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EU Sanctions Against Russia Are a Double-Edged Sword

By Erik Jones

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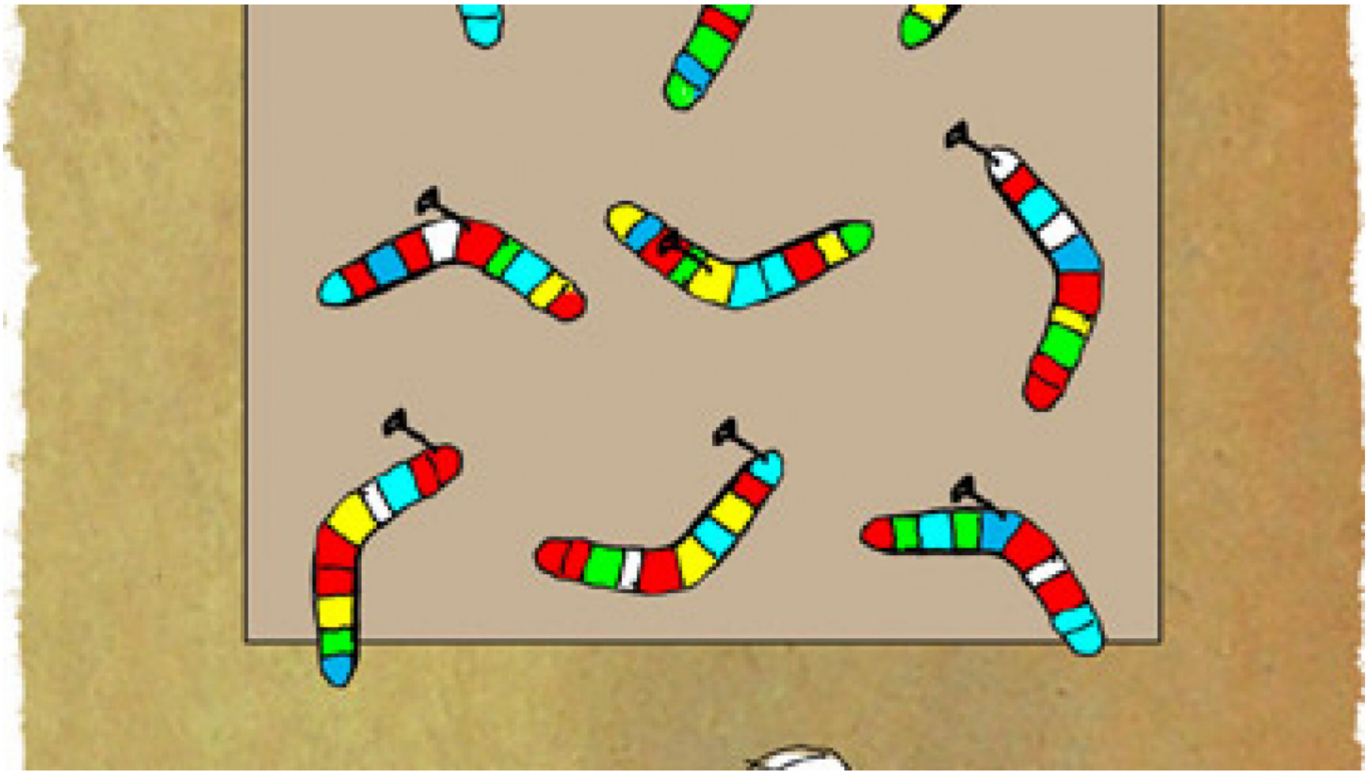

The financial elements of the European Union's "third stage" sanctions are sure to have a serious effect on the Russian economy. By prohibiting EU citizens and firms from trading in the new debt or equity of state-owned Russian banks, the EU has effectively shut Russian government-sponsored enterprises out of European capital markets.

But while these sanctions will hopefully be enough to end Kremlin interference in Ukraine, the EU should be cautious in its use of financial leverage. Although the EU's role as the world's banker gives it a powerful diplomatic tool, using its power carelessly may drive non-Western countries to create alternative financing models.

In the short term, financial sanctions place Russia under a great deal of strain. According to estimates published in the Financial Times, state-owned banks like Gazprombank, Rosselkhozbank, Sberbank, Vneshekonombank, and VTB have roughly 25 billion euros ($33 billion) in foreign currency denominated debt to roll over in the coming year.

Much of that debt is in dollars or euros. Without access to capital markets in the United States and now Europe, these banks will have to look to either Russia's Central Bank or other foreign lenders for support. In turn, Russia will see a drop in demand for its currency and a drawdown on the Central Bank's foreign currency reserves. Rating actions are also likely. The cost of capital will rise in Russia as a result. Indeed, that is the EU's goal.

The policy will have a significant impact on Europe. London will start hurting almost immediately as large financial firms lose new business providing services to Russian banks. Amid the growing uncertainty over Russia's future, spooked European and U.S. investors are likely to offload their exposure to Russia, if they have not already done so.

Over time, however, it is the countries with the largest financial exposure to Russia that will take the biggest hit. In absolute terms, the focus is on France (Societe Generale), Italy (UniCredit) and Austria (Raiffeisen). Once relative size is taken into account, however, even smaller countries like Hungary (OTP) should be added to the list.

Before long, the interest-rate shock will spread to trade financing and begin to suppress investment and consumption. That means trade with Europe will fall off, and European export-led growth along with it. Here the impact will be felt not only on traditional net exporters like Germany but any country that borders Russia (and so benefits from that proximity) as well.

The leaders who voted for sanctions have gambled that the EU's economy is more important to Russia than Russia's is to the EU. This leverage, they hope, will be great enough to force President Vladimir Putin to compromise over Ukraine before the EU's still-fragile economic recovery is affected. They are arguably right to hold that position. Financial interdependence offers a powerful opportunity for coercive diplomacy.

But the unintended message Europe's leaders sent is that financial interdependence is a source of vulnerability that countries like Russia, but also China, Iran and others, would be wise to avoid.

This is hardly a new lesson. Iranian firms have long-recognized the weakness implied by their dependence on having to rely on Western banks to do dollar-clearing. French financial giant BNP Paribas, which the U.S. Treasury recently fined $9 billion for servicing sanctioned accounts, is only the most recent example of the associated risks.

Iran also learned the hard way in 2012 about its reliance on the SWIFT interbank messaging service. Once its banks lost access to SWIFT, their ability to engage efficiently with the rest of the world of finance collapsed.

China has been quick to learn from the experience of other countries and to look for alternatives to Western financial interdependence. That is why it has been so eager to support an international currency to rival the dollar. China has also looked for new institutions to provide balance-of-payments financing and long-term development lending. It has been reluctant to engage fully with SWIFT or replace its own messaging services. And it has sought multiple partners for the internationalization of its currency.

Europe's financial sanctions against Russia likewise add incentives for countries to look for alternative arrangements that reduce financial interdependence.

Moreover, those incentives will only increase if the sanctions are successful. Even if Europe encourages the Russian government to change its policy toward Ukraine, the Russian government will respond over the longer term by seeking financial arrangements that leave it less exposed to such coercion.

The inevitable duplication of markets, infrastructures and messaging standards will make the world economy less stable and less efficient. The Russian government will be better insulated, but we will all be worse off.

This impact on the global economy is not an intended consequence of Europe's sanctions. Nor should it be an excuse for Europe's political leaders to meekly accept the Russian government's policy in Ukraine. The EU's cause is just, and the instrument they have chosen is likely to prove effective. The EU's leadership should be congratulated on having taken such a decisive step.

Nevertheless, the long-term global effects of Europe's financial sanctions on Russia should be taken into consideration so that when economic relations between Europe and Russia do return to normal, European leaders create sufficient incentives for Russia to resist the temptation to go it alone.

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