FedFin Client Report

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FedFin Assessment: Sanctions, Crypto, CBDC Outlook all Change Following Invasion

Client Report: SANCTION16

Executive Summary

In this report, we address many of the questions we've received about U.S. policy in the wake of Russia's invasion into Ukraine. We focus in particular on sanctions, but also address longer-term policy implications for the global payment system, cryptocurrency, and CBDC. It is impossible to forecast final outcomes since Russia's intentions are unknown with regard not only to Ukraine, but also peripheral nations it believes reside within its empire that are NATO members. Indeed, developments in some of them (e.g., Eastern Poland) are already arguably within the range of actions that might trigger NATO intervention and, with it, that of the U.S. and many consequences beyond the already-dangerous ones attendant to the Ukraine invasion. As is usual, we will not attempt to forecast Fed monetary policy or that in other nations, but we here note the stresses created by global financial-market uncertainty and broader macroeconomic stress. With FRB Chairman Powell set next week to testify before HFSC and Senate Banking even as his nomination remains up in the air, this report does detail the short-term political pressures on the U.S. central bank and how these are likely to shape policy outcomes. We do not address the extent to which Treasury-market and other pressures may lead the Fed to open its central-bank swap lines, temper its plans for portfolio reduction, or provide emergency liquidity support except to note that global markets now expect the U.S. central bank to act as both a lender and market-maker of last resort. This could lead to risk-on behavior that exposes continuing weaknesses especially in highly-leveraged arenas such as hedge funds and corporate debt.

Analysis

Sanctions: Although President Biden yesterday and Treasury announced still more export and financial sanctions, media questioned the President hard about why others -- e.g., SWIFT access -- remain on hold. Many senior Republicans are also pressing for tougher, faster action. Democratic support for sanctions so far will forestall legislative intervention, but all of this combines to put considerable pressure on the White House to show vigor with regard to the U.S. sanctions already deployed.

Typically, sanctions violations take time to emerge and, while penalties can be significant, franchise value or the ability to do business in the U.S. remains. Given both geopolitical

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

and domestic pressures, this time may be different. To the extent that U.S. intelligence identifies sanctions violations in the payment system or other financial channels with real-time records, rapid and public enforcement action may follow. Foreign banks are reminded (see FSM Report SANCTION14) of severe repercussions even if an action violating U.S. sanctions occurs in any parent-company entity seemingly exempt from direct U.S. law. Domestic political pressures are such that any significant incidents may be turned into high-profile cases to reinforce public perception of Biden Administration resolve.

Cryptocurrency: Although policy-makers have long fretted about the extent to which cryptocurrencies might facilitate sanctions evasion, current developments have transformed this from a forward-looking concern into an immediate priority. Enforcement actions may well be most immediately instigated against any aspect of a U.S.-domiciled crypto issuer or exchange found to have facilitated sanctioned transactions because law enforcement is likely to deploy the same tools used to track bitcoin transactions related to ransomware and other crimes under this very high-priority national-security threat.

This threat will also speed the slow-mo "sprint" U.S. banking agencies began in 2021 to craft a new digital-currency regulatory framework. In the immediate term, any crypto actions that violate sanctions are already against U.S. law and, in at least some cases, also federal rules. However, there are many gray areas especially with regard to special-purpose depository institutions chartered under state law often allowed to operate without full application of know-your-customer, due-diligence, and similar standards. Even assertions of significant violations are likely to suffice to encourage Congress to create a new federal framework expressly mandating application of AML, CFT, and sanctions law along with the transparency to ensure it. Hopes for access to master accounts for individual companies along with the overall digital-currency sector will also be dashed by credible assertions of violations.

CBDC: Although Chairman Powell is skeptical of the need for CBDC, he and other policy-makers have suggested that fast-growing, unregulated stablecoins may create a compelling case for digitalizing the U.S. dollar. The Fed's new discussion draft (see FSM Report CBDC10) not only takes no stand on the need for CBDC, but also focuses principally on broad policy questions such as the extent to which CBDC could preempt financial intermediation or improve the payment system. If stablecoins and other cryptocurrencies are found to have posed a significant national-security threat by virtue of anonymity and ready, if indirect, payment system access, then the Fed may find itself under more intense pressure to rev up its technical work on CBDC to introduce one far more quickly than now seems necessary.

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2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com