# SANCTIONS ON RUSSIA:
## Disruptions in Emerging Markets

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## SUMMARY


- The role of the Russian economy in the emerging markets has been diminishing since the 2014 sanctions were applied following the annexation of the Crimean Peninsula. Despite a recovery in 2021, Russia's share in the global economy is now in further decline as the financial impacts of the Russia-Ukraine war are priced into global markets.
- Offloading Russia from global market indices has not brought dramatic changes to weight allocation in the top four emerging markets (Mainland China, Taiwan, South Korea and India).
- Russia's decline has made Brazil the largest mover in 2022; however, high volatility could hinder further expansion of investment into Brazil's equity market.
- China was already facing an economic slowdown in 2021. The new economic sanctions, imposed on Russia in reaction to the Ukraine invasion, are expected to bring extra turbulence to China's economy.


## THE TWO RECENT SANCTIONS ON RUSSIA

Definition: **Economic sanctions** are defined as deliberate, government-inspired (threat of) withdrawal of customary trade and official relations with a targeted country to amend the targeted country's policies.

**Because of the Russian annexation of the Crimean Peninsula in 2014, both the European Union member states and the United States introduced a wide variety of economic sanctions against Russia.** The 2014 economic sanctions on Russia, which included a restriction on travel and international trade, as well as an asset freeze, were relatively mild. The sanctions did not aim to ruin the Russian economy, nor did they render a significant decrease in the living standards of ordinary Russians .

**In response to Russia's invasion of Ukraine in February 2022, the western world reacted promptly by stepping in with significantly expanded sanctions.** Unlike in 2014, the current sanctions are designed to cripple the aggressor's economy and financially hurt the country's wealthiest individuals, known as the oligarchs. The measures include sanctions on the Russian central bank, major commercial banks, oil and gas trade and the assets of (and travel ban on) oligarchs. Sanctions started to take effect on February 21st. On March 7th, the Russian ruble dropped to a historic low of 0.67 U.S. cents, almost halved from its value before the invasion. It is the first time in history that such strong and long-lasting sanctions have been imposed on a country of such size.

## RUSSIA – UN-INVESTABLE IN 2022

**The sanctions have thrown index giants into disarray.** In early March, the world's largest index providers - MSCI , FTSE , and JPMorgan - announced removing Russian stocks and bonds from all their emerging market benchmarks. These indices are tracked by about half a trillion dollars of assets.

**Russia's weight shrunk significantly across major indices.** The weight of Russian equities dropped by over a third, YTD, on the MSCI Emerging Market index (Figure 1), one of the most recognizable emerging market indices. A similar pattern is seen in global equity, debt, and other benchmark indices after the announcement of sanctions. In addition, Russian securities are currently "un-investable" due to capital control. Consequently, investors who had not liquidated their Russia exposure before the announcement of sanctions remain exposed.

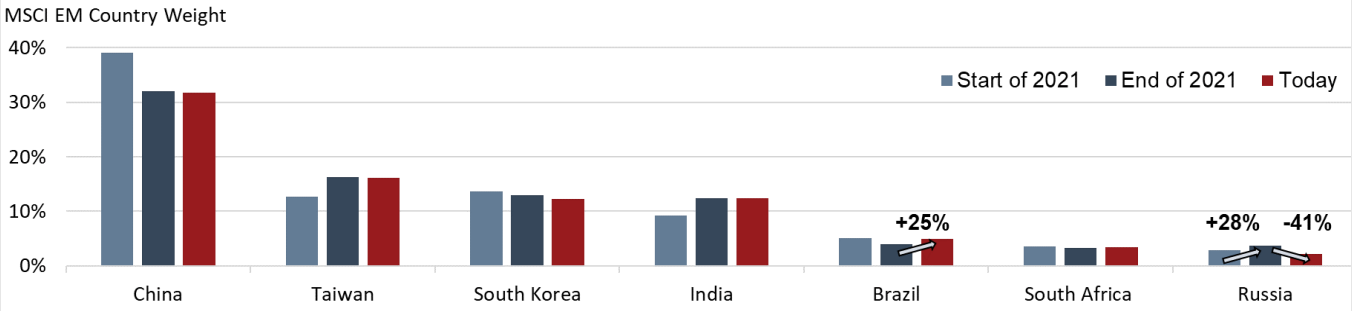
**Offloading Russia from global market indices has not brought dramatic changes to the weights of the top four emerging markets,** namely China (mainland), Taiwan, South Korea, and India. The weights of these four regions remained relatively unchanged after the announcement of sanctions on Russia (Figure 1).

**Russia's exit makes Brazil a hot emerging market in 2022.** The weight of Brazil (the fifth largest emerging market) jumped by over 20 percentage points YTD (Figure 1). The strong start of 2022 in Brazil is driven by the nation's high yields, low stock valuation, and the rally in commodity prices. Despite the growth, equity premium has been higher in Brazil than in the other emerging markets and economists argue that the much higher Brazilian volatility discourages heavier investment in Brazil's equity market. The increased volatility can be attributed, in part, to the uncertainty from the upcoming federal elections in October 2022. It is being viewed as a referendum on the polarizing President Bolsonaro and his handling of the pandemic and Brazil's economy , . Current polls indicate a potential return of former President Luiz Inácio Lula da Silva (2003-2010) and his leftist Workers Party.

## DIMINISHING ROLE OF RUSSIA WITHIN EMERGING MARKETS SINCE THE 2014 SANCTIONS

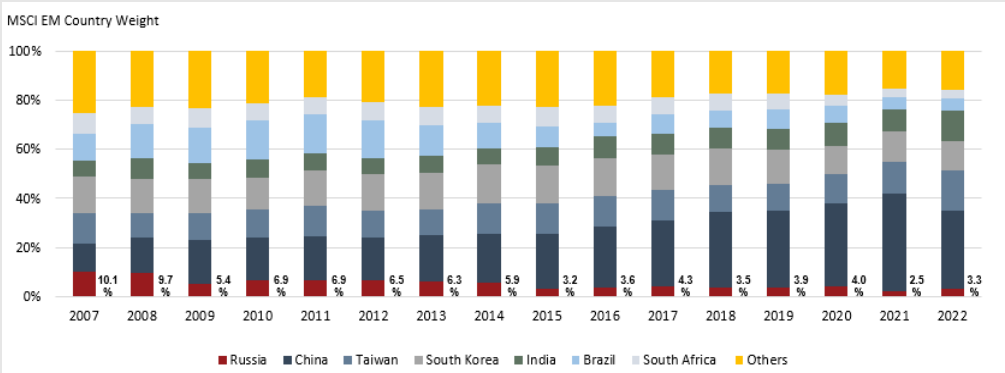
**The 2014 sanctions have substantially diminished the Russian economy and the country's role in emerging markets.** According to the IMF , sanctions reduced Russia's growth rate by 0.2 percentage points every year during 2014- 2018. Comparable analysis from the Bank of Finland reported that the cumulative effect of sanctions in 2014 and 2015 decreased the Russian GDP by 1.2 percent. With a decade of economic sanctions and the resulting currency depreciation, investors have reduced exposure to Russia sharply since 2014. Before the 2008 global financial crisis, Russia was the fourth largest emerging market, behind China, South Korea and Brazil. Its weight peaked at 10.1 per cent in early 2007 (Figure 2). Russia's weight dropped to 3.2 per cent in early 2015, reflecting investors' concern about international sanctions imposed on Russia. Since then, its weight has rarely exceeded 4 per cent though the Russian economy was much more resilient than initially thought.[xiv]

**Figure 1:** MSCI EM Country Weight Before and After Imposing Economic Sanctions on Russia



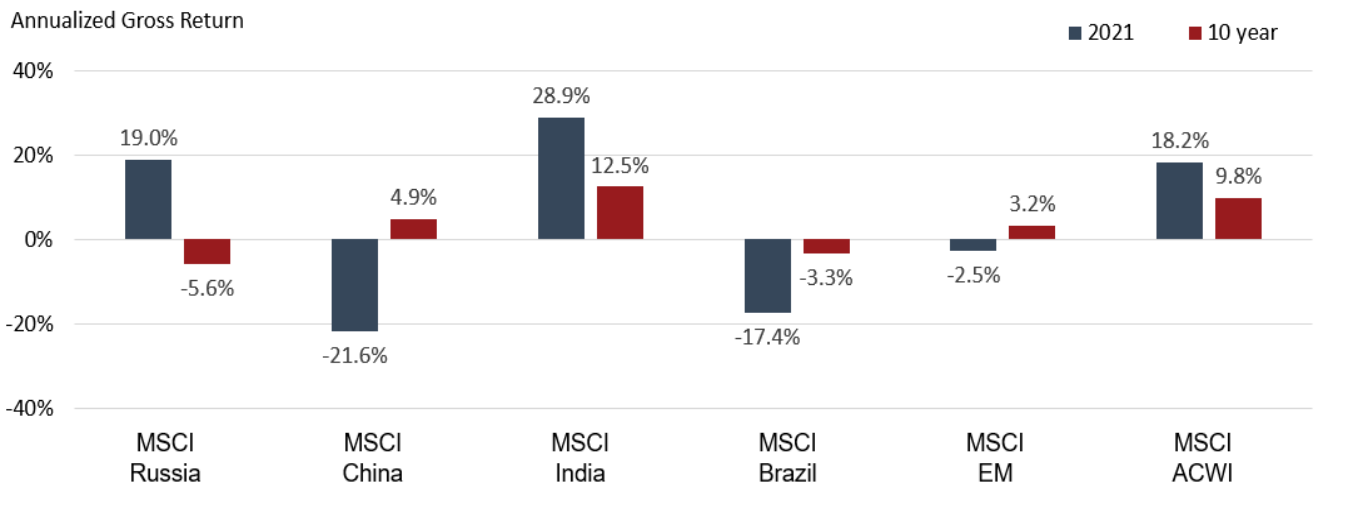

**Source:** *MSCI, ETF. Data as of March 18, 2022.*

**Figure 2:** MSCI Emerging Market Country Weight




**Source:** *MSCI, ETF. Data as of March 18, 2022.*

**Figure 3:** Annualized MSCI emerging market index performance, 2021 v. 10 years (2013-2022).




**Source:** *MSCI, ETF. Data as of March 18, 2022.*

**Despite a strong recovery in 2021, Russia remained a suboptimal market for long-term investors.** The MSCI Russia index gained 19 percent in 2021, outperforming the MSCI global index (MSCI ACWI). Russia's weight in the MSCI EM index increased significantly over 2021 (Figure 1). The country's economy benefited from rising oil prices and exchange rates. Investors were not dissuaded from pouring into Russian assets even when geopolitical tensions rose. While short-term gains were seen, the 10-year annualized MSCI Russia index return is down to a negative 5.6 per cent (see Figure 3).

## CHINA'S DILEMMA

**China was already facing an economic slowdown in 2021**- a turbulent year for the emerging markets as China slumped (Figures 2 and 3). The MSCI China index fell more than 20 per cent for the year. The World Bank projects a continuous slowdown of China's economy in 2022. It argues that the highly leveraged property sector and the "zero-COVID" approach of locking down are significant downside risks contributing to China's 2022 economic outlook.

**The invasion has put China in an awkward position**. Investors are watching closely to see how China reacts as sanctions hit Russia. On the one hand, Russia sees China as a sanctions lifeline; on the other hand, the U.S. has warned China regarding it supporting Russia. In today's tense geopolitical environment, siding with Russia could damage the country's economic stability, a top priority for the Chinese government. In his call with Biden on March 18th, President Xi has "clearly and comprehensively" clarified China's position on the Ukraine issue- China has always been a force for maintaining world peace.

## CONCLUSION

Post the 2014 sanctions, Russia's economic growth has continued to trail global economic growth despite a short-lived recovery in 2021. As a result, Russia's weight within the emerging market has diminished tremendously since the Crimean annexation. The new sanctions, imposed in early 2022, will further deteriorate the Russian economy and, thereby, disrupt the entire emerging markets balance.

This is now a pivotal moment for China. If seen as assisting President Putin to bypass global sanctions it, potentially, puts itself at risk of bearing the brunt of widespread, global geopolitical action. China is already experiencing a slowdown in their domestic economy with the effects of the tail end of the COVID-19 pandemic and would not want to put its economic stability and recovery at risk.

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## ENDNOTES

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