A Test of Wills on Sanctions

Juan C. Zarate

For all the costs that Western sanctions and lower oil prices are inflicting on the Russian economy, the Russian flag still flies over Crimea, Moscow remains undeterred, and the September 5, 2014, ceasefire in Ukraine has failed to end the fighting in Eastern Ukraine. In response, Russia is using its own form of economic and energy warfare as both a shield and a sword. This all suggests that there are limits to the West's ability to deter Russian aggression.

Since Russia's annexation of Crimea in March, Western strategy has focused on blocking future deals with the Russian military sector, restricting Russian banks' access to long-term capital, depriving elements of the Russian oil sector of technology they need for offshore and shale drilling, and freezing the overseas assets of individuals tied to the Kremlin.

THERE IS A LIMIT TO THE AMOUNT OF FINANCIAL PAIN THAT THE WEST CAN INFLICT ON A MAJOR ECONOMY WITH SUBSTANTIAL ECONOMIC AND ENERGY TIES TO EUROPE.

But most existing contracts between Western interests and their Russian clients have been allowed to continue. Rather than dealing an instant blow, the aim has been to starve the country of capital by sowing doubts among Western investors about the wisdom of investing in Russia. These efforts have produced tangible results, impacting Russia's ability to access the global banking and trade systems, and have already imposed direct transactional, investment, and reputational costs.

The capital constriction strategy appears to have been effective. Contracts and capital have evaporated, and Moscow has attempted to dampen rumors that it could assert capital controls to halt the outflow of funds (net capital outflows are estimated to exceed $100 billion this year). The Russian Central Bank has been forced to intervene decisively in defense of the ruble as currency demand continues to plummet, spending $1.5 billion on October 8 alone. Growth has slowed to a near halt (projected to be just 0.4 percent for the year), and major Russian companies such as Aeroflot have been unable to acquire necessary investment.

Since Putin's return to the presidency, he has understood that Russia is economically vulnerable, and in recent years he has moved to reduce Russia's reliance on the dollar in international trade and finance. He also knew that there is a limit to the amount of financial pain that the West can inflict on a major economy with substantial economic and energy ties to Europe and the rest of the world. Russia's entanglements may be vulnerabilities, but they also allow Russia to exact a price of its own.

Companies subject to Western sanctions are making moves to circumvent the restrictions. Rosneft, the Russian oil company, is set to buy 30 percent of Norway's north Atlantic drilling, enabling it to access offshore drilling capabilities in the Arctic despite technologyexport bans and financial restrictions. Meanwhile, Russian investors continue to deepen their economic interests in London, Frankfurt, and New York. And the Russian sovereign wealth fund and Russian pensions funds will be tapped for billions of dollars to shore up necessary capital requirements for its banks hit by sanctions.

Moscow is also responding to Western sanctions by substantially reducing flows of oil and gas to Ukraine, which restricts exports to other European customers as winter approaches. As some European countries have sent excess gas back to Ukraine in a reverse pipeline flow, Moscow has specifically punished these countries. For example, on October 2, Gazprom unexpectedly cut its supply of natural gas to Slovakia by 50 percent as punishment for this reverse flow. A recent visit by the CEO of Gazprom to Hungary completely ended Hungary's efforts to send gas to Ukraine.

The Kremlin has also banned agricultural imports from countries that have participated in the sanctions, which economically damages neighboring countries such as Poland and Finland. Symbolically, Russia has closed four McDonald's restaurants, citing health and sanitation reasons—a common Russian tactic when it seeks to

punish a country or company. Moscow has frequently suggested that it will develop a national payment system that could replace Visa and MasterCard and they have threatened to prevent Western airlines from flying over Siberia to Asian destinations at great expense. American consulting and accounting firms could also be prevented from operating in Russia.

Russia has more cards to play. It could cut off supplies of engines to the U.S. space program. It is a big exporter of titanium and other resources needed by western companies and could restrict exports in retaliation. Moscow could emerge as a sanctions-busting financial partner to a country such as Iran, at the height of nuclear negotiations. Finally, in the past Russia has launched cyber-attacks against Estonia and Georgia as well as used tax and money-laundering investigations to silence critics. The Kremlin could enlist hackers and organized criminals to disrupt financial systems and companies in the West to complement the tit-for-tat sanctions war that has erupted. Some have questioned whether recent massive cyber-attacks against JP Morgan and others were Russian-originated due to events in Ukraine.

There are measures the West can take to minimize Russian countermeasures. Europe must finally take decisive measures to secure alternative sources of oil and gas. This will be a gradual shift, however, as Europe lacks the critical infrastructure necessary, particularly liquefied natural gas (LNG) facilities and alternative pipelines, to receive greater imports from abroad. Other countries should also seek diversity of Russian energy supply as Moscow becomes increasingly unpredictable.

New Russian investments in the United States and Europe also should be carefully scrutinized, and Western commercial contacts with suspect individuals and companies further constrained. There also needs to be a broader effort to marginalize illicit financial behavior—not just those individuals and entities tied to the invasion of Ukraine. Thus far, sanctions have been limited to targeted asset freezes, visa bans, and trade and financial restrictions in critical sectors.

A more robust sanctions campaign, however, would entail aggressive investigations of illicit financial activity of Russian interests globally—tied to concerns about money laundering, corruption, tax evasion, and links to Russian organized crime. This could include European measures to apply enhanced due diligence and reporting requirements on Russian entities or individuals with bank accounts or new investments in real estate. Europe applied similar scrutiny in Cyprus during its recent banking crisis but it must redouble its efforts.

But these steps would not be without complications. Distinguishing between legitimate and illicit financial activity would prove difficult. And at a time of weak growth, Europe has little appetite for additional economic pain. Already, existing sanctions have had tangible impacts on Europe's economy, impacting both large and small countries already struggling against a triple-dip recession.

At the end of the day, enduring the economic pain of sanctions for both Russia and the West is a test of wills. If one side is unwilling to endure the economic pain, their sanctions campaign will prove ineffective. At this moment, Moscow seems willing to accept the pain as it exerts its influence in its near abroad; the West also has accepted the cost to defend the international system but it seems to do so with increasing reluctance. The West must realize that this crisis may be a new frozen economic conflict, where both sides use financial and economic tools to impose pain on the other. Both sides should prepare themselves for a long campaign. ►