

HKUST ECON Seminar

18 March, 2026, 3:00 – 4:30 pm

Arbitraging the US sanction: Theory and Evidence

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Abstract:

We document a striking anomaly in international capital flows that we term sanction arbitrage: U.S. investors exploited the 2014 sanctions on Russia by significantly increasing holdings in Russian equities while Rest-of-World (ROW) investors fled. We rationalize this behavior through a simple game-theoretic model where the sanctioning government faces a trade-off between geopolitical objectives and domestic welfare, effectively creating a protective shield for domestic investors and driving out ROW investors. Empirically, we confirm that pre-sanction U.S. flows negatively predicted subsequent sanction designations. Consequently, U.S. investors internalized this protection to act as opportunistic buyers, absorbing fire-sale assets from exiting foreign investors and capturing significant excess returns from Russian stock holdings. These findings reveal that “smart” sanctions designed to preserve market access can inadvertently generate wealth transfers from foreign to domestic agents.