TONY BLAIR
INSTITUTE
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CHANGE

Sanctioning Russia: Where Does the West Go Next?

ANTON SPISAK

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Published at https://institute.global/policy/sanctioning-russia-where-does-west-go-next on March 24 2022

Introduction

After a hesitant start, the West has responded to Russia's invasion of Ukraine with exceptional collective unity, resolve and speed. One of its main weapons in countering the vicious offensive that Vladimir Putin has inflicted on Ukraine has been far-reaching financial and economic restrictions. These sanctions have put enormous pressure on the Russian economy and will over time constrain the Kremlin's capacity to wage its illegal war. But exactly a month after the start of the conflict, Western leaders need to take stock of their sanctions and fine-tune their response. Now is the time to be clearer about the precise objectives they want the sanctions to achieve in the weeks and months ahead, and to recalibrate their policies accordingly.

How the West Has Responded to Russia

In the build-up to Russia's invasion of Ukraine, the West's sole focus was diplomacy. Strong words from EU leaders and the governments of the United Kingdom and United States signalled that any breach of Ukraine's territorial integrity and sovereignty would be met with a robust response, but little economic pressure was placed on Moscow to deter it from advancing its plans. It was only after Putin abandoned a peaceful resolution to the crisis, recognised the independence of the separatist republics in Donetsk and Luhansk in eastern Ukraine, and then launched a full-scale invasion of Ukraine that Western leaders came together to respond to Russia's aggression with economic and financial restrictions.

In the first days of the invasion, the West's response was limited to trade restrictions and sanctioning a small number of individuals among the powerful Russian elite by freezing their assets deposited abroad. Following this hesitant start, the Western alliance imposed an unprecedented array of sanctions. Foreign reserves of the Central Bank of Russia have been frozen, access to the SWIFT global financial messaging system has been suspended for several state-owned banks, assets of numerous Russian financial institutions frozen and access to Western financial markets restricted. In a later move, the US and UK governments banned imports of Russian oil into their countries and, together with the EU, expanded the range of businesses and people who are subject to sanctions. The EU continues to import commodities but has introduced an ambitious plan to cut Russian gas imports by two-thirds before the end of 2022. During the past month, with the specific aim of ratcheting up pressure on the Kremlin, Western governments have continued to roll out fresh measures, deepening their import and export restrictions, financial sanctions and restrictions covering powerful Russian individuals. Some of the most significant measures are summarised in Figure 1 below.

Figure 1 – An overview of sanctions against Russia (as of 22 March, non-comprehensive list)

Restrictions on the Central Bank of Russia and the Russian government	• Freezing of the foreign reserves of the Central Bank of Russia (UK, US, EU and Canada) • Ban on transactions with the Central Bank of Russia (UK, US, EU and Canada), and with the National Wealth Fund and Ministry of Finance (UK and US)
Financial sanctions	• Exclusion from SWIFT, the global financial messaging system, for several large Russian financial institutions (UK, US, EU and Canada), including SberBank and VTB (US and UK), and several Belarusian banks, including Bank Dabrabyt, Development Bank and Belagroprombank (EU) • Freezing of the assets of leading Russian banks and other financial institutions, and blocking sanctions, including on: VTB Bank (US and UK); SberBank (US); Alfa-Bank, Otkritie (EU and US); Bank Rossiya (EU, UK, US and Japan); Promsvyazbank (EU, UK, Switzerland, Japan and Canada); Sovcombank, Novikombank, Russian Agricultural Bank, Central Bank of Moscow, Gazprombank (US); Is Bank, GenBank, Black Sea Bank for Development and Reconstruction (UK); VEB.RF (EU, UK, US, Switzerland, Japan and Canada); and others • Freezing of assets of state-owned Belarusian banks, including Belinvestbank and Bank Dabrabyt (US) • A ban on Russian deposits above €100,000 in EU banks, on Russian accounts held by EU central-securities depositories and on selling euro-denominated securities to Russian clients (EU) • A ban on listing the shares of Russian state-owned entities (EU); on the issuance of new Russian sovereign bonds (Japan); on sterling clearing through UK and Russian companies from the issuing of transferable securities and money-market instruments (UK); and on the dollar clearing for Russian financial institutions (US)
Economic and trade restrictions	• A ban on commercial activities with selected Russian companies, particularly in the aerospace, defence and energy sectors, and with most publicly owned and controlled Russian companies (UK, US, EU, Switzerland, Canada and Australia)

	• Export ban on an array of goods and technologies aimed at the transport, telecoms, energy and commodities sectors, and wider sectors (UK, US, EU, Switzerland and Australia) • Ban on dual-use items and high-end technologies, covering key sectors such as defence, aerospace and maritime (US, EU, UK and Japan). Limited exemptions for international organisations, pandemic-related deliveries, overflight and emergency landings, and energy • Restrictions on providing certain services that relate to some sanctioned goods and activities, including technical assistance and engineering services related to selected sectors and the supply of tourism services (UK, US, EU, Switzerland and Australia) • A wide range of import restrictions, including a ban on Russian crude oil imports (US, Canada and Australia); the phasing out of gas by the end of 2022 (UK); and a ban on natural gas and coal, and other raw materials (US) • A ban on the import of targeted goods from Russia, such as agri-food products and raw materials including steel (EU, US and Canada); plus all goods originating from Russia (Australia) • Withdrawal of the "most favoured nation" status for Russia and Belarus from the World Trade Organisation (UK, US, EU, South Korea, Canada, Australia, Japan and eight other WTO members)
Restrictions on persons	• Restrictions on providing assets to designated persons and on dealing with the assets of designated persons (asset freezes), covering the Russian elite and including members of the government, the State Duma and businesspeople (UK, US, EU, Switzerland, Australia and Canada); plus lists of designated persons that varies country by country • Travel bans on designated persons (UK, US, EU, Switzerland, Australia and Canada)
Other	• Territorial sanctions already imposed on Crimea extended to Donetsk and Luhansk (UK and EU) • Ban on Russian planes using airspace (UK, US, EU and Switzerland) • Ban on Russian ships using ports (UK, EU and Canada)

Source: TBI

As the scope of sanctions has expanded, so too has the Western alliance against Russia. The coalition, initially led by the UK, US and EU, has rapidly grown to include Switzerland, a historically neutral country, which has matched the EU's sanctions. Canada has introduced bans on major Russian banks and crude oil imports as well as on Russian planes from using its airspace. Japan has prohibited the use of its financial messaging system and introduced export controls. South Korea has joined the SWIFT ban and restricted Russian banks in its markets. Even Singapore, a state usually reluctant to meddle in foreign affairs, has imposed export controls on items that could inflict harm to Ukraine and blocked financial transactions linked to Russia. At least 41 countries have taken individual action to impose sanctions on Russia so far.

It is inconceivable that Moscow would have failed to factor in a price of the response when it decided to launch its invasion. Some sanctions had already been in place following Russia's illegal annexation of Crimea in 2014 and ensuing destabilisation of eastern Ukraine. But the speed and scale of measures this year have come as a surprise to the Kremlin, which assumed that division within the West, and the EU in particular, would prevent them from taking tough decisions. The most significant of all was the move to target nearly half of the $650 billion in foreign-exchange reserves that the Central Bank of Russia prudently amassed to "sanction-proof" the economy in a moment of crisis. The measure was later described by Putin as "akin to an act of war".

It is true the West has used sanctions as an economic weapon against Russia. What has been less clear, however, is the exact objectives the West is trying to accomplish with these far-reaching measures. The purpose of sanctions is usually to bring about a change in behaviour. The logic is that economic interdependence can be exploited, and sanctions can deter state actors from undesirable behaviours or, at least, signal to them that those behaviours will carry large costs. Although the West has long experience of using sanctions as a foreign-policy tool, their effectiveness has been mixed.

The evidence suggests that sanctions work best when they impose high costs on the targeted economy, when they are imposed by several countries at once and when they aim to achieve specific security goals rather than major policy objectives, such as a regime change. But they are much less effective when they are imposed on autocracies rather than democracies and when the sanctioned countries assume the conflict will continue. Throughout much of the 20th century, they have worked better against smaller states and often backfired against larger, authoritarian ones – as recent research by Nicholas Mulder on the history of sanctions shows.

Unlike in countries such as Iran, where the West used sanctions to apply longer-term economic pressure, the Russian sanctions have a more immediate goal: stopping Putin's military offensive in Ukraine and de-escalating aggression. However, if the sanctions are to have sufficient deterrence, they need not only to impose serious costs but also to do so at the right time. Deterrence works best when the threat of sanctions compels the targeted country to change its calculations prior to undertaking what is a costly action. When the sanctions are imposed after the event – for example, to deter a country from further escalation – they work better if those applying them make it explicit to the sanctioned state under what conditions they could be lifted. In the case of Ukraine, the toughest measures from the West came too late, failing to deter Putin from launching his full-scale invasion. Nor have Western leaders yet signalled to Russia under what conditions they could start being eased and whether they could be used to open up a space for negotiations. The result is that the sanctions imposed by the West are having more of a punitive than deterrent effect.

Yet even though sanctions have failed to deter Russia, their punitive effects are not insignificant. Punitive measures send an important signal to other countries that violating the territorial integrity of a sovereign nation comes with serious costs. They also restrict Russia's ability to trade and import technology, weakening the underlying capabilities of its economy and its ability to sustain the war without the involvement of other countries. But these measures should not be relied upon to accomplish deterrence – without considering how they may be used more strategically.

Taking Stock: What the Sanctions Mean for Russia

The Western sanctions have had an immediate and substantial impact on the Russian economy. The value of Russia's currency is down by 45 per cent this year, putting it on track for the biggest fall since 1998 when Russia defaulted on its rouble-denominated debt. The Central Bank of Russia has more than doubled its interest rate, from 9.5 per cent to 20 per cent, and imposed monetary capital controls in an effort to stabilise the currency. The freeze on central-bank reserves has shrunk Russia's large foreign-currency reserves, curbing its ability to draw on almost half the $650 billion that could be used to prop up the rouble and offer liquidity to the banks under sanction. As Russia's financial system comes under heavy strain from sanctions, the chances that the country will default on its debt for the first time since 1998 are considerable, with the central bank now threatening to make external payments in roubles.

There has been an exodus of Russian assets and businesses since the invasion: asset-management companies have frozen funds with Russian exposure or had their value written-down altogether; Moscow's stock market has been mostly closed, and shares in many Russian companies have plummeted in value. Doing business with Russia has, for most Western companies in this environment, become both impossible to navigate and reputationally risky. In cases where restrictions have not involved an outright trade ban with the country, their costs have increased substantially, with a large number of companies voluntarily deciding to exit the Russian market or suspend sales to the country. Whether motivated by a sudden moral aversion to human-rights abuses or concerns about the Kremlin aggressively expropriating foreign assets in the country, the risks of staying in Russia are significant. The growing concern for foreign firms and investors now is that the measures may over time expand to "secondary sanctions" that would hit companies doing business with banned entities. An early exit from Russia is, therefore, a cheaper exit.

Significant effects have been seen in the commodity markets, with the demand for Russian exports plunging and global commodity prices soaring. The demand for Russian crude oil, which accounts for 9 per cent of all global supply, has fallen to a record low, with Russian oil trading at an unprecedented discount of £30 dollars per barrel. A significant proportion of Russian oil exports is struggling to find buyers at present, partly due to the voluntary Russian oil boycott by Western businesses and partly due to Russian ships being prohibited from entering ports in various countries. At the same time, the race to find supplies from other markets has helped push oil prices globally above $113 a barrel based on the expectation that the market will remain short of supply for months because of sanctions on Russia.

Beyond the immediate effects, sanctions are likely to push the Russian economy into a recession worse than seen during the 1998 crisis, with increasing inflation and cost of living for Russian households. The country's gross domestic product (GDP) is expected to fall by 12 per cent this year, according to a forecast by JP Morgan, with inflation rising to between 11 per cent and 17 per cent during the same period, in what is fast becoming one of the worst years for the Russian economy in its post-Soviet history. Sanctions are bound to constrain Russia's ability to maintain the underlying technological capabilities necessary to wage its war against Ukraine. Russian leaders will therefore need to look for help elsewhere, for example by requesting that China and its partners in Central Asia ramp up exports.

Looking ahead, the impact of sanctions will depend on whether, and for how long, Western countries choose to sustain them and how assertively European countries move to restrict their dependence on commodities imports. Even though aggressive sanctions have squeezed Russian accumulated stocks, they have done little to stop the flows into the Russian economy. The country is still receiving up to $2 billion of foreign-currency income a day for its crude oil and gas, with over $750 million a day from European countries. Since 24 February, the day when Russia invaded Ukraine, EU countries have paid Russia more than €18 billion in hard currency, with over €11 billion for oil imports and €6.5 billion for gas, according to the live tracker by the Europe Beyond Coal campaign and the Centre for Research on Energy and Clean Air. Russia's ability to receive daily payments for its lucrative energy supplies – which exporters now have to convert into roubles – is allowing the government to weather the most devastating effects of sanctions. Thanks to the continuing commodity exports, and despite the sanctions, Russia is likely to have a positive current-account balance this year.

The political fallout is much harder to anticipate. The sanctions will put pressure on individuals linked to the Kremlin, but whether this translates into pressure on Putin to alter his calculus is harder to tell. The byproduct of comprehensive sanctions is a hit to the economy, with ordinary Russian households and small businesses being punished for the actions of their political leaders. Whether Putin cares about the damage that sanctions are wreaking on the real economy or not, he is already using them to trigger a "rally-around-the-flag" movement, framing the Western response as a plot to punish the ordinary Russian people.

Looking Ahead: What the West Should Do Next

The West has surprised many with its decisive response to Russia's aggression. Short of a military intervention to defend Ukraine, the options available to Western leaders are limited to ratcheting up economic pressure on Russia and assisting Ukraine with military and humanitarian aid. The initial set of sweeping sanctions were put together at high speed. While they have been effective in ensuring that Russia pays a high price for its attack and ties to the international community are cut, leaders now need to take stock of their impact and fine-tune their strategy.

Western leaders need to consider what objectives they are pursuing both with existing and future sanctions. Are the sanctions mostly intended to punish Russia for its unprovoked and illegal war? Or are they part of a concerted effort to exert maximum pressure on Putin to cease his assault on Ukraine? The measures imposed to date have worked more as ex-post punitive measures rather than deterring ones. If punishment is the primary objective of the Western response, then Western leaders must be prepared to ratchet up pressure on Russia with further measures that not only target accumulated Russian stocks but also curb the flows of hard foreign currency into the country. If, on the other hand, the aim is to use sanctions as part of a strategy to compel Russia to de-escalate – not just to cripple the country's ability to wage its war – then it is important to use more controlled pressure and do more to be explicit about the conditions under which sanctions could be eventually eased. The key is clarity about the goal.

Imposing sanctions is generally easier than deciding when to start lifting them. The difficulty is not only that the decision to ease sanctions depends on our best judgement about the future intentions of the sanctioned country, but also that it might spark division among the coalition of countries imposing the sanctions. Signalling to the Kremlin under which circumstances sanctions could be eased could, in theory, alter Putin's calculations, especially if the Russian president searches for a way to save face and the West is willing, with the express agreement of Ukraine, to facilitate an "off-ramp" for the Kremlin. But by withdrawing sanctions too early and inconsistently across the countries, the risks are not only that leverage over the adversary could be undermined but also that the effectiveness of sanctions could wane as an instrument of coercion in the future. It is important that Western leaders consider these trade-offs now. Whichever path they choose to pursue, they must also ensure that public messaging around their goal is united and consistent.

In addition to having a clearer strategy, the West also needs to recalibrate its response as the space for rolling out further sanctions is becoming increasingly constrained. It is always possible for individual governments to expand existing restrictions to an even greater number of entities and sectors, in much the same way as they have done in the past few weeks. There is also scope to be more aggressive in seizing the Russian assets of individuals linked to the Kremlin, although swift asset expropriation in many countries requires changing national laws. But the most significant measures – which would curb hard-currency flows by sanctioning imports of Russian commodities – remain controversial for EU countries because of their high economic and political price. Without imposing an embargo on energy imports from Russia to Europe, the West will always stop short of imposing maximum pressure on the Kremlin.

At the same time, the focus of the Western response now needs to be on making their collective response as robust and concerted as possible. One crucial aspect is ensuring that sanctions cannot be easily evaded. As the sanctions' landscape grows in complexity, so do the opportunities for evasion. And, as the evidence from North Korea suggests, the longer such measures are in place, the more sophisticated the methods for evading them. Russian state actors and elites will be using all avenues to circumvent sanctions by using third-party intermediaries, offshore havens and covert finance. Western governments should therefore be working together to eliminate any loopholes and coordinate across regimes as a matter of urgency. They should set up a Joint Sanctions Taskforce, a cross-governmental unit tasked with multilateral efforts to implement the sanctions and prevent evasion.

The second component of the West's recalibrated strategy should be to deter other countries from assisting Russia in its aggression. Some sanctions have already been imposed on Belarus, but more could be done to exert pressure on the Lukashenko regime. Furthermore, as Moscow piles duress on the countries of the Collective Security Treaty Organisation (CSOT) – a Russia-led military alliance that includes Armenia, Kazakhstan, Kyrgyzstan and Tajikistan alongside Belarus – it is essential to make clear that any direct or indirect assistance to Moscow for its war would be met with primary sanctions applied directly to those countries. If it becomes clear that bigger players, such as China, are willing to aid Russian war efforts, Western leaders must be ready to impose Iran-style "secondary sanctions" on those entities that do business with the sanctioned entities in Russia. For deterrence, it is important to make the full costs of assisting Russia clear to the wider international community now.

Finally, the West, and the EU in particular, should actively prepare for the possibility of retaliation by Moscow. The Russian government has so far responded with a ban on foreign investors and seizures of valuable assets. But as the Kremlin runs out of options, ever more aggressive counter-measures are likely. The Russian president is already forcing the West's hand with his latest announcement that Russia would start selling its gas to "unfriendly countries" in roubles, which will help stabilise the country's currency and weather the effects of sanctions. The more cornered Putin becomes, the more likely it is that he will seek to exploit Europe's weak spot and abruptly cut off energy supplies to the EU. Countries in the EU should therefore put in place emergency plans to address the economic and political fallout of disruption to energy supplies, including agreeing on common ways to compensate European consumers who are exposed to higher energy prices. The best way to achieve this is for the EU to place itself in a position to fully embargo Russian oil and gas, adding to the pressure on the Kremlin and demonstrating its seriousness about cutting its energy dependence on Russia.

The Western alliance has shown unprecedented resolve and unity in implementing a dizzying array of sanctions against Russia. But it remains to be seen whether the economic pressure of their measures can achieve more than simply punishing Russia for its unprovoked and illegal war in Ukraine and for its blatant violation of international laws and norms. Imposing new sanctions is the easy part; deciding how to use them is much harder. The West needs a sanctions strategy and it has no time to waste.

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