Key Questions

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How Would a Russian Default Affect the US?

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Over the past century, Russia has defaulted on its debt twice – in 1918, when the Bolshevik revolutionaries repudiated all Tsarist obligations, and again 80 years later as a fledgling post-Soviet Union nation. Is history about to repeat itself?

Post-Cold War Era

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of light, it was the season of darkness, it was the spring of hope, it was the winter of despair."

– Excerpted from "A Tale of Two Cities" by Charles Dickens.

The end of the Cold War ushered in an exceptional period of global stability, free-market reforms and prosperity. The emergence of democratic norms led to a peace dividend that helped accelerate global economic expansion and to a technological and stock market boom not seen since the 1920s. For Russia, however, the 1990s marked a period of disorder, economic chaos and instability.

After the fall of the Soviet Union, the Russian state tried to enact democratic and free-market reforms, all of which proved ineffectual.

By 1996, the Russian economy had contracted by nearly 50%, inflation had averaged more than 100% and life expectancy declined from 67 years to 58 years. By 1998, Russia had been forced to default on its domestic debt, devalue the ruble and suspend payments on its foreign obligations.

The Russian default, the largest in history, quickly turned into a systemic risk. Concerns of a deep global recession rattled markets, including the S&P 500 Index, which declined by 20% between July and October of 1998. The impact of the Russian crisis was so endemic that the Federal Reserve (Fed) felt compelled to bail out a hedge fund, Long-Term Capital Management ($129 billion in assets), whose investments were heavily tied to Russia. Eventually, the International Monetary Fund and the World Bank intervened and provided capital to help stabilize the global financial system.

History Rhymes, Rarely Repeats

Unlike the Soviet days, the modern Russian economy is well integrated into global markets. The West accounts for nearly half of its exports, primarily energy and financial services, and its economy is heavily dependent on foreign investments (sovereign and corporate). The Russian attack on Ukraine has prompted a wave of sanctions by the international community, targeting almost every sector of the Russian economy, and those sanctions have started to bite. The ruble has lost nearly 50% of its value since the beginning of the year, inflation has skyrocketed to over 20% and many foreign firms have decided to divest from Russia. The Institute for International Finance expects the sanctions to cripple the Russian economy, which is projected to contract by 15% this year.

How Would a Russian Default Affect the US?

Russia learned many lessons during the 1998 crisis, most important of which was keeping its foreign currency reserves high to defend the ruble in times of crisis. Russia's reserves currently stand at approximately $640 billion, but approximately $300 billion is inaccessible because of the sanctions. Foreigners hold approximately $150 billion (par value) in foreign currency debt owed by both the government and Russian corporations. The global banking sector has about $120 billion in total exposure to Russia (local and foreign currency) and another $40 billion of credit default swaps (insurance against Russian default) are also outstanding.

Russia has several coupon and principal obligations due in the coming months. Investors are increasingly concerned that Russia could retaliate by defaulting on its foreign obligations, plunging the world into a scenario akin to 1998.

The Kremlin has insisted that it plans on meeting all obligations but investors are skeptical of Moscow's ability and willingness to repay its creditors. So far Russia has kept its promise: On March 17 it paid a $117 million coupon on its US dollar-denominated bond. Moscow has another $2 billion in payments due later this year, however.

Key Takeaway

At approximately $200 billion, Russian debt and equity exposure is not negligible, but it also does not pose a systemic risk to global financial markets. The International Monetary Fund (IMF), the Bank for International Settlements and the Fed have stated that the global banking sector is well capitalized and should be able to weather a Russian default, should it occur. Emerging markets, which were quickly engulfed in the 1998 crisis and had to be bailed out, have tried to insulate themselves from any fallout by building their own foreign currency reserves and raising interest rates in anticipation of market instability. They seem ready to act decisively in case volatility shoots up.

With the situation in Ukraine intensifying, we worry that the conflict could drag on for an extended period and the events currently unfolding could lead to a durable geopolitical shift whose effects will be felt for years to come. Our exposure to Russian securities is limited, but we remain concerned about the implications of a potential Russian default. That said, while the exact ramifications of such an event are difficult to measure, we believe that unlike 1998, the global financial markets are well prepared to deal with the consequences.

For more information, please contact your advisor.

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