The West's Tricky Economic War With Russia

What if Russians are feeling the squeeze of sanctions but Putin doesn't care?

BY JAMILA TRINDLE

The mere threat of additional Western sanctions against Moscow this week sent Russia's currency to new lows; it's down 12 percent this year. Inflation is expected to rise at least 1 percentage point. More than $100 billion in capital has already fled the country, by some estimates. Russia is feeling the Obama administration's intended financial pain. The only problem is that its faltering economy hasn't dissuaded President Vladimir Putin's Ukrainian ambitions.

The conflict in eastern Ukraine is hurting Russia in terms of lost investment, higher inflation, slower growth, and declining asset values. The ruble sank to new depths, dipping below 37 rubles to the dollar before recovering slightly, this week. Analysts' inflation expectations are up; according to a Reuters survey, 15 Russia watchers now expect inflation to hit 7.2 percent by the end of the year, in part because of Moscow's ban on Western food imports. According to the Russian government, $75 billion left the country in the first half of 2014, and officials predict that number will hit $100 billion by the end of the year. Others think that much is already gone. U.S. President Barack Obama said on Aug. 6 that between $100 billion and $200 billion has already fled the country. On Monday, Sept. 1, Russia’s Economic Development Ministry downgraded growth expectations from 2 percent to 1 percent for 2015. Growth has already fallen below 1 percent for the first half of 2014, according to the World Bank.

The confluence of economic bad news with Putin's most aggressive stance in Ukraine brings to the fore a question that lingers under all sanctions programs: What if the targeted government doesn't care about the economic pain?

"The West needs to realize that economic and financial measures imposed to date haven't been effective in deterring Putin's ambitions in Ukraine -- and that even a maximalist financial..."
isolation campaign alone may not be enough to stop Russian adventurism," Juan Zarate, a former senior Treasury Department official charged with overseeing sanctions for George W. Bush's administration, said in an email.

Investors' message to Putin is clear. A brief cease-fire agreement Wednesday pushed the ruble up 1.7 percent and sent the Russian Micex stock index climbing 3.5 percent, according to Bloomberg. But Ukraine quickly retracted the announcement after Moscow said it wasn't a party to the conflict and, therefore, couldn't strike a cease-fire deal. Putin later said that he had reached an agreement with Ukrainian President Petro Poroshenko to end the fighting in eastern Ukraine that included Kiev pulling troops out of the region, according to Russian state-owned media. Markets would doubtless welcome a return to peace, but uncertainty lingered Wednesday as to whether peace truly was on the horizon.

Obama greeted the cease-fire announcement with skepticism at a press conference in Tallinn, Estonia, where he was on a stopover before attending the NATO summit in Wales Thursday and Friday.

"No realistic political settlement can be achieved if effectively Russia says we are going to continue to send tanks and troops and arms and advisors under the guise of separatists, who are not homegrown, and the only possible settlement is if Ukraine cedes its territory or its sovereignty," Obama said on Wednesday.

The White House points to the billions of dollars moving out of Russia, the volatile Micex stock index, and the ruble's falling value as evidence that sanctions are inflicting economic pain. But if the goal of the sanctions was to get Putin to stop bullying Ukraine, then they have yet to hit the mark. Instead, Putin is telling the head of the European Union that he could conquer Kiev in two weeks -- if he wanted to. Yuri Ushakov, a Kremlin foreign-policy advisor, told the Guardian on Tuesday that Putin's remarks were taken out of context. NATO plans to station rapid-response forces to protect Eastern Europe, though it's unclear whether the United States -- the most powerful military in the 28-member alliance -- will participate.
Meanwhile, leaders on both sides of the Atlantic are again sifting through a variety of incremental financial measures to further isolate Russia's economy. Whether Russia would have been even more aggressive in the absence of sanctions is anyone's guess.

Yet Putin's unchanged stance toward Ukraine and Russian troops' engaging directly with Ukrainian forces have prompted calls for the West to send military support to Kiev. Top U.S. senators, including Republican John McCain and Democrat Robert Menendez, head of the Senate Foreign Relations Committee, want to arm the Ukrainians. But that position is not expected to gain wider traction.

"My guess is that, absent a dramatic change in the situation in Ukraine, the West will soon apply additional sanctions," Steven Pifer, a former ambassador to Ukraine and a senior fellow at the Brookings Institution, said in an email. "Providing arms may be a tougher question for [the] U.S., [and] other Western leaders."

The EU is considering implementing a new round of sanctions this week, but observers expect those to only incrementally tighten existing restrictions. European leaders could still postpone their next step to see whether Russia's cease-fire plan sticks. The toughest sanctions proposal on the table would strengthen prohibitions on Western investors lending money to Russian state-owned companies, according to a draft obtained by the Financial Times. EU leaders might also boycott the 2018 World Cup in Russia, according to the draft. The West's step-by-step approach has prompted criticism from some observers and ridicule from others.

"EU looking at banning double espresso sales in Russia," Tim Ash, head of emerging-markets research at Standard Bank, joked in an emailed analyst's note on Tuesday. "Single espresso sales will still be allowed for the time-being as the EU wants to give Putin plenty of opportunity to ramp down."

The West is going to financial war not with the weapons it has, but with the ones it is willing to use. For example, Europeans and Americans are not expected to restrict Western companies from handling Russia's sovereign bonds or ban Russia from using the international banking
transactions system SWIFT (Society for Worldwide Interbank Financial Telecommunication). British officials advocated the move last week, according to a draft policy document obtained by Bloomberg.

Shutting Iran out of the SWIFT system, a crucial communications network for international banking, in 2012 was a turning point in the West's effort to isolate Tehran financially in order to get the government to stop its nuclear program. Many see the actions taken against Iran as a template for sanctions against Moscow, though Russia's economy is much more interconnected with the global -- and particularly European -- economy and its GDP is at least five times that of Iran's.

"They're going to be moderate so that we can continue telephone diplomacy with Putin," Mujtaba Rahman, Eurasia Group's head of European risk analysis, said from London. He said the debate has shifted in Europe toward potential military options, because economic deterrents aren't working. However, he expects more sanctions will be central to the European response as policymakers are unlikely to agree on a military solution.

Sanctions are also limited by the amount of economic pain Western countries are willing to endure in order to punish Russia. Europe's dependence on natural gas imports from Russia means that the bloc's economy could be severely damaged if Moscow decided to retaliate by turning off the spigot.

But European leaders have become more willing to take measures that could hurt their own economies as Russia has become more menacing in their view. French officials said Wednesday that they wouldn't allow the delivery of the first of two Mistral warships Russia ordered. France will likely have to return whatever Russia has already paid of the $1.6 billion price tag. Russian officials said the two ships were already two-thirds paid for, according to Bloomberg. That's a reversal from July when France defiantly refused to reconsider the contract, even in the face of criticism from other Western leaders. The United Kingdom was viewed as unlikely to strike out at Russia, thereby preserving London's place as a global finance hub for Russian businesses.
Now British officials are advocating some of the toughest financial measures yet against Russia. As the conflict drags on, Europe's pain threshold could increase further.

Former Treasury Department sanctions official Elizabeth Rosenberg, who is now a senior fellow at the Center for a New American Security, said that was the case with Iran. Initially, the United States had trouble getting other countries to sign on, but as European leaders saw Tehran as more and more of a threat, they became more willing to reduce their economic ties, no matter the cost.

"The more that political circumstances escalate, it might be that there is a growing appetite for economic pain," Rosenberg said about Europe's view of the Ukrainian conflict. "I would urge caution for anyone suggesting that sanctions have been a failure."

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