DOLLAR & SENSE: THE BROOKINGS TRADE PODCAST

WHAT YOU SHOULD KNOW ABOUT SANCTIONS ON RUSSIA

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DOLLAR: This is David Dollar. I'm the host of the Brookings Trade podcast Dollar and Sense. Today, we have a special episode; very fortunate to have as our guest Doug Rediker, who's a senior fellow at Brookings and a leading expert on international finance. Among other things, he represented the U.S. on the board of the International Monetary Fund during the Obama administration. And we're going to talk about the economic sanctions on Russia. So welcome to the show, Doug.

REDIKER: Thanks for having me, David.

DOLLAR: So let's start with the basics. What are the main economic sanctions that have been placed on Russia in response to its invasion of Ukraine?

REDIKER: Well, there have been a number of them that have been rolled out over the past week or so. I think it's important, first of all, to remember the invasion only happened less than a week ago. So what we have seen has been a remarkable escalation of sanctions and other related reactions by the U.S. and its European allies and the G7 as well.

The main ones started last week with some more sophisticated, longer term sanctions. They included, most importantly I would say, but probably most misunderstood, the application of export control limitations on high tech exports into Russia from anywhere in the world that contained U.S. components, and U.S. components includes U.S. software or intellectual property. So what that really means is anything high tech that has a chip in it from anywhere in the world is effectively now subject to enormous restrictions on whether it can be imported into Russia. And that's important because part of the U.S. strategy has been to impede Vladimir Putin's migration over the coming years and decades from a fossil fuel-based economy to a more high tech economy. If you can't put chips in your country, you can't manufacture them yourself. China is way behind in trying to create a similar kind of a chip. This is a big deal, but it's not short-term.

In the short-term, last week, we imposed sanctions on a number of Russian banks. We used what are known as blocking sanctions on some. We use correspondent blocking sanctions on others. Those are sophisticated and basically saying those banks cannot engage in transactions with counterparties around the world.

What we didn't do at the end of last week was impose SWIFT sanctions on Russian banks. This caused great consternation in Kyiv, in Washington where there were protests, in European capitals. And the reason that we didn't do that is because the sanctions that we imposed last week on banks we're actually more effective and more targeted than imposing SWIFT sanctions would be. But over the weekend, we escalated and we imposed those SWIFT sanctions on some, but not all, Russian banks.

Now the reason that I draw a distinction between SWIFT sanctions and the sanctions we had already imposed—the blocking sanctions and the correspondent banking sanctions—is because if you use the analogy of a heater in your basement that is providing heat to your bedroom two floors up, SWIFT is kind of the thermostat on your bedroom wall. You can turn that on and turn that off from the comfort of your bedroom. But if you actually didn't have that thermostat working, you could walk down two flights, turn the heat up or down from the heater itself, trudge back upstairs, and you wouldn't be any less comfortable. You'd be a little inconvenienced. What SWIFT is is that thermostat. What the blocking sanctions are are the pipes between the basement heater and the bedroom.

We'd already impose sanctions so that it didn't matter what you did to that thermostat, the heat wasn't coming up from the basement anyway. Nevertheless, there was a proxy for we're going to stand by Ukraine that crept into the public mindset that said we've got to do SWIFT and therefore we're putting SWIFT on the table.

What we didn't do was impose SWIFT sanctions on everyone. SWIFT, again, is a financial messaging system—it is not the actual pipes, as I mentioned a moment ago. But what we didn't do was apply that to all the banks. And that's because what we have not done, and the Europeans have not yet done, is apply financial sanctions to the energy sector, and we can get into why that is in a moment. And I want to just make it clear the sanctions that we imposed up through the weekend were big. They got bigger over the weekend, and we'll talk about it in a moment, but the central bank sanctions that were imposed were an even bigger sanction. And that came over the weekend as well, as well as the oligarchs, we can talk about that.

So what has happened is the U.S. and its European and G7 allies have taken an unprecedented set of sanctions measures against Russia that are intended to have short, medium, and long-term impact. The problem is this is a land war in Europe, and it's not clear whether the Russian government is going to be deterred by any of the steps we've taken so far.

DOLLAR: Okay, Doug, thanks. That was very clear. We'll come back to this issue of exempting the energy sector, but first I want to ask do we have a good sense of what the immediate effect of these sanctions are on the Russian economy?

REDIKER: So, the one sanction I left out because I wanted to take a sip of water was the big one we did over the weekend, which was the sanctions are on transactions undertaken by the Central Bank of Russia. We did not sanction the assets. We didn't freeze the assets of the Central Bank of Russia. Russia has made a big point of being Fortress Russia and, quote, "sanctions-proofing" their economy. That means over the years, Vladimir Putin has not only accumulated $630 billion worth of reserves, but he has divested from U.S. reserves, U.S. dollar treasuries and other U.S. dollar assets, into a wide range of euros, of yen, of sterling, of Swiss franc, of gold, of SDRs, a wide range in the assumption that those reserves would provide him with a means by which to resist any sanctions that the U.S. might impose on him.

What the U.S. did over the weekend, in conjunction with its G7 allies, was say, we are not going to freeze your assets. We are simply going to say you can no longer use those assets to buy rubles on the international marketplace. Your question was about what is the immediate impact to Russia. The immediate impact of Russia is if the Central Bank of Russia cannot buy rubles, thereby using those reserves—dollars, euros, sterling—to buy rubles, then pressure on the ruble value, downward to weaken it because of the global weakness in the Russian economy, imposed in part by their own actions and in part by these other sanctions that we've applied, means the central bank cannot intervene in the currency market. And that means the ruble has effectively one way to go, which is to weaken, which it did.

And so the Central Bank of Russia had only one tool, which was to raise interest rates to around 20 percent, which means they managed to stem the bleeding in the value of the ruble for a day. But it means that the cost to Russian businesses of borrowing just went to 20 percent plus. So the impact on Russia's economy is going to be dramatic in the short term.

The impact on day-to-day lives of a weaker ruble is similarly going to be rather dramatic in the short term, and it's probably going to get worse because if you can't intervene, then the pressure is in a one way direction. Either rates are going to have to continue to rise or the ruble is going to continue to weaken without a safety net or some combination of both.

DOLLAR: So let's come back to the energy sector carve out, and so as I understand it, this is probably the main reason we didn't cut all the Russian banks out of the SWIFT network or sanction all of them is we're actually aiming at a pretty fine target. We want Russia to continue to produce and export a certain amount of energy, particularly natural gas to Western Europe, but also oil and Russia's a major coal exporter as well. So we're aiming at a pretty fine target. Do you think we'll be able to really make this work?

REDIKER: Well, to date, you're right that the sanctions have been structured to work around the necessity to roll natural gas and oil and other commodities, but primarily gas and oil, into the sanctions. The problem is if you're Vladimir Putin and you're getting some $700 million a day of revenue from selling oil and gas—but as I said earlier, the central bank restrictions mean you can't use those reserves for the purpose that in a crisis you would normally use them for. They're called reserves for a reason. Then there is likely to come a point in which Vladimir Putin says, Why am I providing this gas, particularly as you mentioned gas, to Europe if what I'm getting is a lot of revenue, but I can't use the revenue?

So I think that there is an effort on the part of the U.S. administration and the Europeans to avoid sanctioning gas and oil. But Vladimir Putin may decide at some point that it's in his interest to actually unilaterally shut down, particularly the gas side. The oil side, because oil can be put on tankers and shipped into a global market and because China is the glaring outlier that has not agreed to the similar sanctions that the other G7 members have, then Vladimir Putin could continue to put oil on ships and sell them off to a very, very willing China, presumably at some point with a global discount since they might be the only takers.

But I would not be surprised to see if there's escalating talk of Russia shutting off Europe from natural gas. It is again not on the cards right now. The Europeans don't want it, the Americans don't want it, and Russia doesn't want it. That calculus could change. But you're right in asking the question why these were structured the way they were. It is to allow a more targeted application of sanctions to exempt oil and gas as necessary. And let me just be clear, the reason they were exempting it is because in order to keep sanctions effective, you need to have your own domestic political support behind you. If in fact, gasoline in the United States were to increase by, let's say, 50 cents a gallon, a dollar a gallon—I'm making up a number, who knows what it would be—then the question is would there continue to be the same level of support for the U.S. position vis-a-vis Russia in Ukraine as there has been to date?

One would like to think that we are living in a country where when you see the atrocities, we're seeing that we would be willing to take a shared sacrifice. But it's not clear politically that we would be willing to do so. And similarly, in Europe, while we have seen signals that Europeans seem to be willing to sacrifice and bear the costs more than we might have expected on trying to impose a punishment on Vladimir Putin and Russia for these actions, it's still not clear from a political, realistic standpoint whether in fact those sanctions will be able to remain in place if people start to feel the pain of not being able to pay for heat, not being able to pay for energy, or maybe that energy supply simply isn't there.

DOLLAR: So, Putin also has to worry about domestic political support. Obviously, he's got a repressive regime, but he has to pay attention, like everyone else, to domestic politics to some extent. I think part of these sanctions we're discussing are aimed at the Russian oligarchs who've been major supporters of Putin. And I've seen a couple of academic studies recently, Doug, showing that really Russia really stands out in the extent to which rich people there keep their money outside of the country. So the Russian oligarchs have their resources all around the world. We're putting sanctions on them now. Do we really have the tools to track these funds down? Who owns things? Can we really make these sanctions bite?

REDIKER: Well, two points there. First of all, I'm going to push back on the idea that Vladimir Putin is sensitive to public pressure in Russia, or even that he's sensitive to the pressure from the oligarchs. I'm not sure that's a winning strategy for the West, and I'm not sure that we believe that at the policy level, either. I don't think that the Russian citizenry is seeing the same images on their TV screens as we are in the U.S. and elsewhere. So far to date, this has been portrayed in Russia as aggression by the West, not by Russia. And I don't think that the Russian people, even if the ruble continues to weaken and their lives are made worse, are going to necessarily hold President Putin accountable.

I would similarly say the oligarchs do in fact hold a lot of assets out of the country. And one of the measures that was undertaken over the weekend was to create a task force of the U.S., the E.U., the U.K., a number of other countries, to actually try and coordinate figuring out who owns what where, and engage in whatever legal requirements there are to seize or at least freeze those assets. The oligarchs themselves have suffered an enormous amount of damage in the last week simply because of their shareholdings in those companies that they own have diminished enormously. There was some study overnight that said as of yesterday, so yesterday being Monday, February 28, that the oligarchs collectively had lost $83 billion just in public stock valuation declines.

But the effort is to do something more high profile. So you've got mansions, you've got yachts, and you've got jets. And they are all over the world. Many of them have been moved back to Russian soil or waters. But you can't move a house, and the jets, some of them are trapped. And some of the yachts are also trapped. I think there is going to be an increasing effort, not as a matter of PR, because that sounds like I'm disparaging the effort, but as a matter of showing we're serious that there will be coordination across borders to figure out who actually owns what, where it is, and actually make some high profile either seizures or freezes that will probably make the front cover of a bunch of tabloids to show that the West is serious here.

Whether in fact, that puts pressure on the oligarchs to have them come down on Vladimir Putin. I'm again very skeptical of that as well. I don't think the oligarchs whose wealth has been accumulated over the past several decades—largely because they have been complicit in not necessarily the atrocities we're seeing in Ukraine today, but in the Putinism, the system that allowed them to benefit in Russia—I don't think they're getting those houses or those mansions back any time soon. So therefore, for them, the upside of coming out and trying to undermine Vladimir Putin seems to be a limited upside. So I'm not sure that's going to work as a strategy. But again, some of this is punitive. And to actually just say, we're not going to take it anymore.

DOLLAR: You alluded briefly to the Russia-China relationship. Putin was one of the few world leaders who attended the Beijing Winter Olympics last month, and he and Xi Jinping announced a kind of economic and political alliance. So to what extent can China alleviate the Western sanctions or undermine the Western sanctions that we put in place against Russia?

REDIKER: So, I have a slightly different view on the Beijing meeting between Putin and Xi. I think if you read that statement carefully, and it's a long statement, a lot of it was espousing the view that came, it seems, from an alliance against NATO and against the West. But it wasn't Ukraine specific. It sounded to me as if a lot of that was written by the Chinese. It was a more sweeping indictment of democracy and human rights as we in the West seek to define them. It did not have a specific reference to Ukraine. It did not have any specific reference to China's willingness to provide a financial or economic backstop to Russia in the event that there was an invasion and there were sanctions, both of which have now taken place. And it also did not include a reference to a pipeline that Vladimir Putin was seeking to get China to agree to and finance which would have allowed Russia to turn the taps of gas from east to west or west to east. It announced a small 25 kilometer pipeline extension, that was already in the ground from the East, from Sakhalin Island to China. But that does nothing to provide Putin with the geopolitical pivot that he was looking for.

So, I came away thinking that Putin was not unhappy, but came away with a lot less than he had hoped for. I also think that President Xi did not believe the intelligence that the U.S. was apparently sharing with China, that turned out to be right, that Putin was in fact planning to invade. It might be that Putin had not been truthful with Xi. It might have been the Putin had not, in fact, decided whether to invade. But one way or the other, I would argue that Xi probably today is not happy and somewhat surprised at where things have played out in the Russia Ukraine crisis.

I think Xi is also very surprised at the enormous unity that has been demonstrated between the U.S., Europe, and other G7 members. Because if you're President Xi, let's face it, Xi and China are very self-interested and they're looking at the U.S. and the EU as the two largest markets. If this goes as poorly as it appears to be going for Putin, and if the military escalation that we're seeing every day causes more and more global outrage, then China being seen as complicit with President Putin is not a great place for President Xi to be in.

One year ago, China signed a comprehensive trade agreement with Europe, which went off the rails because China expressed certain wolf warrior style behavior in Europe that alienated Europeans. But there was still a hope that they could get back on track, because China looks at the EU as its biggest market for trade. But in fact, the closer Xi looks to Russian aggression and atrocities now, the worse it is for China's prospects, not only in the U.S. and the EU, but really all around the world. So I think what we're looking at is a China that is not necessarily going to provide Putin with the economic and financial backstop that he had hoped for.

And you're starting to see again, I want to emphasize as of today, it's just the percolating little bubbles of China saying, Hold on now, let's see, maybe we really want to emphasize that Ukraine is the victim here and that Russia needs to back off. Whether Putin listens to Xi, if Xi were to send that message, is a completely open question. We don't know if Xi would even send that message. But the idea that Russia is going to rely on China is true to the extent that everything else is being shut off from them. But whether China is going to be all that excited about it, let's see. And let's also see whether Putin likes the idea that he becomes effectively a supplicant to China in this scenario. And that's something that Putin has to think about as well.

DOLLAR: Yeah, Doug, I very much agree with your perspective on China here. I do think that Xi Jinping and the Chinese were blindsided to some extent. Putin may have signaled that after the Olympics there'll be some kind of incursion into Ukraine, but I doubt he told the Chinese there'd be a full scale invasion. So I think the Chinese have been caught a little bit flat footed, seem a little bit awkward in their statements. And then I would also add that it would be very hard under the best of circumstances from Russia's point of view for China to really replace the rest of the world's economic relations with Russia. China is happy to import a certain amount of energy, but it doesn't want to become too dependent on Russia. It exports certain manufactured products to Russia, but Russia imports a lot from Western Europe. That's probably all going to disappear, China can't replace that.

And then what we're hearing right away is Chinese banks seem quite nervous about violating any of these sanctions, even though the official Chinese position is that trade is going to continue on. The Chinese banks are actually quite leery of running afoul of the U.S. Treasury Department. Did you agree with that? Do you have any anything you can add on this issue of why the Chinese banks might very well fall into line with the Western sanctions?

REDIKER : Well, because, as you suggest, the risks of violating sanctions that are on the scale and scope of what have been put in place to date for a Chinese bank even if the U.S. will be reluctant to go after China simply because of the geopolitical tensions between the U.S. and China, separate from the Russia invasion of Ukraine. You're correct that Chinese banks are very wary of running afoul of those sanctions because if they get cut off from not only the U.S. dollar market, but just in this case, the euro market as well, the Europeans and the Americans, that's a big deal.

Other than the energy export from Russia to China and certain commodities and minerals and metals, Russia is a very small part of China's market relative to the U.S. and the EU and the other G7 countries. So on a pure cost-benefit analysis, Russia pales in significance to the Chinese economy and to the Chinese financial sector. So if this comes down to a looming threat, the Chinese banks could in fact be swept up in some sort of sanctions enforcement action. That's a big deal for China. That doesn't mean China has played nice by previous sanctions, whether it's in the case of Iran or Venezuela, but they've still been somewhat circumspect about how they've done it. And financial institutions operate at different level where they're very wary of being caught out by the U.S. government, Treasury, and other parts of the US government. That puts them in a potential—I don't want to call it a life or death situation—but if you're a Chinese bank and you lose access to the U.S. dollar market and the euro market, I'm not sure your business model tomorrow looks the same way I did yesterday.

DOLLAR: Yes, absolutely, and especially for the big Chinese banks are among the largest in the world, they're deeply integrated with the global system. So they're going to be careful. So, Doug, last question, let's speculate a little bit. Do you expect these sanctions to be in place for a long time? What do you think the effect will be on the Russian economy if they are in place for a long time? And do you really see any good off-ramps here?

REDIKER: Yeah, well, you're ending with a terrible question, because the answer is we are probably entering into a new normal in which these sanctions are largely irreversible. Now by technical means, I believe they have to get rolled over and reapplied every six months in Europe and every year under the executive orders here in the United States. But for as long as

Vladimir Putin and his regime are in place, I see very little means by which we are going to reverse sanctions. It's kind of a famous thing here in Washington that it's always easy to put sanctions on, it's really hard to take them off, not because it's legally hard, but because it's politically hard. And so I think that we're looking at a return to, let's call it, an economic cold war akin to pre-detente relations between the U.S. and the Soviet Union, where there really were separate segregated blocks that were hostile to one another and had little to no integration. I don't know, if I were an oligarch, if I would be saying, Well, I'll see my yacht again in six months or I'll see that mansion in San Tropez in six months. I'm not sure they're ever going to see those again.

And if you're looking at the sanctions that are imposed on the Central Bank and on the banking system again, if Vladimir Putin is somehow no longer the president, if there is an outcome in Ukraine where Russian aggression is rolled back and Russia becomes a country that is different than the country that Vladimir Putin sees it as today, then certainly those sanctions could be rolled back. But under Putin's regime, I find it very hard to imagine a scenario in which someone who is being accused of war crimes and global atrocities is going to somehow negotiate his way out of the sanctions regime that we and our G7 allies have imposed on him and his country. I think that for the foreseeable future, these are here to stay.

DOLLAR: Well, thank you very much, Doug. This is David Dollar. We've been doing a special episode of the Dollar and Sense podcast, airing it live and really appreciate Doug's insight. If you want to listen to future episodes of Dollar and Sense, you can find us at Brookings Dot Edu slash dollar and sense.

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Until next time, I'm David Dollar and this has been Dollar and Sense.