *supra* note 3, at 157.

<sup>115</sup> Cohen & Goldman, *supra* note 20, at 147 (observing, regarding the post-Crimea conflict that “while UN-based sanctions may have been the preferable . . . Russia effectively prevented their imposition”).

<sup>116</sup> See generally Breydo, *Putin’s Matryoshka*, *supra* note 36 (discussing policy implications and considerations with respect to prospective seizure of Russian foreign reserves frozen by sanctions).

## APPENDIX

**Sanctions Market Impact Summary: \$3Bn 2023 USD-Denominated Russia Sovereign Bond**

Event*	Event Date		2023 Russia Bond Price (%)		Impact on \$3Bn 2023 Bond: % Change	Market Value (\$MM)
	Start	End	Before	After		
1. Russia Invades Ukraine US and EU Freeze Russian	2/24/22	2/25/22	100.744	83.006	-17.61%	(532.1)
2. Central Bank Reserves Russia Makes March 2022	2/25/22	3/1/22	83.006	22.824	-72.50%	(1,805.5)
3. Interest Payment EO 14071 bans Russia	3/22/22	3/23/22	22.824	46.585	104.11%	712.8
4. investment Russia Makes April 2022	4/4/22	4/6/22	48.729	26.17	-46.29%	(676.8)
5. Interest Payment UST Declines to extend GL-	4/28/22	4/29/22	26.026	36.321	39.56%	308.9
6. 9C Payment Safe-Harbor	5/17/22	5/18/22	35.671	22.818	-36.03%	(385.6)

*Analysis as of May 2022 and may not account for subsequent developments.*

*\* Events map to Sanctions Market Impact chart presented at Part I.B.*

Source: Market prices from Bloomberg data for Russia's 2023 4.875% USD sovereign bond (ISIN: XS0971721450).