View from the Beltway

The Trouble With Economic Sanctions

By Owen Ullmann

A powerful weapon but a dumb one.

In the summer of 1941, the U.S. government ordered a ban on oil exports to imperial Japan, the latest in a series of economic sanctions it had imposed in response to Japan's expansion throughout Asia. If the goal of the embargo was to deter such aggressive moves, it obviously failed. A few months later, as we all know, Japan attacked Pearl Harbor, officially drawing the United States into World War II.

That's a valuable history lesson for the Biden administration to master as it oversees the most extensive set of economic sanctions ever coordinated against a major military and economic power in hopes of making Russia think twice about its unprovoked war against Ukraine.

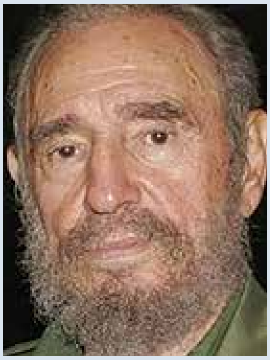
Economic sanctions are a powerful weapon but a dumb one, to use a military analogy. Unlike high-tech precision armaments that can seek out the most obscure target and score a direct hit, sanctions are blunt tools for conducting foreign policy. They have a mixed record of producing a change in regimes or policies. They are almost never airtight—the target of the sanctions usually can find loopholes to reduce the harsh penalties. And even when effective, they take a long time to produce the desired results, often years.

Sanctions are a "two-edged sword."

That's not to say they shouldn't have been imposed against Russian President Vladimir Putin for ordering an attack on a neighboring sovereign nation that had been at peace. He should pay a heavy price for his evil venture. And his country will suffer, though the West may not see tangible evidence for many, many months because of Russia's maneuvering to keep massive revenue flowing into its coffers from energy exports and its moves to shield data on the true state of its economy.

The ruble, which crashed when Western sanctions first were enacted, has recovered in response to stringent capital controls imposed by Putin's government. Life appears normal for average Russians, even after many foreign companies pulled out and imports were cut off. Inflation is rising and the consensus forecast is that Russia will plunge into a recession next year. No one knows how steep it might be or whether the continuation of sanctions, like a slowly tightening vise, will prompt the Russian people to turn against the war and Putin. For now, both Russia's president and his "special military operation" are enjoying broad public support.

Owen Ullmann is TIE*'s executive editor and author of* Empathy Economics, *a biography of Treasury Secretary Janet Yellen to be published in fall 2022.*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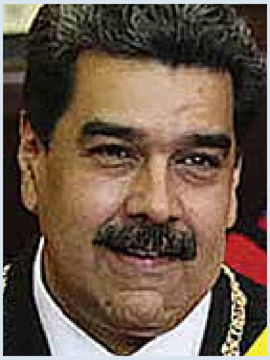
Fidel Castro



Nicolás Maduro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Kim Jong-un


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Vladimir Putin

Rogues' Gallery of Sanctions

A U.S. embargo against Fidel Castro's Cuba was imposed sixty years ago, but it never achieved the end of the communist regime it had targeted. It probably was counterproductive by prompting the Cuban government to tighten its control and rally the public against a common enemy: the imperialist Uncle Sam. Likewise, a decade of U.S. sanctions have failed to oust Venezuelan President Nicolás Maduro.

North Korean dictator Kim Jong-un has thumbed his nose at stringent international sanctions and continues to build up his arsenal of nuclear weapons and ballistic missiles.

Russian President Vladimir Putin's response is impossible to predict because we are in uncharted territory. The extent of the sanctions and the number of countries cooperating against such a powerful nation is unlike anything that has come before. Frequent mentions of Russia's massive nuclear arsenal by Putin and his acolytes may be mere bluffs but are terrifying, nonetheless, since no one may survive World War III.

—O. Ullmann

Jeffrey Schott, a senior fellow at the Peterson Institute for International Economics in Washington, has studied several hundred cases of sanctions for decades and concludes that they are much more effective as a form of punishment than as a tool for reversing a nation's foreign policy. "In many instances, sanctions do not make a major contribution to policy changes," he said. Certainly, President Biden's vow of consequences if Russia invaded Ukraine did not stop Putin from giving the order to attack. Schott suspects Putin did not expect Western Europe to join the United States in levying harsh economic penalties, and bet the invasion would be over quickly before he would have to worry about the sanctions causing much damage to the Russian economy. To the contrary, the invasion provoked a spike in energy prices, creating windfall profits for the Russians.

Now, as Russian forces face unexpectedly fierce resistance from Ukrainian fighters armed with massive supplies from the West, Putin's war drags on with no end in sight and the sanctions are becoming punishing.

Sanctions will certainly prove to be punishing over time if kept in place.

"Clearly that is happening given the unprecedented scope of financial sanctions that have gone far beyond what we have seen in the past with regard to restrictions on activities of a major central bank. No one anticipated that," Schott said. "They have had a dramatic impact on the Russian economy and will continue to have that impact going forward. There is $300 billion or so of assets frozen that are unlikely to be returned to Russia as the lawyers begin to file their claims for reparations and damages and other support for refugees and the like that's going to involve steep costs and last a long time."

Detachment from much of the global economy will bite deeply, as Russia faces shortages of imports—including vital factory parts and military components—and risks the permanent loss of energy customers. Ultimately, it may return to the kind of autarkic economic system that prevailed during the

Soviet era. “The sanctions are likely to remain regardless of what happens on the military front and that’s going to isolate the Russian economy going forward,” Schott continued. “The near-term prospects for the Russian economy are not good. The medium-term prospects for the Russian economy are worse. And that’s the damage that Putin has caused. Indeed, it’s put him in a position where he’s placed his bets and he’s got to play out his hand. And that can be very dangerous.”

The unpredictable response from a sanctioned country is one of the perilous consequences of using this blunt economic weapon.

As history has shown, the unpredictable response from a sanctioned country is one of the perilous consequences of using this blunt economic weapon. The League of Nations formally adopted “the economic weapon” as a way to deter hostile nations from waging war. The idea was that the mere threat of a blockade would maintain the peace. Not so. Twenty years later, World War II erupted, as a seething Nazi Germany struck out in response to the economic punishment and chaos it suffered as the loser in World War I.

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Ever-tightening economic sanctions supported by financial institutions that boycotted South African investments, along with international political pressure, finally prompted South Africa’s minority white government to eliminate apartheid and pave the way for a peaceful transfer to majority black rule, but that took decades to accomplish. Iran finally came to the table to negotiate restrictions on its nuclear program, but only after years of punishing economic restrictions and a collapse of oil prices. By contrast, North Korean dictator Kim Jong-un has thumbed his nose at stringent international sanctions and continues to build up his arsenal of nuclear weapons and ballistic missiles.

Putin’s response is impossible to predict because we are in uncharted territory. The extent of the sanctions and the number of countries cooperating against such a powerful nation is unlike anything that has come before. Frequent mentions of Russia’s massive nuclear arsenal by Putin and his acolytes may be mere bluffs but are terrifying, nonetheless, since no one may survive World War III. “There is that risk of tactical nuclear weapons being used. Russia has the capability to do it, even though that would basically make them a pariah for a long, long time,” said Schott. “If you use sanctions to push the target regime into a corner, they could either collapse because of domestic opposition or they could strike back.”

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And just as sanctions are a “dumb weapon” with imprecise consequences, they also are a “two-edged sword,” to use another military analogy. The economic pain imposed on Russia is also spreading around the world, hurting the very countries that imposed the sanctions. An obvious immediate impact is the soaring price of oil and natural gas and short-term energy shortages that are driving up inflation in the United States and Europe and hurting economic growth. European nations are switching to or seeking new suppliers to wean themselves off Russian fossil fuels, which will have a lasting negative effect on Russia’s economy, but the readjustment in the short term is costly for Russia’s customers. Food prices globally also are rising because of shortages of wheat and fertilizer from Ukraine and Russia, which are major exporters of both. Russia is blocking shipments of Ukrainian wheat in retaliation for Western sanctions, exacerbating the shortages.

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Another potential side effect of sanctions that could hurt the United States is the weakening role of the dollar as the world’s preeminent reserve currency, a status it has enjoyed since the Bretton Woods system of financial management was created in 1944 near the end of World War II. Over the last thirty years, the dollar has accounted for the majority of foreign exchange reserves, ranging from just over 70 percent to just under 60 percent, where it is now. The euro accounts for about 20 percent of reserves, followed by the Japanese yen and British pound sterling at a combined 10 percent.

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220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

That dominance has given the United States and its allies a powerful tool to punish Russia. They have cut off Russia's central bank and other financial institutions from the global payment system by expelling them from SWIFT—the Society for Worldwide Interbank Financial Telecommunication system. The highly unusual step has proven more effective than expected.

Russia had reduced its dollar reserves after seizing the Crimean peninsula from Ukraine in 2014, anticipating such a move by the West. Still, it now is likely to look for new ways to conduct global transactions that avoid use of the dollar. "It will be interesting to see how quickly the Russian economy can pivot to countries that are willing to continue doing business with Russia, like China and, to some degree, India," said Aaron Klein, a senior fellow in economic studies at the Brookings Institution, which has compiled a "Sanctions Tracker" that follows the myriad of steps the United States and its allies have taken against Russia.

Klein said the moves to bar Russian banks from SWIFT intentionally left some loopholes for transactions, such as allowing some Russian banks to process oil purchases. But the United States could weaponize the dollar even more by closing those loopholes and look for other ways to tighten the sanctions "There's more that can be done, such as cracking down on secondary trading in Russian debt," he said. "We could threaten other countries that do business with Russia, but are we prepared to pay the economic consequences of following through with that threat?"

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"Every time the United States uses the dollar as a tool for American foreign policy, it increases the incentive for the rest of the world to find an alternative to the dollar, China being first and foremost," Klein added. "I'm comfortable with the United States using this weapon because of the fact that Russia invaded a peaceful sovereign nation with no provocation. So, we will cut off your access to dollars. That to me is a very reasonable. It is a clear line that no other country should be afraid of crossing unless it has plans to invade a peaceful sovereign nation with no justification."

"But there's an increasing incentive to create a new financial system," Klein said. "There are alternatives. China has built CIPS (Cross-Border Interbank Payment System) as a payment alternative to SWIFT in 2015. You can settle in renminbi, you can settle in Bitcoin. You can settle in euros. I don't think we're anywhere near the tipping point. But I do think as an intellectual matter, every time we use this screw, the pressure on the other side for an alternative to the dollar grows. In this case I'm totally comfortable with its usage."

It is true that global foreign reserves in renminbi have grown from barely 1 percent in 2016 to nearly 3 percent now. Yet that is still a tiny share compared to the mighty dollar. And there's the trust factor: Investors believe in the dollar because it is based on a transparent set of laws and free-market principles. The same can't be said for the renminbi, which China's government often manipulates. So at least for the foreseeable future, Russia is stuck with a dollar-dominated payment system and will suffer the consequences of seeing half of its $600 billion in foreign reserves frozen.

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The sanctions imposed on Russia may not change the outcome of its attack on Ukraine. That country's unexpectedly high morale and stiff resistance, aided by Western armaments, will determine what happens on the battlefield. But the sanctions will certainly prove to be punishing over time if kept in place—and will serve as a warning to any other nation that it will pay a heavy price for an unprovoked attack, say, if China were to try to reintegrate Taiwan through force.

Jeffrey Schott gives the Biden White House and Treasury Department high marks for how it has handled sanctions against Russia, in part because many current officials had experience using that economic tool when they worked in the Obama administration. "You have a team that is battle-tested," he observed. "The level of coordination with Europe has been very high. The strength of the coalition is one of the highlights of the sanctions."

Imperfect as sanctions may be, the West has no alternative. Russia cannot go unpunished and all-out military war is unthinkable. The slow but steady drip, drip, drip of economic penalties may prove to be a winning strategy. We can only hope that is the case. ◆