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The Sanctions Dilemma

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OVERVIEW

Bottom Line: Sanctioning Russia requires a tougher response and a willingness from the West to accept pain, too.

The sanctions put in place on Russia to date have been limited and largely symbolic. Travel bans and asset freezes have been placed on a small number of businessmen and officials, as well as one Russian bank thought to be closely associated with the Kremlin. A decision has been made to suspend the Group of Eight (G8) process, and the Group of Seven (G7), which excludes Russia, will fill the gap. Trade and financial negotiations already underway with Russia have been suspended. Together, the economic effects of these measures appear minimal.

The muted response reflects caution, particularly in Europe, over the risks to regional and global growth from sanctions and the potential for retaliatory moves from Russia. There is fear of provoking what the sanctions are intended to deter—Russian movement into eastern Ukraine. It may also reflect the desire to have a tiered response, preserving "off ramps"—strategies that allow both the G7 and Russia to step back from confrontation—and holding tougher measures in reserve in case Russia takes further destabilizing actions. There is a reported consensus that, should Russia move into eastern Ukraine, the G7 would move to more far-reaching sanctions aimed at specific companies and industries.

I have argued elsewhere that markets may be underpricing the risk of an escalation of the crisis. Nonetheless, Russia has already paid a price measured in a 9 percent decline in its stock market, a roughly 10 percent decline in the ruble (despite a sharp rise in interest rates by the central bank to defend the currency), and estimates of $60 billion to $70 billion in capital flight in the first quarter of this year alone. There has been little if any effect on global markets more broadly, including German equities (an oft-cited proxy for concerns about retaliation given Germany's substantial exports to Russia). Still, Russia's low growth and oil dependence make it particularly vulnerable to serious sanctions.

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Would a further ratcheting up of sanctions work? That depends a lot on what is meant by "work." If one means dislodging Russia from Crimea, that looks increasingly unlikely. A more achievable goal would be deterring Russia from any further excursion into or destabilization of Ukraine by imposing material losses on Russian elites. More broadly, effective sanctions have the potential to send a signal to other countries about respecting sovereign boundaries. Certainly China will be paying close attention to how this plays out, given recent tensions over the South and East China Seas.

My read of the economics literature on sanctions is that a substantial strengthening of the sanctions, in conjunction with substantial financial support for Ukraine and longer-term measures to reduce Western reliance on Russian energy, could impose far more substantial costs on Russia, but it will take time. In the near term, sanctions will impose material dislocations and costs on the West. The possibility of a global recession may be one of the necessary risks.

LESSONS FROM THE PAST

The record of earlier sanctions is spotty. Often they are ineffective, or achieve more partial objectives than desired. They are more likely to be effective when they are multilateral, targeted at a well-defined economic objective rather than a broad geopolitical agenda, and when the economy is less developed and more vulnerable to a trade disruption. However, sanctions often take time to be effective. Disconnect between the longer timeline over which sanctions bite and the shorter timeline dictated by military or political imperatives is a recurring theme in the literature. The cases of Cuba and Iran—often cited as examples of sanctions that inflicted pain—are illustrative. In both, sanctions took years to have a profound economic effect, and failed to achieve the broader political change sought by their creators.

IS THIS TIME DIFFERENT?

The most powerful effects on Russia stem from financial sanctions.

The Russian economy is far more complex and integrated in the global economy than the economies of Cuba or Iran, which provides both opportunity and challenge. Greater integration means that Russian oligarchs and business leaders have significant stakes in the West—businesses, wealth, houses, and soccer teams—that are vulnerable to sanctions. If these leaders are influential on Russian decision-making, then a strong case can be made for sanctions. The converse to this vulnerability is a greater vulnerability in the West as well, both in terms of the costs to lost commerce with Russia and Russian elites, and the threat of potential retaliation.

Direct bans on business trade and investment can meaningfully reduce Russian wealth and growth, but the most powerful effects on Russia stem from financial sanctions. In part, this reflects the inherent importance of finance for cross-border trade and investment. More specifically, the complexity of Russian entities' financial dealings with the West creates the potential for forced, rapid deleveraging—an intense "Lehman moment" of the sort witnessed in global markets after the failure of Lehman Brothers in September 2008. Tightening of know-your-customer and anti–money laundering rules can be chilling even without a change in law, discouraging Western financial institutions from taking on Russian clients. Blocking Russian banks from accessing international payments systems will also affect investments, and can make it difficult for Russians to invest and save. (A temporary halt in payments services to Rossiya, the sanctioned Russian bank, had immediate effects on the Russian payments system and led to rushed plans by Moscow to develop an alternative payments system.) Credit limits will be reduced and projects halted. Already there is anecdotal evidence that companies doing business with Russia are becoming more cautious, waiting to see whether there will be new, harsher sanctions.

Concern about retaliation has centered on gas. Given energy's central role in the supply chain, and with Europe receiving roughly 30 percent of its natural gas from Russia, the effect of a disruption is sizeable in the near term, even after taking into account upcoming warmer weather and abundant reserves. Larry Summers makes the obvious point for the United States that unplugging the electricity grid and the resultant blackouts would have near-term costs far in excess of its 4 percent share of the economy. By the same logic, a disruption

The effects of a reorientation of European energy imports elsewhere in gas supply— even though those imports are only 7 percent of overall energy consumption and reserves are high—will have magnified economic effects in the short term. This argument is well appreciated by those who follow the U.S. economy: all but one of the U.S. postwar recessions were preceded by a run-up in oil prices. And while energy shocks are less disruptive than in the past due to a changing global economy and reduced energy demand, there is little doubt that a material run-up in energy prices would be recessionary for the global economy.

Arguably, though, the longer-term effects of a reorientation of European energy imports elsewhere would be far more damaging to the Russian economy than to the West. Thus, a short-term Russian threat could become a longer-term point of leverage for the West. The United States should encourage this sort of diversification through liberalizing oil and gas exports to Europe, a point stressed here and here. These types of measures do not change the flow of oil or gas overnight. Infrastructure has to be put in place. But the long-term gains from such measures will be priced from the start, contributing to a further fall in Russian asset prices. Moreover, as political statements of commitment, such announcements would be powerful.

Beyond oil, Russian sanctions would have meaningful and visible effects on certain Western markets: by some estimates, London property prices could fall by 20 percent if Russian money were pulled from the United Kingdom. German exports also would be hit hard and French military sales would suffer.

The risks of retaliation should be taken into account but should not be a barrier to action. Arguably, it is the costs of retaliatory sanctions on the West that adds power to the commitment to use them if needed. If credible, the willingness to accept these costs can make sanctions more effective, not less. It also provides a more powerful signal to other countries. Of course, sometimes you end up taking the pain when you would rather not (recall that the U.S. budget sequester was meant to be so draconian that Republicans and Democrats would agree on a long-term fiscal plan in order to avoid it). But it may be worth the risk given the stakes that are involved.

Sanctions cannot be expected to carry the full load. They need to be supplemented by positive measures such as strong financial support for Ukraine and the oil market measures mentioned above. But together they can be effective.

Looking Ahead: Kahn’s take on the news on the horizon

Spring Meetings
The IMF–World Bank Spring Meetings will feature an upbeat global forecast, but the discussion will be on sanctions and recession risks. It is global growth and domestic policy imbalances, not the taper, that poses the primary threat to emerging markets.

The Role of Congress
Congress looks unlikely to approve a renewal of extended unemployment benefits. Meanwhile, important IMF legislation was put aside to get Ukraine aid approved, undermining the institutions long-run ability to encourage market-oriented reforms.

Opposition Rising
Look for more polls showing rising support for opposition parties ahead of European parliamentary elections.